

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, 2004, and 2003, and the related Consolidated Statements of Activities and 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 financial statements present fairly, in all material respects, the financial position of Northwestern University and subsidiaries as of August 31, 2004, and 2003, and the changes in their assets and their 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 23, 2004, 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.

The logo for Deloitte & Touche LLP, featuring the word "Deloitte" in a large, stylized, cursive font, followed by "& Touche" in a smaller, similar font, and "LLP" in a bold, sans-serif font below it.

Chicago, Illinois

December 23, 2004

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

As of August 31, 2004, and August 31, 2003

<i>(in thousands of dollars)</i>	<i>2004</i>	<i>2003</i>
Assets		
Cash and cash equivalents	\$225,679	\$271,633
Accounts receivable	233,040	196,142
Notes receivable	49,329	49,943
Contributions receivable	162,266	192,384
Collateral held for securities loaned	479,621	
Investments	3,983,449	3,443,837
Land, buildings, and equipment	1,046,683	941,242
Bond proceeds held by trustees	50,448	1,761
Other assets	41,430	35,146
Total assets	\$6,271,945	\$5,132,088
Liabilities		
Accounts payable and accrued expenses	\$102,214	\$90,817
Deferred revenue	204,132	190,148
Payable under securities loan agreements	479,621	
Actuarial liability of annuities payable and deposits payable	59,691	58,926
Reserves for self-insurance	79,454	61,390
Government advances for student loans	40,371	41,102
Bonds and notes payable	591,851	453,963
Total liabilities	1,557,334	896,346
Net assets		
Unrestricted	3,799,036	3,329,311
Temporarily restricted	163,283	194,178
Permanently restricted	752,292	712,253
Total net assets	4,714,611	4,235,742
Total liabilities and net assets	\$6,271,945	\$5,132,088

<i>2004</i>				
Detail of net assets	Unrestricted	Temporarily restricted	Permanently restricted	
Operating funds	\$395,776	\$77,185		\$472,961
Invested in plant facilities	945,906	34,432		980,338
Annuity and life income funds	26,077	36,556	\$28,569	91,202
Endowment and similar funds	2,431,277	15,110	723,723	3,170,110
Total net assets	\$3,799,036	\$163,283	\$752,292	\$4,714,611

<i>2003</i>				
Detail of net assets	Unrestricted	Temporarily restricted	Permanently restricted	
Operating funds	\$325,284	\$96,746		\$422,030
Invested in plant facilities	865,099	48,684		913,783
Annuity and life income funds	37,665	28,099	\$26,221	91,985
Endowment and similar funds	2,101,263	20,649	686,032	2,807,944
Total net assets	\$3,329,311	\$194,178	\$712,253	\$4,235,742

See Notes to the Consolidated Financial Statements, beginning on page 18.

CONSOLIDATED STATEMENTS OF ACTIVITIES

For the fiscal years ended August 31, 2004, and August 31, 2003

<i>(in thousands of dollars)</i>	<i>2004</i>	<i>2003</i>	
Changes in unrestricted net assets			
<i>Operating revenues</i>			
Tuition and fees	\$496,484	\$464,595	
(less scholarships and fellowships)	(145,171)	(139,065)	
Net tuition and fees	351,313	325,530	
Auxiliary services	65,626	63,373	
Grants and contracts	333,154	297,928	
Private gifts	18,869	40,508	
Investment return designated for operations	210,290	201,140	
Professional fees	27,502	24,720	
Sales and services	103,716	95,019	
Other income	5,144	6,262	
Total operating revenues	\$1,115,614	\$1,054,480	
<i>Operating expenses</i>			
Instruction	392,186	358,786	
Research	275,430	240,140	
Academic support	124,953	109,021	
Student services	82,998	78,204	
Institutional support	88,831	83,023	
Auxiliary services	99,191	89,708	
Total operating expenses	1,063,589	958,882	
Excess of operating revenues over expenses	52,025	95,598	
<i>Nonoperating</i>			
Private gifts and grants for buildings and equipment	28,751	19,746	
Investment gains reinvested	338,618	103,113	
Change in unrestricted net assets from nonoperating activities	367,369	122,859	
Net assets released from restrictions	50,331	111,410	
Change in unrestricted net assets	469,725	329,867	
Changes in temporarily restricted net assets			
Private gifts	10,293	60,524	
Net gain on annuity obligation	7,017	9,328	
Investment returns	2,126	19,436	72,185
Net assets released from restrictions	(50,331)	(111,410)	
Change in temporarily restricted net assets	(30,895)	(39,225)	
Changes in permanently restricted net assets			
Private gifts	38,998	40,419	
Net gain (loss) on annuity obligation	1,041	40,039	34,206
Change in permanently restricted net assets	40,039	34,206	
Change in net assets	478,869	324,848	
Beginning net assets	\$4,235,742	\$3,910,894	
Ending net assets	\$4,714,611	\$4,235,742	

See Notes to the Consolidated Financial Statements, beginning on page 18.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the fiscal years ended August 31, 2004, and August 31, 2003

<i>(in thousands of dollars)</i>	<i>2004</i>	<i>2003</i>
Cash flows from operating activities		
Change in net assets	\$478,869	\$324,848
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation	52,890	46,864
Loss on retirement of equipment	749	1,980
Net realized and unrealized gains on investments	(464,959)	(249,491)
Private gifts and grants for long-term investments	(28,751)	(19,746)
<i>Changes in assets and liabilities</i>		
Accounts receivable	(36,876)	(2,183)
Contributions receivable	30,118	(12,618)
Other assets	(6,284)	(1,217)
Accounts payable and accrued expenses	11,397	16,764
Deferred revenue	13,984	3,549
Reserves for self-insurance	18,064	16,753
Government advances for student loans	(731)	(587)
Net cash provided by operating activities	68,470	124,916
Cash flows from (used in) investing activities		
Purchases of investments	(1,830,837)	(2,084,564)
Proceeds from sales of investments	1,759,569	2,118,860
Increase in trusts held by others	(22)	(288)
Increase in investments held for others	(3,385)	
Acquisitions of land, buildings, and equipment	(159,080)	(131,846)
Student loans disbursed	(101,957)	(81,703)
Principal collected on student loans	102,571	84,506
Net cash used in investing activities	(233,141)	(95,035)
Cash flows from financing activities		
Net proceeds from issuance of notes payable and bonds payable	185,010	12,000
Net principal payments on notes and bonds payable	(48,332)	(4,837)
Amortization of discount on bonds payable	1,210	107
(Increase) decrease in bond proceeds held by trustees	(48,687)	9,635
Proceeds from private gifts and grants for long-term investments	28,751	19,746
Increase (decrease) in annuities and deposits payable	765	(4,884)
Net cash provided by financing activities	118,717	31,767
Increase (decrease) in cash and cash equivalents	(45,954)	61,648
Cash and cash equivalents at beginning of year	271,633	209,985
Cash and cash equivalents at end of year	\$225,679	\$271,633
Supplemental disclosure of cash flow information		
Cash paid for interest	\$18,884	\$13,088

See Notes to the Consolidated Financial Statements, beginning on page 18.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the fiscal years ended August 31, 2004, and August 31, 2003

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 \$1,951.8 million and \$1,743.4 million at August 31, 2004, and 2003, respectively, of which \$5.9 million and \$1.3 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 such 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 uses various financial instruments to hedge the risk of decline in fair value of certain equity securities. Equity options and equity-indexed options are used to reduce the primary market risk exposure (e.g., equity price risk) of the hedged item in conjunction with the specific hedged strategy; if applicable, these have a reference index (e.g., S&P 500) that is the same, or highly correlated with, the reference index of the hedged item. Similarly, the University also enters into swap agreements to hedge public real estate equity exposure and obtain S&P 500

equity index exposure, and it uses futures contracts on an equity index. Such equity instruments 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. At August 31, 2004, the fair values of the University's fixed rate debt of \$384 million exceeded the carrying value of \$362 million by \$22 million. At August 31, 2003, the fair values of the University's fixed rate debt of \$238 million exceeded the carrying value of \$219 million by \$19 million.

Accounts and Notes Receivable

Accounts receivable arising from tuition and fees are carried net of an allowance for doubtful accounts of \$286,000 and \$338,000 as of August 31, 2004, and 2003, respectively. Notes receivable resulting from student loans are carried net of an allowance for doubtful accounts of \$271,000 and \$298,000 as of August 31, 2004, and 2003, respectively.

Receivables from Northwestern Medical Faculty Foundation (NMFF), a related party (see below), arising out of operational activities totaled \$25.7 million and \$16.2 million as of August 31, 2004, and 2003, 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. Fiscal year 2005 fall-quarter tuition and fees, billed in fiscal year 2004, are reported as deferred revenue in fiscal year 2004. Similarly, fiscal year 2004 fall-quarter tuition and fees, billed in fiscal year 2003, are reported as deferred revenue in fiscal year 2003.

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.

Related Parties

Northwestern Medical Faculty Foundation is a multispecialty physician organization committed to providing clinical care to patients and to supporting the research and academic endeavors of Northwestern's Feinberg School of Medicine. An independent not-for-profit organization, NMFF is governed by a board of directors. NMFF physicians are full-time faculty members or researchers at Feinberg and attending physicians at Northwestern Memorial Hospital.

Under the terms of an agreement with Northwestern University, NMFF contributes a percentage of its revenue to a research and education fund, medical education programs, basic and applied biomedical research facilities and programs, and research and educational support services. NMFF also contributes funds to Feinberg's teaching and research activities on a discretionary basis. These contributions totaled \$21.9 million in fiscal year 2004 and \$19.1 million in fiscal year 2003.

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, 2004, and 2003, 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 reserves and liabilities are appropriate.

Accounting Pronouncements

In December 2003 the Financial Accounting Standards Board (FASB) issued a revision to SFAS No. 132(R), "Employers' Disclosures about Pensions and Other Postretirement Benefits," which revises employers' disclosures but does not change the measurement or recognition of those plans. The University implemented the requirements of SFAS No. 132(R) in fiscal year 2004.

The FASB issued two new accounting pronouncements relevant to the University that became effective during fiscal year 2003. The first relates to accounting for costs associated with exit or disposal activities; the second relates to derivative instruments and hedging activities. In addition, FASB Interpretation No. 45 regarding guarantor's accounting and disclosure requirements for guarantees became effective during fiscal year 2003. The implementation of these new pronouncements did not have a significant impact on the University's financial statements or require a transition adjustment.

2. Bonds and Notes Payable

The University had \$135.8 million and \$136 million placed in commercial paper at August 31, 2004, and 2003, respectively.

Bonds payable are as follows:

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>	<i>August 31, 2003</i>
<i>Mortgage bonds</i>		
Illinois Facilities Authority (IFA)—Series 1974, 6.183%		\$500
<i>Demand revenue bonds</i>		
IFA—Series 1985 varying adjustable interest rates	\$35,300	35,300
IFA—Series 1985 University Pooled Financing Program, variable rate	4,000	10,000
IFA—Series 1985 Cultural Pooled Financing Program, variable rate	9,992	10,004
IFA—Series 1988, variable rate	45,100	45,400
IFA—Series 1993, fixed rate	27,420	68,630
Less unamortized discount on IFA—Series 1993	(731)	(1,941)
IFA—Series 1997, fixed rate	150,000	150,000
IFA—Series 2003, fixed rate	185,010	
Total	\$456,091	\$317,893

Total obligations at August 31, 2004, are scheduled to mature through August 31 of each period as follows:

<i>(in thousands of dollars)</i>	
2005	\$112,564
2006	12,864
2007	33,574
2008	12,919
2009	18,119
2010–2014	98,230
2015–2019	62,685
2020–2024	45,145
2025–2029	45,751
Thereafter	150,000
Total	\$591,851

At the option of the University and upon compliance with certain conditions, the IFA–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, 2004, \$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, 2004, was 1.3 percent.

Under the IFA–Series 1985 Cultural Pooled Financing Program, the University assumed an additional liability representing its prorated share of

underabsorbed financing costs that at August 31, 2004, amounted to \$255,000. 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, 2004, the bonds operated in the weekly variable mode and bore interest at 1.3 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 IFA–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, 2004, of 5.3 percent) and maturing from December 1, 2004, to December 1, 2013. 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 IFA–Series 1985 bonds and related interest until maturity. In 1993 this transaction was accounted for as an in-substance defeasance. In October 2003, \$35 million of the outstanding IFA–Series 1993 bonds were refunded with the issuance of the IFA–Series 2003 revenue bonds.

The IFA–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 IFA–Series 1995 Pooled Financing Program. Principal payment on the 1985 demand revenue bond is also included in the program. At August 31, 2004, the commercial paper issued under the program totaled \$35.8 million, all maturing within a year.

The IFA–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, 2004, 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 IFA–Series 2003 fixed-rate revenue bonds totaling \$185 million were issued on October 29, 2003. The bonds were issued to acquire, construct, or renovate certain University facilities and to bring about the current refunding of \$35 million of the University's outstanding IFA–Series 1993 bonds, subject to conditions set forth in a trust indenture and loan agreement between the University and the Illinois Facilities Authority. The bonds were issued at a fixed rate of 5 percent and will mature from December 1, 2014, to December 1, 2038.

The lending agreements covering the IFA 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, 2004.

3. Contributions Receivable

Contributions receivable consisted of the following:

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>	<i>August 31, 2003</i>
Unconditional promises expected to be collected in		
Less than one year	\$47,239	\$64,981
One year to five years	121,536	139,300
More than five years	47,285	52,646
Less discount to present value and other reserves		
Discount to present value	(43,698)	(50,969)
Other reserves	(10,096)	(13,574)
Total	\$162,266	\$192,384

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 of units in the investment pools subscribes to or disposes of units on the basis of the market value per unit at the beginning of each month.

Endowment Payout/Spending Guideline

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.

Investment Market Value

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

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>		<i>August 31, 2003</i>	
	Cost	Estimated fair value	Cost	Estimated fair value
<i>Equity securities</i>				
Domestic	\$610,510	\$699,297	\$476,678	\$548,736
International	422,618	527,230	441,049	487,617
<i>Debt securities</i>				
Domestic — government	576,230	591,643	489,759	497,443
Domestic — corporate debt securities	194,904	197,202	140,229	142,003
International	9,763	16,296	14,491	24,589
<i>Other investments</i>				
Distressed securities	27,835	65,589	89,247	119,768
Hedge funds	497,701	832,698	380,044	660,062
Natural resources	153,964	205,786	145,849	178,002
Private equity	771,643	583,762	706,141	523,603
Real estate	148,208	185,148	156,055	191,648
Other	59,796	78,798	53,676	70,366
Total investments	\$3,473,172	\$3,983,449	\$3,093,218	\$3,443,837

The University is committed to making future capital contributions in other investments in the amount of \$879 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:

					<i>August 31, 2004</i>
<i>(in thousands of dollars)</i>	Operations and plant	Quasi-endowment	Annuity and life-income	Permanent endowment	Total
Long-Term Balanced Pool	\$357,750	\$1,153,010	\$32,931	\$1,776,046	\$3,319,737
Intermediate-Term					
Bond Pool	401,590	17,114			418,704
Separately invested	3,615	13,254	84,766	5,672	107,307
Working capital	137,701				137,701
Total investments	\$900,656	\$1,183,378	\$117,697	\$1,781,718	\$3,983,449

					<i>August 31, 2003</i>
<i>(in thousands of dollars)</i>	Operations and plant	Quasi-endowment	Annuity and life-income	Permanent endowment	Total
Long-Term Balanced Pool	\$266,565	\$976,703	\$31,393	\$1,621,877	\$2,896,538
Intermediate-Term					
Bond Pool	330,084	3,777			333,861
Separately invested	114	14,116	81,089	6,194	101,513
Working capital	111,925				111,925
Total investments	\$708,688	\$994,596	\$112,482	\$1,628,071	\$3,443,837

Investment Return

The components of total investment return were as follows:

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>	<i>August 31, 2003</i>
Investment income	\$86,053	\$57,383
Net realized gains (losses)	308,686	(67,437)
Change in net unrealized gains on investments reported at fair value	156,295	316,640
Total investment return	\$551,034	\$306,586

Investment return from operations is defined as the investment payout according to the spending guideline 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:

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>	<i>August 31, 2003</i>
Changes in unrestricted net assets		
Operating: investment return	\$210,290	\$201,140
Nonoperating: investment gains reinvested	338,618	103,113
Changes in temporarily restricted net assets		
Investment return	2,126	2,333
Total investment return	\$551,034	\$306,586

Derivative Financial Instruments

The University used a swap agreement to hedge public real estate equity exposure and obtain S&P 500 equity index exposure. The market value of the underlying equity assets hedged by the swap was \$23.3 million at August 31, 2004. In addition, the University had \$22.7 million S&P 500 equity index exposure related to the swap as of August 31, 2004. The swaps outstanding at August 31, 2004, had an unrealized loss of \$763,000. No underlying equity assets were hedged to swaps at August 31, 2003. The swap settlements during 2004 resulted in a realized loss of \$4.1 million.

The University also used futures contracts on an equity index during 2004 and 2003 and incurred a realized gain of \$4.7 million and \$5.1 million, respectively, on the purchase and sale of S&P 500 equity index futures contracts. As of August 31, 2004, and 2003, respectively, the University had 287 and 140 September S&P 500 index futures contracts outstanding. These contracts had an underlying notional value of \$81.4 million and \$35.3 million, respectively, and an unrealized loss of \$2.1 million at August 31, 2004, and an unrealized gain of \$63,000 at August 31, 2003.

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 \$362 million and \$337 million at August 31, 2004, and 2003, respectively.

Valuation of Permanent Endowment Funds

The University is monitoring endowment accounts in which historical cost was more than market value as of August 31, 2004. Historical cost and market value totals for these accounts were approximately \$83 million and \$65.7 million, respectively. In 2003 historical cost and market value totals for these accounts were approximately \$163.3 million and \$142.7 million, respectively. Associated unrealized losses are recorded in the unrestricted net assets classification.

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 \$30.1 million and \$26.7 million to the two plans in 2004 and 2003, respectively. It expects to contribute \$30.8 million to the two plans in 2005.

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:

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>	<i>August 31, 2003</i>
Active employees not yet eligible	\$2,767	\$3,457
Active employees eligible	2,506	3,154
Retirees	676	1,424
Total	\$5,949	\$8,035

The following table sets forth the plan's change in benefit obligation:

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>	<i>August 31, 2003</i>
Benefit obligation at beginning of year	\$4,127	\$3,598
Service cost (benefits attributed to employee service during the year)	469	313
Interest cost on accumulated postretirement benefit obligation	517	398
Amortization of prior service cost	109	109
Amortization of unrealized loss	195	94
Benefits paid	(356)	(385)
Total	\$5,061	\$4,127

During fiscal year 2004 postretirement benefit payments (net of retirees' contributions) were approximately \$356,000.

The following table sets forth the plan's funded status:

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>	<i>August 31, 2003</i>
Funded status	(\$5,061)	(\$4,127)
Unrecognized net actuarial loss	(68)	(2,979)
Unrecognized prior service cost	(820)	(929)
Total	(\$5,949)	(\$8,035)

The accrued benefit cost recognized in the Consolidated Statements of Financial Position, which is included in accounts payable and accrued expenses, was \$5.9 million and \$8 million at August 31, 2004, and 2003, respectively.

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

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>	<i>August 31, 2003</i>
Service cost (benefits attributed to employee service during the year)	\$469	\$313
Interest cost on accumulated postretirement benefit obligation	517	398
Amortization of prior service cost	109	109
Amortization of unrealized loss	195	94
Total	\$1,290	\$914

The discount rate used in determining the APBO was 6 percent and 6.5 percent as of August 31, 2004, and 2003, respectively. The assumed health care cost trend rate used in measuring the APBO was maintained in fiscal years 2004 and 2003 using a graded table starting at 10 percent and decreasing 1 percent each year to an ultimate rate of 5 percent.

	<i>August 31, 2004</i>	<i>August 31, 2003</i>
Health care cost trend rate assumed	10%	10%
Rate to which the cost trend rate is assumed to ultimately decline	5%	5%
Year that rate will reach the ultimate trend rate	2009	2008

A one percentage point change in assumed health care cost trend rates would have had the following effects in fiscal year 2004:

	<i>1% increase</i>	<i>1% decrease</i>
Increase (decrease) in total of service and interest cost	\$114	(\$98)
Increase (decrease) in postretirement benefit obligation	458	(401)

Estimated future benefit payments reflecting anticipated service, as appropriate, are expected to be paid as follows:

<i>(in thousands of dollars)</i>	
2005	\$76
2006	141
2007	195
2008	282
2009	329
2010-2014	2,540
Total	\$3,563

The University offers a deferred compensation plan under Internal Revenue Code 457(b) to a select group of management and highly compensated employees. There is no University contribution related to this deferred compensation plan.

In late 2003 the Medicare Prescription Drug Improvement and Modernization Act of 2003 became law. The University is waiting for the government to issue specific guidance on the accounting and disclosure requirements of the act. That guidance could require

the University to change previously reported information related to the measurement of its APBO or net periodic postretirement benefit costs under the provisions of the Financial Accounting Standard's Board's Staff Position No. FAS 106-1. Consequently, any measures of the APBO or net periodic postretirement benefit cost in the financial statements or accompanying notes do not reflect the effects of the act on the University's postretirement medical benefits plan.

6. Land, Buildings, and Equipment

Land, buildings, and equipment consisted of the following:

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>	<i>August 31, 2003</i>
Land and improvements	\$27,951	\$26,694
Buildings	1,337,525	1,207,496
Equipment	199,270	177,558
Accumulated depreciation	(518,063)	(470,506)
Total	\$1,046,683	\$941,242

At August 31, 2004, the University had under construction buildings that will cost approximately \$352.7 million. The estimated cost to complete this construction is \$175.9 million. Costs incurred through August 31, 2004, of \$176.8 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, 2004, and 2003. Those expenses have been distributed to the functional areas of the University as follows:

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>		
	Depreciation	Plant maintenance	Interest on indebtedness
Instruction	\$8,568	\$14,573	\$3,059
Research	11,160	18,981	3,985
Academic support	8,357	14,213	2,984
Student services	4,972	8,456	1,775
Institutional support	3,967	6,747	1,416
Auxiliary services	15,866	26,987	5,665
Total	\$52,890	\$89,957	\$18,884

<i>(in thousands of dollars)</i>	<i>August 31, 2003</i>		
	Depreciation	Plant maintenance	Interest on indebtedness
Instruction	\$7,545	\$13,068	\$2,107
Research	8,717	15,098	2,434
Academic support	7,264	12,581	2,029
Student services	4,686	8,117	1,309
Institutional support	2,906	5,033	811
Auxiliary services	15,746	27,273	4,398
Total	\$46,864	\$81,170	\$13,088

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 \$79.5 million and \$61.4 million at August 31, 2004, and 2003, 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, a proportionate share of professional liability insurance costs is borne by NMFF. As of August 31, 2004, and 2003, accounts receivable from NMFF related to professional liability insurance costs totaled \$18.6 million and \$15 million, respectively. As of November 1, 2004, NMFF obtained excess medical liability coverage through another institution for all events after October 1, 2002. NMFF has agreed to continue to bear a proportionate share of the primary medical professional liability costs that arise out of events prior to November 1, 2004.

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 \$199.8 million at August 31, 2004. Service revenues are the excess of the actual interest collected above a guaranteed rate of return on the serviced loans. Under the agreement in effect through May 31, 2006, the University guarantees these loans against default up to 10 percent of the original loan portfolio amount. The maximum future total payments is \$20 million as of August 31, 2004. At August 31, 2004, and 2003, \$541,000 and \$514,000, 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, 2004, and 2003, were as follows:

<i>(in thousands of dollars)</i>	<i>August 31, 2004</i>	<i>August 31, 2003</i>
Salaries, wages, and benefits	\$585,293	\$529,476
Services and professional fees	142,509	123,677
Supplies	59,880	53,447
Travel and promotion	50,545	47,414
Other expenses	46,713	47,998
Maintenance, utilities, and equipment	106,875	96,918
Interest on indebtedness	18,884	13,088
Depreciation	52,890	46,864
Total	\$1,063,589	\$958,882

10. Securities Lending

During the year ended August 31, 2004, the University entered into an agreement with its investment custodian to lend University securities to approved brokers in exchange for a fee. Among other provisions that limit the University's risk, the securities lending agreement specified that the custodian was responsible for the lending of securities and obtaining adequate collateral from the borrower. Collateral was limited to cash, government securities, and irrevocable letters of credit. At August 31, 2004, investment securities with an aggregate market value of \$539.9 million were loaned to various brokers and were returnable on demand. In exchange, the University received cash collateral of \$479.6 million and noncash collateral of \$70.9 million. In accordance with SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," the cash collateral is shown as both an asset and a liability on the Consolidated Statements of Financial Position.

11. Subsequent Event

On September 9, 2004, the University issued \$135.8 million in variable rate revenue bonds subject to conditions set forth in a trust indenture and loan agreement between it and the Illinois Finance Authority.

The bonds were issued to design, plan, equip, acquire, construct, or renovate certain University facilities in Evanston and Chicago. The bonds were issued with a weekly variable rate mode and will ultimately mature on December 1, 2034.

In addition, the University redeemed \$126.2 million in variable rate bonds and notes in September 2004: IFA-Series 1985 Adjustable Demand Revenue Bonds totaling \$35.3 million, IFA-Series 1985 Cultural Pooled Financing Program Adjustable Rate Demand Revenue Bonds totaling \$10 million, IFA-Series 1988 Adjustable Demand Revenue Bonds totaling \$45.1 million, and the 1995 Commercial Paper Revenue Note totaling \$35.8 million.