NORTHWESTERN UNIVERSITY

# Northwestern University 2003 Financial Report

*On the cover: Among acquisitions made with Nancy McCormick's major gift to the University Library endowment are two first editions celebrating French King Louis XIII's visit to the city of Lyon in 1623. One edition appears on the cover and the other on page 3.*

*The successful conclusion of Campaign Northwestern in 2003* was extremely gratifying. Major construction on both campuses is the most visible result, but the campaign funded more than new facilities. An even larger share of campaign contributions support something less visible but no less permanent — the University's endowment.

At the start of the campaign in 1998, Northwestern's endowment was $2.02 billion. When the campaign ended on August 31, 2003, contributions and investment earnings had boosted the endowment to $3.16 billion, a 56 percent increase.

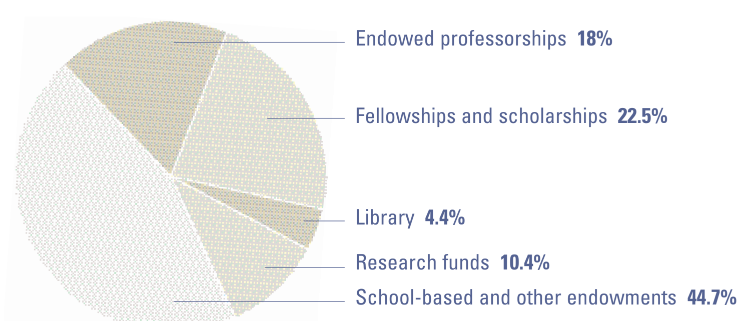
What does the increase mean in real terms? Among other things:

- Thirty-seven new named endowed professorships. Northwestern now is better positioned to compete for renowned scholars and artists and to retain the ones already on our faculty.
- One hundred and one new undergraduate scholarships, 33 new graduate fellowships, and 52 new professional school scholarships. Greater numbers of excellent students will now say yes to Northwestern because we can meet their financial aid needs.

As a result of this increased funding for faculty and students, Northwestern is becoming a more intellectually exciting place, and our academic reputation is growing.

The endowment also supports research efforts, book purchases, visiting lectureships, and myriad needs of our schools and centers. Each of these categories attracted endowment donations from people seeking to have a permanent impact on the University's development in an area of personal interest.

**Endowment Contributions to Campaign Northwestern, by Category**
Total **$594,384,714**



A healthy endowment enables the University to plan for the future with confidence. Since only the earnings in an endowment fund may be spent, a prudently invested endowment provides a dependable revenue source. It safeguards the University from fluctuations in research funding and in federal and state aid for students and helps keep tuition increases in check. At a time when government aid for students is failing to keep pace with rising costs, Northwestern can remain committed to its policies of need-blind admission and of meeting the full financial need of our students.

Of course, it is imperative that the University's financial staff make prudent decisions about investing the endowment, especially during economic downturns such as the recent one. At a minimum the University's investments must earn enough to cover actual spending plus inflation over the long term.

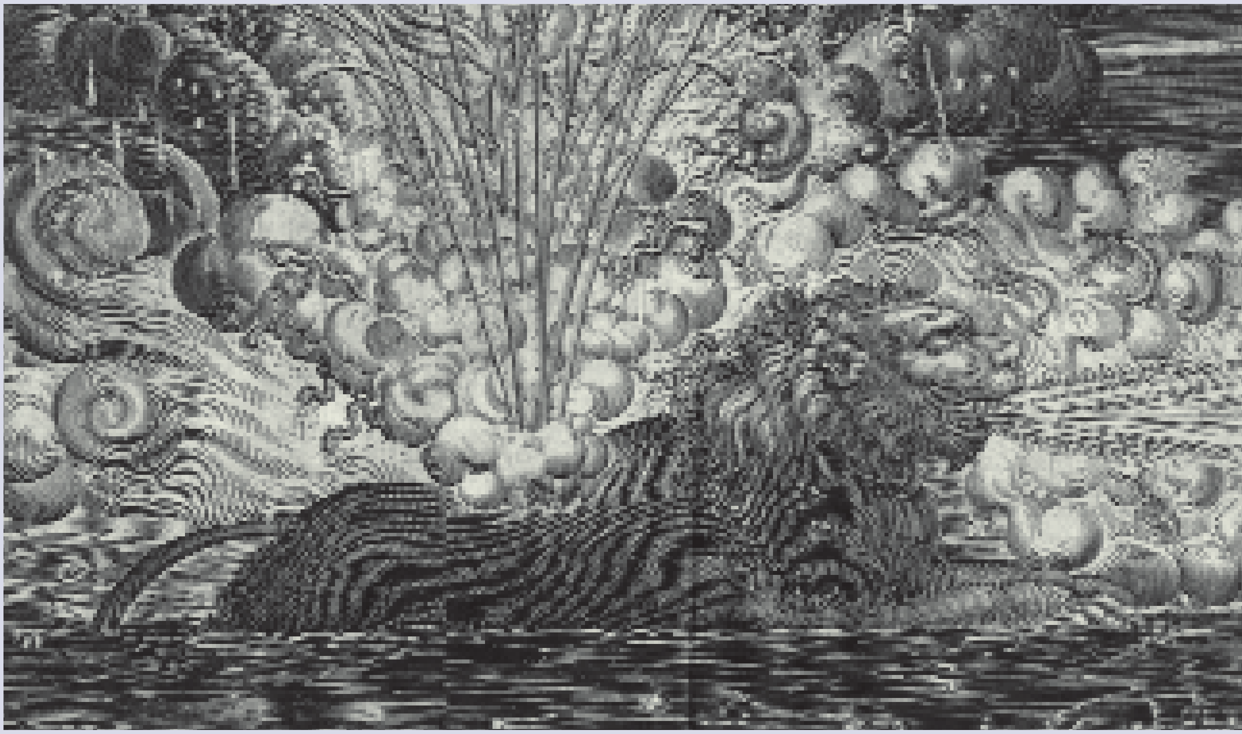
Investing wisely is a skill at which Northwestern has excelled for many years. Our annual rate of return on the endowment for the last decade has been more than 9 percent. Through a combination of sound financial management, wise investment of our resources, and the remarkable success of Campaign Northwestern, the University is in a strong financial position.

This does not mean, however, that the University can rest on success. Although the overall endowment giving of $594 million exceeded the campaign goal, some areas did not reach their goals. These included graduate and professional student fellowships and endowed professorships for schools other than the Kellogg School of Management and the Feinberg School of Medicine. Moreover, Northwestern's endowment still lags behind a number of our peer institutions with whom we compete for the best talent. We continue to welcome endowment gifts — gifts that will live on forever, helping generation after generation and perpetually honoring those for whom the funds are named.

So, as I am asked what's next now that Campaign Northwestern has ended, I answer that we will go on raising money and managing it well. Northwestern has many institutional goals — new programs, new faculty, more research, an even more excellent student body — all of which have budget ramifications. Our underlying fiscal strength is a key component of these plans for the future; without it, we could not consider the ambitious efforts that we are undertaking.

Henry S. Bienen
*President*

# Library Donations Spoke Volumes



*Without library collections to support intellectual ambitions,* Northwestern would be unable to maintain its academic excellence or to recruit outstanding faculty and students.

That point is well understood by the University's donors. University Library exceeded its original Campaign Northwestern goal by 200 percent, more than any other area. The campaign added $26 million to the library's highest priority, the collections endowment. As a result the library can maintain subscriptions to journals, add new research-caliber materials, and consistently acquire other scholarly resources needed by students and faculty.

One of the largest gifts, $5 million from Nancy McCormick, enhanced the special collections that bear her late husband's name. The Charles Deering McCormick Library of Special Collections houses one-of-a-kind pieces with historic or intellectual value to researchers.

McCormick Special Collections recently has been able to make extraordinary acquisitions such as the first edition of Hegel's *System der Wissenschaft*, a collection of copperplates of early Dutch drawings and paintings, and the Humphrey Winterton Collection of 6,500 photographs of East Africa taken between 1860 and 1960.

Already strong in social movements and artistic works of the 19th and 20th centuries, Special Collections is now positioned to look for scholarly materials to distinguish other areas. "All research libraries carry more or less the same books. It's through special collections that a university library develops its own character," says Charles Deering McCormick University Librarian David Bishop.

*Triumphal arches, fireworks displays, emblematic trophies, and the royal barge are illustrated in two books celebrating Louis XIII's visit to Lyon in 1623. The books were purchased by Special Collections with Nancy McCormick's gift to the library endowment.*

*Nicole Mash with Don Perkins*

*Growing up in Chicago's Rogers Park neighborhood as a child of a single mother,* Nicole Mash knew that she would need a scholarship to realize her dream of attending college.

Of the many schools to which she applied, close-to-home Northwestern especially attracted Mash, but tuition at one of the nation's most prestigious private universities was way out of her reach. Then she learned that a donor, Campaign Northwestern cochair Don Perkins, had established a scholarship for an exceptional student raised in a single-parent household. Mash became the first recipient of the Donald S. Perkins Scholarship. In 2003 she graduated from the Judd A. and Marjorie Weinberg College of Arts and Sciences with a bachelor's degree in history and economics. She is now in a leadership development program at SIRVA, a global services relocation firm based in the Chicago suburbs.

Perkins, a Northwestern trustee and retired chairman and CEO of Jewel Foods, had a personal reason for endowing a scholarship fund for children of single parents. A child of a single mother himself, he attended Yale University and then Harvard Business School on scholarships. "I see endowing a scholarship as doing for someone else what the scholarship at Yale did for me," he comments.

Mash says she gained not only a scholarship but also mentoring. She has lunch or speaks on the phone with Perkins regularly, as she did as a student. "I can ask him for job advice," she says. "I have someone who not only paid my way through Northwestern but who's also taken me under his wing and shown me the kind of person I can aspire to be."

*The 33 graduate fellowships created through Campaign Northwestern* include the prestigious Presidential Fellowships for graduate students working at the cutting edge of their fields.

Only the third program of its kind at an American university, Northwestern's Presidential Graduate Fellowships provide tuition and a stipend for one to two years beyond the usual graduate student support.

Eight fellows were appointed during the program's first year in 2002 and six more in spring 2003. Rob Beck, a PhD candidate in anthropology, exemplifies their advanced level. "Rob is already a mature academic, able to define a significant research question, obtain money for funding, carry out the fieldwork, and write up the evidence to make a compelling case," says anthropology professor Tim Earle.

As part of his dissertation research, Beck excavated a ritual burial mound and several buildings in Bolivia dating back 2,500 years. He and colleagues are also working at a site in his native North Carolina, where they found the remains of a 1560s Spanish fort.

Since the program affirms that leaders should be able to communicate across disciplines, Presidential Fellows meet to explain their research to one other. Beck spoke enthusiastically about not only his own research but also archaeology's role in illuminating the past. "More than 95 percent of all human history took place before the invention of writing," he says. "If we are to understand our deep past at all, it must be through a better appreciation of the archaeological record."

*Rob Beck*

Greg Duncan with Jennifer Romisch, one of his PhD advisees

*Seven years after luring Greg Duncan from another university,* Northwestern was able to offer the renowned expert on poverty and child development the ultimate enticement to stay here: an endowed professorship.

Thanks to an exceptional gift to Campaign Northwestern from alumna Edwina S. Tarry, the School of Education and Social Policy created the Edwina S. Tarry Professorship in Education. In 2002 Duncan became the first to hold this chair.

At his investiture Duncan paid tribute to the "unique blend of development and economics" in the school's Human Development and Social Policy Program, which "presumes that understanding human development and the social policies that might affect that development requires insights and methods from several disciplines."

An economist by education, Duncan specializes in the effects of poverty, neighborhood conditions, and welfare reform on children's development. He directs the Northwestern University/University of Chicago Joint Center for Research on Poverty. Among his books is the classic *Years of Poverty, Years of Plenty,* which introduced many social scientists and policy analysts to the dynamic nature of socioeconomic status, poverty, and welfare use. He was a distinguished research scientist at the University of Michigan for 23 years before coming to Northwestern in 1995.

The namesake of the Edwina S. Tarry Professorship in Education is a 1938 graduate of the School of Education and Social Policy. She and her late husband also funded the school's George W. and Edwina S. Tarry Center for Collaborative Teaching and Learning in Walter H. Annenberg Hall and the Tarry Research and Education Building on the Chicago campus.

*Northwestern's reputation in the performing arts* is as distinguished as its reputation in academic subjects, and the competition for star faculty in theater and music is every bit as intense as in engineering and economics.

It was helpful, therefore, that a Campaign Northwestern donor endowed a faculty chair in music theater, allowing the University to reward the man who heads that renowned interdisciplinary program. In 2001 Dominic Missimi was named the first Donald G. Robertson Director in Music Theatre.

Missimi has staged more than 50 plays, musicals, and operas on campus in his 23 years at Northwestern, including the last nine Waa-Mu Shows. His Northwestern production of *Cendrillon* was awarded first place by the National Opera Association. He is also active in Chicago theater — having directed more than 30 Equity productions, garnering two Joseph Jefferson Awards and numerous nominations — and has staged shows elsewhere around the country.

Missimi teaches all levels of acting, directing, and musical theater techniques and has special interests in commedia dell'arte and the history of the lyric theater. One of his students expressed the view of many in evaluating Missimi's Music Theatre Techniques class: "Absolutely irreplaceable for anyone who wants to learn the true craft of musical theater performance."

The Donald G. Robertson Director of Music Theatre Chair was endowed by Sanford R. Robertson of San Francisco in honor of his late father, a 1913 Northwestern graduate who as a student wrote the "Push On" fight song, also known as "Rise, Northwestern."

*Dominic Missimi*

*Barbara Newman*

*If John Evans could return to campus,* he would likely be pleased to find that Northwestern's first two endowed chairs, which he funded in the late 1860s, are now worth millions of dollars. He might be doubly pleased to learn how well the current occupants of those chairs meet the University founders' standard of "the highest order of excellence."

Growing untouched for almost a century and a half, the principal in the John Evans Chair in Moral and Intellectual Philosophy is now worth more than $6 million; that in the John Evans Chair in the Latin Language and Literature, more than $2 million. The earnings on those endowments continue to support distinguished professors.

The John Evans Chair in the Latin Language and Literature was awarded to Barbara Newman, professor of religion and English and current chair of the religion department, in spring 2003 for a four-year renewable term. Best known for her work on medieval religious culture and women's spirituality, Newman teaches a range of subjects from Arthurian literature to women in contemporary world religions. She is the foremost scholar in English on the 12th-century German abbess and theologian Hildegard of Bingen, whose collection of Latin liturgical songs she edited and translated. Newman's most recent book, *God and the Goddesses: Vision, Poetry, and Belief in the Middle Ages,* explores the relationship between Latin visionary writing and medieval vernacular poetry. Praised as one of Northwestern's most riveting lecturers, Newman is a Charles Deering McCormick Professor of Teaching Excellence.

The John Evans Chair in Moral and Intellectual Philosophy is held by visiting professor Quassim Cassam, an Oxford University philosopher, in 2004. An endowed visiting professorship allows Northwestern schools and departments to bring renowned scholars from other institutions to campus for a term. Cassam, the author of *Self and World,* an exploration of the nature of self-awareness, and editor of the volume *Self-Knowledge* in the Oxford Readings in Philosophy series, will be in residence at Northwestern for spring quarter.

*The University's net assets increased* 8.3 percent in fiscal year 2003 after two years of decline and at August 31, 2003, totaled more than $4.2 billion. For the first time in University history, total revenue sources exceeded $1 billion. Exercising fiscal restraint in budgeting, Northwestern generated a significant increase in operating revenues over expenses.

Unrestricted net assets increased 11 percent, to a total of more than $3.3 billion, and at August 31 accounted for more than 78 percent of the University's total net assets. Permanently restricted net assets totaled $712.3 million, a 5 percent increase.

Positive investment results after two years of negative returns were the major factor in the increase in assets. The Long-Term Balanced Pool, the investment vehicle for the University's permanent and quasi-endowment assets, returned 8.7 percent, net of expenses. Also contributing to the increase in assets were a change in unrealized gains on investments of $316.6 million and the maturation of a $67.8 million annuity trust.

The excess of operating revenues over expenses was $95.6 million in fiscal 2003, compared with $67.3 million the year before. Increases resulted from greater net tuition revenue, unrestricted private gifts, federal grants, and returns on investments designated for operations.

Increasing slightly over 4 percent from 2002, operating expenses totaled nearly $959 million in 2003. Instruction-related expenditures were relatively flat as a result of the one-time expensing of $22.5 million in software in 2002. Research expenditures continued to grow, totaling more than $240 million in 2003, an increase of 8.8 percent over 2002.

In short, fiscal 2003 financial results make evident the University's success in navigating the economic downturn of recent years. By keeping its mission of excellent instruction and cutting-edge research in the forefront when allocating resources, Northwestern has emerged from this recessionary period in excellent financial condition.

Eugene S. Sunshine

Eugene S. Sunshine
*Senior Vice President for Business and Finance*

Since March 2003, U.S. and international financial markets have experienced a strong rebound from three successive years of negative returns. As measured by the S&P 500, the U.S. market rose 20.9 percent from March 1 to August 31, 2003. The broad EAFE (Europe, Australasia, Far East) index, which measures international equities in developed countries, gained 23.2 percent over the same period.

Northwestern University's investments benefited from this rise in global financial assets. When the fiscal year ended on August 31, 2003, the University's investment assets totaled $3.75 billion, including cash and intra-University investments. This represents an increase of $276 million from August 31, 2002.

These assets are invested across several merged pools as described on page 13. Of these, the primary fund is the Long-Term Balanced Pool, which is managed with the objective of long-term total return. Because of its size and long-term orientation, performance data and investment strategy information in this discussion relate to the Long-Term Balanced Pool.

**Investment Approach in the Long-Term Balanced Pool**

The Investment Committee of the University annually reviews asset allocation policy for the Long-Term Balanced Pool. Its only change in fiscal 2003 was to move 3 percent from private investments to market-hedged funds on July 1. This change reflects the University's competitive advantage within the market-hedged portfolio as well as concerns over the large amount of money attracted to private equity. The chart below displays the current asset allocation policy for the University.

**Policy Portfolio Targets and Ranges**

| | *Range* | *Target* | *At August 31, 2003* | *Difference* |
|---|---|---|---|---|
| U.S. equity securities | 14–26% | 20% | 20.3% | .3% |
| International equity securities | 8–18% | 13% | 14.2% | 1.2% |
| Fixed-income securities | 12–22% | 17% | 14.2% | -2.8% |
| Market-hedged securities | 14–26% | 20% | 20.4% | .4% |
| Private investments | 12–24% | 18% | 19.5% | 1.5% |
| Real assets | 7–17% | 12% | 11.4% | -.6% |

The principal objective for Northwestern's Long-Term Balanced Pool is to preserve purchasing power and to provide a growing stream of income to fund University programs. On average, the pool seeks to achieve an annual total rate of return (i.e., actual income plus appreciation) equal to inflation plus actual spending. This objective of preserving purchasing power emphasizes the need for a long-term perspective in formulating both spending and investment policies. A more detailed look at the University's spending guideline is on page 12 of this report.

The University's investments historically have grown at a rate exceeding the objective. For the 12-month period ending August 31, 2003, the portfolio increased 8.7 percent, which was 1.67 percent above the objective. For the 5-, 10-, and 15-year periods ending August 31, 2003, the objective was exceeded by 2.06 percent, 2.93 percent, and 3.45 percent, respectively.

**Annualized Returns: Exceeding the Objective**

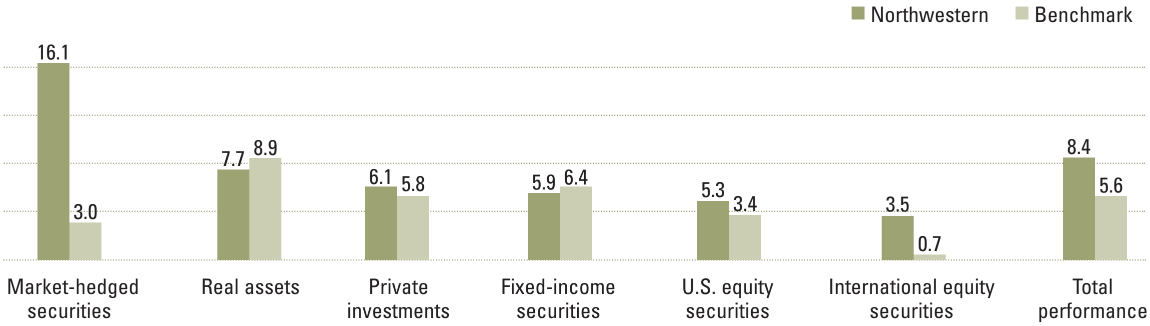
| | **1-year** | **5-year** | **10-year** | **15-year** |
|---|---|---|---|---|
| *Annual total return** | 8.70% | 8.37% | 9.11% | 10.38% |
| – Spending | 4.87% | 3.87% | 3.74% | 3.98% |
| – Inflation | 2.16% | 2.44% | 2.44% | 2.95% |
| = Above objective | **1.67%** | **2.06%** | **2.93%** | **3.45%** |

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

**Investment Performance**

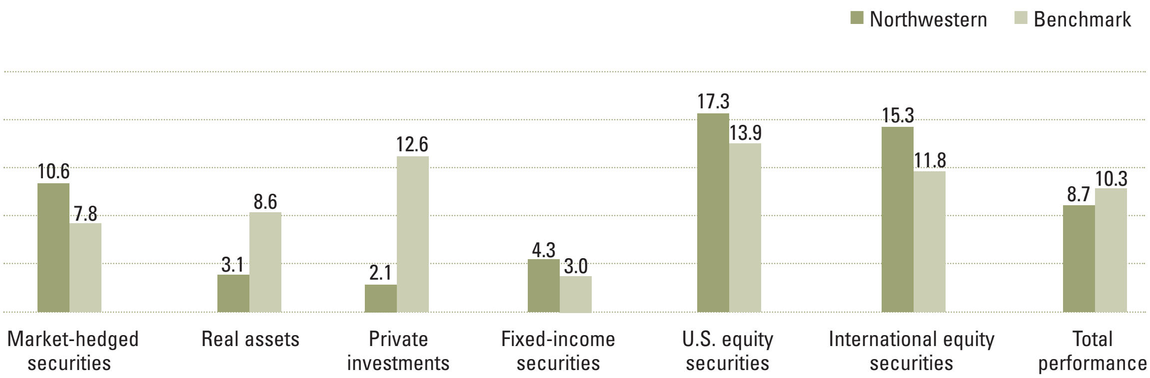
As of August 31, 2003, the Long-Term Balanced Pool's assets were $3.16 billion, up approximately $425 million from last year. The pool's 8.7 percent gain for the 12-month period fell below the 10.3 percent return of the composite benchmark, which represents a blending of the benchmark returns for each asset class weighted by the policy allocation targets. Underperformance resulted primarily from the private investments category falling short of a public benchmark that distorted comparisons and has been changed. For time periods longer than one year, the pool has outperformed the composite benchmark, as is shown in the next chart.

**Long-Term Balanced Pool: Five-Year Performance Relative to Benchmarks (in percentages)**




The following chart shows returns and benchmarks for the six asset classes for the fiscal year. A more detailed explanation of their activity and performance follows the chart.

**Long-Term Balanced Pool: Fiscal 2003 Net Performance Relative to Benchmarks (in percentages)**




**U.S. Equity Funds Category**

U.S. equities include large-, mid-, and small-cap public equities and Real Estate Investment Trusts. A more active management of equity holdings has been a major initiative during the past 18 months and was discussed in last year's Investment Report. The initial goal of having at least half this portfolio under active management has been achieved by adding a half-dozen U.S. equity managers. Returns have been encouraging. For the fiscal year Northwestern's U.S. equity funds gained 17.3 percent, compared with 13.9 percent for the Russell 3000 benchmark. An intentional bias to smaller-capitalization stocks has also benefited this portfolio.

**International Equity Funds Category**

International equities include developed-market ex-U.S. public equities and emerging market debt and equities. The international equity portfolio experienced an outperformance during the fiscal year, gaining 15.3 percent, compared with 11.8 percent for its benchmark, the MSCI ACWI ex-U.S. It benefited from the addition of five active managers during the year and from significant exposure to emerging markets.

**Fixed-Income Funds Category**

The fixed-income category did not perform as well as equities on account of the rise in interest rates during the year. However, relative performance was good. Northwestern's bond portfolio gained 4.3 percent, compared with 3 percent for its benchmark, the Lehman Government Index. The difference was due largely to the inclusion of TIPs (Treasury Inflation-Protected Securities), which outperformed nominal bonds. In addition, credit spreads narrowed dramatically with the improving economy, and the portfolio's exposure to credit and high-yield bonds was quite profitable.

**Market-Hedged Funds Category**

The market-hedged portfolio includes long/short equity managers, relative value strategies, and other arbitrage strategies. The 17 managers in this group produced consistently strong returns for the University. This category has little correlation with the other major asset categories and achieved its goal of equity-like returns with less risk. The portfolio has averaged a greater than 16 percent annual gain over the past five years. During the last fiscal year it grew by 10.6 percent, beating the 7.8 percent return of its customized benchmark. Several new managers were added during the year to further diversify the market-hedged portfolio.

**Private Investments Category**

This category, which includes venture capital, global buyout, and distressed investments, caused overall portfolio performance to lag behind the composite benchmark. Although the private investments portfolio itself was up 2.1 percent, it significantly trailed the benchmark's return of 12.6 percent. As already noted, use of a public market index as the benchmark was problematic, since the lag between public and private markets caused a huge deviation. The benchmark has been changed to a Cambridge Associates universe of private investments returns, one that is commonly used by our peer universities. It will better measure performance relative to the opportunity set in which investment is possible.

The benchmark was not the only problem with private investments during the fiscal year. Many firms wrote down or off their troubled companies. The IPO (Initial Public Offering) window remained shut, limiting potential exit opportunities. During the past year Northwestern sold nine of its private equity partnerships in the secondary market. Since a 19 percent discount was taken on these partnerships' value, short-term performance was hurt. The move should prove positive over the longer term, however, because the funds' values were unstable; the University was released from more than $45 million of unfunded commitments to these partnerships. The large amount of capital overhang in the industry continues to be a concern and requires that the University be disciplined and more selective about partnerships. Northwestern remains committed to private equity investing, which has proven to be an attractive option over the long run.

**Real Assets Category**

Real assets include real estate, energy, timber investments, and other commodity-based investments. The real assets portfolio gained 3.1 percent during the fiscal year, trailing a benchmark that returned 8.6 percent. Real estate fundamentals are still weak, although prices have remained high for trophy properties. Energy investments — which have been in the portfolio as a protection against unexpected increases in inflation — offer great promise, particularly if oil and natural gas prices remain firm as expected.

**Long-Term Balanced Pool Spending Guideline**

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

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

The actual spending rate per unit for fiscal year 2003 was $6.90; it will be $6.89 for fiscal year 2004. The payout rate for fiscal year 2003 was 4.76 percent.

**Payout Determined by Spending Guideline**

| | *1999* | *2000* | *2001* | *2002* | *2003* |
|---|---|---|---|---|---|
| Spending per unit | $4.27 | $5.30 | $6.22 | $6.56 | $6.90 |
| Net asset value per unit | $141.97 | $181.27 | $156.17 | $136.09 | $140.14 |
| Payout rate* | 3.18% | 3.19% | 3.56% | 4.33% | 4.87% |
| Total (in millions of dollars) | $73.20 | $95.50 | $117.20 | $130.20 | $150.69 |
| Growth in spending per unit | 2.40% | 24.12% | 17.36% | 5.47% | 5.18% |

*Payout rate is calculated as spending per unit divided by the two-year average net asset value per unit before distribution of the annual contribution to the budget.

**The Long-Term Balanced Pool: In Conclusion**

Northwestern University and its peer institutions have gone through a tumultuous three-year period of correction in financial markets. Through diversification, a long-term horizon, and exposure to uncorrelated strategies and assets, the Long-Term Balanced Pool is well positioned to protect its purchasing power for years to come. The portfolio is also better positioned to respond when shorter-term opportunities present themselves, thanks to active management, new strategies, and a focus on improving overall liquidity.

**The University's Total Investment Pools**

The preceding discussion focused on the Long-Term Balanced Pool, since it is the University's principal investment. The University also maintains other investment pools and separately invested assets.

Each investment pool has a specific set of objectives.

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

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

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

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

The table below illustrates the net asset values and unitized information for the University's investment pools for the past five years.

**History of the Merged Pools as of August 31**

| | *1999* | *2000* | *2001* | *2002* | *2003* |
|---|---|---|---|---|---|
| **Long-Term Balanced Pool** | | | | | |
| Net asset value (in thousands of dollars) | $2,476,184 | $3,337,660 | $2,981,351 | $2,731,507 | $3,156,423 |
| Number of units (in thousands) | 17,442 | 18,413 | 19,091 | 20,072 | 22,523 |
| Net asset value per unit | $141.97 | $181.27 | $156.17 | $136.09 | $140.14 |
| *Payout amount per unit* | | | | | |
| Current earned income | $1.61 | $1.05 | $1.05 | $0.58 | $0.21 |
| Previously reinvested realized gains withdrawn | $2.66 | $4.25 | $5.17 | $5.98 | $6.69 |
| *Total payout per unit* | $4.27 | $5.30 | $6.22 | $6.56 | $6.90 |
| **Short-Term Money Market Pool** | | | | | |
| Net asset value (in thousands of dollars) | $13,023 | $30,959 | $5,762 | $4,077 | $41,827 |
| Number of units (in thousands) | 1,301 | 3,093 | 576 | 407 | 4,183 |
| Net asset value per unit | $10.01 | $10.01 | $10.00 | $10.01 | $10.00 |
| *Payout amount per unit* | | | | | |
| Current earned income | $0.50 | $0.61 | $0.50 | $0.22 | $0.12 |
| **Intermediate-Term Bond Pool** | | | | | |
| Net asset value (in thousands of dollars) | $188,788 | $251,180 | $249,536 | $272,155 | $339,525 |
| Number of units (in thousands) | 14,738 | 16,231 | 18,188 | 22,213 | 27,409 |
| Net asset value per unit | $12.81 | $15.48 | $13.72 | $12.25 | $12.39 |
| *Payout amount per unit* | | | | | |
| Current earned income | $0.48 | $0.57 | $0.62 | $0.63 | $0.63 |
| **Summary of net asset values** (in thousands of dollars) | | | | | |
| Above pools | $2,677,995 | $3,619,799 | $3,236,649 | $3,007,739 | $3,537,775 |
| Pools liquidated in fiscal 2001 | 90,594 | 105,529 | — | — | — |
| Separately invested funds | 101,076 | 92,879 | 172,461 | 157,272 | 101,513 |
| Working capital | 235,131 | 237,736 | 237,502 | 309,993 | 111,923 |
| **Total net asset value** (in thousands of dollars) | **$3,104,796** | **$4,055,943** | **$3,646,612** | **$3,475,004** | **$3,751,211** |

William H. McLean
*Vice President and Chief Investment Officer*

# Report of Independent Auditors

To the Board of Trustees of Northwestern University:

We have audited the accompanying Consolidated Statements of Financial Position of Northwestern University and subsidiaries (the "University") as of August 31, 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.

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