Report of Independent Auditors

To the Board of Trustees of Northwestern University:

We have audited the accompanying Consolidated Statements of Financial Position of Northwestern University and subsidiaries (the “University”) as of August 31, 2003, and 2002, and the related Consolidated Statements of Activities and Consolidated Statements of Cash Flows for the years then ended. These financial statements are the responsibility of the University’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the University as of August 31, 2003, and 2002, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we also have issued a report, dated December 12, 2003, on our consideration of the University’s internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

Chicago, Illinois
December 12, 2003

Consolidated Statements of Financial Position

As of August 31, 2003, and August 31, 2002

(in thousands of dollars)	*2003*	*2002*
Assets		
Cash and cash equivalents	$271,633	$209,985
Accounts receivable	196,142	193,671
Notes receivable	49,943	52,746
Contributions receivable	192,384	179,766
Investments	3,443,837	3,228,642
Land, buildings, and equipment	941,242	858,240
Bond proceeds held by trustees	1,761	11,396
Other assets	35,146	33,929
Total assets	**$5,132,088**	**$4,768,375**
Liabilities		
Accounts payable and accrued expenses	$90,817	$74,053
Deferred revenue	190,148	186,599
Actuarial liability of annuities payable and deposits payable	58,926	63,810
Reserves for self-insurance	61,390	44,637
Government advances for student loans	41,102	41,689
Bonds and notes payable	453,963	446,693
Total liabilities	**896,346**	**857,481**
Net assets		
Unrestricted	3,329,311	2,999,444
Temporarily restricted	194,178	233,403
Permanently restricted	712,253	678,047
Total net assets	**4,235,742**	**3,910,894**
Total liabilities and net assets	**$5,132,088**	**$4,768,375**

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

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

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

Consolidated Statements of Activities

For the fiscal years ended August 31, 2003, and August 31, 2002

(in thousands of dollars)	*2003*		*2002*	
Changes in unrestricted net assets				
Operating revenues				
Tuition and fees	$464,595		$428,036	
(less scholarships and fellowships)	(139,065)		(125,245)	
Net tuition and fees	325,530		302,791	
Auxiliary services	63,373		58,667	
Grants and contracts	297,928		285,909	
Private gifts	40,508		25,883	
Investment return designated for operations	201,140		191,973	
Professional fees	24,720		29,640	
Sales and services	95,019		85,231	
Other income	6,262		8,383	
Total operating revenues		**$1,054,480**		**$988,477**
Operating expenses				
Instruction	358,786		357,072	
Research	240,140		220,741	
Academic support	109,021		110,975	
Student services	78,204		68,107	
Institutional support	83,023		80,725	
Auxiliary services	89,708		83,605	
Total operating expenses		**958,882**		**921,225**
Excess of operating revenues over expenses		**95,598**		**67,252**
Nonoperating				
Private gifts and grants for buildings and equipment	19,746		29,726	
Investment gains reinvested (losses uninvested)	103,113		(413,140)	
Change in unrestricted net assets from nonoperating activities		**122,859**		**(383,414)**
Net assets released from restrictions		**111,410**		**86,186**
Change in unrestricted net assets		**329,867**		**(229,976)**
Changes in temporarily restricted net assets				
Private gifts	60,524		25,076	
Net gain (loss) on annuity obligation	9,328		(4,333)	
Investment returns	2,333	72,185	1,398	22,141
Net assets released from restrictions		**(111,410)**		**(86,186)**
Change in temporarily restricted net assets		**(39,225)**		**(64,045)**
Changes in permanently restricted net assets				
Private gifts	40,419		77,370	
Net loss on annuity obligation	(6,213)	34,206	(2,719)	74,651
Change in permanently restricted net assets		**34,206**		**74,651**
Change in net assets		**324,848**		**(219,370)**
Beginning net assets		**$3,910,894**		**$4,130,264**
Ending net assets		**$4,235,742**		**$3,910,894**

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

Consolidated Statements of Cash Flows

For the fiscal years ended August 31, 2003, and August 31, 2002

(in thousands of dollars)	*2003*	*2002*
Cash flows from operating activities		
Change in net assets	**$324,848**	**($219,370)**
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation	46,864	42,954
Loss on retirement of equipment	1,980	1,166
Net realized and unrealized (gains) losses on investments	(249,491)	294,329
Private gifts and grants for long-term investments	(19,746)	(29,726)
Changes in assets and liabilities		
Accounts receivable	(2,183)	(39,211)
Contributions receivable	(12,618)	22,275
Other assets	(1,217)	(1,172)
Accounts payable and accrued expenses	16,764	(2,312)
Deferred revenue	3,549	8,804
Reserves for self-insurance	16,753	4,703
Government advances for student loans	(587)	(1,067)
Operating loss for Dental School closure	—	(298)
Net cash provided by operating activities	**124,916**	**81,075**
Cash flows from (used in) investing activities		
Purchases of investments	(2,084,564)	(1,631,458)
Proceeds from sales of investments	2,118,860	1,530,142
Increase in trusts held by others	(288)	(246)
Acquisitions of land, buildings, and equipment	(131,846)	(148,771)
Student loans disbursed	(81,703)	(87,465)
Principal collected on student loans	84,506	86,895
Net cash used in investing activities	**(95,035)**	**(250,903)**
Cash flows from financing activities		
Net proceeds from issuance of notes payable and bonds payable	12,000	42,000
Net principal payments on notes and bonds payable	(4,837)	(4,722)
Amortization of discount on bonds payable	107	107
Decrease in bond proceeds held by trustees	9,635	59,227
Proceeds from private gifts and grants for long-term investments	19,746	29,726
Increase (decrease) in annuities and deposits payable	(4,884)	10,293
Net cash provided by financing activities	**31,767**	**136,631**
Increase (decrease) in cash and cash equivalents	**61,648**	**(33,197)**
Cash and cash equivalents at beginning of year	**209,985**	**243,182**
Cash and cash equivalents at end of year	**$271,633**	**$209,985**
Supplemental disclosure of cash flow information		
Cash paid for interest	$13,088	$13,749

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

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 $1,743.4 million and $1,598.4 million at August 31, 2003, and 2002, respectively, of which $1.3 million and $4.3 million, respectively, were carried at cost. A range of possible values exists for these securities, and therefore the estimated values may differ from the values that would have been used had a ready market for these securities existed. In the absence of another basis, management has determined that cost represents an approximation of the fair value of such investments.

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

Derivative Financial Instruments

The University enters into equity options and equity-indexed options to hedge 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. At August 31, 2003, the fair values of the University's fixed rate debt of $238 million exceeded the carrying value of $219 million by $19 million. At August 31, 2002, the fair values of the University's financial instruments other than investments approximated their carrying value.

Accounts and Notes Receivable

Accounts receivable arising from tuition and fees are carried net of an allowance for doubtful accounts of $338,000 and $425,000 as of August 31, 2003, and 2002, respectively. Notes receivable resulting from student loans are carried net of an allowance for doubtful accounts of $298,000 and $336,000 as of August 31, 2003, and 2002, respectively.

Receivables from Northwestern Memorial Faculty Foundation (NMFF), a related party, arising out of operational activities totaled $16.2 million as of August 31, 2003.

Land, Buildings, and Equipment

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

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

Charitable Remainder Trusts

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

Annuities Payable

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

Revenue Recognition

Revenues from tuition and fees are reported in the fiscal year in which educational programs are predominantly conducted. Fiscal year 2004 fall-quarter tuition and fees, billed in fiscal year 2003, are reported as deferred revenue in fiscal year 2003. Similarly, fiscal year 2003 fall-quarter tuition and fees, billed in fiscal year 2002, are reported as deferred revenue in fiscal year 2002.

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, 2003, and 2002, 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

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

2. Contributions Receivable

Contributions receivable consisted of the following:

(in thousands of dollars)	*August 31, 2003*	*August 31, 2002*
Unconditional promises expected to be collected in		
Less than one year	$64,981	$75,515
One year to five years	139,300	102,509
More than five years	52,646	61,390
Less discount to present value and other reserves		
Discount to present value	(50,969)	(46,947)
Other reserves	(13,574)	(12,701)
Total	**$192,384**	**$179,766**

3. Bonds and Notes Payable

The University had $136 million and $124 million placed in commercial paper at August 31, 2003, and 2002, respectively. The issues as of August 31, 2003, mature in fiscal year 2004. Bonds payable are as follows:

(in thousands of dollars)	*August 31, 2003*	*August 31, 2002*
Mortgage bonds		
Illinois Educational Facilities Authority (IEFA)–Series 1974, 6.183%	$500	$970
Demand revenue bonds		
IEFA–Series 1985 varying adjustable interest rates	35,300	35,300
IEFA–Series 1985 University Pooled Financing Program, variable rate	10,000	12,000
IEFA–Series 1985 Cultural Pooled Financing Program, variable rate	10,004	10,016
IEFA–Series 1988, variable rate	45,400	45,700
IEFA–Series 1993, fixed rate	68,630	70,685
Less unamortized discount on IEFA–Series 1993	(1,941)	(2,048)
IEFA–Series 1997, fixed rate	150,000	150,000
Total	**$317,893**	**$322,623**

Total obligations at August 31, 2003, are scheduled to mature through August 31 of each period as follows:

(in thousands of dollars)	
2004	$4,952
2005	6,637
2006	11,722
2007	12,902
2008	12,992
2009–2013	93,325
2014–2018	77,550
2019–2023	42,491
2024–2028	57,263
Total	**$319,834**

Mortgage bonds, totaling $500,000 at August 31, 2003, are collateralized by land and buildings with carrying values of $7 million at August 31, 2003. In addition, at August 31, 2003, 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, 2003, $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, 2003, was .85 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, 2003, amounted to $267,000. 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, 2003, the bonds operated in the weekly variable mode and bore interest at .85 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, 2003, of 5.3 percent) and maturing from December 1, 2003, 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, 2003, the commercial paper issued under the program totaled $36 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, 2003, 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, 2003.

4. Investments

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

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

Endowment Payout/Spending Guideline

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

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

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

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

Investment Market Value

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

		August 31, 2003		*August 31, 2002*
(in thousands of dollars)	**Cost**	**Estimated fair value**	**Cost**	**Estimated fair value**
Equity securities				
Domestic	$476,678	$548,736	$510,654	$415,115
International	441,049	487,617	530,476	492,757
Debt securities				
Domestic — government	489,759	497,443	519,169	550,063
Domestic — corporate debt securities	140,229	142,003	159,806	152,643
International	14,491	24,589	13,535	19,622
Other investments				
Distressed securities	89,247	119,768	99,196	121,179
Hedge funds	380,044	660,062	304,298	532,069
Natural resources	145,849	178,002	125,868	158,761
Private equity	706,141	523,603	706,143	498,694
Real estate	156,055	191,648	173,631	223,508
Other	53,676	70,366	52,175	64,231
Total investments	**$3,093,218**	**$3,443,837**	**$3,194,951**	**$3,228,642**

The University is committed to making future capital contributions in other investments in the amount of $615 million, primarily in the next five years.

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

August 31, 2003

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

August 31, 2002

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

Investment Return

The components of total investment return were as follows:

(in thousands of dollars)	*August 31, 2003*	*August 31, 2002*
Investment income	$57,383	$74,806
Net realized losses	(67,437)	(55,893)
Change in net unrealized gains (losses) on investments reported at fair value	316,640	(238,682)
Total investment return	**$306,586**	**($219,769)**

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:

(in thousands of dollars)	*August 31, 2003*	*August 31, 2002*
Changes in unrestricted net assets		
Operating: investment return	$201,140	$191,973
Nonoperating: investment gains reinvested (losses uninvested)	103,113	(413,140)
Changes in temporarily restricted net assets		
Investment return	2,333	1,398
Total investment return	**$306,586**	**($219,769)**

Derivative Financial Instruments

The University used 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 was 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 as of August 31, 2002. The equity collars were sold in fiscal year 2003, and no underlying equity assets were hedged to equity collars at August 31, 2003. The sale of derivative equity collars resulted in a realized gain of $633,000 at August 31, 2003, and a net unrealized gain of approximately $2 million at August 31, 2002.

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

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 $337 million and $309 million at August 31, 2003, and 2002, respectively.

Valuation of Permanent Endowment Funds

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

5. Retirement Plans

The University maintains two contributory retirement plans for its eligible faculty and staff. The plans offer employees the choice of two investment company options, Teachers Insurance and Annuity Association (TIAA) and College Retirement Equities Fund (CREF), and the mutual funds offered by Fidelity Investments. Participating employee and University contributions are immediately vested. The University contributed $26.7 million and $27.3 million to the two plans in 2003 and 2002, respectively.

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

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

(in thousands of dollars)	*August 31, 2003*	*August 31, 2002*
Active employees not yet eligible	$3,457	$2,253
Active employees eligible	3,154	2,600
Retirees	1,424	1,448
Unrecognized prior service cost	(929)	(1,039)
Unrealized loss	(2,979)	(1,664)
Total	**$4,127**	**$3,598**

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

(in thousands of dollars)	*August 31, 2003*	*August 31, 2002*
Service cost (benefits attributed to employee service during the year)	$469	$313
Interest cost on accumulated postretirement benefit obligation	517	398
Amortization of prior service cost	109	109
Amortization of unrealized loss	195	94
Total	**$1,290**	**$914**

During fiscal 2003 postretirement benefit payments (net of retirees' contributions) were approximately $385,000.

The discount rate used in determining the APBO was 6.5 percent as of August 31, 2003, and August 31, 2002. The assumed health care cost trend rate used in measuring the APBO was changed in fiscal year 2003 to a graded table starting at 10 percent for August 31, 2003, and decreasing 1 percent each year to an ultimate rate of 5 percent. The assumed health care trend rate used in measuring the APBO was 5 percent for August 31, 2002.

If the health care cost trend rate assumptions were increased by 1 percent, the APBO as of August 31, 2003, would have been increased by approximately 8 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 2003 would have been an increase of 8 percent.

6. Land, Buildings, and Equipment

Land, buildings, and equipment consisted of the following:

(in thousands of dollars)	*August 31, 2003*	*August 31, 2002*
Land and improvements	$26,694	$26,107
Buildings	1,207,496	1,098,540
Equipment	177,558	172,405
Accumulated depreciation	(470,506)	(438,812)
Total	**$941,242**	**$858,240**

At August 31, 2003, the University had under construction buildings that will cost approximately $367.6 million. The estimated cost to complete this construction is $211 million. Costs incurred through August 31, 2003, of $156.6 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, 2003, and 2002. Those expenses have been distributed to the functional areas of the University as follows:

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

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

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 $61.4 million and $44.6 million at August 31, 2003, and 2002, 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. As of August 31, 2003, accounts receivable from NMFF related to professional liability insurance costs totaled $15 million.

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 $170.7 million at August 31, 2003. Service revenues are the excess of the actual interest collected above a guaranteed rate of return on the serviced loans. Under the agreement in effect through May 31, 2006, the University guarantees these loans against default up to 10 percent of the original loan portfolio amount. The maximum future total payments is $17.1 million as of August 31, 2003. At August 31, 2003, and 2002, $514,000 and $429,000, 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, 2003, and 2002, were as follows:

(in thousands of dollars)	*August 31, 2003*	*August 31, 2002*
Salaries, wages, and benefits	$529,476	$493,229
Services and professional fees	123,677	116,887
Supplies	53,447	71,682
Travel and promotion	47,414	43,117
Other expenses	47,998	48,153
Maintenance, utilities, and equipment	96,918	91,454
Interest on indebtedness	13,088	13,749
Depreciation	46,864	42,954
Total	**$958,882**	**$921,225**

10. Subsequent Event

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