

Financial Statements
Peabody Essex Museum, Inc.
December 31, 2011 and 2010



Mayer Hoffman McCann P.C.
Tofias New England Division
An Independent CPA Firm

PEABODY ESSEX MUSEUM, INC.

Financial Statements

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Independent Auditors' Report

The Board of Trustees
Peabody Essex Museum, Inc.
Salem, Massachusetts

We have audited the accompanying statements of financial position of Peabody Essex Museum, Inc. (the "Museum") as of December 31, 2011 and 2010, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the Museum's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with U.S. generally accepted auditing standards. 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. 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 Peabody Essex Museum, Inc. at December 31, 2011 and 2010, and the changes in its net assets and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Mayer Hoffman McCann P.C.

May 14, 2012
Boston, Massachusetts

Peabody Essex Museum, Inc.
Statements of Financial Position
December 31, 2011 and 2010

| | 2011 | 2010 |
|---|-----------------------|-----------------------|
| Assets | | |
| Cash and cash equivalents | \$ 1,410,332 | \$ 1,699,580 |
| Certificates of deposit | 750,000 | - |
| Accounts receivable | 116,460 | 576,864 |
| Grants, dividends and interest receivable | 127,127 | 595,456 |
| Pledges receivable | 10,781,750 | 42,603,595 |
| Inventories | 712,429 | 672,150 |
| Prepaid expenses | 1,149,714 | 806,748 |
| Investments | 282,116,876 | 241,695,884 |
| Funds held by others | 3,843,037 | 4,125,854 |
| Assets and residual interests under split-interest agreements | 2,590,308 | 524,074 |
| Mortgages receivable - related party | 197,316 | 197,316 |
| Bond issuance costs | 222,015 | 240,873 |
| Bond principal escrow | 416,667 | 409,036 |
| Land, buildings and equipment, net | 76,542,354 | 78,283,562 |
| Total assets | <u>\$ 380,976,385</u> | <u>\$ 372,430,992</u> |
| Liabilities and Net Assets | | |
| Liabilities: | | |
| Accounts payable | \$ 1,441,086 | \$ 947,763 |
| Accrued expenses | 530,213 | 539,869 |
| Deferred revenues | 427,806 | 457,082 |
| Notes payable | 750,000 | - |
| Bonds payable | 30,310,000 | 31,285,000 |
| Interest rate swap | 3,087,235 | 3,064,952 |
| Environmental remediation liability | 115,000 | 325,000 |
| Obligation under lease | 73,999 | 133,462 |
| Obligation under split-interest agreements | 937,108 | 147,637 |
| Total liabilities | <u>37,672,447</u> | <u>36,900,765</u> |
| Net assets: | | |
| Unrestricted | 79,648,077 | 86,917,566 |
| Temporarily restricted | 66,173,726 | 75,580,279 |
| Permanently restricted | 197,482,135 | 173,032,382 |
| Total net assets | <u>343,303,938</u> | <u>335,530,227</u> |
| Total liabilities and net assets | <u>\$ 380,976,385</u> | <u>\$ 372,430,992</u> |

Peabody Essex Museum, Inc.
Statement of Activities
Year Ended December 31, 2011
(with summarized financial information
for the year ended December 31, 2010)

| | Unrestricted | Temporarily Restricted | Permanently Restricted | Total | |
|--|---------------|---------------------------|---------------------------|----------------|----------------|
| | | | | 2011 | 2010 |
| Operating support and revenue: | | | | | |
| Contributions | \$ 1,872,610 | \$ 14,559,103 | \$ 24,393,417 | \$ 40,825,130 | \$ 84,077,559 |
| Grants | 1,315,295 | - | 41,775 | 1,357,070 | 2,546,817 |
| Spending rate transfer appropriated for operations | 5,614,167 | - | - | 5,614,167 | 5,132,259 |
| Enterprise and other revenues | 3,612,397 | 2,919 | - | 3,615,316 | 3,995,206 |
| Admissions | 1,423,254 | - | - | 1,423,254 | 1,338,574 |
| Memberships | 778,000 | - | - | 778,000 | 706,764 |
| Satisfaction of program restrictions | 7,411,928 | (7,411,928) | - | - | - |
| Total operating support and revenue | 22,027,651 | 7,150,094 | 24,435,192 | 53,612,937 | 97,797,179 |
| Expenses: | | | | | |
| Program services: | | | | | |
| Exhibitions and publications | 3,579,008 | - | - | 3,579,008 | 4,109,378 |
| Curatorial and collections | 2,566,374 | - | - | 2,566,374 | 2,239,851 |
| Educational programs | 1,535,784 | - | - | 1,535,784 | 1,590,514 |
| Enterprises | 1,621,942 | - | - | 1,621,942 | 1,597,706 |
| Public information | 1,993,009 | - | - | 1,993,009 | 1,883,763 |
| Membership and guest services | 720,261 | - | - | 720,261 | 624,416 |
| Media services | 371,665 | - | - | 371,665 | 588,635 |
| Facilities and security | 2,776,409 | - | - | 2,776,409 | 2,746,291 |
| Total program services | 15,164,452 | - | - | 15,164,452 | 15,380,554 |
| Supporting services: | | | | | |
| Development | 2,301,962 | - | - | 2,301,962 | 2,235,911 |
| Administrative | 3,695,567 | - | - | 3,695,567 | 3,502,371 |
| Facilities and security | 844,133 | - | - | 844,133 | 834,976 |
| Total supporting services | 6,841,662 | - | - | 6,841,662 | 6,573,258 |
| Total program and supporting services | 22,006,114 | - | - | 22,006,114 | 21,953,812 |
| Changes in net assets from operations before other operating activities | 21,537 | 7,150,094 | 24,435,192 | 31,606,823 | 75,843,367 |
| Other operating activities: | | | | | |
| Contributions and revenues | 18,881 | - | - | 18,881 | 560 |
| Bequests | 83,842 | - | - | 83,842 | 50,074 |
| Grant revenue | 7,497 | - | - | 7,497 | - |
| Settlements received | 444,225 | - | - | 444,225 | 379,627 |
| Expansion expenses | (1,162,695) | - | - | (1,162,695) | - |
| Other expenses | (353,478) | - | - | (353,478) | (487,142) |
| Satisfaction of restrictions | 868,728 | (868,728) | - | - | - |
| Changes in net assets from operations | (71,463) | 6,281,366 | 24,435,192 | 30,645,095 | 75,786,486 |
| Nonoperating activities: | | | | | |
| Investment income and gains (losses) net of amounts appropriated | (1,544,455) | (10,869,717) | 230,435 | (12,183,737) | 15,718,968 |
| Change in value of split-interest agreements and funds held by others | - | (119,981) | (215,874) | (335,855) | 369,269 |
| Debt service costs | (1,638,151) | - | - | (1,638,151) | (1,594,085) |
| Unrealized loss under interest rate swap | (22,283) | - | - | (22,283) | (457,665) |
| Environmental remediation cost | (306,172) | - | - | (306,172) | (419,494) |
| Depreciation and amortization | (4,211,328) | - | - | (4,211,328) | (4,208,210) |
| Plant related satisfaction of program restrictions | 541,771 | (541,771) | - | - | - |
| Sale of collection items | - | 112,710 | - | 112,710 | 1,400 |
| Collection items purchased | (4,286,568) | - | - | (4,286,568) | (407,256) |
| Satisfaction of program restrictions - collection items | 4,269,160 | (4,269,160) | - | - | - |
| Change in net assets from nonoperating activities | (7,198,026) | (15,687,919) | 14,561 | (22,871,384) | 9,002,927 |
| Change in net assets | (7,269,489) | (9,406,553) | 24,449,753 | 7,773,711 | 84,789,413 |
| Net assets at beginning of year | 86,917,566 | 75,580,279 | 173,032,382 | 335,530,227 | 250,740,814 |
| Net assets at end of year | \$ 79,648,077 | \$ 66,173,726 | \$ 197,482,135 | \$ 343,303,938 | \$ 335,530,227 |

See accompanying notes to the financial statements.

Peabody Essex Museum, Inc.
Statement of Activities
Year Ended December 31, 2010

| | Unrestricted | Temporarily Restricted | Permanently Restricted | Total 2010 |
|---|---------------|------------------------|------------------------|----------------|
| Operating support and revenue: | | | | |
| Contributions | \$ 1,912,176 | \$ 6,361,476 | \$ 75,803,907 | \$ 84,077,559 |
| Grants | 2,096,817 | - | 450,000 | 2,546,817 |
| Spending rate transfer appropriated for operations | 5,132,259 | - | - | 5,132,259 |
| Enterprise and other revenues | 3,992,258 | 2,948 | - | 3,995,206 |
| Admissions | 1,338,574 | - | - | 1,338,574 |
| Memberships | 706,764 | - | - | 706,764 |
| Satisfaction of program restrictions | 6,802,201 | (6,802,201) | - | - |
| Total operating support and revenue | 21,981,049 | (437,777) | 76,253,907 | 97,797,179 |
| Expenses: | | | | |
| Program services: | | | | |
| Exhibitions and publications | 4,109,378 | - | - | 4,109,378 |
| Curatorial and collections | 2,239,851 | - | - | 2,239,851 |
| Educational programs | 1,590,514 | - | - | 1,590,514 |
| Enterprises | 1,597,706 | - | - | 1,597,706 |
| Public information | 1,883,763 | - | - | 1,883,763 |
| Membership and guest services | 624,416 | - | - | 624,416 |
| Media services | 588,635 | - | - | 588,635 |
| Facilities and security | 2,746,291 | - | - | 2,746,291 |
| Total program services | 15,380,554 | - | - | 15,380,554 |
| Supporting services: | | | | |
| Development | 2,235,911 | - | - | 2,235,911 |
| Administrative | 3,502,371 | - | - | 3,502,371 |
| Facilities and security | 834,976 | - | - | 834,976 |
| Total supporting services | 6,573,258 | - | - | 6,573,258 |
| Total program and supporting services | 21,953,812 | - | - | 21,953,812 |
| Changes in net assets from operations before other operating activities | 27,237 | (437,777) | 76,253,907 | 75,843,367 |
| Other operating activities: | | | | |
| Contributions and revenues | 560 | - | - | 560 |
| Bequests | 50,074 | - | - | 50,074 |
| Settlements received | 379,627 | - | - | 379,627 |
| Other expenses | (487,142) | - | - | (487,142) |
| Changes in net assets from operations | (29,644) | (437,777) | 76,253,907 | 75,786,486 |
| Nonoperating activities: | | | | |
| Investment income and gains net of amounts appropriated | 4,642,252 | 10,962,169 | 114,547 | 15,718,968 |
| Change in value of split-interest agreements and funds held by others | - | 150,846 | 218,423 | 369,269 |
| Debt service costs | (1,594,085) | - | - | (1,594,085) |
| Unrealized loss under interest rate swap | (457,665) | - | - | (457,665) |
| Environmental remediation cost | (419,494) | - | - | (419,494) |
| Depreciation and amortization | (4,208,210) | - | - | (4,208,210) |
| Plant related satisfaction of program restrictions | 90,379 | (90,379) | - | - |
| Sale of collection items | - | 1,400 | - | 1,400 |
| Collection items purchased | (407,256) | - | - | (407,256) |
| Satisfaction of program restrictions - collection items | 378,994 | (378,994) | - | - |
| Change in net assets from nonoperating activities | (1,975,085) | 10,645,042 | 332,970 | 9,002,927 |
| Change in net assets | (2,004,729) | 10,207,265 | 76,586,877 | 84,789,413 |
| Net assets at beginning of year | 88,922,295 | 65,373,014 | 96,445,505 | 250,740,814 |
| Net assets at end of year | \$ 86,917,566 | \$ 75,580,279 | \$ 173,032,382 | \$ 335,530,227 |

See accompanying notes to the financial statements.

Peabody Essex Museum, Inc.
Statements of Cash Flows
Years Ended December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---------------------|---------------------|
| Cash flows from operating activities: | | |
| Change in net assets | \$ 7,773,711 | \$ 84,789,413 |
| Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 4,211,328 | 4,208,210 |
| Payments on contributions restricted for long-term investments and capital additions | (56,089,293) | (42,366,250) |
| Net unrealized and realized gains (losses) on long-term investments | 10,043,550 | (18,244,694) |
| Interest rate swap, mark to market | 22,283 | 457,665 |
| Environmental remediation cost | (210,000) | (3,713) |
| (Increase) decrease in assets: | | |
| Pledges receivable | 31,821,845 | (32,907,297) |
| Accounts receivable | 460,404 | (556,352) |
| Grants, dividends and interest receivable | 468,329 | (178,632) |
| Inventories | (40,279) | 16,296 |
| Prepaid expenses | (342,966) | 45,608 |
| Increase (decrease) in liabilities: | | |
| Accounts payable | (75,836) | 42,080 |
| Accrued expenses | (9,656) | (63,855) |
| Deferred revenue | (29,276) | 125,253 |
| Net cash used in operating activities | <u>(1,995,856)</u> | <u>(4,636,268)</u> |
| Cash flows from investing activities: | | |
| Additions to land, building, equipment and construction in progress | (1,882,104) | (202,654) |
| Purchases of investments | (184,000,959) | (81,141,772) |
| Proceeds from sales of investments | 132,786,418 | 45,114,346 |
| (Additions to) distribution from split-interest agreements, net | (1,326,745) | 19,005 |
| Change in value of split-interest agreements and perpetual trusts | 332,799 | (352,603) |
| Net cash used by investing activities | <u>(54,090,591)</u> | <u>(36,563,678)</u> |
| Cash flows from financing activities: | | |
| Proceeds from notes payable | 750,000 | - |
| Payments on bonds payable | (975,000) | (925,000) |
| Payments to bond principal escrow, net | (7,631) | (23,497) |
| Payments on contributions restricted for long-term investments and capital additions | 56,089,293 | 42,366,250 |
| Payments of capital lease obligations | (59,463) | (95,461) |
| Net cash provided by financing activities | <u>55,797,199</u> | <u>41,322,292</u> |
| Net increase (decrease) in cash and cash equivalents | (289,248) | 122,346 |
| Cash and cash equivalents at beginning of year | <u>1,699,580</u> | <u>1,577,234</u> |
| Cash and cash equivalents at end of year | <u>\$ 1,410,332</u> | <u>\$ 1,699,580</u> |
| Supplemental disclosure of noncash activities: | | |
| Fixed asset acquisitions remaining in accounts payable and accrued expenses | \$ 569,159 | - |
| Capital leases used to finance equipment | - | 56,256 |

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 1 - Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

The Peabody Essex Museum, Inc. (the “Museum”) was formed on July 1, 1992 through a merger of the former Peabody Museum of Salem and the Essex Institute. The Museum presents outstanding works of artistic and cultural creativity from New England and around the world. The Museum’s collections are among the finest of their kind, showcasing an unrivaled spectrum of American art and architecture (including four national historic landmark buildings), American decorative art, maritime art and culture, and Native American art, as well as Asian, Asian export, African, oceanic, photography and contemporary art collections. In addition to its vast collections, the Museum develops and offers a variety of special exhibitions and educational programs and works with the world’s finest museums to bring traveling exhibitions to audiences in the greater Boston area and beyond. The Museum campus features numerous parks and gardens and 22 historic properties, including Yin Yu Tang, a 200-year-old house that is the only example of Chinese domestic architecture on display outside of China. The Museum’s Phillips Library is one of the oldest and largest research libraries in New England.

In November of 2011, the Museum launched the public phase of a comprehensive, ten-year, \$650 million Campaign designed to advance the Museum’s mission to celebrate outstanding artistic and cultural creativity in ways that transform people’s lives. This campaign, which was initiated in 2006, comprises operating endowment, an expansion of the main museum building, funding for new installations of the collection, several infrastructure improvements to existing facilities, and other advancement initiatives. As is generally expected with fundraising campaigns of this scale, the level of contribution support recognized annually is likely to fluctuate throughout the duration of the 10-year initiative.

The Museum is recognized by the Internal Revenue Service as an organization described in Section 501(c)(3) of the Internal Revenue Code and is generally exempt from federal and state income taxes on related income. Given the limited taxable activities of the Museum, management has concluded that disclosures relative to tax provisions are not necessary.

Basis of Accounting

The accompanying financial statements have been prepared on the accrual basis and in accordance with the reporting principles of not-for-profit accounting.

Unrestricted Net Assets

Unrestricted net assets are not subject to donor-imposed stipulations. Revenues are reported as increases in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions or law. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments and other assets or liabilities are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulations or law.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)

Temporarily Restricted Net Assets

Temporarily restricted net assets carry specific donor-imposed restrictions on the expenditure or other use of contributed funds or limitations imposed by law. Also included in temporarily restricted net assets is accumulated net appreciation which has not yet been appropriated for expenditure by the Board. Temporary restrictions may expire either because of the passage of time or because certain actions are taken by the Museum which fulfill the restriction. Expirations of temporary restrictions on net assets, that is, the donor-imposed stipulated purpose has been accomplished or the stipulated time period has elapsed, are reported as satisfaction of program restrictions in the statement of activities.

Permanently Restricted Net Assets

Permanently restricted net assets are subject to donor-imposed stipulations that they be maintained in perpetuity by the Museum. Generally, the donors of these assets permit the Museum to use all or part of the income earned and capital appreciation on related investments for general or specific purposes. Certain resources in this net asset class contain further restrictions and provisos.

Cash and Cash Equivalents

All highly liquid debt instruments with a maturity of three months or less when purchased are classified as cash equivalents. Cash and cash equivalents include repurchase agreements which are typically issued on an overnight basis. Cash and cash equivalents held by investment managers are considered part of investments. The Museum monitors its exposure associated with cash and cash equivalents and has not experienced any losses in such accounts.

Certificates of Deposit

Certificates of deposit are recorded at cost with an accrual for any interest. The Museum monitors its exposure associated with certificates of deposit and has not experienced any losses in such accounts.

Investments

The Museum reports investments at fair market value. Fair value is determined as more fully described under fair value measurements below. Investment returns are reported as follows:

- as increases in permanently restricted net assets if the terms of the gift require that they be added to the principal of a permanent endowment fund;
- as increases in temporarily restricted net assets if the terms of the gift or state law impose restrictions on the current use of the income or net gains; and
- as increases in unrestricted net assets in all other cases.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)

Fair Value Measurements

The Museum reports certain assets and liabilities at fair value on a recurring and non-recurring basis depending upon the accounting policy for the particular item. Recurring fair value measurements include investments, funds held by others, assets under split interest agreements, bond principal escrow and interest rate swaps. Non-recurring fair value measurements include pledges receivable, residual interests under split interest agreements and obligations under split interest agreements. Fair value standards require an entity to maximize the use of observable inputs (such as quoted prices in active markets) and minimize the use of unobservable inputs (such as appraisals or valuation techniques) to determine fair value. In addition, the Museum reports certain investments using the net asset value per share as determined by investment managers under the so called “practical expedient”. The practical expedient allows net asset value per share to represent fair value for reporting purposes when the criteria for using this method are met. Fair value standards also require the Museum to classify these financial instruments into a three-level hierarchy, based on the priority of inputs to the valuation technique or in accordance with net asset value (“NAV”) practical expedient rules, which allow for either Level 2 or Level 3 depending on lock-up and notice periods associated with the underlying funds.

Instruments measured and reported at fair value are classified and disclosed in one of the following categories:

Level 1 - Quoted prices are available in active markets for identical instruments as of the reporting date. Instruments which are generally included in this category include listed equity and debt securities publicly traded on a stock exchange.

Level 2 - Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date, and fair value is determined through the use of models or other valuation methodologies. Level 2 also includes practical expedient investments that can be redeemed within 90 days or less.

Level 3 - Pricing inputs are unobservable for the instrument and include situations where there is little, if any, market activity for the instrument. The inputs into the determination of fair value require significant management judgment or estimation. Level 3 also includes practical expedient investments that cannot be redeemed within 90 days.

In some instances, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such instances, an instrument’s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)

Fair Value Measurements (Continued)

Market price is affected by a number of factors, including the type of instrument and the characteristics specific to the instrument, as well as the effects of market, interest and credit risk. Instruments with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of market price observability and a lesser degree of judgment used in measuring fair value. It is reasonably possible that change in values of these instruments will occur in the near term and that such changes could materially affect amounts reported in these financial statements.

For more information on the fair value of the Museum's financial instruments, see Note 3 - Fair Values of Financial Instruments.

Pledges and Accounts Receivable, Net

Pledges expected to be collected within one year are recorded at their net realizable value. Pledges that are expected to be collected in future years are recorded at the present value of estimated future cash flows utilizing a risk-adjusted discount rate.

Pledges and accounts receivable are reported at the amount management expects to collect on balances outstanding at year-end. Management estimates the allowance for doubtful accounts based on history of collections and knowledge acquired about specific facts relating to outstanding items. Adjustments to the allowance are charged to bad debt expense. Uncollectible accounts are written off against the allowance. An account is considered uncollectible when all efforts to collect the account have been exhausted.

Grants Receivable

Grants receivable consist of receivables for amounts expended under government grants. All amounts are expected to be received within one year.

Inventories

Inventories, principally retail merchandise, are stated at the lower of cost or market, with cost calculated using the first-in, first-out (FIFO) method, and market based upon net realizable value.

Funds Held by Others

Funds held by others consists of the Museum's share of assets held in trust in perpetuity for which the Museum is the beneficiary of annual distributions of income. Such distributions are reported as other income in the appropriate net asset category depending on the donor's restriction, if any, over such distribution. The change in market value of the Museum's proportional share is reported in nonoperating activity.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)

Assets and Residual Interests under Split-Interest Agreements

This category includes split-interest agreement assets held by the Museum as well as residual interests in assets held by others. Assets held by the Museum are invested in the Museum's pooled investments and are reported at fair value, while residual interests in assets held by third-party trustees are initially recorded at fair value and are updated annually using actuarial methods and the initial discount rate. The Museum's policy for determining fair value is more fully described under the Fair Value Measurements section.

Bond Issuance Costs

Bond issuance costs represent expenses incurred in connection with the issuance of the Museum's bonds. Such costs are amortized using the effective interest method over the life of the associated bond issue.

Bond Principal Escrow

Bond principal escrow represents amounts required to be on deposit with the trustee associated with the Museum's bonds. Such escrow is invested in an institutional money market account and is carried at fair value. Fair value is determined as more fully described under the fair value measurements covered earlier.

Land, Building and Equipment

Buildings, capital improvements, historic house renovations and equipment are stated at cost less accumulated depreciation computed on a straight-line basis over the estimated useful lives of the assets as follows:

| | |
|----------------------------|----------------|
| Buildings | 30 to 50 years |
| Capital improvements | 5 to 20 years |
| Equipment | 3 to 10 years |
| Historic house renovations | 5 to 30 years |

Betterments which materially add to the value of the related assets or materially extend the useful life of the assets are capitalized. Equipment and furnishings of relatively small dollar value are expensed as incurred. When equipment is retired, its cost and the related accumulated depreciation are eliminated from the respective accounts. Gains or losses arising from dispositions are charged to unrestricted net assets.

Interest Rate Swap

The Museum reports its interest rate swap at fair value. Fair value is determined in accordance with the valuation policies described in this section. The Museum recognizes unrealized gain or loss on the estimated fair value of its interest rate swap in its statements of activities. If held to maturity, the net gain or loss over the term of the instrument will equal zero. As of December 31, 2011, the Museum intends to hold the contracts to maturity.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)

Deferred Revenues

Deposits for function rentals and certain other items are deferred and are recorded as unrestricted revenues in the year in which the services are provided.

Obligations under Split-Interest Agreements

These obligations are initially recorded at fair value using actuarial methods and estimated discount rates. During the term of these agreements, changes in the value of split-interest agreements are recognized in the statement of activities based on accretion of the discount and changes in life expectancy and other actuarial assumptions.

Endowment Investment and Spending

State law allows the Board of Trustees to appropriate a percentage of net appreciation as is prudent considering the Museum's long- and short-term needs, present and anticipated financial requirements and expected total return on its investments, price level trends and general economic conditions. The Museum's endowment spending policy is computed based on the average market value for the previous 12 quarters, through September 30 of the prior year. Board designated funds that do not function as endowment are excluded from the calculation. The percentage spent was 5% for the years ended December 31, 2011 and 2010.

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor requires the Museum to retain as a fund of perpetual duration. In accordance with accounting standards, deficiencies of this nature are reported in unrestricted and amounted to \$208,628 and \$0 as of December 31, 2011 and 2010, respectively. These deficiencies resulted from unfavorable market fluctuations associated with permanently restricted funds.

The Museum's investment portfolio is managed to provide for the long-term support of the Museum. Accordingly, these funds are managed with disciplined longer-term investment objectives and strategies designed to meet cash flow and spending requirements. Management of the assets is designed to attain the maximum total return consistent with acceptable and agreed upon levels of risk. The target is to achieve an average annual real total return (net of investment management fees and inflation) of at least 5% when measured over rolling periods of not less than five years.

To satisfy its long-term rate-of-return objectives, the Museum relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The Museum targets an asset allocation strategy wherein assets are diversified among several asset classes. The pursuit of maximizing total return is tempered by the need to minimize the volatility of returns and preserve capital. As such, the Museum seeks broad diversification among assets having different characteristics with the intent to endure lower relative performance in strong markets in exchange for greater downside protection in weak markets.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)

Operating Activities

Operating activities represent revenues by source and expenses by major function. Its purpose is to present revenues and expenses related solely to the budgeted operating activities of the Museum. Other operating activities reflect transactions that are typically non-recurring and are not customarily planned for in the annual budgeting process. Nonoperating activities include investment earnings net of amounts drawn under the spending policy, debt service costs, changes in the valuation of the swap, changes in the value of split-interest agreements and funds held by others, depreciation, collection items purchased as well as certain other items of income and expense.

Collections and Works of Art

The collections, which were acquired through purchases and contributions since the Museum's inception, are not recognized as assets on the statement of financial position. Purchases of collection items are recorded as decreases in unrestricted net assets in the year in which the items are acquired. Proceeds from deaccessions or insurance recoveries are reflected as increases in the appropriate net asset classes. Collection items purchased are funded by purpose-restricted gifts or from net appreciation on acquisition endowments.

Recognition of Contributions and Grants

Contributions and grants, including unconditional promises to give, are recorded as revenue at fair value when verifiably committed. Fair value is determined as more fully described under the fair value measurements covered earlier. Government grants are generally recognized as revenue as costs are recognized associated with the grant. Conditional contributions and grants and intentions to give are recorded as revenue when the conditions have been met. Contributions and grants are reflected as unrestricted, temporarily restricted or permanently restricted based on the existence or absence of donor-imposed restrictions. Amounts received with donor-imposed restrictions that are recorded as temporarily restricted revenues are reclassified to unrestricted net assets when the time or purpose restriction has been satisfied.

Recognition of Other Support and Revenues

Enterprise and other revenues are recorded upon sale or completion of the service depending upon the activity. Admissions are generally recorded as revenue upon sale. Memberships are recorded as revenue upon receipt.

Contributed Services and Gifts In-Kind

Contributions of services are recognized when provided by individuals or organizations whose skills would be purchased if not provided by donation. In addition, a substantial number of unpaid volunteers have made significant contributions of their time to develop and maintain the Museum's programs. The value of this contributed time is not reflected in these statements.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)

Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions. Significant management estimates in the financial statements include the allowance for doubtful accounts and pledges receivable, initial fair value of pledges, initial fair value of residual interests under split-interest agreements, fair value of alternative investments, useful lives of depreciable assets, liability for environmental remediation costs, and valuation of interest rate swap agreement, obligations under split-interest agreements, fair value disclosures for certain financial instruments reported at cost, and satisfaction of program restrictions for the release of restricted net assets.

Environmental Remediation Liability

An environmental remediation liability is a legally binding requirement to remediate the migration of heating oil on museum property, the timing and cost of which, although not known, may be estimated. The Museum records liabilities for the present value of these costs in its statements of financial position.

Advertising Costs

Advertising costs are charged to operations when incurred. Advertising costs for the years ended December 31, 2011 and 2010 were \$655,781 and \$625,533, respectively.

Uncertain Tax Positions

The Museum accounts for the effect of any uncertain tax positions based on a “more likely than not” threshold to the recognition of the tax positions being sustained based on the technical merits of the position under scrutiny by the applicable taxing authority. If a tax position or positions are deemed to result in uncertainties of those positions, the unrecognized tax benefit is estimated based on a “cumulative probability assessment” that aggregates the estimated tax liability for all uncertain tax positions. Interest and penalties assessed, if any, are accrued as income tax expense.

The Museum has identified its status as a publicly supported tax exempt entity as its only significant position and has determined that such position does not result in an uncertainty requiring recognition. Its federal and state income tax returns are generally open for examination for the three years after the date of filing of the related return. The Museum’s 2009 Federal returns 990 and 990-T are currently under examination by the Internal Revenue Service.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)

Subsequent Events

The Museum performed an evaluation of subsequent events through May 14, 2012, the date the financial statements were issued. During that period, the Museum purchased two buildings adjacent to existing museum property with a combined purchase price of \$2,175,000.

Reclassifications

Certain reclassifications have been made to the prior year financial statements in order to conform with the current year presentation.

Note 2 - Pledges Receivable, Net

Pledges receivable as of December 31, 2011 and 2010 are expected to be realized in the following time frame:

| | <i>2011</i> | <i>2010</i> |
|---|-----------------------------|-----------------------------|
| Within one year | \$ 5,297,029 | \$ 38,700,311 |
| One to five years | 5,312,430 | 3,770,205 |
| More than five years | <u>752,315</u> | <u>754,815</u> |
| Pledges receivable | 11,361,774 | 43,225,331 |
| Less: Present value discount | (553,524) | (586,555) |
| Less: Allowance for uncollectible pledges | <u>(26,500)</u> | <u>(35,181)</u> |
| | <u>\$ 10,781,750</u> | <u>\$ 42,603,595</u> |

During 2011, the Museum recognized a significant endowment contribution of \$10,000,000 which was a component of the \$65,000,000 conditional endowment challenge grant awarded in 2006. To date, the Museum has received \$40,000,000 from the conditional endowment challenge grant.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 3 - Fair Values of Financial Instruments

The valuation of the Museum's financial instruments using the fair value hierarchy consisted of the following at December 31:

| | <i>2011</i> | | | |
|---|-------------------------|---------------------------|---------------------------|---------------------------|
| | <i>Total Fair Value</i> | <i>Fair Value Level 1</i> | <i>Fair Value Level 2</i> | <i>Fair Value Level 3</i> |
| Cash equivalents | \$ 10,195,490 | \$ 10,195,490 | \$ - | \$ - |
| Corporate note | 6,180,000 | - | 6,180,000 | - |
| Domestic equities and funds | 31,261,932 | 31,261,932 | - | - |
| International equities and funds | 40,360,935 | 5,850,903 | 34,510,032 | - |
| Global asset allocation strategies | 65,065,531 | 24,948,790 | 40,116,741 | - |
| Private company equity | 31,888,575 | - | 31,888,575 | - |
| Fixed income and funds | 40,308,581 | 24,480,574 | 15,828,007 | - |
| Multi-strategy hedge fund-of-funds | 8,401,397 | - | 8,401,397 | - |
| Absolute return hedge funds | 27,435,848 | - | 9,332,265 | 18,103,583 |
| Real asset commingled trust | 9,468,663 | - | 9,468,663 | - |
| Commodities exchange traded fund | 2,341,156 | 2,341,156 | - | - |
| Real estate limited partnerships | 4,755,365 | - | - | 4,755,365 |
| Private equity | 4,453,403 | - | - | 4,453,403 |
| | <u>\$ 282,116,876</u> | <u>\$ 99,078,845</u> | <u>\$ 155,725,680</u> | <u>\$ 27,312,351</u> |
| Total investments | | | | |
| Bond principal escrow | \$ <u>416,667</u> | \$ <u>416,667</u> | \$ <u>-</u> | \$ <u>-</u> |
| Funds held by others | \$ <u>3,843,037</u> | \$ <u>-</u> | \$ <u>-</u> | \$ <u>3,843,037</u> |
| Assets and residual interests under split-interest agreements | \$ <u>2,590,308</u> | \$ <u>2,003,058</u> | \$ <u>-</u> | \$ <u>587,250</u> |
| Interest rate swap | \$ <u>(3,087,235)</u> | \$ <u>-</u> | \$ <u>(3,087,235)</u> | \$ <u>-</u> |

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 3 - Fair Values of Financial Instruments (Continued)

| | 2010 | | | |
|---|-------------------------|---------------------------|---------------------------|---------------------------|
| | <i>Total Fair Value</i> | <i>Fair Value Level 1</i> | <i>Fair Value Level 2</i> | <i>Fair Value Level 3</i> |
| Cash equivalents | \$ 54,541,696 | \$ 54,541,696 | \$ - | \$ - |
| Domestic equities and funds | 24,422,085 | 24,422,085 | - | - |
| International equities and funds | 23,557,417 | 5,699,703 | 17,857,714 | - |
| Global asset allocation strategies | 50,864,321 | 30,936,617 | 19,927,704 | - |
| Private company equity | 28,666,012 | - | 28,666,012 | - |
| Fixed income and funds | 24,109,061 | 20,466,071 | 3,642,990 | - |
| Multi-strategy hedge fund-of-funds | 10,629,030 | - | - | 10,629,030 |
| Absolute return hedge funds | 12,751,449 | - | 6,568,031 | 6,183,418 |
| Real asset commingled trust | 7,462,447 | - | 7,462,447 | - |
| Real estate limited partnership | 3,311,337 | - | - | 3,311,337 |
| Private equity | 1,381,029 | - | - | 1,381,029 |
| | <u>\$ 241,695,884</u> | <u>\$ 136,066,172</u> | <u>\$ 84,124,898</u> | <u>\$ 21,504,814</u> |
| Total investments | | | | |
| Bond principal escrow | \$ <u>409,036</u> | \$ <u>409,036</u> | \$ <u>-</u> | \$ <u>-</u> |
| Funds held by others | \$ <u>4,125,854</u> | \$ <u>-</u> | \$ <u>-</u> | \$ <u>4,125,854</u> |
| Assets and residual interests under split-interest agreements | \$ <u>524,074</u> | \$ <u>312,505</u> | \$ <u>-</u> | \$ <u>211,569</u> |
| Interest rate swap | \$ <u>(3,064,952)</u> | \$ <u>-</u> | \$ <u>(3,064,952)</u> | \$ <u>-</u> |

Many of the Museum's investment funds contain clauses that under certain unusual circumstances trustees and fund managers may limit distributions from the related fund. As of December 31, 2011, no fund managers had imposed such limits over the Museum's investments.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 3 - Fair Values of Financial Instruments (Continued)

Investment return consisted of the following for the years ended December 31, 2011 and 2010:

| | <i>2011</i> | <i>2010</i> |
|---|-------------------------------|-----------------------------|
| Investment return: | | |
| Interest and dividends income | \$ 4,377,854 | \$ 3,078,481 |
| Net realized gains (losses) | 1,847,624 | (1,470,855) |
| Net unrealized gains (losses) | (11,891,174) | 19,715,548 |
| Less investment fees | <u>(903,874)</u> | <u>(471,947)</u> |
| Net return | (6,569,570) | 20,851,227 |
| Total return appropriated to support operations | <u>(5,614,167)</u> | <u>(5,132,259)</u> |
| Investment return, net of amounts appropriated to support operations | \$ <u>(12,183,737)</u> | \$ <u>15,718,968</u> |

Certain funds' management fees are embedded as a net cost against investment returns and, accordingly, the investment fees reported above relate only to those costs incurred directly by the Museum or reported separately by fund managers.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 3 - Fair Values of Financial Instruments (Continued)

The changes in instruments measured at fair value for which the Museum has used Level 3 inputs to determine fair value are as follows:

| | <u>Hedge Funds</u> | | <u>Real Estate</u> | <u>Private</u> | <u>Total</u> | <u>Funds Held</u> | <u>Residual</u> |
|--|-----------------------|----------------------|---------------------|---------------------|----------------------|---------------------|-------------------|
| | <u>Multi-Strategy</u> | <u>Absolute</u> | <u>Limited</u> | | | | |
| | <u>Fund-of-Funds</u> | <u>Return</u> | <u>Partnerships</u> | <u>Equity</u> | <u>Investments</u> | <u>by Others</u> | <u>Interests</u> |
| Balance as of December 31, 2009 | \$ 9,685,131 | \$ 11,487,952 | \$ 4,208,302 | \$ 1,497,038 | \$ 26,878,423 | \$ 3,817,905 | \$ 188,605 |
| Net unrealized gains (losses) | 943,899 | 1,263,267 | (896,914) | (116,009) | 1,194,243 | 307,949 | - |
| Net realized gains | - | 230 | - | 7,151 | 7,381 | - | - |
| Purchases | - | - | 4,758 | 142,659 | 147,417 | - | - |
| Sales | - | - | - | - | - | - | - |
| Contributions of residual interests | - | - | - | - | - | - | - |
| Change in value of residual interests | - | - | - | - | - | - | 22,964 |
| Transfers out | - | (6,568,031) | (4,809) | (149,810) | (6,722,650) | - | - |
| Balance as of December 31, 2010 | 10,629,030 | 6,183,418 | 3,311,337 | 1,381,029 | 21,504,814 | 4,125,854 | 211,569 |
| Net unrealized gains (losses) | (627,633) | (1,316,236) | 43,855 | (70,759) | (1,970,773) | (282,817) | - |
| Net realized gains | - | 6,586 | - | 431,062 | 437,648 | - | - |
| Net investment expenses | - | - | - | (149,396) | (149,396) | - | - |
| Purchases | - | 14,606,040 | 1,405,357 | 3,870,658 | 19,882,055 | - | - |
| Contributions of residual interests | - | - | - | - | - | - | 399,342 |
| Change in value of residual interests | - | - | - | - | - | - | (23,661) |
| Sales | (1,600,000) | (1,376,225) | (5,184) | (1,009,191) | (3,990,600) | - | - |
| Transfers out | (8,401,397) | - | - | - | (8,401,397) | - | - |
| Balance as of December 31, 2011 | \$ - | \$ 18,103,583 | \$ 4,755,365 | \$ 4,453,403 | \$ 27,312,351 | \$ 3,843,037 | \$ 587,250 |

Transfers out of Level 3 during 2011 include an amount of \$8,401,397 representing an investment for which a three-year lock-up expired on March 1, 2011. This investment is now included in Level 2.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 3 - Fair Values of Financial Instruments (Continued)

A summary of Level 2 and 3 investments of the significant categories of investments utilizing the net asset value practical expedient and their attributes are as follows:

| | <i>Fair Value</i> | <i>Unfunded Commitments</i> | <i>Redemption Frequency (if Currently Eligible)</i> | <i>Redemption Notice Period</i> |
|------------------------------------|-----------------------|---------------------------------|---|---|
| International equity funds | \$ 34,510,032 | \$ - | monthly | 6 - 30 days |
| Global asset allocation strategy | 40,116,741 | - | monthly | 5 - 30 days |
| Private company equity | 31,888,575 | - | quarterly | 90 days |
| Global fixed income fund | 15,828,007 | - | semi-monthly; monthly | 10 - 60 days |
| Multi-strategy hedge fund-of-funds | 8,401,397 | - | quarterly | 65 days |
| Absolute return hedge funds | 27,435,848 | - | monthly; quarterly; annually | 3 - 90 days |
| Real asset commingled trust | 9,468,663 | - | monthly | 7 days |
| Real estate limited partnerships | 4,755,365 | 2,600,000 | | liquidation of fund |
| Private equity | <u>4,453,403</u> | <u>13,348,835</u> | | liquidation of fund |
| | <u>\$ 176,858,031</u> | <u>\$ 15,948,835</u> | | |

International equity funds - includes investments in funds that seek to achieve capital appreciation primarily through investments in equity-related securities and bonds of companies outside the United States. This category includes both growth and value-oriented funds, and managers that invest in both developed and emerging market countries. All of these funds are redeemable on a monthly basis with less than a 30 day notice.

Global asset allocation strategy - includes two funds that seek to achieve long-term capital appreciation primarily through investments in global stocks, inflation protected bonds, high yield and investment grade credit, commodities, government bonds and emerging currencies. These funds hold significant positions in securities of domestic, developed foreign and emerging issuers, and are redeemable on a monthly basis with less than a 30 day notice.

Private company equity - includes participating senior common stock in a private company that provides investment advisory, management and investor services for a range of collective investment vehicles and separately managed accounts for individual and institutional customers. Ownership of these shares is limited to certain groups of permitted holders, including persons employed by the company, its subsidiaries or other organizations with a continuing business relationship with the company, their personal representatives and charities.

Global fixed income funds - includes three funds that invest in a variety of credit sectors, including investment grade bonds, bank loans, securitized assets, high yield credit, emerging country debt securities, and other fixed income obligations. These investments have varied redemption terms, but all can be liquidated on at least a monthly basis with no more than a 60 day notice.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 3 - Fair Values of Financial Instruments (Continued)

Multi-strategy hedge fund-of-funds - includes one limited partnership investment that operates as an offshore feeder fund in a master-feeder type structure. The master fund is a multi-manager, multi-strategy fund-of-funds formed to invest predominantly in partnerships and similar pooled investment vehicles.

Absolute return hedge funds - includes investments in actively managed portfolios that aim to achieve positive annual returns relative to broad equity market indices. These funds invest primarily in equity and equity-related securities in both U.S. and non-U.S. markets, and to a lesser extent in fixed income securities in both U.S. and non-U.S. markets. These investments utilize many different investment strategies, including long and short positions, derivatives and leverage. As of December 31, 2011, approximately 15% of these assets were redeemable on a monthly basis, 19% on a quarterly basis, and 16% on an annual basis. Of the remaining balance, 41% will be redeemable on a quarterly basis after the expiration of a one year lock-up period, and 9% redeemable after a three year lock-up.

Real asset commingled trust - includes one investment in a commingled pool of liquid assets in four primary categories: global energy equities, global metals and mining equities, commodities, and U.S. Treasury Inflation Protected Securities. The portfolio has a strategic allocation of 40% to energy equities, 15% to metals and mining equities, 25% in commodities and 20% in fixed income assets. Within each segment, positions may be concentrated in specific sectors or regions. The investment is redeemable on a monthly basis with 7 days notice.

Real estate limited partnerships - includes private equity funds that invest in a variety of real property interests. These partnerships invest in geographically diversified portfolios of commercial and residential real estate investments, the debt and equity securities of real estate operating companies and real estate investment trusts, as well as commercial mortgages and commercial mortgage-backed securities. These investments are not redeemable; instead, distributions will be received as the underlying investments of the funds are liquidated. It is estimated that the underlying fund assets will be liquidated over the next six to eleven years. The Museum has outstanding capital commitments to the funds totaling \$2,600,000.

Private equity - includes six funds that pursue different private equity strategies, including mezzanine situations, distressed opportunities, secondary interests, and buyouts/growth equity. Some of the managers focus on opportunities within specific sectors, such as technology and energy. These investments are not redeemable; instead, the funds will terminate upon dissolution of the underlying investments. The Museum has outstanding capital commitment to the funds totaling \$13,348,835.

The corporate note is not valued using the NAV practical expedient. The fair value of the note is determined by an independent valuation expert using multiple factors which consider the risk of counterparty default.

Fair values of financial instruments for which the Museum did not elect the recurring fair value option include cash and cash equivalents, certificates of deposit, pledges, residual interests under split-interest agreements, receivables, mortgages, accounts payable, obligations under split-interest agreements and bonds payable. Certain of these instruments are short term in nature and, accordingly, fair values are estimated to approximate carrying values. For the other instruments, management determined that the cost associated with assessing an estimate of fair value outweighed the benefits from this additional information. Different assumptions could significantly affect these estimated fair values. Accordingly, the net realizable values could be materially different from the estimates at December 31, 2011.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 4 - Land, Buildings and Equipment

Land, buildings and equipment are carried at cost and consist of the following at December 31:

| | <i>2011</i> | <i>2010</i> |
|---|-----------------------------|-----------------------------|
| Land and buildings | \$ 85,254,263 | \$ 84,552,263 |
| Capital improvements | 19,802,972 | 19,624,740 |
| Furniture, fixtures and equipment | 13,396,974 | 13,405,075 |
| Historic houses | <u>999,528</u> | <u>999,528</u> |
| Total | 119,453,737 | 118,581,606 |
| Accumulated depreciation | <u>(44,387,134)</u> | <u>(40,326,044)</u> |
| Total | 75,066,603 | 78,255,562 |
| Construction in progress | <u>1,475,751</u> | <u>28,000</u> |
| Land, buildings and equipment, net | <u>\$ 76,542,354</u> | <u>\$ 78,283,562</u> |

Depreciation expense was \$4,192,471 and \$4,188,771 for the years ended December 31, 2011 and 2010, respectively.

Note 5 - Collections and Works of Art

The Museum's collections are made up of works of art, as well as artifacts of historical, cultural and scientific significance, that are held for curatorial, educational and research purposes. Each of the items is cataloged, preserved and cared for, and activities verifying their existence and assessing their condition are performed continuously. The collections are subject to a policy that requires proceeds from their sales to be used to acquire other items for collections.

Note 6 - Defined Contribution Plan

The Museum has a defined contribution plan covering all eligible employees. Employees become eligible to participate after completing one year of service and attaining the age of 21. The Museum contributes 6% (and in some cases higher amounts) of each eligible employee's annual salary. Pension contribution costs of the Museum for the years ended December 31, 2011 and 2010 were \$590,662 and \$615,649, respectively.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 7 - Debt

Note Payable

In December 2011, the Museum entered into a note payable with a financial institution in the amount of \$750,000. Interest is payable monthly at a rate of LIBOR plus 0.45% annually. Monthly principal payments of \$8,929 commence February 1, 2012 and continue through December 1, 2016, at which time the balance of outstanding principal is due. The note is collateralized by \$750,000 in certificates of deposit.

Bonds Payable

Bonds payable consisted of the following for the years ended December 31:

| | <i>2011</i> | <i>2010</i> |
|---|----------------------|----------------------|
| Massachusetts Health and Education Facilities Authority Peabody Essex Museum Issue, Series 2002 Revenue Bonds, interest payable monthly at a variable rate which was .12% and .42% at December 31, 2011 and 2010, respectively, principal due in annual installments through 2033 | \$ 30,310,000 | \$ 31,285,000 |

Payments on the bonds are guaranteed under a direct pay letter of credit issued by Bank of America, which expires on July 1, 2015. The Museum is obligated, under a reimbursement agreement with the bank, to repay any drawings under the letter of credit. Under the terms of the reimbursement agreement, the Museum is subject to certain restrictive covenants involving financial results, additional indebtedness and the maintenance of certain financial ratios. The more restrictive covenants require that the Museum maintain a cash flow available for debt service of \$1 or greater and that the Museum's Liquid Assets, as defined in the current letter of credit agreement, be 1.45 times the funded debt. As of December 31, 2011 and 2010, the Museum was in compliance with its debt covenants.

Total bond interest expense including the effects of the swap was \$1,235,381 and \$1,263,211 in 2011 and 2010, respectively.

Letter of credit fees and bond administration and remarketing fees were \$402,770 and \$281,924 for the years ended December 31, 2011 and 2010, respectively.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 7 - Debt (Continued)

Principal payments on the note and bonds payable are due as follows:

| | <i>Note Payable</i> | <i>Bonds Payable</i> | <i>Total</i> |
|------------|---------------------|----------------------|----------------------|
| 2012 | \$ 98,214 | \$ 1,000,000 | \$ 1,098,214 |
| 2013 | 107,143 | 1,025,000 | 1,132,143 |
| 2014 | 107,143 | 1,075,000 | 1,182,143 |
| 2015 | 107,143 | 1,100,000 | 1,207,143 |
| 2016 | 330,357 | 1,125,000 | 1,455,357 |
| Thereafter | <u>-</u> | <u>24,985,000</u> | <u>24,985,000</u> |
| | <u>\$ 750,000</u> | <u>\$ 30,310,000</u> | <u>\$ 31,060,000</u> |

Note 8 - Interest Rate Swap

In March 2005, the Museum entered into an interest rate swap to manage its exposure to interest rate risk associated with the Museum's variable rate debt.

The Museum's interest rate swap has the following characteristics:

| <i>Notional Amount</i> | <i>Termination Date</i> | <i>Interest Rate Received</i> | <i>Interest Rate Paid</i> | <i>Fair Value</i> | |
|------------------------|-------------------------|-------------------------------|---------------------------|-------------------|--------------|
| | | | | <i>2011</i> | <i>2010</i> |
| \$ 31,325,000 | April 1, 2015 | USD-BMA-Municipal Swap Index | 3.865% | \$ 3,087,235 | \$ 3,064,952 |

The variable rate received by the Museum under the swap agreement was 0.10% and 0.34% at December 31, 2011 and 2010, respectively. Payments made to the swap provider have been included as a component of debt service costs, a nonoperating item on the statement of activities. The Museum recorded as a nonoperating item related to the fair value of the interest rate swap, losses of \$22,283 and \$457,665 as of December 31, 2011 and 2010, respectively.

As a result of the use of derivative instruments, the Museum is exposed to risk that the counterparty will fail to meet its contractual obligations. To mitigate the counterparty credit risk, the Museum only enters into contracts with selected major financial institutions based on their credit ratings and other factors, and continually assesses the creditworthiness of counterparties. At December 31, 2011 and 2010, the counterparty to the Museum's interest rate swap had investment grade ratings. To date, the counterparty has performed in accordance with their contractual obligations. There is no credit risk related to contingent features in the Museum's interest rate swap nor does the swap contain provisions under which the Museum has, or would be required, to post collateral.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 9 - Net Assets and Endowment Matters

Unrestricted Net Assets

Unrestricted net assets consist of the following:

Fixed assets - The value of buildings and equipment, net of depreciation, used in the Museum's operations. This amount is offset by outstanding liabilities related to the assets, such as bond debt.

Board-designated - Funds set aside by the Board of Trustees for strategic purposes and to provide investment income to support operations. These amounts may only be used with the approval of the Board of Trustees.

Operating - Discretionary funds available for carrying on the operating activities of the Museum.

| | <i>2011</i> | <i>2010</i> |
|------------------------------|----------------------|----------------------|
| Fixed assets | \$ 41,845,274 | \$ 43,125,529 |
| Board-designated: | | |
| Functioning as endowment | 9,722,305 | 10,530,823 |
| Funds for strategic purposes | 27,068,531 | 30,512,966 |
| Operating | <u>1,011,967</u> | <u>2,748,248</u> |
| | <u>\$ 79,648,077</u> | <u>\$ 86,917,566</u> |

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 9 - Net Assets and Endowment Matters (Continued)

Temporarily Restricted Net Assets

Temporarily restricted net assets consist of the following:

Unrealized/realized gains on permanently restricted investments - In accordance with standards for accounting for investments and endowment funds held by not-for-profit organizations and with Massachusetts state law, these amounts represent unappropriated net appreciation on permanently restricted endowment investments.

Purpose restricted - Amounts received with donor restrictions which have not yet been expended for their designated purposes.

Time restricted - Amounts designated by donors for use in future periods. At December 31, 2011, all of these funds are purpose restricted.

Split-interest agreements - Assets under split-interest agreements for which the use of the remainder interest is stipulated by the donor.

Funds held by others - Assets held in trust which are restricted in use by the donor.

| | <i>2011</i> | <i>2010</i> |
|--|----------------------|----------------------|
| Unrealized and realized gains on permanently restricted investments: | | |
| General support | \$ 33,774,863 | \$ 43,600,166 |
| Restricted: | | |
| Historic houses | 6,835,061 | 7,893,144 |
| Acquisitions | 1,014,685 | 1,151,700 |
| Program activities | 1,765,627 | 2,025,891 |
| Purpose restricted: | | |
| Historic houses | 2,044,272 | 1,913,016 |
| Acquisitions | 5,218,316 | 5,359,806 |
| Program activities | 4,033,981 | 4,219,664 |
| Strategic purposes | 9,610,295 | 6,428,945 |
| Time restricted | 961,933 | 2,352,252 |
| Split-interest agreements | 663,220 | 295,600 |
| Funds held by others | 251,473 | 340,095 |
| | \$ 66,173,726 | \$ 75,580,279 |

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 9 - Net Assets and Endowment Matters (Continued)

Permanently Restricted Net Assets

Permanently restricted net assets are comprised of the following:

Endowment principal - Amounts restricted by donors against any expenditure of principal. Substantially all the income earned on principal may be used for general or donor-restricted purposes and is recorded in unrestricted net assets or temporarily restricted net assets, as appropriate.

Funds held by others - Assets held in trust in perpetuity for which the Museum is the beneficiary of annual distributions of income.

Split-interest agreements - Assets under split-interest agreements for which the remainder interest is permanently restricted by the donor.

| | <i>2011</i> | <i>2010</i> |
|---------------------------|-----------------------|-----------------------|
| Endowment principal: | | |
| General support | \$ 166,112,605 | \$ 118,218,788 |
| Restricted: | | |
| Historic houses | 13,408,235 | 7,128,491 |
| Acquisitions | 864,648 | 857,171 |
| Program activities | 1,728,270 | 1,713,527 |
| Pledges receivable | 9,787,305 | 40,248,281 |
| Funds held by others | 3,591,564 | 3,785,759 |
| Split-interest agreements | 989,980 | 80,837 |
| Other | 999,528 | 999,528 |
| | \$ 197,482,135 | \$ 173,032,382 |

Endowment for general support includes \$75,000,000 of funds which are restricted to support activities in the Museum's core collections areas. Other restrictions specify how funds may be invested and require consent before additional debt is incurred. The Museum is in compliance with all donor restrictions and will maintain such compliance in perpetuity; accordingly, such funds have been included in the net assets of the Museum.

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 9 - Net Assets and Endowment Matters (Continued)

The following represents required disclosure relative to the composition and activities of endowment and funds functioning as endowment (including funds held by others) for the year ended December 31, 2011:

| | <i>Unrestricted Net Assets</i> | <i>Temporarily Restricted Net Assets</i> | <i>Permanently Restricted Net Assets</i> | <i>Total</i> |
|--|------------------------------------|--|--|-------------------------------------|
| Endowment assets and those functioning as endowment assets, beginning of year | \$ <u>10,530,823</u> | \$ <u>54,670,901</u> | \$ <u>131,784,573</u> | \$ <u>196,986,297</u> |
| Gifts and additions | <u>74</u> | <u>-</u> | <u>54,896,167</u> | <u>54,896,241</u> |
| Investment returns: | | | | |
| Interest and dividends, net of investment expenses | 144,549 | 2,890,297 | 28,612 | 3,063,458 |
| Net realized and unrealized gains (losses) | <u>(413,373)</u> | <u>(8,370,205)</u> | <u>(14,050)</u> | <u>(8,797,628)</u> |
| Total investment returns | <u>(268,824)</u> | <u>(5,479,908)</u> | <u>14,562</u> | <u>(5,734,170)</u> |
| Expenditures: | | | | |
| Amounts appropriated for operations | <u>(539,768)</u> | <u>(5,800,757)</u> | <u>-</u> | <u>(6,340,525)</u> |
| Change in investments | <u>(808,518)</u> | <u>(11,280,665)</u> | <u>54,910,729</u> | <u>42,821,546</u> |
| Endowment assets and those functioning as endowment assets, end of year | \$ <u><u>9,722,305</u></u> | \$ <u><u>43,390,236</u></u> | \$ <u><u>186,695,302</u></u> | \$ <u><u>239,807,843</u></u> |

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 9 - Net Assets and Endowment Matters (Continued)

The following represents required disclosure relative to the composition and activities of endowment and funds functioning as endowment (including funds held by others) for the year ended December 31, 2010:

| | <i>Unrestricted Net Assets</i> | <i>Temporarily Restricted Net Assets</i> | <i>Permanently Restricted Net Assets</i> | <i>Total</i> |
|--|------------------------------------|--|--|-----------------------|
| Endowment assets and those functioning as endowment assets, beginning of year | \$ 9,849,700 | \$ 44,722,417 | \$ 89,207,032 | \$ 143,779,149 |
| Gifts and additions | - | 5,147 | 42,252,961 | 42,258,108 |
| Investment returns: | | | | |
| Interest and dividends, net of investment expenses | 147,696 | 1,989,712 | 29,641 | 2,167,049 |
| Net realized and unrealized gains (losses) | 1,120,443 | 13,267,664 | 294,939 | 14,683,046 |
| Total investment returns | 1,268,139 | 15,257,376 | 324,580 | 16,850,095 |
| Expenditures: | | | | |
| Amounts appropriated for operations | (587,016) | (5,314,039) | - | (5,901,055) |
| Change in investments | 681,123 | 9,948,484 | 42,577,541 | 53,207,148 |
| Endowment assets and those functioning as endowment assets, end of year | \$ 10,530,823 | \$ 54,670,901 | \$ 131,784,573 | \$ 196,986,297 |

PEABODY ESSEX MUSEUM, INC.

Notes to Financial Statements

Note 10 - Commitments and Contingencies

The Museum continues to carry a liability for environmental remediation costs associated with the migration of heating oil on its property. Management expects to incur the balance of these costs by mid 2013. The Museum believes that its adjusted reserves for these costs are adequate. The Museum recovered \$420,000 toward these costs in 2011 and is seeking to recover additional costs through insurance coverage, but it is not possible to estimate the amount of additional recovery at this time.

The Museum is involved in legal actions in the ordinary course of business. In the opinion of management, there are no legal proceedings pending against or involving the Museum whose outcome is likely to have a material adverse effect upon the statements of financial position, statements of activities, changes in net assets and the statements of cash flows of the Museum.

At December 31, 2011, the Museum had contractual commitments totaling \$1,682,277 related to a facilities expansion project.

Note 11 - Related Party Transactions

The Museum has a mortgage receivable bearing interest at 6% annually from an officer of the Museum for \$197,316 at December 31, 2011 and 2010.

Certain members of the Museum's Board are employed by firms that provide legal services to the Museum. Aggregate expenses under these arrangements were \$10,154 and \$10,787 for the years ended December 31, 2011 and 2010, respectively.