

## THE UNIVERSITY OF VIRGINIA MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)

### Introduction

This discussion and analysis provides an overview of the financial position and results of activities of the University of Virginia for the year ended June 30, 2003. Comparative information for the year ended June 30, 2002, has been provided where applicable. This overview has been prepared by management and should be read in conjunction with the financial statements and the footnotes that follow this section. The referenced financial statements were prepared in accordance with Governmental Accounting Standards Board (GASB) principles. During fiscal year 2002, the University adopted GASB Statement 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*, as amended by subsequent GASB Statements 37 and 38. These GASB statements establish standards for the preparation of public college and university financial statements that focus on aggregate operations. The previous model, by contrast, focused on accountability of individual fund groups. As a result, these financial statements are not comparable to the financial statements for the fiscal years before 2002.

### Background

The University of Virginia is an agency of the Commonwealth of Virginia and is governed by the University's Board of Visitors. A separate report is prepared for the Commonwealth of Virginia that includes all agencies, boards, commissions, and authorities, over which the Commonwealth exercises or has the ability to exercise oversight authority. The University is a component unit of the Commonwealth of Virginia and is included in the basic financial statements of the Commonwealth.

A public institution of higher learning with approximately 19,200 students and 2,000 instructional and research faculty members in ten separate schools, the University offers a wide diversity of degree programs, including doctorates in fifty-five disciplines. The University is recognized internationally for the quality of its faculty and for its commitment to the primary academic missions of instruction, research, public service, and patient care. The University is consistently ranked among the nation's top universities, both for its general academic programs and for its strengths in specific disciplines. Its dedication to the student experience is extraordinary among major public institutions, and its dedication to new advances in research permeates all of its schools and colleges. The University's Health System also has a tradition of excellence in teaching, advancement of medical science, and patient care.

### Financial Highlights

The University's financial position remained strong at June 30, 2003, with total assets of \$4.5 billion and liabilities of \$1.0 billion. Increases in endowment assets and in net capital assets primarily account for the growth when comparing this year's total assets to 2002's total assets of \$3.9 billion. This is consistent with the performance of the endowment and the additional capital projects undertaken by the University. Net assets, which represent the residual interest in the University's assets after liabilities are deducted, are \$3.4 billion. This is a 6.9 percent increase over fiscal year 2002's restated net assets of \$3.2 billion. The growth in net assets is primarily attributable to a \$170 million increase in investment income over the prior year. Endowment performance came in at a healthy 9.2 percent for the year.

### Using the Financial Statements

The University's financial report includes three financial statements: the Statement of Net Assets, the Statement of Revenues, Expenses, and Changes in Net Assets, and the Statement of Cash Flows. As stated earlier, these financial statements are prepared in accordance with Governmental Accounting Standards Board (GASB) principles, which establish standards for external financial reporting for public colleges and universities, and require that financial statements be presented on a consolidated basis to focus on the university as a whole, with resources classified for accounting and reporting purposes into four net asset categories. Under these principles, revenues and expenses are categorized as either operating or non-operating. Significant recurring sources of the University's revenues, including state appropriations, gifts, and investment income are considered non-operating, as defined by GASB Statement 33. Consequently, the operating loss of \$267 million does not account for these normal revenue sources. Adding the net non-operating revenues of \$421 million for the fiscal year more than offsets the operating loss and results in an adjusted income figure of \$154 million. This provides a more accurate picture of the University's total scope of operations. Pledges from donors (excluding permanent endowments) are recorded as receivables and non-operating revenues at the date of the pledge. Both non-operating gift revenue and pledge receivables decreased slightly this year as more new gifts were received by the University's affiliated foundations.

### Statement of Net Assets (in thousands)

The Statement of Net Assets presents the financial position of the University at the end of the fiscal year and includes all assets and liabilities of the University. The difference between total assets and total liabilities—net assets—is one indicator of the current financial condition of the University, while the change in net assets is an indicator of whether the overall financial condition has improved or worsened during the year. Assets and liabilities are generally measured using current values. One notable exception is capital assets, which are stated at historical cost less an allowance for depreciation. A summary of the University's assets, liabilities, and net assets at June 30, 2003, and June 30, 2002 (restated), follows:

	2003		2002		INCREASE/(DECREASE)	
	AMOUNT	PERCENT	AMOUNT	PERCENT	AMOUNT	PERCENT
<b>SUMMARY OF THE STATEMENT OF NET ASSETS</b>						
<b>CURRENT ASSETS</b>	\$ 749,397		\$ 610,768		\$138,629	22.7%
<b>NON-CURRENT ASSETS:</b>						
Endowment and other long-term investments	2,462,273		2,109,906		352,367	16.7%
Capital assets, net	1,285,009		1,200,948		84,061	7.0%
Other	1,472		2,411		(939)	(38.9%)
<b>TOTAL ASSETS</b>	<b>4,498,151</b>		<b>3,924,033</b>		<b>574,118</b>	<b>14.6%</b>
Current liabilities	423,736		249,107		174,629	70.1%
Non-current liabilities	624,976		447,093		177,883	39.8%
<b>TOTAL LIABILITIES</b>	<b>1,048,712</b>		<b>696,200</b>		<b>352,512</b>	<b>50.6%</b>
<b>NET ASSETS</b>	<b>\$3,449,439</b>		<b>\$3,227,833</b>		<b>\$221,606</b>	<b>6.9%</b>

A review of the University's Statement of Net Assets at June 30, 2003, shows that the University continues to build upon its strong financial foundation. This financial health reflects the prudent utilization of its financial resources, including careful cost controls, effective management of its endowment, conservative utilization of debt, and adherence to its long-range capital plan for the maintenance and replacement of the physical plant.

**Current assets** consist primarily of cash, operating investments, and accounts receivable, which totaled \$749 million as compared to the previous year's \$611 million, a gain of \$138 million or 22.7 percent. This year the University participated again in the Securities Lending program, and the increase in security lending of \$156 million largely accounted for the increase in current assets.

**Current liabilities** consist primarily of accounts payable and obligations under securities lending. Securities lending affects both current assets as outlined above and current liabilities as explained in the footnote on Investment Risk. While total current liabilities increased to \$424 million, the majority of that increase resulted from participation in securities lending. Adjusting for this program, the remaining current liabilities rose 7.5 percent.

From a liquidity perspective, current assets cover current liabilities 1.77 times, an indicator of good liquidity. Current assets also cover six months of total operating expenses, including depreciation.

### Endowment and Other Investments

**Performance.** The major portion of the University's endowment is maintained in a single investment pool named the University Pooled Endowment Fund. The annual return for the Pooled Endowment Fund this year was 9.2 percent. Included in the calculation of this performance figure are realized and unrealized gains and losses, along with investment income. With this return, total investment income for all funds rose 871.5 percent or \$170 million.

**Distribution.** The University distributes endowment earnings in a way to balance the annual support required for operational needs against the requirement to preserve the purchasing power of the endowment for future periods. The endowment spending rate policy is approved by the Board of Visitors and is based on total return, not actual earnings. The total distribution for the Pooled Endowment Fund was \$83.1 million, consisting of \$17.6 million in current year's investment income and \$65.5 million in investment asset appreciation.

**Balance.** The total endowment investment balance on the Statement of Net Assets is \$1.96 billion. The University's portion is approximately \$1.79 billion, while the remainder of \$174 million comprises endowment assets held on behalf of affiliated foundations. At the end of the previous fiscal year, \$100 million of endowment assets were held on behalf of affiliated foundations. From a net assets perspective, earnings from the endowment, while expendable, are mostly restricted as to use by the donor. It is important to note that of the University's endowment funds, only \$523 million or 29 percent can be classified as unrestricted net assets. From this unrestricted endowment, a significant portion of the income is internally designated by the University for scholarships, fellowships, professorships, research efforts, and other important programs and activities. As of June 30, 2003, the remainder of the endowment (71 percent) was classified as restricted net assets with the breakdown being: \$313 million of restricted non-expendable net assets; \$962 million of restricted expendable net assets; and \$32 million of restricted life income funds.

### Capital and Debt Activities

One of the critical factors in continuing the quality of the University's academic and research programs and residential life is the development and renewal of its capital assets. The University continues to implement its long-range plan to modernize its older teaching and research facilities, balanced with new construction.

**Capital additions,** net of retirements, were \$148.9 million in 2003 and \$150.7 million in 2002. Capital additions primarily comprise replacement, renovation, and new construction of academic, research, and health care facilities, as well as significant investments in equipment, including information technology. Construction in process at June 30, 2003, included the building housing the Mary and David Harrison Institute for American History, Literature, and Culture and the Albert and Shirley Small Special Collections Library; expansion of the Cancer Center; expansion of the University Hospital; the John Paul Jones Arena; the Aquatic and Fitness Center addition; and the replacement of the Observatory Hill dining facility.

The University takes seriously its role of financial stewardship and works hard to manage its financial resources effectively, including the use of debt to finance capital projects. As evidence of its financial management, Moody's Investors Service has assigned the University its highest credit rating (Aaa) for bonds backed by a broad revenue pledge. Another service, Fitch, Inc., assigned the University its highest AAA rating. And this year, Standard and Poor's joined in assigning its AAA rating to the University. The University of Virginia is now one of only two public institutions with the highest bond ratings from all three agencies. Besides being an official acknowledgment of the University's strong financial position, these ratings enable the University to obtain future debt financing at optimum pricing. In March of 2003, the University issued \$200 million of bonds, under its own bond ratings, for the first time in recent history. Utilizing a mix of variable- and fixed-rate bonds, cost-effective financing was obtained. A portion, \$79.9 million, was used to advance-refund 1992 and 1993 outstanding bonds, resulting in a net present-value savings of \$6.95 million.

**Long-term debt** increased by \$103 million to \$439 million this year. This rise in long-term debt was planned and expected as the University embarked on several major capital projects.

### Net Assets (in thousands)

Net assets represent the residual interest in the University's assets after liabilities are deducted. The University's net assets at June 30, 2003, and 2002 are summarized below.

NET ASSETS	2003	2002	INCREASE/(DECREASE)	
			AMOUNT	PERCENT
<b>INVESTED IN CAPITAL ASSETS, NET OF RELATED DEBT</b>	\$ 917,924	\$ 871,844	\$ 46,080	5.3%
<b>RESTRICTED:</b>				
Non-expendable	311,779	282,719	29,060	10.3%
Expendable	1,275,452	1,215,091	60,361	5.0%
<b>UNRESTRICTED</b>	944,284	858,179	86,105	10.0%
<b>TOTAL NET ASSETS</b>	<b>\$3,449,439</b>	<b>\$3,227,833</b>	<b>\$221,606</b>	<b>6.9%</b>

Net assets invested in capital assets, net of related debt, represent the University's capital assets net of accumulated depreciation and outstanding principal balances of debt attributable to the acquisition, construction, or improvement of those assets.

Restricted non-expendable net assets comprise the University's permanent endowment funds. These are stated at original cost and exclude earnings and gains and losses.

Restricted expendable net assets are subject to externally imposed restrictions governing their use. This category of net assets includes earnings from permanent endowment funds that can be spent, but only in accordance with restrictions imposed by external parties.

Although unrestricted net assets are not subject to externally imposed stipulations, a portion of the University's unrestricted net assets has been designated for various academic and research programs and initiatives, as well as capital projects, and built into the ongoing budget.

### Statement of Revenues, Expenses, and Changes in Net Assets (in thousands)

The Statement of Revenues, Expenses, and Changes in Net Assets presents the University's results of operations. Given below is a summarized statement of the University's revenues, expenses, and changes in net assets for the years ended June 30, 2003, and June 30, 2002.

SUMMARY OF THE STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS	2003	2002	INCREASE/(DECREASE)	
			AMOUNT	PERCENT
Operating revenues	\$1,225,850	\$1,115,255	\$110,595	9.9%
Operating expenses	1,492,882	1,456,795	36,087	2.5%
<b>OPERATING INCOME (LOSS)</b>	<b>(267,032)</b>	<b>(341,540)</b>	<b>74,508</b>	<b>21.8%</b>
<b>NON-OPERATING REVENUES (EXPENSES):</b>				
State appropriations	140,826	176,053	(35,227)	(20.0%)
Gifts	70,544	78,698	(8,154)	(10.4%)
Investment income	189,702	19,527	170,175	871.5%
Other net non-operating revenues	19,513	744	18,769	2,522.7%
<b>NET NON-OPERATING REVENUES</b>	<b>420,585</b>	<b>275,022</b>	<b>145,563</b>	<b>52.9%</b>
<b>INCOME BEFORE OTHER REVENUES, EXPENSES, GAINS OR LOSSES</b>	<b>153,553</b>	<b>(66,518)</b>	<b>220,071</b>	<b>330.8%</b>
Capital appropriations, gifts, and grants	37,883	28,104	9,779	34.8%
Additions to permanent endowments	30,170	63,701	(33,531)	(52.6%)
<b>TOTAL OTHER REVENUES</b>	<b>68,053</b>	<b>91,805</b>	<b>(23,752)</b>	<b>(25.9%)</b>
Increase in net assets	221,606	25,287	196,319	776.4%
Net assets—beginning of year (restated)	3,227,833	3,202,546	25,287	0.8%
<b>NET ASSETS—END OF YEAR</b>	<b>\$3,449,439</b>	<b>\$3,227,833</b>	<b>\$221,606</b>	<b>6.9%</b>

One of the University's greatest strengths is its well-balanced stream of revenues, which allows it to weather difficult economic times.

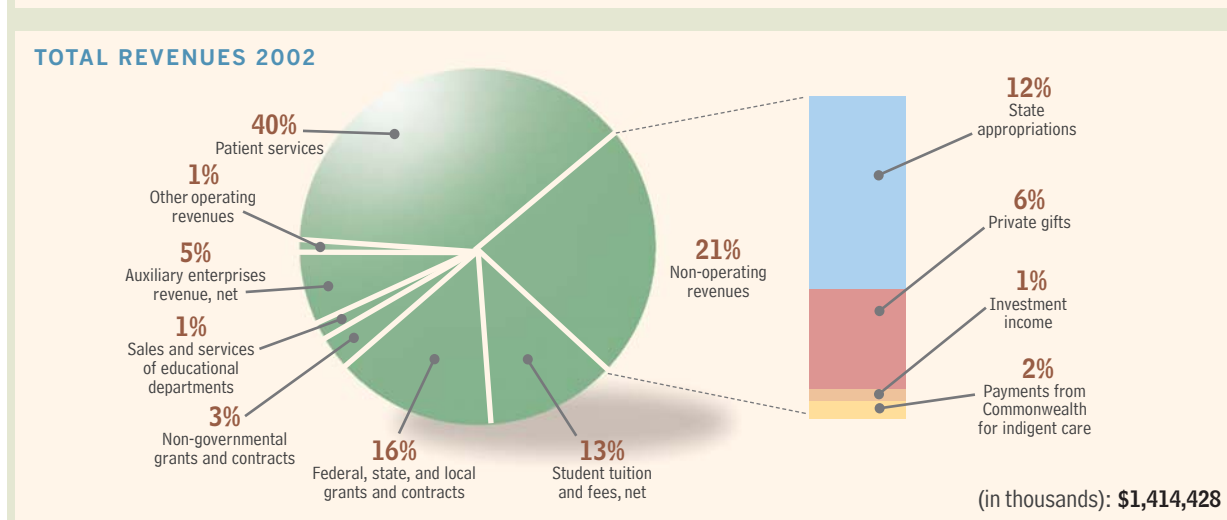
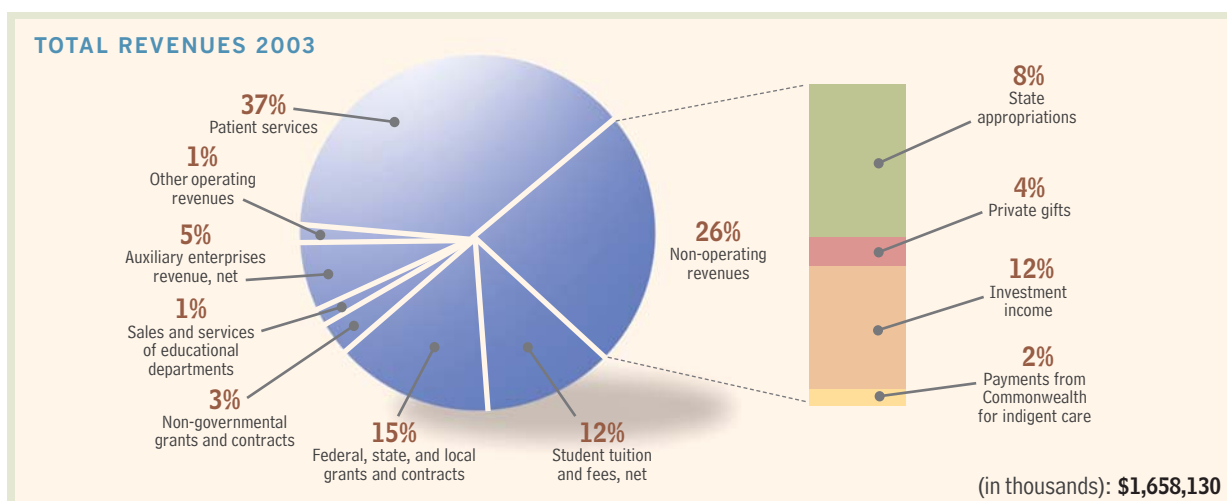
On the following page is a graphic illustration of revenues by source (both operating and non-operating), which are used to fund the University's operating activities for the fiscal years ended June 30, 2003, and 2002. As noted previously, GASB Statement 33 requires state appropriations, gifts, and other significant revenues to be treated as non-operating revenues. However, since these revenues support operating expenses they are included in the charts.

Summary of Revenues, Total University (in thousands)

OPERATING REVENUES	2003	2002	INCREASE/(DECREASE)	
			AMOUNT	PERCENT
Student tuition and fees, net	\$ 204,092	\$ 177,913	\$ 26,179	14.7%
Federal, state, and local grants and contracts	253,733	218,223	35,510	16.3%
Non-governmental grants and contracts	46,573	43,539	3,034	7.0%
Sales and services of educational departments	19,905	19,773	132	0.7%
Auxiliary enterprises revenue, net	81,672	77,070	4,602	6.0%
Other operating revenues	13,192	10,365	2,827	27.3%
Patient services	606,683	568,372	38,311	6.7%
<b>TOTAL OPERATING REVENUES</b>	<b>1,225,850</b>	<b>1,115,255</b>	<b>110,595</b>	<b>9.9%</b>
NON-OPERATING REVENUES				
State appropriations	140,826	176,053	(35,227)	(20.0%)
Private gifts	70,544	78,698	(8,154)	(10.4%)
Investment income	189,702	19,527	170,175	871.5%
Payments from Commonwealth for indigent care	31,208	21,195	10,013	47.2%
Other non-operating revenues	-	3,700	(3,700)	(100.0%)
<b>TOTAL NON-OPERATING REVENUES</b>	<b>432,280</b>	<b>299,173</b>	<b>133,107</b>	<b>44.5%</b>
<b>TOTAL UNIVERSITY REVENUES</b>	<b>\$1,658,130</b>	<b>\$1,414,428</b>	<b>\$243,702</b>	<b>17.2%</b>

Patient services revenues accounted for 37 percent of the University's operating and non-operating revenues combined. Additionally, state appropriations and student tuition and fees, which represent 8 percent and 12 percent of the University's total revenues, respectively, are used to fund current operations.

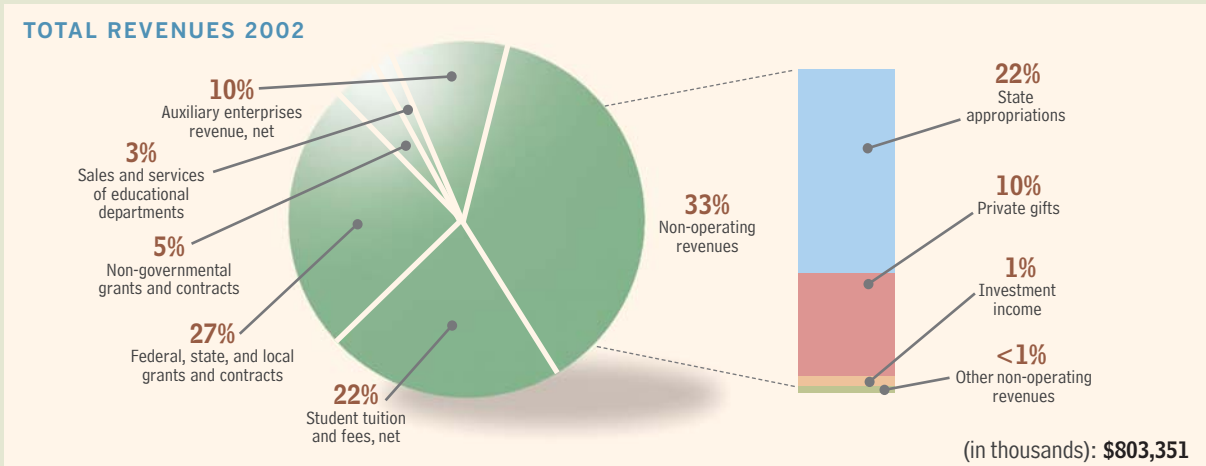
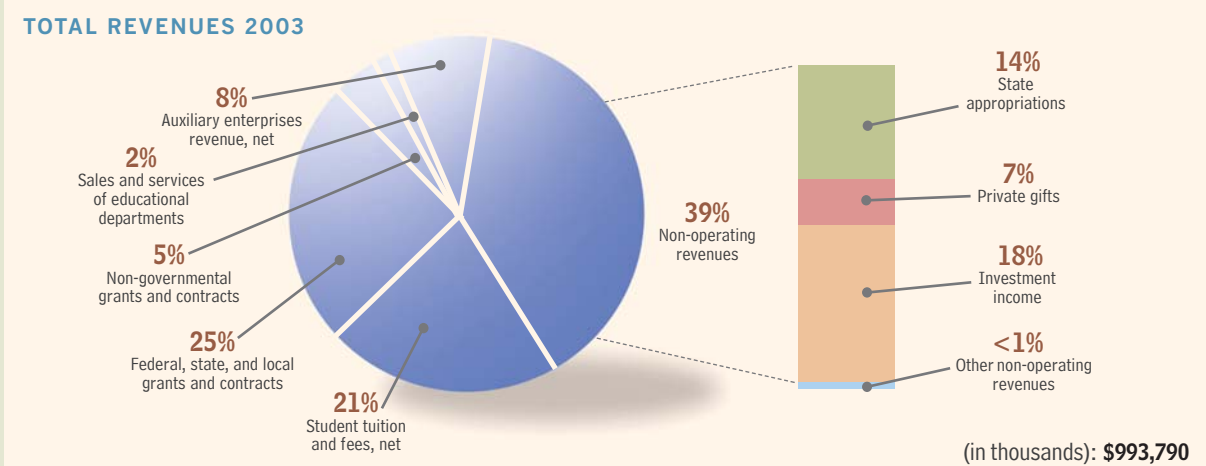
On further examination, state appropriations decreased by \$35 million or 20 percent. This decrease continues a trend of decreased state funding for operations. On the other hand, net tuition and fees increased by \$26 million or 14.7 percent. The Board of Visitors approved a tuition and fee increase last year to help offset the continued reductions in state funding.



**Summary of Revenues, Excluding the Medical Center (in thousands)**

The University measures its performance both for the University as a whole and for the University without its Medical Center. The exclusion of the University's Medical Center allows a clearer view of the operations of the schools and colleges, as well as the central administration. The following is a graphic illustration of University revenues by source (both operating and non-operating), which are used to fund operating activities other than the hospitals, health centers, and similar activities, for the years ended June 30, 2003, and 2002.

OPERATING REVENUES	2003	2002	INCREASE/(DECREASE)	
			AMOUNT	PERCENT
Student tuition and fees, net	\$204,092	\$177,913	\$26,179	14.7%
Federal, state, and local grants and contracts	253,733	218,223	35,510	16.3%
Non-governmental grants and contracts	46,573	43,539	3,034	7.0%
Sales and services of educational departments	19,905	19,773	132	0.7%
Auxiliary enterprises revenue, net	81,672	77,070	4,602	6.0%
<b>TOTAL OPERATING REVENUES</b>	<b>605,975</b>	<b>536,518</b>	<b>69,457</b>	<b>12.9%</b>
NON-OPERATING REVENUES				
State appropriations	140,826	176,053	(35,227)	(20.0%)
Private gifts	70,160	78,258	(8,098)	(10.3%)
Investment income	175,684	9,290	166,394	1,791.1%
Other non-operating revenues	1,145	3,232	(2,087)	(64.6%)
<b>TOTAL NON-OPERATING REVENUES</b>	<b>387,815</b>	<b>266,833</b>	<b>120,982</b>	<b>45.3%</b>
<b>TOTAL ACADEMIC REVENUES</b>	<b>\$993,790</b>	<b>\$803,351</b>	<b>\$190,439</b>	<b>23.7%</b>



Excluding the Medical Center illustrates that the other revenue streams are balanced but changing. Major sources for 2003 included federal, state, and local grants and contracts, 25 percent; net tuition and fees, 21 percent; investment income, 18 percent; and state appropriations, 14 percent. These percentages show a shift from the previous fiscal year, when 22 percent was provided by state appropriations and only 1 percent was provided by investment income. As noted earlier, state appropriations continue to decrease, while the performance of the endowment in 2003 was very strong.

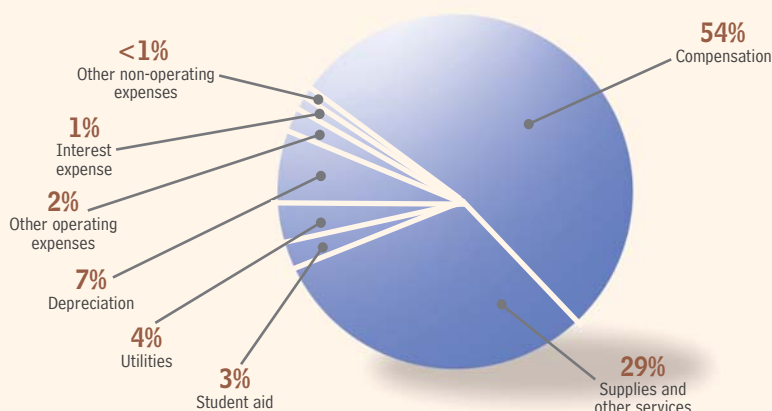
The University continues to make revenue diversification, along with cost containment, an ongoing priority. This is necessary as the University continues to face significant financial pressure with state budget reductions, increased compensation and benefit costs, and escalating technology and energy prices. While tuition and state appropriations fund 35 percent of the University's academic division costs, private support has been, and will continue to be, essential to the University's academic excellence. Private support comes in the form of gifts, additions to permanent endowment, and investment income. Revenues for all sponsored programs increased \$38.5 million, or 14.7 percent, to a total of \$300.3 million in 2003. While all schools are integral to the research mission of the University, the School of Medicine accounts for about 60 percent of all grant and contract awards.

**Summary of Expenses, Total University (in thousands)**

A summary of the University's expenses for the years ended June 30, 2003, and 2002 appears below.

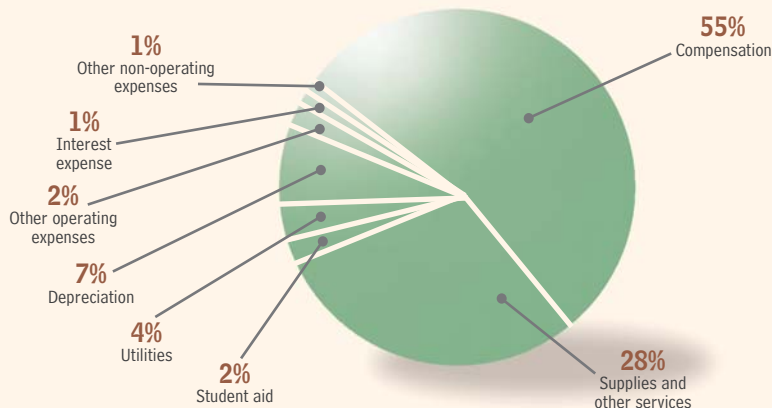
OPERATING EXPENSES	2003	2002	INCREASE/(DECREASE)	
			AMOUNT	PERCENT
Compensation	\$ 822,201	\$ 831,980	\$(9,779)	(1.2%)
Supplies and other services	448,985	411,139	37,846	9.2%
Student aid	37,738	34,155	3,583	10.5%
Utilities	58,718	56,204	2,514	4.5%
Depreciation	99,915	98,628	1,287	1.3%
Other operating expenses	25,325	24,689	636	2.6%
<b>TOTAL OPERATING EXPENSES</b>	<b>1,492,882</b>	<b>1,456,795</b>	<b>36,087</b>	<b>2.5%</b>
<b>NON-OPERATING EXPENSES</b>				
Interest expense	11,467	12,038	(571)	(4.7%)
Other non-operating expenses	228	12,113	(11,885)	(98.1%)
<b>TOTAL NON-OPERATING EXPENSES</b>	<b>11,695</b>	<b>24,151</b>	<b>(12,456)</b>	<b>(51.6%)</b>
<b>TOTAL UNIVERSITY EXPENSES</b>	<b>\$1,504,577</b>	<b>\$1,480,946</b>	<b>\$23,631</b>	<b>1.6%</b>

**TOTAL EXPENSES 2003**



(in thousands): **\$1,504,577**

**TOTAL EXPENSES 2002**



(in thousands): **\$1,480,946**

Compensation (salaries and benefits) decreased slightly from 55 percent to 54 percent of total expenses. This slight decrease reflects last year's budget reductions and the University's implementation of a hiring freeze. Student aid expense increased from 2 percent to 3 percent, reflecting an increase of \$3.6 million; this expense was expected as the University continued its commitment to meet 100 percent of need and as the total cost of attendance increased. Depreciation increased slightly by \$1.3 million. Interest expense remained at just 1 percent of total University expenditures. The relative stability in interest costs was the result of advance refunding of bonds, both by the University and by the Commonwealth. This resulted in the retirement of higher-cost debt, which was replaced by lower-cost debt.

In addition to their natural (object) classification, it is also informative to review operating expenses by function. A complete matrix of expenses, natural versus functional, is contained in the footnotes to the financial statements. Expenses for patient services, instruction, and research account for 41 percent, 15 percent, and 17 percent, respectively, of total operating expenses. When combined, these major functions account for 73 percent of the total, which is consistent with the mission-critical nature of instruction, research, and patient services for the University.

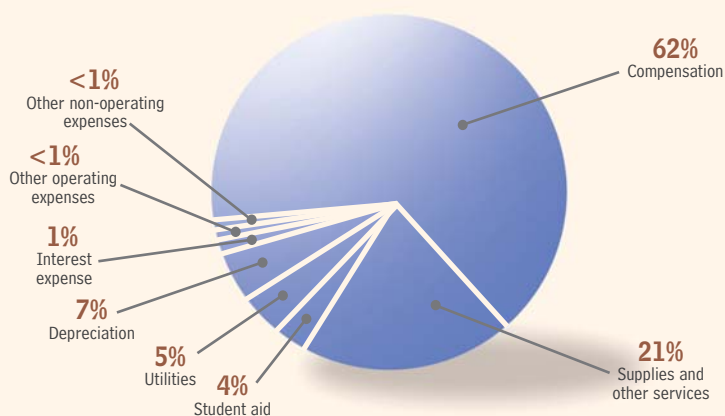


**Summary of Expenses, Excluding the Medical Center (in thousands)**

A summary of the University's expenses for the years ended June 30, 2003, and 2002, excluding the Medical Center, appears below. The exclusion of the Medical Center provides a more focused view of the expenses of the schools and colleges, as well as the central administration.

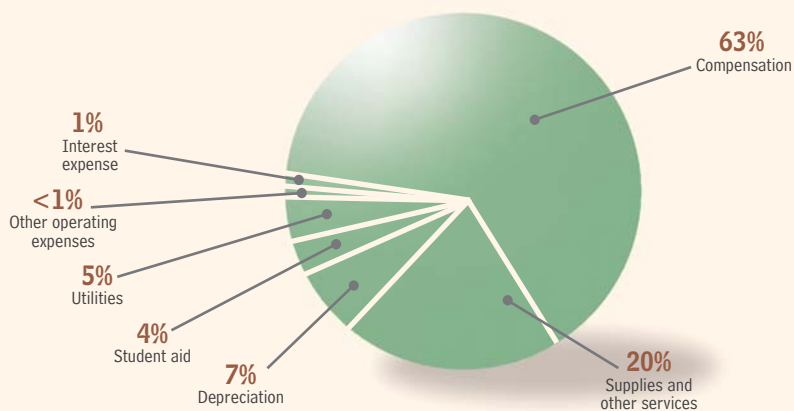
OPERATING EXPENSES	2003	2002	INCREASE/(DECREASE)	
			AMOUNT	PERCENT
Compensation	\$544,870	\$546,362	\$ (1,492)	(0.3%)
Supplies and other services	188,327	174,853	13,474	7.7%
Student aid	37,738	34,155	3,583	10.5%
Utilities	47,203	45,185	2,018	4.5%
Depreciation	63,942	64,266	(324)	(0.5%)
Other operating expenses	2,466	2,168	298	13.7%
<b>TOTAL OPERATING EXPENSES</b>	<b>884,546</b>	<b>866,989</b>	<b>17,557</b>	<b>2.0%</b>
<b>NON-OPERATING EXPENSES</b>				
Interest expense	7,039	7,424	(385)	(5.2%)
Other non-operating expenses	840	-	840	-
<b>TOTAL NON-OPERATING EXPENSES</b>	<b>7,879</b>	<b>7,424</b>	<b>455</b>	<b>6.1%</b>
<b>TOTAL ACADEMIC EXPENSES</b>	<b>\$892,425</b>	<b>\$874,413</b>	<b>\$18,012</b>	<b>2.1%</b>

**TOTAL EXPENSES 2003**



(in thousands): **\$892,425**

**TOTAL EXPENSES 2002**



(in thousands): **\$874,413**

## Statement of Cash Flows

The Statement of Cash Flows provides additional information about the University's financial results, by reporting the major sources and uses of cash. GASB principles define four major sources of cash flows: cash flows from operating activities, cash flows from non-capital financing activities, cash flows from capital and related financing activities, and cash flows from investing activities.

This statement provides a slightly different financial perspective from the Statement of Revenues, Expenses, and Changes in Net Assets. On the latter statement, state appropriations, gifts, and investment income are considered non-operating revenues. However, on the Cash Flow Statement, state appropriations and gifts are reflected under non-capital financing activities, while investment income resides under investing activities. These cash inflows are critical to funding the operations of the University.

SUMMARY OF STATEMENT OF CASH FLOWS (in thousands)				
	2003	2002	INCREASE/(DECREASE)	
			AMOUNT	PERCENT
Cash flows from operating activities	\$(134,114)	\$(204,593)	\$70,479	34.5%
Cash flows from non-capital financing activities	270,446	294,422	(23,976)	(8.1%)
Cash flows from capital and related financing activities	(39,192)	(104,821)	65,629	62.6%
Cash flows from investing activities	(61,997)	45,674	(107,671)	(235.7%)
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>\$ 35,143</b>	<b>\$ 30,682</b>	<b>\$ 4,461</b>	<b>14.5%</b>

## Future Economic Outlook

Executive management believes that the University is well positioned to maintain and enhance its strong financial condition, and to continue providing excellent programs and service to all of its constituents. The University's financial position, as evidenced by the highest credit rating obtainable, provides a high degree of flexibility in obtaining capital funds on the most competitive terms. To fund its capital projects, the University anticipates issuing more bonds in the upcoming fiscal year. In addition, the Board of Visitors has authorized a short-term commercial paper program of up to \$100 million. The judicious use of long-term bonds and the creation of the short-term commercial paper program will enable the University to obtain the necessary resources to support and maintain its high level of excellence.

The University will continue to face competitive pressures related to attracting and retaining leading faculty and staff. The cost of the University's health benefits has increased significantly and will probably continue to increase as the cost of medical care and prescription drugs are forecast to rise.

A major factor in the University's future will continue to be its relationship with the Commonwealth of Virginia. There is a direct relationship between the decrease in state support and the University's ability to enhance its core academic programs. For the first time, the University's 2004 operating budget will have a higher amount of private funding than state funding. As state appropriations continue to decrease, the University will look to increase two other sources of revenue: 1) philanthropic support and 2) tuition. The University will move forward with its plan for a capital campaign on a scale unprecedented in its history, and it will critically examine the use of increased tuition to help offset the state reductions. The Board of Visitors approved a mid-year increase in tuition last year and is currently assessing its pricing policy for the long term.

The University continues to execute its long-range plan to modernize and expand its complement of older teaching and research facilities with new construction. This strategy incorporates the University's growth plans and the continuing effects of technology on teaching and research methodologies. With last year's passage of the state's bonds for higher education construction, funds were made available to help the University meet some of these critical needs. Moreover, the University issued \$200 million of its own general revenue pledge bonds in March 2003, and is planning to make another issuance sometime in spring 2004. The Board of Visitors has endorsed a proposal to facilitate new research in line with the Governor's request and the University's own mission.

The University's Medical Center is well positioned, but ongoing constraints on revenue are expected with the unfunded demands to serve indigent patients and fiscal pressures created by new federal and state legislation. The Medical Center has begun a major expansion of its University Hospital facility. The expansion will increase the number of operating rooms and thereby increase patient census and net revenue. Management believes that much of the payment pressure can be offset by growth in patient volume and continued efforts to contain certain growth in expenses.

The University will continue to employ its long-term investment strategy to maximize total returns, at an appropriate level of risk, while utilizing a spending rate policy to insulate the University's operations from temporary market volatility.

The University's philosophy will always stress the undergraduate, residential college experience. With exceptionally strong student demand for admission to the University's programs, and with anticipated statewide growth in the number of college-eligible students, the University plans to increase its undergraduate enrollment at a modest rate over the next ten years.

Taken together, the development of a new relationship with the Commonwealth of Virginia, the creation of a long-range tuition plan, the beginning of a new capital campaign, and a continuing commitment to the core values of its founder will serve the University well in the decade to come.