

***The California
Endowment
(A California Nonprofit Public
Benefit Corporation)***

*Financial Statements for the Years Ended
February 28, 2005 and February 29, 2004 and
Independent Auditors' Report*

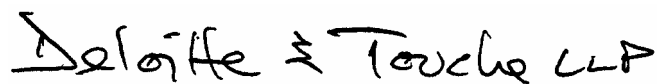
INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
The California Endowment:

We have audited the accompanying statements of financial position of The California Endowment ("The Endowment"), a California nonprofit public benefit corporation, as of February 28, 2005 and February 29, 2004, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of The Endowment's management. Our responsibility is to express an opinion on these 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 financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of The Endowment's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of The Endowment as of February 28, 2005 and February 29, 2004, and the change in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.



June 22, 2005

THE CALIFORNIA ENDOWMENT
(A California Nonprofit Public Benefit Corporation)

STATEMENTS OF FINANCIAL POSITION
FEBRUARY 28, 2005 AND FEBRUARY 29, 2004
(In thousands)

ASSETS	2005	2004
Cash and cash equivalents	\$ -	\$ 11,143
Funds held by trustee	54,288	78,316
Dividends, interest, and other receivables	7,756	6,995
Investments—at fair value	3,598,256	3,431,781
Program-related investments	20,000	20,825
Property and equipment—net	47,720	21,663
Other assets	<u>1,551</u>	<u>1,702</u>
TOTAL	<u>\$3,729,571</u>	<u>\$3,572,425</u>
 LIABILITIES AND UNRESTRICTED NET ASSETS		
LIABILITIES:		
Accounts payable and other liabilities	\$ 27,156	\$ 13,790
Grants payable—net	94,744	97,621
Long-term debt	84,607	84,756
Note payable	5,401	5,401
Deferred excise taxes payable	<u>12,685</u>	<u>9,846</u>
Total liabilities	224,593	211,414
 COMMITMENTS AND CONTINGENCIES		
UNRESTRICTED NET ASSETS	<u>3,504,978</u>	<u>3,361,011</u>
TOTAL	<u>\$3,729,571</u>	<u>\$3,572,425</u>

See accompanying notes to financial statements.

THE CALIFORNIA ENDOWMENT
(A California Nonprofit Public Benefit Corporation)

STATEMENTS OF ACTIVITIES
YEARS ENDED FEBRUARY 28, 2005 AND FEBRUARY 29, 2004
(In thousands)

	2005	2004
INVESTMENT RETURN:		
Net realized and unrealized gains on investments	\$ 278,739	\$ 847,222
Dividend, interest, and other investment income	<u>78,368</u>	<u>82,961</u>
	357,107	930,183
Less investment expenses	<u>11,124</u>	<u>10,456</u>
Net investment gain	<u>345,983</u>	<u>919,727</u>
EXPENSES:		
Grants awarded	150,366	136,490
Direct charitable expenses	16,272	12,252
Program operating expenses	17,845	19,831
General and administrative expenses	10,734	9,680
Federal excise tax provision:		
Current	3,960	3,101
Deferred	<u>2,839</u>	<u>9,846</u>
Total expenses	<u>202,016</u>	<u>191,200</u>
INCREASE IN UNRESTRICTED NET ASSETS	143,967	728,527
ADDITIONAL MINIMUM PENSION LIABILITY ADJUSTMENT	<u> </u>	<u>288</u>
CHANGE IN UNRESTRICTED NET ASSETS	143,967	728,815
UNRESTRICTED NET ASSETS—Beginning of year	<u>3,361,011</u>	<u>2,632,196</u>
UNRESTRICTED NET ASSETS—End of year	<u>\$3,504,978</u>	<u>\$3,361,011</u>

See accompanying notes to financial statements.

THE CALIFORNIA ENDOWMENT
(A California Nonprofit Public Benefit Corporation)

STATEMENTS OF CASH FLOWS
YEARS ENDED FEBRUARY 28, 2005 AND FEBRUARY 29, 2004
(In thousands)

	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Change in unrestricted net assets	\$ 143,967	\$ 728,815
Adjustments to reconcile change in unrestricted net assets to net cash used in operating activities:		
Net realized and unrealized gain on investments	(278,739)	(847,222)
Depreciation and amortization	1,420	1,625
Provision for losses on program-related investments	1,025	
Changes in operating assets and liabilities:		
Dividends, interest, and other receivables	(761)	4,621
Other assets	151	(13)
Accounts payable and other liabilities	10,028	2,063
Grants payable	(2,877)	(15,676)
Deferred excise taxes payable	<u>2,839</u>	<u>9,846</u>
Net cash used in operating activities	<u>(122,947)</u>	<u>(115,941)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Decrease (increase) in funds held by trustee	24,028	(78,316)
Purchases of property and equipment	(24,288)	(4,931)
Additional program-related investments	(200)	(825)
Purchases of investments	(5,760,208)	(3,021,257)
Proceeds from sale of investments	<u>5,872,472</u>	<u>3,140,608</u>
Net cash provided by investing activities	<u>111,804</u>	<u>35,279</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of long-term debt		84,756
Debt issuance costs		<u>(1,142)</u>
Net cash provided by financing activities	<u>-</u>	<u>83,614</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(11,143)	2,952
CASH AND CASH EQUIVALENTS—Beginning of year	<u>11,143</u>	<u>8,191</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ -</u>	<u>\$ 11,143</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION—Cash paid during the year for federal excise tax		
	<u>\$ 5,069</u>	<u>\$ 1,973</u>

SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES—At February 28, 2005, The Endowment had \$3,338 included in accounts payable and other liabilities for the purchase of property and equipment.

See accompanying notes to financial statements.

THE CALIFORNIA ENDOWMENT

(A California Nonprofit Public Benefit Corporation)

NOTES TO FINANCIAL STATEMENTS

FEBRUARY 28, 2005 AND FEBRUARY 29, 2004

1. ORGANIZATION

The California Endowment (“The Endowment”), a California nonprofit public benefit corporation, is a private foundation that began operations in May 1996. The Endowment’s mission is to expand access to affordable, quality health care for underserved individuals and communities and to promote fundamental improvements in the health status of all Californians.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Cash and Cash Equivalents—Cash and cash equivalents are defined as short-term, highly liquid investments with maturities of three months or less at the date of purchase. At February 28, 2005, The Endowment had an overdraft balance of \$7,380,000, which is included in accounts payable and other liabilities.

Investments—Investments in debt and equity securities are stated at fair value as determined by quoted market prices or based on quotations of similar securities. Nonmarketable securities (primarily private equity investments) for which quoted market prices are not available are valued by The Endowment with the assistance of third-party investment managers in good faith using methods they consider appropriate. The Endowment contracts with outside parties who provide investment management and consulting services.

Investing activities are reported on a trade-date basis. Realized gains and losses are calculated based upon the underlying cost of individual lots. Interest income is recorded when earned. Dividends are recorded on the ex-dividend date.

Investment securities, in general, are exposed to various risks, such as interest rate, credit, and overall market volatility. Due to the level of risk associated with certain long-term investments, it is reasonably possible that changes in the values of these investments will occur in the near term and that such changes could materially affect the amounts reported in the statement of financial position.

Property and Equipment—Property and equipment consists of land, leasehold improvements, furnishings, fixtures, and equipment for The Endowment’s offices and construction in progress and is carried at cost, less accumulated depreciation. Depreciation is computed using the straight-line method over the lesser of the estimated useful lives of individual assets, ranging from three to five years, or the term of noncancelable leases.

Deferred Financing Costs—Deferred financing costs are capitalized at cost and amortized using the straight-line method over the terms of the related financing. Such amortization is reflected as a component of interest expense.

Capitalized Interest—When qualifying assets are financed with the proceeds of restricted tax-exempt borrowings, the amount of interest cost is capitalized less any interest earned on temporary investment of the proceeds of the borrowings, from the date of the borrowings until the assets constructed with those borrowings are ready for their intended use.

Grants—Unconditional grants are recognized as an expense in the period in which they are approved. Grants which are conditioned on future uncertain events are expensed when those conditions are substantially met. There were \$1,571,000 and \$5,350,000 in conditional grants at February 28, 2005 and February 29, 2004, respectively, which are conditioned principally on grantees raising certain matching gifts by a specified date.

Direct Charitable and Program Operating Expenses—Direct charitable expenses pertain to charitable activities for the benefit of others initiated and conducted in whole or in part by The Endowment. The Endowment’s direct charitable activities consist of social marketing on health issues, policy and advocacy work, health-related research, and publishing and dissemination of research. Program operating expenses pertain to the general grant making activities of The Endowment, such as reviewing grant applications, and awarding, monitoring and evaluating grants. Certain program operating expenses are allocated based on employee ratios and estimates made by management.

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 the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications—Certain amounts in the prior year’s financial statements have been reclassified to conform to the current year’s presentation.

3. INVESTMENTS

Investments consist of the following (in thousands):

February 28, 2005	Cost	Fair Value
Money market and treasury bills	\$ 365,013	\$ 365,934
Government and corporate obligations	436,599	448,620
Equity securities	1,865,213	2,468,122
Private equity and other	<u>282,340</u>	<u>315,580</u>
	<u>\$2,949,165</u>	<u>\$3,598,256</u>
February 29, 2004	Cost	Fair Value
Money market and treasury bills	\$ 362,026	\$ 362,626
Government and corporate obligations	453,413	464,564
Equity securities	1,998,344	2,472,750
Private equity and other	<u>119,632</u>	<u>131,841</u>
	<u>\$2,933,415</u>	<u>\$3,431,781</u>

The Endowment has entered into certain agreements with various private limited partnership investment funds to make future investments in such funds. As of February 28, 2005, the unfunded commitments related to these investments totaled \$202,291,000.

In the normal course of business, The Endowment uses various financial instruments, including derivative financial instruments, to maintain desired asset allocations, primarily in fixed income securities. Interest rate futures and options are purchased and sold to manage the interest rate risk on

government and corporate obligations. The fair value of interest rate futures is included in investments. Derivative financial instruments are recorded at their current market value with any changes reflected as a change in net assets during the period of the change. The Endowment's investment managers are permitted, under the terms of individual investment guidelines, to utilize such financial instruments. Derivatives consist of the following positions at the dates indicated:

	<u>February 28, 2005</u>		<u>February 29, 2004</u>	
	Number of Positions	Notional Amounts (in thousands)	Number of Positions	Notional Amounts (in thousands)
Interest rate call options	7	\$ 9,275	5	\$ (39,300)
Interest rate put options	5	(120,700)	6	(200,900)
Interest rate futures	8	443,100	28	785,900
Interest rate swaps	8	40,500	6	53,800
Various forward positions	4	67,339	10	53,052

In addition to the above derivative positions, The Endowment also has equity index future positions with fair values of \$971,000 and \$284,000 at February 28, 2005 and February 29, 2004, respectively. Delivery dates for the contracts extend through December 2005, swaps through March 2017. All of the instruments are supported by government and corporate obligations.

4. PROGRAM-RELATED INVESTMENTS ("PRI")

The Endowment invests a portion of its funds in projects that advance its philanthropic purposes by providing non-interest bearing loans to certain organizations. At February 28, 2005 and February 29, 2004, these loans totaled \$ 20,000,000 and \$20,825,000, respectively. The loans expire on September 2013 and March 2029 and are expected to be repaid in various installments over their terms beginning in 2007. Management has reviewed the PRIs and has recorded an allowance of \$1,150,000 as of February 28, 2005.

5. PROPERTY AND EQUIPMENT

Property and equipment consist of the following at February 28, 2005 and February 29, 2004 (in thousands):

	2005	2004
Land	\$ 11,412	\$ 11,412
Leasehold improvements	3,892	3,870
Equipment	4,837	4,175
Furniture	3,440	3,413
Capital projects in process	<u>32,846</u>	<u>6,048</u>
	56,427	28,918
Less accumulated depreciation	<u>(8,707)</u>	<u>(7,255)</u>
Property and equipment—net	<u>\$ 47,720</u>	<u>\$ 21,663</u>

In September 2002, The Endowment announced plans to relocate its principal facilities to a 6.5-acre site adjacent to the historic Terminal Annex building in downtown Los Angeles. To that end, The Endowment purchased land at a cost of \$11,411,900. The Endowment obtained a \$5,401,100 non-interest bearing note from the seller for a portion of the purchase price. The note, which is secured by the property, is due upon the seller complying with certain conditions of the purchase agreement, including vacating nearby premises.

The Endowment is in the process of building the facilities described above. The facilities will include a community conference center, as well as the principal offices of The Endowment. As of February 28, 2005, The Endowment has capitalized \$32,527,000 of expenses related to the building. The Endowment expects to move to the new facilities in the spring of 2006.

6. GRANTS PAYABLE

Grants payable are as follows at February 28, 2005 and February 29, 2004 (in thousands):

	2005	2004
Amounts due in:		
Less than one year	\$ 59,659	\$ 59,962
One year to five years	<u>37,079</u>	<u>39,417</u>
Gross grants payable	96,738	99,379
Less unamortized discount to present value	<u>(1,994)</u>	<u>(1,758)</u>
Grants payable—net	<u>\$ 94,744</u>	<u>\$ 97,621</u>

7. LONG-TERM DEBT

In December 2003, the California Statewide Communities Development Authority (the “Authority”) issued \$80,600,000 aggregate principal of Revenue Bonds, Series 2003 (the “Bonds”) resulting in \$84,756,000 in bond proceeds. Concurrent with the issuance, the Authority and The Endowment executed an agreement under which the Authority loaned The Endowment the bond proceeds. The loan, which is unsecured, accrues interest at rates ranging between 4% to 5.25% per annum. Interest only is

payable semiannually through January 2007. Thereafter, principal and interest are payable semiannually through July 2036. The Endowment capitalized interest of \$2,903,000, which is net of interest of \$1,456,000 earned on temporary investment of the bond proceeds for the year ended February 28, 2005.

Annual future principal payments under the loan agreement are as follows: 2008, \$1,225,000; 2009, \$1,275,000; thereafter, \$78,100,000.

The Endowment incurred \$1,177,000 of costs in connection with the financing. These costs, which have been deferred, are included in other assets in the accompanying statements of financial position and are being amortized over the loan term using the straight-line method. As of February 28, 2005, the balance in prepaid bond issuance related costs was \$1,135,000.

8. FUNDS HELD BY TRUSTEE

Funds held by trustee consist of unexpended proceeds from the Bonds and are primarily invested in Guaranteed Investment Contracts and money market funds. These amounts are restricted for the construction of a community conference center and other facilities for The Endowment in downtown Los Angeles (see Note 5), and for the payment of related capitalized interest and deferred financing costs.

9. COMMITMENTS AND CONTINGENCIES

The Endowment leases its office facilities and certain equipment under various agreements. Rental expense was approximately \$2,919,000 and \$3,088,000 for the fiscal years ended February 28, 2005 and February 29, 2004, respectively. Future minimum rental payments related to noncancelable operating leases as of February 29, 2005 are as follows (in thousands):

Year Ending February	
2006	\$ 2,905
2007	2,322
2008	2,039
2009	919
2010	926
Thereafter	<u>1,592</u>
Total minimum future rentals	<u>\$ 10,703</u>

In conjunction with The Endowment's building project, at February 28, 2005, The Endowment had a \$210,000 irrevocable standby letter of credit outstanding. The letter of credit is required by the City of Los Angeles; prior to issuance of a building permit, a developer shall either pay a fee to the Arts Development Fee Trust Fund, or guarantee to the satisfaction of the Cultural Affairs Department that an arts development fee project equal in value to the fee will be included in the development.

The Endowment is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of such matters will not have a material adverse effect on the financial position of The Endowment.

10. FEDERAL EXCISE TAXES

The Endowment is exempt from federal income taxes under Section 501(a) of the Internal Revenue Code ("IRC") as an organization described in Section 501(c)(3). The Endowment is subject to federal excise taxes imposed on private foundations at 2% or at 1% if certain conditions are met. The excise tax is imposed on net investment income, as defined under federal tax law, which includes interest and dividend income, and realized gains, net of investment expenses. Deferred excise taxes arise primarily from unrealized gains on investments and are calculated at the effective rate expected to be paid by The Endowment. At February 28, 2005 and February 29, 2004, \$12,685,000 and \$9,846,000 of deferred taxes was recorded, respectively.

11. DISTRIBUTION REQUIREMENTS

The Endowment is subject to distribution requirements of the IRC. Accordingly, it must distribute within one year after the end of each fiscal year, a minimum of 5% of net value of noncharitable-use assets, as defined. The assets that are to be included in the 5% distribution requirement are based on average monthly balances and are exclusive of those assets deemed to be held for charitable activities or program-related investments. In determining qualifying distributions, grant payments are considered on a cash basis and certain expenses are considered as qualifying distributions.

For the period March 1999 through February 2004, The Endowment exceeded the minimum distribution requirements by \$217 million. The IRC allows The Endowment to utilize all or some of this excess to meet future years' distribution requirements. Each fiscal year's excess distributions carryover expires after five years.

12. RETIREMENT PLAN

The Endowment maintains a qualified 401(k) Employee Investment Plan that provides for uniform employer contributions of 75 cents for every dollar contributed by a participant up to 6% of the participant's salary deferral contribution. The Endowment's contribution to this plan for the years ended February 28, 2005 and February 29, 2004 was \$450,000 and \$457,000, respectively.

The Endowment has a defined benefit cash balance plan (the "Plan") covering all employees with one year of service. The Plan is entirely funded by The Endowment, with benefits based on a percentage of each employee's annual compensation. The employees are vested 20% each year, with full vesting at the end of five years. Each employee's account is credited each year with an interest factor, the higher of 5.25% or the interest rate on 20-year Treasury Bonds. At retirement, employees are paid their accumulated amount in the Plan, either as an annuity or lump sum, at their election. Upon termination of service, employees may withdraw or roll over their vested accumulated cash balance.

The Endowment's funding policy is to contribute amounts to the Plan sufficient to meet the minimum funding requirements of the Employee Retirement Income Security Act, plus additional amounts as deemed to be appropriate. Contributions to the Plan are expected to be \$165,000 in fiscal year 2006.

In order to determine the expected long-term rate of return for the Plan, The Endowment considered historical performance of various asset classes, investment community forecasts, and current economic and market conditions.

The Plan investment policy allows assets to be allocated to various asset classes including international investments. The Plan assets are invested with a long-term focus to provide appropriate liquidity, as well as a reasonable rate of return while maintaining a prudent risk level.

The Endowment's year-end Plan weighted average asset allocations by category were:

	Target	2005	2004
Equity securities	70–80%	77 %	73 %
Debt securities	20–30	22	25
Other	0–5	1	2

The Endowment uses its fiscal year end as the measurement date for the Plan. The following table sets forth the Plan's funded status and amounts recognized in the statement of financial position at February 28, 2005 and February 29, 2004 (in thousands):

	2005	2004
Projected benefit obligation	\$ 4,392	\$ 3,567
Plan assets at fair value	<u>3,564</u>	<u>2,873</u>
Unfunded status	<u>\$ (828)</u>	<u>\$ (694)</u>
Accrued benefit liability recognized in the statement of financial position	<u>\$ (564)</u>	<u>\$ (272)</u>

Weighted-average assumptions used to determine benefit obligations at February 28, 2005 and February 29, 2004 are as follows:

	2005	2004
Discount rate	5.75 %	6.00 %
Rate of compensation increase	5.00	5.00

Weighted-average assumptions used to determine net periodic pension costs at February 28, 2005 and February 29, 2004 are as follows:

	2005	2004
Discount rate	6.00 %	6.25 %
Expected return on plan assets	7.50	7.50
Rate of compensation increase	5.00	5.00

Net periodic benefit cost, employer contributions, and benefits paid for fiscal years 2005 and 2004 are as follows (in thousands):

	2005	2004
Net periodic benefit cost	\$ 922	\$ 970
Employer contributions	630	1,366
Benefits paid	223	108

The accumulated benefit obligation for the Plan was \$3,915,000 and \$3,077,000 at February 28, 2005 and February 29, 2004, respectively.

The estimated future benefit payments are as follows:

Year Ending February	
2006	\$ 137,000
2007	263,000
2008	122,000
2009	139,000
2010	468,000
2011–2015	<u>2,118,000</u>
	<u>\$3,247,000</u>

In March 2002, The Endowment adopted a defined contribution Supplemental Executive Retirement Plan (“SERP”), which provides supplemental retirement benefits to certain key management employees and is funded solely from the general assets of The Endowment. SERP expense for the years ended February 28, 2005 and February 29, 2004 was \$73,000 and \$57,000, respectively.

In November 2002, The Endowment adopted a Section 457(b) Deferred Compensation Plan, which permits certain key management employees to make voluntary contributions on a pretax basis. Total compensation deferred for the years ended February 28, 2005 and February 29, 2004 was \$50,000 and \$57,000, respectively.

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