

## REPORT OF THE SENIOR VICE PRESIDENT FOR BUSINESS AND FINANCE

To the Board of Trustees of Northwestern University:

This *Financial Report* illustrates that in 2006 Northwestern increased its substantial financial resources and added to its history of favorable operating results.

During fiscal year 2006 Northwestern's total investments grew \$760.5 million to nearly \$5.3 billion, the result of a 15.6 percent return on the Long-Term Balanced Pool. Total assets grew to \$7.67 billion, up from \$7.07 billion at August 31, 2005. Total net assets of \$5.97 billion reflect an increase of \$563.3 million, or 10.4 percent, from August 31, 2005.

Unrestricted net assets increased \$568.8 million, due primarily to investment gains reinvested of \$446.1 million. Operating revenues increased 12 percent, or \$142.8 million, while operating expenses increased 6.4 percent, or \$75.4 million, over fiscal year 2005.

In temporarily restricted net assets, the University was able to expend \$93 million in accordance with donor restrictions while recognizing new restricted revenue of \$57.2 million; this category decreased \$35.8 million as a result. Permanently restricted net assets increased \$30.3 million, primarily as a result of contributions received for endowment.

In 2006 the University received the highest available debt rating, a key indicator of financial strength and stability, from both Moody's and Fitch rating services.

The stewards of Northwestern take very seriously their responsibility to maintain the economic foundation for long-term success in all of the University's fields of endeavor. The careful management and allocation of resources are key to Northwestern's ability to attract the best students, faculty, and staff. I am confident that Northwestern will continue to use its resources prudently to achieve the institution's many goals and objectives.



Eugene S. Sunshine  
Senior Vice President for Business and Finance

## INDEPENDENT AUDITORS' REPORT

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, 2006 and 2005, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of management of the University. 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. 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 consideration of internal control over financial reporting as a basis for designating audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 the University as of August 31, 2006 and 2005, and the changes in its net assets and the cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, in 2006 the University adopted Financial Accounting Standards Board ("FASB") Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations—An Interpretation of FASB Statement No. 143," and changed its method of accounting for conditional asset retirement obligations.

*Deloitte + Touche LLP*

Chicago, Illinois

December 22, 2006

# CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

As of August 31, 2006, and August 31, 2005

<i>(in thousands of dollars)</i>	2006	2005
<b>Assets</b>		
Cash and cash equivalents	\$177,588	\$266,246
Accounts receivable	224,474	195,613
Notes receivable	48,144	51,842
Contributions receivable	96,305	162,783
Collateral held for securities loaned	508,976	561,675
Investments	5,272,712	4,512,236
Land, buildings, and equipment	1,191,254	1,152,879
Bond proceeds held by trustees	108,886	126,699
Other assets	42,302	42,860
<b>Total assets</b>	<b>\$7,670,641</b>	<b>\$7,072,833</b>
<b>Liabilities</b>		
Accounts payable and accrued expenses	\$113,455	\$116,590
Deferred revenue	236,524	204,174
Payable under securities loan agreements	508,976	561,675
Actuarial liability of annuities payable and deposits payable	46,320	69,409
Reserves for self-insurance	65,531	80,306
Government advances for student loans	39,353	39,815
Asset retirement obligations	103,596	—
Bonds and notes payable	588,111	595,348
<b>Total liabilities</b>	<b>\$1,701,866</b>	<b>\$1,667,317</b>
<b>Net assets</b>		
Unrestricted	\$5,017,368	\$4,448,572
Temporarily restricted	129,362	165,150
Permanently restricted	822,045	791,794
<b>Total net assets</b>	<b>\$5,968,775</b>	<b>\$5,405,516</b>
<b>Total liabilities and net assets</b>	<b>\$7,670,641</b>	<b>\$7,072,833</b>

				2006
Detail of net assets	Unrestricted	Temporarily restricted	Permanently restricted	
Operating funds	\$590,290	\$75,907		\$666,197
Invested in plant facilities	1,029,816	17,314		1,047,130
Annuity and life income funds	26,257	18,419	\$30,971	75,647
Endowment and similar funds	3,371,005	17,722	791,074	4,179,801
<b>Total net assets</b>	<b>\$5,017,368</b>	<b>\$129,362</b>	<b>\$822,045</b>	<b>\$5,968,775</b>

				2005
Detail of net assets	Unrestricted	Temporarily restricted	Permanently restricted	
Operating funds	\$491,865	\$83,639		\$575,504
Invested in plant facilities	1,012,542	26,402		1,038,944
Annuity and life income funds	29,188	35,599	\$28,828	93,615
Endowment and similar funds	2,914,977	19,510	762,966	3,697,453
<b>Total net assets</b>	<b>\$4,448,572</b>	<b>\$165,150</b>	<b>\$791,794</b>	<b>\$5,405,516</b>

See Notes to the Consolidated Financial Statements, beginning on page 10.

## CONSOLIDATED STATEMENTS OF ACTIVITIES

For the fiscal years ended August 31, 2006, and August 31, 2005

<i>(in thousands of dollars)</i>	2006	2005	
<b>Changes in unrestricted net assets</b>			
<i>Operating revenues</i>			
Tuition and fees	\$562,633		\$527,864
(less scholarships and fellowships)	(166,854)		(153,205)
Net tuition and fees	395,779		374,659
Auxiliary services	64,531		63,579
Grants and contracts	351,590		336,548
Private gifts	92,998		52,102
Investment return designated for operations	232,407		219,023
Professional fees	29,393		27,735
Sales and services	112,989		102,430
Royalties and trademarks	44,546		7,106
Other income	7,139		5,372
<b>Total operating revenues</b>	<b>\$1,331,372</b>		<b>\$1,188,554</b>
<i>Operating expenses</i>			
Instruction	452,427		416,302
Research	309,323		291,478
Academic support	156,823		144,830
Student services	104,105		94,891
Institutional support	120,394		123,463
Auxiliary services	101,957		98,692
<b>Total operating expenses</b>	<b>1,245,029</b>		<b>1,169,656</b>
<b>Excess of operating revenues over expenses</b>	<b>86,343</b>		<b>18,898</b>
<i>Nonoperating</i>			
Private gifts and grants for buildings and equipment	27,464		30,826
Investment gains reinvested	446,082		560,401
<b>Change in unrestricted net assets from nonoperating activities</b>	<b>473,546</b>		<b>591,227</b>
<b>Net assets released from restrictions</b>	<b>93,022</b>		<b>39,411</b>
<b>Increase in unrestricted net assets before cumulative effect of change in accounting principle</b>	<b>652,911</b>		
<b>Cumulative effect of change in accounting principle</b>	<b>(84,115)</b>		
<b>Change in unrestricted net assets</b>	<b>568,796</b>		<b>649,536</b>
<b>Changes in temporarily restricted net assets</b>			
Private gifts	45,270		40,503
Net gain (loss) on annuity obligation	9,948		(1,410)
Investment returns	2,016	57,234	2,185
<b>Net assets released from restrictions</b>		<b>(93,022)</b>	<b>(39,411)</b>
<b>Change in temporarily restricted net assets</b>		<b>(35,788)</b>	<b>1,867</b>
<b>Changes in permanently restricted net assets</b>			
Private gifts	27,885		39,423
Net gain on annuity obligation	2,366	30,251	79
<b>Change in permanently restricted net assets</b>		<b>30,251</b>	<b>39,502</b>
<b>Change in net assets</b>		<b>563,259</b>	<b>690,905</b>
<b>Beginning net assets</b>		<b>\$5,405,516</b>	<b>\$4,714,611</b>
<b>Ending net assets</b>		<b>\$5,968,775</b>	<b>\$5,405,516</b>

See Notes to the Consolidated Financial Statements, beginning on page 10.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the fiscal years ended August 31, 2006, and August 31, 2005

<i>(in thousands of dollars)</i>	2006	2005
<b>Cash flows from operating activities</b>		
Change in net assets	<b>\$563,259</b>	<b>\$690,905</b>
<b>Adjustments to reconcile change in net assets to net cash provided by operating activities</b>		
Cumulative effect of change in accounting principle	84,115	—
Depreciation	70,471	62,426
Accretion for asset retirement obligations	5,118	—
Loss on retirement of equipment	848	869
Amortization of discount on bonds payable	73	74
Net realized and unrealized gains on investments	(567,800)	(658,145)
Private gifts and grants for long-term investments	(27,464)	(30,826)
<i>Changes in assets and liabilities</i>		
Accounts receivable	(28,897)	37,422
Contributions receivable	66,478	(517)
Other assets	558	(1,430)
Accounts payable and accrued expenses	(11,424)	(6,607)
Deferred revenue	32,350	42
Reserves for self-insurance	(14,775)	852
Government advances for student loans	(462)	(556)
<b>Net cash provided by operating activities</b>	<b>172,448</b>	<b>94,509</b>
<b>Cash flows from (used in) investing activities</b>		
Purchases of investments	(2,567,346)	(1,907,909)
Proceeds from sales of investments	2,378,049	2,040,278
Decrease in trusts held by others	36	5
Increase in investments held for others	(3,379)	(3,011)
Acquisitions of land, buildings, and equipment	(87,042)	(148,508)
Student loans disbursed	(107,925)	(106,833)
Principal collected on student loans	111,623	104,320
<b>Net cash used in investing activities</b>	<b>(275,984)</b>	<b>(21,658)</b>
<b>Cash flows from (used in) financing activities</b>		
Net proceeds from issuance of notes payable and bonds payable	—	135,800
Net principal payments on notes and bonds payable	(7,310)	(132,377)
Decrease (increase) in bond proceeds held by trustees	17,813	(76,251)
Proceeds from private gifts and grants for long-term investments	27,464	30,826
(Increase) decrease in annuities payable and deposits payable	(23,089)	9,718
<b>Net cash provided by (used in) financing activities</b>	<b>14,878</b>	<b>(32,284)</b>
<b>(Decrease) increase in cash and cash equivalents</b>	<b>(88,658)</b>	<b>40,567</b>
<b>Cash and cash equivalents at beginning of year</b>	<b>266,246</b>	<b>225,679</b>
<b>Cash and cash equivalents at end of year</b>	<b>\$177,588</b>	<b>\$266,246</b>
<b>Supplemental disclosure of cash flow information</b>		
Accrued liabilities for construction in progress	\$8,289	\$20,983
Capitalized interest	12,118	—
Cash paid for interest	22,356	21,114

See Notes to the Consolidated Financial Statements, beginning on page 10.

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the fiscal years ended August 31, 2006, and August 31, 2005

## 1. Summary of Significant Accounting Policies

### *University Activities*

Northwestern University (the University) is a major private research university with more than 17,000 students enrolled in 11 academic divisions on two lakefront campuses. Its mission is to provide the highest-quality education for its students, to develop innovative programs in research, and to sustain an academic community that embraces these enterprises. Activities supporting its mission may be classified as either operating or nonoperating.

Operating activities primarily reflect transactions of a current nature, such as tuition or unrestricted gift revenues, as well as instructional or auxiliary services expenses. Investment return from operations is defined as the investment payout, according to the spending guideline (see note 4 on page 15) for the Long-Term Balanced Pool and the actual investment income for all other investments.

Nonoperating activities primarily reflect transactions of a noncurrent nature such as long-term investment or capital events, including contributions to be invested for the support of future operations, contributions to be used for facilities and equipment, and unrealized gains or losses that are not defined as from operations.

### *Basis of Accounting*

#### *General*

The University maintains its accounts and prepares its consolidated financial statements on the accrual basis of accounting in conformity with generally accepted accounting principles in the United States of America (GAAP). These statements include all wholly owned subsidiaries. All significant intercompany transactions and accounts have been eliminated.

#### *Contributions*

The University prepares its financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 116, "Accounting for Contributions Received and Contributions Made." SFAS No. 116 requires that contributions received, including unconditional promises to give (pledges), be recognized as revenues at their fair values. 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.

#### *Net Asset Classifications*

SFAS No. 117, "Financial Statements of Not-for-Profit Organizations," 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.

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. The expiration of a donor-imposed restriction on a contribution is recognized in the period in which the restriction expires. 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.

### *Cash and Cash Equivalents*

*Cash* reflects currency and deposits or other accounts with financial institutions that may be deposited or withdrawn without restriction or penalty. *Cash equivalents* represent short-term and highly liquid investments that convert readily to cash and carry little risk of change in value at maturity due to interest rate changes.

### ***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 included within fixed income, high-yield credit, absolute return, private investments, and real assets was \$2,805.3 million and \$2,062.2 million at August 31, 2006, and 2005, respectively. Management has reviewed the valuation policies for all partnerships in which Northwestern University is invested and deemed those policies appropriate. In addition to receiving the most recent available audited and unaudited financial statements from the external managers, management contacted the majority of general partners regarding the aggregate carrying value of the respective investments at August 31, 2006. A small number of investments within certain partnerships may have holdings at a carrying value of cost, and management has determined this to be appropriate for these specific investments. 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.

The University continually monitors the difference between the cost and the estimated fair value of its investments. If any of the investments experiences a decline in value that the University believes is other than temporary, the University recognizes a realized loss in investment income in the consolidated statements of activities.

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 equity and bond indices. Such instruments are not designated as hedges for accounting purposes and are recorded at fair value. In fiscal year 2006, all swap agreements were liquidated.

### ***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, 2006, the fair value of the University's fixed rate debt of \$370.5 million exceeded the carrying value of \$352.9 million by \$17.6 million. At August 31, 2005, the fair value of the University's fixed rate debt of \$385 million exceeded the carrying value of \$360 million by \$25 million.

### ***Accounts and Notes Receivable***

Accounts receivable arising from tuition and fees are carried net of an allowance for doubtful accounts of \$457,000 and \$332,000 as of August 31, 2006, and 2005, respectively. Notes receivable resulting from student loans are carried net of an allowance for doubtful accounts of \$279,000 and \$253,000 as of August 31, 2006, and 2005, respectively.

Receivables from Northwestern Medical Faculty Foundation, a related party (see page 13), arose out of operational activities. They totaled \$13.9 million and \$15.6 million as of August 31, 2006, and 2005, respectively.

### ***Contributions Receivable***

Contributions receivable arising from unconditional promises to give are carried net of an allowance for uncollectible pledges that totaled \$9.5 million and \$6.7 million at August 31, 2006, and 2005, respectively. Additionally, unconditional promises expected to be collected in periods from less than one year through more than five years are discounted to present value. The discount rate for pledges made in fiscal year 2006 was 4.7 percent; the discount rate used on all pledges receivable prior to September 1, 2006, was 6.5 percent. Significant conditional promises to give totaled \$25.8 million at August 31, 2006; there were no significant conditional promises to give at August 31, 2005.

### ***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. The University follows SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The provisions under this statement include a requirement that long-lived assets be reviewed for impairment by comparing the future cash flows expected from the asset to the carrying value of the asset. 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. In management's opinion, no impairment existed as of August 31, 2006.

### ***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, Publication 939, April 2003).

### ***Self-Insurance Reserves***

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.

### ***Revenue Recognition***

Revenues from tuition and fees are reported in the fiscal year in which educational programs are predominantly conducted. Fiscal year 2007 fall-quarter tuition and fees, billed in fiscal year 2006, are reported as deferred revenue in fiscal year 2006. Similarly, fiscal year 2006 fall-quarter tuition and fees, billed in fiscal year 2005, are reported as deferred revenue in fiscal year 2005.

Revenues from auxiliary services such as residence halls and food services represent fees for goods and services furnished to University students, faculty, and staff. Grants and contracts revenue is recognized as expenses are incurred on the project. Professional fees arise from faculty and department services provided to external institutions such as hospitals. Sales and services revenues represent fees for services and goods provided to external parties in the course of educational activities; also included are revenues from the provision of physical plant services and goods to external institutions contiguous to the University campuses. Trademark and royalty revenues arise from licensing of innovative technologies, copyrights, and other intellectual property. Other income includes revenues not otherwise categorized, such as rental revenues from property not held for investment, reimbursements for goods and services, and sundry payments to the University.

### ***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.



### ***Related Parties***

Northwestern Medical Faculty Foundation (NMFF) 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 \$25 million in fiscal year 2006 and \$25.9 million in fiscal year 2005.

### ***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, 2006, and 2005, 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 March 2005, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations—An Interpretation of FASB Statement No. 143" (FIN 47). FIN 47 clarifies the term *conditional asset retirement obligation* as it is used in SFAS No. 143, "Accounting for Asset Retirement Obligations," and requires a liability to be recorded if the fair value of the obligation to retire an asset can be reasonably estimated. Asset retirement obligations covered by FIN 47 include those for which an entity has a legal obligation to perform an asset retirement activity; however, the timing and/or method of settling the obligation are conditional on a future event that may or may not be within the control of the entity.

In accordance with FIN 47, the University records all known asset retirement obligations for which the fair value of the liability can be reasonably estimated, including certain obligations relating to regulatory remediation. As a result of adopting FIN 47 at the beginning of fiscal year 2006, the University recorded a cumulative effect of change in accounting principal of \$84.1 million and recognized current-year depreciation expense of \$497,000 and accretion expense of \$5.1 million. The University recorded a liability for asset retirement obligation of \$98.5 million and increased the carrying value of the related assets by \$14.3 million, net of accumulated depreciation of \$15.2 million.

The FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets," an amendment of FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," in March 2006. SFAS No. 156 requires that in any of several specific situations in which an entity enters into a contract to service a financial asset, it must recognize a servicing asset or a servicing liability. The implementation of SFAS No. 156 during fiscal year 2006 did not have an impact on the University's financial statements.

### ***Reclassifications***

Prior-year building asset amounts totaling \$109.4 million have been reclassified to separately identify construction in progress for the respective fiscal year. In addition, prior-year leasehold improvement assets in the amount of \$595,000 were reclassified from land and improvements to building assets. Prior-year private gifts of \$29.1 million, and grants and contracts revenues totaling \$12.7 million, were also reclassified. Both trademark and royalty revenues and expenses of \$7.1 million and \$1.3 million, respectively, have been reclassified to be separately identified from sales and services revenues and other expenses.

## 2. Bonds and Notes Payable

Bonds and notes payable are as follows:

<i>(in thousands of dollars)</i>	<i>August 31, 2006</i>	<i>August 31, 2005</i>
Demand revenue bonds		
IEFA–Series 1993	\$22,885	\$25,195
Less unamortized discount on IEFA–Series 1993	(584)	(657)
IEFA–Series 1997	145,000	150,000
IEFA–Series 2003	185,010	185,010
IFA–Series 2004	135,800	135,800
Bonds payable subtotal	488,111	495,348
Commercial paper, taxable	100,000	100,000
Notes payable subtotal	100,000	100,000
<b>Total bonds and notes payable</b>	<b>\$588,111</b>	<b>\$595,348</b>

Bond issuance	Interest rate mode	Interest rate	Maturity
IEFA–Series 1993	Fixed	5.49%*	December 1, 2006, to December 1, 2013
IEFA–Series 1997	Fixed	5.08%*	November 1, 2006, to November 1, 2015
IEFA–Series 2003	Fixed	5%*	December 1, 2014, to December 1, 2038
IFA–Series 2004	Variable, weekly rate	3.38% and 3.43%+	December 1, 2034
Commercial paper, taxable	Fixed	5.4%*	September 5, 2006, to December 6, 2006

\* Weighted average interest rate at August 31, 2006 + Weekly variable rate at August 31, 2006

Total obligations including commercial paper at August 31, 2006, are scheduled to mature through August 31 of each period as follows:

<i>(in thousands of dollars)</i>	
2007	\$112,317
2008	12,407
2009	17,507
2010	17,602
2011	17,802
2012–2016	96,836
2017–2021	23,040
2022–2026	4,800
2027–2031	—
Thereafter	285,800
<b>Total</b>	<b>\$588,111</b>

### ***Bonds Payable***

In fiscal year 2005, the University elected to prepay the following variable-rate bonds in whole, without premium: Series 1985 Adjustable Demand Bonds; Series 1988 Adjustable Demand Bonds; and Series 1985 Cultural Pooled Financing Program. Their principals amounted to \$35.3 million, \$45.1 million, and \$10 million, respectively.

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. 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.

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. 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 IEFA-Series 2003 Fixed-Rate Revenue Bonds were issued to acquire, construct, or renovate certain University facilities and to refund \$35 million of the University's outstanding IEFA-Series 1993 bonds, subject to conditions set forth in a trust indenture and loan agreement between the University and the Illinois Facilities Authority.

The IFA-Series 2004 Adjustable Rate Revenue Bonds were issued to acquire, construct, renovate, remodel, improve, and equip capital projects on both the Evanston and the Chicago campuses, subject to conditions set forth in a trust indenture and loan agreement between the University and the Illinois Finance Authority. The bonds may operate in a daily, weekly, adjustable, or auction-rate mode. In fiscal year 2006, the revenue bonds operated in a weekly rate mode determined by the remarketing agents.

In September 2004, the University elected to prepay the Illinois Educational Facilities Authority Series 1995 Commercial Paper Revenue Bonds in whole, without premium. The total principal balance was \$35.8 million.

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

#### **Notes Payable**

In fiscal year 2005, the University began placing commercial paper under a new \$200 million Taxable Commercial Paper Note. On July 15, 2005, the University closed on two standby letters of credit: \$100 million was issued to assure liquidity of short-term debt, and \$50 million was issued to provide working capital as needed.

### **3. Contributions Receivable**

Contributions receivable consisted of the following:

<i>(in thousands of dollars)</i>	<i>August 31, 2006</i>	<i>August 31, 2005</i>
Unconditional promises expected to be collected in		
Less than one year	\$74,927	\$49,431
One year to five years	37,860	116,874
More than five years	1,181	43,986
Less discount to present value and other reserves		
Discount to present value	(8,163)	(40,842)
Other reserves	(9,500)	(6,666)
<b>Total</b>	<b>\$96,305</b>	<b>\$162,783</b>

### **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 or external equity investment managers, external and internal fixed-income and cash managers, and various limited partnership managers direct the investment of endowment and trust assets, certain working capital, temporarily invested expendable funds, and commercial real estate.

Substantially all of 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 revised guideline effective in fiscal year 2007 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 4.4 percent of the market value of a unit in the pool, averaged for the 12 months ending October 31 of the prior fiscal year. 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 1.5 percent, plus the actual rate of inflation. 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, 2006</i>		<i>August 31, 2005</i>	
	<b>Cost</b>	<b>Estimated fair value</b>	<b>Cost</b>	<b>Estimated fair value</b>
U.S. equity securities	\$745,649	\$867,498	\$639,974	\$791,726
International equity securities	634,690	845,471	517,303	693,679
Fixed income securities	651,749	645,157	677,507	692,771
High-yield credit	153,404	216,568	146,905	207,708
Absolute return	518,081	855,125	493,676	779,742
Private investments	1,078,319	958,022	901,322	763,817
Real assets	673,615	834,340	447,224	545,326
Other assets	34,222	50,531	23,510	37,467
<b>Total investments</b>	<b>\$4,489,729</b>	<b>\$5,272,712</b>	<b>\$3,847,421</b>	<b>\$4,512,236</b>

The University is committed to making future capital contributions in other investments in the amount of \$1,649 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>(in thousands of dollars)</i>	<i>August 31, 2006</i>				
	<b>Operations and plant</b>	<b>Quasi-endowment</b>	<b>Annuity and life-income</b>	<b>Permanent endowment</b>	<b>Total</b>
Long-Term Balanced Pool	\$634,143	\$1,524,387	\$40,405	\$2,363,652	\$4,562,587
Intermediate-Term Bond Pool	547,784	32,601			580,385
Separately invested	161	13,597	60,186	4,527	78,471
Working capital	51,269				51,269
<b>Total investments</b>	<b>\$1,233,357</b>	<b>\$1,570,585</b>	<b>\$100,591</b>	<b>\$2,368,179</b>	<b>\$5,272,712</b>

<i>(in thousands of dollars)</i>	<i>August 31, 2005</i>				
	<b>Operations and plant</b>	<b>Quasi-endowment</b>	<b>Annuity and life-income</b>	<b>Permanent endowment</b>	<b>Total</b>
Long-Term Balanced Pool	\$511,388	\$1,308,475	\$36,194	\$2,057,223	\$3,913,280
Intermediate-Term Bond Pool	435,345	21,190			456,535
Separately invested	160	14,248	87,523	4,989	106,920
Working capital	35,501				35,501
<b>Total investments</b>	<b>\$982,394</b>	<b>\$1,343,913</b>	<b>\$123,717</b>	<b>\$2,062,212</b>	<b>\$4,512,236</b>

The following table is a summary of private investments in which cost basis exceeds fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position. Management regularly monitors unrealized gains and losses in this class of investments over the fiscal periods, noting trends and tracking performance compared with expectations. Private equity and international private equity categories consist of long-term partnerships that have predictable life cycles resulting in unrealized losses at the beginning and the ending of the cycle. In the early years of these partnerships, initial investments are made with the expectation of gains in future years; thus, fees and expenses cause a temporary impairment. In the late stages of these partnerships, realized gains have materially already occurred; thus, the remaining investments on the books are fairly valued at current prices below the original cost basis of these partnerships. Based on continuing analysis and evaluation, management has determined that declines in fair value are temporary and that these assets are not impaired at August 31, 2006.

The unrealized losses of \$273,000 have been reflected in the consolidated financial statements in conjunction with the adjustment of all investments to fair market value.

<i>(in thousands of dollars)</i>	<i>August 31, 2006</i>					
	<b>Less than 12 months</b>		<b>12 months or more</b>		<b>Total</b>	
	<b>Fair value</b>	<b>Unrealized losses</b>	<b>Fair value</b>	<b>Unrealized losses</b>	<b>Fair value</b>	<b>Unrealized losses</b>
Private equity securities	\$7,122	(\$3,738)	\$166,593	(\$83,308)	\$173,715	(\$87,046)
International private equity securities	16,357	(1,018)	32,176	(13,276)	48,533	(14,294)
Venture capital	25,171	(7,005)	209,652	(164,144)	234,823	(171,149)
Separately invested			80	(129)	80	(129)
<b>Total temporarily impaired securities</b>	<b>\$48,650</b>	<b>(\$11,761)</b>	<b>\$408,501</b>	<b>(\$260,857)</b>	<b>\$457,151</b>	<b>(\$272,618)</b>

### ***Investment Return***

The components of total investment return were as follows:

<i>(in thousands of dollars)</i>	<i>August 31, 2006</i>	<i>August 31, 2005</i>
Investment income	\$112,741	\$123,469
Net realized gains	453,011	507,015
Change in net unrealized gains on investments reported at fair value	114,753	151,125
<b>Total investment return</b>	<b>\$680,505</b>	<b>\$781,609</b>

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, 2006</i>	<i>August 31, 2005</i>
<b>Changes in unrestricted net assets</b>		
Operating: investment return	\$232,407	\$219,023
Nonoperating: investment gains reinvested	446,082	560,401
<b>Changes in temporarily restricted net assets</b>		
Investment return	2,016	2,185
<b>Total investment return</b>	<b>\$680,505</b>	<b>\$781,609</b>

### ***Derivative Financial Instruments***

In fiscal year 2006, the University used a swap agreement to hedge public real estate equity exposure and obtain S&P 500 equity index exposure; these were liquidated in fiscal year 2006 at a net realized gain of \$45,000. The University also used a swap agreement to hedge small-cap equity exposure and obtain S&P 500 equity index exposure; these were liquidated in fiscal year 2006. The swap settlements and liquidation in 2006 resulted in a realized loss of \$1.9 million. At August 31, 2005, the market value of the underlying real estate equity assets hedged by the swap was \$9.4 million, and the University also had \$9.6 million S&P 500 equity index exposure related to the swap. The swaps outstanding at August 31, 2005, had an unrealized loss of \$254,000. The swap settlements during 2005 resulted in a realized loss of \$1.5 million.

The University bought and sold futures contracts on a domestic equity index during 2006 and 2005 and incurred realized gains of \$3.4 million and \$3.1 million, respectively, on the purchase and sale of S&P 500 equity index futures contracts. As of August 31, 2006, and 2005, respectively, the University had 246 and 325 September S&P 500 index futures contracts outstanding. These contracts had an underlying notional value of \$80.3 million and \$99.2 million, respectively; an unrealized gain of \$1.2 million at August 31, 2006; and an unrealized gain of \$777,000 at August 31, 2005.

In addition, the University bought and sold futures contracts on international equity indices during 2006 and incurred realized gains of \$1.8 million. As of August 31, 2006, the University had several international equity index futures contracts outstanding, representing a Europe, Australia, and Far East (EAFE) basket of securities. These contracts had an underlying notional value of \$18.6 million and an unrealized gain of \$290,000 at August 31, 2006.

Lastly, the University bought and sold futures contracts on the 10-year Treasury note during 2006 and incurred realized gains of \$153,000. As of August 31, 2006, the University had 145 10-year Treasury note contracts outstanding. These contracts had an underlying notional value of \$15.6 million and an unrealized gain of \$48,000 at August 31, 2006.

Such equity instruments are not designated as hedges for accounting purposes and are recorded at fair value and included in investments on the consolidated statements of financial position.

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 the cash collateral held at the counterparties at the reporting date.

The University manages its exposure to credit risk by using 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 19 independent asset managers of the University funds totaling approximately \$1,002 million and \$520 million at August 31, 2006, and 2005, respectively.

#### ***Valuation of Permanent Endowment Funds***

The University monitors endowment accounts in which historical cost was more than market value as of August 31, 2006. Historical cost and market value totals for these accounts were approximately \$4.2 million and \$1.8 million, respectively. In 2005 historical cost and market value totals for such accounts were approximately \$3.9 million and \$2.2 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 \$33.3 million and \$32.2 million to the two plans in 2006 and 2005, respectively. It expects to contribute \$35.3 million to the two plans in 2007.

The University currently sponsors a health care plan permitting retirees to continue participation on a "pay-all" basis. The retiree contribution is based on the average per-capita cost of coverage for the plan's entire 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 accrued cost for postemployment benefits was \$6.6 million and \$8.7 million at August 31, 2006, and 2005, respectively, and is included in accounts payable and accrued expenses on the consolidated statements of financial position.

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, 2006</i>	<i>August 31, 2005</i>
Active employees not yet eligible	\$3,285	\$3,299
Active employees eligible	3,895	3,149
Retirees	1,498	539
<b>Total</b>	<b>\$8,678</b>	<b>\$6,987</b>

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

<i>(in thousands of dollars)</i>	<i>August 31, 2006</i>	<i>August 31, 2005</i>
Benefit obligation at beginning of year	\$6,987	\$5,949
Service cost (benefits attributed to employee service during the year)	497	412
Interest cost on accumulated postretirement benefit obligation	346	352
Actuarial loss	990	437
Benefits paid	(1,203)	(1,138)
Contributions from participants	1,061	975
<b>Benefit obligation at end of year</b>	<b>\$8,678</b>	<b>\$6,987</b>

During fiscal year 2006, postretirement benefit payments (net of retirees' contributions) were approximately \$436,000.

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

<i>(in thousands of dollars)</i>	<i>August 31, 2006</i>	<i>August 31, 2005</i>
Funded status	(\$8,678)	(\$6,987)
Unrecognized net actuarial loss	1,523	505
Unrecognized prior service cost	601	711
<b>Total</b>	<b>(\$6,554)</b>	<b>(\$5,771)</b>

The accrued benefit cost recognized in the consolidated statements of financial position, which is included in accounts payable and accrued expenses, was \$8.7 million and \$7 million at August 31, 2006, and 2005, respectively.

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

<i>(in thousands of dollars)</i>	<i>August 31, 2006</i>	<i>August 31, 2005</i>
Service cost (benefits attributed to employee service during the year)	\$497	\$412
Interest cost on accumulated postretirement benefit obligation	346	352
Amortization of prior service cost	109	109
Amortization of unrealized gain	(27)	—
<b>Total</b>	<b>\$925</b>	<b>\$873</b>

The following tables present key actuarial assumptions used in determining APBO as of August 31, 2006, and 2005:

	<i>August 31, 2006</i>	<i>August 31, 2005</i>
Discount rate	5.6%	5%
Rate of increase in compensation levels	4%	4%

	<i>August 31, 2006</i>	<i>August 31, 2005</i>
Health care cost trend rate assumed	10%	9%
Rate to which the cost trend rate is assumed to ultimately decline	5%	5%
Year that rate will reach the ultimate trend rate	2011	2009

A one-percentage-point change in assumed health care cost trend rates would have had the following effects in fiscal year 2006:

	<i>1% increase</i>	<i>1% decrease</i>
Increase (decrease) in total of service and interest cost	\$81	(\$69)
Increase (decrease) in postretirement benefit obligation	560	(493)

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

<i>(in thousands of dollars)</i>	
2008	\$496
2009	530
2010	594
2011	667
2012–2016	4,384
<b>Total</b>	<b>\$6,671</b>

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. The University has recorded both an asset and a liability related to the deferred compensation plan that totaled \$9.8 million and \$6.4 million in fiscal years 2006 and 2005, respectively.

In May 2004, the FASB issued FASB Staff Position SFAS No. 106-2, "Accounting and Disclosure Requirement Related to the Medicare Prescription Drug, Improvements, and Modernization Act of 2003." It requires that the University disclose, effective with the year ended August 31, 2005, the effects of the act and assess the impact of the Medicare Part D subsidy on the accumulated postretirement benefit obligation and net periodic postretirement benefit cost. Since in fiscal years 2006 and 2005 the University chose not to pursue the subsidy, measures of the APBO or net periodic postretirement benefit cost do not reflect any amount associated with it.

In September 2006, the FASB issued Statement No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Benefit Plans." SFAS No. 158 amends FASB Statement No. 87, "Employers' Accounting for Pensions"; FASB Statement No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits"; FASB Statement No. 106, "Employers' Accounting for Postretirement Benefits Other than Pensions"; FASB Statement No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits"; and related accounting guidance.

SFAS No. 158 requires that an employer sponsoring one or more single-employer defined benefit plans must recognize an asset or a liability in the statements of financial position for the plans' overfunded or underfunded status. The asset or the liability is the difference between the fair value of plan assets and the related benefit obligation, defined as the projected benefit obligation for pension plans and the accumulated postretirement benefit obligation for other postretirement benefit plans, such as a retiree health care plan. SFAS No. 158 also requires an employer to recognize the actuarial gains or losses and prior service costs or credits in the statements of activities that arise during the period but are not components of net periodic benefit cost pursuant to SFAS Nos. 87 and 106. In addition, an employer must measure defined benefit plan assets and obligations as of the date of its fiscal year-end and make specified disclosures for the upcoming fiscal year.

SFAS No. 158 takes effect for Northwestern in fiscal year 2008; the University has not yet completed evaluating the impact of adopting the statement.

## 6. Land, Buildings, and Equipment

Land, buildings, and equipment consisted of the following:

<i>(in thousands of dollars)</i>	<i>August 31, 2006</i>	<i>August 31, 2005</i>
Land	\$27,355	\$27,355
Construction in progress	38,908	109,383
Buildings and leasehold improvements	1,528,261	1,371,482
Equipment	254,447	220,634
Accumulated depreciation	(657,717)	(575,975)
<b>Total</b>	<b>\$1,191,254</b>	<b>\$1,152,879</b>

The estimated cost to complete construction in progress at August 31, 2006, is \$91 million. Costs included in construction in progress are future leasehold improvements and building and equipment capitalizations. Building costs are funded by loans, gifts (received or pledged), grants, and unrestricted funds.

In fiscal year 2006, the University prospectively implemented a new interest capitalization policy. Under this policy, actual interest expense incurred during the period of construction of an asset for University use is capitalized until that asset is substantially completed and ready for use. The capitalized cost is reflected in the total cost of the asset and depreciated over the useful life of the asset. Assets may include buildings and major equipment.

### *Lease obligations*

The University is obligated under numerous operating leases to pay base rent through the lease expiration dates. Operating leases consist primarily of leases for the use of real property and have terms expiring in various years through fiscal year 2021. Noncancelable real estate lease expenses totaled \$4.7 million at August 31, 2006, and \$4.5 million at August 31, 2005. The future minimum lease payments under noncancelable operating leases were allocated on a straight-line basis over the term of the lease. These payments through August 31 of each period are as follows:



<i>(in thousands of dollars)</i>	
2007	\$5,179
2008	5,179
2009	5,003
2010	4,862
2011 and thereafter	17,071
<b>Total</b>	<b>\$37,294</b>

## 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, 2006, and 2005. In addition, in fiscal year 2006, FIN 47 accretion for asset retirement obligations (ARO) expense of \$5.1 million was also allocated. Those expenses have been distributed to the functional areas of the University as follows:

<i>(in thousands of dollars)</i>	<i>August 31, 2006</i>			
	<b>Accretion for ARO</b>	<b>Depreciation</b>	<b>Plant maintenance</b>	<b>Interest on bond indebtedness</b>
Instruction	\$717	\$9,866	\$16,318	\$3,115
Research	1,208	16,631	27,508	5,250
Academic support	1,070	14,728	24,361	4,650
Student services	445	6,131	10,141	1,935
Institutional support	312	4,299	7,110	1,357
Auxiliary services	1,366	18,816	31,120	5,940
<b>Total</b>	<b>\$5,118</b>	<b>\$70,471</b>	<b>\$116,558</b>	<b>\$22,247</b>

<i>(in thousands of dollars)</i>	<i>August 31, 2005</i>			
	<b>Accretion for ARO</b>	<b>Depreciation</b>	<b>Plant maintenance</b>	<b>Interest on bond indebtedness</b>
Instruction	—	\$9,114	\$14,984	\$3,083
Research	—	12,797	21,040	4,328
Academic support	—	13,796	22,682	4,666
Student services	—	5,806	9,545	1,964
Institutional support	—	3,870	6,363	1,309
Auxiliary services	—	17,043	28,018	5,764
<b>Total</b>	<b>—</b>	<b>\$62,426</b>	<b>\$102,632</b>	<b>\$21,114</b>

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

## 8. Self-Insurance Reserves and Other Contingencies

Reserves for losses under the University's self-insurance program, aggregating \$65.5 million and \$80.3 million at August 31, 2006, and 2005, 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. The discount rate was 7.5 percent in fiscal years 2006 and 2005. Self-insurance reserves are based on estimates of historical loss experience, and while management believes that the reserves are adequate, the ultimate liabilities may be more or less than the amounts provided.

Under an agreement between the University and Northwestern Medical Faculty Foundation, a proportionate share of primary medical professional liability costs that arise out of events prior to November 1, 2004, is borne by NMFF. As of November 1, 2004, NMFF obtained excess medical liability coverage through another institution for all events after October 1, 2002, and reported after November 1, 2004. As of August 31, 2006, there were no accounts receivable from NMFF related to professional liability insurance costs; as of August 31, 2005, such accounts receivable totaled \$2.9 million.

The University may borrow 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. Additionally, the University has contracted to service these loans, which totaled \$252.7 million at August 31, 2006.

Service revenues are the excess of the actual interest collected above the agreed-upon warehouse fees on the serviced loans. The University manages the program to break even and generates no servicing assets or liabilities through these activities. Under the agreement in effect through June 30, 2008, the University guarantees these loans against default up to 10 percent of the original domestic loan portfolio and 30 percent of the original international amounts. The maximum future total payments are \$30.1 million as of August 31, 2006. At August 31, 2006, and 2005, \$506,000 and \$549,000, respectively, were reserved in anticipation of future defaults. Notes receivable on the consolidated statements of position are shown net of these reserves in fiscal years 2006 and 2005.

From time to time, various claims and suits generally incidental 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, 2006, and 2005, were as follows:

<i>(in thousands of dollars)</i>	<i>August 31, 2006</i>	<i>August 31, 2005</i>
Salaries, wages, and benefits	\$672,010	\$623,417
Services and professional fees	163,601	154,007
Supplies	69,034	64,365
Travel and promotion	62,286	54,275
Trademark and royalty fees	10,076	1,258
Other expenses	59,163	72,557
Maintenance, utilities, and equipment	111,023	116,237
Accretion for asset retirement obligations	5,118	—
Interest on bond indebtedness	22,247	21,114
Depreciation	70,471	62,426
<b>Total</b>	<b>\$1,245,029</b>	<b>\$1,169,656</b>

## 10. Securities Lending

The University has had 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 specifies that the custodian is responsible for lending securities and obtaining adequate collateral from the borrower. Collateral is limited to cash, government securities, and irrevocable letters of credit. At August 31, 2006, and 2005, investment securities with an aggregate market value of \$509.5 million and \$654.9 million, respectively, were loaned to various brokers and were returnable on demand. In exchange, the University received cash collateral of \$509 million and noncash collateral of \$14.1 million at August 31, 2006, and cash collateral of \$561.7 million and noncash collateral of \$105 million at August 31, 2005. 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 October 3, 2006, the University refunded the IEFA-Series 1997 Adjustable Medium-Term Revenue Bonds with fixed-rate tax-exempt revenue bonds (Illinois Finance Authority Revenue Refunding Bonds Series 2006) totaling \$145.1 million. The 1997 issuance was structured as tendered bonds and scheduled to mature and be tendered between November 1, 2006, and November 1, 2015, at values between \$5 million and \$20 million. The refunding bonds will be subject to conditions set forth in a trust indenture and loan agreement between the University and the authority. The bonds were issued with a fixed rate of 5 percent and will mature December 1, 2042.