Northwestern University
2012 FINANCIAL REPORT

Report of the Senior Vice President for Business and Finance

To the Board of Trustees of Northwestern University:

The University's 2012 financial statements confirm Northwestern's continuing successful management of its operations and resources in an unpredictable external environment. It remains well situated financially to face such challenges as uncertain research funding levels, the outlook for long-term investments and interest rates, and concerns about rising healthcare costs and the impact of market changes.

Despite investment markets' experiencing only modest gains, the University's statement of position remained strong in fiscal 2012. Investments grew to $7.2 billion, and total assets increased 5.4 percent, to nearly $9.9 billion. The Long-Term Balanced Pool had a total return (net of expenses) of 5.3 percent, the bulk of which was distributed and used to fund operational activities. Proceeds from the sale of $200 million in taxable bonds increased cash and cash equivalents and will be used over the next 12 to 18 months to fund major capital projects on the Evanston campus and at the Feinberg School of Medicine. The issuance of the bonds was the primary reason for a 13.7 percent increase in total liabilities. Total net assets increased 3.8 percent, to more than $8.1 billion.

Reflecting Northwestern's commitment to providing the necessary resources to maintain a diverse student body, the rate of increases in scholarships and fellowships (6.3 percent) outpaced that of tuition and fee revenue (4.1 percent). Grant and contract revenue and related expenditures saw modest variances. Total operating revenues increased 2.6 percent, to just over $1.9 billion.

The increase of 6.2 percent in total operating expenses outpaced that of total operating revenues. Operating expenditures are largely driven by salary and benefits costs, which increased 4.4 percent the past fiscal year. Adding to the increase in operating expenses were planned reserves spending for noncapital plant deferred maintenance and other one-time projects.

The University's total excess of operating revenue over expenses was $116.9 million for fiscal year 2012, a decrease from 2011's $173.1 million. Net assets grew $293.9 million in 2012, compared with $1,029.8 million in 2011, as more moderate investment returns were experienced.

Northwestern has ambitious projects and plans for the coming years. Careful implementation involving priority setting, a close monitoring of external factors, and the undertaking of additional expenditure-reduction initiatives will be the hallmark of our financial behavior.

Eugene S. Sunshine

Eugene S. Sunshine
Senior Vice President for Business and Finance

Investment Report

The past fiscal year saw a return to volatility for investors in global financial markets. Worries about the Economic and Monetary Union of Europe and slowing global economies put pressure on equity market returns—notably those outside the United States. Investors gravitated toward US Treasury bonds for safety and in a low-interest-rate environment sought yield-oriented investments. US equities and high-yield bonds enjoyed double-digit returns against that backdrop, while most other asset classes had low- to mid-single-digit returns.

Northwestern's diversified portfolio had a marginal gain of 5.3 percent for fiscal year 2012. On August 31, 2012, the University's investment assets (including cash and intra-University investments) totaled $7.42 billion, an increase of $176 million over August 31, 2011.

The University's Total Investment Pools

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

The Long-Term Balanced Pool, used for endowed and quasi-endowed purposes, is managed with the objective of long-term total return. It is a "unitized fund" using mutual fund accounting principles. 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 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 or, if not needed within 90 days, are invested in the Long-Term Balanced Pool.

Separately invested funds are donated funds, including restricted investments and some life-income plans. These assets may not be merged with other assets for consolidated management.

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, 2012

	2008	*2009*	*2010*	*2011*	*2012*
Long-Term Balanced Pool					
Net asset value (in thousands of dollars)	$6,942,081	$5,639,701	$6,015,844	$7,012,867	$7,186,794
Number of units (in thousands)	31,378	32,524	33,301	34,144	35,155
Net asset value per unit	$221.24	$173.40	$180.65	$205.39	$204.43
Payout amount per unit					
Current earned income	($0.65)	($0.50)	($0.71)	($0.75)	($0.75)
Previously reinvested realized gains withdrawn	$8.45	$9.04	$9.25	$9.03	$9.07
Total payout per unit	$7.80	$8.54	$8.54	$8.28	$8.32
Summary of net asset values (in thousands of dollars)					
Treasury pool funds	$87,819	$73,001	$117,334	$148,378	$146,675
Separately invested funds	151,169	129,037	103,462	85,741	89,328
Total net asset value (in thousands of dollars)	**$7,181,069**	**$5,841,739**	**$6,236,640**	**$7,246,986**	**$7,422,797**

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 year 2012 the committee reaffirmed the allocation targets based on the Investment Office's optimization modeling, which seeks to generate higher returns with lower risk levels. Subjective considerations such as liquidity and inflation/deflation protection were also part of the analysis. Target allocations were maintained because little significant relative change was expected in the returns for the seven asset classes.

The next chart displays the current asset allocation policy for the University. Reflecting the Investment Office's bias against market timing or tactical asset allocation as a primary driver of value added, actual allocations varied from targeted levels by modest amounts. The illiquidity of private investments and real assets was partly responsible for their overweights.

Policy Portfolio Targets and Ranges

	Range	*Target*	*August 31, 2012*	*Difference*
US equity	9–15%	12%	11.1%	-0.9%
International equity	13–19%	16%	13.9%	-2.1%
Fixed-income	9–15%	12%	11.2%	-0.8%
High-yield credit	0–10%	5%	5.8%	0.8%
Absolute return	14–22%	18%	16.0%	-2.0%
Private investments	16–24%	20%	22.9%	2.9%
Real assets	13–21%	17%	18.9%	1.9%
Cash		0%	0.2%	0.2%

Primary 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. 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 6 of this report.

The University's investments historically have grown at a rate exceeding the objective. For the 10- and 15-year periods ending August 31, 2012, the objective was exceeded by 2 percent and 1.7 percent, respectively. For the 12 months ending August 31, 2012, the portfolio increased 5.3 percent, which was 1.1 percent below the objective.

Annualized Returns: Exceeding the Objective

	1-year	**3-year**	**5-year**	**10-year**	**15-year**
*Annual total return**	5.3%	11.2%	2.6%	9.2%	8.5%
– Spending	4.0%	4.3%	4.1%	4.1%	3.9%
– University management fee and support	0.7%	0.7%	0.6%	0.6%	0.6%
– Inflation	1.7%	2.2%	2.1%	2.5%	2.3%
= Above or below objective	**-1.1%**	**4.0%**	**-4.2%**	**2.0%**	**1.7%**

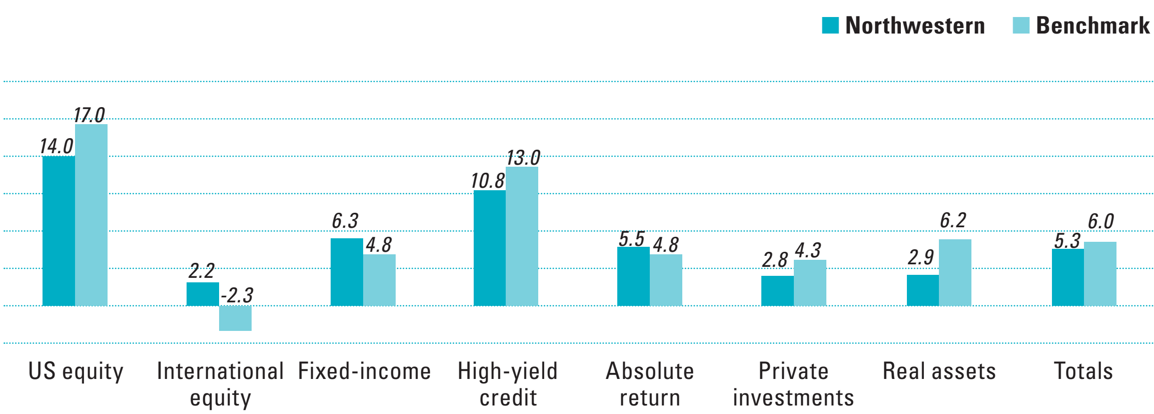
** Total returns are net of fees and are calculated on annual changes in net asset value. They may differ from payout distributions.*

Secondary Investment Performance Objective: Benchmark Comparisons

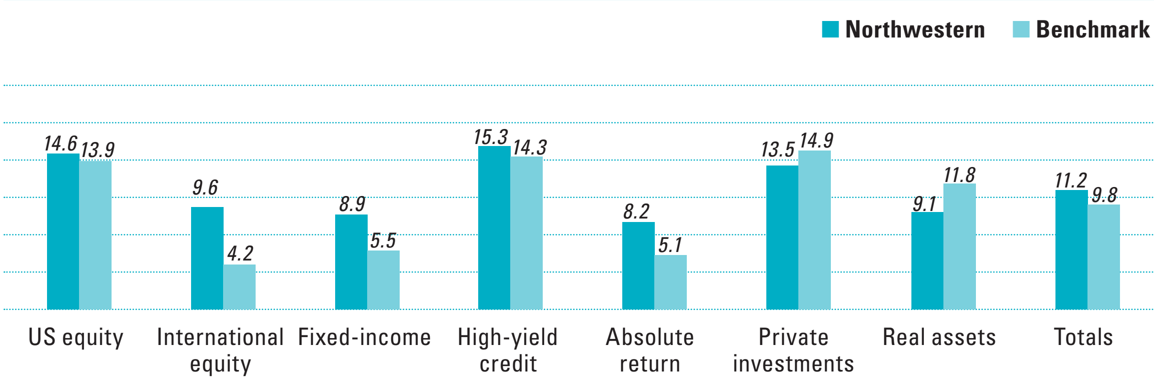
The pool's 5.3 percent gain for the 12-month period underperformed the 6 percent return of the composite benchmark, a blend of the benchmark returns for each asset class weighted by the policy allocation targets. The largest class by weight, private investments, underperformed on a relative basis (2.8 percent versus the benchmark's 4.3 percent). International equity was the best performer on a relative basis (2.2 percent versus -2.3 percent), but its performance was counterbalanced by US equity's underperformance (14 percent versus 17 percent). Fixed income enjoyed outstanding relative performance for the fifth year in a row (6.3 percent versus 4.8 percent). Absolute return outperformed its benchmark by 0.7 percent. The first chart that follows shows returns and benchmarks for all asset classes for the fiscal year.

For the three-year period ended August 31, 2012, the Long-Term Balanced Pool outperformed the composite benchmark (11.2 percent versus 9.8 percent), as shown in the second chart. Five of the seven portfolios exceeded their benchmarks over three years, but private investments and real assets underperformed. Three of the asset classes were double-digit performers and reflect the recovery from the financial crisis of 2008–09. A more detailed explanation of activity and performance follows the three-year performance chart below.

Long-Term Balanced Pool: Fiscal 2012 Net Performance Relative to Benchmarks (in percentages)



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



Marketable Securities Categories

Fixed income was one of the top-performing asset classes during the fiscal year in relative terms, gaining 6.3 percent, compared with 4.8 percent for its benchmark, the Barclays Government Index. For the last three years fixed income returned 8.9 percent, versus 5.5 percent for its benchmark. It has outperformed in 8 of the last 11 fiscal years due to superior active management and exposure to global and inflation-protected bonds.

The international equity portfolio gained 2.2 percent and in relative terms was the best-performing asset class, outperforming the benchmark (67 percent, MSCI EAFE Index; 33 percent, MSCI EM Index) by 4.5 percent. Returning 9.6 percent for the last three years, compared with the benchmark's 4.2 percent, this portfolio was helped by a heavier weight to smaller-cap foreign stocks and overweight exposure to emerging markets. It has outperformed in 9 of the last 11 fiscal years.

The US equity portfolio rose 14 percent for the fiscal year, underperforming the 17 percent gain of its Russell 3000 benchmark, primarily due to manager selection. US equity was the top performer in this portfolio in absolute terms and has exceeded its benchmark over 3 years by 0.7 percent (14.6 percent versus 13.9 percent) and in 7 of the last 11 fiscal years.

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 increased 10.8 percent during the fiscal year, below the 13 percent increase of the benchmark Merrill Lynch High-Yield Master II Index, yet on an absolute basis it was the second-best performer. Over the past three years it is the best performer in this category in absolute terms, returning 15.3 percent (versus 14.3 percent for the benchmark). Even though it has a conservative concentration of safer bank loans, the portfolio has outperformed the more risky high-yield bonds in the benchmark index.

Absolute-Return Category

Made up of 25 different hedge funds, this portfolio aims to provide equity-like returns with low correlation to the equity markets. For the year it gained 5.5 percent, surpassing the 4.8 percent return of its benchmark (80 percent Treasury bills plus 400 basis points; 20 percent MSCI All-Country World Index). The portfolio's three-year return of 8.2 percent exceeded the benchmark's 5.1 percent. Northwestern's absolute-return portfolio is weighted toward long-short equity managers (44 percent), but the University has been reducing this exposure by increasing the allocation in other hedge-fund strategies. The remaining hedge funds (56 percent) are less equity-market sensitive and represent diversifying strategies.

Private Investments Category

The private investments portfolio includes investments in global buyout, growth equity, and venture capital funds. This portfolio was the second-lowest-returning asset class in absolute terms in fiscal 2012, with a gain of 2.8 percent, but its three-year gain of 13.5 percent was a strong performance. The global slowdown affected the one-year return for this asset class, but increased profitability at underlying portfolio companies and merger and acquisition activity significantly bolstered returns for the three-year period. In addition, the initial public offering environment significantly improved worldwide.

Cash flows (total distribution less new investments or capital calls) were strong and were positive for the first time since the financial crisis of 2008–09. The portfolio continued to experience an increase in trade sales, recapitalizations, and public offerings, resulting in more distributions from the portfolio companies. For fiscal year 2012 private investment distributions were $258.7 million and capital calls $191 million, for a net cash flow of $67.7 million. The University's manager relationships and reputation in the marketplace remain strong.

Real Assets Category

The real assets portfolio includes the University's investments in energy, timber, real estate, and public investments in commodity funds. This portfolio had weak absolute results in fiscal year 2012, gaining only 2.9 percent. Distribution activity significantly increased, however, as there continued to be substantially higher realizations in private-partnership real estate and energy investments. With distributions of $237.8 million and capital calls of $225.2 million, the net cash flow was $12.6 million.

Long-Term Balanced Pool Spending Guideline

To sustain the Long-Term Balanced Pool's long-term earning ability and provide adequate resources to the University, the Board of Trustees in fiscal year 2006 ratified a revised spending guideline that blends two elements:

- Market element adjusts annual endowment spending to the long-term sustainable target spending of 4.35 percent of the average actual market value of the endowment for the 12 months ending October 31 of the prior fiscal year. This component of the spending rate receives a 30 percent weighting in the spending rate calculation.
- Spending element increases the previous year's spending rate by actual inflation plus budget growth (1.5 percent). This element of the spending rate receives a weight of 70 percent.

The amount per unit for fiscal year 2013, calculated using the guideline above, is $8.74. The spending rate for fiscal year 2012 was 4 percent.

Payout Determined by Spending Guideline

	2008	*2009*	*2010*	*2011*	*2012*
Spending per unit	$7.80	$8.54	$8.54	$8.28	$8.32
Net asset value per unit	$221.24	$173.40	$180.65	$205.39	$204.43
Annual spending rate*	3.40%	4.24%	4.71%	4.20%	3.98%
Total (in millions)	$233.50	$272.95	$281.91	$279.61	$280.61
Growth in total spending	18.23%	16.90%	3.28%	-0.81%	0.36%

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

The Long-Term Balanced Pool: In Conclusion

Northwestern's portfolio weathered a difficult period in good condition and is poised to continue to grow and support the University's needs. Its success is based on the diversification of the Long-Term Balanced Pool and the skill of outstanding money managers worldwide in meeting investment objectives over long time horizons. Northwestern's leadership continues to maintain a long-term investment focus and remains confident in the portfolio's prospects.

William H. McLean

William H. McLean
Vice President and Chief Investment Officer

Report of Independent Auditors

To the Board of Trustees of Northwestern University:

In our opinion, the accompanying consolidated statement of financial position and the related consolidated statements of activities and of cash flows present fairly, in all material respects, the financial position of Northwestern University (the "University") and its subsidiaries at August 31, 2012, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. 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. The prior year summarized comparative information has been derived from the University's August 31, 2011 financial statements, and in our report dated January 13, 2012, we expressed an unqualified opinion on those financial statements. We conducted our audits of these statements 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 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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

Chicago, Illinois

January 9, 2013

Consolidated Statements of Financial Position

As of August 31, 2012, and August 31, 2011

(in thousands of dollars)	*2012*	*2011*
Assets		
Cash and cash equivalents	$613,731	$340,624
Accounts receivable	275,488	325,259
Notes receivable	75,762	58,503
Contributions receivable	99,289	61,341
Investments	7,220,057	7,040,068
Land, buildings, and equipment	1,576,025	1,529,056
Other assets	16,545	16,921
Total assets	**$9,876,897**	**$9,371,772**
Liabilities		
Accounts payable and accrued expenses	$245,282	$217,866
Deferred revenue	252,333	309,024
Deposits payable and actuarial liability of annuities payable	113,058	77,887
Government advances for student loans	38,738	38,968
Asset retirement obligations	129,842	121,091
Bonds, notes, and other debt payable	972,310	775,459
Total liabilities	**$1,751,563**	**$1,540,295**
Net assets		
Unrestricted	$4,952,584	$4,741,452
Temporarily restricted	2,047,109	2,015,356
Permanently restricted	1,125,641	1,074,669
Total net assets	**$8,125,334**	**$7,831,477**
Total liabilities and net assets	**$9,876,897**	**$9,371,772**

See Notes to the Consolidated Financial Statements, beginning on page 11.

Consolidated Statements of Activities

For the fiscal years ended August 31, 2012, and August 31, 2011

(in thousands of dollars)	*2012*				*2011*
Operating revenues	**Unrestricted**	**Temporarily restricted**	**Permanently restricted**	**Total**	**Total**
Tuition and fees	$799,143			$799,143	$767,939
(less scholarships and fellowships)	(270,215)			(270,215)	(254,109)
Net tuition and fees	528,928			528,928	513,830
Auxiliary services	76,507			76,507	75,187
Grants and contracts	535,049			535,049	537,523
Private gifts	108,178			108,178	79,366
Investment return designated for operations	234,373	$116,992		351,365	367,408
Sales and services	149,303			149,303	144,609
Professional fees	32,354			32,354	29,372
Royalties and trademarks	122,488			122,488	105,414
Other income	4,216			4,216	6,952
Total operating revenues	**1,791,396**	**116,992**	**—**	**1,908,388**	**1,859,661**
Net assets released from restrictions	**172,483**	**(172,483)**		**—**	**—**
Total operating revenues and other additions (reductions)	**1,963,879**	**(55,491)**	**—**	**1,908,388**	**1,859,661**
Operating expenses					
Instruction	631,164			631,164	612,628
Research	425,743			425,743	413,632
Academic support	215,659			215,659	163,405
Student services	156,309			156,309	141,081
Institutional support	260,055			260,055	251,092
Auxiliary services	102,521			102,521	104,679
Total operating expenses	**1,791,451**	**—**	**—**	**1,791,451**	**1,686,517**
Excess (deficit) of operating revenues over expenses	**172,428**	**(55,491)**	**—**	**116,937**	**173,144**
Nonoperating revenues and expenses					
Private gifts and grants for buildings and equipment	2,423	14,221		16,644	3,159
Restricted private gifts		77,755	$57,139	134,894	107,719
Net gain (loss) on annuity obligations		4,657	(6,167)	(1,510)	(7,480)
Investment returns, reduced by operating distribution	36,281	(9,389)		26,892	753,280
Excess of nonoperating revenues over expenses	**38,704**	**87,244**	**50,972**	**176,920**	**856,678**
Change in net assets	**211,132**	**31,753**	**50,972**	**293,857**	**1,029,822**
Beginning net assets	**4,741,452**	**2,015,356**	**1,074,669**	**7,831,477**	**6,801,655**
Ending net assets	**$4,952,584**	**$2,047,109**	**$1,125,641**	**$8,125,334**	**$7,831,477**

See Notes to the Consolidated Financial Statements, beginning on page 11.

Consolidated Statements of Cash Flows

For the fiscal years ended August 31, 2012, and August 31, 2011

(in thousands of dollars)	*2012*	*2011*
Cash flows from operating activities		
Change in net assets	**$293,857**	**$1,029,822**
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities		
Depreciation	105,582	102,379
Accretion for asset retirement obligations	5,892	5,765
Net losses on retirements and sales of buildings and equipment	359	959
Net amortization of discounts and (accretion) of premiums on bonds payable	(79)	(78)
Allowance for student loans receivable	(152)	395
Net realized and unrealized gains on investments	(337,050)	(1,055,817)
Contributed securities	22,097	23,977
Private gifts and grants for buildings and equipment	(16,644)	(3,159)
Changes in assets and liabilities		
Accounts receivable	51,781	(6,386)
Contributions receivable	(37,948)	24,348
Other assets	376	48,825
Accounts payable and accrued expenses	25,289	(25,721)
Deferred revenue	(56,691)	(10,125)
Government advances for student loans	(230)	(175)
Net cash provided by (used in) operating activities	**56,439**	**135,009**
Cash flows from (used in) investing activities		
Purchases of investments	(1,275,520)	(1,423,537)
Proceeds from sales of investments	1,417,032	1,569,244
Acquisitions of land, buildings, and equipment	(148,164)	(148,881)
Proceeds from sale of buildings or equipment	240	—
Student loans disbursed	(18,023)	(18,898)
Principal collected on student loans	916	8,637
Other	(8,558)	(5,904)
Net cash provided by (used in) investing activities	**(32,077)**	**(19,339)**
Cash flows from (used in) financing activities		
Net proceeds from issuance of bonds payable	200,000	—
Principal payments on notes, bonds, and other debt payable	(3,070)	(32,875)
Decrease in bond proceeds held by trustees	—	21,597
Proceeds from private gifts and grants for buildings and equipment	16,644	3,159
Increase in deposits payable and annuities payable	35,171	5,721
Net cash provided by (used in) financing activities	**248,745**	**(2,398)**
Increase in cash and cash equivalents	**273,107**	**113,272**
Cash and cash equivalents at beginning of year	**340,624**	**227,352**
Cash and cash equivalents at end of year	**$613,731**	**$340,624**
Supplemental disclosure of cash flow information		
Accrued liabilities for construction in progress	$8,960	$13,218
Capitalized interest	5,536	—
Cash paid for interest	32,595	29,834

See Notes to the Consolidated Financial Statements, on page 11.

1. Summary of Significant Accounting Policies

University Activities

Northwestern University (the University) is a major private research university with more than 17,000 students enrolled in 11 academic divisions on two lakefront campuses in Evanston and Chicago and an international campus in Doha, Qatar.

Northwestern's mission is to provide the highest-quality education for its students, to develop innovative programs in research, and to sustain an academic community that embraces these enterprises. Activities supporting its mission may be classified as either operating or nonoperating. Operating revenues include student tuition, research funding, investment return designated for operations, educational sales and services, private gifts, royalties, and auxiliary services. Operating expenses reflect support for all functions of the University. Nonoperating activities include unrealized gains and losses on investments, temporarily restricted gifts for building, and all permanently restricted endowment gifts.

Basis of Accounting

General

The University maintains its accounts and prepares its consolidated financial statements on the accrual basis of accounting in conformity with generally accepted accounting principles in the United States of America (GAAP). The Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) is the source of authoritative GAAP. The University prepares its consolidated financial statements in accordance with the Not-for-Profit Entities Topic of the FASB ASC. These statements include all wholly owned subsidiaries. All significant intercompany transactions and accounts have been eliminated.

Net Asset Classifications

Net assets and the flow of those net assets are classified in three net asset categories according to the existence or absence of donor-imposed restrictions. For further discussion of the classification of donor-restricted endowment funds and disclosures about both donor-restricted and board-designated endowment funds, see note 9 to the consolidated financial statements.

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.

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. In addition, the excess of the fair value over the historical cost of permanently restricted endowments is classified as temporarily restricted net assets until appropriated for expenditure.

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. Net unrealized losses on permanently restricted endowment funds for which the historical cost exceeds fair value are recorded as a reduction to unrestricted net assets.

Revenue 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. The expiration of a donor-imposed restriction on a contribution is recognized in the period in which the restriction expires. 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. Donor-restricted purposes include instruction, research, library collections, scholarship and awards, and building construction.

Fair Value Measurements

The University makes fair value measurements and enhanced disclosures about fair value measurements as required by the Fair Value Measurements and Disclosures Topic of the FASB ASC. For further discussion, see note 4 to the consolidated financial statements.

Cash and Cash Equivalents

Cash reflects currency and deposits or other accounts with financial institutions that may be deposited or withdrawn without restriction or penalty. *Cash equivalents* represent short-term and highly liquid investments that convert readily to cash and carry little risk of change in value at maturity due to interest-rate changes; maturities of the investments are three months or less at the date of purchase.

Contributions

Contributions received, including unconditional promises to give (pledges), are recognized by the University as revenues at their fair values. 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.

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). The fair values for these securities are classified as Level 1 because the securities have observable market inputs. Certain fixed-income securities are valued based on dealer-supplied valuations; since these securities have significant other observable inputs, they are classified as Level 2.

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. The guidance permits an entity, as a practical expedient, to measure the fair value of such investments based on the net asset value (NAV) per share. These estimates 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. These investments are generally less liquid than other investments. The fair values for these securities are classified as Level 3, reflecting significant unobservable inputs that are supported by little or no market inputs. The fair values of investments based on NAV are categorized as Level 2 if the investments are redeemable at the reporting date or within the near term, defined by the University as within 90 days of the reporting date.

During the examination process, management reviewed the valuation policies for all partnerships whose fair values were classified as Level 3 and deemed those policies appropriate. In addition to receiving the most recent available audited and unaudited financial statements from the external managers, management contacted the majority of these managers regarding the aggregate carrying value of the respective investments at August 31, 2012.

A range of possible values exists for these partnership investments, and the estimated values may therefore be materially different from the values that would have been used had a ready market for these partnerships existed. In the absence of another basis, management has determined that cost represents an approximation of the fair value of such investments. A small number of investments within certain partnerships may have holdings at a carrying value of cost, and management has determined this to be appropriate for these specific 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 obtain equity market exposure (e.g., equity price risk) of an underlying investment 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 investment strategy. Such instruments are not designated as hedges for accounting purposes and are recorded at fair value.

In fiscal years 2012 and 2011, the University entered into swap agreements to hedge future interest-rate movements. It also added various interest-rate options to hedge the overall portfolio and used an interest-rate swap agreement to hedge variable interest-rate exposure. For further discussion, see notes 4 and 8 to the consolidated financial statements.

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.

Accounts and Notes Receivable

Accounts receivable are recorded at net realizable value. Those generally expected to be collected within one year are carried without an allowance. The allowance for student accounts receivable is based on an analysis of outstanding account balances and is calculated using percentages based on historical collection data that are applied to the outstanding accounts-receivable balances. Accounts receivable deemed to be uncollectible are expensed at that time.

Notes receivable are recorded at net realizable value and are predominantly student loans with varying maturities. Notes receivable deemed to be uncollectible are expensed at that time.

Management assesses the adequacy of the allowance for credit losses on a regular basis by performing ongoing analysis of the student loan portfolio. Factors considered are differing economic risks associated with each loan category, the financial condition of specific borrowers, the economic environment in which the borrowers operate, the level of delinquent loans, and other significant influences. Loans disbursed under federally guaranteed student loan programs have special provisions. Based on this evaluation and management judgment, an uncollectible percentage is calculated and applied to each category of student loan balances outstanding. Management considers the allowance for student loan portfolio credit losses to be prudent and reasonable.

Contributions Receivable

Contributions receivable arising from unconditional promises to give are carried net of an allowance for uncollectible pledges. Additionally, unconditional promises are presented at estimated fair value considering duration and collection risk. There were no significant conditional promises to give as of August 31, 2012, and August 31, 2011.

Land, Buildings, and Equipment

The value of land, buildings, and equipment is recorded at cost or, if received as gifts, at fair 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 and works of art are also expensed.

Depreciation is calculated using the straight-line method over the useful lives of the equipment, which are estimated to be 3 to 20 years; of the buildings and land improvements, which are estimated to be up to a maximum of 40 years; and of the leasehold improvements, which are estimated to be the shorter of the useful life or lease term. The land useful life is deemed indefinite and not depreciable.

The University reviews long-lived assets 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, 2012.

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 not permanently restricted 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.

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. The reserves for self-insurance and postretirement medical and life insurance benefits were based on actuarial studies and management estimates. See note 12 for additional discussion.

Asset Retirement Obligations

The University records all known asset retirement obligations (ARO) for which the fair value of the liability can be reasonably estimated, including certain obligations relating to regulatory remediation. Asset retirement obligations covered include those for which an entity has a legal obligation to perform an asset retirement activity; however, the timing and/or method of settling the obligation are conditional on a future event that may or may not be within the control of the entity. The reserves for asset retirement obligations were based on analyses of University assets, review of applicable regulatory and other guidance, and management estimates.

Revenue Recognition

Revenues from tuition and fees are reported in the fiscal year in which they are earned, including pro-rata adjustments for educational programs crossing over fiscal years. Fiscal year 2013 fall-quarter tuition and fees, billed but not collected in fiscal year 2012, are reported as deferred revenue in fiscal year 2012. Similarly, fiscal year 2012 fall-quarter tuition and fees, billed but not collected in fiscal year 2011, are reported as deferred revenue in fiscal year 2011.

Revenues from auxiliary services, such as residence and food services, represent fees for goods and services furnished to University students, faculty, and staff; these revenues are recognized in the fiscal year in which the goods and services are provided. Grants and contracts revenue is recognized as expenses are incurred on a project. Professional fees arise from faculty and department services provided to external institutions such as hospitals. Sales and services revenues represent fees for services and goods provided to external parties in the course of educational activities and also include revenues from the provision of physical plant services and goods to external institutions contiguous to the University campuses. Trademark and royalty revenues arise from licensing of innovative technologies, copyrights, and other intellectual property; these revenues are recognized in the fiscal year in which they are earned. Other income includes revenues not otherwise categorized, such as rental revenues from property not held for investment, reimbursements for goods and services, and sundry payments to the University; these revenues are also recognized in the fiscal year in which they are earned.

Federal Grants and Contracts Revenue

The University receives funding or reimbursement from federal agencies. In addition, indirect cost recovery on federal grants and contracts is based on an institutional rate negotiated with its cognizant federal agency, the US Department of Health and Human Services.

Income Taxes

The Internal Revenue Service has determined that the University is exempt from income taxes under Section 501(c)(3) of the US Internal Revenue Code, except with regard to unrelated business income, which is taxed at corporate income tax rates. The University files federal and various state and local tax returns. The statute of limitations on the University's federal tax returns remains open for fiscal years 2009 through 2012.

The University makes an assessment of individual tax positions and follows a process for recognition and measurement of uncertain tax positions. Tax positions are evaluated on whether they meet the "more likely than not" standard for sustainability on examination by tax authorities.

Uses of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with GAAP 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 consolidated financial statements; and the reported amounts of revenues and expenses during the relevant period. Actual results could differ from those estimates.

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

Subsequent Events

The University has evaluated subsequent events in accordance with the FASB ASC Subsequent Event Topic through January 9, 2013, the date when the consolidated financial statements were issued. The University did not identify any subsequent events to be disclosed.

Recent Accounting Pronouncements

Accounting Standard Update (ASU) 2010–20 was issued July 21, 2010, and amends Topic 310 to improve disclosures that an entity provides about the credit quality of its financing receivables and related allowance for credit losses. The University implemented these improved and new disclosures in fiscal 2012.

ASU 2010–06 was effective in fiscal year 2012. The University implemented new disclosures for increased transparency and disaggregation, including disclosures about transfers into and out of Levels 1 and 2 and separate disclosures about purchases, sales, issuances, and settlements on a gross basis related to Level 3 measurement.

ASU 2012–05, issued in October 2012 and effective in fiscal year 2014, amends the Statement of Cash Flows Topic 320 and clarifies how not-for-profit entities (NFPs) classify cash receipts from the sale of certain donated financial assets. This ASU requires that, if such cash receipts were converted nearly immediately into cash, NFPs classify them as cash inflows from operating activities unless the donor restricted their use to long-term purposes; in that case, the cash receipts should be classified as cash flows from investing activities. The University adopted the classification in fiscal year 2012 and was updated to conform for fiscal year 2011.

Reclassifications

Certain fiscal year 2011 amounts have been reclassified in functional expenses on the consolidated statements of activity and in note 15, Natural Classification of Expenses. In addition, contributed securities and proceeds from sales of investments have been reclassified for fiscal year 2011 on the consolidated statements of cash flows.

2. Accounts Receivable and Notes Receivable

Accounts receivable are summarized on the consolidated statements of financial position as follows:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Research and other sponsored programs support	$71,272	$82,445
Student receivables	87,333	138,923
Royalty receivables	50,339	44,810
Other receivables	67,069	59,630
Accounts receivable subtotal	**276,013**	**325,808**
Less allowances for student uncollectible amounts	(525)	(549)
Total accounts receivable	**$275,488**	**$325,259**

Notes receivable are summarized on the consolidated statements of financial position as follows:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Notes receivable	$76,728	$59,621
Less allowances for student uncollectible amounts	(966)	(1,118)
Total notes receivable	**$75,762**	**$58,503**

Activity within the allowances was insignificant for fiscal years 2012 and 2011.

3. Contributions Receivable

Contributions receivable consisted of the following:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Unconditional promises expected to be collected in		
Less than one year	$42,958	$40,162
One year to five years	65,048	36,067
More than five years	5,188	2,183
Less discount to present value and other reserves		
Discount to present value	(4,413)	(2,461)
Other reserves	(9,492)	(14,610)
Total contributions receivable	**$99,289**	**$61,341**

Contributions receivable are discounted based on the weighted average borrowing rates for short-term and long-term bonds, notes, and other debt payable to correspond to the terms of the pledges receivable. The discount rate for pledges made in fiscal years 2012 and 2011 was 2.7 percent; the discount rate for pledges made in prior fiscal years ranged from 2.9 to 6.5 percent. The University deems these yields to be a Level 3 input.

The table below summarizes the change in contributions receivable for the years ended August 31, 2012, and 2011.

(in thousands of dollars)	*2012*	*2011*
Balance—beginning of year	$61,341	$85,689
New pledges	80,564	25,345
Collections on pledges	(41,547)	(48,518)
Adjustments to pledges	(4,234)	(6,092)
(Increase) decrease in discount to present value	(1,952)	1,533
Decrease in other reserves	5,117	3,384
Balance at end of year	**$99,289**	**$61,341**

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 or external equity investment managers, external and internal fixed-income and cash managers, and various limited partnership managers direct the investment of endowment and trust assets, certain working capital, temporarily invested expendable funds, and commercial real estate.

Substantially all of 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.

Investment Fair Value

The University has valued its investments using a hierarchy of valuation inputs based on the extent to which the inputs are observable in the marketplace. Observable inputs reflect market data obtained from sources independent of the reporting entity; unobservable inputs reflect the entity's own assumptions about how market participants would value an asset or a liability based on the best information available. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The fair-value hierarchy is based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value.

The following describes the hierarchy of inputs used to measure fair value and the primary valuation methodologies used by the University for financial instruments measured at fair value on a recurring basis.

Level 1: Quoted prices in active markets for identical assets or liabilities. Market-price data are generally obtained from relevant exchanges or dealer markets.

Level 2: Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the same term of the assets or liabilities. Inputs are obtained from various sources, including market participants, dealers, and brokers.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

A financial instrument's categorization within the valuation hierarchy is based on the lowest level of input that is significant to the fair-value measurement.

The following charts show the estimated fair value of investments and derivatives held by the University, grouped by the valuation hierarchy as defined above, for the fiscal years ended August 31, 2012, and 2011:

(in thousands of dollars) — *August 31, 2012*

	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total fair value
US equity securities	$266,249	$182,818	$391,725	$840,792
International equity	289,446	277,381	325,420	892,247
Fixed income	6,211	707,195	139,524	852,930
High-yield credit	—	—	417,340	417,340
Absolute return	—	256,067	870,174	1,126,241
Private investments	229	—	1,666,530	1,666,759
Real assets	80,969	3,130	1,291,469	1,375,568
Other investments	10,210	2,685	44,811	57,706
Subtotal investment assets	**653,314**	**1,429,276**	**5,146,993**	**7,229,583**
Interest-rate derivatives	—	—	(9,526)	(9,526)
Subtotal investments	**653,314**	**1,429,276**	**5,137,467**	**7,220,057**
Interest-rate swaps	—	—	(71,103)	(71,103)
Total	**$653,314**	**$1,429,276**	**$5,066,364**	**$7,148,954**

(in thousands of dollars) — *August 31, 2011*

	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total fair value
US equity securities	$232,525	$158,101	$359,119	$749,745
International equity	291,189	293,871	296,619	881,679
Fixed income	6,157	643,060	134,126	783,343
High-yield credit	—	17,438	538,608	556,046
Absolute return	—	205,365	811,379	1,016,744
Private investments	17,522	—	1,633,500	1,651,022
Real assets	105,851	3,881	1,246,828	1,356,560
Other investments	3,460	1,764	42,472	47,696
Subtotal investment assets	**656,704**	**1,323,480**	**5,062,651**	**7,042,835**
Interest-rate derivatives	—	—	(2,767)	(2,767)
Subtotal investments	**656,704**	**1,323,480**	**5,059,884**	**7,040,068**
Interest-rate swaps	—	—	(51,058)	(51,058)
Total	**$656,704**	**$1,323,480**	**$5,008,826**	**$6,989,010**

Investments included in Level 3 primarily consist of the University's ownership in alternative investments (principally limited partnership interests in hedge, private equity, real estate, and other similar funds). When quoted market prices are not available, the estimated fair values of these investments are generally based on reported partners' capital or NAV provided by the associated external investment managers. Since a range of possible values exists for these partnership investments, the estimated values may be materially different from the values that would have been used had a ready market for these partnerships existed. The University exercises diligence in assessing the policies, procedures, and controls of external investment managers; management's assessment includes a valuation review process that may result in adjustment to the external managers' valuations of the securities' fair value at August 31. Management reviewed the valuation policies for all partnerships in which the University is invested and deemed that its policies are appropriate and that the carrying amount of these assets represents a reasonable estimate of fair value.

Interest-rate swaps are valued using observable inputs, such as quotations received from the counterparty, dealers, or brokers, whenever available and considered reliable. In instances where models are used, the value of the interest-rate swap depends on the contractual terms of, and specific risks inherent in, the instrument as well as the availability and reliability of observable inputs. Such inputs include market prices for reference securities, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of such inputs. The interest-rate swaps classified within Level 3 have inputs that are unobservable and have little or no market activity.

Perpetual trusts held by third parties are valued at the present value of the future distributions expected to be received over the term of the agreement and are included in other investments in the summary of changes in investments within Level 3.

The methods described above may produce a fair value that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the University believes its valuation methods are appropriate and consistent with those of other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

The following tables summarize changes in the investments and derivatives classified by the University in Level 3 of the fair-value hierarchy for the fiscal years ended August 31, 2012, and 2011:

(in thousands of dollars)	*August 31, 2011*							*August 31, 2012*
	Fair value	**Purchases**	**Sales and settlements**	**Unrealized gains (losses)**	**Realized gains (losses)**	**Transfers into and out of Level 3**	**Reclassifications**	**Fair value**
US equity securities	$359,119		(29,167)	61,773				$391,725
International equity	296,619	5,502	(9,392)	33,279	(588)			325,420
Fixed income	134,126			5,398				139,524
High-yield credit	538,608	31,284	(82,836)	29,189	1,938		(100,843)	417,340
Absolute return	811,379	14,000	(113,053)	49,851	7,154		100,843	870,174
Private investments	1,633,500	396,120	(423,200)	4,535	55,567	8		1,666,530
Real assets	1,246,828	214,224	(141,454)	(24,419)	(3,710)			1,291,469
Other investments	42,472	2,834	(495)	18	(18)			44,811
Total investments	**5,062,651**	**663,964**	**(799,597)**	**159,624**	**60,343**	**8**	**—**	**5,146,993**
Interest-rate derivatives	(2,767)			(6,759)				(9,526)
Interest-rate swaps	(51,058)			(20,045)				(71,103)
Total	**$5,008,826**	**663,964**	**(799,597)**	**132,820**	**60,343**	**8**	**—**	**$5,066,364**

(in thousands of dollars)	*August 31, 2010*							*August 31, 2011*
	Fair value	**Purchases**	**Sales and settlements**	**Unrealized gains (losses)**	**Realized gains (losses)**	**Transfers into Level 3**	**Transfers out of Level 3**	**Fair value**
US equity securities	$303,894	6,665	(271)	48,831				$359,119
International equity	315,522	77,551	(106,327)	69,246	106	278	(59,757)	296,619
Fixed income	450	70,993	(284)	4,393	26	59,757	(1,209)	134,126
High-yield credit	523,884	40,545	(74,322)	46,222	2,279			538,608
Absolute return	767,199	88,851	(88,517)	43,280	566			811,379
Private investments	1,433,845	237,547	(198,062)	153,835	6,280	55		1,633,500
Real assets	964,388	217,170	(92,557)	158,145	(318)			1,246,828
Other investments	37,519	3,874	(989)	2,026	42			42,472
Total investments	**4,346,701**	**743,196**	**(561,329)**	**525,978**	**8,981**	**60,090**	**(60,966)**	**5,062,651**
Interest-rate derivatives	(10,307)			7,540				(2,767)
Interest-rate swaps	(72,620)			21,562				(51,058)
Total	**$4,263,774**	**743,196**	**(561,329)**	**555,080**	**8,981**	**60,090**	**(60,966)**	**$5,008,826**

There were no significant transfers or reclassifications between Levels 1 and 2 during fiscal year 2012.

The next table presents funding obligations and redemption terms of investments by asset class. The University is required under certain partnership agreements to advance additional funding up to specified levels over a period of several years. These uncalled commitments have fixed expiration dates and other termination clauses. At August 31, 2012, the University was committed to making future capital contributions in the amount of $1,155 million, primarily in the next five years, as detailed below. Certain agreements also contain notice periods, lock-ups, and gates that limit the University's ability to initiate redemptions.

(in thousands of dollars)

	Fair value	**Remaining life**	**Uncalled commitments**	**Redemption terms**	**Redemption restrictions**
US equity securities	$840,792	No limit	—	Daily to annually, with 1–90-day notice periods	Lock-up provisions ranging from none to 2 years
International equity	892,247	No limit	—	Daily to annually, with 1–93-day notice periods	Lock-up provisions ranging from none to 3 years
Fixed income	852,930	No limit	—	Daily to quarterly, with 1–90-day notice periods	Lock-up provisions ranging from none to 3 years
High-yield credit	417,340	No limit to 8 years	55,597	Certain partnerships ineligible for redemption; other funds monthly to annually, with 30–90-day notice periods	Certain partnerships not redeemable; lock-up provisions on all other funds ranging from none to 2 years
Absolute return	1,126,241	No limit	—	Monthly to annually, with 5–120-day notice periods	Lock-up provisions ranging from none to 5 years; side pockets on many funds
Private investments	1,666,759	1–12 years	610,011	Partnerships ineligible for redemption	Not redeemable
Real assets	1,375,568	No limit to 14 years	489,193	Partnerships ineligible for redemption; commodity funds daily to annually, with 3–30-day notice periods	Partnerships not redeemable; no restrictions on commodity funds

Northwestern's marketable securities categories include investments in US equities, international equity, and fixed-income strategies via separately managed accounts, partnerships, and commingled funds. US equity strategies include large-, mid-, and small-cap public equities. The restriction period for several of these funds was approximately one year as of August 31, 2012. International equities include developed market (ex–US public equities) and emerging market strategies. One investment in this category cannot currently be redeemed because redemptions are not allowed in the first three years.

Fixed-income strategies include US government securities, agency securities, inflation-linked bonds (TIPS), corporate bonds, global bonds, and short-term cash investments. As of August 31, 2012, one investment in this category can be only partially redeemed over the next three years.

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 absolute-return portfolio is weighted toward long-short equity managers. The remaining hedge funds are more market neutral or represent diversifying event-driven strategies. One investment in this portfolio cannot currently be redeemed because redemptions are not allowed in the first three years. The remaining restriction period for these funds ranged from approximately two to four years as of August 31, 2012.

The private investments portfolio includes investments in global buyout and venture capital funds. The real assets portfolio includes the University's investments in energy, timber, real estate, and public investments in some commodity funds.

Management's estimate of the lives of the funds could vary significantly depending on the investment decisions of the external fund managers, changes in the University's portfolio, and other circumstances. Furthermore, the University's obligation to fund these commitments may be waived by the fund managers for a variety of reasons, including the market environment and/or changes in investment strategy.

Investment Return

The components of total investment return were as follows:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Investment income	$39,197	$64,611
Net realized gains	318,786	376,660
Change in net unrealized gains	20,274	679,417
Total investment return	**$378,257**	**$1,120,688**

Investment return designated for 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. Other investment returns are categorized as nonoperating. As reflected in the consolidated statements of activities, investment return was as follows:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Changes in unrestricted net assets		
Operating: investment return	$234,373	$253,817
Nonoperating: investment returns, reduced by operating distribution	36,281	426,515
Changes in temporarily restricted net assets		
Operating: investment return	116,992	113,591
Nonoperating: investment returns, reduced by operating distribution	(9,389)	326,765
Total investment return	**$378,257**	**$1,120,688**

Derivative Financial Instruments

The University has entered into hedging transactions via various interest-rate swaps and options and maintained those positions since fiscal year 2010. The fair value of derivatives were in liability positions of $9.5 million and $2.7 million as of August 31, 2012, and 2011, respectively. These swaps and options had a notional value of $400 million at August 31, 2012, and August 31, 2011. These instruments are held in the fixed-income asset class in the summary of changes in investments within Level 3.

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 the cash collateral held at the counterparties at the reporting date. The University manages its exposure to credit risk by using highly rated counterparties, establishing risk-control limits, and obtaining collateral where appropriate. As a result, the University has limited credit risk. The University has entered into margin collateral agreements with major investment banks that impose a $1 million threshold on both parties. As of August 31, 2012, the collateral account at one counterparty held $10.2 million in cash to support the University's unrealized loss at fiscal year-end. To date, the University has not incurred any losses on derivative financial instruments due to counterparty nonperformance.

In addition, in fiscal year 2012 the University hired an external manager to use derivative financial instruments to obtain market exposure in equity and fixed-income indices on excess cash balances. As of August 31, 2012, the outstanding notional value of these derivatives was $108 million, and they had a realized gain for the fiscal year 2012 of $1.7 million.

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 numerous independent asset managers of the University.

5. Land, Buildings, and Equipment

Land, buildings, and equipment consisted of the following:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Land	$28,389	$28,389
Construction in progress	183,350	162,274
Buildings and leasehold improvements	2,058,724	1,958,385
Equipment	468,494	443,730
Accumulated depreciation	(1,162,932)	(1,063,722)
Total land, buildings, and equipment	**$1,576,025**	**$1,529,056**

The estimated cost to complete construction in progress at August 31, 2012, was $397 million. Costs included in construction in progress are leasehold improvements and building and equipment capitalizations. Building costs are funded by loans, gifts (received or pledged), grants, and unrestricted funds.

Under the University's interest capitalization policy, actual interest expense incurred during the period of construction of an asset for University use is capitalized until that asset is substantially completed and ready for use. The capitalized cost is reflected in the total cost of the asset and depreciated over the useful life of the asset. Assets may include buildings and major equipment.

Asset Retirement Obligations

Asset retirement obligations were adjusted during fiscal years 2012 and 2011 as follows:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Balance at beginning of year	$121,091	$115,326
Increase in asset retirement obligations	2,859	—
Accretion expense	5,892	5,765
Balance at end of year	**$129,842**	**$121,091**

Lease Obligations

The University is obligated under numerous operating leases to pay base rent through the lease expiration dates. Operating leases consist primarily of leases for the use of real property and have terms expiring in various years through fiscal year 2025. Noncancelable real estate lease expenses totaled $12.1 million at August 31, 2012. In fiscal year 2011 real estate lease expenses were $11.7 million at August 31. The future minimum lease payments under noncancelable operating leases through August 31 of each period are as shown at right.

(in thousands of dollars)	
2013	$13,483
2014	14,804
2015	14,928
2016	15,092
2017	14,562
2018 and thereafter	72,371
Total	**$145,240**

6. Other Assets

Other assets are summarized on the consolidated statements of financial position as follows:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Prepaid bond expenses	$6,899	$6,057
Inventories	1,998	2,358
Other assets	7,648	8,506
Total other assets	**$16,545**	**$16,921**

7. Deposits Payable and Actuarial Liability of Annuities Payable

Deposits payable and actuarial liability of annuities payable are summarized on the consolidated statements of financial position as follows:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Agency deposits payable	$66,995	$57,038
Actuarial liability of annuities payable	17,623	14,438
Student loan deposits payable	23,436	—
Other deposits payable	5,004	6,411
Total deposits payable and actuarial liability of annuities payable	**$113,058**	**$77,887**

8. Bonds, Notes, and Other Debt Payable

Bonds, notes, and other debt payable are as follows:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
IEFA–Series 1993	$6,815	$9,885
Less unamortized discount on IEFA–Series 1993	(146)	(219)
IEFA–Series 2003	185,010	185,010
IFA–Series 2004	135,800	135,800
IFA–Series 2006	145,130	145,130
Plus unaccreted premium on IFA–Series 2006	4,701	4,853
IFA–Series 2008	125,000	125,000
Taxable—Series 2012	200,000	—
Bonds payable subtotal	**802,310**	**605,459**
Notes payable—commercial paper, taxable	170,000	170,000
Total bonds, notes, and other debt payable	**$972,310**	**$775,459**

Debt issuance	**Interest-rate mode**	**Interest rate**	**Maturity**
IEFA–Series 1993	Fixed	5.5%	December 1, 2012, to December 1, 2013
IEFA–Series 2003	Fixed	5%[a]	December 1, 2014, to December 1, 2038
IFA–Series 2004	Variable, annual rate	1.75%[b]	December 1, 2034
IFA–Series 2006	Fixed	5%[a]	December 1, 2042
IFA–Series 2008	Variable, annual rate	1.2% and .37%[c]	December 1, 2046
Taxable—Series 2012	Fixed	4.2%	December 1, 2038, to December 1, 2047
Notes payable —commercial paper, taxable	Fixed	.18%[a]	September 6, 2012, to November 6, 2012

[a] *Weighted average interest rate at August 31, 2012*
[b] *$135.8 million, with interest rate reset at March 3, 2014*
[c] *$50 million, with interest rate reset at March 1, 2013; $75 million, with interest rate reset at March 3, 2014, respectively*

Total obligations, including notes and other debt payable at August 31, 2012, are scheduled to mature through August 31 of each period as noted at right. The schedule has been prepared based on the contractual maturities of the debt outstanding at August 31, 2012. Accordingly, if remarketing of bonds fails in future periods, debt repayments may become more accelerated than presented here. The potential failed remarketings coincide with the interest-rate reset dates and amounts noted above.

(in thousands of dollars)	
2013	$173,265
2014	3,550
2015	3,470
2016	3,700
2017	4,040
Thereafter	779,730
Total	**$967,755**

Bonds Payable

The Taxable-Series 2012 Fixed Rate Revenue Bonds were issued to pay the cost of acquiring, constructing, and equipping certain educational facilities of the University and pay certain costs relating to the issuance of the bonds, subject to conditions set forth in a trust indenture between the University and Wells Fargo Bank, National Association.

The IFA–Series 2008 Adjustable Rate Revenue Bonds were issued to acquire, construct, renovate, remodel, improve, and equip capital projects, subject to conditions set forth in a trust indenture and loan agreement between the University and the Illinois Finance Authority. The bonds may operate in a daily, weekly, adjustable, or auction-rate mode.

The IFA–Series 2006 Revenue Bonds were issued to refund the University's outstanding IEFA–Series 1997 Adjustable Medium-Term Revenue Bonds totaling $145 million. The refunding bonds are subject to conditions set forth in a trust indenture and loan agreement between the University and the Illinois Facilities Authority.

The IFA–Series 2004 Adjustable Rate Revenue Bonds were issued to acquire, construct, renovate, remodel, improve, and equip capital projects on both the Evanston and the Chicago campuses, subject to conditions set forth in a trust indenture and loan agreement between the University and the Illinois Finance Authority. The bonds may operate in a daily, weekly, adjustable, or auction-rate mode.

The IEFA–Series 2003 Fixed Rate Revenue Bonds were issued to acquire, construct, or renovate certain University facilities and to refund $35 million of the University's outstanding IEFA–Series 1993 bonds, subject to conditions set forth in a trust indenture and loan agreement between the University and the Illinois Facilities Authority.

The IEFA–Series 1993 Revenue Refunding Bonds operate in a fixed mode until maturity, currently bearing interest at a fixed rate of 5.5 percent. Proceeds of the refunding bonds were invested in United States government securities with a cost of $75.4 million and placed in escrow to satisfy scheduled payments of $66.4 million of the IEFA–Series 1985 bonds and related interest until maturity.

Based on Level 2 observable inputs, at August 31, 2012, the fair value of the University's fixed-rate debt of $582.7 million exceeded the carrying value of $537 million by $45.7 million. At August 31, 2011, the fair value of the University's fixed-rate debt of $365.5 million exceeded the carrying value of $340 million by $25.5 million.

Derivative Financial Instruments

The University has entered into interest-rate swap agreements to hedge variable-rate exposure related to its variable-rate debt. The agreements effectively fix the interest rates to a range from 4.2 percent to 4.38 percent. The notional value is $262.1 million through August 29, 2014, and reduces to $125 million effective August 30, 2014, through expiration on December 1, 2046.

In fiscal year 2011, the University executed amendments to interest-rate swap agreements with notional values of $45.2 million, $46.6 million, and $45.3 million. These amendments shortened the maturity date of these swaps to August 29, 2014, at no cost, at a cost of $60,000, and with receipt of $115,000 to do so, respectively.

The University recognized a net unrealized loss on the swap investment totaling $20 million at August 31, 2012, and a net unrealized gain of $21.6 million at August 31, 2011. The fair values of the swap position were in a liability position of $71.1 million and $51.1 million as of August 31, 2012, and 2011, respectively, and are included in accounts payable and accrued expenses on the consolidated statements of financial position.

Notes Payable

The University places commercial paper under a $300 million Taxable Commercial Paper Note.

Other Debt Payable

At August 31, 2012, the University held or had the ability to draw $300 million in standby lines of credit to supplement working capital requirements as follows:

(in thousands of dollars)

Expiration Date	Available credit
December 14, 2012[a]	$25,000
April 2, 2013	75,000
May 13, 2013	25,000
June 14, 2013	50,000
July 26, 2013	75,000
August 20, 2013	50,000
Total	**$300,000**

[a] *Renewed on December 14, 2012, through December 13, 2013*

9. Endowments

The FASB ASC Not-for-Profit Entities Presentation of Financial Statements Subtopic provides guidance on the net asset classification of donor-restricted endowment funds for not-for-profit organizations subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) and improves disclosure about an organization's endowment funds, both donor-restricted and board-designated, regardless of whether the organization is subject to UPMIFA.

The University interprets UPMIFA as requiring that the fair value of the original donor-restricted endowment gift be preserved as of the gift date unless there are explicit donor stipulations to the contrary. Therefore, the University classifies as permanently restricted net assets the original value of gifts donated to the permanent endowment, the original value of subsequent gifts, and accumulations to the permanent endowment made in accordance with the applicable donor gift instrument at the time the accumulation was added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for University expenditure in a manner consistent with UPMIFA's standard of prudence. In accordance with UPMIFA, the University considers the following factors in determining to appropriate or accumulate donor-restricted endowment funds:

- The duration and preservation of the endowment fund
- The purposes of the institution and of the endowment fund
- General economic conditions
- The possible effects of inflation or deflation
- The expected total return from income and appreciation of investments
- Other resources of the institution
- The institutional investment policy

The University's endowment consists of about 2,200 individual donor-restricted endowment funds and about 900 funds it designates to function as endowments. The net assets associated with endowment funds, including funds designated by the University to function as endowments, are classified and reported based on whether there are donor-imposed restrictions. Institution-designated endowment funds include quasi-endowments established by specific Board of Trustees approval as well as endowments created by management under general guidelines and policies approved by the Board of Trustees.

The following tables present the endowment net asset composition by type of fund at fair value for the years ended August 31, 2012, and 2011:

(in thousands of dollars) *August 31, 2012*

Endowment net asset composition by type of fund	Unrestricted	Temporarily restricted	Permanently restricted	Total
Donor-restricted endowment funds	($4,527)	$1,870,885	$1,055,210	$2,921,568
Institution-designated endowment funds	2,652,751			2,652,751
Total endowment funds	**$2,648,224**	**$1,870,885**	**$1,055,210**	**$5,574,319**

(in thousands of dollars) *August 31, 2011*

Endowment net asset composition by type of fund	Unrestricted	Temporarily restricted	Permanently restricted	Total
Donor-restricted endowment funds	($4,267)	$1,884,520	$983,605	$2,863,858
Institution-designated endowment funds	2,611,077			2,611,077
Total endowment funds	**$2,606,810**	**$1,884,520**	**$983,605**	**$5,474,935**

Investment and Spending Policies

The University's endowment is primarily invested in the Long-Term Balanced Pool, which is managed with the objective of long-term total return. The Investment Committee of the Board of Trustees annually reviews asset allocation policy for the pool.

The principal objective for the 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.

The Board of Trustees has adopted a guideline for the annual spending rate from the University's 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 4.35 percent of the market value of a unit in the pool, averaged for the 12 months ended October 31 of the prior fiscal year. 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 1.5 percent plus the actual rate of inflation. It is weighted at 70 percent in determining the total.

If investment income received is not sufficient to support the total-return objective, the balance is provided from realized and unrealized gains. If the 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.

Change In Endowment Net Assets

The following tables represent the changes in endowment net assets for the years ended August 31, 2012, and 2011:

(in thousands of dollars) *August 31, 2012*

	Unrestricted	Temporarily restricted	Permanently restricted	Total
Endowment net assets, beginning of year	$2,606,810	$1,884,520	$983,605	$5,474,935
Investment loss	(8,057)	(8,533)		(16,590)
Net appreciation (realized and unrealized)	106,994	113,858		220,852
Total investment return	98,937	105,325	—	204,262
Contributions		260	46,487	46,747
Appropriation of endowment assets for expenditure	(105,833)	(117,159)	—	(222,992)
Other changes				
Transfers to create institutional funds	147,087	—	—	147,087
Transfers of institutional funds per donor requirement	—	76	16,625	16,701
Spending of institution-designated endowment fund	(92,421)	—	—	(92,421)
Other reclassifications	(6,356)	(2,137)	8,493	—
Endowment net assets, end of year	**$2,648,224**	**$1,870,885**	**$1,055,210**	**$5,574,319**

(in thousands of dollars)				*August 31, 2011*
	Unrestricted	**Temporarily restricted**	**Permanently restricted**	**Total**
Endowment net assets, beginning of year	$2,230,469	$1,561,568	$934,903	$4,726,940
Investment loss	(6,695)	(7,542)		(14,237)
Net appreciation (realized and unrealized)	425,210	445,637		870,847
Total investment return	418,515	438,095	—	856,610
Contributions		542	37,514	38,056
Appropriation of endowment assets for expenditure	(103,132)	(114,497)		(217,629)
Other changes				
Transfers to create institutional funds	93,602			93,602
Transfers of institutional funds per donor requirement		1,282	13,333	14,615
Spending of institution-designated endowment fund	(37,259)	—	—	(37,259)
Other reclassifications	4,615	(2,470)	(2,145)	—
Endowment net assets, end of year	**$2,606,810**	**$1,884,520**	**$983,605**	**$5,474,935**

Underwater Endowment Funds

The University monitors endowment funds to identify those for which historical cost was more than fair value. As of August 31, 2012, and 2011, the historical cost for such accounts was approximately $74 million, and the fair value totaled $69 million and $70 million, respectively. Associated unrealized losses are recorded in the unrestricted net assets classification; subsequent gains increase unrestricted net assets.

10. Retirement Plans

The University maintains two contributory retirement plans for its eligible faculty and staff. The plans offer employees 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 $58.9 million and $56.6 million to the two plans in 2012 and 2011, respectively. It expects to contribute $61.2 million to the two plans in 2013.

The University currently sponsors a healthcare plan permitting retirees to continue participation on a "pay-all" basis. The retiree contribution is based on the average per-capita cost of coverage for the plan's entire 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 $14.2 million and $10.2 million at August 31, 2012, and 2011, respectively, and is included in accounts payable and accrued expenses on the consolidated statements of financial position.

The University recognizes an asset or a liability in the statements of financial position for the plans' overfunded or underfunded status. The asset or liability is the difference between the fair value of plan assets and the related benefit obligation, defined as the projected benefit obligation for pension plans and the accumulated postretirement benefit obligation for other postretirement benefit plans such as a retiree healthcare plan. The University recognizes actuarial gains or losses and prior service costs or credits in the statements of activities that arise during the period but are not components of net periodic benefit cost. The University measures defined-benefit plan assets and obligations as of the date of its fiscal year-end and makes specified disclosures for the upcoming fiscal year.

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, 2012*	*August 31, 2011*
Active employees not yet eligible	$7,421	$6,702
Active employees eligible	6,605	5,762
Retirees	1,484	1,686
Total	**$15,510**	**$14,150**

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

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Benefit obligation at beginning of year	$14,150	$14,864
Service cost (benefits attributed to employee service during the year)	774	806
Interest cost on accumulated postretirement benefit obligation	623	638
Actuarial loss (gain)	299	(907)
Benefits paid	(825)	(1,922)
Contributions from participants	489	671
Benefit obligation at end of year	**$15,510**	**$14,150**

The following table sets forth the change in plan assets:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Fair value of plan assets at beginning of year	—	—
Employer contribution	$336	$1,251
Benefits paid	(825)	(1,922)
Contributions from participants	489	671
Fair value of plan assets at end of year	**—**	**—**

The accrued benefit cost recognized in the consolidated statements of financial position, which is included in accounts payable and accrued expenses, was $15.5 million and $14.1 million at August 31, 2012, and 2011, respectively.

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

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Service cost (benefits attributed to employee service during the year)	$774	$806
Interest cost on accumulated postretirement benefit obligation	623	638
Amortization of prior service cost	54	109
Amortization of unrealized loss	209	296
Total	**$1,660**	**$1,849**

The following tables present key actuarial assumptions used in determining APBO as of August 31, 2012, and 2011.

First, the assumptions used to determine benefit obligations:

	August 31, 2012	*August 31, 2011*
Settlement (discount) rate	3.2%	4.5%
Weighted average rate of increase in future compensation levels	3%	4%
Current pre-65 health cost trend rate	7.75%	8%
Current post-64 health cost trend rate	7.75%	8%
Ultimate healthcare cost trend rate	5%	5%
Year when trend rate will reach ultimate trend rate	2023	2023

Next, the assumptions used to determine net periodic benefit cost:

	August 31, 2012	*August 31, 2011*
Discount rate	4.5%	4.4%
Weighted average rate of increase in future compensation levels	4%	4%
Current pre-65 health cost trend rate	8%	6%
Current post-64 health cost trend rate	8%	6%
Ultimate healthcare cost trend rate	5%	5%
Year when trend rate will reach ultimate trend rate	2023	2011

A one-percentage-point change in assumed healthcare cost trend rates would have had these effects in fiscal year 2012:

(in thousands of dollars)	*1% point decrease*	*1% point increase*
(Decrease) increase in total of service and interest cost	($103)	$118
(Decrease) increase in postretirement benefit obligation	(912)	1,026

Estimated future benefit payments reflecting anticipated service, as appropriate, are expected to be paid as shown below.

(in thousands of dollars)	
2013	$548
2014	545
2015	673
2016	780
2017	879
2018–2022	6,095
Total	**$9,520**

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. The University has recorded both an asset and a liability related to the deferred compensation plan that totaled $35.3 million and $28.8 million in fiscal years 2012 and 2011, respectively; these are included in investments and deposits payable and actuarial liability of annuities payable on the consolidated statements of financial position.

The University is required to disclose 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. Since the University chose not to pursue the subsidy, measures of the APBO or net periodic postretirement benefit cost do not reflect any amount associated with it in 2012 or prior years.

11. Related Parties

Members of the University's Board of Trustees, senior management, and faculty may on occasion be associated either directly or indirectly with entities doing business with the University. The University bylaws and conflict of interest policies establish guidelines for disclosure and regulation of such activities as circumstances warrant. When such associations exist, measures are taken to mitigate any actual or perceived conflict, in the best interests of the University. Transactions with related parties may include investment management, common membership in investment partnerships or other investment vehicles, or the purchase of goods or services.

Northwestern Medical Faculty Foundation (NMFF), a related party, 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 (Feinberg). 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. Accounts receivable from NMFF arise out of operational activities. Such receivables totaled $9.7 million and $14.1 million as of August 31, 2012, and 2011, respectively, and are included in accounts receivable on the consolidated statements of financial position. In addition, under the terms of an agreement with the 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 $47.1 million in fiscal year 2012 and $45.6 million in fiscal year 2011 and are included in private gifts on the consolidated statements of activities.

12. Self-Insurance Reserves and Other Contingencies

Reserves for losses under the University's self-insurance program, aggregating $11.6 million and $13.9 million at August 31, 2012, and 2011, respectively, include reserves for probable 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 2012 and 2011. 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 more or less than the amounts provided. These reserves are included in accounts payable and accrued expenses on the consolidated statements of financial position.

Under an agreement between the University and NMFF, a proportionate share of primary medical professional liability costs that arise out of events prior to November 1, 2004, 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.

The University has contracted to service student loans sold to a lending agency prior to fiscal year 2009; these totaled $84.4 million and $116.7 million at August 31, 2012, and 2011, respectively. Service revenues are the excess of the actual interest collected above the agreed-upon warehouse fees on the serviced loans. The University manages the program to break even and generates no servicing assets or liabilities through these activities. The University guarantees these loans against default up to 10 percent of the original domestic loan portfolio and 30 percent of the original international amounts. The maximum future total payments were $9.5 million as of August 31, 2012. At August 31, 2012, and 2011, $256,000 and $211,000, respectively, were reserved in anticipation of future defaults. Notes receivable on the consolidated statements of financial position are shown net of these reserves in fiscal years 2012 and 2011.

In August 2009, the University, as originating lender, began participation in a student loan securitization program. In 2009 and 2010, it sold student loans to a school trust totaling $65 million and $19.8 million, respectively; the University issued University guaranteed notes, which were purchased by a funding trust that procures financing to support the lending program. The programs are managed to break even and generate no servicing assets or liabilities. Guaranteed notes under these programs totaled $54.7 million and $65.1 million as of August 31, 2012, and 2011, respectively. In August 2012, the University placed an additional $22.5 million of student loans in another student loan securitization program. These loans are included in notes receivable and deposits payable on the consolidated statements of financial position. Reserves in anticipation of securitized student loan future defaults totaled $216,000 and $117,000 at August 31, 2012, and 2011, respectively. Notes receivable on the consolidated statements of financial position are shown net of this reserve in fiscal years 2012 and 2011.

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.

13. Grants and Contracts

Grants and contracts are summarized on the consolidated statements of activities as follows:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Federal grants	$406,375	$418,831
Private grants and contracts	118,385	113,145
State grants	10,289	5,547
Total grants and contracts	**$535,049**	**$537,523**

14. Allocation of Expenses

The University allocated accretion for asset retirement obligations (ARO), 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, 2012, and 2011. Those expenses have been distributed to the functional areas of the University as follows:

(in thousands of dollars)				*August 31, 2012*
	Accretion for ARO	**Depreciation**	**Plant maintenance**	**Interest on bond indebtedness**
Instruction	$790	$14,148	$19,119	$4,653
Research	1,484	26,606	35,957	8,751
Academic support	1,143	20,483	27,680	6,736
Student services	778	13,937	18,834	4,583
Institutional support	289	5,174	6,991	1,701
Auxiliary services	1,408	25,234	34,101	8,299
Total	**$5,892**	**$105,582**	**$142,682**	**$34,723**

(in thousands of dollars)				*August 31, 2011*
	Accretion for ARO	**Depreciation**	**Plant maintenance**	**Interest on bond indebtedness**
Instruction	$781	$13,870	$16,695	$4,089
Research	1,427	25,346	30,508	7,474
Academic support	1,102	19,566	23,550	5,768
Student services	764	13,572	16,336	4,001
Institutional support	313	5,556	6,688	1,638
Auxiliary services	1,378	24,469	29,453	7,214
Total	**$5,765**	**$102,379**	**$123,230**	**$30,184**

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

15. Natural Classification of Expenses

Operating expenses incurred in the fiscal years ended August 31, 2012, and 2011, were as follows:

(in thousands of dollars)	*August 31, 2012*	*August 31, 2011*
Salaries, wages, and benefits	$989,250	$947,924
Services and professional fees	280,550	248,869
Supplies	100,085	99,648
Travel and promotion	76,550	80,600
Trademark and royalty fees	41,339	38,062
Other expenses	37,533	30,200
Maintenance, utilities, and equipment	119,947	102,886
Accretion for asset retirement obligations	5,892	5,765
Interest on bond indebtedness	34,723	30,184
Depreciation	105,582	102,379
Total operating expenses	**$1,791,451**	**$1,686,517**

Administration and Trustees

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