

McGladrey LLP



Independent Auditor's Report

Board of Directors
American Quarter Horse Association
Amarillo, Texas

We have audited the accompanying consolidated statements of financial position of the American Quarter Horse Association and American Quarter Horse Foundation (collectively, the Association) as of September 30, 2012 and 2011, and the related consolidated statements of activities and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Association as of September 30, 2012 and 2011, and the changes in its net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

McGladrey LLP

Dallas, Texas
January 9, 2013

American Quarter Horse Association

Consolidated Statements of Financial Position
September 30, 2012 and 2011

Assets	2012	2011
Cash and cash equivalents	\$ 938,749	\$ 950,331
Accounts receivable, net	1,669,719	1,507,354
Contributions receivable, net	3,901,387	3,496,685
Investments	68,565,370	64,558,807
Property and equipment, net	20,059,549	20,708,107
Prepaid expenses and other assets	1,820,639	1,875,596
Total assets	\$ 96,955,413	\$ 93,096,880
Liabilities and Net Assets		
Trade accounts payable and accrued expenses	\$ 3,126,928	\$ 3,680,338
Incentive Fund and Racing Challenge deferred income	12,029,155	12,356,626
Other deferred income	18,489,385	18,930,145
Liability for pension benefits	7,891,118	6,170,342
Total liabilities	41,536,586	41,137,451
Commitments and contingencies	-	-
Net assets:		
Unrestricted	33,077,429	33,009,933
Temporarily restricted	1,059,503	508,449
Permanently restricted	21,281,895	18,441,047
Total net assets	55,418,827	51,959,429
Total liabilities and net assets	\$ 96,955,413	\$ 93,096,880

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

American Quarter Horse Association

Consolidated Statements of Activities
Years Ended September 30, 2012 and 2011

	2012	2011
Unrestricted net assets:		
Operating revenues:		
Memberships and member services:		
Memberships	\$ 7,489,803	\$ 7,658,730
Registrations	4,541,959	4,748,359
Transfers	1,922,065	1,966,275
Stallion breeding report fees and late fees	1,628,072	1,743,270
Genotyping/blood typing	2,090,775	2,228,819
Drug testing	1,831,878	1,347,681
World championship shows	5,604,060	5,244,896
Sponsorships	6,540,466	7,075,675
Publication advertising	1,893,427	1,896,997
Publication circulation	1,270,536	1,363,363
Incentive Fund and Racing Challenge programs	5,631,692	6,161,298
Gift store sales	1,024,058	1,047,698
Other	4,270,370	4,115,742
Total operating revenues	45,739,161	46,598,803
Net assets released from restriction	1,648,898	625,202
Total operating revenues and other support	47,388,059	47,224,005
Operating expenses:		
Program expenses:		
Registration	3,865,745	3,803,171
Shows	12,612,118	12,787,624
Racing	4,755,002	5,083,407
Member services	4,315,340	4,298,053
Marketing	4,648,792	4,558,211
Publications	6,449,755	6,673,712
Foundation program expenses	3,681,058	3,637,313
General and administrative	9,843,179	9,755,508
Fundraising	512,080	432,362
Total operating expenses	50,683,069	51,029,361
Decrease in unrestricted net assets from operations	(3,295,010)	(3,805,356)
Other activities:		
Investment return (loss)	4,967,407	(887,018)
Pension plan actuarial loss recognized	(1,531,715)	(5,526,537)
Uncollectible pledges	(73,186)	(1,829)
Total other activities	3,362,506	(6,415,384)
Increase (decrease) in unrestricted net assets	67,496	(10,220,740)
Temporarily restricted net assets:		
Contributions	673,887	818,624
Investment return (loss)	1,526,065	(526,479)
Uncollectable pledges	-	(8,500)
Net assets released from restrictions and changes in donor designation	(1,648,898)	(629,202)
Increase (decrease) in temporarily restricted net assets	551,054	(345,557)
Permanently restricted net assets:		
Contributions	2,990,848	1,140,582
Uncollectable pledges	(150,000)	(37,500)
Reclassification due to change in donor designation	-	4,000
Increase in permanently restricted net assets	2,840,848	1,107,082
Increase (decrease) in net assets	3,459,398	(9,459,215)
Net assets, beginning of year	51,959,429	61,418,644
Net assets, end of year	<u>\$ 55,418,827</u>	<u>\$ 51,959,429</u>

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

American Quarter Horse Association

Consolidated Statements of Cash Flows Years Ended September 30, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Increase (decrease) in net assets	\$ 3,459,398	\$ (9,459,215)
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Depreciation and amortization	1,833,224	1,776,268
(Gain) loss on disposal of equipment	(3,623)	112
Net (appreciation) depreciation on investments	(6,018,409)	2,737,104
Proceeds from permanently restricted contributions	(2,046,400)	(651,457)
Change in pension liability	1,720,776	635,406
Noncash gifts received	(6,590)	(24,470)
Changes in operating assets and liabilities:		
Accounts and contributions receivable, net	(567,067)	(34,312)
Prepaid expenses and other assets	54,957	(343,059)
Trade accounts payable and accrued expenses	(553,410)	28,173
Other deferred income	(440,760)	(285,341)
Incentive Fund and Racing Challenge deferred income	(327,471)	(1,403,987)
Net cash used in operating activities	(2,895,375)	(7,024,778)
Cash flows from investing activities:		
Purchases of investments	(15,130,541)	(10,367,707)
Proceeds from sales and maturities of investments	17,148,977	19,370,878
Purchase of property and equipment	(1,208,986)	(3,367,436)
Proceeds from sale of property and equipment	27,943	-
Net cash provided by investing activities	837,393	5,635,735
Cash flows from financing activities:		
Proceeds from permanently restricted contributions	2,046,400	651,457
Net cash provided by financing activities	2,046,400	651,457
Net decrease in cash	(11,582)	(737,586)
Cash, beginning of year	950,331	1,687,917
Cash, end of year	\$ 938,749	\$ 950,331

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

American Quarter Horse Association

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies

Nature of operations: The American Quarter Horse Association (AQHA) was formed and exists for the purpose of collecting, recording and preserving the pedigrees of Quarter Horses, and stimulating and regulating matters which pertain to the history, breeding, exhibition, publicity, racing or improvement of the Quarter Horse breed.

The American Quarter Horse Foundation (AQHF) was formed to encourage, by public contribution, support of worthwhile educational and charitable projects of interest and benefit to devotees of the American Quarter Horse. In addition, AQHF operates the American Quarter Horse Hall of Fame and Museum (the Hall of Fame), which opened in 1991. The Hall of Fame is devoted to honoring the American Quarter Horse and those responsible for the success of the breed. The Executive Committee of AQHA serves as the Board of Trustees of AQHF.

Financial statements presentation: The Association's consolidated financial statements are reflected on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. The consolidated financial statements include the accounts and transactions of AQHA and AQHF (collectively, the Association). All material intercompany balances and transactions have been eliminated. The Association reports information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets and permanently restricted net assets.

Use of estimates: The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents: For purposes of the consolidated statements of cash flows, the Association considers all cash and other highly liquid investments with initial maturities of three months or less to be cash equivalents. Cash and cash equivalents held to be redeployed in investments are included in investments in the accompanying statements of financial position. The Association maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Association has not experienced any losses related to these concentrations.

Contributions receivable: Contributions receivable that are expected to be collected within one year are recorded at net realizable value. Contributions receivable that are expected to be collected in future years are recorded at the present value of the expected future cash flows using a discount rate.

An allowance for uncollectible accounts is estimated by management based on its historical loss analysis and is adjusted for those specific contributions receivable for which collection is uncertain. Such amounts will be written-off if and when they are deemed uncollectible.

Accounts receivable: Accounts receivable are included in the accompanying consolidated statements of financial position at original invoice net of the allowance for doubtful accounts. The accounts receivable balance is comprised of amounts owed to the Association for gift shop purchases, sponsorships, journal advertising and other miscellaneous receivables.

The Association determines its allowance based on specific uncollectible accounts. The Association writes off receivables when they become uncollectible. The Association has had minimal losses on accounts receivable in prior years. The allowance for doubtful accounts at September 30, 2012 and 2011 is approximately \$1,000 and \$400, respectively.

Investments: The Association records investments at fair value, which is 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. Absent donor specific requirements, unrealized gains and losses are included in the change in net assets in the accompanying statement of activities and changes in net assets.

The fair value of marketable securities with readily determinable market values is determined using quoted market prices. The fair value of investments in real estate partnerships is determined using the practical expedient. The practical expedient applied to investments real estate partnership provides for the use of the ownership percentage in each partnership applied to total partners' capital to determine the fair value of the investment. See Note 3 for further discussion of fair value.

American Quarter Horse Association

Notes to Consolidated Financial Statements

Property and equipment: Property and equipment are recorded at cost or estimated fair value at the date of donation. Depreciation is provided for in amounts sufficient to relate the cost of depreciable assets over their estimated service lives of approximately 35 to 40 years on buildings and improvements and 3 to 10 years on furniture and equipment on a straight-line basis.

Collections and exhibits: AQHF has capitalized collections since its inception. Collections and exhibits are recorded at cost or estimated fair value at the date of donation and are included in property and equipment. Collections consist primarily of donated art objects where fair value at the date of contribution is determined by appraisal. Depreciation is provided for in amounts sufficient to relate the cost of exhibits over their estimated service lives of approximately 5 to 15 years on a straight-line basis. No depreciation has been provided for collections which are limited works of a rare nature. Gains or losses on the disposition of collections and exhibits are recorded in the consolidated statement of activities at the time of disposition and are classified as unrestricted or temporarily restricted depending on donor restrictions, if any, placed on the item at the date of donation.

Impairment of long-lived assets: The Association reviews long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of carrying amount or the fair value less costs to sell. As of September 30, 2012 and 2011, the Association's management has not recognized impairment on any long-lived assets.

Income taxes: AQHA is qualified under Section 501 of the Internal Revenue Code (IRC); therefore, the majority of its income is exempt from federal income tax under the provisions of Section 501(c)(5). Income from certain operations of AQHA, primarily advertising in its publications, is taxable for federal income tax purposes. For the years ended September 30, 2012 and 2011, AQHA did not incur any federal income tax expense. All other operations of AQHA are exempt from federal income tax. AQHF claims exemption from federal income taxes under Section 501(c)(3) of the IRC and is recognized as a public charity under Section 509(a)(3) of the IRC.

Financial Accounting Standards Board (FASB) provides guidance for how uncertain tax positions should be recognized, measured, disclosed and presented in the financial statements. This requires the evaluation of tax positions taken or expected to be taken in the course of preparing the Association's tax return to determine whether the tax positions are "more-likely-than-not" of being sustained "when challenged" or "when examined" by the applicable tax authority. Tax positions not deemed to meet the more-likely-than-not threshold would be recorded as a tax benefit or expense and liability in the current year. Management has determined that there are no material uncertain income tax positions. The Association is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years prior to 2008.

Revenue recognition: The primary sources of revenue for the Association are recognized as follows:

Contributions: The Association recognizes contribution revenue at the time of donation or when an unconditional promise to give is made by the donor. Contributions are recorded as either unrestricted, temporarily restricted, or permanently restricted in accordance with donor restrictions, if any.

Memberships and member services: Association memberships are deferred and recognized as income during the membership period; lifetime memberships are amortized on a straight-line basis over an estimated life of 10 years. Amounts received for registration, transfer and other member services are reflected in income as the required process is completed.

World Championship Show: Income from shows is deferred and recognized as income in the period in which the show takes place.

Sponsorships: Sponsorship income is deferred and recognized as income in accordance with the terms of various sponsorship agreements.

Publications, advertising and circulation: Subscriptions for the Association's trade publications are deferred and recognized as income during the subscription period.

Incentive Fund and Racing Challenge programs: All Incentive Fund receipts and investment earnings (losses) are credited to deferred income until incurred. The Association recognizes revenue and expense for these programs for the amount of prize monies and purse awards paid.

American Quarter Horse Association

Notes to Consolidated Financial Statements

Functional allocation of expenses: The costs of providing the activities of the Association have been summarized on a functional basis in the consolidated statement of activities. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

Endowments: The AQHF endowments consist of several different individual funds established for a variety of purposes. AQHF's Board of Trustees does not have the ability to distribute any amount of the donor's initial permanently restricted contribution. In accordance with the Uniform Prudent Management of Institutional Funds Act (UPMIFA), the Foundation considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

- (1) The duration and preservation of the fund
- (2) The purposes of the organization and the donor-restricted endowment fund
- (3) General economic conditions
- (4) The possible effect of inflation and deflation
- (5) The expected total return from income and the appreciation of investments
- (6) Other resources of the organization
- (7) The investment policies of the organization

Endowment investment and spending policies: The Association has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment. The Association's investment and spending policies work together to achieve this objective. The investment policy establishes an achievable return objective through diversification of asset classes. The current long-term return objective is to compare to a similarly weighted benchmark representing the returns of the S&P 500 Index and the Intermediate Government/Corporate Index.

The Association targets a diversified asset allocation that places a greater emphasis on asset preservation while striving to achieve its long-term return objectives within prudent risk parameters.

The spending policy calculates the amount of money annually distributed from the earnings of the Association's various endowed funds. The current spending policy is to distribute an amount equal to 5% of the trailing thirty-six month average principal balance, limited to available undistributed earnings.

Subsequent event review: In preparing these consolidated financial statements, the Association has evaluated events and transactions for potential recognition or disclosure through January 9, 2013, the date the financial statements were available to be issued.

Recent accounting pronouncements: In May 2011, the FASB issued updated accounting guidance related to fair value measurements and disclosures that result in common fair value measurements and disclosures between U.S. GAAP and International Financial Reporting Standards (ASU Update 2011-4). This guidance includes amendments that clarify the application of existing fair value measurement requirements, in addition to other amendments that change principles or requirements for measuring fair value and for disclosing information about fair value measurements. This guidance is effective for annual periods beginning after December 15, 2011. The adoption of this guidance is not expected to have a material effect on the Association's consolidated financial statements.

In October 2012, the FASB issued guidance which requires a not-for-profit entity to classify cash receipts from the sale of donated financial assets consistently with cash donations received in the statement of cash flows if those cash receipts were from the sale of donated financial assets that upon receipt were directed without any not-for-profit entity-imposed limitations for sale and were converted nearly immediately into cash. Accordingly, the cash receipts from the sale of those financial assets should be classified as cash inflows from operating activities, unless the donor restricted the use of the contributed resources to long-term purposes, in which case those cash receipts should be classified as cash flows from financing activities. Otherwise, cash receipts from the sale of donated financial assets should be classified as cash flows from investing activities. This guidance is effective prospectively for fiscal years, and interim periods within those years, beginning after June 15, 2013. The adoption of this guidance is not expected to have a material effect on the Association's consolidated financial statements.

American Quarter Horse Association

Notes to Consolidated Financial Statements

Note 2. Contributions Receivable

At September 30, 2012 and 2011, contributions receivable are expected to be received as follows:

	2012	2011
Within one year	\$ 3,325,780	\$ 2,286,422
One to five years	829,481	1,408,579
After five years	154,188	197,784
Less allowance for doubtful accounts	(191,894)	(118,709)
Less unamortized discount	(216,168)	(277,391)
Total contributions receivable, net	<u>\$ 3,901,387</u>	<u>\$ 3,496,685</u>

Note 3. Investments and Fair Value Measurements

At September 30, 2012 and 2011 investments consisted of the following:

	2012	2011
Cash and cash equivalents available for investment	\$ 4,009,762	\$ 11,111,218
Investments at fair value	64,555,608	53,447,589
Total investments	<u>\$ 68,565,370</u>	<u>\$ 64,558,807</u>

The following schedule summarizes the investment return and its classification in the consolidated statement of activities for the years ended September 30, 2012 and 2011:

	2012	2011
Interest and dividends	\$ 1,506,004	\$ 1,323,607
Net realized and unrealized gains (losses)	4,987,468	(2,737,104)
Total return (loss) on investments	<u>\$ 6,493,472</u>	<u>\$ (1,413,497)</u>

Guidance provided by the FASB defines fair value 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 Association utilizes valuation techniques to maximize the use of observable inputs and minimize the use of unobservable inputs. Inputs are broadly defined as assumptions market participants would use in pricing an asset or liability. Assets and liabilities recorded at fair value are categorized within the fair value hierarchy based upon the level of judgment associated with the inputs used to measure their value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:

Level 1 Inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the Foundation has the ability to access at the measurement date. The types of investments included in Level 1 include listed mutual funds and individual stocks.

Level 2 Inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means. The category also includes investments reported at fair value using the practical expedient which do not have excessively restrictive redemption requirements.

Level 3 Inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities. This category includes investments reported at fair value using the practical expedient that have restrictive redemption requirements.

American Quarter Horse Association

Notes to Consolidated Financial Statements

The inputs or methodology used for valuing financial instruments are not necessarily an indication of the risks associated with investing in those instruments. Investments may be exposed to various risks such as interest rate, market and credit. Due to the level of risk associated with such investments and the level of uncertainty related to changes in the value of such investments, it is at least reasonably possible that changes in risks in the near term could affect investment balances and the amounts reported in the financial statements.

The Association assesses the levels of the investments at each measurement date, and transfers between levels are recognized on the actual date of the event or change in circumstances that caused the transfer in accordance with the Foundation's accounting policy regarding the recognition of transfers between levels of the fair value hierarchy. For the years ended September 30, 2012 and 2011, there were no significant transfers among fair value levels.

The following table represents assets reported on the consolidated statement of financial position at their fair value as of September 30, 2012 and 2011 by level within the fair value measurement hierarchy:

	Fair Value			
	Assets Measured at Fair Value September 30	Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2012:				
Measured on a recurring basis:				
Assets:				
Investments:				
Equity mutual funds	\$ 48,596,387	\$ 48,596,387	\$ -	\$ -
Domestic common stock	11,313,335	11,313,335	-	-
International common stock	99,290	99,290	-	-
Real estate partnerships	4,546,596	-	-	4,546,596
Total assets at fair value	\$ 64,555,608	\$ 60,009,012	\$ -	\$ 4,546,596
September 30, 2011:				
Measured on a recurring basis:				
Assets:				
Investments:				
Equity mutual funds	\$ 36,869,779	\$ 36,869,779	\$ -	\$ -
Domestic common stock	5,708,876	5,708,876	-	-
International common stock	5,825,277	5,825,277	-	-
Real estate partnerships	5,039,417	-	-	5,039,417
Other	4,240	4,240	-	-
Total assets at fair value	\$ 53,447,589	\$ 48,408,172	\$ -	\$ 5,039,417

The changes in Level 3 assets measured at fair value on a recurring basis are summarized as follows:

	Real Estate Partnerships
Balance October 1, 2010	\$ 5,235,471
Change on unrealized loss on real estate investments	(196,054)
Balance September 30, 2011	5,039,417
Change on unrealized loss on real estate investments	(492,821)
Balance September 30, 2012	\$ 4,546,596
Net unrealized losses attributable to assets held	\$ (1,935,404)

American Quarter Horse Association

Notes to Consolidated Financial Statements

The following tables provide additional information that describe the nature and risk of the investments held at September 30, 2012 that are recorded at fair value measured using the practical expedient:

	Fair Value	Redemption Frequency (if Currently Eligible)	Redemption Notice Period	Unfunded Commitments
JM Texas Land Fund No. 4, L.P.	\$ 2,536,009	N/A, redemption upon dissolution	N/A	\$ -
New Boston Institutional Fund, L.P. VI	<u>2,010,587</u>	N/A, redemption upon dissolution	N/A	-
	<u>\$ 4,546,596</u>			

Both of these investments consist of investments in real estate partnerships invested in a portfolio of real property located in the United States. The General Partner of each partnership has the authority and discretion to manage and control the affairs of the Partnership, including selecting real property to invest in and when to sell owned assets. The fair values of the investments in this category have been determined using the practical expedient methodology as described in Note 1. Both of the investments in real estate partnerships were not available to be redeemed as of September 30, 2012 and 2011 because the invested capital is not returned until the dissolution of the partnership.

Note 4. Property and Equipment

At September 30, 2012 and 2011, property and equipment consisted of the following:

	2012	2011
Depreciable assets:		
Land	\$ 420,772	\$ 420,772
Building and improvements	16,797,229	16,752,983
Furniture and equipment	12,132,468	12,289,156
Collections and exhibits	3,982,269	3,991,831
	<u>33,332,738</u>	<u>33,454,742</u>
Less accumulated depreciation	(14,973,234)	(14,406,581)
Total depreciable assets	<u>18,359,504</u>	<u>19,048,161</u>
Non-depreciable art and exhibits	1,700,045	1,659,946
	<u>\$ 20,059,549</u>	<u>\$ 20,708,107</u>
Total property and equipment, net		

Note 5. Incentive Fund and Racing Challenge Program Deferred Income

Incentive Fund: The AQHA Incentive Fund is a program whereby AQHA sanctioned show participants and breeders win cash prizes based on total points accumulated during each show year. In order to be eligible, breeders must pay nomination fees for their stallions and foals. The nomination fees and the related investment income represent the source of funds for the cash prizes awarded. Nominated stallions and foals are eligible to receive payments from the Incentive Fund based on total show points earned during the previous year.

The following is a summary of activity of the Incentive Fund for the years ended September 30, 2012 and 2011:

	2012	2011
Net assets of fund, beginning of year	\$ 8,030,912	\$ 9,617,293
Nomination receipts	1,748,049	1,600,250
Investment income	636,493	(207,428)
Miscellaneous income	-	39,031
Incentive fund disbursements	<u>(2,749,615)</u>	<u>(3,018,234)</u>
Net assets of fund, end of year	<u>\$ 7,665,839</u>	<u>\$ 8,030,912</u>

American Quarter Horse Association

Notes to Consolidated Financial Statements

The investment balance allocated to the Incentive Fund as of September 30, 2012 and 2011 is included in the investment balance shown on the statement of financial position.

Racing Challenge: The AQHA Racing Challenge is an incentive-type program open to all registered foals. The Racing Challenge receives funds from individuals for the nomination of their horses. Nominations received are used to supplement purse awards at Challenge races and are paid to the nominators and owners as bonus awards. Race entry fees are received from individuals to enter a Challenge race and are added to the purse award, along with amount contributed by corporate sponsors. Investment income attributable to the Racing Challenge is included in the purse awards as well.

The following is a summary of activity of the Racing Challenge for the years ended September 30, 2012 and 2011:

	2012	2011
Net assets of fund, beginning of year	\$ 4,325,714	\$ 4,153,320
Program receipts	2,389,834	3,534,620
Investment income (loss)	529,845	(219,162)
Program disbursements	(2,882,077)	(3,143,064)
Net assets of fund, end of year	<u>\$ 4,363,316</u>	<u>\$ 4,325,714</u>

The investment balance allocated to the Racing Challenge as of September 30, 2012 and 2011 is included in the investment balance shown on the statement of financial position.

Note 6. Other Deferred Income

At September 30, 2012 and 2011, deferred income, not including deferred income related to the Incentive Fund and Racing Challenge programs, consisted of the following:

	2012	2011
Deferred breeder account	\$ 2,901,894	\$ 3,250,150
Deferred membership income	9,354,029	9,704,603
Deferred publications income	924,908	1,025,890
Deferred world championship shows income (net of prepaid expense of \$582,361 and \$513,642)	2,552,017	2,396,471
Deferred sponsorship and other income	2,756,537	2,553,031
Total other deferred income	<u>\$ 18,489,385</u>	<u>\$ 18,930,145</u>

Note 7. Employee Benefit Plans

Defined benefit plan: The Association has a noncontributory defined benefit pension plan (the Plan) limited to participants who were in the Plan as of October 31, 2003, or active employees as of October 31, 2003 that subsequently become eligible by reaching 21 years of age and completing one year of eligible service. Benefits are based on years of service and the average of each participant's highest five years of compensation out of the last fifteen calendar years.

It is the Association's policy to fund the Plan consistent with the ERISA minimum funding requirements. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. Contributions are predominantly invested in equity securities.

The actuarial present value of benefit obligations is calculated based on certain assumptions pertaining to interest rates, inflation rates and employee compensation and demographics. Due to the uncertainties inherent in setting assumptions, it is reasonably possible that changes in these assumptions will occur in the near term and the effect of such changes could be material to the consolidated financial statements.

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Notes to Consolidated Financial Statements

The Association follows FASB guidance surrounding employers' accounting for defined benefit pension and other postretirement plans, which requires companies that sponsor single-employer defined benefit plans to recognize the funded status of such plans in their statement of financial position. For pension plans, the funded status is measured as the difference between plan assets at fair value and the projected benefit obligation. Gains and losses and prior service costs that arise during the period, but are not recognized as components of net periodic benefit expense, are recognized as a separate line item or items within changes in unrestricted net assets.

The following tables provide further information about the Plan:

Obligations and funded status:

	2012	2011
Cash and cash equivalents	\$ 188,180	\$ 3,455,092
Plan assets at fair value	36,762,816	28,790,915
Total plan assets at September 30	<u>\$ 36,950,996</u>	<u>\$ 32,246,007</u>
Projected benefit obligation at September 30	\$ (44,842,114)	\$ (38,416,349)
Funded status	(7,891,118)	(6,170,342)
Accrued benefit cost recognized in the consolidated statement of financial position	(7,891,118)	(6,170,342)
Benefit cost	1,789,061	1,320,815
Employer contributions	1,600,000	6,200,000
Benefits paid	1,399,041	1,266,870

The accumulated benefit obligation for the defined benefit pension plan was approximately \$41,882,000 and \$34,249,000 at September 30, 2012 and 2011, respectively.

Assumptions:

	2012	2011
Weighted average assumptions used to determine benefit obligations at September 30:		
Discount rate	4.30%	5.35%
Rate of compensation increase	1.50%	3.00%
Weighted average assumptions used to determine net periodic benefit cost for years ended September 30:		
Discount rate	5.35%	5.50%
Expected return of plan assets	7.00%	7.00%
Rate of compensation increase	3.00%	3.00%

The Association's expected rate of return on plan assets is determined by the plan assets' historical long-term investment performance, current asset allocation and estimates of future long-term returns by asset class.

Changes in plan assets and benefit obligations recognized in changes in unrestricted net assets are as follows:

	2012	2011
Interest cost	\$ 2,038,217	\$ 1,950,261
Service cost	816,525	788,477
Amortization of prior service credit	(255,084)	(255,084)
Expected return on plan assets	(2,270,228)	(2,091,556)
Net loss amortization	<u>1,459,631</u>	<u>928,717</u>
Total recognized in net periodic pension cost and unrestricted net assets (recorded in general and administrative expense)	<u>\$ 1,789,061</u>	<u>\$ 1,320,815</u>
Actuarial loss recognized in net assets not yet included in net periodic pension cost	<u>\$ 1,531,715</u>	<u>\$ 5,526,537</u>

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Plan assets: The Association's pension plan weighted-average asset allocations at September 30, 2012 and 2011 by asset category are as follows:

	<u>2012</u>	<u>2011</u>
Asset category:		
Cash	1%	11%
Equity securities	15%	17%
Real estate	3%	4%
Mutual funds	81%	68%
	<u>100%</u>	<u>100%</u>

The Association's investment policy for plan assets is to manage the portfolio to preserve principal and liquidity while maximizing the return on the investment portfolio through the full investment of available funds. The portfolio is diversified by investing in multiple types of investment-grade securities. The investment policy requires assets of the plan to be primarily invested in short-term securities with at least an investment grade rating to minimize interest rate and credit risk, as well as to provide for an immediate source of funds.

The Association attempts to mitigate investment risk by rebalancing between equity and bond asset classes periodically. Although changes in interest rates may affect the fair value of the investment portfolio and cause unrealized gains or losses, such gains or losses would not be realized unless the investments are sold.

Cash flows: The Association contributed more than the IRS minimum required contribution for the plan years ended September 30, 2012 and 2011 in the amount of \$1,600,000 and \$6,200,000, respectively. At this time the Association anticipates contributing the IRS minimum required contribution for the 2013 fiscal year. This amount is not currently available, and the Association may provide additional funding for the plan.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

2013	\$ 1,534,687
2014	1,717,178
2015	1,853,968
2016	1,955,024
2017	2,101,380
2018-2022	<u>12,152,361</u>
	<u>\$ 21,314,598</u>

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The fair values of the Association's Plan assets at September 30, 2012 by asset class are as follows:

Assets Measured at Fair Value September 30	Fair Value Measurements at Reporting Date Using		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2012:			
Asset class:			
Common stocks	\$ 5,389,387	\$ 5,389,387	\$ -
Equity mutual funds	30,202,649	30,202,649	-
Real estate partnerships	1,170,780	-	1,170,780
Total fair value of plan assets	\$ 36,762,816	\$ 35,592,036	\$ 1,170,780
September 30, 2011:			
Asset class:			
Common stocks	\$ 5,390,960	\$ 5,390,960	\$ -
Equity mutual funds	22,117,480	22,117,480	-
Real estate partnerships	1,282,475	-	1,282,475
Total fair value of plan assets	\$ 28,790,915	\$ 27,508,440	\$ 1,282,475

The changes in Level 3 assets measured at fair value on a recurring basis are summarized as follows:

Balance September 30, 2010	\$ 1,317,525
Unrealized loss on real estate estate partnership investments	(35,050)
Balance September 30, 2011	1,282,475
Unrealized loss on real estate estate partnership investments	(111,695)
Balance September 30, 2012	\$ 1,170,780
Net unrealized losses attributable to assets held	\$ (505,220)

No changes in the investment valuation techniques occurred during the periods presented.

Defined contribution plan: The Association established a defined contribution 401(k) plan (the 401(k) Plan) during 1997. Employees are eligible to participate upon employment and reaching age 18. The 401(k) Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974. Under provisions of the 401(k) Plan, eligible employees are allowed to contribute up to 100% of their compensation each year, up to the maximum limits established by the Internal Revenue Service. The Association has the option to make contributions to the 401(k) Plan. The Association also provides for a 100% employer matching contribution to the 401(k) Plan as it relates to certain participants, up to a maximum matching contribution of 6% of participant deferrals. The participants covered under the matching provision are those employees not otherwise eligible for participation in the American Quarter Horse Association Employee Pension Plan (those employees hired subsequent to November 1, 2003). For the years ended September 30, 2012 and 2011, the Association contributed approximately \$226,000 and \$192,000, respectively, to the American Quarter Horse Association 401(k) Plan.

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Note 8. Endowments and Net Assets

Restricted purposes for temporarily and permanently restricted net assets at September 30, 2012 and 2011 are as follows:

	2012		2011	
	Temporarily Restricted	Permanently Restricted	Temporarily Restricted	Permanently Restricted
Operations	\$ 113,282	\$ 9,531,295	\$ 43,444	\$ 8,707,033
Research	115,260	4,665,814	22,361	3,889,696
Education	399,966	1,836,989	275,355	1,840,890
Scholarships	343,491	5,247,797	93,086	4,003,428
Fund raising	87,504	-	74,203	-
	\$ 1,059,503	\$ 21,281,895	\$ 508,449	\$ 18,441,047

The changes in endowment net assets for the fiscal years ended September 30, 2012 and 2011 are summarized below:

	Unrestricted	Temporarily Restricted	Permanently Restricted
Endowment net assets at September 30, 2010	\$ -	\$ 353,978	\$ 17,333,965
Contributions	-	-	1,140,582
Pledge receivable write-off	-	-	(37,500)
Investment (loss) return on endowment assets	(541,848)	15,551	-
Net assets appropriated for expenditure	(56,245)	(155,197)	-
Net assets permanently restricted due to donor requirements	-	-	4,000
Endowment net assets at September 30, 2011	(598,093)	214,332	18,441,047
Contributions	-	-	2,990,848
Pledge receivable write-off	-	-	(150,000)
Investment return on endowment assets	596,892	1,526,065	-
Net assets appropriated for expenditure	-	(1,064,891)	-
Endowment net assets at September 30, 2012	\$ (1,201)	\$ 675,506	\$ 21,281,895

At September 30, 2012 the Foundation had one individual endowment fund where the fair value of the net assets in the fund was less than the original corpus contributed by the donor. The fair value of this endowment was less than the corpus by approximately \$1,200.

Note 9. Commitments and Contingencies

The Association is party to certain legal proceedings and other matters arising from time to time in the normal course of business. Management believes that such legal procedures will not have a material adverse effect on the Association's financial position or activities.