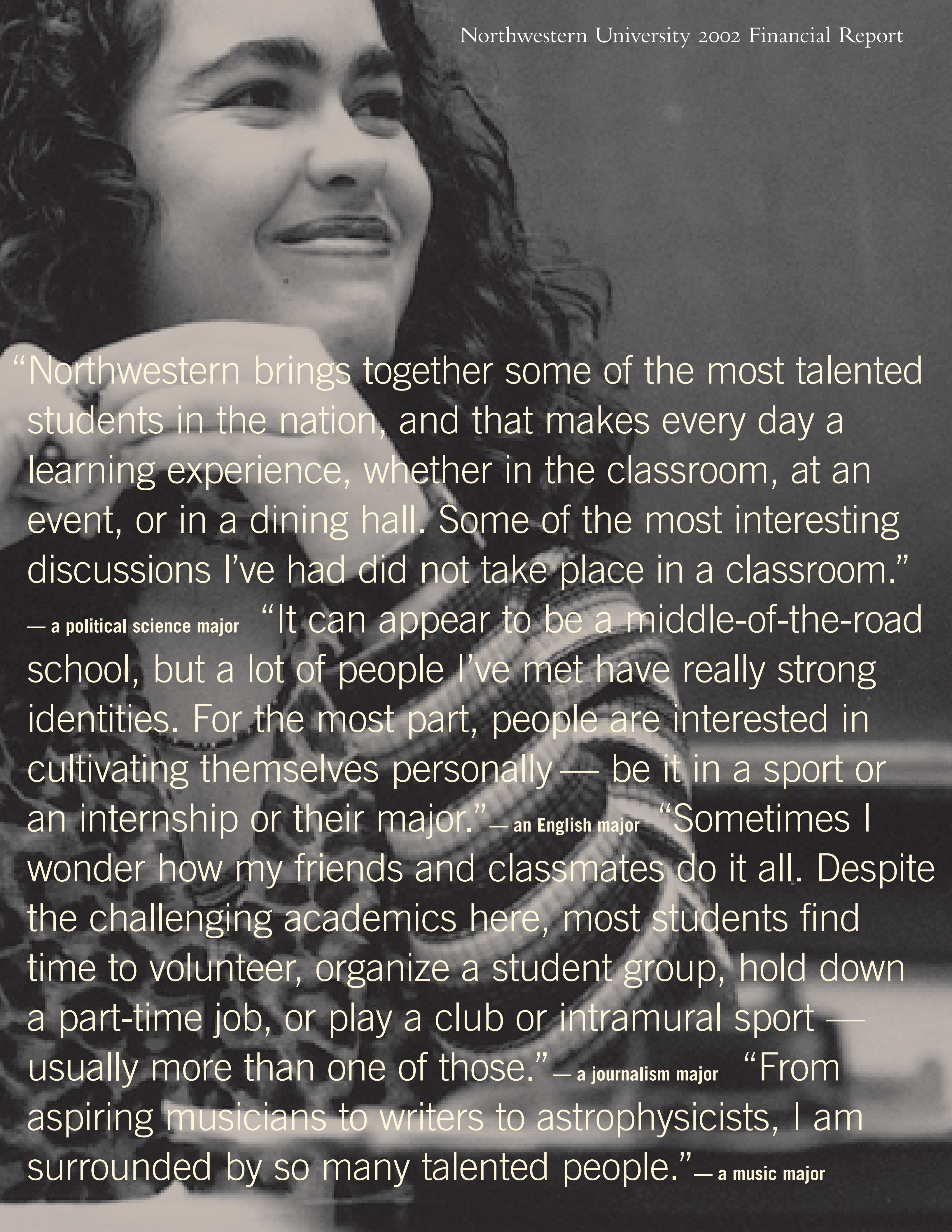
Northwestern University 2002 Financial Report



"Northwestern brings together some of the most talented students in the nation, and that makes every day a learning experience, whether in the classroom, at an event, or in a dining hall. Some of the most interesting discussions I've had did not take place in a classroom." **— a political science major**

"It can appear to be a middle-of-the-road school, but a lot of people I've met have really strong identities. For the most part, people are interested in cultivating themselves personally — be it in a sport or an internship or their major." **— an English major**

"Sometimes I wonder how my friends and classmates do it all. Despite the challenging academics here, most students find time to volunteer, organize a student group, hold down a part-time job, or play a club or intramural sport — usually more than one of those." **— a journalism major**

"From aspiring musicians to writers to astrophysicists, I am surrounded by so many talented people." **— a music major**

Message from the President

Other than academic excellence, what characterizes Northwestern students? Attempting to create a profile of a typical Northwestern undergraduate is ill-advised. Just as Northwestern students are not typical of young adults in general, there is no typical Northwestern student. When we characterize the undergraduate student body, the word we use most often is diverse. Our undergraduates come from across the country and around the globe, from every economic stratum, from large cities and small towns, from many ethnic backgrounds and religious traditions.

Admission to Northwestern is highly competitive. Each year a freshman class numbering about 1,925 is selected from approximately 15,000 applicants. While secondary school performance and test scores remain the best predictor of success here, our admission staff evaluates much more than grades and SAT numbers. We look for students who will nourish and be nourished by the totality of our rich environment. An engineering major who hopes to play in the Concert Band, an economics major who edited her high school newspaper, any student who intends to spend several hours a week tutoring children in the local schools, will find encouragement at Northwestern to feed every dimension of their being.

Keeping these well-rounded young men and women challenged is both an exhilarating and a formidable task. We continually strive to enhance what is already a superb undergraduate experience. Our current fundraising effort, Campaign Northwestern, will not end until next August, yet the funds it has raised have already assisted undergraduates immeasurably. Campaign Northwestern has allowed us to hire new faculty to broaden the scope of academic offerings, to develop more cross-disciplinary courses and programs, and to allow more students to take part in individual and small-group work with professors. Undergraduates are benefiting from new opportunities to do research projects during the academic year and in the summer and to study abroad. In student services, we have improved career guidance and placement activities; implemented a new information system to simplify and facilitate enrollment, course registration, and financial aid; and constructed new residences, including the new Residential College of Science and Engineering at Slivka Hall.

As we have made these investments in the undergraduate experience, we have seen the number of applications to the University rise, along with the academic credentials of the applicants. Northwestern's reputation is growing as an institution that attracts the *best* students — in every sense of the word. The following pages will offer myriad facts and figures about the exceptional, dynamic, and diverse students who come to Northwestern.

Henry S. Bienen
President

Academic credentials of applicants

Thirty-three percent of high school students applying to Northwestern are accepted, and about 43 percent of those accepted enroll here. The median secondary school ranking of current freshmen was the 96th percentile, and the median combined score on the Scholastic Assessment Test was 1390. About one-half of the freshman class received some form of advanced placement upon entrance.

Demographically speaking

More than one-half of our undergraduates — 52 percent — are female. Almost one-third are members of minority groups, including 20 percent Asian American, 6 percent African American, and 5 percent Hispanic. And, dispelling stereotypes about the deep pockets of their parents, 60 percent enroll with financial aid, which may be a combination of work-study, loans, and outright grants.

Where Northwestern students call home

Our undergraduates come from all 50 states and 134 countries. Among the current student body, 43.2 percent are from the Midwest, 19.4 percent from the New England and the Mid-Atlantic states, 19.4 percent from the West and the Southwest, 10 percent from the South, and 8 percent from foreign countries. After Illinois (22 percent), the states with the largest representation in the 2001–02 freshman class were California (8 percent), New York (7 percent), and Ohio (5 percent).

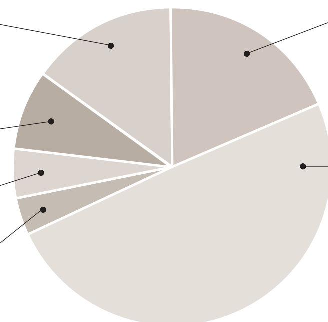
"One of my earliest thrills here was finding that I was around people who are motivated and intelligent." **— a biological sciences major**

Large photo at left: **Hamilton Harper (McCormick '04)**

A chemical engineering major from West Carollton, Ohio, Hamilton serves as president of the National Society of Black Engineers and social chair of the American Institute of Chemical Engineers. Though he spends most of his class time in the Technological Institute, Hamilton says his favorite class is on the other end of campus from Tech. "After all the engineering classes, Introduction to Music is a great stress reliever," he says. He also likes to unwind by lifting weights in Patten Gymnasium. "Of the three gyms on campus," he says, "this is the home of the hardcore lifter." Hamilton says he appreciates the moderate size of Northwestern when he sees many familiar faces while walking down Sheridan Road.

What they study

The liberal arts form the core of any bachelor's degree program at Northwestern. Moreover, half of Northwestern undergraduates receive BA degrees in the arts and sciences. The undergraduate population of 7,698 breaks down among our six undergraduate schools as follows:

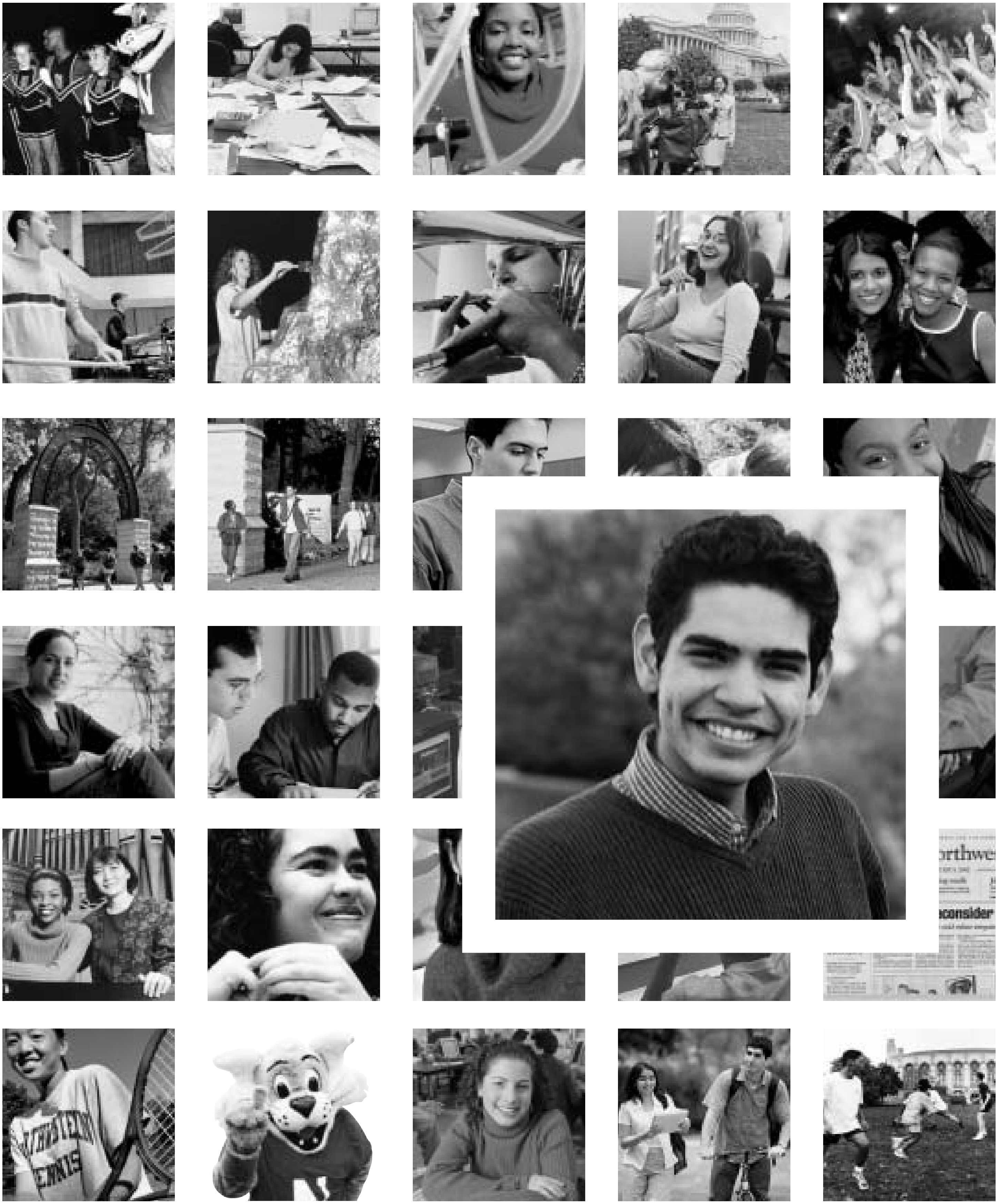


Nearly 90 percent of Northwestern undergraduates earn a bachelor's degree within five years. That figure includes students in double-degree programs and the five-year Walter P. Murphy Cooperative Engineering Education Program. Less than 3 percent of Northwestern undergraduates leave for academic reasons.

"The great thing about Northwestern is that it really is not competitive. People work hard because they want to." **— a theater major**

Large photo at right: **Melissa McGonegle (Education and Social Policy '03)**
Melissa's days at Northwestern are filled with classes for her social policy major, meetings to coordinate service projects for Alternative Spring Break, and brainstorming sessions to promote Greek philanthropies through the Panhellenic Association. A former candidate for Homecoming queen and a Chicago native, she also is working with a high school nonprofit program through the Service Learning Certificate Program. Melissa says she enjoys life's simple pleasures — like microwave popcorn and MTV's *The Real World* — and never underestimates the importance of power napping.


TENNIS
BACCHAE



Where students live

About 4,250 undergraduate students live in the University's residences, 900 live in fraternity or sorority houses, and the remaining 2,550 commute from home or live off campus. Of those who live in University residences, nearly a third are members of special communities called "residential colleges." From three dozen to 300 students live in each of Northwestern's 11 residential colleges, where they are able to focus on a common interest such as business, science, the arts, and public affairs.

What they participate in outside of class

On a campus with more than 250 extracurricular groups, Northwestern students obviously don't spend all their time hitting the books. Extracurricular activities range from Associated Student Government to the *Daily Northwestern,* the student newspaper, to Dance Marathon, one of the largest college philanthropic events in the country. Each year about 3,000 Northwestern students volunteer for some sort of community service. On the sports front, 75 Northwestern athletes have earned first-team All-American honors in the Big Ten since 1995.

After graduation

In a recently surveyed graduating class, 54 percent accepted full-time employment, 30 percent entered a graduate or professional program, and 16 percent pursued full-time community service or volunteer work, an internship or fellowship, or other endeavors. The majority of people leaving here with bachelor's degrees go on to earn advanced degrees. One survey found that within 10 years of graduating, 60 percent had earned a higher degree. Among those, 12 percent received MBAs, 11 percent JDs, 9 percent MDs, and 6 percent PhDs.

"It is no coincidence that the leaders of tomorrow graduate from this institution." **— a communications sciences and disorders major**

Large photo at left: **Evelio Contreras (Medill '04)**

With a double major in journalism and philosophy, Evelio has been a reporter and editor for the *Daily Northwestern* and an editorial intern at *Northwestern* magazine. The native Texan has also been a volunteer, helping people to study for the GED exam. He says he enjoys running along the lakeshore anytime he needs a break. Evelio's stage talents helped pay for his books in his freshman year: He won $200 in bookstore gift certificates for his performances of ABBA's "Dancing Queen" and the Beatles' "Strawberry Fields Forever" at a karaoke contest. He believes in seeking out professors after class. "People say go to office hours to show that you care about the class," he comments, "but I say go to learn more about them and to see how they can help you learn more about yourself."

Report of the Senior Vice President for Business and Finance

To the Board of Trustees of Northwestern University:

Like all universities, Northwestern operated in the throes of a national economic decline during the last two years. While we are in better circumstances than some of our peers — thanks to previous years' robust returns on our endowment and the fundraising success of Campaign Northwestern — the economic downturn and weak investment markets have affected us, as the financial statements in this report document. We now must depend on our historically successful prudent management principles and strong budget controls to ensure the University's continuing financial soundness.

A second consecutive year of negative investment returns was the major factor contributing to the decline in assets as reported on the Consolidated Statements of Financial Position. After decreasing 5.3 percent in 2001, assets decreased another 3.3 percent in 2002. They totaled more than $4.7 billion as of August 31, 2002. Although the University's endowment assets continued to outperform the benchmarks in most asset classes, the Long-Term Balanced Pool still suffered a return of -6.77 percent.

The Investment Report describes Northwestern's systematic approach to reviewing the market valuations provided by external investment managers. As a result of this process, a $55 million write down from the June 30 valuations from private equity managers was recorded.

Among the $158.1 million in gift revenue recognized across all net assets classes in 2002 was a major pledge of $75 million to the medical school. The school, whose teaching and research missions are significantly enhanced by the gift, was renamed the Feinberg School of Medicine in recognition of the donor, the Joseph and Bessie Feinberg Foundation.

Increasing research funding continues to be a priority, and grants and contracts revenue grew 15.1 percent in fiscal 2002, to $285.9 million.

The increase in net tuition and fees revenue was a modest 2 percent, as the University continued to show restraint with its tuition increases and to spend more for graduate fellowships.

The spending rule calculation, explained in the Investment Report, was revised for 2002. The new rule resulted in a 3.2 percent increase, or $192 million, in investment returns spent to support the operating budget.

Operating expenses increased in 2002. They totaled $921.2 million, an increase of less than 5.7 percent over 2001. Factors in the increase include the expensing of $22.5 million in software received in 2002 in payment on a 2001 contribution receivable, as well as higher costs for property and liability insurance and for employee health benefits.

The University's net assets totaled more than $3.9 billion at August 31, 2002, a decline of 5.3 percent over 2001. Assets were reclassified from temporarily restricted net assets to unrestricted net assets as payments on a number of large pledges were made. This increase in unrestricted net assets was more than offset, however, by unrealized investment losses. As a result, unrestricted net assets and temporarily restricted net assets decreased by 7.1 percent and 21.5 percent, respectively. The aforementioned Feinberg Foundation pledge generated a 12.4 percent increase in permanently restricted net assets.

The Consolidated Statements of Activities show an excess of operating revenues over expenses of $67.3 million. This operating surplus, although not as great as the previous year's, signifies that the University exercises good stewardship over its financial resources. While maintaining fiscal restraint is imperative, Northwestern remains well positioned to sustain an academic community to meet its missions of providing the highest-quality education for its students, developing innovative research programs, and delivering public service to the world, region, and community.

Eugene S. Sunshine

Eugene S. Sunshine

Senior Vice President for Business and Finance

During the past year financial markets reflected a difficult economic environment as well as corporate misdeeds, profit adjustments, and continued unwinding of the speculative market of the late 1990s. As global equity markets completed their third consecutive negative calendar year, the days of the liquidity bubble seemed long past.

Northwestern's investments were not immune to the declines in calendar year 2002, when the Dow dropped 15 percent and the S&P 500 dropped 22.1 percent. As of August 31, 2002, the University's investment assets totaled $3.475 billion, including cash equivalents and intra-University investments. This total represents a decrease of approximately $172 million from August 31, 2001. While realized and unrealized losses for the year totaled $295 million, net new investment by the University was $123 million.

The following pages detail both past financial results and new efforts for the Investment Office. Some efforts maintain existing policies, while others depart from them. New asset allocation policies, as well as a move to more active management within marketable securities, will be highlighted here. Reviewing past history, we will look at both absolute and relative performance versus a number of stated objectives.

The University's Investment Pools

The University maintains investment pools and separately invested assets. Each pool has a specific set of objectives. The Annuity, Unitrust, and Life Income Bond Pool, the Charitable Remainder Trust Balanced Pool, and the Charitable Remainder Trust Tax-Exempt Bond Pool were liquidated in fiscal year 2001. Their assets were transferred to Mellon Trust and reclassified as separately invested funds. The table below illustrates the net asset values and unitized information for the surviving investment pools for the past five years.

History of the Merged Pools as of August 31

	1998	*1999*	*2000*	*2001*	*2002*
Long-Term Balanced Pool					
Net asset value (in thousands of dollars)	$2,024,494	$2,476,184	$3,337,660	$2,981,351	$2,731,507
Number of units (in thousands)	17,156	17,442	18,413	19,091	20,072
Net asset value per unit	$118.00	$141.97	$181.27	$156.17	$136.09
Payout amount per unit					
Current earned income	$1.98	$1.61	$1.05	$1.05	$0.58
Previously reinvested realized gains withdrawn	$2.19	$2.66	$4.25	$5.17	$5.98
Total payout per unit	$4.17	$4.27	$5.30	$6.22	$6.56
Short-Term Money Market Pool					
Net asset value (in thousands of dollars)	$15,027	$13,023	$30,959	$5,762	$4,077
Number of units (in thousands)	1,502	1,301	3,093	576	407
Net asset value per unit	$10.01	$10.01	$10.01	$10.00	$10.01
Payout amount per unit					
Current earned income	$0.53	$0.50	$0.61	$0.50	$0.22
Intermediate-Term Bond Pool					
Net asset value (in thousands of dollars)	$134,657	$188,788	$251,180	$249,536	$272,155
Number of units (in thousands)	11,934	14,738	16,231	18,188	22,213
Net asset value per unit	$11.28	$12.81	$15.48	$13.72	$12.25
Payout amount per unit					
Current earned income	$0.54	$0.48	$0.57	$0.62	$0.63
Summary of net asset values (in thousands of dollars)					
Above pools	$2,174,178	$2,677,995	$3,619,799	$3,236,649	$3,007,739
Pools liquidated in fiscal 2001	13,418	90,594	105,529	—	—
Separately invested funds	95,537	101,076	92,879	172,461	157,272
Working capital	222,064	235,131	237,736	237,502	309,993
Total net asset value (in thousands of dollars)	**$2,505,197**	**$3,104,796**	**$4,055,943**	**$3,646,612**	**$3,475,004**

The Long-Term Balanced Pool is the University's principal endowment pool. It is managed with the objective of long-term total return.

The Short-Term Money Market Pool is a money market fund used for cash reserves. Its investment objective is to maximize current income consistent with preservation of principal and maintenance of liquidity.

The Intermediate-Term Bond Pool has two purposes. It is used for investment purposes to segregate money available for retirement of indebtedness. It is also used to maximize investment income available to defray annual debt service expenses.

Separately invested funds are donated funds, including restricted investments and some life-income plans.

Working capital funds held by the University are generated through the temporary differences between operating receipts and disbursements. These funds are not unitized. The income from investing them is used for general operating purposes. Working capital investments are held in a variety of money market instruments and guaranteed student loans or, if not needed within 90 days, are invested in the Long-Term Balanced Pool.

The Long-Term Balanced Pool

As of August 31, 2002, the Long-Term Balanced Pool's assets stood at $2.96 billion (including $230 million of interpool loans), down approximately $250 million from the previous year. For the purposes of asset allocation and investment strategy, the Investment Office combines the Long-Term Balanced Pool with $51 million from the liquidated Charitable Remainder Trust Pools (the latter are classified in the chart on page 10 among separately invested funds). Because of the size and long-term orientation of the Long-Term Balanced Pool and charitable remainder trusts, performance data and investment strategy information in this discussion relate to the total of $3.01 billion invested in them.

The principal objective for Northwestern's Long-Term Balanced Pool is to preserve purchasing power and to provide a growing stream of income to fund University programs. On average, the pool seeks to achieve an annual total rate of return (i.e., actual income plus appreciation) equal to inflation plus actual spending. This objective of preserving purchasing power emphasizes the need for a long-term perspective in formulating both spending and investment policies. The University's investments historically have grown at a rate exceeding this objective. For the 12-month period ending August 31, 2002, the portfolio declined 6.77 percent, which was 13.26 percent below the objective. However, for the 5-, 10-, and 15-year periods ending August 31, 2002, the objective was exceeded by 0.75 percent, 3.09 percent, and 2.1 percent, respectively.

Annualized Returns

	1-year	5-year	10-year	15-year
*Annual total return**	-6.77%	6.66%	9.22%	9.16%
– Spending	4.39%	3.58%	3.63%	3.98%
– Inflation	2.10%	2.33%	2.50%	3.08%
= Above (below) objective	**-13.26%**	**0.75%**	**3.09%**	**2.10%**

*Total returns are net of fees and are calculated on annual changes in net asset value. They may differ from payout distributions.

Long-Term Balanced Pool Spending Rule

In light of recent media attention to universities' falling endowments and consequent lower spending, it is important to review Northwestern's current spending rule. The spending rule blends two elements:

- The *market element* adjusts annual endowment spending to the long-term sustainable target spending of 4.1 percent of the average actual market value of the endowment for the most recent two years. This component of the spending rate receives a 30 percent weighting in the spending rate calculation.
- The *spending element* increases the previous year's spending rate by a factor for inflation (3.5 percent) plus budget growth (1.5 percent). This element of the spending rate receives a weight of 70 percent.

The actual spending rate per unit for fiscal year 2002 was $6.56; it will be $6.90 for fiscal year 2003. The payout rate for fiscal year 2002 was 4.33 percent.

Spending Rule

	1998	*1999*	*2000*	*2001*	*2002*
Spending per unit	$4.17	$4.27	$5.30	$6.22	$6.56
Net asset value per unit	$118.00	$141.97	$181.27	$156.17	$136.09
Payout rate*	3.38%	3.18%	3.19%	3.56%	4.33%
Total (in millions of dollars)	$70.30	$73.20	$95.50	$117.20	$130.20
Growth in spending per unit	11.80%	2.40%	24.12%	17.36%	5.47%

*Payout rate is calculated as spending per unit divided by the two-year average net asset value per unit.

Performance

The performance of the Long-Term Balanced Pool for the 12-month period ending August 31, 2002, was -6.77 percent, net of fees. (The August 31, 2002, data includes a write down of $55 million, which will be discussed in the Private Investments section on page 14.) The decline of 6.77 percent compares with the Northwestern composite benchmark performance of -8.87 percent. The following chart illustrates the performance of the asset classes within the Long-Term Balanced Pool relative to their respective benchmarks.

Long-Term Balanced Pool: Performance Relative to Benchmarks

	Market value at August 31, 2002 (in millions of dollars)	*Northwestern*	*Performance Benchmark*	*Difference*
U.S. equity securities	$521	-16.1%	-16.5%	0.4%
International equity securities	420	-12.2%	-13.5%	1.3%
Fixed-income securities	572	8.3%	9.4%	-1.1%
Market-hedged securities	532	9.5%	-12.3%	21.8%
Private investments	618	-24.0%	-14.3%	-9.7%
Real assets	350	12.0%	8.4%	3.6%
Total assets	**$3,013**	**-6.77%**	**-8.9%**	**2.1%**

Asset Allocation

The chart below displays the asset allocation policy that the Investment Committee of the Board of Trustees ado14 pted effective July 1, 2002. The policy is derived from a combination of quantitative and qualitative factors and represents the optimal opportunity to reach long-term return objectives with the least amount of risk. The resulting diversified portfolio, including substantial fixed-income securities, reflects a need for "insurance" for disaster scenarios and liquidity to meet budgetary demands.

New Policy Portfolio Targets and Ranges

	Range	*Target*	*At August 31, 2002*	*Difference*
U.S. equity securities	14–26%	20%	17.3%	-1.8%
International equity securities	8–18%	13%	13.9%	
Fixed-income securities	12–22%	17%	19.0%	2%
Market-hedged securities	11–23%	17%	17.7%	.7%
Private investments	15–27%	21%	20.5%	-.5%
Real assets	7–17%	12%	11.6%	-.4%

The Investment Committee approved the following asset classes of the Long-Term Balanced Pool, effective July 1, 2002:

U.S. equities include large-, mid-, and small-cap public equities and REITS.

International equities include developed-market ex-U.S. public equities and emerging market debt and equities.

Fixed income includes U.S. government securities, agency securities, inflation-linked bonds (TIPS), corporate bonds, high-yield bonds, and cash.

Market hedged encompasses hedge fund strategies including long-short equity, event driven, diversified multi-strategy, macro-, and relative value arbitrage.

Private investments include venture capital, global buyout, and distressed investments.

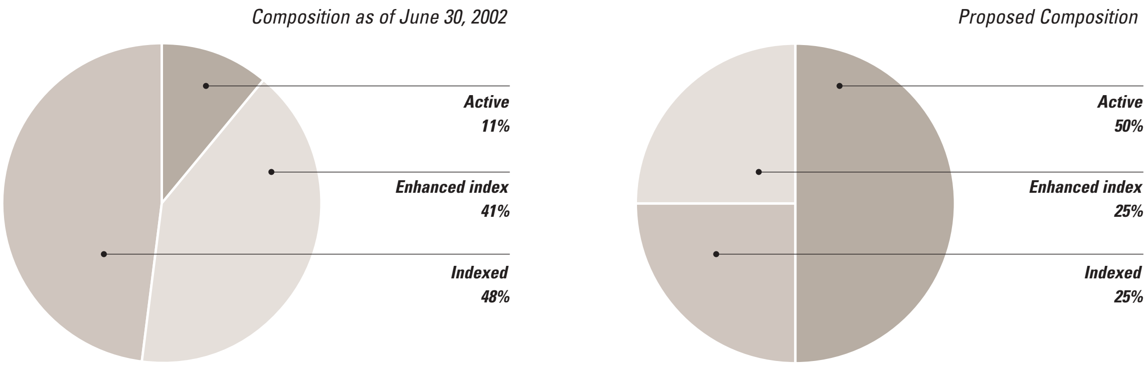
Real assets include real estate, energy, timber investments, and other commodity-based investments.

Public Equity Funds

Over the past seven years the Investment Office passively managed marketable securities while constructing the alternative assets portfolio. The use of index funds allowed full attention to be given to manager relationships for the alternatives portfolio. At its July 2002 meeting, the Investment Committee approved more active management on the assumptions that inefficiencies in parts of the markets allow for active management to add value, and that the current environment favors active strategies over index-like vehicles.

To balance passive, enhanced-index, and active strategies, the Investment Office set the goal of 40 to 60 percent active strategies, with the remainder split between passive and enhanced strategies. This should allow for greater out-performance of the benchmark. The following charts compare the distribution of manager types in the U.S. equities portfolio before and after active management:

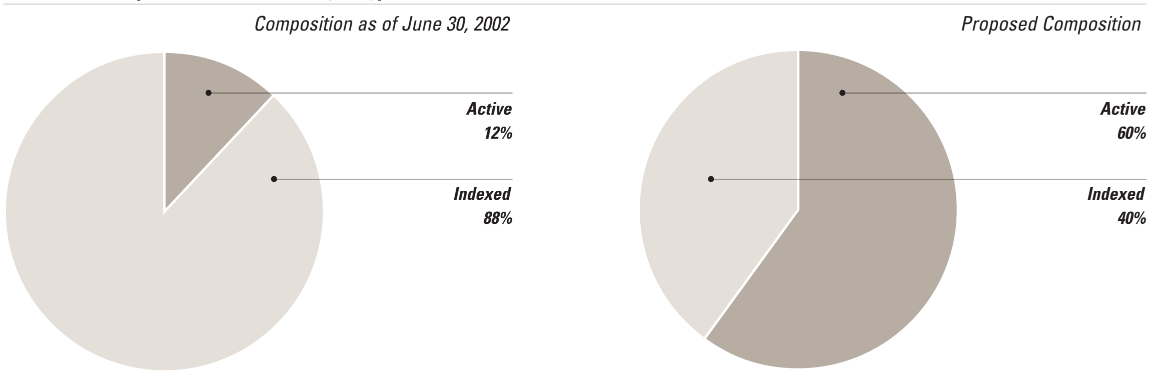
U.S. Equities Portfolio Manager Types



For the recent fiscal year, the U.S. equities portfolio dropped 16.1 percent, slightly bettering the 16.5 percent decline of the target.

The following charts compare the distribution of manager types in the international equities portfolio before and after active management:

International Equities Portfolio Manager Types



The international equities portfolio performed better than its benchmark and better than the U.S. equities portfolio yet produced only a -12.2 percent return.

Fixed-Income Funds

Fixed-income markets, especially government and agency bonds, showed relatively strong performance in the fiscal year ended August 31, 2002. They provided a safe haven in the face of declining public equity markets and international uncertainty resulting from global terrorism and turmoil in the Middle East. In response to a weak domestic economy, Federal Reserve policies supported higher bond prices and lower interest rates throughout the 12-month period. On the other hand, there were wider spreads and relative underperformance in corporate fixed-income securities, reflecting corporate management and accounting scandals and weakness in the domestic stock market. The internally managed fixed-income pools and Treasury inflation-protected securities outperformed the fixed-income benchmark for the year. However, the portfolio's exposure to credit and cash generated overall returns in this category below those of its benchmark for fiscal year 2002.

Market-Hedged Funds

Given the decline in equity markets during fiscal year 2002, the market-hedged portfolio proved to be an important component in the outperformance of the Long-Term Balanced Pool. Hedge funds provide access to returns uncorrelated with traditional investments. Allocation to multiple uncorrelated strategies is most important in the market-hedged portfolio, where managers use skill to isolate and capitalize on specific risks they are experts at exploiting, while hedging out most other risk factors. Valued at $532 million as of August 31, 2002, the market-hedged portfolio consisted of 15 managers, 9 of whom invest in global long-short strategies, 3 in event-driven strategies, and 3 in diversified multistrategies. For the 12 months ending August 31, 2002, the market-hedged portfolio returned 9.5 percent.

Private Investments

Northwestern's private investments portfolio, including domestic and international private equities, venture capital, and distressed securities, was affected by the continued weakness in technology spending and the overall softness in the economy. Prior to an Investment Office valuation review (discussed below), portfolio returns were down 14 percent for fiscal year 2002, in line with the equity benchmark.

Individual managers provide quarterly valuations for private investments. At Northwestern's fiscal year-end of August 31, 2002, only June 30 valuations were available; therefore, the time-weighted returns for private investments did not reflect mark-to-market values as of August 31. The Investment Office reviewed the private investments portfolio to determine the change in valuation for June 30 through August 31, looking at actual valuation changes in public securities within the private portfolio and conducting numerous conversations with the majority of the private portfolio managers. Management accepted the results of the review and reflected the adjusted value in its report of investment assets. This is incorporated in the financial statements beginning on page 16. With the discretionary write down factored in, the private investments portfolio returns were down 24 percent for fiscal year 2002.

Northwestern remains committed to private investments. The Investment Office believes that it has assembled a portfolio of top-tier managers and that this is an attractive time to be investing in private equity because of significantly lower pricing of deals and the availability of proven entrepreneurs. The office is confident that investing in both private equity and venture capital through various cycles will enable the endowment to enjoy premium returns relative to equity indices.

Real Assets

Since 1993 Northwestern's real-asset strategy has been to provide significant absolute return and a measure of diversification in the Long-Term Balanced Pool by assembling a portfolio of managers who, while diversified, represent exposure to inflation-oriented investments. As of August 31, 2002, the real-assets portfolio consisted of nine real estate managers, six energy managers, and one timber manager. With a total market value of $350 million and a 12-month return of 12 percent, this portfolio outperformed its respective benchmark by 3.6 percent.

William H McLean

William H. McLean
Vice President and Chief Investment Officer

Report of Independent Auditors

To the Board of Trustees of Northwestern University:

We have audited the accompanying Consolidated Statements of Financial Position of Northwestern University and subsidiaries (the "University") as of August 31, 2002, and 2001, and the related Consolidated Statements of Activities and Consolidated Statements of Cash Flows for the years then ended. These financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. 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, such consolidated financial statements present fairly, in all material respects, the financial position of the University as of August 31, 2002, and 2001, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we also have issued a report, dated December 11, 2002, on our consideration of the University's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

Chicago, Illinois

December 11, 2002

Consolidated Statements of Financial Position

As of August 31, 2002, and August 31, 2001

(in thousands of dollars)	*2002*	*2001*
Assets		
Cash and cash equivalents	$209,985	$243,182
Accounts receivable	193,671	154,214
Notes receivable	52,746	52,176
Contributions receivable	179,766	202,041
Investments	3,228,642	3,421,655
Land, buildings, and equipment	858,240	753,589
Bond proceeds held by trustees	11,396	70,623
Other assets	33,929	32,757
Total assets	**$4,768,375**	**$4,930,237**
Liabilities		
Accounts payable and accrued expenses	$74,053	$76,365
Deferred revenue	186,599	177,795
Actuarial liability of annuities payable and deposits payable	63,810	53,517
Reserves for self-insurance	44,637	39,934
Government advances for student loans	41,689	42,756
Bonds and notes payable	446,693	409,308
Reserve for Dental School closure	—	298
Total liabilities	**857,481**	**799,973**
Net assets		
Unrestricted	2,999,444	3,229,420
Temporarily restricted	233,403	297,448
Permanently restricted	678,047	603,396
Total net assets	**3,910,894**	**4,130,264**
Total liabilities and net assets	**$4,768,375**	**$4,930,237**

Detail of net assets	**Unrestricted**	**Temporarily restricted**	**Permanently restricted**	**2002**
Operating funds	$313,798	$45,860		$359,658
Invested in plant facilities	792,666	59,367		852,033
Annuity and life income funds	39,821	86,616	$31,479	157,916
Endowment and similar funds	1,853,159	41,560	646,568	2,541,287
Total net assets	**$2,999,444**	**$233,403**	**$678,047**	**$3,910,894**

Detail of net assets	**Unrestricted**	**Temporarily restricted**	**Permanently restricted**	**2001**
Operating funds	$266,128	$94,294		$360,422
Invested in plant facilities	717,991	59,095		777,086
Annuity and life income funds	37,360	90,604	$33,177	161,141
Endowment and similar funds	2,207,941	53,455	570,219	2,831,615
Total net assets	**$3,229,420**	**$297,448**	**$603,396**	**$4,130,264**

See Notes to the Consolidated Financial Statements, beginning on page 19.

Consolidated Statements of Activities

For the fiscal years ended August 31, 2002, and August 31, 2001

(in thousands of dollars)	*2002*		*2001*	
Changes in unrestricted net assets				
Operating revenues				
Tuition and fees	$428,036		$411,513	
(less scholarships and fellowships)	(125,245)		(114,516)	
Net tuition and fees	302,791		296,997	
Auxiliary services	58,667		57,394	
Grants and contracts	285,909		248,320	
Private gifts	25,883		53,647	
Investment return designated for operations	191,973		185,936	
Professional fees	29,640		29,818	
Sales and services	85,231		82,126	
Other income	8,383		5,161	
Total operating revenues		**$988,477**		**$959,399**
Operating expenses				
Instruction	357,072		321,513	
Research	220,741		211,486	
Academic support	110,975		107,588	
Student services	68,107		65,533	
Institutional support	80,725		76,557	
Auxiliary services	83,605		89,258	
Total operating expenses		**921,225**		**871,935**
Excess of operating revenues over expenses		**67,252**		**87,464**
Nonoperating				
Private gifts and grants for buildings and equipment	29,726		11,154	
Investment (losses uninvested)	(413,140)		(472,725)	
Gain on sale of plant assets	—		4,861	
Change in unrestricted net assets from nonoperating activities		**(383,414)**		**(456,710)**
Discontinued operations				
Loss on discontinuance of Dental School, including provision for operating losses during closing period		—		**(1,496)**
Net assets released from restrictions		**86,186**		**15,872**
Change in unrestricted net assets		**(229,976)**		**(354,870)**
Changes in temporarily restricted net assets				
Private gifts	25,076		43,023	
Net gain (loss) on annuity obligation	(4,333)		524	
Investment returns	1,398	22,141	1,970	45,517
Net assets released from restrictions		**(86,186)**		**(15,872)**
Change in temporarily restricted net assets		**(64,045)**		**29,645**
Changes in permanently restricted net assets				
Private gifts	77,370		38,344	
Net loss on annuity obligation	(2,719)	74,651	(3,323)	35,021
Change in permanently restricted net assets		**74,651**		**35,021**
Change in net assets		**(219,370)**		**(290,204)**
Beginning net assets		**$4,130,264**		**$4,420,468**
Ending net assets		**$3,910,894**		**$4,130,264**

See Notes to the Consolidated Financial Statements, beginning on page 19.

Consolidated Statements of Cash Flows

For the fiscal years ended August 31, 2002, and August 31, 2001

(in thousands of dollars)	*2002*	*2001*
Cash flows from operating activities		
Change in net assets	**($219,370)**	**($290,204)**
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation	42,954	44,059
Loss on retirement of equipment	1,166	2,092
Net realized and unrealized losses on investments	294,329	369,721
Private gifts and grants restricted for long-term investments	(29,726)	(11,154)
Provision for loss on Dental School closure	—	1,496
Changes in assets and liabilities		
Accounts receivable	(39,211)	(612)
Contributions receivable	22,275	(21,038)
Other assets	(1,172)	768
Accounts payable and accrued expenses	(2,312)	14,373
Deferred revenue	8,804	13,316
Reserves for self-insurance	4,703	5,810
Government advances for student loans	(1,067)	(709)
Operating loss for Dental School closure	(298)	(8,109)
Net cash provided by operating activities	**81,075**	**119,809**
Cash flows from (used in) investing activities		
Purchases of investments	(1,631,458)	(3,480,036)
Proceeds from sales of investments	1,530,142	3,431,078
Decrease (increase) in trusts held by others	(246)	986
Acquisitions of land, buildings, and equipment	(148,771)	(90,665)
Proceeds from sales of plant assets	—	5,114
Student loans disbursed	(87,465)	(81,490)
Principal collected on student loans	86,895	84,446
Net cash used in investing activities	**(250,903)**	**(130,567)**
Cash flows from financing activities		
Net proceeds from issuance of notes payable and bonds payable	42,000	12,000
Net principal payments on notes and bonds payable	(4,722)	(24,490)
Amortization of discount on bonds payable	107	95
Decrease in bond proceeds held by trustees	59,227	29,881
Proceeds from private gifts and grants restricted for long-term investments	29,726	11,154
Increase in annuity and deposits payable	10,293	2,217
Net cash provided by financing activities	**136,631**	**30,857**
Increase (decrease) in cash and cash equivalents	**(33,197)**	**20,099**
Cash and cash equivalents at beginning of year	**243,182**	**223,083**
Cash and cash equivalents at end of year	**$209,985**	**$243,182**
Supplemental disclosure of cash flow information		
Cash paid for interest	$13,749	$16,770

See Notes to the Consolidated Financial Statements, beginning on page 19.

1. Summary of Significant Accounting Policies

Operations

Northwestern University is a major private research university with more than 17,000 students enrolled in 11 academic divisions on two lakefront campuses.

Basis of Accounting

The University maintains its accounts and prepares its consolidated financial statements on the accrual basis of accounting. These statements include all wholly owned subsidiaries.

The University prepares its financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 116, "Accounting for Contributions Received and Contributions Made," and SFAS No. 117, "Financial Statements of Not-for-Profit Organizations." SFAS No. 116 requires that contributions received, including unconditional promises to give (pledges), be recognized as revenues at their fair values. SFAS No. 117 establishes standards for external financial reporting by not-for-profit organizations and requires that net assets and the flow of those assets be classified in three net asset categories according to the existence or absence of donor-imposed restrictions.

The category *Unrestricted Net Assets* describes funds that are legally available for any purpose and have no donor-imposed restrictions. All revenues, expenses, gains, and losses are classified as unrestricted net assets unless they are changes in temporarily or permanently restricted net assets.

The category *Temporarily Restricted Net Assets* includes gifts for which donor-imposed restrictions have not been met (these are primarily future capital projects) and trust activity and pledges receivable whose ultimate use is not permanently restricted.

The category *Permanently Restricted Net Assets* applies to gifts, trusts, and pledges whose donors required that the principal be held in perpetuity and that only the income be available for stipulated program operations. This category includes gifts stipulated for student loans.

Nonoperating activities primarily reflect transactions of a long-term investment or capital nature, including contributions to be invested for the support of future operations, contributions to be used for facilities and equipment, and certain unrealized gains or losses.

Income from temporarily restricted sources is reclassified as unrestricted income when the circumstances of the restriction have been fulfilled. Donor-restricted revenues whose restrictions are met within the same fiscal year are reported as unrestricted income. All expenditures are reported in the unrestricted class of net assets, since the use of restricted contributions in accordance with the donor's stipulations causes the release of the restriction.

Investments

Investments are recorded at fair value, determined on the following basis:

- Equity securities with readily determinable fair values and debt securities are valued at the last sale price (if quotations are readily available) or at the closing bid price in the principal market in which such securities are normally traded (if no sale price is available). Certain fixed-income securities are valued based on dealer-supplied valuations.
- The estimated fair values of equity securities that do not have readily determined fair values, and of other investments, are based on estimates provided by external investment managers and are examined through a valuation review process performed by management. After this review, management may determine that an adjustment to the external managers' valuations is appropriate in recording the securities' fair value at August 31. The aggregate carrying value of such investments was $1,598.4 million and $1,696.6 million at August 31, 2002, and 2001, respectively, of which $4.3 million and $55.8 million, respectively, were carried at cost. A range of possible values exists for these securities, and therefore the estimated values may differ from the values that would have been used had a ready market for these securities existed. In the absence of another basis, management has determined that cost represents an approximation of the fair value of investments.

Investment income is recorded on the accrual basis, and purchases and sales of investment securities are reflected on a trade-date basis.

Derivative Financial Instruments
The University enters into equity options and equity-indexed options to mitigate the risk of decline in fair value of certain equity securities. The options reduce the primary market risk exposure (e.g., equity price risk) of the hedged item in conjunction with the specific hedged strategy and, if applicable, have a reference index (e.g., S&P 500) that is the same, or highly correlated with, the reference index of the hedged item. Such equity options are not designated as hedges for accounting purposes and are recorded at fair value.

Fair Values of Financial Instruments Other than Investments
The fair values of financial instruments other than investments are based on a variety of factors. In some cases, fair values represent quoted market prices for identical or comparable instruments. In other cases, fair values have been estimated based on assumptions about the amount and timing of estimated future cash flows and assumed discount rates reflecting varying degrees of risk. Accordingly, the fair values may not represent actual values that could have been realized at year-end or that will be realized in the future. Fair values of the University's financial instruments other than investments approximate their carrying value in the accompanying consolidated financial statements.

Accounts and Notes Receivable
Accounts receivable arising from tuition and fees are carried net of an allowance for doubtful accounts of $425,000 and $510,000 as of August 31, 2002, and 2001, respectively. Notes receivable resulting from student loans are carried net of an allowance for doubtful accounts of $336,000 and $325,000 as of August 31, 2002, and 2001, respectively.

Land, Buildings, and Equipment
The value of land, buildings, and equipment is recorded at cost or, if received as gifts, at fair market value at the date of the gift. Significant renewals and replacements are capitalized. The cost of repairs and maintenance is expensed as incurred. Purchases of library books are also expensed.

Depreciation is calculated using the straight-line method over the useful lives of the buildings and equipment, which are estimated to be 3 to 20 years for equipment and a maximum of 40 years for buildings. If the carrying value of an asset exceeds the sum of estimated undiscounted future cash flows, an impairment loss is recognized for the difference between estimated fair value and carrying value.

Charitable Remainder Trusts
Charitable remainder trusts are classified as permanently restricted net assets if, upon termination of the trust, the donor permanently restricts the remaining trust assets. If the remainder is temporarily restricted or unrestricted by the donor, the charitable remainder trust assets are recorded as temporarily restricted net assets.

Annuities Payable
Annuities payable consist of annuity payments currently due and the actuarial amount of annuities payable. The actuarial amount of annuities payable is the present value of the aggregate liability for annuity payments over the expected lives of the beneficiaries (based on the mortality tables in the Internal Revenue Code as of January 1, 1997).

Revenue Recognition
Revenues from tuition and fees are reported in the fiscal year in which educational programs are predominantly conducted. Fall-quarter tuition and fees, billed in the prior fiscal year, are reported as deferred revenue.

Grants and contracts revenue is recognized as expenses are incurred on the project. Private gifts, including unconditional promises to give, are recognized as revenues in the period received. Conditional promises to give are not included in revenue until the conditions are substantially met. Pledges receivable due in more than one year are recorded at the present value of the estimated future cash flows. The expiration of a donor-imposed restriction on a contribution is recognized in the period in which the restriction expires, and the related resources then are classified as unrestricted net assets.

Income Taxes
The University is exempt from income taxes under Section 501(c)(3) of the U.S. Internal Revenue Code, except with regard to unrelated business income, which is taxed at corporate income tax rates.

Uses of Estimates in the Preparation of Financial Statements

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; the disclosure of contingent assets and liabilities at the date of the financial statements; and the reported amounts of revenues and expenses during the relevant period. Actual results could differ from those estimates.

At August 31, 2002, and 2001, reserves were established for uncollectible accounts, student loans, and pledges receivable. These reserves were estimated based on historical collection and allowance practices as well as on management's evaluation of current trends.

The reserves for self-insurance and postretirement medical and life insurance benefits were based on actuarial studies.

The University believes that the methods and assumptions used in computing these liabilities are appropriate.

Accounting Pronouncements

The Financial Accounting Standards Board issued two new accounting pronouncements related to derivative financial instruments for which implementation was required for fiscal 2001. The implementation of these new pronouncements did not have a significant impact on the University's financial statements or require a transition adjustment.

2. Contributions Receivable

Contributions receivable consisted of the following:

(in thousands of dollars)	*August 31, 2002*	*August 31, 2001*
Unconditional promises expected to be collected in		
Less than one year	$75,515	$111,104
One year to five years	102,509	126,283
More than five years	61,390	11,529
Less discount to present value and other reserves		
Discount to present value	(46,947)	(33,536)
Other reserves	(12,701)	(13,339)
Total	**$179,766**	**$202,041**

3. Bonds and Notes Payable

The University had $124 million and $82 million placed in commercial paper at August 31, 2002, and 2001, respectively. The issues as of August 31, 2002, mature in fiscal 2003. Bonds payable are as follows:

(in thousands of dollars)	*August 31, 2002*	*August 31, 2001*
Mortgage bonds		
Illinois Educational Facilities Authority (IEFA)–Series 1974, 6.183%	$970	$1,415
Demand revenue bonds		
IEFA–Series 1985 varying adjustable interest rates	35,300	35,300
IEFA–Series 1985 University Pooled Financing Program, variable rate	12,000	14,000
IEFA–Series 1985 Cultural Pooled Financing Program, variable rate	10,016	10,028
IEFA–Series 1988, variable rate	45,700	46,000
IEFA–Series 1993, fixed rate	70,685	72,650
Less unamortized discount on IEFA–Series 1993	(2,048)	(2,155)
IEFA–Series 1997, fixed rate	150,000	150,000
Total	**$322,623**	**$327,238**

Total obligations at August 31, 2002, are scheduled to mature through August 31 of each period as follows:

(in thousands of dollars)	
2003	$4,837
2004	4,952
2005	6,637
2006	11,722
2007	12,902
2008–2012	87,140
2013–2017	90,286
2018–2022	38,520
2023–2027	62,475
Thereafter	5,200
Total	**$324,671**

Mortgage bonds, totaling $1 million at August 31, 2002, are collateralized by land and buildings with carrying values of $6.6 million at August 31, 2002. In addition, at August 31, 2002, the University had $1.8 million in assets held by trustees for debt service. The IEFA–Series 1974 bond issue is further collateralized by the first $475,000 of student tuition and fees collected in each calendar year.

At the option of the University and upon compliance with certain conditions, the IEFA–Series 1985 and 1988 bonds may operate in one of four variable-interest-rate modes or may be converted to a fixed rate until maturity or earlier redemption. At August 31, 2002, $35.3 million of the Series 1985 and all of the Series 1988 demand revenue bonds operated in the weekly variable modes, under which the interest rate is adjusted weekly based on prevailing market rates for similar securities. The weekly interest rate at August 31, 2002, was 1.4 percent.

Under the IEFA–Series 1985 Cultural Pooled Financing Program, the University assumed an additional liability representing its prorated share of underabsorbed financing costs that at August 31, 2002, amounted to $279,000. The University Pooled Financing Program and Cultural Pooled Financing Program may operate in the weekly variable-interest-rate mode or may be converted to a fixed rate until maturity. The fixed-rate conversion requires the consent of all participants in the pools. At August 31, 2002, the bonds operated in the weekly variable mode and bore interest at 1.4 percent. The bonds are collateralized by certificates of deposit held by the trustee in amounts equal to 1.67 percent of the bonds outstanding.

The IEFA–Series 1993 Revenue Refunding Bonds operate in a fixed mode until maturity, bearing interest at fixed rates ranging from 3 percent to 5.55 percent (weighted average rate at August 31, 2002, of 5.3 percent) and maturing from December 1, 2002, to December 1, 2021. Proceeds of the refunding bonds were invested in United States government securities with a cost of $75.4 million and placed in escrow to satisfy scheduled payments of $66.4 million of the IEFA–Series 1985 bonds and related interest until maturity. In 1993 this transaction was accounted for as an in-substance defeasance.

The IEFA–Series 1976 and 1977 demand revenue bonds were defeased on June 1 and July 1, 1996, respectively, through the issuance of commercial paper through the IEFA–Series 1995 Pooled Financing Program. Principal payment on the 1985 demand revenue bond is also included in the program. At August 31, 2002, the commercial paper issued under the program totaled $34 million, all maturing within a year.

The IEFA–Series 1997 adjustable medium-term revenue bonds operate in a fixed mode until maturity, bearing interest at fixed rates ranging from 4.7 percent to 5.25 percent (weighted average rate at August 31, 2002, of 5.07 percent) and maturing from November 1, 2005, to November 1, 2015. The bonds are subject to mandatory tender at the stated dates and may be reissued in one of several permissible modes described in the agreements. The bonds will ultimately mature on November 1, 2032.

The lending agreements covering the IEFA demand revenue bond issues also provide that the bank may purchase bonds, at a rate not exceeding the bank's corporate base rate or prime rate (as defined), for which a demand has been made.

The lending agreements covering the demand revenue bond issues contain covenants that, among other things, require the University to maintain prescribed amounts of working capital (as defined). The covenants place certain limits on indebtedness and require holding investments in prescribed minimum amounts and maintaining certain financial ratios related to debt service, net assets to indebtedness, and assets to indebtedness. The University was in compliance with the covenants at August 31, 2002.

4. Investments

The University's investments are overseen by the Investment Committee of the Board of Trustees. Guided by the policies established by the Investment Committee, the University's Investment Office manages the investment of endowment and trust assets, certain working capital, temporarily invested expendable funds, and commercial real estate. These assets are also managed by external equity investment managers, external and internal fixed-income and cash managers, and various limited partnership managers.

Substantially all these assets are merged into internally managed investment pools on a market-value basis. Each holder subscribes to or disposes of units on the basis of the market value per unit at the beginning of each month.

Endowment Payout/Spending Rule

The Board of Trustees adopted a new guideline effective in fiscal year 2002 for the annual spending rate from the Long-Term Balanced Pool. The calculation blends market and spending elements for the total annual spending rate.

The market element is an amount equal to 4.1 percent of the market value of a unit in the pool, averaged at the end of the two most recent fiscal years. It is weighted at 30 percent in determining the total. The spending element is an amount equal to the current fiscal year's spending amount increased by 5 percent. It is weighted at 70 percent in determining the total.

If endowment income received is not sufficient to support the total-return objective, the balance is provided from realized and unrealized gains. If income received is in excess of the objective, the balance is reinvested in the Long-Term Balanced Pool on behalf of the unit holders.

The University's policy is to allocate the current income of all other investment pools.

Summary of Investments

The following charts show the cost and estimated fair value of investments held by the University:

		August 31, 2002		*August 31, 2001*
(in thousands of dollars)	**Cost**	**Estimated fair value**	**Cost**	**Estimated fair value**
Equity securities				
Domestic	$510,654	$415,115	$799,847	$713,505
International	530,476	492,757	324,213	291,387
Debt securities				
Domestic — government	519,169	550,063	568,605	590,597
Domestic — corporate debt securities	159,806	152,643	113,854	109,637
International	13,535	19,622	13,357	19,917
Other investments				
Distressed securities	99,196	121,179	72,186	94,959
Hedge funds	304,298	532,069	306,542	533,023
Natural resources	125,868	158,761	108,305	130,229
Private equity	706,143	498,694	610,602	641,389
Real estate	173,631	223,508	175,190	226,350
Other	52,175	64,231	54,232	70,662
Total investments	**$3,194,951**	**$3,228,642**	**$3,146,933**	**$3,421,655**

The University is committed to making future capital contributions in other investments in the amount of $690 million, primarily in the next five years.

The carrying value of the University's investments (excluding intrauniversity investments, cash, and cash equivalents) is shown by investment pool in the following charts:

					August 31, 2002
(in thousands of dollars)	**Operations and plant**	**Quasi-endowment**	**Annuity and life-income**	**Permanent endowment**	**Total**
Long-Term Balanced Pool	$36,609	$919,995	$33,073	$1,499,544	$2,489,221
Intermediate-Term					
Bond Pool	267,890	4,266			272,156
Separately invested	51	6,339	141,880	9,002	157,272
Working capital	309,993				309,993
Total investments	**$614,543**	**$930,600**	**$174,953**	**$1,508,546**	**$3,228,642**

					August 31, 2001
(in thousands of dollars)	**Operations and plant**	**Quasi-endowment**	**Annuity and life-income**	**Permanent endowment**	**Total**
Long-Term Balanced Pool	$44,451	$1,013,835	$35,858	$1,668,011	$2,762,155
Intermediate-Term Bond Pool	243,615	5,922			249,537
Separately invested	4,879	14,820	147,370	5,392	172,461
Working capital	237,502				237,502
Total investments	**$530,447**	**$1,034,577**	**$183,228**	**$1,673,403**	**$3,421,655**

Investment Return

The components of total investment return were as follows:

(in thousands of dollars)	*August 31, 2002*	*August 31, 2001*
Investment income	$74,806	$86,106
Net realized (losses) gains	(55,893)	343,169
Change in net unrealized (losses) on investments reported at fair value	(238,682)	(714,094)
Total investment return	**($219,769)**	**($284,819)**

Investment return from operations is defined as the investment payout according to the spending rule for the Long-Term Balanced Pool and the actual investment income for all other investments. As reflected in the Consolidated Statements of Activities, investment return was as follows:

(in thousands of dollars)	*August 31, 2002*	*August 31, 2001*
Changes in unrestricted net assets		
Operating: investment return	$191,973	$185,936
Nonoperating: investment (losses uninvested)	(413,140)	(472,725)
Changes in temporarily restricted net assets		
Investment return	1,398	1,970
Total investment return	**($219,769)**	**($284,819)**

Derivative Financial Instruments

The University uses derivative equity collars in the form of options to hedge equity exposure related to restricted assets held in trust. The value of the put and call options associated with the equity collars is inversely related to the market value of the underlying equity securities when outside of the range of the equity collars. The market value of the underlying equity assets hedged by the equity collars was $24.4 million at August 31, 2002. The derivative equity collars have a net unrealized gain of approximately $2 million at August 31, 2002.

Credit exposure represents the University's potential loss if all the counterparties fail to perform under the terms of the contracts, and if all collateral, if any, becomes worthless. This exposure is measured by the fair value of contracts with a positive fair value at the reporting date.

The University manages its exposure to credit risk by utilizing highly rated counterparties, establishing risk control limits, and obtaining collateral where appropriate. As a result, the University has limited credit risk. To date, the University has not incurred any losses on derivative financial instruments due to counterparty nonperformance.

The University regularly reviews the use of derivative financial instruments by each of the managers of alternative investment funds in which it participates. While these outside managers generally use such instruments for hedging purposes, derivative financial instruments are employed for trading purposes by seven independent asset managers of Northwestern University funds totaling approximately $309 million and $314 million at August 31, 2002, and 2001, respectively.

5. Retirement Plans

The University maintains two contributory retirement plans for its eligible faculty and staff. The plans offer employees the choice of two investment company options, Teachers Insurance and Annuity Association (TIAA) and College Retirement Equities Fund (CREF), and the mutual funds offered by Fidelity Investments. Participating employee and University contributions are immediately vested. The University contributed $27.3 million and $21.3 million to the two plans in 2002 and 2001, respectively.

The University currently sponsors a health care plan permitting retirees to continue participation on a "pay-all" basis, which requires a retiree contribution based on the average per capita cost of coverage for the entire plan group of active employees and retirees rather than the per capita cost for retirees only. Retirees are also eligible to participate in certain tuition reimbursement plans and may receive a payment for sick days accumulated at retirement.

The University funds the benefit costs as they are incurred. The accumulated postretirement benefit obligation (APBO) was as follows:

(in thousands of dollars)	*August 31, 2002*	*August 31, 2001*
Active employees not yet eligible	$2,253	$2,067
Active employees eligible	2,600	2,514
Retirees	1,448	1,507
Unrecognized prior service cost	(1,039)	(1,148)
Unrealized loss	(1,664)	(1,909)
Total	**$3,598**	**$3,031**

The components of the net periodic postretirement benefit cost were as follows:

(in thousands of dollars)	*August 31, 2002*	*August 31, 2001*
Service cost (benefits attributed to employee service during the year)	$313	$292
Interest cost on accumulated postretirement benefit obligation	398	413
Amortization of prior service cost	109	109
Amortization of unrealized loss	94	117
Total	**$914**	**$931**

During fiscal 2002 postretirement benefit payments (net of retirees' contributions) were approximately $363,000.

The discount rate used in determining the APBO was 6.5 percent and 7 percent as of August 31, 2002, and 2001, respectively. The assumed health care cost trend rate used in measuring the APBO was 5 percent for 1999 and thereafter.

If the health care cost trend rate assumptions were increased by 1 percent, the APBO as of August 31, 2002, would have been increased by approximately 7.4 percent. The effect of this change on the sum of the service-cost and interest-cost components of the net periodic postretirement benefit cost for 2002 would have been an increase of 7.4 percent.

6. Land, Buildings, and Equipment

Land, buildings, and equipment consisted of the following:

(in thousands of dollars)	*August 31, 2002*	*August 31, 2001*
Land and improvements	$26,107	$26,107
Buildings	1,098,540	971,183
Equipment	172,405	156,776
Accumulated depreciation	(438,812)	(400,477)
Total	**$858,240**	**$753,589**

At August 31, 2002, the University had under construction buildings that will cost approximately $244.7 million. The estimated cost to complete this construction is $96.2 million. Costs incurred through August 31, 2002, of $148.5 million are included in land, buildings, and equipment. These buildings are being funded by loans, gifts (received or pledged), and grants.

7. Allocation of Expenses

The University allocated depreciation, plant maintenance expenditures, and interest on indebtedness to the various functional expense categories in the Consolidated Statements of Activities for the fiscal years ended August 31, 2002, and 2001. Those expenses have been distributed to the functional areas of the University as follows:

(in thousands of dollars)			*August 31, 2002*
	Depreciation	**Plant maintenance**	**Interest on indebtedness**
Instruction	$6,787	$11,816	$2,172
Research	7,946	13,836	2,544
Academic support	9,063	15,780	2,901
Student services	2,148	3,739	687
Institutional support	3,136	5,459	1,004
Auxiliary services	13,874	24,157	4,441
Total	**$42,954**	**$74,787**	**$13,749**

(in thousands of dollars)			*August 31, 2001*
	Depreciation	**Plant maintenance**	**Interest on indebtedness**
Instruction	$6,961	$14,157	$2,687
Research	8,151	16,576	3,146
Academic support	9,296	18,906	3,589
Student services	2,203	4,480	850
Institutional support	3,216	6,541	1,242
Auxiliary services	14,232	28,942	5,494
Total	**$44,059**	**$89,602**	**$17,008**

The allocations were based on the functional use of space on the University's campus.

8. Self-Insurance Reserves and Other Contingencies

The University maintains a self-insurance program for general liability, professional liability, and certain employee and student insurance coverages. This program is supplemented with commercial excess insurance above the University's self-insurance retention.

Reserves for losses under the University's self-insurance program, aggregating $44.6 million and $39.9 million at August 31, 2002, and 2001, respectively, include reserves for known losses and for losses incurred but not yet reported. A portion of the reserves pertaining to professional liability has been determined on a discounted present-value basis. Self-insurance reserves are necessarily based on estimates of historical loss experience, and while management believes that the reserves are adequate, the ultimate liabilities may be in excess of or less than the amounts provided.

Under an agreement between the University and Northwestern Medical Faculty Foundation (NMFF), a proportionate share of professional liability insurance costs is borne by NMFF.

The University has borrowed under an agreement whereby monies are advanced for the purpose of originating student loans. These loans, when fully disbursed, are sold to the lending agency, and proceeds are applied to retire the debt amount. Additionally, the University has contracted to service these loans, which totaled $164.7 million at August 31, 2002. Service revenues are the excess of the actual interest collected above a guaranteed rate of return on the serviced loans. The University guarantees these loans against default up to a defined percentage of the original loan amount. At August 31, 2002, and 2001, $429,000 and $418,000, respectively, were reserved in anticipation of future defaults.

From time to time, various claims and suits generally incident to the conduct of normal business are pending or may arise against the University. It is the opinion of management of the University, after taking into account insurance coverage, that any losses from the resolution of pending litigation should not have a material effect on the University's financial position or results of operations.

All funds expended in connection with government grants and contracts are subject to audit by government agencies. While any ultimate liability from audits of government grants and contracts by government agencies cannot be determined at present, management believes that it should not have a material effect on the University's financial position or results of operations.

9. Natural Classification of Expenses

Operating expenses incurred in the fiscal years ended August 31, 2002, and 2001, were as follows:

(in thousands of dollars)	*August 31, 2002*	*August 31, 2001*
Salaries, wages, and benefits	$493,229	$465,302
Services and professional fees	116,887	108,774
Supplies	71,682	47,671
Travel and promotion	43,117	45,438
Other expenses	48,153	48,056
Maintenance, utilities, and equipment	91,454	95,627
Interest on indebtedness	13,749	17,008
Depreciation	42,954	44,059
Total	**$921,225**	**$871,935**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