

# **Howard Hughes Medical Institute**

Consolidated Financial Statements  
for the years ended August 31, 2009 and 2008  
and report of Independent Auditors Thereon

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**Report of Independent Auditors**

The Trustees of the  
Howard Hughes Medical Institute:

In our opinion, the accompanying consolidated statements of financial position and the related consolidated statements of operations and changes in net assets and of cash flows present fairly, in all material respects, the financial position of the Howard Hughes Medical Institute (Institute) at August 31, 2009 and 2008, and the changes 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. These financial statements are the responsibility of the Institute's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

*PricewaterhouseCoopers LLP*

PricewaterhouseCoopers LLP  
October 22, 2009

HOWARD HUGHES MEDICAL INSTITUTE

Consolidated Statements of Financial Position  
August 31, 2009 and 2008

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(In thousands)

<u>Assets</u>	<u>2009</u>	<u>2008</u>
Cash and Cash Equivalents	\$ 725,268	\$ 141,983
Escrowed Bond Proceeds	29,915	60,378
Other Receivables		
Investment income and other	37,932	45,367
Currency receivables, swaps, and sales of investments	52,099	86,001
Investments	14,201,922	18,270,104
Securities Pledged as Collateral	100,961	2,178,766
Laboratory Space, Equipment, Buildings and Other Property, net	<u>865,385</u>	<u>835,936</u>
Total Assets	<u>\$ 16,013,482</u>	<u>\$ 21,618,535</u>
 <u>Liabilities</u>		
Accounts Payable and Accrued Expenses	\$ 109,258	\$ 51,115
Investment Purchases Payable, Swaps, Currency Payables and Other Payables	321,217	927,483
Repurchase Obligations	101,476	2,171,044
Grant Commitments	131,837	202,073
Post-Retirement/Employment Obligations	197,016	151,004
Capital Financing		
Note payable	40,376	40,376
Bonds payable	<u>1,260,000</u>	<u>660,000</u>
Total Liabilities	2,161,180	4,203,095
Net Assets	<u>13,852,302</u>	<u>17,415,440</u>
Total Liabilities and Net Assets	<u>\$ 16,013,482</u>	<u>\$ 21,618,535</u>

The accompanying notes are an integral part of these consolidated financial statements.

HOWARD HUGHES MEDICAL INSTITUTE

Consolidated Statements of Operations and Changes in Net Assets  
For the Years Ended August 31, 2009 and 2008

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(In thousands)

<u>Revenue</u>	<u>2009</u>	<u>2008</u>
Investment Earnings (Loss)		
Interest and Dividends, and Income from Non Publicly-Traded Investments	\$ 200,670	\$ 429,507
Realized (Loss)/Gain on Investment Sales, net	(655,134)	899,134
Unrealized Depreciation of Investments, net	(2,210,626)	(1,626,521)
Less - Expenses Incurred in the Production of Income:		
Investment management expenses	(90,194)	(114,682)
Interest expense	(3,655)	(51,139)
Net Investment Loss	(2,758,939)	(463,701)
Intellectual Property and Other Income	<u>7,896</u>	<u>5,323</u>
Total Loss	(2,751,043)	(458,378)
<u>Expenses</u>		
Program Activities		
Medical Research	696,669	561,441
Grants and Special Programs	29,186	123,548
Management and General	<u>86,240</u>	<u>74,234</u>
Total Expenses	<u>812,095</u>	<u>759,223</u>
Decrease in Net Assets	(3,563,138)	(1,217,601)
Net Assets, beginning of year	<u>17,415,440</u>	<u>18,633,041</u>
Net Assets, end of year	<u>\$ 13,852,302</u>	<u>\$ 17,415,440</u>

The accompanying notes are an integral part of these consolidated financial statements.

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HOWARD HUGHES MEDICAL INSTITUTE

Consolidated Statements of Cash Flows  
For the Years Ended August 31, 2009 and 2008

(In thousands)	<u>2009</u>	<u>2008</u>
Decrease in Net Assets	\$ (3,563,138)	\$ (1,217,601)
<u>To Reconcile Change in Net Assets to Net Cash Used</u> <u>in Operating Activities</u>		
Depreciation and Amortization	90,137	78,414
Loss on Disposal of Assets	2,048	3,093
Decrease in Receivables	16,371	28,020
Increase in Accounts Payable, Accrued Expenses, Commitments and Obligations	37,741	27,749
Net Depreciation/(Appreciation) of Investments		
Realized	655,134	(899,134)
Unrealized	<u>2,210,626</u>	<u>1,626,521</u>
Net Cash Used in Operating Activities	<u>(551,081)</u>	<u>(352,938)</u>
<u>Cash Flows From Investing Activities</u>		
Use of Escrowed Bond Proceeds	30,463	24,076
Purchases of Facilities, Leasehold Improvements, and Equipment	(121,634)	(116,730)
Proceeds from Sales of Investments	7,721,935	16,683,318
Purchases of Investments	<u>(5,026,830)</u>	<u>(17,216,165)</u>
Net Cash Provided by/(Used in) Investing Activities	<u>2,603,934</u>	<u>(625,501)</u>
<u>Cash Flows from Financing Activities</u>		
Repayment of Note Payable	-	(12,804)
Proceeds from Note Payable	-	3,414
Proceeds from Bond Issuance	600,000	-
Repayment of Repurchase Obligations	(2,069,568)	-
Proceeds From Repurchase Obligations	<u>-</u>	<u>1,025,430</u>
Net Cash (Used in)/Provided by Financing Activities	<u>(1,469,568)</u>	<u>1,016,040</u>
Net Increase in Cash	583,285	37,601
Cash and Cash Equivalents, beginning of year	<u>141,983</u>	<u>104,382</u>
Cash and Cash Equivalents, end of year	<u>\$ 725,268</u>	<u>\$ 141,983</u>

The accompanying notes are an integral part of these consolidated financial statements.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General - Howard Hughes Medical Institute ("HHMI" or the "Institute") was established for the purpose of promoting knowledge within the basic sciences, principally medical research and education, and the effective application of this knowledge for the benefit of humanity. The Institute conducts medical research in conjunction with hospitals and academic research institutions ("host institutions") under the terms of various agreements with these institutions. The agreements generally require the Institute to fund a portion of the construction cost, if any, and to pay occupancy charges for research space the Institute occupies within the host institution, and reimburse certain other costs. In return, the host institution provides laboratory and office space together with related maintenance & repairs, and a range of services including animal care, hazardous materials purchasing, management and disposal, and management of intellectual property created by Institute scientists. The Institute has contractual rights to occupy host institution facilities for periods ranging from five to forty years. In most cases, the Institute's obligation to pay occupancy charges is not fixed and will vary depending on the space occupied by investigators at the host institution.

In addition to its basic research activities the Institute funds grants to both institutions and individuals in support of a wide range of science and research-related initiatives, including precollege and undergraduate science education, pre- and post-doctoral research fellowships, and international research scholars. Grant awards to individuals are generally administered by the grantee's institution on behalf of the grantee. Grant awards to individuals located in the former Soviet Union are administered through an Institute office located in Moscow, Russia.

The consolidated financial statements include the accounts of the Institute's single member limited liability companies, which are used in connection with investment activities. All intra-company transactions and accounts have been eliminated.

Basis of Presentation - The accompanying financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. These principles require that management make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosures of contingencies at the dates of the financial statements, and reported revenues and expenses for the years then ended. Actual results could differ from those estimates.

Cash and Cash Equivalents - Cash and cash equivalents may include operating cash and both US and non-US currency held at the Institute's custodian bank for investment purposes and a daily operating sweep account that is invested in short-term interest-bearing marketable instruments with original maturities of less than three months. It also includes a program spending reserve account, which was created to provide spending flexibility and which contains the net proceeds of a \$600 million bond offering and approximately \$130 million from the sale of investments.

The total cash and cash equivalents maintained at various institutions exceeds the amount guaranteed by federal agencies and, therefore, bears some risk. The Institute has not experienced any loss due to this risk.

Short-term investments with maturities at dates of purchase of three months or less are classified as cash equivalents, except for those held in externally managed accounts. Cash equivalents include short-term US Treasury securities and other short-term, highly liquid investments that are carried at cost, which approximates fair value.

Escrowed Bond Proceeds - Escrowed bond proceeds are restricted to the construction and outfitting of an expansion of the Institute's headquarters located in Chevy Chase, Maryland. These funds are maintained in an interest-bearing account.

Restricted Funds - The Institute does not accept cash or other contributions. As a result, there are no restrictions on the net assets of the Institute.

Intellectual Property - The Institute receives licensing fees and royalty income in connection with the commercialization of intellectual property created by its scientists. Licensing fees and royalty income are recorded as revenue in the Consolidated Statements of Operations and Changes in Net Assets at the time of receipt.

In addition, the Institute may receive equity interests in startup companies formed to commercialize inventions created by its investigators. Such equity interests are held in the host institution's name for the benefit of HHMI until such time as the host institution disposes of that interest. HHMI generally cannot exercise control over this equity interest, and cannot either execute or block its sale. Valuations of these equity interests are generally provided by the host institution or management of the startup. Such values are highly subjective and may not be fully realized. As a result, revenue related to such equity interests is recorded only upon notification to HHMI by the host institution that its equity interest has been sold, and the Institute's share of the proceeds has been determined. No value for such equity interests is carried on the balance sheet.

Investments - The Institute's investment fund is its principal source of support. A majority of the Institute's spending is made under its medical research program in which it makes multi-year employment and spending commitments to its scientists, and a grants program in which it makes multi-year grant commitments for science education. These attributes of the Institute's mode of operation present the need to balance longer-term investment fund growth, stability of investment returns, and liquidity, for a significant part of the fund. The Institute's long-range investment goal is to manage the fund in a prudent manner that will fund the Institute's programs in perpetuity. Significant accounting policies related to investments are as follows:

1. Investment transactions are accounted for on a trade-date basis. Net realized and unrealized gains and losses are calculated using the average cost of investments and are recognized in the Consolidated Statements of Operations and Changes in Net Assets. Investment income, including interest, is accrued as earned. Dividend income is recorded on the ex-dividend date.
2. Publicly-traded investments are valued based on quoted market prices except for certain alternative investments such as private equity and commingled funds, for which the detailed composition of holdings, and therefore quoted market prices, may not be readily available.

3. The estimated fair value for private equity investments is determined by management after consideration of valuations provided by the external investment managers adjusted for receipts, disbursements, distributions, and management fees. The valuations for these alternative investments may involve estimates, appraisals, assumptions, and methods which are evaluated by internal investment management.
4. Investments in commingled funds for which detailed holdings information is not available, including those that may consist of publicly-traded securities, are carried at values provided by the managers and reviewed and approved by internal investment management.
5. The Institute uses various subsidiary entities to support its investment activities. All of the assets and liabilities of these subsidiary entities are included in these financial statements.
6. Derivatives, such as foreign currency forwards, futures, options and credit default swap contracts, are recorded at fair value with the resulting gain or loss recognized in the Consolidated Statements of Operations and Changes in Net Assets.

Laboratory Space, Equipment and Other Property - Costs of renovating laboratory space under lease from host institutions and leasehold improvements in excess of \$25,000 are capitalized and amortized over the lesser of the minimum lease term or the remaining appointment term of the investigator for whom renovations are being made. These terms may vary from less than five years to forty years. Buildings and equipment having a useful life of more than one year and a unit cost of at least \$25,000 and \$10,000, respectively, are capitalized. Interest paid on construction debt is capitalized as a component of the building cost. There is no interest cost associated with any renovations. Repair and maintenance costs are expensed as incurred.

Depreciation is computed using the straight-line method over the estimated useful lives as follows:

<u>Classification</u>	<u>Estimated Useful Life</u>
Equipment and furniture	5
Buildings	35

Grant Commitments - The Institute awards grants domestically and internationally for periods ranging from one to five years. For multi-year awards, grant commitments are recorded as expenses in the Consolidated Statements of Operations and Changes in Net Assets in the year the grant commitment is made, and the present value of the grant commitment liability is reflected in the Consolidated Statements of Financial Position. The discount rate used to arrive at the present value of future payments is based on the rates for US Treasury Notes with maturities in the years in which the payments will be made.

Self-Insurance - The Institute self-insures at varying levels for property and casualty risks. Third party insurance is purchased to cover individuals under Directors' and Officers' liability and fiduciary liability. The Institute also purchases workers' compensation insurance and commercial automobile liability coverage.

New Accounting Pronouncements - In March 2008, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133* ("SFAS 161"). The Statement requires enhanced disclosures about an entity's derivative and hedging activities to improve the transparency of financial reporting. The objective of the guidance is to provide users of financial statements with an enhanced understanding of how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for; and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The Statement applies to reporting periods beginning after November 15, 2008, and therefore will be effective for the Institute's year ended August 31, 2010. Management is reviewing the requirements of the Statement.

## 2. INVESTMENTS

In October 2006 the FASB issued Statement of Financial Accounting Standards No.157, *Fair Value Measurements* ("SFAS 157"). This statement, which is effective for the Institute's fiscal year ending August 31, 2009, defines fair value, establishes a framework for measuring fair value within generally accepted accounting principles ("GAAP"), and expands disclosures about fair value measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The measurement is applied to individual assets and liabilities, or to groups of assets or liabilities with common characteristics. Generally, for a financial instrument that trades in an active market, it is based on the quoted price for the individual instrument. Restrictions on the sale or use of an asset, such as a lockup period, may affect the values assigned.

The statement establishes a fair value hierarchy consisting of observable and unobservable inputs at three levels. Observable inputs are based on market data obtained from sources independent of the reporting entity; unobservable inputs are based on the best information available in the circumstances.

- Level 1 inputs consist of quoted prices in active markets for identical assets or liabilities.
- Level 2 inputs are from sources other than quoted prices that are observable for an asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates, and market corroborated inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3 inputs are unobservable inputs for the asset or liability. They have been used to measure fair value when observable inputs are not available, including situations in which there is little, if any, market activity for the asset or liability at the measurement date.

The availability of inputs relevant to the asset or liability and the reliability of the inputs determines the selection of appropriate valuation techniques. Valuation techniques applied to HHMI's investments include a combination of both observable and unobservable inputs. Where there is little, if any, market activity for the asset or liability at the measurement date, the best available information is used. Valuation techniques have been applied as considered appropriate to the circumstances and have been consistently applied. A change in a valuation technique or its application will be made only if the change results in a measurement that is more representative of fair value in the circumstances.

HOWARD HUGHES MEDICAL INSTITUTE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED AUGUST 31, 2009 AND 2008

The following tables present the financial instruments carried at fair value as of August 31, 2009 by the SFAS 157 valuation hierarchy defined above.

(In thousands)		Quoted	Other	Unobservable	Total Fair Value	
Assets	Market Prices	Observable	Inputs	Inputs	8/31/2009	8/31/2008
	(Level 1)	(Level 2)	(Level 3)	(Level 3)		
Operating cash and cash equivalents	\$ -	\$ 725,268	\$ -	\$ -	\$ 725,268	\$ -
Foreign exchange contracts	-	9,876	-	-	9,876	26,894
Repurchase obligations collateral	-	100,961	-	-	100,961	2,178,766
Investments						
Securities lending collateral	-	77,184	-	-	77,184	394,619
Cash and cash equivalents	324,884	414,211	45,838	-	784,933	2,593,288
Equity	3,619,459	-	538,132	-	4,157,591	5,985,079
Fixed income securities	-	1,595,437	4,106	-	1,599,543	734,409
Mutual funds	10,192	-	-	-	10,192	13,133
Preferred securities	66,682	-	10,240	-	76,922	46,227
Private equity	-	-	7,229,782	-	7,229,782	8,152,524
Convertible securities	-	36,285	-	-	36,285	44,819
Natural resources	-	-	101,841	-	101,841	118,938
Real estate	-	-	125,188	-	125,188	187,068
Other	2,461	-	-	-	2,461	-
Total investments	4,023,678	2,123,117	8,055,127	-	14,201,922	18,270,104
Deferred compensation plan mutual funds	-	10,283	-	-	10,283	8,608
Totals	\$ 4,023,678	\$ 2,969,505	\$ 8,055,127	-	\$ 15,048,310	\$ 20,484,372

  

(In thousands)		Quoted	Other	Unobservable	Total Fair Value	
Liabilities	Market Prices	Observable	Inputs	Inputs	8/31/2009	8/31/2008
	(Level 1)	(Level 2)	(Level 3)	(Level 3)		
Repurchase obligations	\$ -	\$ 101,476	\$ -	\$ -	\$ 101,476	\$ 2,171,044
Interest rate swaps payable	63,763	-	-	-	63,763	19,166
Investments:						
Short positions	198,292	341	-	-	198,633	789,141
Foreign exchange contracts	-	8,226	-	-	8,226	26,572
Options payable	332	-	-	-	332	702
Credit default swaps	99	-	-	-	99	1,532
Totals	\$ 262,486	\$ 110,043	\$ -	\$ -	\$ 372,529	\$ 3,008,157

HOWARD HUGHES MEDICAL INSTITUTE

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED AUGUST 31, 2009 AND 2008

The following table is a rollforward of instruments classified within Level 3 of the fair value hierarchy defined above:

(In thousands)

	Fair Value 9/1/2008	Realized/ Unrealized G/(L)	Net Acquisitions/ Dispositions	Transfers In/(Out)	Fair Value 8/31/2009
Cash and cash equivalents	\$ 10,960	\$ 91	\$ 34,718	\$ 69	\$ 45,838
Equity	741,810	(129,547)	(74,362)	231	538,132
Fixed income securities	1,197	(8)	2,917	-	4,106
Preferred securities	13,520	(3,280)	-	-	10,240
Private equity	8,139,159	(1,522,602)	613,225	-	7,229,782
Natural resources	118,938	(12,731)	(4,366)	-	101,841
Real estate	187,068	(79,582)	17,702	-	125,188
Totals	<u>\$ 9,212,652</u>	<u>\$ (1,747,659)</u>	<u>\$ 589,834</u>	<u>\$ 300</u>	<u>\$ 8,055,127</u>

For Level 3 holdings, changes in unrealized gains or losses relating to assets held during the year ended August 31, 2009 totaled approximately \$1.9 billion. These gains and losses are included in Unrealized Depreciation of Investments, net in the Statement of Operations and Changes In Net Assets.

Fair value for Level 3, which primarily consists of alternative investments (principally limited partnership interests in absolute return, hedge, private equity, real estate, and natural resources funds) is based on valuation techniques that use significant inputs that are unobservable. The fair values of the securities held by alternative investments that do not have readily determinable fair values are determined by the general partner, reviewed and approved by internal investment management and are based on historical cost, appraisals, pricing models, discounted cash flows or other estimates that require varying degrees of professional judgment. If no public market exists for the investment securities, the fair value is determined by the general partner or management taking into consideration, among other things, the cost of the securities, prices of recent significant placements of securities of the same issuer, risk inherent in the valuation techniques, risk inherent in the inputs to the valuation models, and subsequent developments concerning the companies to which the securities relate.

At August 31, 2009, approximately 84% of the Institute's holdings are domestic; no other single country exposure is greater than 3%.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED AUGUST 31, 2009 AND 2008**Receivables and Payables**

The Institute's investment receivables and payables as included in the Consolidated Statements of Financial Position as of August 31, 2009 and 2008 consist of the following:

(In thousands)	2009		2008	
	Receivable	Payable	Receivable	Payable
Short Sales	\$ -	\$ 198,633	\$ -	\$ 789,141
Securities Pending Settlement	38,588	30,681	45,457	78,445
Foreign Exchange Contracts	9,876	8,226	26,894	26,572
Interest Rate Swap Contracts	-	63,763	-	19,166
Management Fees	-	18,563	-	11,924
Federal Tax Receivable	3,619	-	12,556	-
Other	16	1,351	1,094	2,235
Total	<u>\$ 52,099</u>	<u>\$ 321,217</u>	<u>\$ 86,001</u>	<u>\$ 927,483</u>

**Commitments, Obligations and Other**

The Institute had loaned securities to third parties with a market value of approximately \$75 million and \$384 million at August 31, 2009 and 2008, respectively. In connection with the securities lending program, collateral must be maintained at 102% and 105% of the market value of domestic and foreign loaned securities, respectively. During the period securities are on loan all dividends and interest accrue to the third party. Collateral designated for the Institute's benefit by third parties is not in the custody of the Institute. Loaned securities and collateral, which may consist of cash or U.S. Treasuries, are marked to market daily. The value of collateral posted was \$77.2 million and \$394.6 million at August 31, 2009 and 2008, respectively. Income from securities lending activities totaled approximately \$1.9 million and \$3.6 million for fiscal years 2009 and 2008, respectively. The Institute has unfunded commitments of approximately \$3,039 million to fund investments in non-public entities as of August 31, 2009. These commitments are callable in varying increments over the term of the commitment, which could be up to 7 years.

The Institute has entered into repurchase obligations as part of its overall investment strategy to leverage its operational needs and changes in interest rates. These repurchase agreements and related collateral, which consists of US Treasury notes and bonds with maturity dates ranging from less than one to twenty one years, are reflected in the Consolidated Statement of Financial Position as Repurchase Obligations and Securities Pledged as Collateral. The Institute has the obligation to repurchase \$101 million and \$2,171 million of marketable securities for which the Institute had provided collateral of \$101 million and \$2,179 million to its counterparties as of August 31, 2009 and 2008, respectively.

Certain currency contracts described below are entered into by single-member Limited Liability Companies of the Institute. The Institute has issued a guarantee and commitment for one Limited Liability Company with a face value of \$25 million for the net settlement of trades by them.

The Institute incurred expenses in the production of investment income, which include routine internal operating expenditures, external management and incentive fees, custodial fees and interest expense related to the repurchase obligations mentioned earlier. These expenses, which are reflected in the Consolidated Statements of Operations and Changes in Net Assets, totaled \$93.8 million and \$165.1 million for the fiscal years ended August 31, 2009 and 2008, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED AUGUST 31, 2009 AND 2008**Derivatives**

The Institute invests in derivative financial instruments to control market risks, manage its portfolio exposure, reduce investment implementation costs, and enhance returns. Derivatives are recorded at fair value with the resulting gain or loss recognized in the Consolidated Statements of Operations and Changes in Net Assets. Most derivative trades are transacted with counterparties that are operating under master netting agreements. As a result of investing in derivative financial instruments, the Institute is exposed to potential credit-related losses in the event of nonperformance by counterparties. The Institute limits its exposure by evaluating the creditworthiness of potential counterparties before investing. In September 2008, one of the Institute's interest rate swap counterparties declared bankruptcy. As a result, the swap was terminated and reinstated with another counterparty.

Foreign currency forward contracts are over-the-counter contractual agreements primarily used to sell or buy certain amounts of foreign currencies as a means to control foreign exchange risk, and are actively traded for the purpose of exploiting opportunities for arbitrage in the foreign currency market. The notional value of open forward contract purchases and sales totaled approximately \$484 million and \$485.7 million, respectively, at August 31, 2009 and \$1,541 million and \$1,541 million, respectively, at August 31, 2008. The market value of these contracts was approximately \$150.5 million and \$104.4 million, respectively, at August 31, 2009 and \$150.8 million and \$96.8 million, respectively, at August 31, 2008.

Futures contracts are commitments to purchase or sell a financial instrument at a stated time and price in the future, usually for the purpose of increasing exposure to a specific market or to reduce risk. These contracts are settled daily to reflect the changes in their market values. As of August 31, 2009 and 2008, the Institute had entered into various exchange-traded contracts with notional exposures at fair values as follows:

(In thousands)	2009		2008	
	Buy	Sell	Buy	Sell
Equity Indexes	\$ 29,181	\$ 9,450	\$ 198,064	\$ 164,456
Commodities	14,961	3,927	10,708	2,852
Fixed Income	514,882	74,913	2,048,332	243,583
Total	<u>\$ 559,024</u>	<u>\$ 88,290</u>	<u>\$ 2,257,104</u>	<u>\$ 410,891</u>

Option contracts are typically contractual agreements to buy or to sell an underlying security or index at a fixed price. The Institute uses options as a means to increase exposure to a specific market or to decrease market risk. The notional amount of open purchased option contracts as of August 31, 2009 was \$838.8 million. The notional amounts of open written contracts was \$10.2 million and \$12.1 million as of August 31, 2009 and 2008, respectively.

Credit default swap contracts are used as a means to transfer credit risk of fixed income securities. Credit default swaps notional and unrealized loss reflecting the market value of the swaps were \$82.3 million and \$0.1 million, respectively at August 31, 2009. Credit default swaps notional and unrealized loss reflecting the market value of the swaps were \$70 million and \$1.5 million, respectively at August 31, 2008.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED AUGUST 31, 2009 AND 2008

## 3. LABORATORY SPACE, EQUIPMENT AND OTHER PROPERTY

The cost and accumulated amortization and depreciation of the Institute's investment in laboratory space, equipment and other property at August 31, 2009 and 2008 are as follows:

(In thousands)	2009	2008
Laboratory space and leasehold improvements	\$ 418,757	\$ 416,765
Equipment, furniture and fixtures	432,040	379,703
Buildings	557,631	539,111
Land	87,358	87,109
	1,495,786	1,422,688
Accumulated amortization and depreciation	(696,101)	(619,766)
Net book value	799,685	802,922
Construction in Progress	65,700	33,014
Total	\$ 865,385	\$ 835,936

Construction in progress represents costs of \$9.2 million incurred in connection with the completion of the Janelia Farm Research Campus, and \$56.5 million in connection with the expansion of the Institute's headquarters building in Chevy Chase, Maryland. Construction in progress includes capitalized interest of approximately \$2.8 million related to the headquarters expansion project. Expected total renovation and construction costs for the headquarters expansion are approximately \$83.5 million.

Approximately \$6.3 million and \$4.6 million related to the construction at the Headquarters and Janelia Farm campuses, equipment, and other property was included in Accounts Payable and Accrued Expenses at August 31, 2009 and 2008, respectively.

## 4. ECONOMIC DEVELOPMENT BONDS PAYABLE

On February 27, 2003, the Institute issued \$500 million in tax-exempt bonds through Loudoun County, Virginia to finance construction of the Janelia Farm Research Campus. The bonds carry a variable interest rate determined on a weekly basis and mature on February 15, 2038. Concurrently, the Institute entered into receive-variable, pay-fixed interest rate swaps with a total notional amount of \$450 million. The interest rate swaps were entered into with several counterparties and have terms of 10 and 30 years. The net composite interest rate on the bonds and interest rate swaps for the fiscal years ended August 31, 2009 and 2008 was 3.05% and 3.04% respectively. The interest expense for the fiscal years ended August 31, 2009 and 2008 was \$15.4 million and \$15.3 million respectively, which approximates the net cash paid. The unrealized loss reflecting the market value of the swaps was \$33.5 million at August 31, 2009, which is included in Investment Purchases Payable, Swaps, and Currency Payables in the Consolidated Statements of Financial Position. As described more fully in Note 13, subsequent to August 31, 2009, a receive-variable pay-fixed 30-year interest rate swap was entered into with a single counterparty for the remaining bonds.

On February 15, 2008, the Institute issued \$83.5 million in tax-exempt bonds through the Maryland Economic Development Corporation ("MEDCO") to finance the expansion of the Institute's existing headquarters and conference facilities. The bonds carry a variable interest rate determined on a weekly basis and mature on February 15, 2043. At issuance the funds were transmitted to the Trustee, and resulted in an increase in escrowed bond proceeds of \$83.5 million. The Institute entered into a receive-variable, pay-fixed interest rate swap with a total notional amount of \$83.5 million. The interest rate swap was entered into with a single counterparty with a term of 30 years. The net composite interest rate on the bonds and interest rate swap for the fiscal years ended August 31, 2009 and 2008 was 3.23% and 3.31% respectively. The interest expense for the fiscal years ended August 31, 2009 and 2008 was \$2.9 million and \$1.7 million respectively, which approximates the net cash paid. The unrealized loss reflecting the market value of the swap was \$9.4 million at August 31, 2009, which is included in Investment Purchases Payable, Swaps, and Currency Payables in the Consolidated Statements of Financial Position.

On May 15, 2008, the Institute issued \$76.5 million of bonds through MEDCO to refund \$76.5 million of outstanding bonds issued on November 8, 1990 to finance the construction of the Institute's headquarters and conference center complex. The bonds issued in 2008 carry a variable interest rate determined on a weekly basis, and mature on May 15, 2043. The Institute has entered into a receive-variable, pay-fixed interest rate swap with a total notional amount of \$76.5 million. The swap is with a single counterparty and has a remaining term of 27 years. The net composite interest rate on the bonds and interest rate swap for the fiscal years ended August 31, 2009 and 2008 was 3.61% and 3.31%, respectively. The interest expense for each of the fiscal years ended August 31, 2009 and 2008 was \$2.8 million respectively, which approximates the net cash paid. The unrealized loss reflecting the market value of the swaps was \$10.8 million at August 31, 2009, which is included in Investment Purchases Payable, Swaps, and Currency Payables in the Consolidated Statements of Financial Position.

Prior to the maturity of each of these tax-exempt bond issues, the Institute is obligated upon seven-day notice from a holder to redeem any or all bonds unless the remarketing agent is able to place the bonds with another party. To date, no remarketing agent has failed to fulfill their obligations under their respective remarketing agreements. The Institute maintains sufficient cash and marketable securities to pay any bondholder redemption of part or all of the \$660 million outstanding.

## 5. BONDS PAYABLE

On August 12, 2009, the Institute issued \$600 million of taxable fixed rate bonds to establish a program spending reserve. The bonds mature in five years and carry an interest rate of 3.45%. Interest is payable semi-annually in March and September. The effective interest rate on the bonds is 3.52%. Interest expense for the fiscal year ended August 31, 2009 was \$0.8 million and is included in Accounts Payable and Accrued Expenses.

## 6. NOTES PAYABLE

On August 14, 2007, the Institute renewed a promissory note for \$15 million with monthly interest payments based on the one-month LIBOR rate plus 0.1%, to finance the expansion of its headquarters and conference center complex. All principal and any unpaid accrued interest were

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paid in February 2008 from the proceeds of the \$83.5 million bond offering and the note was cancelled. The interest expense for the fiscal year ended August 31, 2008 was \$300,000, which approximates the cash paid.

In June 2003, the Institute entered into a 1-year renewable promissory note to finance the commercially-used land and buildings at the Janelia Farm Research Campus that could not be financed with tax-exempt debt. In June 2009, the Institute renewed the note, which has a current balance of \$40.4 million and carries monthly interest payments based on the one-month LIBOR rate plus 0.85%. In May 2005 the Institute entered into a receive-variable, pay-fixed interest rate swap with a total notional amount of \$40.4 million. The interest rate swap is with a single counterparty and has a term of 7 years. The net composite interest rate on the note and interest rate swap was 4.65% and 4.59% for the fiscal years ended August 31, 2009 and 2008 respectively. The unrealized loss reflecting the market value of the swap was \$3.1 million at August 31, 2009, which is included in Investment Purchases Payable, Swaps, and Currency Payables in the Consolidated Statements of Financial Position. Interest expense for the fiscal years ended August 31, 2009 and 2008 was \$2 million and \$1.9 million respectively, which approximates the cash paid.

Net bond and note interest paid in cash was approximately \$23.9 million and \$21.7 million for the years ended August 31, 2009 and 2008, respectively.

## 7. COMMITMENTS AND CONTINGENCIES

The Institute occupies space at various host institutions for medical research. The Institute's agreements with its host institutions include provisions for the annual payment of utilities and other space charges. Most of these agreements are for an indefinite term, others contain renewal options for periods of 5 to 10 years. Minimum annual rents under these agreements generally are not fixed and vary from year to year depending on the number of investigators at the host institution and the length of their remaining terms.

Laboratory and other space charges, excluding amortization of leasehold improvements, totaled \$81.6 million and \$66.8 million for the years ended August 31, 2009 and 2008, respectively.

Estimated minimum annual rent and other payments due under these agreements as of August 31, 2009 are summarized below:

(In thousands)	
<u>Year</u>	
2010	\$ 83,469
2011	82,854
2012	82,316
2013	82,316
2014	82,090
2015 - 2030	176,151
Total	<u>\$ 589,196</u>

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The timing of the Institute's grant payments and the associated discount is presented below:

(In thousands )	
<u>Year</u>	
2010	\$ 79,196
2011-2014	<u>55,920</u>
Total	135,116
Discount	<u>(3,279)</u>
Net Liability	<u>\$ 131,837</u>

8. EMPLOYEE BENEFITS

Defined Contribution Retirement Plans - The Institute contributes to defined contribution retirement plans offered through the Teachers Insurance and Annuity Association ("TIAA"), College Retirement Equity Fund ("CREF"), and Vanguard Funds for substantially all of its employees. The Institute's contributions to these plans were \$21.4 million and \$18.7 million for the years ended August 31, 2009 and 2008, respectively.

Deferred Compensation Plan - The Institute has an unfunded deferred compensation plan in accordance with Section 457(b) of the Internal Revenue Code. The fair value of the assets and related liability to employees in the amount of approximately \$10.3 million and \$8.6 million at August 31, 2009 and 2008 respectively, is reflected in the Consolidated Statements of Financial Position within Other Receivables and Accounts Payable and Accrued Expenses.

9. POSTRETIREMENT AND POSTEMPLOYMENT BENEFITS

The Institute maintains unfunded defined postretirement and postemployment benefit plans that provide eligible retirees with medical, prescription drug, vision, dental, life insurance and disability programs. The total obligation for these benefits reflected in the Consolidated Statements of Financial Position was \$197 million and \$151 million at August 31, 2009 and 2008, respectively.

The following tables summarize the postretirement plan's funded status and the amount of the accumulated postretirement benefit plan costs for the years ended August 31, 2009 and 2008:

(In thousands)	2009	2008
Accrued Benefit Liability:		
Accumulated postretirement benefit obligation, beginning of year	\$ 148,385	\$ 160,158
Service cost	8,781	9,696
Interest cost	10,266	10,301
Employee contributions	71	77
Benefits paid net of contributions	(3,379)	(3,227)
Net actuarial (gain)/loss	29,601	(29,577)
Medicare subsidies received	114	94
Net adjustment for prior year actual premiums & rebates	694	863
Accumulated benefit obligation, end of year	<u>\$ 194,533</u>	<u>\$ 148,385</u>

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	2009	2008
Change in fair value of plan assets:		
Fair value of plan assets, beginning of year	\$ -	\$ -
Medicare subsidies received	114	94
Employer direct benefit payments	3,308	3,150
Employee contributions	71	77
Employer contributions less subsidy received	(114)	(94)
Benefits paid	<u>(3,379)</u>	<u>(3,227)</u>
Fair value of plan assets, end of year	<u>\$ -</u>	<u>\$ -</u>

	2009	2008
Reconciliation of funded status:		
Funded status	\$ (194,533)	\$ (148,385)
Unrecognized actuarial (gain)/loss	N/A	N/A
Unrecognized transition (asset)/obligation	N/A	N/A
Unrecognized prior term cost	<u>N/A</u>	<u>N/A</u>
Accumulated postretirement benefit liability included in the Consolidated Statements of Financial Position	<u>\$ (194,533)</u>	<u>\$ (148,385)</u>

The Institute's policy is to fund postretirement benefits as payments are made.

	2009	2008
Components of net periodic benefit cost:		
Term/service cost	\$ 8,781	\$ 9,696
Interest cost	10,266	10,301
Immediate recognition of net actuarial (gain)/loss	<u>29,601</u>	<u>(29,577)</u>
Net periodic benefit cost/(income)	<u>\$ 48,648</u>	<u>\$ (9,580)</u>

The Institute's policy is to immediately recognize all actuarial gains and losses; consequently there are no amounts not recognized in net periodic benefit cost. Because all gains and losses are recorded in the current period there are no amounts currently to be amortized from net assets into net periodic benefit cost for the year ended August 31, 2010.

The net periodic benefit cost for the postretirement benefit plan was \$48.6 million for the year ended August 31, 2009. The net periodic benefit income for the postretirement benefit plan was \$9.6 million for the year ended August 31, 2008. The discount rate assumed in determining the actuarial present value of accumulated postretirement benefit obligations was 6.5% and 7% as of August 31, 2009 and 2008, respectively. The average health care cost trend rate assumption used to determine the accumulated postretirement benefit obligation at August 31, 2009 was 8.25% for fiscal year 2010 and decreases each successive year until it reaches 4.5% in fiscal year 2029. A one percent increase in each year of this annual trend rate would increase the accumulated postretirement benefit obligation at August 31, 2009 by approximately \$33.7 million. A one percent decrease in the trend rate would decrease the accumulated postretirement benefit obligation at August 31, 2009 by approximately \$27.3 million.

Health insurance is provided to disabled employees until the age of sixty-five. This postemployment benefit cost was \$267,000 and income of \$500,000 for the years ended August 31, 2009 and 2008, respectively.

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Under the provisions of the Medicare Prescription Drug, Improvement, and Modernization Act, the Institute is eligible for a 28% subsidy from Medicare on its prescription drug benefits for Medicare-eligible retirees. The Medicare subsidy was reflected in the obligation as of August 31, 2009.

The postretirement benefits that are expected to be paid out under the plan in each of the next five fiscal years, which reflects expected future service, and in the aggregate for the five fiscal years thereafter, together with the related Medicare subsidy, are as follows:

(In thousands)	Expected Benefit	Expected Medicare
Year	Payments	Subsidy
2010	\$ 4,126	\$ 229
2011	5,002	281
2012	5,951	342
2013	7,047	415
2014	8,153	497
2015- 2019	62,017	4,018

#### 10. FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of cash and cash equivalents and receivables approximate fair value due to the short maturity of these financial instruments. Investments are reported at fair value as of the date of the consolidated financial statements. The carrying amounts of accounts payable, accrued payroll and related accruals approximate fair value due to their short maturity. The carrying amounts of notes and bonds payable with variable interest rates approximate their fair value because the variable rates reflect current market rates for bonds with similar maturities and credit quality.

#### 11. TAXES

Tax refunds received on income totaled approximately \$5.6 million for the year ended August 31, 2009. Taxes paid on income totaled approximately \$1.3 million and \$14.8 million for the years ended August 31, 2009 and 2008, respectively.

#### 12. MEDICAL RESEARCH ORGANIZATION

The Institute is classified as a medical research organization for federal income tax purposes under section 170 (b)(1)(A)(iii) of the Internal Revenue Code of 1986, as amended (the "Code"). Consequently, the Institute is not a private foundation under Chapter 42 of the Code.

#### 13. SUBSEQUENT EVENTS

On October 2, 2009 the Institute issued \$23 million of tax-exempt bonds through the Industrial Development Authority of Loudoun County, Virginia to finance the construction of a 60-unit

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apartment building at the Janelia Farm Research Campus, to be used by scientists and others engaged in research and administration at the Campus. The bonds carry a variable interest rate determined on a weekly basis and mature on October 1, 2039. For these bonds and the remaining balance of \$50 million of Loudoun County Industrial Development Authority bonds described in Note 4, the Institute entered into receive-variable, pay-fixed interest rate swap at a rate of 2.75% with a total notional amount of \$73 million effective October 1, 2009. The interest rate swap was executed with one counterparty and has a term of 30 years.