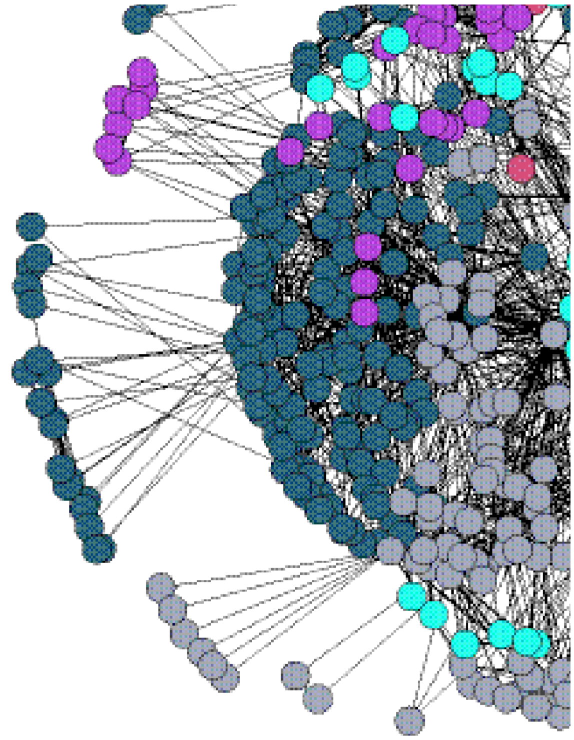

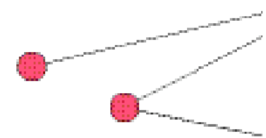

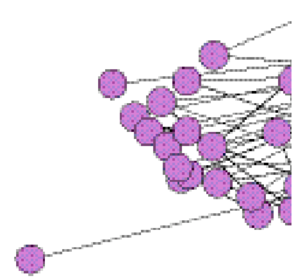

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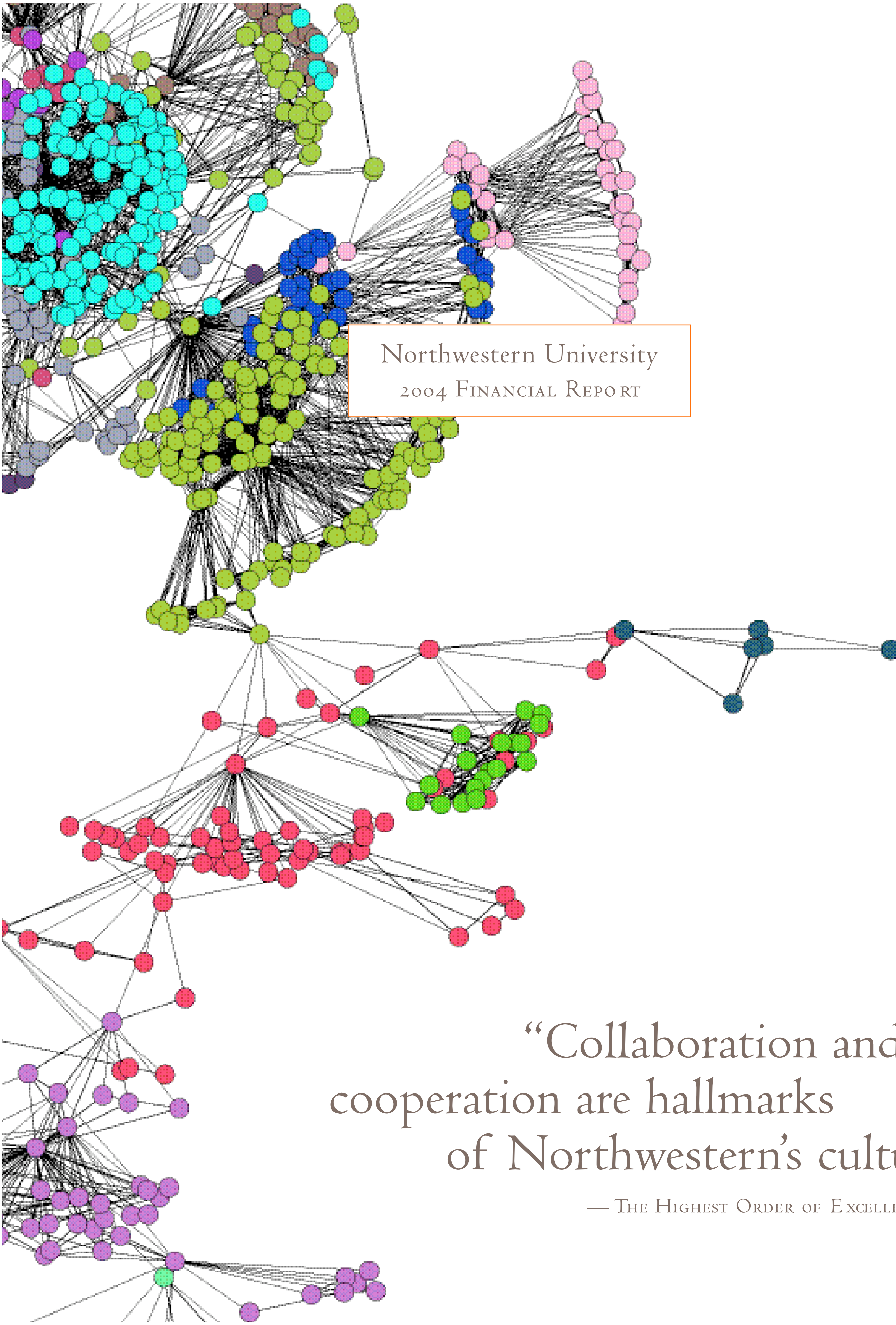


Northwestern University
2004 Financial Report

"Collaboration and cooperation are hallmarks of Northwestern's culture."

— The Highest Order of Excellence II

The figure on the cover shows the network of coauthorship in a department at Northwestern. People are represented by small circles; those who published one or more papers together are joined by a line. The image was provided by Luis Amaral and Roger Guimera of the Department of Chemical and Biological Engineering and the newly created Institute on Complex Systems. Seeds for the institute were planted during a "Domain Dinner" (a free dinner and presentation open to all faculty) on complexity. Afterwards a core group of faculty chose to sustain grassroots research efforts with personal commitments and modest funding from their home schools. In winter 2004 they presented a well-developed concept and business plan to the University administration and received start-up funding for a multidisciplinary institute to analyze complicated problems.

Collaboration and cooperation are hallmarks of Northwestern's culture, characterizing interactions not only between disciplines but also in research, teaching, and real-world practice. In this midsize research university, 11 independent schools, each with relatively small academic departments, offer remarkably diverse programs. The environment for cross-fertilization of ideas is rich and challenging yet collegial. Northwestern is one of the special places in academe where faculty and students eagerly look beyond their own ideas and individual spheres of inquiry, identifying ever broader and more significant intellectual agendas and searching out collaborators.

One of Northwestern's first interdisciplinary programs was African Studies, established in 1948. The Transportation Center and the predecessor of today's Institute for Policy Research followed in 1954. The Materials Research Center, one of the first three of its kind in the nation, was established in 1960 to exploit the intersection of physics, chemistry, and engineering. Northwestern also pioneered such interdisciplinary fields as biomedical engineering and performance studies. Emphasis on teamwork was no small factor in the Kellogg School of Management's rise to prominence. The School of Education and Social Policy defined an innovative mission to think creatively about the interface of human cognition, human development, and social policy.

Interdisciplinary activities continue to proliferate, and today Northwestern is also a leader in such areas as nanoscience and biochemistry. The number of research centers, where scholars from sometimes disparate fields focus on an area or a problem, has grown to 80 with the addition of the newly formed Institute on Complex Systems. Many of the capital projects resulting from the recent Campaign Northwestern connect directly to interdisciplinary research and teaching: the Arthur and Gladys Pancoe–Evanston Northwestern Healthcare Life Sciences Pavilion; the Center for Nanofabrication and Molecular Self-Assembly; the Robert H. Lurie Medical Research Center; and Crowe Hall, an addition to Kresge Centennial Hall that allows humanities faculty to be in close proximity to each other.

Clearly, Northwestern has earned its national reputation as a university that supports and encourages collaboration across school and department boundaries. Top scholars join our faculty for precisely this reason. Enterprising undergraduate and graduate students come here because they value the chance to engage not only with other students but also, to an unusual degree, with faculty across traditional disciplinary lines.

Now we want to leverage our collaborative and interdisciplinary culture into new competitive advantages. Looking at ways to build on our strengths, we used a recent reaccreditation review as an opportunity for a self-study on interdisciplinary teaching and research. Four committees examined the role of interdisciplinarity in graduate and professional education, undergraduate education, faculty research, and faculty career development. Their work was followed by *The Highest Order of Excellence II,* an institutional plan for the years 2005–10 with interdisciplinary initiatives at its core.

The plan envisions a university in which students have more unifying experiences and ways of belonging to Northwestern as a whole in addition to their departments. Many students complete traditional majors but still seek interdisciplinary courses and other opportunities for intellectual interaction outside their own schools.

For students interested in interdisciplinary majors or in combining a traditional major with an interdisciplinary adjunct major, minor, or certificate, Northwestern offers more than 30 choices. A number of these emerged from the original 1998 *Highest Order of Excellence* plan, including art and technology, transportation and logistics, and engineering and law. They join such long-standing interdisciplinary programs as integrated science, music theater, and American studies.

To extend interdisciplinary learning opportunities to larger numbers of students, we intend to develop more courses that explore a broad problem or issue from multiple perspectives, perhaps substituting these courses for some of the current distribution requirements. We also will develop more classes for nonmajors, following on the success of School of Music's courses for nonmajors.

In graduate and professional education, the advantages of inter- and multidisciplinary programs depend on the fields involved, but clearly among them is the ability of graduate students to access a larger faculty base when choosing research mentors. Professional and graduate students have often actively sought out faculty with whom they share interests, even when they are in other schools. Growth in the underlying knowledge base, new approaches to old material, and the development of new and more powerful technologies demand that we continue to enact corresponding changes in graduate and professional education. Northwestern has added programs that give graduate students insight into two or more fields, such as Medill master's programs that give journalists a second degree or a certificate in a specialized reporting area. PhD-level interdisciplinary training programs have been particularly successful in the life sciences.

Multidisciplinary Scholars

It's impossible to count the number of faculty and students who participate in some form of collaborative study, research, or teaching, but certainly they are already a majority and growing. On a more formal level, 37 professors have paid joint appointments in two departments or more, and about 200 in a department and a research center. Samuel Stupp (below left) tops the list of professors having joint appointments, with four: materials science and engineering, chemistry, medicine, and biomedical engineering. Mary Pattillo (right) has appointments in two departments — African American studies and sociology — and a center, the Institute for Policy Research. Among students taking advantage of the opportunity to double major is Jonathan Durant (below right), who will graduate with a degree in engineering and music. "I'd be wasting something if I didn't try to follow both my interests," he says. "Very few schools are strong in both engineering and music."

It is impossible to precisely quantify the number of professors engaged in interdisciplinary teaching and research, but a faculty survey found that self-defined interdisciplinary activity is common across Northwestern and that there are widespread expressions of support from the faculty for such interaction. Since the original *Highest Order of Excellence* was issued, many initiatives have given structure to what was already happening informally. Special funds have been provided to support cross-disciplinary presentations and to seed cross-school curricular collaborations. Five new cutting-edge interdisciplinary research centers have been established. Many important faculty recruitments have been made expressly to build on ties among schools or disciplines.

Now we intend to increasingly link faculty recruitment to interdisciplinary strategic initiatives. We plan to create a special pool of 30 faculty positions for those whose work involves broad multidisciplinary areas identified as University priorities. Deans will share and coordinate hiring plans to promote collaborative searches. The administration will encourage the recruitment of clusters of scholars to form cohesive research teams. We also aim to better reward interdisciplinary teaching, advising, and scholarship.

Complementing the above-mentioned endeavors is the desire to build a stronger community overall. The University will devote more resources to encouraging undergraduate-graduate-faculty interactions and team building, to supporting ad hoc interdisciplinary initiatives, and to informing the whole campus about cooperative activities.

Northwestern at its heart is an open community of learners where undergraduate, graduate, or faculty status matters less than curiosity, passion, and commitment. We value a continuing spirit of collaborative, pioneering creative work and learning at the intersections of academic disciplines. We aspire to be the university of choice for the most talented faculty and students sharing this vision.

Henry S. Bienen
President

Building Bridges

Many of the capital projects resulting from the recent Campaign Northwestern were designed expressly to further interdisciplinary teaching and research. The Arthur and Gladys Pancoe–Evanston Northwestern Healthcare Life Sciences Pavilion (above left) brings basic and clinical interdisciplinary research together in one building. The Center for Nanofabrication and Molecular Self-Assembly (above right) provides facilities where chemists and engineers search for answers to nanoscale problems. The Robert H. Lurie Medical Research Center on the Chicago campus (right) has hundreds of people involved in its programs.

A sampling of Northwestern's

Interdisciplinary Successes

- Northwestern's oldest interdisciplinary program, the Program of African Studies, continues to cross traditional lines. It is joining with other regional Africanist training centers to emphasize a cross-institutional, transcontinental focus on the African world.

- The Institute for Policy Research draws affiliated faculty, researchers, students, and visiting scholars from sociology, political science, economics, education, communication, law, management, and statistics, among other fields. They participate in research projects, seminars, conferences, and workshops, and their research is widely disseminated. With another Northwestern center, the Center for International and Comparative Studies, IPR is developing projects around such important and interrelated issues as the international context for homeland security, the ethics of humanitarian intervention, and the growing development gap between rich and poor countries.

- Graduate students training in basic and clinical sciences through the Feinberg School of Medicine's Integrated Graduate Program in the Life Sciences have wide-open choices; they are not restricted to any one department or set of faculty.

- Each year the Alice Berline Kaplan Center for the Humanities announces an interpretive theme designed to spark wide-ranging interdisciplinary debate among Northwestern humanists. The center organizes graduate and undergraduate seminars around the theme.

- The Music Theatre Program, a joint effort of the School of Music and the School of Communication's Department of Theatre, allows students majoring in voice or theater to create a second area of specialization.

- More than 400 undergraduates from throughout the University are enrolled in the Business Institutions Program, an interdisciplinary minor that focuses on analyzing the institutional aspects, theoretical frameworks, and history of American and international business institutions.

Crossing Academic Lines

One of Northwestern's highly successful cross-school efforts is the Music Theatre Program (left), a joint offering of the Schools of Music and Communication that allows students majoring in voice or theater to create a second area of specialization. In the Feinberg School of Medicine (below right), graduate students enjoy wide-open choices; they are not restricted to any one department or set of faculty. Research centers that allow faculty from different departments to focus their collective expertise on an issue or problem provide a model for future interdisciplinary endeavors. One of Northwestern's oldest centers, the Institute for Policy Research (below left), draws faculty affiliates from political science, education, sociology, economics, communication, management, law, and statistics, among other fields.

- Since 1976 the Integrated Science Program has put the brightest science students into a demanding curriculum integrating mathematics with physics, chemistry, biology, geology, and astronomy.

- The Arthur and Gladys Pancoe–Evanston Northwestern Healthcare Life Sciences Pavilion blurs the lines between basic and clinical interdisciplinary research by bringing them together in one building. A partnership between Northwestern and the Evanston Northwestern Healthcare system, it provides lab space in molecular, genetic, cell, neuro-, developmental, and reproductive biology.

- Undergraduate students in any of the four concentrations in the School of Education and Social Policy may develop their own interdisciplinary specialization around issues such as poverty, welfare, counseling, or business organizations.

- With 70 faculty in six academic departments on the Evanston campus and in six divisions at nearby Evanston Hospital, the Interdepartmental Biological Sciences Program readily allows PhD students to cross departmental and disciplinary boundaries in choosing courses and faculty research advisers.

- The Institute for Nanotechnology serves as an umbrella organization for individual and group research efforts across the University that address key problems in science and technology at the nanoscale.

- The Mary and Leigh Block Museum of Art is a national leader among university museums for critical and creative approaches to interdisciplinary learning through the visual arts.

- Northwestern's newest center, the Institute on Complex Systems, was created in 2004 to bring faculty from many departments together to analyze complicated problems. (See inside front cover for more.)

Report of the Senior Vice President for Business and Finance

For many years Northwestern's financial stewards have understood that maintaining fiscal strength is vital. Their prudent management of financial resources through economic peaks and valleys has allowed the administration to keep its focus on the mission of world-class instruction and research.

For the fiscal year ending August 31, 2004, the University's operating revenues totaled more than $1.1 billion, a 5.8 percent increase. Operating costs surpassed $1 billion, a 10.9 percent increase largely due to depreciation and plant maintenance expenses. Rising interest rates caused service costs on the University's variable rate debt to increase. As grants received increased, research expenditures grew to more than $275 million, an increase of 14.7 percent. Expenditures for academic support increased 14.6 percent.

The University's net assets increased 11.3 percent to more than $4.7 billion. Permanently restricted net assets totaled $752.3 million, a 5.6 percent increase. Unrestricted net assets increased 14.1 percent and totaled nearly $3.8 billion. At the end of the fiscal year, unrestricted net assets accounted for more than 80 percent of the University's total net assets.

During fiscal 2004 the University issued $185 million in fixed-rate bonds for building construction or renovation and to refund previously outstanding debt.

The University's investment activity was largely responsible for a 22.2 percent increase in assets, which totaled nearly $6.3 billion at year's end. The accompanying Investment Report provides the highlights of the investment activities of the fiscal year. The University takes a long-term view in developing its investment policies, looking to preserve its ability to fund its academic and research programs through its endowment well into the future.

In summary, Northwestern University is financially well prepared to accomplish the interdisciplinary initiatives proposed in the second phase of *The Highest Order of Excellence* plan.

Eugene S. Sunshine

Eugene S. Sunshine
Senior Vice President for Business and Finance

Steady economic growth and stable interest rates aided financial markets in fiscal year 2004. The broad domestic stock market rose 11.3 percent, while foreign equities gained nearly twice that amount. Lower real interest rates also provided a positive impetus to activity in private investments and real estate.

Northwestern benefited from this improved environment and registered solid portfolio growth. When the fiscal year ended on August 31, 2004, the University's investment assets totaled $4.34 billion, including cash and intra-University investments. This represents an increase of $589 million from August 31, 2003.

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.

Asset Allocation for the Long-Term Balanced Pool

The Investment Committee of the University annually reviews asset allocation policy for the Long-Term Balanced Pool. In fiscal 2004 the committee designated a new asset class, high-yield credit, that combines strategies of several asset classes. High-yield credit includes distressed debt, emerging market debt, and other credit instruments with fixed-income characteristics but more specific risk tied to the securities and their underlying cash flows. The high-yield credit portfolio is slightly underweight in relation to a long-term policy target of 6 percent. This target allocation derived from the asset classes where the strategies previously resided (absolute return, 2 percent; fixed income, 2 percent; and private investments, 2 percent). This chart displays the current asset allocation policy for the University:

Policy Portfolio Targets and Ranges

	Range	*Target*	*At August 31, 2004*	*Difference*
U.S. equity securities	14–26%	20%	19.6%	-.4%
International equity securities	8–18%	13%	14.2%	1.2%
Fixed-income securities	10–22%	15%	13.9%	-1.1%
High-yield credit	0–14%	6%	5.3%	-.7%
Absolute return	12–25%	18%	20.4%	2.4%
Private investments	10–22%	16%	16%	0%
Real assets	6–18%	12%	10.4%	-1.6%
Cash		0%	.2%	.2%

Investment Performance: Preserving Purchasing Power and Growing Income

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. As of August 31, 2004, the Long-Term Balanced Pool's assets were $3.67 billion, up approximately $512 million from last year. For the 12-month period ending August 31, 2004, the portfolio increased 15.9 percent, which was 8.69 percent above the objective. For the 5-, 10-, and 15-year periods ending August 31, 2004, the objective was exceeded by .44 percent, 4.28 percent, and 3.19 percent, respectively.

Annualized Returns: Exceeding the Objective

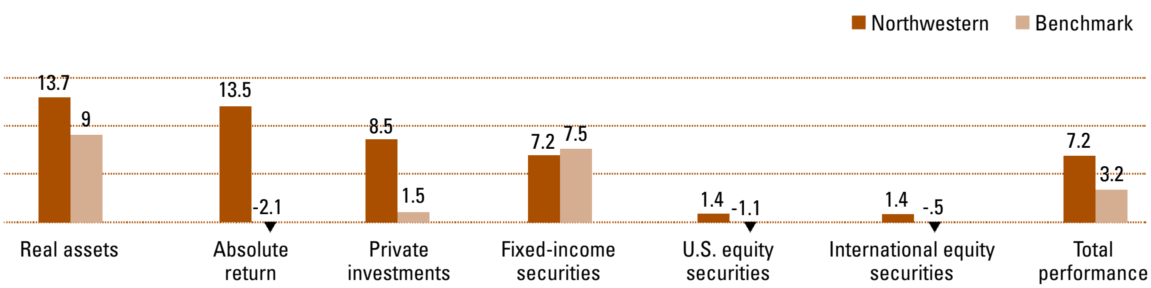
	1-year	**5-year**	**10-year**	**15-year**
*Annual total return**	15.9%	7.2%	10.5%	9.95%
– Spending	4.56%	4.13%	3.81%	3.94%
– Inflation	2.65%	2.63%	2.41%	2.82%
= Above objective	**8.69%**	**.44%**	**4.28%**	**3.19%**

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

Investment Performance: Benchmark Comparisons

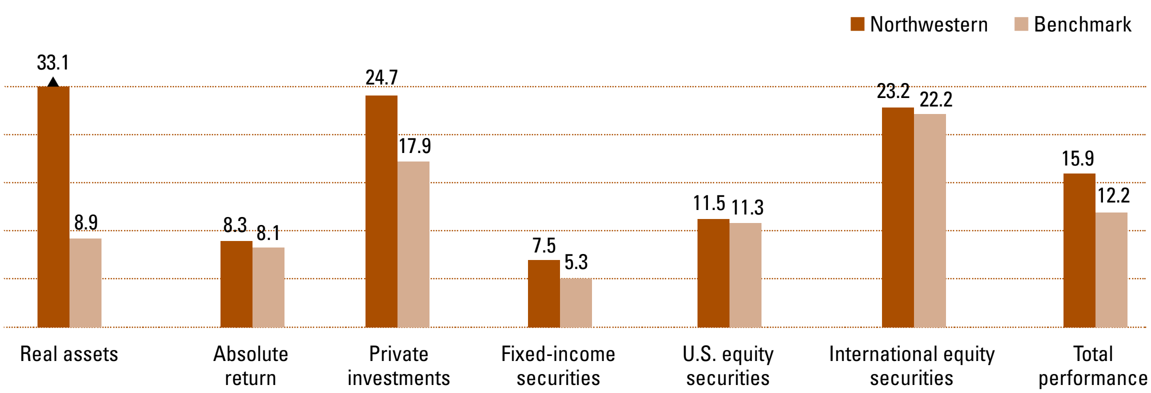
The pool's 15.9 percent gain for the 12-month period exceeded the 12.2 percent return of the composite benchmark, a blend of the benchmark returns for each asset class weighted by the policy allocation targets. Outperformance resulted primarily from the strong performance of the private investments and real assets categories. For the five-year period ending August 31, 2004, the pool also outperformed the composite benchmark (7.2 percent versus 3.2 percent), as 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 all asset classes for the fiscal year. A more detailed explanation of their activity and performance follows the chart.

Long-Term Balanced Pool: Fiscal 2004 Net Performance Relative to Benchmarks (in percentages)



Equities and Fixed-Income Categories

The domestic equity portfolio rose 11.5 percent for the fiscal year, slightly beating the 11.3 percent for the benchmark Russell 3000. Moving from passive to active management has paid off; this portfolio has outperformed its benchmark by 250 basis points (1.4 percent versus -1.1 percent) over the five-year period.

The fiscal year performance for the international equity portfolio was strong in both absolute and relative terms. Helped by heavier allocations to smaller-cap foreign stocks and to emerging markets, the portfolio gained 23.2 percent, 1 percent above the performance of the benchmark Morgan Stanley All Country World Index. For the last five years, the international portfolio is ahead of the benchmark by 1.9 percent annualized.

Bonds also had a solid fiscal year, gaining 7.5 percent, versus 5.3 percent for the Lehman Government Index. The outperformance was almost entirely due to investment in Treasury Inflation Protected securities.

Absolute Return Category

Made up of 19 hedge fund managers and multiple strategies, this portfolio aims to provide equity-like returns with little or no correlation to the equity markets. For the year this portfolio gained 8.3 percent, beating the return of 8.1 percent of its benchmark (80 percent, Treasury bills plus 500 basis points; 20 percent, the Morgan Stanley Capital International All Country World Index). As a result of a large amount of money chasing a limited set of opportunities, actual and expected returns for this category have declined.

Private Investments Category

The private investments portfolio includes investments in global buyout funds as well as venture capital. Good stock markets, low interest rates, and growing economies worldwide contributed to a positive environment for these investments. The Northwestern portfolio gained 24.7 percent, exceeding the 17.9 percent gain of the new benchmark (Cambridge Associates' universe median return of private investments). This benchmark exhibits a closer correlation with actual returns than does a public equity benchmark. Cash flows were strong in this portfolio, as trade sales, recapitalizations, and initial public offerings resulted in numerous distributions from the portfolio companies. While large sums of capital have flowed to these businesses, Northwestern remains committed to the private investments category. The University's manager relationships are good and should add value over time.

Real Assets Category

The real assets portfolio includes the University's investments in energy, timber, real estate, and other commodities. This portfolio was very strong in fiscal 2004, gaining 33.1 percent. Rising energy prices, stable interest rates, and improving real estate fundamentals all contributed to the returns. Cash distributions from energy and real estate partnerships were particularly strong. One transaction especially, the sale of Intrepid Energy North Sea, caused much of the outperformance. The University realized more than $90 million from the sale of Intrepid, which had a cost basis of just over $25 million.

Long-Term Balanced Pool Spending Guideline

Northwestern's current spending guideline for the Long-Term Balanced Pool 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 2004 was $6.87; it will be $6.75 for fiscal year 2005. The payout rate for fiscal year 2004 was 4.46 percent of total assets.

Payout Determined by Spending Guideline

	2000	*2001*	*2002*	*2003*	*2004*
Spending per unit	$5.30	$6.22	$6.56	$6.90	$6.87
Net asset value per unit	$181.27	$156.17	$136.09	$140.14	$154.36
Annual spending rate	3.23%	3.62%	4.39%	4.87%	4.56%
NACUBO+ spending rate	3.73%	3.43%	4.2%	5.07%	4.9%
Payout rate*	3.19%	3.56%	4.3%	4.76%	4.46%
Total (in millions of dollars)	$95.50	$117.20	$130.20	$150.69	$160.44
Growth in spending per unit	24.12%	17.36%	5.47%	5.18%	-4.3%

*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. +National Association of College and University Business Officers

Securities Lending

Northwestern initiated a securities lending program with its bank custodian, Northern Trust, during the fiscal year. The agreement allows the investment custodian to lend University securities to approved brokers in exchange for a fee. At August 31, 2004, investment securities with an aggregate market value of $539.9 million were loaned to various brokers and are returnable on demand. In exchange, the University received cash collateral of $479.6 million and noncash collateral of $70.9 million at August 31, 2004. The University earned $692,154 on securities lending activities through the end of fiscal 2004.

The Long-Term Balanced Pool: In Conclusion

In summary, the pool has recovered nicely from the difficult postbubble environment, attaining new highs in asset value. Its diversified nature was enhanced by the addition of numerous uncorrelated strategies. The portfolio is well positioned to perform over long time horizons in order to meet its investment objectives.

The University's Total Investment Pools

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

Each investment pool has a specific set of objectives.

Treasury Pool funds are money market funds used for cash reserves and to preserve principal and maintain liquidity; intermediate-term bond investments; and working capital funds held by the University, which 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.

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

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					
	2000	*2001*	*2002*	*2003*	*2004*
Long-Term Balanced Pool					
Net asset value (in thousands of dollars)	$3,337,660	$2,981,351	$2,731,507	$3,156,423	$3,668,410
Number of units (in thousands)	18,413	19,091	20,072	22,523	23,765
Net asset value per unit	$181.27	$156.17	$136.09	$140.14	$154.36
Payout amount per unit					
Current earned income	$1.05	$1.05	$0.58	$0.21	$1.46
Previously reinvested realized gains withdrawn	$4.25	$5.17	$5.98	$6.69	$5.41
Total payout per unit	$5.30	$6.22	$6.56	$6.90	$6.87
Summary of net asset values (in thousands of dollars)					
Long-Term Balanced Pool (above)	$3,337,660	$2,981,351	$2,731,507	$3,156,423	$3,668,410
Treasury Pool funds	519,875	492,800	586,225	493,275	567,519
Separately invested funds	198,408	172,461	157,272	101,513	103,922
Total net asset value (in thousands of dollars)	**$4,055,943**	**$3,646,612**	**$3,475,004**	**$3,751,211**	**$4,339,851**

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, 2004, and 2003, and the related Consolidated Statements of Activities and of Cash Flows for the years then ended. These financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such financial statements present fairly, in all material respects, the financial position of Northwestern University and subsidiaries as of August 31, 2004, and 2003, and the changes in their assets and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we also have issued a report, dated December 23, 2004, on our consideration of the University's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

Chicago, Illinois
December 23, 2004

Consolidated Statements of Financial Position

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

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

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

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**

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

Consolidated Statements of Activities

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

(in thousands of dollars)	*2004*		*2003*	
Changes in unrestricted net assets				
Operating revenues				
Tuition and fees	$496,484		$464,595	
(less scholarships and fellowships)	(145,171)		(139,065)	
Net tuition and fees	351,313		325,530	
Auxiliary services	65,626		63,373	
Grants and contracts	333,154		297,928	
Private gifts	18,869		40,508	
Investment return designated for operations	210,290		201,140	
Professional fees	27,502		24,720	
Sales and services	103,716		95,019	
Other income	5,144		6,262	
Total operating revenues		**$1,115,614**		**$1,054,480**
Operating expenses				
Instruction	392,186		358,786	
Research	275,430		240,140	
Academic support	124,953		109,021	
Student services	82,998		78,204	
Institutional support	88,831		83,023	
Auxiliary services	99,191		89,708	
Total operating expenses		**1,063,589**		**958,882**
Excess of operating revenues over expenses		**52,025**		**95,598**
Nonoperating				
Private gifts and grants for buildings and equipment	28,751		19,746	
Investment gains reinvested	338,618		103,113	
Change in unrestricted net assets from nonoperating activities		**367,369**		**122,859**
Net assets released from restrictions		**50,331**		**111,410**
Change in unrestricted net assets		**469,725**		**329,867**
Changes in temporarily restricted net assets				
Private gifts	10,293		60,524	
Net gain on annuity obligation	7,017		9,328	
Investment returns	2,126	19,436	2,333	72,185
Net assets released from restrictions		**(50,331)**		**(111,410)**
Change in temporarily restricted net assets		**(30,895)**		**(39,225)**
Changes in permanently restricted net assets				
Private gifts	38,998		40,419	
Net gain (loss) on annuity obligation	1,041	40,039	(6,213)	34,206
Change in permanently restricted net assets		**40,039**		**34,206**
Change in net assets		**478,869**		**324,848**
Beginning net assets		**$4,235,742**		**$3,910,894**
Ending net assets		**$4,714,611**		**$4,235,742**

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

Consolidated Statements of Cash Flows

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

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

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

1. Summary of Significant Accounting Policies

Operations

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

Basis of Accounting

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

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

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

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

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

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

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

Investments

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

- Equity securities with readily determinable fair values and debt securities are valued at the last sale price (if quotations are readily available) or at the closing bid price in the principal market in which such securities are normally traded (if no sale price is available). Certain fixed-income securities are valued based on dealer-supplied valuations.
- The estimated fair values of equity securities that do not have readily determined fair values, and of other investments, are based on estimates provided by external investment managers and are examined through a valuation review process performed by management. After this review, management may determine that an adjustment to the external managers' valuations is appropriate in recording the securities' fair value at August 31. The aggregate carrying value of such investments was $1,951.8 million and $1,743.4 million at August 31, 2004, and 2003, respectively, of which $5.9 million and $1.3 million, respectively, were carried at cost. A range of possible values exists for these securities, and therefore the estimated values may differ from the values that would have been used had a ready market for these securities existed. In the absence of another basis, management has determined that cost represents an approximation of the fair value of such investments.

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

Derivative Financial Instruments

The University uses various financial instruments to hedge the risk of decline in fair value of certain equity securities. Equity options and equity-indexed options are used to reduce the primary market risk exposure (e.g., equity price risk) of the hedged item in conjunction with the specific hedged strategy; if applicable, these have a reference index (e.g., S&P 500) that is the same, or highly correlated with, the reference index of the hedged item. Similarly, the University also enters into swap agreements to hedge public real estate equity exposure and obtain S&P 500 equity index exposure, and it uses futures contracts on an equity index. Such equity instruments are not designated as hedges for accounting purposes and are recorded at fair value.

Fair Values of Financial Instruments Other than Investments

The fair values of financial instruments other than investments are based on a variety of factors. In some cases, fair values represent quoted market prices for identical or comparable instruments. In other cases, fair values have been estimated based on assumptions about the amount and timing of estimated future cash flows and assumed discount rates reflecting varying degrees of risk. Accordingly, the fair values may not represent actual values that could have been realized at year-end or that will be realized in the future. At August 31, 2004, the fair values of the University's fixed rate debt of $384 million exceeded the carrying value of $362 million by $22 million. At August 31, 2003, the fair values of the University's fixed rate debt of $238 million exceeded the carrying value of $219 million by $19 million.

Accounts and Notes Receivable

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

Receivables from Northwestern Medical Faculty Foundation (NMFF), a related party (see below), arising out of operational activities totaled $25.7 million and $16.2 million as of August 31, 2004, and 2003, respectively.

Land, Buildings, and Equipment

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

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

Charitable Remainder Trusts

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

Annuities Payable

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

Revenue Recognition

Revenues from tuition and fees are reported in the fiscal year in which educational programs are predominantly conducted. Fiscal year 2005 fall-quarter tuition and fees, billed in fiscal year 2004, are reported as deferred revenue in fiscal year 2004. Similarly, fiscal year 2004 fall-quarter tuition and fees, billed in fiscal year 2003, are reported as deferred revenue in fiscal year 2003.

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

Related Parties

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

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

Income Taxes

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

Uses of Estimates in the Preparation of Financial Statements

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

At August 31, 2004, and 2003, reserves were established for uncollectible accounts, student loans, and pledges receivable. These reserves were estimated based on historical collection and allowance practices as well as on management's evaluation of current trends.

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

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

Accounting Pronouncements

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

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

2. Bonds and Notes Payable

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

Bonds payable are as follows:

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

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

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

At the option of the University and upon compliance with certain conditions, the IFA–Series 1985 and 1988 bonds may operate in one of four variable-interest-rate modes or may be converted to a fixed rate until maturity or earlier redemption. At August 31, 2004, $35.3 million of the Series 1985 and all of the Series 1988 demand revenue bonds operated in the weekly variable modes, under which the interest rate is adjusted weekly based on prevailing market rates for similar securities. The weekly interest rate at August 31, 2004, was 1.3 percent.

Under the IFA–Series 1985 Cultural Pooled Financing Program, the University assumed an additional liability representing its prorated share of underabsorbed financing costs that at August 31, 2004, amounted to $255,000. The University Pooled Financing Program and Cultural Pooled Financing Program may operate in the weekly variable-interest-rate mode or may be converted to a fixed rate until maturity. The fixed-rate conversion requires the consent of all participants in the pools. At August 31, 2004, the bonds operated in the weekly variable mode and bore interest at 1.3 percent. The bonds are collateralized by certificates of deposit held by the trustee in amounts equal to 1.67 percent of the bonds outstanding.

The IFA–Series 1993 Revenue Refunding Bonds operate in a fixed mode until maturity, bearing interest at fixed rates ranging from 3 percent to 5.55 percent (weighted average rate at August 31, 2004, of 5.3 percent) and maturing from December 1, 2004, to December 1, 2013. Proceeds of the refunding bonds were invested in United States government securities with a cost of $75.4 million and placed in escrow to satisfy scheduled payments of $66.4 million of the IFA–Series 1985 bonds and related interest until maturity. In 1993 this transaction was accounted for as an in-substance defeasance. In October 2003, $35 million of the outstanding IFA–Series 1993 bonds were refunded with the issuance of the IFA–Series 2003 revenue bonds.

The IFA–Series 1976 and 1977 demand revenue bonds were defeased on June 1 and July 1, 1996, respectively, through the issuance of commercial paper through the IFA–Series 1995 Pooled Financing Program. Principal payment on the 1985 demand revenue bond is also included in the program. At August 31, 2004, the commercial paper issued under the program totaled $35.8 million, all maturing within a year.

The IFA–Series 1997 adjustable medium-term revenue bonds operate in a fixed mode until maturity, bearing interest at fixed rates ranging from 4.7 percent to 5.25 percent (weighted average rate at August 31, 2004, of 5.07 percent) and maturing from November 1, 2005, to November 1, 2015. The bonds are subject to mandatory tender at the stated dates and may be reissued in one of several permissible modes described in the agreements. The bonds will ultimately mature on November 1, 2032.

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

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

The lending agreements covering the demand revenue bond issues contain covenants that, among other things, require the University to maintain prescribed amounts of working capital (as defined). The covenants place certain limits on indebtedness and require holding investments in prescribed minimum amounts and maintaining certain financial ratios related to debt service, net assets to indebtedness, and assets to indebtedness. The University was in compliance with the covenants at August 31, 2004.

3. Contributions Receivable

Contributions receivable consisted of the following:

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

4. Investments

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

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

Endowment Payout/Spending Guideline

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

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

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

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

Investment Market Value

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

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

The University is committed to making future capital contributions in other investments in the amount of $879 million, primarily in the next five years.

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

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

					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**

Investment Return

The components of total investment return were as follows:

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

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

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

Derivative Financial Instruments

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

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

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

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

The University regularly reviews the use of derivative financial instruments by each of the managers of alternative investment funds in which it participates. While these outside managers generally use such instruments for hedging purposes, derivative financial instruments are employed for trading purposes by seven independent asset managers of Northwestern University funds totaling approximately $362 million and $337 million at August 31, 2004, and 2003, respectively.

Valuation of Permanent Endowment Funds

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

5. Retirement Plans

The University maintains two contributory retirement plans for its eligible faculty and staff. The plans offer employees the choice of two investment company options, Teachers Insurance and Annuity Association (TIAA) and College Retirement Equities Fund (CREF), and the mutual funds offered by Fidelity Investments. Participating employee and University contributions are immediately vested. The University contributed $30.1 million and $26.7 million to the two plans in 2004 and 2003, respectively. It expects to contribute $30.8 million to the two plans in 2005.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

	1% increase	*1% decrease*
Increase (decrease) in total of service and interest cost	$114	($98)
Increase (decrease) in postretirement benefit obligation	458	(401)

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

(in thousands of dollars)	
2005	$76
2006	141
2007	195
2008	282
2009	329
2010–2014	2,540
Total	**$3,563**

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

In late 2003 the Medicare Prescription Drug Improvement and Modernization Act of 2003 became law. The University is waiting for the government to issue specific guidance on the accounting and disclosure requirements of the act. That guidance could require the University to change previously reported information related to the measurement of its APBO or net periodic postretirement benefit costs under the provisions of the Financial Accounting Standard's Board's Staff Position No. FAS 106-1. Consequently, any measures of the APBO or net periodic postretirement benefit cost in the financial statements or accompanying notes do not reflect the effects of the act on the University's postretirement medical benefits plan.

6. Land, Buildings, and Equipment

Land, buildings, and equipment consisted of the following:

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

At August 31, 2004, the University had under construction buildings that will cost approximately $352.7 million. The estimated cost to complete this construction is $175.9 million. Costs incurred through August 31, 2004, of $176.8 million are included in land, buildings, and equipment. These buildings are being funded by loans, gifts (received or pledged), and grants.

7. Allocation of Expenses

The University allocated depreciation, plant maintenance expenditures, and interest on indebtedness to the various functional expense categories in the Consolidated Statements of Activities for the fiscal years ended August 31, 2004, and 2003. Those expenses have been distributed to the functional areas of the University as follows:

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

(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**

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

8. Self-Insurance Reserves and Other Contingencies

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

Reserves for losses under the University's self-insurance program, aggregating $79.5 million and $61.4 million at August 31, 2004, and 2003, respectively, include reserves for known losses and for losses incurred but not yet reported. A portion of the reserves pertaining to professional liability has been determined on a discounted present-value basis. Self-insurance reserves are necessarily based on estimates of historical loss experience, and while management believes that the reserves are adequate, the ultimate liabilities may be in excess of or less than the amounts provided.

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

The University has borrowed under an agreement whereby monies are advanced for the purpose of originating student loans. These loans, when fully disbursed, are sold to the lending agency, and proceeds are applied to retire the debt amount. Additionally, the University has contracted to service these loans, which totaled $199.8 million at August 31, 2004. Service revenues are the excess of the actual interest collected above a guaranteed rate of return on the serviced loans. Under the agreement in effect through May 31, 2006, the University guarantees these loans against default up to 10 percent of the original loan portfolio amount. The maximum future total payments is $20 million as of August 31, 2004. At August 31, 2004, and 2003, $541,000 and $514,000, respectively, were reserved in anticipation of future defaults.

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

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

9. Natural Classification of Expenses

Operating expenses incurred in the fiscal years ended August 31, 2004, and 2003, were as follows:

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

10. Securities Lending

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

11. Subsequent Event

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

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

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

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