

# Consolidated Statements of Financial Position

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

<i>(in thousands of dollars)</i>	2002	2001
<b>Assets</b>		
Cash and cash equivalents	\$209,985	\$243,182
Accounts receivable	193,671	154,214
Notes receivable	52,746	52,176
Contributions receivable	179,766	202,041
Investments	3,228,642	3,421,655
Land, buildings, and equipment	858,240	753,589
Bond proceeds held by trustees	11,396	70,623
Other assets	33,929	32,757

<b>Total assets</b>	<b>\$4,768,375</b>	<b>\$4,930,237</b>
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<b>Liabilities</b>		
Accounts payable and accrued expenses	\$74,053	\$76,365
Deferred revenue	186,599	177,795
Actuarial liability of annuities payable and deposits payable	63,810	53,517
Reserves for self-insurance	44,637	39,934
Government advances for student loans	41,689	42,756
Bonds and notes payable	446,693	409,308
Reserve for Dental School closure	—	298

<b>Total liabilities</b>	<b>857,481</b>	<b>799,973</b>
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<b>Net assets</b>		
Unrestricted	2,999,444	3,229,420
Temporarily restricted	233,403	297,448
Permanently restricted	678,047	603,396

<b>Total net assets</b>	<b>3,910,894</b>	<b>4,130,264</b>
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<b>Total liabilities and net assets</b>	<b>\$4,768,375</b>	<b>\$4,930,237</b>
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Detail of net assets	Unrestricted	Temporarily restricted	Permanently restricted	2002
Operating funds	\$313,798	\$45,860		\$359,658
Invested in plant facilities	792,666	59,367		852,033
Annuity and life income funds	39,821	86,616	\$31,479	157,916
Endowment and similar funds	1,853,159	41,560	646,568	2,541,287
<b>Total net assets</b>	<b>\$2,999,444</b>	<b>\$233,403</b>	<b>\$678,047</b>	<b>\$3,910,894</b>

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

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

# Consolidated Statements of Activities

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

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

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

# Consolidated Statements of Cash Flows

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

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

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

# Notes to the Consolidated Financial Statements

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

## 1. Summary of Significant Accounting Policies

### *Operations*

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

### *Basis of Accounting*

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

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

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

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

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

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

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

### *Investments*

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

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

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

#### *Derivative Financial Instruments*

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

#### *Fair Values of Financial Instruments Other than Investments*

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

#### *Accounts and Notes Receivable*

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

#### *Land, Buildings, and Equipment*

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

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

#### *Charitable Remainder Trusts*

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

#### *Annuities Payable*

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

#### *Revenue Recognition*

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

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

#### *Income Taxes*

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

### Uses of Estimates in the Preparation of Financial Statements

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

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

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

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

### Accounting Pronouncements

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

## 2. Contributions Receivable

Contributions receivable consisted of the following:

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

## 3. Bonds and Notes Payable

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

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

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

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

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

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

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

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

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

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

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

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

#### 4. Investments

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

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

##### *Endowment Payout/Spending Rule*

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

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

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

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

##### *Summary of Investments*

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

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

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

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

<i>(in thousands of dollars)</i>	<i>August 31, 2002</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	\$36,609	\$919,995	\$33,073	\$1,499,544	\$2,489,221
Intermediate-Term					
Bond Pool	267,890	4,266			272,156
Separately invested	51	6,339	141,880	9,002	157,272
Working capital	309,993				309,993
<b>Total investments</b>	<b>\$614,543</b>	<b>\$930,600</b>	<b>\$174,953</b>	<b>\$1,508,546</b>	<b>\$3,228,642</b>

August 31, 2001

<i>(in thousands of dollars)</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	\$44,451	\$1,013,835	\$35,858	\$1,668,011	\$2,762,155
Intermediate-Term Bond Pool	243,615	5,922			249,537
Separately invested	4,879	14,820	147,370	5,392	172,461
Working capital	237,502				237,502
<b>Total investments</b>	<b>\$530,447</b>	<b>\$1,034,577</b>	<b>\$183,228</b>	<b>\$1,673,403</b>	<b>\$3,421,655</b>

#### Investment Return

The components of total investment return were as follows:

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

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

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

#### Derivative Financial Instruments

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

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

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

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

## 5. Retirement Plans

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

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

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

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

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

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

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

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

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

## 6. Land, Buildings, and Equipment

Land, buildings, and equipment consisted of the following:

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

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

## 7. Allocation of Expenses

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

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

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

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

## 8. Self-Insurance Reserves and Other Contingencies

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

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

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

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

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

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

## 9. Natural Classification of Expenses

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

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