

# **The William and Flora Hewlett Foundation**

**Financial Statements  
December 31, 2012 and 2011**



## Independent Auditor's Report

To The Board of Directors of The William and Flora Hewlett Foundation:

We have audited the accompanying financial statements of The William and Flora Hewlett Foundation ("The Foundation"), which comprise the statements of financial position as of December 31, 2012 and December 31, 2011, and the related statements of activities and changes in net assets and statements of cash flows for the years then ended.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditor's Responsibility***

Our responsibility is to express an opinion on the 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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Foundation's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Foundation's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### ***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The Foundation at December 31, 2012 and December 31, 2011, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*PricewaterhouseCoopers LLP*

April 29, 2013

**The William and Flora Hewlett Foundation**  
**Statements of Financial Position**  
**December 31, 2012 and 2011**  
**(dollars in thousands)**

	December 31,	
	2012	2011
<b>Assets</b>		
Cash	\$ 13,035	\$ 1,555
Investments, at fair value (Notes 3 and 4)	7,686,849	7,257,897
Unrelated business income (UBI) tax refund due	6,386	6,539
Prepaid expenses and other assets	1,460	1,820
Fixed assets, net of accumulated depreciation and amortization	27,642	28,695
	<u>\$ 7,735,372</u>	<u>\$ 7,296,506</u>
<b>Liabilities and Net Assets</b>		
Accounts payable and accrued liabilities	\$ 8,952	\$ 11,806
Payable on lines of credit	50,000	-
Accrued postretirement health care benefit	6,999	5,933
Deferred and federal excise tax payable	13,074	9,837
Grants payable (Note 7)	145,705	157,921
Gifts payable, net of discount (Note 8)	116,017	172,783
Total liabilities	340,747	358,280
Commitments (Note 3)		
Unrestricted net assets	7,394,625	6,938,226
	<u>\$ 7,735,372</u>	<u>\$ 7,296,506</u>

See accompanying notes to the financial statements.

**The William and Flora Hewlett Foundation**  
**Statements of Activities and Changes in Net Assets**  
**Years Ended December 31, 2012 and 2011**  
**(dollars in thousands)**

	<b>Year Ended December 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Unrestricted Net Assets</b>		
Net investment revenues:		
Interest, dividends and other	\$ 86,712	\$ 73,827
Gain on investment portfolio (Note 3)	744,339	254,669
Investment management expense	<u>(17,479)</u>	<u>(25,277)</u>
Net investment income	813,572	303,219
Tax expense on investment income (Note 10)	<u>(12,099)</u>	<u>(2,747)</u>
Net investment revenues	<u>801,473</u>	<u>300,472</u>
Expenses:		
Grants awarded, net of cancellations	(304,089)	(202,844)
Change in gift discount (Note 8)	(6,234)	(10,374)
Direct and other charitable activities	(6,497)	(8,843)
Administrative expenses	<u>(28,254)</u>	<u>(24,778)</u>
Total expenses	<u>(345,074)</u>	<u>(246,839)</u>
Income before net assets released from time restriction and contribution	456,399	53,633
Net assets released from time restriction	-	1,037
Contribution	<u>-</u>	<u>46</u>
Net change in unrestricted net assets	<u>456,399</u>	<u>54,716</u>
<b>Temporarily Restricted Net Assets</b>		
Change in temporarily restricted net assets:		
Change in value	-	14
Net assets released from time restriction	<u>-</u>	<u>(1,037)</u>
Net change in temporarily restricted net assets	<u>-</u>	<u>(1,023)</u>
Change in total net assets	456,399	53,693
Net assets at beginning of year	<u>6,938,226</u>	<u>6,884,533</u>
Net assets at end of year	<u>\$ 7,394,625</u>	<u>\$ 6,938,226</u>

See accompanying notes to the financial statements.

**The William and Flora Hewlett Foundation**  
**Statements of Cash Flows**  
**Years Ended December 31, 2012 and 2011**  
**(dollars in thousands)**

	<b>Year Ended December 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Cash flows used in operating activities:</b>		
Interest and dividends received	\$ 82,060	\$ 72,944
Cash paid for taxes	(8,710)	(5,450)
Cash paid to suppliers and employees	(52,072)	(57,469)
Cash contributions received	-	46
Grants and gifts paid	(379,305)	(351,693)
Net cash used in operating activities	<u>(358,027)</u>	<u>(341,622)</u>
<b>Cash flows from investing activities:</b>		
Purchases of fixed assets	(540)	(565)
Proceeds from sale of fixed assets	7	-
Cash received from partnership distributions	520,218	367,809
Proceeds from sale of investments	16,253,456	17,204,133
Purchase of investments	(16,453,634)	(17,231,712)
Net cash from investing activities	<u>319,507</u>	<u>339,665</u>
<b>Cash flows used in financing activities:</b>		
Cash received from lines of credit	150,000	100,000
Cash paid on lines of credit	(100,000)	(100,000)
Net cash received from financing activities	<u>50,000</u>	<u>-</u>
Net change in cash	11,480	(1,957)
Cash at beginning of year	1,555	3,512
Cash at end of year	<u>\$ 13,035</u>	<u>\$ 1,555</u>

See accompanying notes to the financial statements.

**The William and Flora Hewlett Foundation**  
**Statements of Cash Flows**  
**Years Ended December 31, 2012 and 2011**  
**(dollars in thousands)**

	<b>Year Ended December 31,</b>	
	<b>2012</b>	<b>2011</b>
Reconciliation of change in net assets to net cash used		
in operating activities:		
Change in total net assets	\$ 456,399	\$ 53,693
Adjustments to reconcile change in net assets		
to net cash used in operating activities:		
Depreciation and amortization on fixed assets	1,593	1,717
Gain on disposal of fixed assets	(7)	-
Change in value of gifts discount	6,234	10,374
Net unrealized and realized gain on investments	(744,339)	(254,669)
Decrease (increase) in UBI tax refund due	153	(6,413)
Increase in deferred and federal excise tax payable	3,237	3,818
Increase in accrued postretirement	1,066	1,212
health care benefit		
Increase in value of temporarily restricted net assets	-	(14)
Changes in operating assets and liabilities:		
Increase in interest and dividends receivable	(4,653)	(883)
Decrease (increase) in prepaid expenses and other assets	360	(452)
Decrease in accounts payable and accrued liabilities	(2,854)	(1,156)
Decrease in grants payable	(12,216)	(18,849)
Decrease in gifts payable	(63,000)	(130,000)
Net cash used in operating activities	<u>\$ (358,027)</u>	<u>\$ (341,622)</u>

See accompanying notes to the financial statements.

**The William and Flora Hewlett Foundation**  
**Notes to Financial Statements**  
**December 31, 2012 and 2011**  
**(dollars in thousands)**

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**1. The Organization**

The William and Flora Hewlett Foundation (the “Foundation”) is a private foundation incorporated in 1966 as a non-profit 501(c)(3) charitable organization. The Foundation’s grantmaking activities are concentrated in the program areas of education, environment, performing arts, global development and population. More detailed information regarding the Foundation’s charitable activities can be obtained from the Foundation’s website at [www.hewlett.org](http://www.hewlett.org).

**2. Significant Accounting Policies**

**Basis of presentation**

The accompanying financial statements have been prepared on the accrual basis of accounting.

**Investments**

Investments in stocks and bonds which are listed on national securities exchanges, quoted on NASDAQ or on the over-the-counter market are valued at the last reported sale price, or in the absence of a recorded sale, at a value between the most recent bid and asked prices. Futures, forwards, swaps and options that are traded on exchanges are valued at the last reported sale price or, if they are traded over-the-counter, at the most recent bid price. Index swaps, which gain exposure to equities and fixed income securities in a leveraged form, are traded with a counterparty and are valued at each month end. Equity swaps are valued based on the last reported price of the relevant index or ETF. Fixed income swaps are valued at the last reported sale price, or in the absence of a recorded sale, at a value between the most recent bid and asked prices. Short-term investments are valued at amortized cost, which approximates fair value. Since there is no readily available market for investments in limited partnerships, such investments are valued at amounts reported to the Foundation by the general partners of such entities. The investments of these limited partnerships, such as venture capital, buyout firms and real estate partnerships, include securities of companies that are not immediately liquid. Accordingly, their values are based upon guidelines established by the general partners. Management believes this method provides a reasonable estimate of fair value. These values may differ significantly from values that would have been used had a readily available market existed for such investments, and the differences could be material to a change in net assets of the Foundation.

Investment transactions are recorded on trade date. Realized gains and losses on sales of investments are determined on the specific identification basis.

Foreign currency amounts are translated into U.S. dollars based upon exchange rates as of December 31. Transactions in foreign currencies are translated into U.S. dollars at the exchange rate prevailing on the transaction date.

Cash equivalents categorized as investments include money market mutual funds, foreign currency held for investment purposes, and fixed income securities with an original or remaining maturity when purchased of three months or less.

**The William and Flora Hewlett Foundation**  
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**Cash**

Cash consists of funds held in commercial interest-bearing accounts, for operating expenses.

**Fixed Assets**

Fixed assets are recorded at cost and depreciated using the straight-line basis over their estimated useful lives. The headquarters building and associated fixtures are depreciated over ten to fifty years. Furniture and computer and office equipment are depreciated over estimated useful lives of three to ten years.

**Net Asset Classification**

The Foundation's activities and related assets and liabilities are classified as unrestricted and temporarily restricted according to the terms of the contributions, if any. The Foundation has no permanently restricted net assets.

Unrestricted balances consist of funds undesignated and currently available for all Foundation activities. Temporarily restricted balances, if any, consist of funds available for support of the Foundation's activities, which are expendable only for purposes specified by the donor or within a specified period. As of December 31, 2012 and 2011 there were no temporarily restricted net assets.

**Grants**

Grant awards are expensed when awarded by the Foundation.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements. Estimates also affect the reported amounts of changes in net assets during the reporting period. Actual results could differ from those estimates.

**Reclassifications**

Certain reclassifications have been made to the 2011 balances to conform to the presentation of the 2012 Statement of Cash Flows in the "cash flow from investing activities" section. These reclassifications had no effect on net cash from investing activities or the net change in cash for the year ended December 31, 2011.



**The William and Flora Hewlett Foundation**  
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**Recent Accounting Pronouncements**

In May 2011, the FASB issued Accounting Standards Update (“ASU”) 2011-04, an amendment to the Accounting Standards Codification (ASC) 820: *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirement in U.S. GAAP and IFRSs*. This update clarified the application of existing fair value measurement requirements, and changed certain requirements relating to fair value disclosures for certain entities (including those at the investment partnership level) for assets which are categorized within Level 3 of the fair value hierarchy. The Foundation adopted this guidance for the year ending December 31, 2012 and there was no impact to the Foundation’s financial statements and disclosures.

In December 2011, the FASB issued Accounting Standards Update (“ASU”) 2011-11, *Disclosures about Offsetting Assets and Liabilities*. These disclosures will provide additional information about offsetting arrangements of an entity’s financial assets and liabilities. The guidance will be effective for the Foundation beginning January 1, 2013. The Foundation is currently assessing the impact of this guidance on its financial statements.

**3. Investments**

The Foundation’s investment portfolio, at December 31 consists of the following:

	<u>2012</u>	<u>2011</u>
Investments, at fair value		
Hewlett-Packard and Agilent common stock	\$ 171,908	\$ 198,608
Global equities	771,199	426,546
Commingled funds	1,509,313	1,269,536
Alternative assets	4,301,055	4,378,307
Fixed income	1,041,503	897,885
Net (payable) on forward fixed income transactions	(575,822)	(493,330)
Cash equivalents	303,952	876,772
Net receivable (payable) from unsettled securities purchases & sales	171,886	(288,842)
Derivatives	(8,145)	(7,585)
Total	<u>\$7,686,849</u>	<u>\$7,257,897</u>

Alternative assets consist of private equity, real assets, absolute return and distressed / credit assets, held in partnership or trust format. The commingled funds are primarily global funds invested in long-only equities; assets in these funds are held indirectly by the Foundation in either partnership or trust format.

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The investment goal of the Foundation is to maintain or grow its asset size and spending power in real (inflation adjusted) terms with risk at a level appropriate to the Foundation's program objectives. The Foundation diversifies its investments among various financial instruments and asset categories, and uses multiple investment strategies. As a general practice, except for the Foundation's holdings in Hewlett-Packard and Agilent stock and certain index swaps, all financial assets of the Foundation are managed by external investment management firms selected by the Foundation. All financial assets of the Foundation are held in custody by a major commercial bank, except for assets invested with partnerships, commingled funds and the overlay swaps, which have separate arrangements related to their legal structure.

Approximately 44% and 40% of the Foundation's assets at December 31, 2012 and 2011, respectively, are invested (directly or indirectly) in publicly traded equities, which are listed on national exchanges, quoted on NASDAQ, or in the over-the-counter market; treasury and agency bonds of the U.S. government; and investment grade corporate bonds for which active trading markets exist.

Net realized and unrealized gains and losses on investments are reflected in the statements of activities and changes in net assets. The gain or loss on the Foundation's investment portfolio for the years ended December 31, 2012 and 2011 consists of the following:

	<u>2012</u>	<u>2011</u>
Net realized gain	\$ 517,904	\$ 354,296
Net unrealized gain / (loss)	<u>226,435</u>	<u>(99,627)</u>
	<u>\$ 744,339</u>	<u>\$ 254,669</u>

Approximately 56% and 60% of the Foundation's investments at December 31, 2012 and 2011, respectively, were invested with various limited partnerships and managers that invest in the securities of companies that are not immediately liquid, such as venture capital and buyout firms, and in real estate limited partnerships or private REITs that have investments in various types of properties. At December 31, 2012 and 2011, the Foundation's commitment to contribute additional capital in future years to various partnerships was approximately \$1,048,362 and \$1,187,575, respectively.

Investment securities are exposed to various risks, such as changes in interest rates or credit ratings and market fluctuations. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is possible that the value of the Foundation's investments and total net assets balance could fluctuate materially.

Legal, tax and regulatory changes could occur during the term of the Foundation's fund investments. The regulatory environment for private equity and hedge funds is evolving, and changes in the regulation of these funds may adversely affect the value of investments held by the Foundation. The Foundation believes that the effect of any future regulatory change on the Foundation's assets would likely not be substantial.

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The Foundation maintains a custody account with its primary custodian, The Bank of New York Mellon Corporation (BNY Mellon). Although the Foundation monitors BNY Mellon and believes that it is an appropriate custodian, there is no guarantee that BNY Mellon, or any other custodian that the Foundation may use from time to time, will not become insolvent. The Foundation believes that, in the event of the insolvency of its custodian, some of the Foundation's assets may be unavailable for a period of time, but that it would ultimately have full recovery of its assets.

The Foundation holds repurchase agreement and reverse repurchase agreement securities in its investment portfolio. These securities are held in separately managed accounts, in both the cash equivalent and the distressed / credit portion of the portfolio. In a repurchase agreement, the Foundation buys a security from another party (usually a financial institution) with the agreement that it be sold back in the future at an agreed upon price. In a reverse repurchase agreement, the Foundation sells a security to another party (usually a financial institution) with the agreement that it be bought back in the future at an agreed upon price. Repurchase and reverse repurchase agreements subject the Foundation to counterparty risk, meaning that the Foundation could lose money if the other party fails to perform under the terms of the agreement. For repurchase agreements, the Foundation mitigates this risk by ensuring that its repurchase agreements are collateralized by U.S. government agency securities and treasury securities. For reverse repurchase agreements, the Foundation mitigates this risk by ensuring that it receives cash in exchange for the security. Collateral for repurchase agreements amounts to \$8,976 and \$726,546 as of December 31, 2012 and 2011, respectively. Securities sold for reverse repurchase agreements amounts to \$(39,922) and \$0 as of December 31, 2012 and 2011, respectively. All collateral is held by the custodian and is monitored daily to ensure that it continues to meet the terms of the repurchase agreement. Investments in repurchase and reverse repurchase agreements are also based on a review of the credit quality of the counterparty.

At December 31, 2012, the Foundation's net receivable from unsettled securities purchases and sales includes a receivable from brokers of \$190,689 and a payable to brokers of \$18,803. At December 31, 2011, the net payable from unsettled securities purchases and sales included a receivable from brokers of \$54,519 and a payable to brokers of \$343,361.

The Foundation held 3.8 million shares of Hewlett-Packard Company ("Hewlett-Packard") stock with a market price of \$14.25 per share at December 31, 2012. At December 31, 2011, the Foundation held 3.8 million shares with a market price of \$25.76 per share. The Foundation held 2.9 million shares of Agilent Company ("Agilent") stock with a market price of \$40.94 per share at December 31, 2012. At December 31, 2011, the Foundation held 2.9 million shares of Agilent stock with a market price of \$34.93 per share.

### **Derivative Instruments**

The Foundation transacts in a variety of derivative instruments including futures, forwards, swaps and options primarily for trading purposes with each instrument's primary risk exposure being interest rate, credit, foreign exchange, equity or commodity risk. The fair value of these derivative instruments, held in the Foundation's separately managed accounts, is included in the investments line item in the statements of financial position with changes in fair value reflected as realized gains (losses) or unrealized gains (losses) on derivatives within the statements of activities and changes in net assets.

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The Foundation does not designate any derivative instruments as hedging instruments under GAAP.

Some investment managers retained by the Foundation have been authorized to use certain financial derivative instruments in a manner set forth by either the Foundation's written investment policy, specific manager guidelines or partnership/fund agreement documents. Specifically, financial derivative instruments may be used for the following purposes: (1) currency forward contracts and options are used to hedge nondollar exposure in foreign investments, or to take positions in managed currency portfolios; (2) futures and swap contracts are used to rebalance asset categories within the portfolio and to manage market exposures in managed portfolios; and (3) futures contracts, swaps and options are used to hedge or leverage positions in managed portfolios.

Certain of the Foundation's managers purchase or sell fixed income securities on a delayed delivery or forward settled basis. These transactions involve a commitment by the Foundation to purchase or sell securities for a predetermined price or yield, with payment and delivery taking place beyond the customary settlement period, typically from 1 to 3 months. When purchasing a security on a delayed delivery basis, the Foundation assumes the rights and risks of ownership of the security, including the risk of price and yield fluctuations, and reflects such fluctuations in its net assets. The manager may dispose of or renegotiate a delayed delivery transaction after it is entered into, and may sell the securities before they are delivered, which may result in a capital gain or loss. At December 31, 2012 and 2011 the net liability for these forward purchases and sales was \$575,822 and \$493,330, respectively.

Premiums paid or received with respect to open options contracts at December 31, 2012 and 2011 were \$(16,748) and \$(8,412), respectively. The total value of investments pledged with respect to options and futures contracts at December 31, 2012 and 2011 was \$2,998 and \$2,056, respectively. The value of restricted cash held at brokers as collateral for variation margin at December 31, 2012 and 2011 was \$(1,490) and \$2,457 respectively.

In the opinion of the Foundation's management, the use of financial derivative instruments in its investment program is appropriate and customary for the investment strategies employed. Using those instruments reduces certain investment risks and may add value to the portfolio. The instruments themselves, however, do involve investment and counterparty risk in amounts greater than what are reflected in the Foundation's financial statements. Management does not anticipate that losses, if any, from such instruments would materially affect the financial position of the Foundation.

**The William and Flora Hewlett Foundation**  
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**(dollars in thousands)**

The following table lists fair value of derivatives by contract type as included in the statement of financial position at December 31, 2012. This table excludes exposures relating to derivatives held indirectly through commingled funds.

	Statement of Financial Position Location	Asset Derivatives		Liability Derivatives	
		Average	Fair	Average	Fair
		Notional / # of Contracts	Value	Notional / # of Contracts	Value
Derivatives not designated as hedging instruments under ASC 815					
Interest rate contracts	Investments	\$ 138,000	\$ 3,392	\$ (132,000)	\$ (766)
Futures - Interest rate contracts	Investments	(0)	923	0	(171)
Credit contracts	Investments	122,351	1,283	73,504	(1,302)
Equity contracts	Investments	2,044	948	(13,139)	(11,761)
Foreign exchange contracts	Investments	108,696	105,211	(109,281)	(105,902)
Total derivatives not designated as hedging instruments under ASC 815			<u>\$ 111,757</u>		<u>\$ (119,902)</u>

The following table lists fair value of derivatives by contract type as included in the statement of financial position at December 31, 2011. This table excludes exposures relating to derivatives held indirectly through commingled funds.

	Statement of Financial Position Location	Asset Derivatives		Liability Derivatives	
		Average	Fair	Average	Fair
		Notional / # of Contracts	Value	Notional / # of Contracts	Value
Derivatives not designated as hedging instruments under ASC 815					
Interest rate contracts	Investments	\$ 87,725	\$ 1,792	\$ (175,050)	\$ (928)
Futures - Interest rate contracts	Investments	1	860	0	(81)
Credit contracts	Investments	78,715	471	114,203	(4,675)
Equity contracts	Investments	362	433	(14,387)	(5,677)
Foreign exchange contracts	Investments	102,737	112,898	(102,807)	(112,678)
Total derivatives not designated as hedging instruments under ASC 815			<u>\$ 116,454</u>		<u>\$ (124,039)</u>

**The William and Flora Hewlett Foundation**  
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**(dollars in thousands)**

The following table indicates the gains and losses on derivatives, by contract type, as included in the Statement of Activities and Change in Net Assets for the year ended December 31, 2012.

	Location of Gain or (Loss) Recognized as <u>Income on Derivatives</u>	Change in Unrealized Gain or (Loss) Recognized as <u>Income on Derivatives</u>	Realized Gain or (Loss) Recognized as <u>Income on Derivatives</u>
Derivatives not designated as hedging instruments under ASC 815			
Interest rate contracts	Gain on investment portfolio	\$ 506	\$ 2,676
Futures - Interest rate contracts	Gain on investment portfolio	(26)	(8,993)
Credit contracts	Gain on investment portfolio	2,795	3,431
Equity contracts	Gain on investment portfolio	3,049	24,719
Foreign exchange contracts	Gain on investment portfolio	(912)	(253)
Total derivatives not designated as hedging instruments under ASC 815		<u>\$ 5,412</u>	<u>\$ 21,580</u>

The following table indicates the gains and losses on derivatives, by contract type, as included in the Statement of Activities and Change in Net Assets for the year ended December 31, 2011.

	Location of Gain or (Loss) Recognized as <u>Income on Derivatives</u>	Change in Unrealized Gain or (Loss) Recognized as <u>Income on Derivatives</u>	Realized Gain or (Loss) Recognized as <u>Income on Derivatives</u>
Derivatives not designated as hedging instruments under ASC 815			
Interest rate contracts	Gain on investment portfolio	\$ 2,545	\$ (4,637)
Futures - Interest rate contracts	Gain on investment portfolio	912	3,560
Credit contracts	Gain on investment portfolio	(3,493)	1,330
Equity contracts	Gain on investment portfolio	3,308	36,984
Foreign exchange contracts	Gain on investment portfolio	53	(610)
Total derivatives not designated as hedging instruments under ASC 815		<u>\$ 3,325</u>	<u>\$ 36,626</u>

**The William and Flora Hewlett Foundation**  
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**Credit Default Swaps**

The Foundation's investment managers enter into credit default swaps, generally to simulate long and short bond positions that are either unavailable or considered to be less attractively priced in the bond market. The Foundation managers use these swaps to reduce risk where the Foundation has exposure to the issuer, or to take an active long or short position with respect to the likelihood of an event of default. The reference obligation of the swap can be a single issuer, a "basket" of issuers, or an index. The underlying referenced assets are typically corporate debt, sovereign debt and asset backed securities.

The buyer of a credit default swap is generally obligated to pay the seller a periodic stream of payments over the term of the contract in return for a contingent payment upon the occurrence of a credit event with respect to an underlying reference obligation. If a credit event occurs, the seller typically must pay the contingent payment to the buyer, which is typically the par value (full notional value) of the reference obligation, though the actual payment may be mitigated by terms of the International Swaps and Derivative Agreement ("ISDA"), allowing for netting arrangements and collateral.

The contingent payment may be a cash settlement or a physical delivery of the reference obligation in return for payment of the face amount of the obligation. If the Foundation's investment manager is a buyer and no credit event occurs, the Foundation may lose its investment and recover nothing. However, if a credit event occurs, the buyer typically receives full notional value for a reference obligation that may have little or no value. As a seller, the Foundation receives a fixed rate of income throughout the term of the contract, which typically is between one month and five years, provided that no credit event occurs. If a credit event occurs, the seller may be obligated to pay the buyer an amount up to the full notional value of the reference obligation.

As of December 31, 2012 and 2011, the Foundation is the buyer ("receiving protection") on a total notional amount of \$74,034 and \$2,300, respectively, and is the seller ("providing protection") on a total notional amount of \$120,649 and \$208,142, respectively. The notional amounts of the swaps are not recorded in the financial statements; however the notional amount does approximate the maximum potential amount of future payments that the Foundation could be required to make if the Foundation were the seller of protection and a credit event were to occur.

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Those credit default swaps for which the Foundation is providing protection at December 31, 2012 are summarized as follows:

Written Credit Derivative Contracts Reference Asset:	Single Name Credit Default Swaps		Credit Default Swap Index			Total
	Corporate Debt	Sovereign Debt	Asset Backed Securities	Corporate Debt	Sovereign Debt	
	Fair value of written credit derivatives	\$ (2)	\$ 135	\$ (310)	\$ (84)	
Maximum potential amount of future payments	\$ 44,200	\$ 11,500	\$ 7,200	\$ 57,049	\$ 700	\$ 120,649
Recourse provisions with 3rd parties to recover any amounts paid under the credit derivative						\$ -

<u>Maximum Potential Amount of Future Payments By Contract Term</u>					
	<u>0-12 months</u>	<u>1-5 years</u>	<u>5-10 years</u>	<u>Over 10 years</u>	<u>Total</u>
Current rating on underlying :					
AAA	\$ -	\$ 4,275	\$ -	\$ -	\$ 4,275
AA		8,700	100	7,200	16,000
A	1,400	38,300	2,000		41,700
BBB		23,874	34,000		57,874
<BBB		800			800
<b>Total</b>	<u>\$ 1,400</u>	<u>\$ 75,949</u>	<u>\$ 36,100</u>	<u>\$ 7,200</u>	<u>\$ 120,649</u>



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Those credit default swaps for which the Foundation was providing protection at December 31, 2011 are summarized as follows:

Written Credit Derivative Contracts  Reference Asset:	Single Name Credit Default Swaps		Credit Default Swap Index		Total
	Corporate Debt	Sovereign Debt	Asset Backed Securities	Corporate Debt	
Fair value of written credit derivatives	\$ (1,447)	\$ (878)	\$ (640)	\$ (1,236)	\$ (4,201)
Maximum potential amount of future payments	\$ 21,230	\$ 22,319	\$ 6,800	\$ 157,793	\$ 208,142
Recourse provisions with 3rd parties to recover any amounts paid under the credit derivative					\$ -

<u>Maximum Potential Amount of Future Payments By Contract Term</u>					
	<u>0-12 months</u>	<u>1-5 years</u>	<u>5-10 years</u>	<u>Over 10 years</u>	<u>Total</u>
Current rating on underlying :					
AAA	\$ 1,640	\$ 8,100	\$ 675	\$ -	\$ 10,415
AA	500	11,619	2,000	6,800	20,919
A	2,800	12,300	4,700		19,800
BBB	19,000	101,708	34,000		154,708
<BBB		2,300			2,300
<b>Total</b>	<u>\$ 23,940</u>	<u>\$ 136,027</u>	<u>\$ 41,375</u>	<u>\$ 6,800</u>	<u>\$ 208,142</u>

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**4. Valuation of Investments**

U. S. GAAP has established a framework to measure fair value, and defined the required disclosures about fair value measurements. FASB Accounting Standards Codification ASC 820 on Fair Value Measurements favors the use of market-based information over entity-specific information. The standard prescribes a three-level hierarchy for fair value measurements based on the transparency of information, such as the pricing source, used in the valuation of an asset as of the measurement date.

Investments measured and reported at fair value are classified and disclosed in one of the following categories.

Level I – Quoted prices are available in active markets for identical investments as of the reporting date, without adjustment. The type of investments in Level I include listed equities held in the name of the Foundation, and exclude listed equities and other securities held indirectly through commingled funds.

Level II – Pricing inputs, including broker quotes, are generally those other than exchange quoted prices in active markets, which are either directly or indirectly observable as of the measurement date, and fair value is determined through the use of models or other valuation methodologies.

Level III – Pricing inputs are unobservable and include situations where there is little, if any, market activity for the investment. Investments that are included in this category generally include privately held investments and securities held in partnership or trust format, and for these the Net Asset Value (NAV) as a practical expedient has been used.

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The following table summarizes the valuation of the Foundation's investments by the ASC 820 fair value hierarchy levels as of December 31, 2012:

	<b>Level I</b>	<b>Level II</b>	<b>Level III</b>	<b>Total</b>
Equities and Fixed Income:				
Equity Securities - U.S.	\$ 624,267	\$ -	\$ -	\$ 624,267
Equity Securities - Non-U.S.	318,840			318,840
Corporate Debt Securities		38,154	5,012	43,166
U.S. Government Securities	743,584	152,500		896,084
Asset-Backed Securities		20,084	3,618	23,702
Other Fixed Income Securities	10,469	50,473	17,609	78,551
Commingled Funds <sup>1</sup>			1,509,313	1,509,313
Cash Equivalents	21,179	282,436	337	303,952
Alternative Assets:				
Private Equity			1,680,611	1,680,611
Real Assets			1,150,847	1,150,847
Distressed / Credit		81,163	734,055	815,218
Absolute Return / Market Neutral			654,379	654,379
Derivatives - Assets	106,134	5,623		111,757
<b>Assets</b>	<b>1,824,473</b>	<b>630,433</b>	<b>5,755,781</b>	<b>8,210,687</b>
Derivatives - Liabilities	(106,933)	(12,969)		(119,902)
<b>Investments, at fair value</b>	<b>\$ 1,717,540</b>	<b>\$ 617,464</b>	<b>\$ 5,755,781</b>	8,090,785
Accrued Income and Net Payables and Receivables				(403,936)
<b>Total Investments</b>				<b>\$ 7,686,849</b>

<sup>1</sup> These are directional investments, invested mostly in equity portfolios. These funds invest mostly in long only securities, and some invest in both long and short securities. The investments are public securities, and the funds are held in partnership or trust format.

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The following table summarizes the valuation of the Foundation's investments by the ASC 820 fair value hierarchy levels as of December 31, 2011:

	<u>Level I</u>	<u>Level II</u>	<u>Level III</u>	<u>Total</u>
Equities and Fixed Income:				
Equity Securities - U.S.	\$ 363,953	\$ -	\$ 221	\$ 364,174
Equity Securities - Non-U.S.	260,980			260,980
Corporate Debt Securities		50,783	1,783	52,566
U.S. Government Securities	482,644	204,189		686,833
Mortgage-Backed Securities		10,740		10,740
Other Fixed Income Securities	67,543	43,645	36,558	147,746
Commingled Funds <sup>1</sup>			1,269,536	1,269,536
Cash Equivalents	20,452	856,079	241	876,772
Alternative Assets:				
Private Equity			1,673,622	1,673,622
Real Assets			1,112,361	1,112,361
Distressed / Credit			1,060,942	1,060,942
Absolute Return / Market Neutral			531,382	531,382
Derivatives - Assets	113,758	2,696		116,454
<b>Assets</b>	<b><u>1,309,330</u></b>	<b><u>1,168,132</u></b>	<b><u>5,686,646</u></b>	<b><u>8,164,108</u></b>
Derivatives - Liabilities	(112,759)	(11,280)		(124,039)
<b>Investments, at fair value</b>	<b><u>\$ 1,196,571</u></b>	<b><u>\$ 1,156,852</u></b>	<b><u>\$ 5,686,646</u></b>	8,040,069
Accrued Income and Net Payables and Receivables				(782,172)
<b>Total Investments</b>				<b><u>\$ 7,257,897</u></b>

<sup>1</sup> These are directional investments, invested mostly in equity portfolios. These funds invest mostly in long only securities, and some invest in both long and short securities. The investments are public securities, and the funds are held in partnership or trust format.

The two tables on the following page summarize the Foundation's Level III reconciliation by the ASC 820 standards as of December 31, 2012 and 2011.

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	Beginning Balance at December 31, 2011	Realized Gains (Losses)	Change in Unrealized Gains (Losses)	Purchases and Other Acquisitions	Sales and Other Dispositions	Transfers Into Level III	Transfers Out of Level III	Ending Balance at December 31, 2012
<u>Level III Assets</u>								
Equity Securities U.S.	\$ 221	\$ (9)	\$ 76	\$ 1,303	\$ (212)	\$ 168	\$ (1,547)	\$ -
Corporate Debt Securities	1,783	(3,109)	2,708	4,969	(1,189)	1,224	(1,374)	5,012
Asset-Backed Securities	-	6	122	2,326	(492)	3,087	(1,431)	3,618
Other Fixed Income Securities	36,558	1,205	137	110,860	(131,018)	303	(436)	17,609
Commingled Funds	1,269,536	3,756	244,316	177,971	(186,574)	308		1,509,313
Cash Equivalents	241	1	110		(15)			337
Private Equity	1,673,622	157,106	(116,252)	230,610	(265,538)	3,863	(2,800)	1,680,611
Real Assets	1,112,361	70,269	18,938	143,260	(203,006)	9,025		1,150,847
Distressed / Credit	1,060,942	145,570	(45,508)	99,472	(537,733)	12,116	(804)	734,055
Abs. Return / Market Neutral	531,382	3,902	42,313	204,793	(132,553)	4,542		654,379
<b>Total</b>	<b>\$ 5,686,646</b>	<b>\$ 378,697</b>	<b>\$ 146,960</b>	<b>\$ 975,564</b>	<b>\$ (1,458,330)</b>	<b>\$ 34,636</b>	<b>\$ (8,392)</b>	<b>\$ 5,755,781</b>
	Beginning Balance at December 31, 2010	Realized Gains (Losses)	Change in Unrealized Gains (Losses)	Purchases and Other Acquisitions	Sales and Other Dispositions	Transfers Into Level III	Transfers Out of Level III	Ending Balance at December 31, 2011
<u>Level III Assets</u>								
Equity Securities U.S.	\$ 2,706	\$ (13)	\$ (513)	\$ 1,168	\$ (144)	\$ -	\$ (2,983)	\$ 221
Corporate Debt Securities	5,734	478	1,273	100	(3,518)	1,646	(3,930)	1,783
Other Fixed Income Securities	25,134	632	1	34,032	(24,770)	2,432	(903)	36,558
Commingled Funds	1,236,063	4,572	53,241	170,274	(200,387)	5,773		1,269,536
Cash Equivalents	32		141			68		241
Private Equity	1,418,985	75,445	61,192	226,842	(108,842)			1,673,622
Real Assets	1,002,407	71,401	43,039	111,449	(123,105)	7,170		1,112,361
Distressed / Credit	1,145,935	58,111	(66,969)	208,624	(291,615)	6,856		1,060,942
Abs. Return / Market Neutral	535,393	24,048	3,873	149,943	(181,875)			531,382
<b>Total</b>	<b>\$ 5,372,389</b>	<b>\$ 234,674</b>	<b>\$ 95,278</b>	<b>\$ 902,432</b>	<b>\$ (934,256)</b>	<b>\$ 23,945</b>	<b>\$ (7,816)</b>	<b>\$ 5,686,646</b>

Transfers In (Out) include investments which have been reclassified to Level I and II as the Foundation has the ability to redeem these at NAV in the near term or pricing inputs became observable. This also includes situations where pricing inputs became unobservable for certain Level II investments. All transfer amounts are based on the fair value as of the date of the event or change in circumstances that caused the transfer.

The amount included in the Statement of Activities for the period which is attributable to the change in unrealized gains (losses) related to assets still held at December 31, 2012 and 2011 was \$757,562 and \$611,786, respectively.

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The Foundation uses the NAV as a practical expedient to determine the fair value of all the underlying investments which (a) do not have a readily determinable fair value and (b) prepare their financial statements consistent with the measurement principles of an investment company or have the attributes of an investment company.

The following table lists investments in investment funds (in partnership or trust format) by major category as of December 31, 2012:

	Strategy	Fair Value	Remaining Life (Years)	Unfunded Commitments	Redemption Terms	Redemption Restrictions
Private Equity	Venture and buyout, in the U.S. and international	\$ 1,681	1 to 12	\$ 618	Not eligible for redemption	Not redeemable
Real Assets	Real estate and natural resources, primarily in the U.S.	1,151	1 to 12	344	Not eligible for redemption	Not redeemable
Distressed / Credit	Distressed asset funds & credit strategies, globally	815	1 to 12	86	34% by value are in private equity structure, with no redemption ability. For the rest, terms range between monthly and quarterly redemption with 7 - 65 days' notice, to annual redemption with 45 - 180 days' notice.	14% by value (2 funds) have lock up provision between 0 to 2 years. Side pockets exist for approximately 1% by value.
Absolute Return - Market Neutral	Global equity and fixed income funds in market neutral strategies	654	N.A.	-	6% by value are in private equity structure, with no redemption ability. For the rest, terms range from weekly to quarterly redemption with 6 - 90 days' notice, to annual redemption with 60 - 90 days' notice.	N.A.
Commingled funds	Global funds, primarily long-only and primarily in	1,509	N.A.	-	Range from 6 to 90 days' notice.	10% by value (3 funds) have lock up provisions between 0 to 2 years.
Total		<u>\$ 5,810</u>		<u>\$ 1,048</u>		

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The following table lists investments in investment funds (in partnership or trust format) by major category as of December 31, 2011:

	Strategy	Fair Value	Remaining Life (Years)	Unfunded Commitments	Redemption Terms	Redemption Restrictions
Private Equity	Venture and buy out, in the U.S. and international	\$ 1,674	1 to 12	\$ 745	Not eligible for redemption	Not redeemable
Real Assets	Real estate and natural resources, primarily in the U.S.	1,112	1 to 12	321	Not eligible for redemption	Not redeemable
Distressed / Credit	Distressed asset funds & credit strategies, globally	1,061	1 to 12	120	56% by value are in private equity structure, with no redemption ability. For the rest, terms range between quarterly redemption with 60 - 65 days' notice, to annual redemption with 45 - 180 days' notice.	9% by value (2 funds) have lock up provision between 0 to 3 years. Side pockets exist for approximately 1% by value.
Absolute Return - Market Neutral	Global equity and fixed income funds in market neutral strategies	531	N.A.	-	13% by value are in private equity structure, with limited liquidity. For the rest, terms range between monthly and quarterly redemption with 30 - 65 days' notice, to annual redemption with 60 days' notice.	7% by value (1 fund) has lock up provision of less than 1 year.
Commingled funds	Global funds, primarily long-only and primarily in equities	1,270	N.A.	1	Range from 6 to 90 days' notice.	12% by value (4 funds) have lock up provisions between 0 to 3 years.
Total		<u>\$ 5,648</u>		<u>\$ 1,187</u>		

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**5. Fixed Assets**

Fixed assets consist of the following at December 31, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
Building, land lease and land improvements	\$ 34,357	\$ 34,357
Furniture and fixtures	5,549	5,481
Computer and office equipment	<u>2,614</u>	<u>2,433</u>
	42,520	42,271
Less accumulated depreciation and amortization	<u>(14,878)</u>	<u>(13,576)</u>
	<u>\$ 27,642</u>	<u>\$ 28,695</u>

**6. Benefit Plans**

**Retirement Plans**

The Foundation sponsors a 403(b) defined contribution plan for its eligible employees. Foundation contributions to the plan totaled \$1,829 and \$1,753 in 2012 and 2011, respectively.

The Foundation also has an unfunded 457(b) deferred compensation plan. Subject to statutory limits, the Foundation contributes to the plan on behalf of eligible employees that did not receive their full contributions to the defined contribution plan due to Internal Revenue Service limits. In relation to this plan, at December 31, 2012 the Foundation held assets of \$926 that are included in prepaid expenses. These assets are designated by the Foundation to pay future 457(b) plan liabilities. The corresponding liability of \$926 is included in accrued liabilities.

**Postretirement Healthcare Benefits**

The Foundation provides healthcare benefits to retired employees and their eligible dependents. Net periodic benefit costs totaled \$622 and \$593 in 2012 and 2011, respectively. The Foundation recorded a liability for postretirement benefit obligations of \$6,999 and \$5,933 as of December 31, 2012 and 2011, respectively.



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The weighted average discount rate assumptions used for the plan are shown below:

	<u>2012</u>	<u>2011</u>
Discount rate to determine benefit obligations	3.85%	4.27%
Discount rate to determine the net periodic benefit cost	4.27%	5.50%

**7. Grants Payable**

Grant requests are recorded as grants payable when they are awarded. Some of the grants are payable in installments, generally over a two or three-year period. Grants authorized but unpaid at December 31, 2012 are payable as follows:

<u>Year Payable</u>	<u>Amount</u>
2013	\$ 121,978
2014	21,451
2015 and thereafter	<u>2,276</u>
	<u>\$ 145,705</u>

**8. Gifts Payable**

The Foundation made a commitment of \$113,000 in August of 2007 to the University of California, Berkeley, over seven years, for a challenge grant to endow 100 faculty chairs and for the creation of an in-house investment company. The obligation was discounted to a net present value as of December 31, 2012 and 2011 using a discount rate of 4.33%. Payments of \$13,000 and \$30,000 were made in 2012 and 2011, respectively. The Foundation expects to pay \$18,000 over the next two years.

The Foundation made a commitment of \$461,095 in July of 2008 to ClimateWorks Foundation for an initiative to mitigate global climate change. This obligation was fully paid by December 31, 2012. A subsequent commitment of \$100,000 to ClimateWorks Foundation was made in 2012. This obligation is expected to be paid over a period of two years and was discounted to a net present value as of December 31, 2012 using a discount rate of 0.29%. The Foundation expects to pay \$100,000 over the next two years.

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The total gifts payable at December 31, net of discount, is as follows:

	<u>2012</u>	<u>2011</u>
Gifts payable	\$ 118,000	\$ 181,000
Less unamortized discount	<u>(1,983)</u>	<u>(8,217)</u>
Gifts payable, net of discount	<u>\$ 116,017</u>	<u>\$ 172,783</u>

**9. Credit Facilities**

The Foundation has a collateralized revolving line of credit (“LOC”) of \$300,000 with BNY Mellon. This LOC note does not have an expiration date. At December 31, 2012 and 2011 the outstanding principal balance on the line of credit was \$20,000 and \$0, respectively. The interest rate on the LOC is variable and is indexed to the one month London Interbank Offered Rate (“Libor”).

In addition, the Foundation has a one-year committed revolving LOC of \$100,000 and a two-year committed revolving LOC of \$200,000, with JP Morgan Chase. At December 31, 2012, the outstanding principal balance on these two lines of credit was \$30,000 and \$0, respectively. The interest rate on these lines of credit is variable and is indexed to the one, two and three month London Interbank Offered Rate (“Libor”).

**10. Federal Excise and Unrelated Business Income Tax**

The William and Flora Hewlett Foundation is a private foundation and qualifies as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code and corresponding California provisions. Private foundations are subject to a federal excise tax on net investment income and may reduce their federal excise tax rate from 2% to 1% by exceeding a certain payout target for the year. The Foundation qualified for the 1% tax rate in 2011, and expects to qualify for the 1% tax rate for 2012. Each year, current federal excise tax is levied on interest and dividend income and net realized gains of the Foundation; net investment losses do not reduce investment income. At December 31, 2012, deferred federal excise tax is provided at 2%, the maximum rate which could be paid on unrealized gains on investments.

The income from certain investments is subject to unrelated business income tax.

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	<u>2012</u>	<u>2011</u>
Current federal excise tax expense	\$ 5,087	\$ 4,513
Deferred federal excise tax expense	<u>3,034</u>	<u>3,818</u>
Excise tax expense	8,121	8,331
Unrelated business income tax expense	<u>3,978</u>	<u>(5,584)</u>
Tax expense on investment income	<u>\$ 12,099</u>	<u>\$ 2,747</u>

The Foundation believes that it has appropriate support for the excise and other tax positions taken and, as such, does not have any uncertain tax positions that result in a material impact on the Foundation's financial position or change in total net assets.

**11. Subsequent Events**

The Foundation has evaluated subsequent events for the period from December 31, 2012 through April 29, 2013, the date the financial statements were issued, and believes no additional disclosures are required in the financial statements.