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Affairs of the Association

Financial Report

SPROUSE AND ANDERSON, L.L.P.
Accountants and Consultants

To the Members of
The Texas State Historical Association

Independent Auditors' Report

We have audited the accompanying statements of financial position of the Texas State Historical Association (Association) as of August 31, 2005 and 2004 and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the Association'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 audits 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 Association's internal control over financial reporting. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, the financial statements referred to above present fairly, in all material respects, the financial position of the Association as of August 31, 2005 and 2004, and the results of its activities and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

Sprouse & Anderson, L.L.P.

December 9, 2005

Austin, Texas

TEXAS STATE HISTORICAL ASSOCIATION
STATEMENT OF FINANCIAL POSITION
AUGUST 31, 2005 and 2004

	ASSETS	
	<u>2005</u>	<u>2004</u>
Cash and cash equivalents	\$ 367,301	\$ 204,664
Investments	3,520,290	4,410,253
Receivables	69,285	100,794
Pledge receivable, net of an allowance for doubtful accounts of \$-0- and \$7,720	-	75,000
Inventory	349,146	378,484
Prepaid expenses	128,520	10,983
Fixed assets, net	145,245	212,860
Endowment investments	1,871,464	1,654,529
The Handbook of Texas Online:		
A Digital Gateway to Texas History	<u>-</u>	<u>-</u>
TOTAL ASSETS	<u>\$6,451,251</u>	<u>\$7,047,567</u>
	LIABILITIES AND NET ASSETS	
LIABILITIES		
Accounts payable and accrued expenses	\$ 98,531	\$89,459
Capital lease obligation	<u>45,056</u>	<u>69,110</u>
Total Liabilities	143,587	158,569
NET ASSETS		
Unrestricted Net Assets		
Board designated:		
Endowment/general	1,855,077	1,961,254
Publication fund	<u>898,074</u>	<u>921,107</u>
Handbook endowment	114,868	112,170
Total Board Designated	<u>2,868,019</u>	<u>2,994,531</u>
Unrestricted, undesignated	-	187,519
Total Unrestricted Net Assets	3,182,050	3,182,050
Temporarily restricted	<u>1,568,181</u>	<u>2,052,419</u>
Permanently restricted	1,871,464	1,654,529
TOTAL NET ASSETS	<u>6,307,664</u>	<u>6,888,998</u>
TOTAL LIABILITIES AND NET ASSETS	<u>\$6,451,251</u>	<u>7,047,567</u>

TEXAS STATE HISTORICAL ASSOCIATION STATEMENT OF ACTIVITIES FOR THE YEARS ENDED AUGUST 31, 2005 AND 2004

		2005		2004	
		Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES					
Publication and other sales	\$ 173,464	\$ 88,971	\$ -	\$ 118,744	\$ 278,186
Investment income	303,749	169,616	200	146,862	432,647
Contributions	109,674	61,396	10,000	37,613	77,601
Association activities	58,859	-	-	-	54,931
Membership income	80,143	-	-	-	109,080
Educational activities	42,183	-	-	-	136,625
Contributed services	417,900	-	-	105,162	441,444
Philosophical Society	38,269	-	-	-	-
Awards	2,711	-	4,339	-	-
Net assets released from donor and program restrictions	585,323	(585,323)	-	(858,156)	-
TOTAL REVENUES	1,812,275	(265,340)	14,539	(449,775)	1,530,514
EXPENSES					
Program Services:					
Digital Gateway	297,427	-	-	-	202,578
Handbook production	203,296	-	-	-	305,578
Publications	578,533	-	-	-	602,328
<i>Southwestern Historical Quarterly</i>	143,227	-	-	-	136,215
Educational activities	229,478	-	-	-	164,596
Association activities	76,162	-	-	-	59,840
Awards	16,607	-	-	-	14,182
Fundraising	33,211	-	-	-	75,163
General and administrative	564,867	-	-	-	458,844
TOTAL EXPENSES	2,142,808	-	-	-	2,019,324
CHANGE IN NET ASSETS	(330,533)	(265,340)	14,539	(449,775)	(488,810)
CHANGE IN DONOR DESIGNATIONS	16,502	(218,898)	202,396	-	-
BEGINNING NET ASSETS	3,182,050	2,052,419	1,654,529	2,502,194	7,377,808
ENDING NET ASSETS	\$2,868,019	\$1,568,181	\$1,871,464	\$2,502,419	\$6,888,998

See Accompanying Notes to Financial Statements

See Accompanying Notes to Financial Statements
 TEXAS STATE HISTORICAL ASSOCIATION
 STATEMENT OF CASH FLOWS
 FOR THE YEARS ENDED AUGUST 31, 2005 and 2004

CASH FLOWS FROM OPERATING ACTIVITIES

	<u>2005</u>	<u>2004</u>
Change in net assets	\$ (581,334)	\$(488,810)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation expense	79,379	40,948
Bad debt expense	-	1,070
Net gains and losses on investments	(302,105)	(253,554)
Decrease receivables	31,509	(21,849)
Increase (decrease) in inventory and prepaid expenses	(88,199)	266,760
Decrease in pledge receivables	75,000	341,107
Increase (decrease) in accounts payable and other liabilities	<u>9,072</u>	<u>(2,175)</u>

NET CASH USED BY OPERATING ACTIVITIES

(776,678) (72,805)

CASH FLOWS FROM INVESTING ACTIVITIES

Purchases of fixed assets	(11,764)	(87,894)
Proceeds from sales of investments	4,451,478	2,335,105
Purchases of investments	<u>(3,476,345)</u>	<u>(2,638,799)</u>

NET CASH PROVIDED BY (USED BY)
INVESTING ACTIVITIES

963,369 (391,588)

CASH FLOWS FROM FINANCING ACTIVITIES

Principal payments under capital lease obligation	<u>(24,054)</u>	<u>(10,221)</u>
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NET CASH USED BY FINANCING ACTIVITIES

(24,054) (10,221)

NET INCREASE (DECREASE) IN CASH
AND CASH EQUIVALENTS

162,637 (474,614)

CASH AND CASH EQUIVALENTS
AT BEGINNING OF YEAR

204,664 679,278

CASH AND CASH EQUIVALENTS
AT END OF YEAR

\$ 367,301 \$204,664

CASH PAID FOR INTEREST

\$ 4,959 \$ 2,069

NON-CASH TRANSACTIONS

Purchase of software under capital lease obligation	<u>\$ -</u>	<u>\$ 79,331</u>
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See Accompanying Notes to Financial Statements

TEXAS STATE HISTORICAL ASSOCIATION
NOTES TO FINANCIAL STATEMENTS
AUGUST 31, 2005 and 2004

NOTE 1—*Organization and Summary of Significant Accounting Policies*

Organization

The Texas State Historical Association (the Association) is a nonprofit organization formed in 1897. The Association's purpose, as expressed in its bylaws, is to foster the appreciation, understanding and teaching of the rich and unique history of Texas through programs and activities to encourage and promote research, preservation and publication of historical material affecting the State of Texas.

Basis of Presentation

The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. Net assets and revenues, expenses, gains, and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets of the Association and changes therein are classified and reported as follows:

Unrestricted Net Assets—Net assets that are not subject to donor-imposed stipulations.

Temporarily Restricted Net Assets—Net assets subject to donor-imposed stipulations that may or will be met, either by actions of the Association and/or the passage of time. When a restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restrictions.

Permanently Restricted Net Assets—Net assets subject to donor-imposed stipulations that may be maintained permanently by the Association. Generally, the donors of these assets permit the Association to use all or part of the income earned on any related investments for general or specific purposes.

Contributions and Membership Fees

Contributions, including unconditional promises to give, are recorded as made. All contributions are available for unrestricted use unless specifically restricted by the donor. Membership fees are recorded as income in the year in which the fees are received.

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 certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Cash and Cash Equivalents

For purposes of the statement of cash flows, the Association considers all unrestricted cash and other highly liquid investments with initial maturities of three months or less to be cash equivalents.

Investments

The Association follows Statement of Financial Accounting Standards (SFAS) No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. Under SFAS No. 124, investments in marketable securities with readily determinable fair values and all debt securities are valued at their fair value in the statement of financial position with any realized or unrealized gains and losses reported in the statement of activities.

Inventory

Inventory includes various publications and books. Inventory is accounted for under the first-in, first-out (FIFO) method and carried at the lower of cost or market value.

Fixed Assets

Fixed assets are recorded at cost or at estimated fair value. The Association follows the practice of capitalizing all expenditures for equipment in excess of \$100. Depreciation is provided using the straight-line method over the five to seven years estimated useful lives of the assets.

NOTE 1—*Organization and Summary of Significant Accounting Policies (continued):**Income Taxes*

The Association is exempt from Federal income taxes under Internal Revenue Code Section 501(c)(3) and therefore has made no provision for Federal income taxes.

Functional Allocation of Expenses

The costs of providing the Association's various programs and supporting services have been summarized on a functional basis in the statement of activities. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

Contributed Facilities and Services

Contributed facilities and services are recorded at estimated fair value. Contributed facilities are provided on a month-to-month basis and amounted to \$105,086 and \$110,116 for the years ended August 31, 2005 and 2004, respectively. Contributed services are reflected in the financial statements at the fair value of the services received. The contributions of services are recognized if the services received (a) create or enhance non-financial assets or (b) require specialized skills that are provided by individuals possessing those skills and would typically need to be purchased if not provided by donation. Professional services and goods include the value of services donated by the University of Texas amounting to \$417,900 and \$441,444 for the years ended August 31, 2005 and 2004 respectively.

Change in Accounting Estimate

In fiscal year 2004, the Board adopted a policy for the monitoring of inventory obsolescence. This policy states:

For the first three fiscal years, commencing as of the August 31st subsequent to the date of publication or purchase, the Association will value each publication held for sale at cost.

Commencing at August 31 of the fourth year and for each of the next two successive fiscal years then ended since original publication or purchase, the original cost of each publication remaining in inventory and held for sale will be reduced by twenty-five percent (25%) each year. As of August 31st of the seventh fiscal year then ended and years thereafter, the publication will be valued at the lower of its cost or \$2.00.

As a result of this policy, inventory in the amount of \$223,169 was written down in fiscal year 2004.

Expenses for Digital Gateway

All costs incurred under the Digital Gateway to Texas History Program are expensed as incurred. As such, no items were capitalized under this program.

NOTE 2—*Investments*

Investments consist of the following as of August 31:

	2005	2004
Fixed income securities	\$1,723,190	\$1,921,046
Equity securities	3,668,564	4,143,736
Total	<u>\$5,391,754</u>	<u>\$6,064,782</u>
Investments	\$3,520,290	\$4,410,253
Endowment investments	\$1,871,464	\$1,654,529
Total	<u>\$5,391,754</u>	<u>\$6,064,782</u>

Investment income includes the following as of August 31:

	2005	2004
Investment earnings	\$171,460	\$179,093
Net gains and losses	<u>\$302,105</u>	<u>\$253,554</u>
	<u>\$473,565</u>	<u>\$432,647</u>

Investment expenses were approximately \$45,000 and \$53,000 for the years ended August 31, 2005 and 2004, respectively.

NOTE 3—*Pledges Receivable*

Pledges receivable are as follows:

	<u>2004</u>
Receivable in less than one year	\$82,720
Less allowance for doubtful accounts	<u>\$ (7,720)</u>
Total	<u>\$75,000</u>

The Association had no outstanding pledges receivable as of August 31, 2005.

The discount rate used on long-term promises to give was 5.5%.

NOTE 4—*Fixed Assets*

Fixed assets consist of the following at August 31:

	<u>2005</u>	<u>2004</u>
Equipment	\$347,983	\$365,591
Less accumulated depreciation	<u>(202,738)</u>	<u>(152,731)</u>
	<u>\$145,245</u>	<u>\$212,860</u>

Depreciation expense was \$79,379 and \$40,948 for the years ending August 31, 2005 and 2004, respectively.

NOTE 5—*Capital Lease*

The Association is obligated under a capital lease for software. At August 31, 2004, the software is included in the statement of position under fixed assets with a value of \$79,331 and accumulated depreciation of \$30,851. The following is a schedule of future minimum lease payments under the capital lease, together with the net present value of all minimum lease payments as of August 31, 2005:

	2006	29,012
	2007	<u>19,528</u>
Total minimum lease payments		48,540
Less: Amounts representing interest		<u>(3,484)</u>
Total capital lease obligation		<u>\$ 45,056</u>

NOTE 6—*Temporarily Restricted Net Assets*

Temporarily restricted net assets are available for the following purposes:

	<u>2005</u>	<u>2004</u>
Awards	\$165,050	\$200,121
Educational Activities	61,562	54,425
Publication of the Revised Handbook of Texas	1,116,309	1,265,342
Publications	146,374	325,354
Digital Gateway	30,000	179,979
Academic Research Program Activities	<u>48,886</u>	<u>27,198</u>
Temporarily Restricted Net Assets	<u>\$1,568,181</u>	<u>\$2,502,194</u>

NOTE 7—*Permanently Restricted Net Assets*

Permanently restricted net assets are restricted to investments in perpetuity, the income from which is expendable to support:

	2005	2004
Awards	\$196,046	\$109,019
Educational Activities	57,500	50,000
Publication of the Revised Handbook of Texas	553,636	441,427
Publications	64,282	54,083
Directorship	<u>1,000,000</u>	<u>1,000,000</u>
Permanently Restricted Net Assets	<u>\$1,871,464</u>	<u>\$1,654,529</u>

The Fred Rider Cotten Popular History Publications Fund requires 5% of investment income to be reinvested in the endowment fund each year with the remaining 95% available to support activities in temporarily restricted net assets.

NOTE 8—*401(k) Plan*

The Association adopted a 401(k) Plan effective March 1, 1998. All employees are eligible to participate in the plan. Upon completion of one year of service with the Association and attainment of age 18, the employee is eligible to receive the employer contribution. Employees may elect to withhold the maximum percentage allowable by the applicable Internal Revenue Codes. The Association will match 100% of employee contributions up to 7.5% of the employee's annual compensation. The Association may also, at its discretion contribute additional amounts to the plan. Vesting occurs as follows:

Years of Service	Percent Vested
2	25%
3	50%
4	75%
5	100%

Employees become automatically fully vested in the plan upon normal retirement age, early retirement age, disability, death, and termination of the plan. The Association contributed \$25,452 and \$14,669 to the plan for the years ended August 31, 2005 and 2004, respectively.

NOTE 9—*Expenses*

Contributed facilities and services are included in the expenses by function in the statement of activities as follows:

	2005		
	Paid by the Association	Contributed Facilities and Services	Total
Program Services:			
Digital Gateway	\$ 249,261	\$ 48,166	\$ 297,427
Handbook production	154,501	48,795	203,296
Publications	480,612	97,921	578,533
<i>Southwestern Historical Quarterly</i>	97,444	45,783	143,227
Educational activities	146,078	83,400	229,478
Association activities	74,059	2,103	76,162
Awards	16,607	-	16,607
Fundraising	29,006	4,205	33,211
General and administrative	477,340	87,527	564,867
Total expenses	<u>1,724,908</u>	<u>417,900</u>	<u>2,142,808</u>

	2004		
	Paid by the Association	Contributed Facilities and Services	Total
Program Services:			
Digital Gateway	\$ 202,578	\$ -	\$ 202,578
Handbook production	200,416	105,162	305,578
Publications	531,382	70,946	602,328
<i>Southwestern Historical Quarterly</i>	89,297	46,918	136,215
Educational activities	112,232	52,364	164,596
Association activities	54,033	5,807	59,840
Awards	14,182	-	14,182
Fundraising	75,163	-	75,163
General and administrative	298,597	160,247	458,844
Total expenses	<u>1,577,880</u>	<u>441,444</u>	<u>2,019,324</u>

NOTE 10—*Change in Donor Restrictions*

The Association obtained additional information from various donors regarding the intent and restriction on their original contributions. As a result of new information, a reclassification was made between net asset classes in the statement of activities to reflect the new donor intent.

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Reclassifications were made as follows:				
The C. M. and Cora Caldwell Memorial Endowment Fund	\$ -	\$ (75,188)	75,188	-
Kate Harding Bates Parker Award Fund	-	(5,000)	5,000	-
Marguerite Collier and J. F. Wood, Jr. Memorial Award	-	(2,500)	2,500	-
The J. Conrad Dunagan Research Fellowship Fund	-	(50,733)	50,733	-
The Lillie Cranz Cullen and Hugh Roy Cullen Senior Research Fellowship in Texas History Fund	-	(9,551)	9,551	-
The Katherine Sage Temple Research Fellowship in Texas Studies Fund	-	(1,924)	1,924	-
The Edward A. Clark Research Fellowship Fund	-	(50,000)	50,000	-
Marguerite Collier and J. F. Wood, Jr. Memorial Fund (Educational)	-	(7,500)	7,500	-
Other	16,502	(16,502)	-	-
Net Change	<u>\$ 16,502</u>	<u>\$ (218,898)</u>	<u>\$ 202,396</u>	<u>\$ -</u>

NOTE 11—*Concentrations*

The Association received approximately 65% and 52% of its book revenue from one distributor of its books for the years ended August 31, 2005 and 2004, respectively. The contract term with this distributor is for one year and renewed on an annual basis. If this contract term were to lapse and not be renewed, book sales could be impacted. In addition, the Association had outstanding accounts receivable with this distributor of \$31,146 and \$39,140 as of August 31, 2005 and 2004, respectively.

For the years ended August 31, 2005 and 2004, respectively, the Association received approximately 27% and 29% of funding through contributed services and facilities from the University of Texas which provides the Association with office space and pays the salaries of various personnel. The University of Texas has provided contributed services to the Association for almost a hundred years, but such funding is subject to annual approval.

NOTE 12—*The Handbook of Texas Online: A Digital Gateway to Texas History*

The Association is committed to working on the cutting edge of the intersection between Texas history research and information technology. The *Handbook of Texas Online*, launched in 1999, set new standards for public access by publishing all 24,000 articles of the print encyclopedia in an electronically searchable format. In just five years, the online site has responded to more than 75 million requests for information to readers in over 150 countries and currently averages more than 4 million page-views per month. In 2002, the Association launched a multi-year project to develop the *Handbook of Texas Online: A Digital Gateway to Texas History*, creating a one-stop Internet portal to Texas history resources for students, teachers, researchers, and lifelong learners. The site's interactive electronic framework is designed to increase public participation in the quest for historical discovery.

The *Digital Gateway to Texas History* project will expand on this success by digitizing the entire published catalogue of more than one hundred years of Association resources, including more than one hundred and thirty books, one hundred and eight volumes of the *Southwestern Historical Quarterly*, and various updates to the *Handbook of Texas Online*. It will allow individuals around the world to create and purchase research materials based on their particular interests in community, organizational, and family histories, and to have a product delivered in a form that is most suitable to its purpose—from digital downloads for cell phones to bound and printed books. The *Digital Gateway to Texas History* is a portal to the past and to the future of Texas history, offering the means to distribute its 100 years of authoritative content in new ways and to new audiences. It provides the wherewithal for the Association to continue to lead the way among state historical organizations in terms of digital publishing, content development, and fulfilling the expectations of an increasingly technologically sophisticated constituency in the coming century.