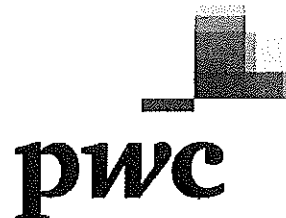
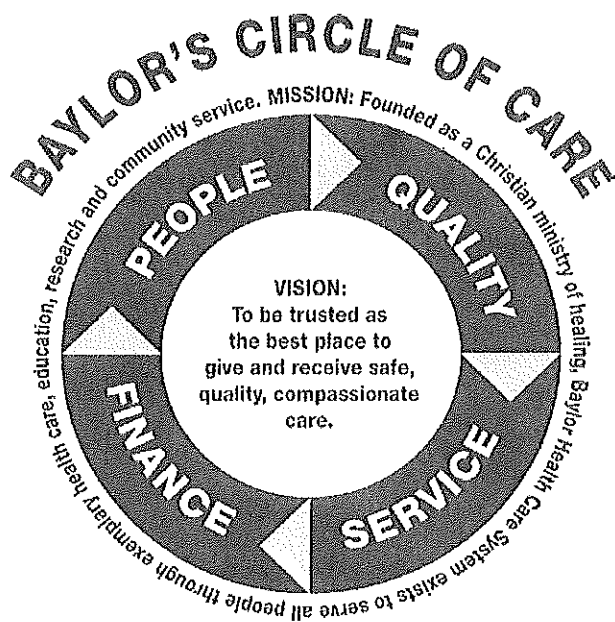




BHCS Foundation

Financial Statements

Years ended June 30, 2011 and 2010



BAYLOR HEALTH CARE SYSTEM FOUNDATION

Financial Statements

Years ended June 30, 2011 and 2010

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Financial Statements

Years ended June 30, 2011 and 2010

CONTENTS

Report of Independent Auditors

Audited Financial Statements

Statements of Financial Position.....	2
Statements of Activities and Changes in Net Assets	3
Statements of Cash Flows	5
Notes to Financial Statements.....	6



REPORT OF INDEPENDENT AUDITORS

To the Board of Directors
Baylor Health Care System Foundation:

In our opinion, the accompanying statements of financial position and the related statements of activities and changes in net assets and of cash flows present fairly, in all material respects, the financial position of Baylor Health Care System Foundation (a Texas nonprofit corporation) at June 30, 2011 and 2010, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Baylor Health Care System Foundation's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

November 3, 2011

BAYLOR HEALTH CARE SYSTEM FOUNDATION

STATEMENTS OF FINANCIAL POSITION

JUNE 30, 2011 AND 2010
(In thousands)

	<u>2011</u>	<u>2010</u>
ASSETS		
CASH AND CASH EQUIVALENTS	\$ 21,111	\$ 20,590
INTEREST AND OTHER RECEIVABLES	2,651	1,427
CONTRIBUTIONS RECEIVABLE, net of allowance for doubtful contributions receivable of approximately \$2,276 and \$2,086 in 2011 and 2010, respectively	25,119	12,614
NOTES RECEIVABLE	-	2
BENEFICIAL INTEREST IN SPLIT-INTEREST AGREEMENTS	14,282	14,572
INVESTMENTS	212,217	178,926
FOUNDATION'S INTEREST IN BHCS MONEY POOL	52,185	43,688
PROPERTY AND EQUIPMENT, net	<u>814</u>	<u>663</u>
Total assets	<u>\$ 328,379</u>	<u>\$ 272,482</u>
LIABILITIES AND NET ASSETS		
ACCOUNTS PAYABLE AND ACCRUED LIABILITIES	\$ 1,124	\$ 855
DUE TO AFFILIATES, net	2,552	1,022
TRUSTS AND ANNUITIES PAYABLE	5,676	5,363
COMMITMENTS AND CONTINGENCIES		
NET ASSETS:		
Unrestricted	44,079	30,473
Temporarily restricted	127,649	112,860
Permanently restricted	<u>147,299</u>	<u>121,909</u>
Total net assets	<u>319,027</u>	<u>265,242</u>
Total liabilities and net assets	<u>\$ 328,379</u>	<u>\$ 272,482</u>

See accompanying notes.

- 2 -

BAYLOR HEALTH CARE SYSTEM FOUNDATION
STATEMENTS OF ACTIVITIES AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2011 AND 2010
(In thousands)

	<u>2011</u>	<u>2010</u>
PUBLIC SUPPORT AND REVENUE:		
Unrestricted contributions	\$ 30	\$ 822
Other operating revenue	12	12
Net assets released from restrictions for program services	20,460	14,329
Net assets released from restrictions for capital expenditures	<u>6,712</u>	<u>3,821</u>
Total public support and revenue	<u>27,214</u>	<u>18,984</u>
OPERATING EXPENSES:		
Salaries, wages, and employee benefits	12,826	8,077
Supplies	273	319
Other operating expenses	<u>22,918</u>	<u>17,905</u>
Total operating expenses	<u>36,017</u>	<u>26,301</u>
Loss from operations	(8,803)	(7,317)
NONOPERATING GAINS(LOSSES):		
Gains on investments, net	717	1,229
Gains on Foundation's interest in BHCS Money Pool	8,497	7,228
Loss on asset disposals, net	<u>-</u>	<u>(12)</u>
Total nonoperating gains	9,214	8,445
REVENUE AND GAINS IN EXCESS OF EXPENSES AND LOSSES	411	1,128
OTHER CHANGES IN UNRESTRICTED NET ASSETS:		
Unrealized gains on investments	5,209	5,781
Transfers between entities under common control	8,043	6,256
Other	<u>(57)</u>	<u>(8,255)</u>
INCREASE IN UNRESTRICTED NET ASSETS	<u>13,606</u>	<u>4,910</u>

BAYLOR HEALTH CARE SYSTEM FOUNDATION

STATEMENTS OF ACTIVITIES AND CHANGES IN NET ASSETS - continued

FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

(In thousands)

	<u>2011</u>	<u>2010</u>
CHANGES IN TEMPORARILY RESTRICTED NET ASSETS:		
Contributions	\$ 12,129	\$ 19,412
Realized gains and investment income, net	12,483	5,768
Unrealized gains on investments	18,246	5,598
Change in value of split-interest agreements	91	1,858
Net assets released from restrictions for program services	(20,460)	(14,329)
Net assets released from restrictions for capital expenditures	(6,712)	(3,821)
Transfers between entities under common control	4	637
Other	<u>(992)</u>	<u>(1,647)</u>
INCREASE IN TEMPORARILY RESTRICTED NET ASSETS	<u>14,789</u>	<u>13,476</u>
CHANGES IN PERMANENTLY RESTRICTED NET ASSETS:		
Contributions	24,099	6,832
Realized gains (losses)	179	(99)
Unrealized gains on investments	511	488
Change in value of split-interest agreements	76	1,655
Other	<u>525</u>	<u>8,169</u>
INCREASE IN PERMANENTLY RESTRICTED NET ASSETS	<u>25,390</u>	<u>17,045</u>
INCREASE IN NET ASSETS	53,785	35,431
NET ASSETS, beginning of year	<u>265,242</u>	<u>229,811</u>
NET ASSETS, end of year	<u>\$ 319,027</u>	<u>\$ 265,242</u>

BAYLOR HEALTH CARE SYSTEM FOUNDATION

STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED JUNE 30, 2011 AND 2010

(In thousands)

	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Increase in net assets	\$ 53,785	\$ 35,431
Adjustments to reconcile increase in net assets to net cash (used in) provided by operating activities:		
Unrealized gains on investments	(23,966)	(11,867)
Unrealized gain on Foundation's interest in BHCS Money Pool	(5,407)	(3,557)
Realized (gains) losses on investments	(3,590)	3,277
Realized gain on Foundation's interest in BHCS Money Pool	(1,821)	(2,715)
Restricted contributions net of release for operations	(15,768)	(11,915)
Loss on disposal of assets	-	12
Transfers between entities under common control	(8,047)	(6,893)
Depreciation	83	71
Change in value of split-interest agreements	(167)	(3,513)
Changes in assets and liabilities:		
(Increase) decrease in receivables and beneficial interest in split-interest agreements	(13,437)	13,011
Increase (decrease) in due to affiliates	1,530	(540)
Increase in accounts payable, accrued liabilities, and trusts and annuities payable	749	4,170
Net cash (used in) provided by operating activities	(16,056)	14,972
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment, net of proceeds	(234)	(26)
Increase in investments, net	(5,735)	(19,429)
Increase in Foundation's interest in BHCS Money Pool	(1,269)	(957)
Net cash used in investing activities	(7,238)	(20,412)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Transfers between entities under common control	8,047	6,893
Restricted contributions net of release for operations	15,768	11,915
Net cash provided by financing activities	23,815	18,808
NET INCREASE IN CASH AND CASH EQUIVALENTS	521	13,368
CASH AND CASH EQUIVALENTS, beginning of year	20,590	7,222
CASH AND CASH EQUIVALENTS, end of year	\$ 21,111	\$ 20,590

See accompanying notes.

- 5 -

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements

Years Ended June 30, 2011 and 2010

1. ORGANIZATION

Baylor Health Care System Foundation (the "Foundation"), an affiliate of Baylor Health Care System (BHCS), is a Texas nonprofit corporation, organized to foster and support the activities and purposes of BHCS, to encourage broad-based public support of the charitable organizations affiliated with BHCS and to advance its medical objectives, including sponsorship of patient care, research, and educational and training programs. The Board of Trustees of BHCS elects the Board of Directors of the Foundation. BHCS consolidates the Foundation into its combined financial statements.

2. SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements of the Foundation have been prepared in conformity with accounting principles generally accepted in the United States. The following is a summary of the significant accounting and reporting policies used in preparing the financial statements.

Adoption of New Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board issued Statement No. 168, "*The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (a replacement of FASB Statement No. 162,*" or SFAS 168, that establishes the FASB Accounting Standards Codification (Codification) as the single source of authoritative US GAAP. The Codification does not create any new GAAP standards but incorporates existing accounting and reporting standards into a new topical structure. The new guidance was effective for the Foundation beginning in the three months ended September 30, 2009, and a new referencing system is now used to identify authoritative accounting standards, replacing the existing references to SFAS, EITF, FSP, etc. Existing standards are designated by their "*Accounting Standards Codification (ASC)*" topical reference and new standards will be designated as "*Accounting Standards Updates (ASU)*," with a year and assigned sequence number.

In January 2010, the Financial Accounting Standards Board issued ASU 2010-06, "*Fair Value Measurements and Disclosure (Topic 820): Improving Disclosures about Fair Value Measurements,*" or ASU 2010-06. This ASU amends the disclosure requirements of ASC 820

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

related to recurring and non-recurring fair value measurements. The ASU requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers.

Additionally, the ASU requires an expanded roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). The ASU became effective for the Foundation on July 1, 2010, except for the disclosure on the roll forward activities for the Level 3 fair value measurements, which will become effective for the Foundation for fiscal years, and interim periods within those fiscal years, beginning July 1, 2011. The adoption of the disclosure provisions of transfers between Level 1 and Level 2 assets and liabilities has no impact on the results of operations or financial position as of June 30, 2011.

Cash and Cash Equivalents

Cash equivalents are defined as investments which have original maturities of three months or less. Cash equivalents consist primarily of securities issued by the United States government or its agencies.

Investments

The Foundation has designated all of its investments as other than trading. Substantially all of the Foundation's endowments investments and certain temporarily restricted assets are held by the Baptist Foundation of Texas ("BFT"). These investment's interest and dividends and realized gains (losses) are included in gains on investments, net, in the accompanying statements of activities and changes in net assets. For these investments, interest and dividends and realized gains (losses) are included in gains on investments, net, unless restricted by donor. Unrealized gains (losses) are included in other changes in unrestricted net assets, unless restricted by donor.

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

Interest and dividends, realized gains (losses) and unrealized gains for the years ended June 30, 2011 and 2010 consisted of the following:

	June 30, 2011			
	Interest and dividends	Realized gains/(losses)	Unrealized gains	Total
	(In thousands)			
Nonoperating gains (losses)	\$ 887	\$ (170)	\$ -	\$ 717
Other changes in unrestricted net assets	-	-	5,209	5,209
Changes in temporarily restricted net assets	8,902	3,581	18,246	30,729
Changes in permanently restricted net assets	<u>-</u>	<u>179</u>	<u>511</u>	<u>690</u>
	<u>\$ 9,789</u>	<u>\$ 3,590</u>	<u>\$ 23,966</u>	<u>\$ 37,345</u>

	June 30, 2010			
	Interest and dividends	Realized losses	Unrealized gains	Total
	(In thousands)			
Nonoperating gains (losses)	\$ 1,468	\$ (239)	\$ -	\$ 1,229
Other changes in unrestricted net assets	-	-	5,781	5,781
Changes in temporarily restricted net assets	8,707	(2,939)	5,598	11,366
Changes in permanently restricted net assets	<u>-</u>	<u>(99)</u>	<u>488</u>	<u>389</u>
	<u>\$ 10,175</u>	<u>\$ (3,277)</u>	<u>\$ 11,867</u>	<u>\$ 18,765</u>

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

Foundation's Interest in BHCS Money Pool

BHCS has a cash management program whereby it maintains a money pool for its wholly owned subsidiaries and affiliates (collectively, the "noncash entities"), except for three taxable entities. The Foundation is designated as a noncash entity. Cash and investment funds of the Foundation are transferred to the BHCS Money Pool for investment management purposes and the funding of accounts payable and payroll-related distributions made by BHCS on behalf of the Foundation.

The Foundation's interest in the BHCS Money Pool is classified as other than trading. For these investments, the interest and dividends, realized and unrealized gains (losses) allocated to the Foundation are included in gains (losses) on the Foundation's interest in BHCS Money Pool in the accompanying statements of activities and changes in net assets. Unrealized gains are included in other changes in unrestricted net assets, unless restricted by donor.

Interest and dividends and realized gains on the Foundation's interest in BHCS Money Pool were approximately \$1,269,000 and \$1,821,000, respectively, in 2011 and \$956,000 and \$2,715,000, respectively, in 2010.

Unrealized gains on the Foundation's interest in BHCS Money Pool were approximately \$5,407,000 and \$3,557,000 in 2011 and 2010, respectively.

Unrestricted Net Assets

Unrestricted contributions are available for general use by BHCS or its affiliates.

Temporarily Restricted Net Assets

Temporarily restricted net assets consist of contributions received and pledges receivable. These assets are restricted as to use and are transferred from temporarily restricted net assets to unrestricted net assets when the restrictions are satisfied. Temporarily restricted net assets consist of cash and cash equivalents, marketable equity securities, and marketable debt securities, BHCS Money Pool, mineral rights and real estate interest. Temporarily restricted net assets are restricted for patient care, education and research.

Permanently Restricted Net Assets

Permanently restricted net assets consist of contributions received and pledges receivable with restrictions that the principal be invested in perpetuity and only the income from investments be expended for designated purposes. Income on endowment funds restricted for specified purposes is reported in the accompanying statements of activities and changes in net assets as temporarily restricted realized gains and unrealized gains on investments.

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

Income on endowment funds, which is required to be invested in perpetuity, is reported in the accompanying statements of activities and changes in net assets as permanently restricted realized gains (losses) and unrealized gains on investments.

Split-Interest Agreements

Split-interest agreements consist primarily of charitable gift annuities, charitable lead trusts, and charitable remainder trusts.

Under charitable gift annuities, the donor transfers assets to the Foundation, and in return, the Foundation agrees to pay a certain dollar amount to designated beneficiaries for life. The Foundation records the assets at fair value in investments in the accompany statements of financial position. The related liabilities to other beneficiaries are recorded at the net present value of the estimated future payments in the accompanying statements of financial position as trusts and annuities payable.

Under charitable lead trusts, a donor establishes and funds a trust with specific distributions to be made to the Foundation over a specified period. Upon termination of these trusts, the remainder of the trusts' assets is paid to the designated beneficiaries. The estimated distributions to be made to the Foundation are included in contributions receivable in the accompanying statements of financial position.

Under charitable remainder trusts, donors establish and fund trusts with specified distributions to be made to beneficiaries over the trusts' terms. The Foundation records charitable remainder trusts for which it is not the trustee at the discounted present value of the estimated future cash flows, and these are included in the accompanying statements of financial position as beneficial interest in split-interest agreements. The Foundation is trustee for certain charitable remainder trusts and records the assets at fair value, and the liabilities to other beneficiaries are recorded at the present value of estimated future payments. These trusts are included in investments and the related liabilities to other beneficiaries are included in trusts and annuities payable in the accompanying statements of financial position.

Where applicable, estimated future annuity payments are discounted at a risk-free rate of return appropriate for the expected term of the split-interest agreements at the time the agreements are created, ranging from 2.6% to 11.2%.

The net expected cash flows from split-interest agreements held by others at BFT and other institutions are revalued at year-end using a current risk-free rate of return. The discount rate used at June 30, 2011 and 2010, was 2.8% and 3.2%, respectively.

BAYLOR MEDICAL CENTER AT IRVING

Notes to Combined Financial Statements - continued

Routine maintenance and repairs are charged to expense as incurred. Expenditures that increase capacities or extend useful lives are capitalized.

Irving has recorded asset retirement obligations for the removal of asbestos. These obligations are conditional, based on a portion of the facility undergoing major renovations. Irving recognizes liabilities for this obligation when the fair value can be reasonably estimated, which typically is when a settlement date of the obligation can be determined. Asset retirement obligations, recorded in other long-term liabilities, totaled approximately \$735,000 and \$575,000 as of June 30, 2011 and 2010, respectively.

Irving evaluates whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets may warrant revision or that the remaining balance of an asset may not be recoverable. The assessment of possible impairment is based on whether the carrying amount of the asset exceeds the expected total undiscounted cash flows expected to result from the use of the assets and their eventual disposition. No impairments were recorded in 2011 or 2010.

Physician Income Guarantees

Irving has entered into multiple physician recruiting agreements whereby the hospital provides financial assistance to a physician who is relocating his or her medical practice into the hospital's service area and community under which Irving supplements physician income to a minimum amount over a period of time, typically one year, while the physicians establish themselves in the community. As part of the agreements, the physicians are required to continue to provide medical services in the community for a period of time after the initial start up year, typically three years.

Irving records an asset and liability for the estimated fair value of the minimum revenue guarantees. The asset and liability represent the maximum amount of all unpaid minimum revenue guarantees, net of physician drawdowns, and is reported in other long-term assets and other long-term liabilities in the accompanying combined balance sheets.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets consist of contributions received and pledges receivable. These assets are restricted as to use and are transferred from temporarily restricted net assets to unrestricted net assets when restrictions are satisfied. Temporarily restricted net assets are primarily available for patient care, education and general operations.

Permanently restricted net assets consist of contributions received and pledges receivable with restrictions by donor that the principal be invested in perpetuity and only the income from the investments be expended for designated purposes. Income on endowment funds restricted for specified purposes is reported in the accompanying statement of activities and changes in

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

Trusts, Legacies, and Bequests

The Foundation is the beneficiary under various wills and trust agreements, the total realizable amount of which is not presently determinable. Such amounts are excluded from the accompanying financial statements until clear title is established and the ultimate realizable amount is reasonably estimable.

In-kind Contributions

In-kind contributions for the Foundation for 2011 and 2010 were approximately \$600,000 and \$1,311,000, respectively, and are reported at fair value in the statements of activities and changes in net assets. These in-kind contributions relate to expenses that would have been incurred by the Foundation for meals and entertainment, advertising, printing, and equipment, if they had not been donated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Income Taxes

The Foundation is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code (the "Code") and is exempt from federal income taxes on related income pursuant to Section 501(a) of the Code. Once qualified as a tax-exempt entity, the Foundation is required to operate in conformity with the Code and its tax-exempt purpose to maintain its qualification. Further, the Foundation is defined as a public charity as described in Sections 509(a) (1) and 170(b) (1) (A) (vi).

The Foundation follows the provisions of ASC 740 "*Income Taxes*." As of June 30, 2011 and 2010, the Foundation had no material gross unrecognized tax benefits.

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

3. FAIR VALUE OF FINANCIAL INSTRUMENTS

Cash and Investments:

Estimated fair values of cash and cash equivalents, investments, and the Foundation's interest in the BHCS Money Pool were as follows at June 30 (in thousands):

	<u>2011</u>	<u>2010</u>
Cash and cash equivalents	<u>\$ 21,111</u>	<u>\$ 20,590</u>
Collective investment funds at BFT:		
Baylor Health Care System fund	\$ 160,914	\$ 130,587
Group investment fund	38,487	34,444
Group mortgage and real estate fund	789	2,590
Group bond fund	2,359	2,163
Group equity fund	5,129	4,017
Other funds	1,030	1,506
Real estate and oil and gas interest (carried at lower of cost or market)	133	133
Other	2,750	2,924
Mutual funds	<u>626</u>	<u>562</u>
	<u>\$ 212,217</u>	<u>\$ 178,926</u>
 BHCS Money Pool	 <u>\$ 52,185</u>	 <u>\$ 43,688</u>

Fair value measurements:

As defined in ASC 820, fair value is based on the prices that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In order to increase consistency and comparability in fair value measurements, ASC 820 establishes a three-tier fair value hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 - Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 - Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable by market participants for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

- Level 3 - Inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability are unobservable and developed based on the best information available in the circumstances.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Substantially all of the Foundation's endowment funds investments and certain temporarily restricted assets are held by BFT. Collective investment funds are assets of eligible trust accounts that are pooled to achieve greater diversification of investments and to provide stability of income and/or to satisfy other investment objectives. Fair value of these funds is determined by the custodian, Mellon GSS, based on the fair value of the underlying investments of the funds, which are based on quoted market prices.

Included in collective investment funds held at BFT for the Foundation are investment interests in private equity funds and oil and gas interests. These alternative investments are in limited partnership interests and are carried at the net asset value provided by the underlying investment companies unless management determines some other valuation is more appropriate. As this valuation methodology is based primarily on unobservable inputs, it represents Level 3 assets. Also included in Level 3 assets for the Foundation are other real estate and oil and gas interests which are carried at lower of cost or market.

The Foundation records charitable remainder trusts for which it is not the trustee at the discounted present value of the estimated future cash flows. When a third-party serves as trustee, the beneficial interest is required to be measured at fair value on a recurring basis. As beneficial interests utilize multiple unobservable inputs, including no active markets, and are measured using management's assumption about risk inherent in the valuation technique, this valuation methodology for beneficial interest in split-interest agreements applies to Level 3 assets.

The BHCS Money Pool is invested at Northern Trust and is invested on behalf of the Foundation by BHCS.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Foundation believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

The carrying values of cash, cash equivalents, interest and other receivables, accounts payable, and accrued liabilities are reasonable estimates of their fair value due to the short-term nature of these financial instruments.

The table below sets forth, by level, the financial assets that were measured at fair value on a recurring basis as of June 30, 2011 and 2010, (in thousands):

	June 30, 2011			
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 21,111	\$ -	\$ -	\$ 21,111
Beneficial interests in				
Split-interest agreements	-	-	14,282	14,282
Investments	5,785	203,397	3,035*	212,217
BHCS Money Pool	-	52,185	-	52,185
Total assets at fair value	\$ 26,896	\$ 255,582	\$ 17,317	\$ 299,795
	June 30, 2010			
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 20,590	\$ -	\$ -	\$ 20,590
Beneficial interests in				
Split-interest agreements	-	-	14,572	14,572
Investments	4,981	168,366	5,579*	178,926
BHCS Money Pool	-	43,688	-	43,688
Total assets at fair value	\$ 25,571	\$ 212,054	\$ 20,151	\$ 257,776

* Includes \$133,000 of real estate and oil and gas interests that are carried at lower of cost or market as of June 30, 2011 and June 30, 2010.

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

The following table is a roll forward of the financial instruments classified by the Foundation within Level 3 of the valuation hierarchy defined above (in thousands):

	June 30, 2011				
	Real	Collective	Split Interest	Cash	Total
	<u>Estate</u>	<u>Funds</u>	<u>Agreements</u>	<u>Surrender Value</u>	
Beginning balance at July 1, 2010	\$ 79	\$ 4,500	\$ 14,572	\$ 1,000	\$ 20,151
Realized/unrealized gains (losses), net	-	(1,436)	(290)	(191)	(1,917)
Purchases, issuances and settlements, net	-	(872)	-	(45)	(917)
Balance at June 30, 2011	<u>\$ 79</u>	<u>\$ 2,192</u>	<u>\$ 14,282</u>	<u>\$ 764</u>	<u>\$ 17,317</u>
	June 30, 2010				
	Real	Collective	Split Interest	Cash	Total
	<u>Estate</u>	<u>Funds</u>	<u>Agreements</u>	<u>Surrender Value</u>	
Beginning balance at July 1, 2009	\$ 79	\$ 4,581	\$ 11,685	\$ 1,140	\$ 17,485
Realized/unrealized gains (losses), net	-	(366)	3,934	(140)	3,428
Purchases, issuances and settlements, net	-	285	(1,047)	-	(762)
Balance at June 30, 2010	<u>\$ 79</u>	<u>\$ 4,500</u>	<u>\$ 14,572</u>	<u>\$ 1,000</u>	<u>\$ 20,151</u>

4. CONTRIBUTIONS RECEIVABLE

Contributions receivable are due as follows as of June 30, 2011 (in thousands):

	<u>Less than 1 year</u>	<u>1-5 years</u>	<u>5+ years</u>	<u>Total</u>
Contributions receivable	\$ 10,791	\$ 16,543	\$ 279	\$ 27,613
Discount on contributions receivable	-	(140)	(78)	(218)
Allowance for doubtful contributions	<u>(1,778)</u>	<u>(492)</u>	<u>(6)</u>	<u>(2,276)</u>
Net contributions receivable	<u>\$ 9,013</u>	<u>\$ 15,911</u>	<u>\$ 195</u>	<u>\$ 25,119</u>

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

5. ENDOWMENTS

The Foundation's endowment consists of donor restricted and management-designated endowment funds for a variety of purposes. The net assets associated with endowment funds are classified and reported based on the existence or absence of donor imposed restrictions.

The Foundation has interpreted the "Uniform Prudent Management of Institutional Funds Act" (UPMIFA) as requiring the preservation of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the Foundation classifies as permanently restricted net assets, (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure of the Foundation in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the Foundation considers the following factors in making a determination to appropriate or accumulate endowment funds:

- 1) The duration and preservation of the fund
- 2) The purposes of the Foundation and the donor restricted endowment fund
- 3) General economic conditions
- 4) The possible effect of inflation and deflation
- 5) The expected total return from income and the appreciation of investments
- 6) Other resources of the organization
- 7) The investment policies of the organization.

Endowment net asset composition by type of fund as of June 30, 2011 and 2010 follows (in thousands):

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total 2011</u>
Donor-restricted endowment funds	\$ (1,752)	\$ 50,809	\$ 137,900	\$ 186,957
Board-designated endowment funds	<u>1,000</u>	<u>-</u>	<u>-</u>	<u>1,000</u>
Total endowment funds	<u>\$ (752)</u>	<u>\$ 50,809</u>	<u>\$ 137,900</u>	<u>\$ 187,957</u>

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total 2010</u>
Donor-restricted endowment funds	\$ (4,231)	\$ 34,927	\$ 112,696	\$ 143,392
Board-designated endowment funds	<u>1,000</u>	<u>-</u>	<u>-</u>	<u>1,000</u>
Total endowment funds	<u>\$ (3,231)</u>	<u>\$ 34,927</u>	<u>\$ 112,696</u>	<u>\$ 144,392</u>

Changes in endowment net assets for the year ended June 30, 2011 and 2010 follows (in thousands):

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total 2011</u>
Endowment net assets, beginning of year	\$ (3,231)	\$ 34,927	\$ 112,696	\$ 144,392
Investment income and realized gains	1	8,148	121	8,270
Net appreciation and unrealized gains	2,765	14,504	-	17,269
Gifts	-	-	24,034	24,034
Appropriation of endowment assets for expenditure	(287)	(6,690)	-	(6,977)
Additions to endowments related to matured trusts	-	-	521	521
Other	<u>-</u>	<u>(80)</u>	<u>528</u>	<u>448</u>
Endowment net assets, end of year	<u>\$ (752)</u>	<u>\$ 50,809</u>	<u>\$ 137,900</u>	<u>\$ 187,957</u>

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total 2010</u>
Endowment net assets, beginning of year	\$ (6,708)	\$ 30,472	\$ 97,043	\$ 120,807
Investment income and realized gains	-	5,725	(276)	5,449
Net appreciation and unrealized gains	3,804	1,383	475	5,662
Gifts	-	46	6,329	6,375
Appropriation of endowment assets for expenditure	(339)	(3,816)	-	(4,155)
Additions to endowments related to matured trusts	-	-	955	955
Other	<u>12</u>	<u>1,117</u>	<u>8,170</u>	<u>9,299</u>
Endowment net assets, end of year	<u>\$ (3,231)</u>	<u>\$ 34,927</u>	<u>\$ 112,696</u>	<u>\$ 144,392</u>

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

Permanently restricted net assets

The portion of perpetual endowment funds that is required to be retained permanently either by explicit donor stipulation or by State of Texas UPMIFA follows (in thousands):

	<u>2011</u>	<u>2010</u>
Restricted for education	\$ 26,657	\$ 25,231
Restricted for patient care	66,197	43,022
Restricted for research	<u>45,046</u>	<u>44,443</u>
Total endowment assets classified as permanently restricted net assets	<u>\$ 137,900</u>	<u>\$ 112,696</u>

Endowment Funds with Deficits

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the value of the initial and subsequent donor gift amounts (deficit). When donor endowment deficits exist, they are classified as a reduction of unrestricted net assets. Deficits of this nature reported in unrestricted net assets were approximately \$390,000 and \$3,152,000 as of June 30, 2011 and 2010, respectively. These deficits resulted from unfavorable market fluctuations and authorized appropriation that was deemed prudent.

Return Objectives and Risk Parameters

The Foundation follows an investment policy that attempts to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of endowment assets. Under this policy, the return objective for the endowment assets, measured over a full market cycle, shall be to maximize the return against various indices, based on the endowment's target allocation applied to the appropriate individual benchmarks. Actual returns in any given year may vary from this amount. To achieve its long-term rate of return objectives, the Foundation relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized gains) and current yield (interest and dividends). The Foundation targets a diversified asset allocation that places greater emphasis on equity-based investments to achieve its long-term objectives within prudent risk constraints.

Relationship of Endowment Spending Practices to Investment Objectives

The Foundation determines the appropriation of endowment funds for expenditure through budgeting process. A policy for the Foundation endowments governs the amount of

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

endowment funds that may be appropriated during this process. In establishing this policy, the Foundation considered the long-term expected return on its endowments. Accordingly, over the long-term, the Foundation expects the current distribution policy to allow its endowments to grow at an average of the long-term rate of inflation and maintain its purchasing power. In order to maintain the purchasing power of endowment assets, expenditures are based on investment performance and spending is curbed in response to deficit situations. The corresponding budgeted and approved allocations are distributed at the end of each month in accordance with the Foundation's policy. Over the long term, the Foundation expects its endowment to grow consistent with its intention to maintain the purchasing power of the endowment assets as well as to provide additional real growth through new gifts.

6. TEMPORARILY RESTRICTED NET ASSETS

Temporarily restricted net assets are available for the following purposes as of June 30 (in thousands):

	<u>2011</u>	<u>2010</u>
Patient care	\$ 56,632	\$ 53,424
Education	34,284	31,871
Research	<u>36,733</u>	<u>27,565</u>
	<u>\$ 127,649</u>	<u>\$ 112,860</u>

7. PERMANENTLY RESTRICTED NET ASSETS

Permanently restricted net assets are invested in perpetuity and the income from these investments is expendable to support the following as of June 30 (in thousands):

	<u>2011</u>	<u>2010</u>
Patient care	\$ 68,065	\$ 45,982
Education	29,055	27,435
Research	<u>50,179</u>	<u>48,492</u>
	<u>\$ 147,299</u>	<u>\$ 121,909</u>

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

8. NET ASSETS RELEASED FROM RESTRICTIONS

Net assets were released from donor restrictions by incurring expenses or making capital expenditures satisfying the restricted purposes or by occurrence of other events specified by donors for the following purposes for the years ended June 30 (in thousands):

	<u>2011</u>	<u>2010</u>
Patient care	\$ 12,805	\$ 8,828
Education	9,582	4,491
Research	<u>4,785</u>	<u>4,831</u>
	<u>\$ 27,172</u>	<u>\$ 18,150</u>

9. RETIREMENT BENEFITS

Effective January 1, 2002, a 401(k) defined contribution plan administered by ING was made available to all eligible employees. Employees are eligible to contribute to the plan immediately with no minimum service or age requirement. The Foundation matches amounts contributed by employees, up to five percent of the employee's base compensation.

Employees vest in the Foundation's matching contribution over five years. Retirement benefits equal the amounts accumulated to the employee's individual credit at the date of retirement. The Foundation's contributions to the 401(k) plan totaled approximately \$110,000 for 2011 and 2010, which are included in salaries, wages, and employee benefits expenses in the accompanying statements of activities and changes in net assets.

10. FUNCTIONAL EXPENSES

Expenses are as follows for the years ended June 30 (in thousands):

	<u>2011</u>	<u>2010</u>
BHCS patient care	\$ 12,861	\$ 9,053
BHCS education	9,779	4,729
BHCS research	6,336	6,013
General and administrative	<u>7,041</u>	<u>6,506</u>
	<u>\$ 36,017</u>	<u>\$ 26,301</u>

BAYLOR HEALTH CARE SYSTEM FOUNDATION

Notes to Financial Statements - continued

11. TRANSACTIONS WITH RELATED PARTIES

The Foundation expended approximately \$1,753,000 and \$1,591,000 of unrestricted funds for specific purposes and program services on behalf of BHCS during 2011 and 2010, respectively. BHCS transferred \$8,000,000 and \$7,000,000 to reimburse the Foundation for operating expenses incurred in 2011 and 2010, respectively. The Foundation recorded a due to affiliates, net, in 2011 and 2010 totaling approximately \$2,552,000 and \$1,022,000, respectively.

The Foundation paid BHCS for purchased services and management fees of approximately \$983,000 in 2011 and 2010. These amounts are included in other operating expenses in the accompanying statements of activities and changes in net assets.

12. COMMITMENTS AND CONTINGENCIES

The Foundation is a party to various legal proceedings and complaints arising in the ordinary course of operations. Management is not aware of any claims or contingencies that would be material to the financial position or results of operations of the Foundation.

13. SUBSEQUENT EVENTS

The Foundation has performed an evaluation of subsequent events through November 3, 2011, which is the date the financial statements were available to be issued.