

PEPPERDINE UNIVERSITY

CONSOLIDATED FINANCIAL STATEMENTS

July 31, 2016 and 2015

PEPPERDINE UNIVERSITY

TABLE OF CONTENTS

Report of Independent Auditors	1
Financial Statements:	
Consolidated Statements of Financial Position.....	2
Consolidated Statements of Activities	3 – 4
Consolidated Statements of Cash Flows	5
Notes to Consolidated Financial Statements.....	6 – 30



Report of Independent Auditors

To the Board of Regents of Pepperdine University

We have audited the accompanying consolidated financial statements of Pepperdine University, which comprise the consolidated statements of financial position as of July 31, 2016 and 2015, and the related consolidated statements of activities and of cash flows for the years then ended.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on the consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the University's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pepperdine University as of July 31, 2016 and 2015, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers LLP

November 21, 2016

PEPPERDINE UNIVERSITY
Consolidated Statements of Financial Position
At July 31, 2016 and 2015
(In thousands)

	2016	2015
ASSETS		
Cash and cash equivalents.....	\$ 139,895	\$ 193,700
Student receivables, less allowance for doubtful accounts of \$1,506 and \$988, respectively.....	2,561	2,198
Other accounts receivable.....	3,150	4,647
Prepaid expenses, inventories and other assets.....	3,766	2,330
Student loans, less allowance for loan losses of \$1,537 and \$1,300, respectively.....	20,931	21,481
Beneficial interests and contributions receivable, net.....	34,718	35,872
Investments.....	951,660	848,218
Assets held as trustee or agent.....	117,295	117,032
Property, facilities and equipment, net.....	357,960	358,787
Total assets.....	\$1,631,936	\$1,584,265
LIABILITIES AND NET ASSETS		
Liabilities:		
Accounts payable and accrued liabilities.....	\$ 24,175	\$ 22,925
Accrued salaries and wages.....	3,693	3,324
Student deposits, advance payments and deferred revenue.....	11,166	9,136
Asset retirement obligations.....	6,698	6,428
U.S. government-funded student loans.....	15,205	16,004
Trust and agency obligations.....	65,757	64,323
Other long-term obligations.....	3,576	-
Long-term bonds payable, net.....	310,082	261,903
Total liabilities.....	440,352	384,043
Net assets:		
Unrestricted.....	706,198	710,374
Temporarily restricted.....	119,425	127,308
Permanently restricted.....	365,961	362,540
Total net assets.....	1,191,584	1,200,222
Total liabilities and net assets.....	\$1,631,936	\$1,584,265

See accompanying notes to consolidated financial statements.

PEPPERDINE UNIVERSITY
Consolidated Statement of Activities
For the year ended July 31, 2016
(In thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES				
Student tuition and fees.....	\$ 333,494	\$ -	\$ -	\$ 333,494
Less student aid.....	(102,114)	-	-	(102,114)
Net student tuition and fees.....	231,380	-	-	231,380
Room and board.....	36,923	-	-	36,923
Endowment support.....	37,168	-	163	37,331
Private gifts and grants.....	11,747	3,922	7,357	23,026
Government grants.....	3,662	-	-	3,662
Sales and services.....	6,179	-	-	6,179
Other revenue.....	5,031	-	559	5,590
Net assets released from restriction.....	1,903	(1,908)	5	-
Total revenues.....	333,993	2,014	8,084	344,091
EXPENSES				
Instruction and research.....	93,768	-	-	93,768
Academic support.....	60,574	-	-	60,574
Student services.....	53,585	-	-	53,585
Management and plant operations.....	56,667	-	-	56,667
Auxiliary enterprises.....	28,978	-	-	28,978
Public service.....	15,487	-	-	15,487
Fundraising.....	6,801	-	-	6,801
Alumni relations and development.....	2,831	-	-	2,831
Total expenses.....	318,691	-	-	318,691
Change in net assets before nonoperating revenues and expenses.....	15,302	2,014	8,084	25,400
NON OPERATING REVENUES AND EXPENSES				
Actuarial adjustment of trust and agency obligations.....	-	(1,534)	(1,930)	(3,464)
Investment income:				
Dividends.....	4,287	1,288	20	5,595
Interest.....	1,008	240	31	1,279
Other.....	4,936	-	1	4,937
Investment expenses.....	(3,503)	(1,203)	-	(4,706)
Net realized and unrealized investment losses.....	(20,329)	(7,142)	(2,349)	(29,820)
Foreign currency translation.....	353	-	-	353
Other.....	(6,230)	(1,546)	(436)	(8,212)
Total non-operating revenues and expenses.....	(19,478)	(9,897)	(4,663)	(34,038)
Change in net assets.....	(4,176)	(7,883)	3,421	(8,638)
Net assets at beginning of year.....	710,374	127,308	362,540	1,200,222
Net assets at end of year.....	\$ 706,198	\$ 119,425	\$ 365,961	\$ 1,191,584

See accompanying notes to consolidated financial statements.

PEPPERDINE UNIVERSITY
Consolidated Statement of Activities
For the year ended July 31, 2015
(In thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES				
Student tuition and fees.....	\$ 315,862	\$ -	\$ -	\$ 315,862
Less student aid.....	(100,013)	-	-	(100,013)
Net student tuition and fees.....	215,849	-	-	215,849
Room and board.....	34,278	-	-	34,278
Endowment support.....	34,571	-	261	34,832
Private gifts and grants.....	11,950	3,785	10,405	26,140
Government grants.....	3,574	-	-	3,574
Sales and services.....	6,815	-	-	6,815
Other revenue.....	7,343	-	10	7,353
Net assets released from restriction.....	9,405	(9,405)	-	-
Total revenues.....	<u>323,785</u>	<u>(5,620)</u>	<u>10,676</u>	<u>328,841</u>
EXPENSES				
Instruction and research.....	91,579	-	-	91,579
Academic support.....	54,588	-	-	54,588
Student services.....	51,580	-	-	51,580
Management and plant operations.....	53,566	-	-	53,566
Auxiliary enterprises.....	27,559	-	-	27,559
Public service.....	14,900	-	-	14,900
Fundraising.....	6,172	-	-	6,172
Alumni relations and development.....	2,545	-	-	2,545
Total expenses.....	<u>302,489</u>	<u>-</u>	<u>-</u>	<u>302,489</u>
Change in net assets before nonoperating revenues and expenses.....	21,296	(5,620)	10,676	26,352
NON OPERATING REVENUES AND EXPENSES				
Actuarial adjustment of trust and agency obligations.....	-	317	(184)	133
Investment income:				
Dividends.....	7,834	2,429	6	10,269
Interest.....	340	12	66	418
Other.....	7,138	1	4	7,143
Investment expenses.....	(4,156)	(1,527)	-	(5,683)
Net realized and unrealized investment (losses) gains.....	(23,822)	(8,491)	1,681	(30,632)
Foreign currency translation.....	(789)	-	-	(789)
Other.....	(734)	2,244	(2,559)	(1,049)
Total non-operating revenues and expenses.....	<u>(14,189)</u>	<u>(5,015)</u>	<u>(986)</u>	<u>(20,190)</u>
Change in net assets.....	7,107	(10,635)	9,690	6,162
Net assets at beginning of year.....	703,267	137,943	352,850	1,194,060
Net assets at end of year.....	<u>\$ 710,374</u>	<u>\$ 127,308</u>	<u>\$ 362,540</u>	<u>\$ 1,200,222</u>

See accompanying notes to consolidated financial statements.

PEPPERDINE UNIVERSITY
Consolidated Statements of Cash Flows
For the Years Ended July 31, 2016 and 2015
(In thousands)

	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets.....	\$ (8,638)	\$ 6,162
Adjustments to reconcile change in net assets to net cash and cash equivalents provided by operating activities:		
Depreciation and amortization.....	19,674	19,499
Provision for doubtful accounts.....	700	100
Provision for loan losses.....	400	-
Loss on early extinguishment of debt.....	7,054	236
Non-cash gifts.....	(3,857)	(8,495)
Actuarial adjustment of trust and agency obligations.....	3,464	(134)
Contributions restricted for long-term investment.....	(4,827)	(3,449)
Income restricted for long-term investment.....	(163)	(261)
Premium received on issuance of long-term obligations.....	17,033	2,763
Loss on disposal of property, facilities and equipment.....	44	191
Net realized and unrealized losses on investments.....	29,820	30,761
Change in assets and liabilities:		
Student receivables.....	(1,063)	(450)
Other accounts receivable.....	1,496	(645)
Beneficial interests and contributions receivable.....	1,384	2,532
Prepaid expenses, inventories and other assets.....	(1,436)	667
Accounts payable and accrued liabilities.....	7,614	221
Accrued salaries and wages.....	369	(1,045)
Student deposits, advance payments and deferred revenue.....	2,150	(1,836)
Net cash and cash equivalents provided by operating activities.....	71,218	46,817
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of investments.....	79,459	131,008
Purchases of investments.....	(205,440)	(36,180)
Purchases of property, facilities and equipment.....	(22,010)	(12,915)
Student loans repaid.....	4,214	4,640
Student loans issued.....	(4,064)	(4,083)
Net cash and cash equivalents provided by (used in) investing activities.....	(147,841)	82,470
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from contributions restricted for long-term investment.....	5,682	6,154
Income restricted for long-term investment.....	163	261
Principal received on issuance of long-term obligations.....	176,455	51,485
Principal payments on long-term obligations.....	(152,190)	(25,295)
Net change in bond issue costs.....	431	(376)
(Decrease) increase in U.S. government-funded student loans.....	(798)	309
Investment income and (losses) gains on annuities payable.....	(508)	3,825
Payment of trust and agency obligations.....	(6,417)	(6,600)
Net cash and cash equivalents provided by financing activities.....	22,818	29,763
Net change in cash and cash equivalents.....	(53,805)	159,050
Cash and cash equivalents at beginning of year.....	193,700	34,650
Cash and cash equivalents at end of year.....	\$ 139,895	\$ 193,700

See accompanying notes to consolidated financial statements.

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

1. Nature of Operations

Pepperdine University (the “University”) is an independent private Christian university committed to the highest standards of academic excellence and Christian values, where students are strengthened for lives of purpose, service, and leadership. The University enrolls approximately 7,600 students in its five colleges and schools. Seaver College, the University’s undergraduate liberal arts college, the School of Law, and the School of Public Policy are headquartered on 830 acres in the Santa Monica Mountains overlooking the Pacific Ocean in Malibu, California. The Graduate School of Education and Psychology and the George L. Graziadio School of Business and Management are headquartered at the University’s West Los Angeles, California graduate campus.

Mr. George Pepperdine, the founder of Western Auto Supply Company, established George Pepperdine College in 1937. He envisioned a college with the highest academic standards guided by the spiritual and ethical ideals of Christian faith. University status was achieved in 1970 with the addition of the graduate and professional schools. Through the generosity of Mrs. Frank Roger Seaver, the University’s Malibu campus of Seaver College opened in 1972. Since then, the Malibu campus expanded to include the School of Law in 1978, and the Drescher Graduate Campus in 2003.

The University operates several consolidated affiliated companies. All material transactions and balances between the University and its affiliates have been eliminated in consolidation.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying Consolidated Financial Statements of the University are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America (“GAAP”) applicable to not-for-profit organizations. In preparing the Consolidated Financial Statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities and revenues and expenses for the periods presented. Significant items which could be materially affected by such estimates include: the allowance for doubtful accounts, the allowance for loan losses, beneficial interests and contributions receivable, investments, assets held as trustee or agent, accounts payable and accrued liabilities and trust and agency obligations. The University’s actual results could differ significantly from management’s estimates. Management also utilizes certain estimates based on square footage to allocate depreciation, interest expense and central plant operations expense to the functional expense categories included on the Consolidated Statements of Activities.

Adoption of New Accounting Pronouncements

The University has adopted the required guidance under ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*. ASU 2015-03 requires that debt issuance costs be presented as a direct deduction from the carrying amount of the related debt liability, consistent with the presentation of debt discounts. Prior to the issuance of ASU 2015-03, debt issuance costs were required to be presented as a prepaid expense, separate from the related debt liability. ASU 2015-03 does not change the recognition and measurement requirements for debt issuance costs. The University early-adopted this standard on August 1, 2014, and applied its provisions retrospectively.

The University has also adopted the required guidance under ASU 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share*

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

(or *Its Equivalent*). Under the new guidance, investments measured at net asset value (“NAV”), as a practical expedient for fair value, are excluded from the fair value hierarchy. The University early-adopted this standard on August 1, 2015, and applied its provisions retrospectively.

The University has also adopted the required guidance under ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. This guidance affects all entities that hold financial assets or owe financial liabilities and primarily affects the accounting for equity investments, financial liabilities under the fair value option, and presentation and disclosure requirements for financial instruments. The University early-adopted this standard on August 1, 2015, and applied its provisions retrospectively.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. This standard implements a single framework for recognition of all revenue earned from customers. This framework ensures that entities appropriately reflect the consideration to which they expect to be entitled in exchange for goods and services by allocating the transaction price to identified performance obligations and recognizing revenue as performance obligations are satisfied. Qualitative and quantitative disclosures are required to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The standard is effective for fiscal years beginning after December 15, 2017. The University does not believe adoption of this standard will have a material impact on its financial statements.

In February 2016 the FASB issued ASU 2016-02, *Leases*. This guidance requires the recognition of rights and obligations arising from lease contracts, including existing and new arrangements, as assets and liabilities on the balance sheet. The guidance is effective for annual reporting periods beginning after December 15, 2018. The University is evaluating the impact this will have on its financial statements.

In August 2016 the FASB issued ASU 2016-14, *Presentation of Financial Statements for Not-for-Profit-Entities*. This guidance revises the not-for-profit reporting model. The guidance streamlines and clarifies net asset reporting, provides flexibility regarding the definition of reported operating subtotals, and imposes new reporting requirements related to expenses. The guidance is effective for fiscal years beginning after December 15, 2017. The University is evaluating the impact this will have on its financial statements.

Income Taxes

As a not-for-profit educational institution, the University is exempt from Federal and California income taxes under Section 501(c)(3) of the Internal Revenue Code and Section 23701(d) of the California Revenue and Taxation Code, except for taxes on unrelated business income. Since the University’s unrelated business income for the years ended July 31, 2016 and 2015 was immaterial, no provision for income taxes has been made in the accompanying Consolidated Financial Statements.

Net Assets

The University is required to classify its net assets into the following three categories according to donor-imposed restrictions or provisions of law:

Unrestricted net assets represent resources that are not restricted, either temporarily or permanently, by donor-imposed stipulations. They are available for support of all organizational operations and services.

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

Temporarily restricted net assets represent contributions and other assets whose use is limited by donor-imposed stipulations. These restrictions are temporary in that they either expire by the passage of time or by the fulfillment of certain obligations of the University pursuant to those stipulations.

Permanently restricted net assets represent contributions and other assets whose use by the University is limited by donor-imposed stipulations. These restrictions are permanent in that they neither expire by passage of time nor can they be otherwise removed by the University. Income from these assets can be unrestricted or restricted based on donor stipulations.

Revenue Recognition

Student tuition and fees and room and board are recorded as revenues in the period the services are rendered. Private gifts, including unconditional promises to give, are recognized as revenue in the period received and are reported as increases in the appropriate category of net assets. Conditional or contingent grant awards are not recorded as revenue until the conditions on which they depend have been substantially met. Grants received from departments or agencies of the government considered to be exchange transactions are not recorded as revenue until related costs are incurred. These revenues are subject to audit by government authorities. A receivable is recorded equal to the amount of expenditures incurred prior to the fiscal year end for which cash reimbursement has not been received. Endowment support, limited to the payout calculated under the Total Rate of Return methodology, is comprised of ordinary income and accumulated gains on endowment and quasi-endowment assets.

Concentrations of Financial Aid

A significant number of students attending the University receive financial assistance from U.S. government student financial aid programs. These programs require the University to comply with record keeping, eligibility and other requirements. Failure to comply with such U.S. government requirements could result in the loss of U.S. government financial assistance to the University's students and adversely impact the operations of the University.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, cash in checking and savings accounts, money-market funds, cash held by external trustees and short-term investments with an original maturity of three months or less. Other short-term resources held by external investment managers are classified as investments.

Student Receivables

Student receivables are carried at cost, less an allowance for doubtful accounts.

Management believes that the allowance for doubtful accounts is adequate. Management uses available information to recognize losses on student receivables. Future additions to the allowance may be necessary based on changes in economic conditions and other factors.

Student Loans

Student loans are recorded at the contractual amounts owed by students adjusted for unamortized discounts, premiums, unearned income, undisbursed funds, deferred loan fees and the allowance for loan losses. Interest income is recorded on the accrual basis of accounting in accordance with the terms of the

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

receivables, except that interest accruals are discontinued when the payment of principal or interest is 90 or more days past due or when repayment of principal and interest in full is doubtful. Payments received on delinquent loans are applied to the principal outstanding until the loan is restored to current status.

A student loan is impaired when it is probable that the University will be unable to collect all amounts due according to the contractual terms of the loan agreement. The measurement of impairment may be based on (i) the present value of the expected future cash flows of the impaired loan discounted at the loan's original effective interest rate or (ii) the observable market price of the impaired loan. If the recorded investment of the loan exceeds the measure of impairment, an allowance is recorded in the amount of the excess. The University measures impairment by utilizing a discounted cash flow analysis. The University's income recognition policies for impaired loans are consistent with those for delinquent loans. All loans designated as impaired are either placed on delinquent status or are designated as restructured. Payments received on impaired loans are applied to the principal outstanding until the loan is returned to current status.

On an ongoing basis, management monitors the student loan portfolio and evaluates the adequacy of the allowance for loan losses. In determining the adequacy of the allowance for loan losses, management considers such factors as historical loss experience, known problem loans, assessment of economic conditions and other appropriate data to identify the risks in the student loan portfolio. The amount of the allowance for loan losses is based on estimates and the University's actual losses may vary from management's estimates. Loans deemed by management to be uncollectible are charged to the allowance for loan losses. Recoveries on loans previously charged off are credited to the allowance for loan losses. Provisions for loan losses are charged to expense and credited to the allowance for loan losses in amounts that are deemed appropriate by management based upon its evaluation of the known and inherent risks in the student loan portfolio.

Management believes that the allowance for loan losses is adequate. Management uses available information to recognize losses on loans. Future additions to the allowance may be necessary based on changes in economic conditions and other factors.

Beneficial Interests and Contributions Receivable

Beneficial interests and contributions receivable, including unconditional promises to give, are recognized as revenue in the period received and are reported as increases in the appropriate category of net assets. Beneficial interests and contributions receivable where donor restrictions are met in the same fiscal year as the beneficial interest and contribution receivable is made are reported as unrestricted support. Conditional promises to give are not recognized until they become unconditional, that is, when the conditions on which they depend are substantially met. Beneficial interests and contributions receivable are recorded at their estimated fair value. Amounts to be received in future periods are discounted at a credit-adjusted interest rate.

Investments

Investments are stated at fair value and all related transactions are recorded on the trade date. The fair value of investments is based on quoted market prices from national security exchanges, except for alternative investments for which quoted market prices are not available. The fair value of certain alternative investments, which include limited partnerships in venture capital, real estate and other private debt and equity funds, is typically Net Asset Value ("NAV"), provided by the external investment managers or general partners, adjusted for receipts and disbursements of cash and distributions of securities if the date of valuation is prior to the University's fiscal year end. Such valuations generally

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

reflect discounts for illiquidity and consider variables such as financial performance of investments, recent sales prices of investments and other pertinent information. The University believes the carrying amount of these financial instruments is a reasonable estimate of fair value. For those investments that are not traded on a ready market, the estimates of their fair value may differ from the value that would have been used had a ready market for those investments existed.

Investment income as well as realized and unrealized gains and losses are accounted for within unrestricted net assets, or as changes in temporarily or permanently restricted net assets if so stipulated by the donor of such assets.

Pooled Assets

The University manages two separate investment pools designated as Pool A and Pool D. Pooled investments and allocation of pooled investment income are accounted for using the unit market value method.

The Total Rate of Return methodology is utilized for Pool A which consists primarily of quasi and true endowment funds. The annual total payout is calculated based on an approved spending rate that is applied to a five-year monthly average market value of Pool A funds. For fiscal years 2016 and 2015 the approved spending rate was 5.0%.

Pool D is the charitable gift annuity reserve pool and is invested in accordance with California State Insurance Commission requirements.

Endowment

The University's endowment consists of 417 individual donor-restricted endowment funds and 72 University-designated quasi-endowment funds for a variety of purposes. The net assets associated with endowment funds, including funds designated by the University to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

The University has interpreted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") as allowing the University to appropriate for expenditure or accumulate so much of an endowment fund as the University determines is prudent for the uses, benefits, purposes, and duration for which the endowment funding is established, subject to the intent of the donor as expressed in the gift instrument. As a result of this interpretation, the University 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. The remaining portion of donor-restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the University in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the University considers the following factors in making a determination to appropriate or accumulate endowment funds:

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

- 1) The duration and preservation of the fund
- 2) The purposes of the University 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 University
- 7) The investment policies of the University

Derivatives

From time to time, the University enters into derivative transactions either as part of its overall investment asset allocation or as a specific hedge or risk management tool. Derivatives used as part of the asset allocation strategy are recorded at fair value with realized and unrealized gains and losses reflected in the Consolidated Statements of Activities. These derivatives are included in the investment portfolio categorized as "Other".

Derivatives used to economically hedge specific operations, such as foreign currency contracts, are discussed under the heading, "Foreign Currency Management."

Assets Held As Trustee or Agent

The University uses the actuarial method of recording charitable gift annuities and charitable remainder trusts. When a gift is received, the fair value of the gift received is recorded as an asset and the present value of the related amounts due is recorded as a liability based on United States Internal Revenue Service life expectancy tables and the remainder is recorded as private gift and grant revenue in the appropriate net asset category on the Consolidated Statements of Activities. Investment income is credited, and annuity payments, direct costs of funds management, and investment losses are charged to the related liability. In situations where trust assets are not readily convertible to cash, annuitant payments have been made by the University. For life contingent gifts, the liability is adjusted annually based on the changes in the expected life, and is reflected as an adjustment of the actuarial liability on the Consolidated Statements of Activities. At July 31, 2016 and 2015, the estimated future payments to be made by the University have been discounted at 1.8% and 2.2% per annum, respectively.

Remainder interests in real estate are recorded at their estimated fair value at the date of gift. Investment income and gains are credited, and direct costs of asset management and investment losses are charged to the related net asset category.

The University and its consolidated subsidiaries have legal title, either in their name or as trustee, to the charitable gift annuities, charitable remainder trusts, and life estates subject to life interests of the beneficiaries. No significant financial benefit can be realized until the contractual obligations are released.

Deferred Compensation Plans

Contributions to the University's deferred compensation plan under Section 457(b) and 457(f) of the United States Internal Revenue Code are carried at fair value as a component of assets held as trustee or agent, with an equal and offsetting obligation to pay the employees as a component of trust and agency obligations on the Consolidated Statements of Financial Position.

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

Property, Facilities and Equipment

Property, facilities and equipment are stated at cost or, if received by gift, at fair value at the date of the gift. Depreciation on buildings, improvements, furniture, fixtures and equipment is provided on a straight-line basis over the estimated useful lives as described in the table below:

<u>Asset Class</u>	<u>Useful Life</u>
Furniture and Other Equipment	10-15 years
Computer Hardware and Software	2-10 years
Motor Vehicles	5 years
Buildings	20-70 years
Land Improvements	20 years

Amounts spent for repairs and maintenance are charged to expense as incurred. When assets are sold or retired, the associated cost and accumulated depreciation are removed. Any gain or loss from such disposition is recorded as a component of other non-operating revenues and expenses on the Consolidated Statements of Activities.

Debt Issuance Costs

Capitalized debt issue costs included in long-term obligations are amortized over the life of the related debt using the effective interest method.

U.S. Government-Funded Student Loans

Funds provided by the United States government under the Federal Perkins Loan Program are loaned to qualified students and may be loaned again after their collection. These funds are ultimately refundable to the U.S. government and as such are included as liabilities in the Consolidated Statements of Financial Position.

Foreign Currency Management

The University uses derivative financial instruments to reduce its net exposure to currency fluctuations. As such, the University enters into forward contracts and purchases currency futures (principally the Euro, the British pound, Argentinian Peso, and Swiss francs) to economically hedge forecasted cash flows denominated in foreign currencies. The purpose of the University's foreign currency hedging activities is to reduce the risk that eventual United States dollar net cash outflows resulting from costs outside the U.S. will be adversely affected by changes in exchange rates.

Asset Retirement Obligations

The University recognizes liabilities for legal obligations associated with the retirement of tangible long-lived assets when the timing and/or method of settlement of the obligation is conditional on a future event. The fair value of a liability for a conditional asset retirement obligation is recognized in the period in which it occurs if a reasonable estimate of fair value can be made.

Reclassifications

Certain amounts were reclassified at or for the year ended July 31, 2015 to conform with the current year's presentation.

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

3. Student Receivables

Student receivables consist of the following at July 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Graziadio School of Business and Management...	\$2,681	\$2,054
Seaver College.....	847	778
Graduate School of Education and Psychology.....	382	242
Other	<u>157</u>	<u>112</u>
Gross student receivables	4,067	3,186
Allowance for doubtful accounts.....	<u>(1,506)</u>	<u>(988)</u>
	<u>\$2,561</u>	<u>\$2,198</u>

Activity in the allowance for doubtful accounts was as follows:

	<u>For the year ended July 31,</u>	
	<u>2016</u>	<u>2015</u>
	(In thousands)	
Beginning balance	\$ 988	\$1,007
Provision for doubtful accounts.....	700	100
Accounts charged off.....	(371)	(322)
Recoveries of previously charged off accounts	<u>189</u>	<u>203</u>
Net recoveries/(charge-offs)	<u>(182)</u>	<u>(119)</u>
Ending balance	<u>\$1,506</u>	<u>\$ 988</u>

4. Student Loans

Student loans consist of the following at July 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Perkins.	\$14,416	\$13,839
Weingart	7,042	7,627
Other.	<u>1,010</u>	<u>1,315</u>
Gross student loans.	22,468	22,781
Allowance for loan losses.....	<u>(1,537)</u>	<u>(1,300)</u>
	<u>\$20,931</u>	<u>\$21,481</u>

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

Activity in the allowance for loan losses was as follows:

	<u>For the year ended July 31,</u>	
	<u>2016</u>	<u>2015</u>
	(In thousands)	
Beginning balance	\$1,300	\$1,564
Provision for doubtful accounts.....	400	-
Loans charged off	(297)	(364)
Recoveries of previously charged off loans.....	<u>134</u>	<u>100</u>
Net charge-offs	<u>(163)</u>	<u>(264)</u>
Ending balance	<u>\$1,537</u>	<u>\$1,300</u>

5. Beneficial Interests and Contributions Receivable

Unconditional promises to give with payments due in future periods are reported as temporarily or permanently restricted beneficial interests and contributions receivable. Unconditional promises to give are recorded at their discounted present value based on a credit-adjusted interest rate. At July 31, 2016, the discount rate applied to beneficial interests and contributions receivable ranged from 0.49% per annum to 2.69% per annum and at July 31, 2015 ranged from 0.31% per annum to 3.42% per annum.

The following table provides a summary of beneficial interests and contributions receivable by expected collection date at July 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
In one year or less.....	\$ 1,782	\$ 3,886
Between one and five years.....	3,470	1,091
More than five years.....	<u>29,795</u>	<u>31,445</u>
	35,047	36,422
Less discount.....	<u>(329)</u>	<u>(550)</u>
	<u>\$34,718</u>	<u>\$35,872</u>

During the years ended July 31, 2016 and 2015, the University received payments on prior year promises to give of \$957,000 and \$2.8 million, respectively.

Beneficial interests and contributions receivable include assets held by external trustees totaling \$31.9 million at July 31, 2016 and \$30.7 million at July 31, 2015.

In the event beneficial interests and contributions receivable are deemed uncollectable, they are charged to expense as a component of "Other non-operating revenues and expenses." Beneficial interests and contributions receivable written off during the years ended July 31, 2016 and 2015 amounted to \$1.3 million and \$5.1 million, respectively.

During the years ended July 31, 2016 and 2015 promises to give in the net amount of \$3.0 million and \$15.2 million were received but not recognized, respectively. Promises to give may not be recognized because a donor has not provided sufficient documentation, the promise is conditional, or the promise is revocable.

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

6. Investments

The University's investments consist of the following at July 31, 2016 and 2015:

	2016		2015	
	<u>Cost</u>	<u>Fair Value</u>	<u>Cost</u>	<u>Fair Value</u>
	(In thousands)			
Cash and cash equivalents.....	\$109,239	\$109,239	\$ 44,347	\$ 44,347
Absolute return.....	121,440	161,363	91,331	125,400
Assets held by trustee.....	12,249	149,405	12,250	151,625
Mutual funds.....	28,406	29,011	13,374	14,053
Fixed income.....	68,724	70,798	61,738	62,330
Notes receivable.....	7,589	7,589	7,455	7,455
Opportunistic distressed.....	14,416	21,434	16,088	26,280
Private equity.....	120,483	128,373	109,803	124,227
Natural resources.....	66,269	60,726	33,516	39,859
Private real estate.....	58,484	54,200	56,187	45,501
Public equity.....	86,037	100,997	130,247	151,401
Real estate.....	34,547	55,630	37,377	52,851
Other.....	<u>2,895</u>	<u>2,895</u>	<u>2,889</u>	<u>2,889</u>
	<u>\$730,780</u>	<u>\$951,660</u>	<u>\$616,602</u>	<u>\$848,218</u>
Pooled investments.....	\$641,749	\$703,166	\$540,510	\$615,738
Separately invested.....	<u>89,031</u>	<u>248,494</u>	<u>76,092</u>	<u>232,480</u>
	<u>\$730,780</u>	<u>\$951,660</u>	<u>\$616,602</u>	<u>\$848,218</u>

Assets held by trustee consists primarily of the balance of the Blanche E. Seaver Endowed Trust, of which the University is the sole irrevocable income and principal beneficiary.

Investment expenses for the years ended July 31, 2016 and 2015 includes investment management fees totaling \$4.7 million and \$5.7 million, respectively.

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

7. Endowment Activities

Changes in endowment net assets for the year ended July 31, 2016 are as follows:

	<u>Unrestricted Principal</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
	(In thousands)			
Endowment net assets, beginning of year	\$399,860	\$59,905	\$326,002	\$785,767
Investment income	3,882	1,528	22	5,432
Net realized and unrealized appreciation (depreciation)	(15,808)	26,865	(2,187)	8,870
Private gifts and grants.....	216	29	5,118	5,363
Maturation of Assets Held as Trustee or Agent	-	-	391	391
Endowment support	(3,216)	(33,952)	(163)	(37,331)
Reinvestments and transfers	16,928	(74)	196	17,050
Expenditures	<u>(2,999)</u>	<u>(1,202)</u>	<u>-</u>	<u>(4,201)</u>
Endowment net assets, end of year	<u>\$398,863</u>	<u>\$53,099</u>	<u>\$329,379</u>	<u>\$781,341</u>

Unrestricted undistributed appropriations of endowment were \$7.9 million at July 31, 2016.

Designations of endowment funds for the year ended July 31, 2016 are as follows:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted funds	\$ -	\$53,099	\$329,379	\$382,478
University-designated funds	<u>398,863</u>	<u>-</u>	<u>-</u>	<u>398,863</u>
Total	<u>\$398,863</u>	<u>\$53,099</u>	<u>\$329,379</u>	<u>\$781,341</u>

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

Changes in endowment net assets for the year ended July 31, 2015 are as follows:

	<u>Unrestricted Principal</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
	(In thousands)			
Endowment net assets, beginning of year	\$401,472	\$67,878	\$314,158	\$783,508
Investment income	5,375	2,249	31	7,655
Net realized and unrealized appreciation (depreciation)	(2,101)	8,007	1,942	7,848
Private gifts and grants.....	46	57	4,460	4,563
Maturation of Assets Held as Trustee or Agent	-	-	5,559	5,559
Endowment support	(18,034)	(16,537)	(261)	(34,832)
Reinvestments and transfers	17,358	(221)	219	17,356
Expenditures.....	<u>(4,256)</u>	<u>(1,528)</u>	<u>(106)</u>	<u>(5,890)</u>
Endowment net assets, end of year	<u>\$399,860</u>	<u>\$59,905</u>	<u>\$326,002</u>	<u>\$785,767</u>

Unrestricted undistributed appropriations of endowment were \$7.4 million at July 31, 2015.

Designations of endowment funds for the year ended July 31, 2015 are as follows:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted funds	\$ -	\$59,905	\$326,002	\$385,907
University-designated funds	<u>399,860</u>	<u>-</u>	<u>-</u>	<u>399,860</u>
Total	<u>\$399,860</u>	<u>\$59,905</u>	<u>\$326,002</u>	<u>\$785,767</u>

The University has recorded deficiencies resulting from the decline in fair value of endowment funds to amounts below the original gift amount as a reduction of unrestricted net assets. Such deficiencies totaled \$5.6 million and \$4.1 million and affected 140 and 111 donor-restricted true endowment funds with a market value of \$64.8 million and \$57.1 million at July 31, 2016 and July 31, 2015, respectively.

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

8. Assets Held as Trustee or Agent

The University's assets held as trustee or agent consist of the following at July 31, 2016 and 2015:

	2016		2015	
	<u>Cost</u>	<u>Fair Value</u>	<u>Cost</u>	<u>Fair Value</u>
	(In thousands)			
Cash and cash equivalents.....	\$ 3,801	\$ 3,801	\$ -	\$ -
Publicly traded stocks.....	952	1,789	1,037	1,314
Mutual funds.....	68,857	71,959	63,962	68,742
Notes receivable	2,701	2,701	2,709	2,709
Real estate	22,148	25,618	32,144	37,126
Alternative investments.....	616	686	1,258	1,422
Other.....	<u>10,598</u>	<u>10,741</u>	<u>5,524</u>	<u>5,719</u>
	<u>\$109,673</u>	<u>\$117,295</u>	<u>\$106,634</u>	<u>\$117,032</u>
Pooled investments.....	\$ 23,490	\$ 23,389	\$24,673	\$ 25,244
Separately invested.....	<u>86,183</u>	<u>93,906</u>	<u>81,961</u>	<u>91,788</u>
	<u>\$109,673</u>	<u>\$117,295</u>	<u>\$106,634</u>	<u>\$117,032</u>

9. Pooled Investments

The following table sets forth data for the University's investment pools at July 31, 2016 and 2015:

	2016		2015	
	<u>Pool A</u>	<u>Pool D</u>	<u>Pool A</u>	<u>Pool D</u>
Per unit fair value at end of year	\$375.78	\$124.63	\$391.47	\$125.98
Number of units owned at end of year:				
Unrestricted	1,274,360	109,590	989,821	109,590
Temporarily restricted.....	12,353	27,863	12,275	31,902
Permanently restricted	584,510	43,706	572,745	48,240
Agency.....	<u>2,159</u>	<u>-</u>	<u>1,475</u>	<u>-</u>
Total units.....	<u>1,873,382</u>	<u>181,159</u>	<u>1,576,316</u>	<u>189,732</u>
Average annual income per unit.....	\$6.84	\$1.72	\$1.95	\$5.35

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

10. Property, Facilities and Equipment

Property, facilities and equipment consist of the following at July 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
	<u>(In thousands)</u>	
Land	\$ 28,613	\$ 28,613
Buildings and improvements	464,394	458,849
Furniture, fixtures and equipment.....	61,757	63,863
Construction in progress	<u>25,467</u>	<u>15,705</u>
Total cost	580,231	567,030
Less: accumulated depreciation	<u>(222,271)</u>	<u>(208,243)</u>
	<u>\$357,960</u>	<u>\$358,787</u>

11. Lines of Credit

At July 31, 2016 the University had a \$50.0 million committed line of credit available for general corporate purposes at Wells Fargo Bank's one-month LIBOR rate plus 0.65% per annum. The line expires on April 1, 2019.

At July 31, 2015 the University had a \$600,000 line of credit which expired on August 31, 2015 available to fund the purchase of up to \$20.0 million worth of foreign currency forward contracts for the funding of its international programs at Comerica Bank's prime rate plus 3.0% per annum.

12. Long-Term Obligations

Long term obligations consist of the following at July 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
	<u>(In thousands)</u>	
CEFA 5.00% Refunding Revenue Bonds (Pepperdine University) Series 2005 A, due 2035-2036.....	\$ -	\$ 72,175
CEFA 5.00% Refunding Revenue Bonds (Pepperdine University) Series 2005 B, due 2033.....	-	12,770
Pepperdine University Taxable Bonds Series 2009 A 5.45% interest, due 2019	-	50,000
California Infrastructure and Economic Development Bank Refunding Revenue Bonds Series 2010, 5.00% due 2019-2029.....	-	15,345
CEFA Revenue Bonds (Pepperdine University) Series 2012, 3.00%-5.00% due 2013 -2033	45,395	46,975
CEFA Revenue Bonds (Pepperdine University) Series 2014, 2.00%-5.00% due 2015 -2044	51,165	51,485
CEFA Revenue Bonds (Pepperdine University) Series 2015, 2.00%-5.00% due 2016 -2035	76,455	-
CEFA Revenue Bonds (Pepperdine University) Series 2016, 3.00%-5.00% due 2019 -2036	<u>100,000</u>	<u>-</u>
	273,015	248,750
Net premium on long-term obligations	39,829	16,493
Bond issuance costs.....	<u>(2,762)</u>	<u>(3,340)</u>
	<u>\$310,082</u>	<u>\$261,903</u>

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

At July 31, 2016, principal payments on the preceding obligations are due in the following fiscal years:

	(In thousands)
2017	\$ 3,135
2018	3,240
2019	3,350
2020	4,485
2021	4,580
2022	4,800
2023	5,020
2024	5,265
2025	5,515
2026	5,640
2027	5,920
2028	6,215
2029	6,525
2030	6,860
2031	6,940
2032	7,295
2033	9,545
2034	8,165
2035	12,375
2036	13,000
2037	7,340
2038	7,715
2039	8,115
2040	8,530
2041	8,965
2042	9,425
2043	9,910
2044	10,415
2045	10,950
2046.....	11,515
2047.....	12,105
2048.....	12,725
2049.....	13,375
2050.....	<u>14,060</u>
	<u>\$273,015</u>

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

13. Net Assets

At July 31, 2016 and 2015, temporarily and permanently restricted net assets were available for the following purposes:

	2016		2015	
	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>
	(In thousands)			
Educational program support	\$ 53,907	\$222,149	\$ 57,765	\$224,028
Student services and athletics	1,432	4,665	1,601	4,586
Student loans and scholarships ..	26,737	113,348	30,347	108,011
Annuities and remainder trusts ..	27,173	10,661	28,452	10,400
Facilities	4,361	4,619	3,846	4,619
Public service	2,067	6,494	988	6,893
Other	<u>3,748</u>	<u>4,025</u>	<u>4,309</u>	<u>4,003</u>
	<u>\$119,425</u>	<u>\$365,961</u>	<u>\$127,308</u>	<u>\$362,540</u>

14. Operating Lease Commitments

The University leases facilities for use primarily in its graduate programs. Future minimum lease payments expiring through fiscal 2026 under these non-cancelable operating leases at July 31, 2016 are as follows:

	(In thousands)
2017	\$12,648
2018	11,586
2019	5,186
2020	2,200
2021	2,215
2022	2,282
2023	2,488
2024	2,563
2025	2,640
2026	<u>2,262</u>
	<u>\$46,070</u>

Leases on facilities contain renewal options and rent escalation clauses based on the Consumer Price Index.

15. Employee Retirement and Deferred Compensation Plans

The University participates in a defined contribution plan, which provides retirement benefits for eligible employees. Benefits for the plan are funded by contributions from the University and its employees. University contributions are non-refundable and fully vested. There are no prior service costs. The University contributed \$9.9 million and \$9.6 million to these plans for the years ended July 31, 2016 and 2015, respectively.

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

In July 2002 the University established deferred compensation programs for senior administrators, tenured Full Professors, highly paid and certain other employees under Sections 457(b) and 457(f) of the Internal Revenue Code. Under this plan, eligible employees may defer a limited amount of their compensation to future years. Although deferred by employees for tax purposes, amounts contributed to these plans by the University are treated as an expense in the year earned. Balances held by the University in the plans are recorded as a component of Assets Held as Trustee or Agent. University contributions to these deferred compensation plans for the years ended July 31, 2016 and 2015 were \$409,000 and \$201,000, respectively. At July 31, 2016 and 2015, balances in the plans were \$9.8 million and \$9.0 million, respectively.

16. Faculty and Staff Housing

The University sells condominium units to certain faculty and staff. The sales terms include restrictions on the buyers' eligibility and include a resale price based on a defined index that is not controlled by the University. The University has a right of first refusal to purchase the units when offered for sale by the owner. The University has historically exercised this right and then subsequently sold the units within a short period of time. For the years ended July 31, 2016 and 2015, the University sold seven and three units with associated sales values of \$4.2 million and \$1.4 million, respectively. Should all 122 of the units be available for purchase at July 31, 2016 and 2015, and the University elected to exercise its right of first refusal on all of the units, the total value associated with these transactions would be \$67.4 million and \$63.3 million, respectively. At July 31, 2016 and 2015, the University held legal title to nine and 13 units with a value of \$5.4 million and \$7.6 million, respectively.

The land associated with the condominium units has been leased to the homeowner's associations for 99 years from the date of completion of the construction. Monthly rents are paid to the University for the grounds, utilities and other services subject to adjustments based on the Consumer Price Index and on the costs of furnishing utilities and services.

At July 31, 2016, the University guaranteed the performance of \$19.6 million in mortgage loans obtained by its faculty and staff. These mortgage loans were issued by independent third-party lenders and all of the proceeds of these loans were used to facilitate the purchase of on-campus housing.

At July 31, 2016 and 2015, University-owned notes receivable from on-campus housing sales amounted to \$3.6 million and \$3.4 million, respectively. These amounts are included as a component of investments on the Consolidated Statements of Financial Position. The notes bear interest at various rates ranging between 1.00% per annum and 7.25% per annum and are collateralized by deeds of trust. Interest income recognized by the University related to these notes was \$37,900 and \$44,800 for the years ended July 31, 2016 and 2015, respectively. No allowance for loan losses has been recorded against these loans based on their collateralization and prior collection history. At July 31, 2016 there were no past due amounts related to these notes receivable.

17. Supplemental Cash Flow Information

	<u>For the year ended July 31,</u>	
	<u>2016</u>	<u>2015</u>
	<u>(In thousands)</u>	
Cash paid during the period for:		
Interest	\$10,547	\$11,583
Accrued capitalized asset additions	4,889	6,889

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

18. Natural Expenses

The University's classifications of expenses in the Consolidated Statements of Activities by natural expense category are as follows:

	<u>For the year ended July 31,</u>	
	<u>2016</u>	<u>2015</u>
	<u>(In thousands)</u>	
Personnel	\$182,175	\$176,139
Professional services	24,458	21,222
Depreciation	20,918	19,999
Travel and development	12,873	12,598
Rentals	11,847	11,037
Interest.....	11,040	11,388
Student meals	8,641	7,947
Maintenance	8,022	6,855
Equipment	7,639	7,615
Supplies	6,518	6,583
Utilities	6,187	6,280
Insurance	5,074	4,669
Advertising and promotion	4,861	3,851
Other	<u>8,438</u>	<u>6,306</u>
	<u>\$318,691</u>	<u>\$302,489</u>

19. Commitments and Contingencies

At July 31, 2016 and 2015, \$114.1 million and \$30.7 million of the balance in cash and cash equivalents was related to funds that were restricted for specific construction projects, respectively. The University anticipates that the funds available at July 31, 2016 will be expended by December 31, 2017.

In the normal course of operations, the University is named as a defendant in lawsuits and is subject to periodic examinations by regulatory agencies. After consultation with legal counsel, management is of the opinion that liabilities, if any, arising from such litigation and examinations would not have a material effect on the University's consolidated financial position or change in net assets.

The University receives and expends monies under U.S. government grant programs and is subject to audits by related U.S. governmental agencies. Management believes that any liabilities resulting from such audits will not have a material impact on the University.

At July 31, 2016, the University had open commitments to invest approximately \$103.0 million with investment managers and/or limited partnerships over approximately seven years.

At July 31, 2016, the University's maximum exposure under guarantees of Guaranteed Access To Education ("GATE") student loans totaled approximately \$238,000.

At July 31, 2016, the University had outstanding commitments for capital expenditures in connection with the various construction projects of approximately \$3.8 million. The University expects to fund

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

these costs principally through unrestricted net assets available. Accordingly, no liability has been recorded in the accompanying Consolidated Statements of Financial Position.

As discussed in Note 16, the University guarantees the performance of certain mortgages for on-campus condominiums.

20. Fair Value of Financial Instruments

Financial instruments include cash and cash equivalents, student receivables, other accounts receivable, student loans, beneficial interests and contributions receivable, investments, assets held as trustee or agent, U.S. government-funded student loans and trust and agency obligations. The fair value of certain alternative investments, which include limited partnerships in venture capital, real estate and other private debt and equity funds, is based on valuations provided by the external investment managers or general partners, generally using NAV as a practical expedient, adjusted for receipts and disbursements of cash and distributions of securities if the date of valuation is prior to the University's fiscal year end. Such valuations generally reflect discounts for illiquidity and consider variables such as financial performance of investments, recent sales prices of investments and other pertinent information. These estimates are subjective in nature and involve uncertainties and matters of judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates. In addition, the fair value estimates presented do not include the value of anticipated future operating activities and the value of assets and liabilities that are not considered financial instruments. The University uses the following methods and assumptions in estimating the fair value disclosures for its financial instruments:

Financial Assets

The carrying values of cash and cash equivalents, student receivables, other accounts receivable, student loans, beneficial interests and contributions receivable, investments, and assets held as trustee or agent are considered to approximate fair value. When possible, the fair value of investments and assets held as trustee or agent are determined by reference to quoted market prices. When quoted market prices are not available, fair value is estimated by reference to market values for similar securities or by discounting cash flows at an appropriate rate taking into consideration the varying degrees of risk specific to each financial asset. Determination of the fair value of student loans receivable, which are primarily federally sponsored student loans could not be made without incurring excessive costs.

Derivative Financial Instruments

The fair value of interest rate caps, floors and swaps, forward treasury contracts and interest rate futures, to the extent used by the University, are based on quoted market prices. The fair values of foreign currency derivatives are based on pricing models using currency market rates. These amounts are reflected as a component of prepaid expenses, inventories and other assets on the University's Consolidated Statements of Financial Position.

Fair Value

In accordance with ASC 820, fair value is defined as the price the University would receive to sell an asset or pay a liability in an orderly transaction between the market participants at the reporting date. ASC 820 also establishes a three-level hierarchy for presenting valuations, based on the transparency of inputs used to value investments and other relevant assets. A financial instrument's categorization within

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Valuation inputs may be observable or unobservable, and refer to the assumptions that a market participant would consider significant to value an asset or liability. The determination of “observable” requires judgment by the University. In general, the University considers observable inputs to be data that are readily available, regularly updated, reliable, and verifiable. Unobservable inputs may be used when observable inputs are not readily available or current. In this situation, one or more valuation techniques may be used including the market approach (inputs based on recent market transactions or comparables) or the income approach (discounted cash flow).

The three levels of the fair value hierarchy under ASC 820 are as follows:

- Level 1 – Quoted prices available in active markets for identical investments.
- Level 2 – Quoted prices in active markets for similar investments; quoted prices for identical investments in markets that are inactive; and prices based on observable inputs other than an unadjusted quoted price.
- Level 3 – Prices based on significant unobservable inputs.

The following table summarizes the valuations of the University’s investments and other relevant assets as of July 31, 2016, based on their placement within the fair-value hierarchy:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>NAV</u>	<u>Total</u>
	(In thousands)				
Investments					
Cash and cash equivalents.....	\$137,747	\$ -	\$ -	\$ -	\$137,747
Assets held by trustee.....	104,915	36,010	59	-	140,984
Mutual funds	41,364	-	-	-	41,364
Fixed Income	12,639	63,576	-	-	76,215
Real estate	-	55,629	6,301	-	61,930
Public equity	59,692	43,866	-	-	103,558
Other	-	-	4,184	-	4,184
Investments measured at NAV	<u>-</u>	<u>-</u>	<u>-</u>	<u>385,678</u>	<u>385,678</u>
Total investments	<u>\$356,357</u>	<u>\$199,081</u>	<u>\$10,544</u>	<u>\$385,678</u>	<u>\$951,660</u>
Assets held as trustee or agent					
Cash and cash equivalents.....	\$ 6,310	\$ -	\$ -	\$ -	\$ 6,310
Mutual Funds	81,430	-	-	-	81,430
Real Estate	-	25,742	2,701	-	28,443
Other	651	-	28	-	679
Investments measured at NAV	<u>-</u>	<u>-</u>	<u>-</u>	<u>433</u>	<u>433</u>
Total assets held as trustee or agent	<u>\$ 88,391</u>	<u>\$ 25,742</u>	<u>\$ 2,729</u>	<u>\$ 433</u>	<u>\$ 117,295</u>
Total	<u>\$444,748</u>	<u>\$224,823</u>	<u>\$13,273</u>	<u>\$386,111</u>	<u>\$1,068,955</u>

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

The following summary table illustrates the valuations of the University's investments and other relevant assets as of July 31, 2015, based on their placement within the fair value hierarchy:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>NAV</u>	<u>Total</u>
Investments					
	(In thousands)				
Cash and cash equivalents.....	\$ 44,347	\$ -	\$ -	\$ -	\$ 44,347
Absolute return.....	-	65,734	-	-	65,734
Assets held by trustee.....	107,305	6,284	38,036	-	151,625
Mutual funds	14,053	-	-	-	14,053
Fixed income.....	274	61,925	-	-	62,199
Notes receivable.....	-	-	7,455	-	7,455
Private equity	-	-	2,477	-	2,477
Public equity	91,932	59,469	-	-	151,401
Real estate	-	52,851	-	-	52,851
Other	-	48	2,922	-	2,970
Investments measured at NAV	-	-	-	<u>293,106</u>	<u>293,106</u>
Total investments.....	<u>\$257,911</u>	<u>\$246,311</u>	<u>\$50,890</u>	<u>\$293,106</u>	<u>\$848,218</u>
Assets held as trustee or agent					
Publicly traded stocks	\$ 2,673	\$ -	\$ -	\$ -	\$ 2,673
Mutual funds	68,320	-	-	-	68,320
Real estate	-	37,126	2,709	-	39,835
Alternative investments.....	339	273	175	-	787
Other	4,111	-	667	-	4,778
Investments measured at NAV	-	-	-	<u>639</u>	<u>639</u>
Total assets held as trustee or agent	<u>\$ 75,443</u>	<u>\$ 37,399</u>	<u>\$ 3,551</u>	<u>\$ 639</u>	<u>\$117,032</u>
Total	<u><u>\$333,354</u></u>	<u><u>\$283,710</u></u>	<u><u>\$54,441</u></u>	<u><u>\$293,745</u></u>	<u><u>\$965,250</u></u>

Level 1 generally includes the University's investments in mutual funds and common stock that are regularly traded in active markets where quoted prices may be easily obtained.

Level 2 generally includes the University's investments in debt securities and certain unlisted equity funds that offer a high degree of liquidity and transparency. Debt security prices are obtained from pricing services, or from brokers. Level 2 investments may also be priced using model-based valuation techniques where all assumptions are observable.

Level 3 generally includes the University's alternative investments, which consist of hedge funds, private equity funds, real estate funds, and other fund of funds. These investments do not typically transact on a regular basis, nor do they have readily determinable fair values. Level 3 also includes the University's real property. Oil and gas interests are valued by discounting future expected royalty revenues, while real property is valued based on a number of different approaches including third party appraisals, market comparisons, and discounted future rental revenues.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future values. In addition, while the University believes that its valuation methods are appropriate and consistent with other market participants, the use of different methodologies

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

The following table sets forth a reconciliation of beginning and ending balances for financial instruments designated as Level 3:

	<u>For the year ended July 31,</u>	
	<u>2016</u>	<u>2015</u>
	(In thousands)	
Beginning balance	\$54,441	\$68,508
Realized gains (losses).....	3,459	(1,174)
Unrealized gains (losses).....	5,594	(1,662)
Purchase cost.	4,828	92
Total proceeds.....	(3,370)	(11,323)
Transfers out of Level 3.....	<u>(51,679)</u>	<u>-</u>
Ending balance	<u>\$13,273</u>	<u>\$54,441</u>

All net realized and unrealized gains in the table above are reflected in the accompanying consolidated Statement of Activities.

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

The University uses the NAV to determine the fair value of all the underlying investments which (a) do not have a readily determinable fair value and (b) prepare their financial statements consistent with the measurement principles of an investment company or have the attributes of an investment company. The following table lists investments in other investment companies (in partnership format) by major category for the year ended July 31, 2016:

<u>Investment Category</u>	<u>Strategy</u>	<u>NAV in Funds</u>	<u># of Funds</u>	<u>Remaining Li fe</u>	<u>Amount of Unfunded Com mitments</u>	<u>Redemption Terms</u>	<u>Redemption Restrict ions</u>
(In thousands, except # of funds)							
Absolute Return	US and non-US investments in relative value, event driven, long/short and directional	\$123,855	24	Open Ended	\$ -	Ranges between quarterly with 30, 45, 60 or 90 days notice, semi annual with 90 days notice, annual with 45, 60 or 90 days notice	0.5% of NAV is locked up for an undetermined time
Assets Held by Trustee	US and non-US investments in relative value, event driven, long/short and directional	8,421	9	Open Ended	-	Ranges between quarterly with 30, 45, 60 or 90 days notice, semi annual with 90 days notice, annual with 45, 60 or 90 days notice	0.8% of NAV is locked up for an undetermined time
Private Natural Resources	US and non-US Investments in upstream, midstream, and downstream natural resources	52,845	20	Approx 7 years	20,231	Redemptions are not permitted during the life of the fund	N/A
Private Real Estate	US and non-US real estate	51,537	23	Approx 7 years	20,858	Redemptions are not permitted during the life of the fund	N/A
Public Equity	US and non-US equity securities	-	8	Open Ended	-	Ranges from daily to monthly	N/A
Fixed Income	US and non-US fixed income securities	100	1	Open Ended	-	Daily	N/A
Opportunistic Distressed	US and non-US distressed debt securities	21,369	7	Approx 7 years	3,678	Redemptions are not permitted during the life of the fund	N/A
Private Equity	US and non-US equity securities	<u>127,551</u>	57	Approx 7 years	<u>58,242</u>	Redemptions are not permitted during the life of the fund	N/A
Total		<u>\$385,678</u>			<u>\$103,009</u>		

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

The University uses the NAV to determine the fair value of all the underlying investments which (a) do not have a readily determinable fair value and (b) prepare their financial statements consistent with the measurement principles of an investment company or have the attributes of an investment company. The following table lists investments in other investment companies (in partnership format) by major category for the year ended July 31, 2015:

<u>Investment Category</u>	<u>Strategy</u>	<u>NAV in Funds</u>	<u># of Fun ds</u>	<u>Remaining L ife</u>	<u>Amount of Unfunded Com mitments</u>	<u>Redemption Terms</u>	<u>Redemption Restric tions</u>
(In thousands, except # of funds)							
Absolute Return	US and non-US investments in relative value, event driven, long/short and directional	\$125,400	33	Open Ended	\$ -	Ranges between quarterly with 30, 45, 60 or 90 days notice, semi annual with 90 days notice, annual with 45, 60 or 90 days notice	1.1% of NAV is locked up for an undetermined time
Assets Held By Trustee	US and non-US investments in relative value, event driven, long/short and directional	44,320	12	Open Ended	-	Ranges between quarterly with 30, 45, 60 or 90 days notice, semi annual with 90 days notice, annual with 45, 60 or 90 days notice	1.1% of NAV is locked up for an undetermined time
Public Natural Resources	US and non-US Investments in upstream, midstream, and downstream natural resources	-	1	Approx 7 years	-	Redemptions are not permitted during the life of the fund	N/A
Private Natural Resources	US and non-US Investments in upstream, midstream, and downstream natural resources	-	-	Approx 7 years	26,949	Redemptions are not permitted during the life of the fund	N/A
Private Real Estate	US and non-US real estate	45,469	23	Approx 7 years	26,839	Redemptions are not permitted during the life of the fund	N/A
Public Equity	US and non-US equity securities	59,469	6	Open Ended	-	Ranges from daily to monthly	N/A
Fixed Income	US and non-US fixed income securities	61,925	1	Open Ended	-	Daily	N/A
Opportunistic Distressed	US and non-US distressed debt securities	26,231	7	Approx 7 years	5,532	Redemptions are not permitted during the life of the fund	N/A
Private Equity	US and non-US equity securities	<u>124,227</u>	66	Approx 7 years	<u>61,708</u>	Redemptions are not permitted during the life of the fund	N/A
Total		<u>\$487,041</u>			<u>\$121,028</u>		

PEPPERDINE UNIVERSITY

Notes to Consolidated Financial Statements

21. Asset Retirement Obligations

The following table illustrates the change in conditional asset retirement obligations during the year ended July 31, 2016:

<u>Abatement Timeframe</u>	<u>Average Abatement Date</u>	<u>Balance at July 31, 2015</u>	<u>Accretion</u>	<u>Balance At July 31, 2016</u>
		(In thousands)		
10 years	2016	\$ 837	\$ -	\$ 837
11-20 years	2022	4,286	207	4,493
21-30 years	2036	23	1	24
31-40 years	2044	1,144	55	1,199
41-50 years	2048	130	6	136
51+ years	2061	<u>8</u>	<u>1</u>	<u>9</u>
		<u>\$6,428</u>	<u>\$270</u>	<u>\$6,698</u>

22. Foreign Currency Transactions

For the years ended July 31, 2016 and 2015, the University recorded approximately \$353,000 in net gains and \$789,000 in net losses on foreign currency hedging transactions, respectively.

23. Subsequent Events

The University has performed an evaluation of subsequent events through November 21, 2016 which is the date these financial statements were issued. There were no subsequent events that require disclosure.