NORTHWESTERN
UNIVERSITY

Northwestern University 2005 Financial Report | *Performing Arts on Campus*

Message from the President

Fall 2005 was a special season for the performing arts at Northwestern. *Was,* the first production in our exciting new American Music Theatre Project, played to packed houses — including major newspaper critics who don't usually review college productions.

While *Was* and AMTP were attracting considerable attention, we insiders were reminded that our talented faculty and students make Northwestern a special place for the performing arts day in and day out, year after year.

With its long tradition of strength in the performing arts, Northwestern is the perfect place to mount so ambitious and far-reaching a project as AMTP (see story on page 7). The Schools of Communication and Music were the first two schools to be established at Northwestern after the original liberal arts college, and each has a long history of excellence in performance as well as in the classroom.

The School of Communication was born in 1878 as a school of oratory and added faculty in drama in the early 20th century. During the 1920s the University Theatre developed out of several existing theatrical organizations on campus. The first Waa-Mu Show, Northwestern's student-written revue, hit the stage in 1929. By the 1940s the theater department already enjoyed a national reputation. The ranks of

Northwestern's famed acting alumni are legion and include Patricia Neal, Tony Roberts, David Schwimmer, Laura Innes, Shelley Long, Cloris Leachman, and the late Jerry Orbach and Tony Randall.

The School of Music, established in 1895, is one of the oldest degree-granting music institutions in the country. Combining a music program of conservatory intensity with the resources of an outstanding university, it has long ranked among the top music schools in the nation. Like the School of Communication, it boasts many renowned alumni, including Sherrill Milnes, Sheldon Harnick, Ned Rorem, and the late Howard Hanson.

The two schools collaborate in the Music Theatre Program, without which there would not be an American Music Theatre Project at Northwestern. Allowing majors in one school to train in a second area in the other school, the Music Theatre Program produces a mainstage musical in the fall and the nationally famous Waa-Mu Show in the spring.

On most weekends, and often during the week, Northwestern and the larger community take advantage of high-quality musical and theatrical performances on the Evanston campus. Tickets are reasonably priced, parking is free, and the facilities are the equal of professional concert halls and theaters.

The jewel of the campus music performance venues is the 1,003-seat Pick-Staiger Concert Hall. With its splendid acoustics and intimate ambience, Pick-Staiger is one of the Midwest's finest concert halls and an ideal location for hearing great musicians. Among its annual offerings are the Segovia Classical Guitar Series, the three-week Winter Chamber Music Festival, and a spring festival. Luminaries heard at Northwestern in recent years include Daniel Barenboim, Leon Fleisher, Von Freeman, Lynn Harrell, Sharon Isbin, Christopher O'Riley, Paco Peña, Menahem Pressler, Marcus Roberts, Gil Shaham, Janos Starker, and Pinchas Zukerman. While on campus, many of these artists also give master classes, offering their expertise and insights to our student performers.

In addition, the School of Music annually presents more than 250 solo and chamber music recitals by students and faculty and some 90 performances by the Northwestern University Symphony Orchestra, Symphonic Wind Ensemble, Contemporary Music Ensemble, University Chorale, and other major ensembles. The Edith Mason and William E. Ragland Opera Theater, supported by a generous endowment, presents three fully staged opera productions annually.

In the Theatre and Interpretation Center's multiple professional-level performance spaces and the 1,000-seat Cahn Auditorium, faculty, staff, and students collaborate to produce as many as 40 theater and dance performances a year. The mainstage season offers seven fully mounted productions, including a dance program, and other annual productions include a play for children and experimental presentations.

At Northwestern opportunities to perform are open to students across campus, not just to majors in music and theater. Students continue to develop their artistic talents even if they're preparing for a career in other fields. A student who plays an instrument can find an orchestra, band, or other ensemble in which to perform. Choirs, chorales, and a cappella groups offer opportunities to sing. Any student can audition for a theater production — or launch an independent project (many campus productions result from student initiatives). Our goal is to give all members of the community what they need to develop fully, no matter what career goal they choose.

Opportunities to participate in theater are also available through University organizations outside the theater department. These include

Arts Alliance, the largest student-run theatrical producing organization in the United States, and the Mee-Ow Show, an improvisational comedy revue whose alumni include Julia Louis-Dreyfus and Ana Gasteyer.

Besides myriad opportunities to perform, the Evanston campus offers opportunities to observe and learn from renowned practitioners through visiting artists programs. The School of Communication attracts nationally prominent actors, directors, producers, and dancers who visit classes and offer open question-and-answer sessions. Recent visitors have included Pulitzer Prize–winning playwright Tony Kushner, Oscar-winning actress Meryl Streep, acclaimed lighting designer Jennifer Tipton, Disney Channel creator and president James Jimirro, and celebrated alumni actors Harry Lennix and Zach Braff.

The School of Music has an illustrious history of bringing world-renowned composers to campus, including Sir Michael Tippett, Aaron Copland, and Dmitri Shostakovich. This tradition continues with the recently inaugurated Michael Ludwig Nemmers Prize in Musical Composition, which includes a $100,000 cash award and a performance by the Chicago Symphony Orchestra. The first winner, John Adams, was an ideal choice for a new prize intended for the best of the best. Winner of

the 2003 Pulitzer Prize in Music for *On the Transmigration of Souls*, Adams spent two separate weeks in residence at Northwestern in 2005 and then returned in January 2006 for a visit that included the Chicago Symphony's performance of his *Naïve and Sentimental Music.* He returns for a final residency this May in conjunction with Chicago Opera Theater's production of his *Nixon in China*.

Much as Northwestern's performing-arts activities benefit the entire University and the broader community, above all they serve our primary mission — educating our students. Our outstanding classroom and studio training in music and theater complements what happens on the concert and theatrical stage so that theory and practice enrich each other, and the broad and deep conceptual knowledge we provide to our student performers is strengthened and enhanced by opportunities to learn through direct experience. The result is a complete education in the arts that equips our graduates to pursue their dreams — wherever they may lead.

Henry S. Bienen, President

Building on an Already Stellar Musical Theater Tradition

The American Music Theatre Project seeks to become a permanent center for American musical theater on the Northwestern campus. AMTP will develop and produce new musicals by leading artists in collaboration with Northwestern faculty and students, thereby serving as an incubator for a new generation of writers for the musical stage. The project was launched in May 2005 by the School of Communication in collaboration with the School of Music, J. L. Kellogg School of Management, Judd A. and Marjorie Weinberg College of Arts and Sciences, and Graduate School.

Multitalented students, state-of-the-art facilities, and the Waa-Mu Show's storied history have long made musical theater one of Northwestern's greatest strengths. Under the leadership of theater professor Dominic Missimi, the Music Theatre Program has equipped countless performers, directors, and writers for successful careers on the musical stage. As AMTP executive director, Missimi is now building on this legacy in collaboration with Stuart Oken, former executive vice president of Disney Theatrical, who brings his commercial theater expertise to Northwestern as the project's artistic director.

Over a three-year period AMTP aims to develop and produce five cutting-edge works by leading American creative artists. The inaugural production, *Was,* opened the Theatre and Interpretation Center's 25th-anniversary season last October 28. Based on the novel by Geoff Ryman and with book and lyrics by Barry Kleinbort and music by Northwestern graduate Joseph Thalken, *Was* interweaves the stories of an 1870s orphan named Dorothy Gael and a

dying 1980s actor whose obsession with *The Wizard of Oz* leads him to Kansas in search of proof that Dorothy existed.

The next work scheduled for AMTP is *The Boys Are Coming Home,* a loose adaptation of Shakespeare's *Much Ado About Nothing* set in 1945 on VJ Day with music and lyrics by Leslie Arden and book by Bernie Stapleton. Also in development is *States of Independence,* with music by Ricky Ian Gordon and book and lyrics by Tina Landau.

AMTP is not only about creating new work; it is also about education. The program will offer new learning opportunities for students in the music theater, dance, and opera programs — not only through performing but also through the process of bringing new works to the stage as designers, assistant directors, and stage managers alongside professional writers, directors, and choreographers. The project will also initiate a broad range of research projects that can evolve into an industry-wide dialogue examining the impact of musical theater and helping to shape and define the musical theater of the future.

With the advent of AMTP, artists will seek out Northwestern as a place to develop unique, groundbreaking work that otherwise would not be created in today's commercialized environment. Combined with Northwestern's depth of experience in presenting new work for the musical stage, AMTP puts the University in the perfect place to push musical theater to the highest level of any university in America.

Here and on the cover: The set for the American Music Theatre Project's first production, Was, *featured a simulated tornado and a brick-patterned floor. It was designed by graduate student Collette Pollard. Three actresses portrayed Dorothy Gael at different ages, including junior Morgan Weed (left) as the teenage Dorothy.*

Was *photos by Mary Hanlon.*

Report of the Senior Vice President for Business and Finance

Strong investment performance propelled increases in the University's net assets and total assets for the year ending August 31, 2005. Net assets increased 14.7 percent, to more than $5.4 billion. Unrestricted net assets, which allow Northwestern to achieve strategic goals despite external uncertainties, increased 17.9 percent, to nearly $4.5 billion, and accounted for nearly 83 percent of the University's total net assets. Total assets grew 12.8 percent and amounted to nearly $7.1 billion at August 31.

Investments totaled more than $4.5 billion, as detailed in the accompanying Investment Report. The Long-Term Balanced Pool, the investment vehicle for the University's permanent and quasi-endowment assets, performed particularly well, returning nearly 20 percent.

A restructuring made the variable rate debt portfolio less costly to administer and generated a new source of construction and renovation funds for the next few years. In 2005 the University issued variable rate debt totaling $135 million while prepaying a similar amount of variable rate debt from various older issuances. Total liabilities increased only 7.1 percent, to less than $1.7 billion.

Increases in net tuition revenue, federal grants, and unrestricted private gifts helped boost operating revenue sources 9.1 percent, to more than $1.2 billion. Operating expenses rose more than 10 percent, to over $1.1 billion, due largely to facilities depreciation, plant maintenance, and interest on indebtedness. Expenditures allocated to institutional support, including an increase in insurance and fringe benefits expenses, increased by $34 million.

The University takes a responsible approach to budgeting and investments. Our goal is to manage finances so that the ability to fund academic programs and research remains strong long-term.

Eugene S. Sunshine

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

The recovery in global economies boosted financial markets in fiscal year 2005. The broad domestic stock market rose 15.3 percent, while foreign equities gained significantly more. Increased merger and acquisition activity provided a positive impetus to private investments and real estate. Sharp increases in the prices of commodities, particularly oil, drove returns in real assets such as commodity and energy investments. Increased demand from emerging market economies, including China and India, also played a role in price increases.

Benefiting from this continued recovery, Northwestern registered solid portfolio growth. When the fiscal year ended on August 31, 2005, the University's investment assets totaled $4.98 billion, including cash and intra-University investments, an increase of $644 million from August 31, 2004. It was the second year in a row of asset growth of more than $500 million.

The University's Total Investment Pools

The University maintains three primary investment pools: the Long-Term Balanced Pool, treasury pool funds, and separately invested assets. Each investment pool has a specific set of objectives.

The *Long-Term Balanced Pool*, the primary fund, 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 the discussion that follows relate to the Long-Term Balanced Pool.

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

	2001	*2002*	*2003*	*2004*	*2005*
Long-Term Balanced Pool					
Net asset value (in thousands of dollars)	$2,981,351	$2,731,507	$3,156,423	$3,668,410	$4,374,206
Number of units (in thousands)	19,091	20,072	22,523	23,765	24,704
Net asset value per unit	$156.17	$136.09	$140.14	$154.36	$177.06
Payout amount per unit					
Current earned income	$1.05	$0.58	$0.21	$1.46	$2.73
Previously reinvested realized gains withdrawn	$5.17	$5.98	$6.69	$5.41	$4.02
Total payout per unit	$6.22	$6.56	$6.90	$6.87	$6.75
Summary of net asset values (in thousands of dollars)					
Long-Term Balanced Pool (above)	$2,981,351	$2,731,507	$3,156,423	$3,668,410	$4,374,206
Treasury pool funds	492,800	586,225	493,275	567,519	496,132
Separately invested funds	172,461	157,272	101,513	103,922	106,760
Total net asset value (in thousands of dollars)	**$3,646,612**	**$3,475,004**	**$3,751,211**	**$4,339,851**	**$4,977,098**

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 2005 the committee implemented modest changes to the allocation targets based on the Investment Office's optimization modeling, which identified a more efficient portfolio that should generate higher returns with lower risk levels. The target allocations for international equity and real assets were both increased by 2 percent. These target allocation increases were sourced from the following asset classes: absolute return, 2 percent; fixed income, 1 percent; and high-yield credit, 1 percent. The next chart displays the current asset allocation policy for the University. The chart also shows that actual allocations vary from targeted levels by modest amounts, reflecting the Investment Office's bias against market timing or tactical asset allocation as a primary driver of value added.

Policy Portfolio Targets and Ranges

	Range	*Target*	*At August 31, 2005*	*Difference*
U.S. equity securities	16–24%	20%	19.1%	-.9%
International equity securities	12–18%	15%	16.3%	1.3%
Fixed-income securities	11–17%	14%	12.2%	-1.8%
High-yield credit	2–8%	5%	4.8%	-.2%
Absolute return	12–20%	16%	17.9%	1.9%
Private investments	12–20%	16%	17.2%	1.2%
Real assets	10–18%	14%	12.5%	-1.5%
Cash		0%	0%	0%

Investment Performance Objective: 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 13 of this report.

The University's investments historically have grown at a rate exceeding the objective. As of August 31, 2005, the Long-Term Balanced Pool's assets were $4.37 billion, up approximately $706 million from last year. For the 12-month period ending August 31, 2005, the portfolio increased 19.81 percent, which was 12.18 percent above the objective. For the 3-, 10-, and 15-year periods ending August 31, 2005, the objective was exceeded by 7.42 percent, 5.2 percent, and 4.9 percent, respectively. Only for the 5-year period did the pool perform below the objective, reflecting the post–tech bubble difficulties of the late 1990s.

Annualized Returns: Exceeding the Objective

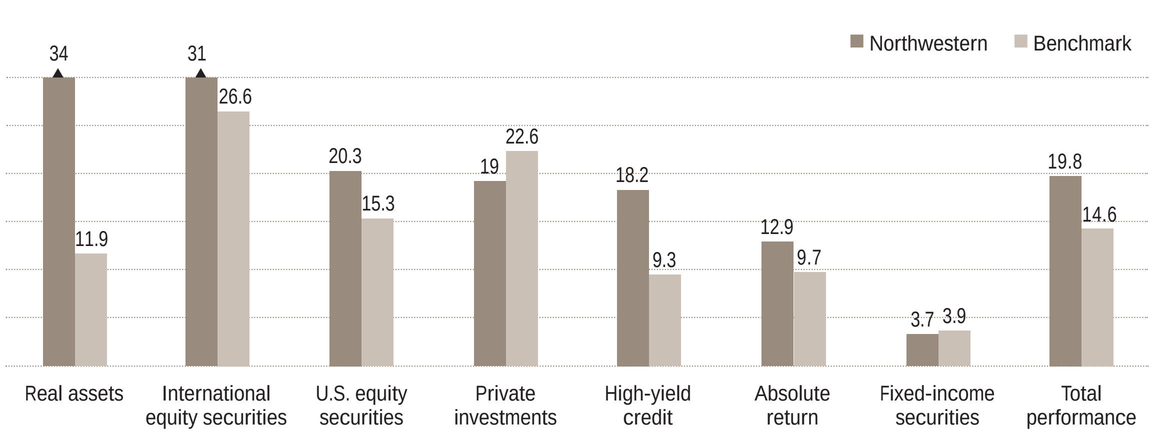
	1-year	**3-year**	**5-year**	**10-year**	**15-year**
*Annual total return**	19.81%	14.71%	5.19%	11.42%	11.39%
– Spending	3.99%	4.47%	4.29%	3.82%	3.88%
– Inflation	3.64%	2.81%	2.67%	2.4%	2.61%
= Above objective	**12.18%**	**7.42%**	**-1.77%**	**5.2%**	**4.9%**

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

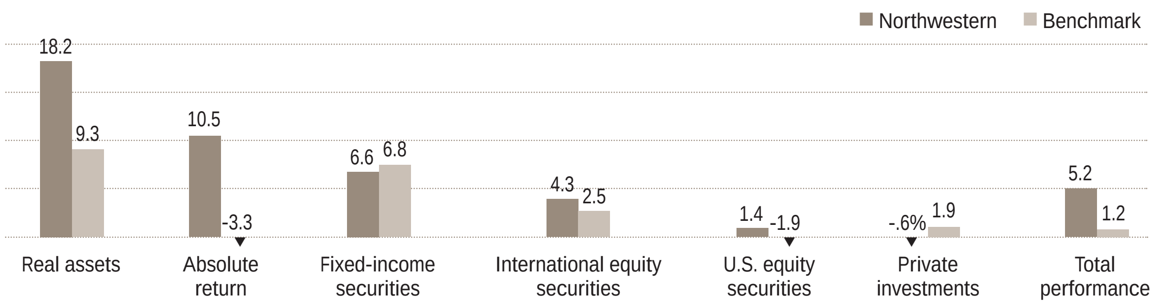
Investment Performance Objective: Benchmark Comparisons

The pool's 19.8 percent gain for the 12-month period exceeded the 14.6 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 various portfolios relative to their respective benchmarks. In particular, real assets and international equities enjoyed outstanding absolute and relative performance. The following charts show returns and benchmarks for all asset classes for the fiscal year and for the five-year period ended August 31, 2005, when the pool also outperformed the composite benchmark (5.2 percent versus 1.2 percent). A more detailed explanation of activity and performance follows the second chart.

Long-Term Balanced Pool: Fiscal 2005 Net Performance Relative to Benchmarks (in percentages)



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



Marketable Securities Categories

The domestic equity portfolio rose 20.3 percent for the fiscal year, significantly beating the 15.3 percent of the benchmark Russell 3000. The move from passive to active management has paid off; this portfolio has outperformed its benchmark by 280 basis points (16.3 percent versus 13.5 percent) over the three-year period since an active program began.

The fiscal-year performance for the international equity portfolio was strong in both absolute and relative terms. The portfolio gained 31 percent, more than 4 percent above the 26.6 percent earned by the benchmark Morgan Stanley All Country World ex-U.S. Index. The portfolio benefited from giving heavier weights to smaller-cap foreign stocks and emerging markets. For each of the last three years the international program was ahead of the benchmark by 3 percent.

The bond portfolio slightly underperformed during the fiscal year, gaining 3.7 percent, versus 3.9 percent for the Lehman Government Index. Global bonds, which the University added for further diversification, caused a slight drag on performance in fiscal 2005. For the three-year period, however, the bond portfolio outperformed the index by 120 basis points (5.3 percent versus 4.1 percent), almost entirely because of investment in Treasury Inflation-Protected Securities.

High-Yield Credit Category

The high-yield credit portfolio includes investments in 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 portfolio gained 18.2 percent during the fiscal year, outpacing the 9.3 percent achieved by the benchmark Merrill Lynch High Yield Master II Index. Strong returns in distressed and emerging market debt instruments led the strong performance.

Absolute Return Category

Made up of numerous hedge funds, this portfolio aims to provide equity-like returns with little or no correlation to the equity markets. For the year this portfolio gained 12.9 percent, beating its benchmark's return of 9.7 percent. The benchmark composition is Treasury bills plus 400 basis points, 80 percent, and the Morgan Stanley Capital International All Country World Index, 20 percent.

Private Investments Category

The private investments portfolio includes investments in global buyout funds as well as venture capital. Increased merger and acquisition activity, higher stock markets, stable interest rates, and growing economies worldwide contributed to a positive environment for these investments. The Northwestern portfolio's gain of 19 percent was not quite up to the benchmark's 22.6 percent. (Cambridge Associates' universe median return of private investments is used as the benchmark because it exhibits a closer correlation with actual returns than does a public equity benchmark.) Northwestern's return trailed the benchmark in part due to the large influence of Google's publicly traded stock. The inclusion of Google boosted the index, but the portfolio did not share in the effect due to smaller holdings.

Cash flows were strong in this portfolio, as trade sales, recapitalizations, and initial public offerings resulted in numerous distributions from the portfolio companies. Private investment distributions were $188 million for the fiscal year, and the private equity portfolio had a positive cash flow. The University is constantly working to add value by maintaining and improving its already strong long-standing manager relationships.

Real Assets Category

The real assets portfolio includes the University's investments in energy, timber, real estate, and other commodities. This portfolio was the strongest asset category in fiscal 2005, gaining 34 percent. Rising energy prices, increasing global demand for commodities and energy-related substances, and improving real estate fundamentals all contributed to the returns. Cash distributions of $203 million from energy and real estate partnerships were particularly strong.

Long-Term Balanced Pool Spending Guideline

After reviewing the Long-Term Balanced Pool's spending guideline, the University's Investment and Budget Committees recommended changing the market value calculation from the average of the prior two years to the average of the latest 12 months of a unit in the pool. The Board of Trustees ratified the change in fiscal 2005. The revised 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 latest 12 months. 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 2005 was $6.75; it will be $6.81 for fiscal year 2006. The payout rate for fiscal year 2005 was 3.91 percent.

Payout Determined by Spending Guideline

	2001	*2002*	*2003*	*2004*	*2005*
Spending per unit	$6.22	$6.56	$6.90	$6.87	$6.75
Net asset value per unit	$156.17	$136.09	$140.14	$154.36	$177.06
Payout rate*	3.56%	4.3%	4.76%	4.46%	3.91%
Total (in millions of dollars)	$117.20	$130.20	$150.69	$160.44	$161.44
Growth in spending per unit	17.36%	5.47%	5.18%	-.43%	-1.75%

*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

In summary, the Long-Term Balanced Pool continues to recover from the difficult post–tech bubble 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 investment objectives.

Securities Lending

During the prior fiscal year Northwestern initiated a securities lending program with its bank custodian, Northern Trust. The agreement allows the investment custodian to lend University securities to approved brokers in exchange for a fee. At August 31, 2005, investment securities with an aggregate market value of $655 million were loaned to various brokers and are returnable on demand. In exchange, the University received cash collateral of $562 million and noncash collateral of $105 million at August 31, 2005. The University earned $1.2 million on securities lending activities through the end of fiscal 2005.

William H. McLean

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, 2005 and 2004, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the management of the University. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the University's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the University as of August 31, 2005 and 2004, and the changes in its net assets and the cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

Chicago, Illinois
January 6, 2006

Consolidated Statements of Financial Position

As of August 31, 2005, and August 31, 2004

(in thousands of dollars)	*2005*	*2004*
Assets		
Cash and cash equivalents	$266,246	$225,679
Accounts receivable	195,613	233,040
Notes receivable	51,842	49,329
Contributions receivable	162,783	162,266
Collateral held for securities loaned	561,675	479,621
Investments	4,512,236	3,983,449
Land, buildings, and equipment	1,152,879	1,046,683
Bond proceeds held by trustees	126,699	50,448
Other assets	42,860	41,430
Total assets	**$7,072,833**	**$6,271,945**
Liabilities		
Accounts payable and accrued expenses	$116,590	$102,214
Deferred revenue	204,174	204,132
Payable under securities loan agreements	561,675	479,621
Actuarial liability of annuities payable and deposits payable	69,409	59,691
Reserves for self-insurance	80,306	79,454
Government advances for student loans	39,815	40,371
Bonds and notes payable	595,348	591,851
Total liabilities	**1,667,317**	**1,557,334**
Net assets		
Unrestricted	4,477,698	3,799,036
Temporarily restricted	165,150	163,283
Permanently restricted	762,668	752,292
Total net assets	**5,405,516**	**4,714,611**
Total liabilities and net assets	**$7,072,833**	**$6,271,945**

Detail of net assets	**Unrestricted**	**Temporarily restricted**	**Permanently restricted**	*2005*
Operating funds	$491,865	$83,639		$575,504
Invested in plant facilities	1,012,542	26,402		1,038,944
Annuity and life income funds	29,188	35,599	$28,828	93,615
Endowment and similar funds	2,944,103	19,510	733,840	3,697,453
Total net assets	**$4,477,698**	**$165,150**	**$762,668**	**$5,405,516**

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**

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

Consolidated Statements of Activities

For the fiscal years ended August 31, 2005, and August 31, 2004

(in thousands of dollars)	*2005*		*2004*	
Changes in unrestricted net assets				
Operating revenues				
Tuition and fees	$527,864		$496,484	
(less scholarships and fellowships)	(153,205)		(145,171)	
Net tuition and fees	374,659		351,313	
Auxiliary services	63,579		65,626	
Grants and contracts	349,215		333,154	
Private gifts	68,561		18,869	
Investment return designated for operations	219,023		210,290	
Professional fees	27,735		27,502	
Sales and services	109,536		103,716	
Other income	5,372		5,144	
Total operating revenues		**$1,217,680**		**$1,115,614**
Operating expenses				
Instruction	416,302		392,186	
Research	291,478		275,430	
Academic support	144,830		124,953	
Student services	94,891		82,998	
Institutional support	123,463		88,831	
Auxiliary services	98,692		99,191	
Total operating expenses		**1,169,656**		**1,063,589**
Excess of operating revenues over expenses		**48,024**		**52,025**
Nonoperating				
Private gifts and grants for buildings and equipment	30,826		28,751	
Investment gains reinvested	560,401		338,618	
Change in unrestricted net assets from nonoperating activities		**591,227**		**367,369**
Net assets released from restrictions		**39,411**		**50,331**
Change in unrestricted net assets		**678,662**		**469,725**
Changes in temporarily restricted net assets				
Private gifts	40,503		10,293	
Net (loss) gain on annuity obligation	(1,410)		7,017	
Investment returns	2,185	41,278	2,126	19,436
Net assets released from restrictions		**(39,411)**		**(50,331)**
Change in temporarily restricted net assets		**1,867**		**(30,895)**
Changes in permanently restricted net assets				
Private gifts	10,297		38,998	
Net gain on annuity obligation	79	10,376	1,041	40,039
Change in permanently restricted net assets		**10,376**		**40,039**
Change in net assets		**690,905**		**478,869**
Beginning net assets		**$4,714,611**		**$4,235,742**
Ending net assets		**$5,405,516**		**$4,714,611**

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

Consolidated Statements of Cash Flows

For the fiscal years ended August 31, 2005, and August 31, 2004

(in thousands of dollars)	*2005*	*2004*
Cash flows from operating activities		
Change in net assets	**$690,905**	**$478,869**
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation	62,426	52,890
Loss on retirement of equipment	869	749
Net realized and unrealized gains on investments	(658,145)	(464,959)
Private gifts and grants for long-term investments	(30,826)	(28,751)
Changes in assets and liabilities		
Accounts receivable	37,422	(36,876)
Contributions receivable	(517)	30,118
Other assets	(1,430)	(6,284)
Accounts payable and accrued expenses	(6,607)	(7,777)
Deferred revenue	42	13,984
Reserves for self-insurance	852	18,064
Government advances for student loans	(556)	(731)
Net cash provided by operating activities	**94,435**	**49,296**
Cash flows from (used in) investing activities		
Purchases of investments	(1,907,909)	(1,830,837)
Proceeds from sales of investments	2,040,278	1,759,569
(Increase) decrease in trusts held by others	5	(22)
Increase in investments held for others	(3,011)	(3,385)
Acquisitions of land, buildings, and equipment	(148,508)	(139,906)
Student loans disbursed	(106,833)	(101,957)
Principal collected on student loans	104,320	102,571
Net cash used in investing activities	**(21,658)**	**(213,967)**
Cash flows from financing activities		
Net proceeds from issuance of notes payable and bonds payable	135,800	185,010
Net principal payments on notes and bonds payable	(132,377)	(48,332)
Amortization of discount on bonds payable	74	1,210
Increase in bond proceeds held by trustees	(76,251)	(48,687)
Proceeds from private gifts and grants for long-term investments	30,826	28,751
Increase in annuities and deposits payable	9,718	765
Net cash (used in) provided by financing activities	**(32,210)**	**118,717**
Increase (decrease) in cash and cash equivalents	**40,567**	**(45,954)**
Cash and cash equivalents at beginning of year	**225,679**	**271,633**
Cash and cash equivalents at end of year	**$266,246**	**$225,679**
Supplemental disclosure of cash flow information		
Accrued liabilities for construction in progress	$20,983	$19,174
Cash paid for interest	21,114	18,884

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. All significant intercompany transactions and accounts have been eliminated.

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 $2,062.2 million and $1,951.8 million at August 31, 2005, and 2004, respectively. A range of possible values exists for these securities, and therefore the estimated values may differ from the values that would have been used had a ready market for these securities existed. In the absence of another basis, management has determined that cost represents an approximation of the fair value of such investments.

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

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

Derivative Financial Instruments

The University uses various financial instruments to hedge the risk of decline in fair value of certain equity securities. Equity options and equity-indexed options are used to reduce the primary market risk exposure (e.g., equity price risk) of the hedged item in conjunction with the specific hedged strategy; if applicable, these have a reference index (e.g., S&P 500) that is the same, or highly correlated with, the reference index of the hedged item. Similarly, the University also enters into swap agreements to hedge public real estate equity exposure and obtain S&P 500 equity index exposure, and it uses futures contracts on 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, 2005, the fair values of the University's fixed rate debt of $385 million exceeded the carrying value of $360 million by $25 million. 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.

Accounts and Notes Receivable

Accounts receivable arising from tuition and fees are carried net of an allowance for doubtful accounts of $332,000 and $286,000 as of August 31, 2005, and 2004, respectively. Notes receivable resulting from student loans are carried net of an allowance for doubtful accounts of $253,000 and $271,000 as of August 31, 2005, and 2004, respectively.

Receivables from Northwestern Medical Faculty Foundation (NMFF), a related party (see next page), arising out of operational activities totaled $15.6 million and $25.7 million as of August 31, 2005, and 2004, 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. The University follows SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The provisions under this statement include a requirement that long-lived assets be reviewed for impairment by comparing the future cash flows expected from the asset to the carrying value of the asset. If the carrying value of an asset exceeds the sum of estimated undiscounted future cash flows, an impairment loss is recognized for the difference between estimated fair value and carrying value. In management's opinion, no impairment existed as of August 31, 2005.

Charitable Remainder Trusts

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

Annuities Payable

Annuities payable consist of annuity payments currently due and the actuarial amount of annuities payable. The actuarial amount of annuities payable is the present value of the aggregate liability for annuity payments over the expected lives of the beneficiaries (based on the mortality tables in the Internal Revenue Code, Publication 939, April 2003).

Self-Insurance Reserves

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

Revenue Recognition

Revenues from tuition and fees are reported in the fiscal year in which educational programs are predominantly conducted. Fiscal year 2006 fall-quarter tuition and fees, billed in fiscal year 2005, are reported as deferred revenue in fiscal year 2005. Similarly, fiscal year 2005 fall-quarter tuition and fees, billed in fiscal year 2004, are reported as deferred revenue in fiscal year 2004.

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.

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 $25.9 million in fiscal year 2005 and $21.9 million in fiscal year 2004.

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, 2005, and 2004, 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 May 2003 the Financial Accounting Standards Board (FASB) issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS 150 modifies the accounting and financial statement disclosures for instruments with characteristics of both liabilities and equity that an issuer previously could account for as equity in its statement of financial position. In FASB Staff Position No. 150-3, "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150," issued November 2003, the FASB deferred the effective date of SFAS 150 for nonpublic entities until the first fiscal period beginning after December 15, 2004, or, for the University, for the fiscal year ending August 31, 2006. The University believes that the adoption of SFAS 150 during the fiscal year ending August 31, 2006, will not have a material effect on the consolidated financial statements.

In March 2005 the FASB issued FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations — an Interpretation of FASB Statement No. 143." FIN 47 clarifies that the term "conditional asset retirement obligation" used in SFAS No.143 refers to an entity's legal obligation to perform an asset retirement activity whose timing and/or method of settlement depend on a future event the entity does not necessarily control. Accordingly, the entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value can be reasonably estimated. The fair value should be recognized when incurred — generally upon acquisition, construction, or development and/or through the normal operation of the asset.

FIN 47 will be effective for the 2006 fiscal year, and the University plans to adopt it then. The University is reviewing and analyzing the impact that adopting FIN 47 will have on the consolidated financial statements.

Reclassifications

Certain prior-year amounts have been reclassified to conform to current-year presentation of investments held by the University. In addition, the prior-year cash flow has been modified to reflect a change in the presentation of accrued liabilities for construction in progress. The amount reclassified, totaling $19,174, is reflected as a decrease in net cash provided by operating activities and a decrease in net cash used in investing activities.

2. Bonds and Notes Payable

The University had $100 million and $135.8 million placed in commercial paper at August 31, 2005, and 2004, respectively.

Bonds payable are as follows:

(in thousands of dollars)	*August 31, 2005*	*August 31, 2004*
Demand revenue bonds		
IFA–Series 1985 varying adjustable interest rates	$0	$35,300
IFA–Series 1985 University Pooled Financing Program, variable rate	0	4,000
IFA–Series 1985 Cultural Pooled Financing Program, variable rate	0	9,992
IFA–Series 1988, variable rate	0	45,100
IFA–Series 1993, fixed rate	25,195	27,420
Less unamortized discount on IFA–Series 1993	(657)	(731)
IFA–Series 1997, fixed rate	150,000	150,000
IFA–Series 2003, fixed rate	185,010	185,010
IFA–Series 2004, variable rate	135,800	
Total	**$495,348**	**$456,091**

Total obligations including commercial paper at August 31, 2005, are scheduled to mature through August 31 of each period as follows:

(in thousands of dollars)	
2006	$107,237
2007	12,317
2008	12,407
2009	17,507
2010	17,602
2011–2015	90,938
2016–2020	41,405
2021–2025	10,135
2026–2030	0
Thereafter	285,800
Total	**$595,348**

In fiscal year 2005 the University elected to prepay the IFA–Series 1985 and 1988 Adjustable Demand Revenue Bonds in whole, without premium. The Series 1985 bond, whose principal amounted to $35.3 million, was redeemed on September 25, 2004. The Series 1988 bond, whose principal amounted to $45.1 million, was redeemed on September 10, 2004.

At the option of the University and upon compliance with certain conditions, the IFA–Series 1985 and 1988 Adjustable Demand Revenue 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 September 8, 2004, $35.3 million of the Series 1985 and all of the Series 1988 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 September 8, 2004, was 1.3 percent.

Also in fiscal year 2005, the University elected to prepay the IFA–Series 1985 Cultural Pooled Financing Program bond in whole, without premium; its promissory note; and the underabsorbed financing costs on September 15, 2004, which amounted to $9.99 million in principal costs.

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 September 2, 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 September 8, 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, 2005, of 5.3 percent) and maturing from December 1, 2005, 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. The commercial paper, totaling $35.8 million in aggregate principal, was prepaid in whole, without premium, on September 2, 2004. In addition, on July 15, 2005, the University began placing commercial paper under a new $200 million commercial paper program.

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, 2005, 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 IFA–Series 2004 Adjustable Rate Revenue Bonds, totaling $135.8 million, were issued on September 9, 2004. The bonds were issued to acquire, construct, renovate, remodel, improve, and equip capital projects on both the Evanston and Chicago campuses, subject to conditions set forth in a trust indenture and loan agreement between the University and the Illinois Facilities Authority. The bonds may operate in a daily, weekly, adjustable, or auction rate mode. In fiscal year 2005 the revenue bonds operated in a weekly rate mode, determined by the remarketing agents. The weekly interest rates at August 31, 2005, were 2.36 and 2.32 percent. The bonds will mature December 1, 2034.

The lending agreements covering the IFA demand revenue bond issues also provide that the third-party lender may purchase bonds, at a rate not exceeding the third-party lender'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, 2005.

3. Contributions Receivable

Contributions receivable consisted of the following:

(in thousands of dollars)	*August 31, 2005*	*August 31, 2004*
Unconditional promises expected to be collected in		
Less than one year	$49,431	$47,239
One year to five years	116,874	121,536
More than five years	43,986	47,285
Less discount to present value and other reserves		
Discount to present value	(40,842)	(43,698)
Other reserves	(6,666)	(10,096)
Total	**$162,783**	**$162,266**

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 either by Northwestern or 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 revised guideline effective in fiscal year 2005 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 for the latest 12 months. 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, 2005		*August 31, 2004*
(in thousands of dollars)	**Cost**	**Estimated fair value**	**Cost**	**Estimated fair value**
U.S. equity	$639,974	$791,726	$606,498	$696,255
International equity	517,303	693,679	421,014	525,356
Fixed income	677,507	692,771	741,219	758,561
High-yield credit	146,905	207,708	134,006	190,262
Absolute return	493,676	779,742	432,701	757,815
Private investments	901,322	763,817	773,365	582,238
Real estate	447,224	545,326	304,573	394,164
Other assets	23,510	37,467	59,796	78,798
Total investments	**$3,847,421**	**$4,512,236**	**$3,473,172**	**$3,983,449**

The University is committed to making future capital contributions in other investments in the amount of $976 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, 2005
(in thousands of dollars)	**Operations and plant**	**Quasi-endowment**	**Annuity and life-income**	**Permanent endowment**	**Total**
Long-Term Balanced Pool	$511,388	$1,308,475	$36,194	$2,057,223	$3,913,280
Intermediate-Term Bond Pool	435,345	21,190			456,535
Separately invested	160	14,248	87,523	4,989	106,920
Working capital	35,501				35,501
Total investments	**$982,394**	**$1,343,913**	**$123,717**	**$2,062,212**	**$4,512,236**

					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**

The following table is a summary of private investments where cost basis exceeds fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position. Based upon continuing analysis and evaluation, management has determined that declines in fair value are temporary and that these assets were not impaired at August 31, 2005.

(in thousands of dollars)						*August 31, 2005*
	Less than 12 months		**12 months or more**		**Total**	
	Fair value	**Unrealized losses**	**Fair value**	**Unrealized losses**	**Fair value**	**Unrealized losses**
Private equity	$17,891	$437	$112,125	$71,761	$130,016	$72,198
International private equity	4,993	577	34,547	13,916	39,540	14,493
Venture capital	1,992	125	176,160	165,293	178,152	165,418
Separately invested			13,878	3,264	13,878	3,264
Total temporarily impaired securities	**$24,876**	**$1,139**	**$336,710**	**$254,234**	**$361,586**	**$255,373**

Investment Return

The components of total investment return were as follows:

(in thousands of dollars)	*August 31, 2005*	*August 31, 2004*
Investment income	$123,469	$86,053
Net realized gains	507,015	308,686
Change in net unrealized gains on investments reported at fair value	151,125	156,295
Total investment return	**$781,609**	**$551,034**

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, 2005*	*August 31, 2004*
Changes in unrestricted net assets		
Operating: investment return	$219,023	$210,290
Nonoperating: investment gains reinvested	560,401	338,618
Changes in temporarily restricted net assets		
Investment return	2,185	2,126
Total investment return	**$781,609**	**$551,034**

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 real estate assets hedged by the swap was $9.4 million at August 31, 2005. In addition, the University had $9.6 million S&P 500 equity index exposure related to the swap as of August 31, 2005. The swaps outstanding at August 31, 2005, had an unrealized loss of $254,000. The swap settlements during 2005 resulted in a realized loss of $1.5 million. At August 31, 2004, the market value of the underlying equity assets hedged by the swap was $23.3 million. 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. The swap settlements during 2004 resulted in a realized loss of $4.1 million.

The University also used a swap agreement to hedge small-cap equity exposure and obtain S&P 500 equity index exposure. The market value of the underlying small-cap equity assets hedged by the swap was $23.2 million at August 31, 2005. In addition, the University had $21.3 million S&P 500 equity index exposure related to the swap as of August 31, 2005. The swap settlements during 2005 resulted in a realized loss of $2 million.

The University bought and sold futures contracts on a domestic equity index during 2005 and 2004 and incurred realized gains of $3.1 million and $4.7 million, respectively, on the purchase and sale of S&P 500 equity index futures contracts. As of August 31, 2005, and 2004, respectively, the University had 325 and 287 September S&P 500 index futures contracts outstanding. These contracts had an underlying notional value of $99.2 million and $81.4 million, respectively; an unrealized gain of $777,000 at August 31, 2005; and an unrealized loss of $2.1 million at August 31, 2004.

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 11 independent asset managers of Northwestern University funds totaling approximately $520 million and $362 million at August 31, 2005, and 2004, 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, 2005. Historical cost and market value totals for these accounts were approximately $3.9 million and $2.2 million, respectively. In 2004 historical cost and market value totals for these accounts were approximately $83 million and $65.7 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 $32.2 million and $30.1 million to the two plans in 2005 and 2004, respectively. It expects to contribute $34.2 million to the two plans in 2006.

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 accrued cost for postemployment benefits was $8.7 million and $6.1 million at August 31, 2005, and 2004, respectively, and is included in accounts payable and accrued expenses on the consolidated statements of financial position.

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

(in thousands of dollars)	*August 31, 2005*	*August 31, 2004*
Active employees not yet eligible	$3,299	$2,767
Active employees eligible	3,149	2,506
Retirees	539	676
Total	**$6,987**	**$5,949**

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

(in thousands of dollars)	*August 31, 2005*	*August 31, 2004*
Benefit obligation at beginning of year	$5,949	$8,035
Service cost (benefits attributed to employee service during the year)	412	469
Interest cost on accumulated postretirement benefit obligation	352	517
Actuarial loss (gain)	437	(2,716)
Benefits paid	(1,138)	(1,308)
Contributions from participants	975	952
Benefit obligation at end of year	**$6,987**	**$5,949**

During fiscal year 2005 postretirement benefit payments (net of retirees' contributions) were approximately $163,000.

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

(in thousands of dollars)	*August 31, 2005*	*August 31, 2004*
Funded status	($5,771)	($5,061)
Unrecognized net actuarial loss	(505)	(68)
Unrecognized prior service cost	(711)	(820)
Total	**($6,987)**	**($5,949)**

The accrued benefit cost recognized in the consolidated statements of financial position, which is included in accounts payable and accrued expenses, was $7 million and $5.9 million at August 31, 2005, and 2004, respectively.

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

(in thousands of dollars)	*August 31, 2005*	*August 31, 2004*
Service cost (benefits attributed to employee service during the year)	$412	$469
Interest cost on accumulated postretirement benefit obligation	352	517
Amortization of prior service cost	109	109
Amortization of unrealized loss	0	195
Total	**$873**	**$1,290**

The discount rate used in determining the APBO was 5 percent and 6 percent as of August 31, 2005, and 2004, respectively. The assumed health care cost trend rate used in measuring the APBO in 2005 and 2004 was a graded table starting at 9 and 10 percent, respectively, and decreasing 1 percent each year to an ultimate rate of 5 percent.

	August 31, 2005	*August 31, 2004*
Health care cost trend rate assumed	9%	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	2009

A one percentage point change in assumed health care cost trend rates would have had the following effects in fiscal year 2005:

	1% increase	*1% decrease*
Increase (decrease) in total of service and interest cost	$114	($98)
Increase (decrease) in postretirement benefit obligation	614	(523)

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

(in thousands of dollars)	
2006	$143
2007	214
2008	302
2009	350
2010	437
2011–2015	3,308
Total	**$4,754**

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 May 2004 the FASB issued FASB Staff Position SFAS No. 106-2, “Accounting and Disclosure Requirement Related to the Medicare Prescription Drug, Improvements, and Modernization Act of 2003.” This FASB staff position requires that the University disclose, effective with the year ended August 31, 2005, the effects of the act and assess the impact of the Medicare Part D subsidy on the accumulated postretirement benefit obligation and net periodic postretirement benefit cost. Measures of the APBO or net periodic postretirement benefit cost do not reflect any amount associated with the subsidy because the University does not expect to qualify. In the future, should the University qualify, it may elect to pursue the subsidy.

6. Land, Buildings, and Equipment

Land, buildings, and equipment consisted of the following:

(in thousands of dollars)	*August 31, 2005*	*August 31, 2004*
Land and improvements	$27,950	$27,951
Buildings	1,480,270	1,337,525
Equipment	220,634	199,270
Accumulated depreciation	(575,975)	(518,063)
Total	**$1,152,879**	**$1,046,683**

At August 31, 2005, the University had under construction buildings that will cost approximately $209.7 million. The estimated cost to complete this construction is $100.3 million. Costs incurred through August 31, 2005, of $109.4 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, 2005, and 2004. Those expenses have been distributed to the functional areas of the University as follows:

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

(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**

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

8. Self-Insurance Reserves and Other Contingencies

Reserves for losses under the University’s self-insurance program, aggregating $80.3 million and $79.5 million at August 31, 2005, and 2004, respectively, include reserves for known losses and for losses incurred but not yet reported. A portion of the reserves pertaining to professional liability has been determined on a discounted present-value basis. The discount rate was 7.5 percent in fiscal years 2005 and 2004. Self-insurance reserves are based on estimates of historical loss experience, and while management believes that the reserves are adequate, the ultimate liabilities may be 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 November 1, 2004, NMFF obtained excess medical liability coverage through another institution for all events after October 1, 2002, and reported after November 1, 2004. 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. As of August 31, 2005, and 2004, accounts receivable from NMFF related to professional liability insurance costs totaled $2.9 million and $18.6 million, respectively.

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 $228.6 million at August 31, 2005. Service revenues are the excess of the actual interest collected above a guaranteed rate of return on the serviced loans. The University manages the program to break even and generates no servicing assets or liabilities through these activities. Under the agreement in effect through 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 are $22.9 million as of August 31, 2005. At August 31, 2005, and 2004, $549,000 and $541,000, respectively, were reserved in anticipation of future defaults. Notes receivable on the consolidated statements of position are shown net of these reserves in fiscal years 2005 and 2004.

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

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

9. Natural Classification of Expenses

Operating expenses incurred in the fiscal years ended August 31, 2005, and 2004, were as follows:

(in thousands of dollars)	*August 31, 2005*	*August 31, 2004*
Salaries, wages, and benefits	$623,417	$585,293
Services and professional fees	154,007	142,509
Supplies	64,365	59,880
Travel and promotion	54,275	50,545
Other expenses	73,815	46,713
Maintenance, utilities, and equipment	116,237	106,875
Interest on indebtedness	21,114	18,884
Depreciation	62,426	52,890
Total	**$1,169,656**	**$1,063,589**

10. Securities Lending

The University has had an agreement with its investment custodian to lend University securities to approved brokers in exchange for a fee. Among other provisions that limit the University's risk, the securities lending agreement specified that the custodian was responsible for 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, 2005, and 2004, investment securities with an aggregate market value of $654.9 million and $539.9 million, respectively, were loaned to various brokers and were returnable on demand. In exchange, the University received cash collateral of $561.7 million and noncash collateral of $105 million at August 31, 2005, and cash collateral of $479.6 million and noncash collateral of $70.9 million at August 31, 2004. 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.

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