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, 2007. Comparative information for the year ended June 30, 2006, 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 University of Virginia is an agency of the Commonwealth of Virginia and is governed by the University's Board of Visitors. The Commonwealth prepares a separate financial report that incorporates all agencies, boards, commissions, and authorities over which the Commonwealth exercises or has the ability to exercise oversight authority. The University, consisting of three major divisions, is a component unit of the Commonwealth of Virginia and is included in the Commonwealth's *Comprehensive Annual Financial Report*. The University of Virginia's three divisions are its Academic Division, Medical Center, and the College at Wise.

Academic Division

A public institution of higher learning with 20,834 students and 2,140 instructional and research faculty members in ten separate schools, the University offers a diverse range of degree programs, including doctorates in fifty-eight disciplines. The University is recognized internationally for the quality of its faculty and for its commitment to the primary academic missions of instruction, research, and public service. The University consistently ranks among the nation's top public colleges and universities, both for its general academic programs and for its strengths in specific disciplines. Its emphasis on the student experience is extraordinary among major public institutions, and its dedication to new advances in research permeates all of its schools and colleges.

Medical Center

The University of Virginia Medical Center is an integrated network of primary and specialty care services ranging from wellness programs and routine checkups to the most technologically advanced care. The hub of the Medical Center is a hospital with more than 500 beds in operation and a state-designated Level 1 trauma center. In addition, primary and specialty care are provided at convenient clinic locations throughout central Virginia communities.

College at Wise

Located in southwestern Virginia, the College at Wise is a public liberal arts college with 1,911 students and 140 instructional faculty members. It offers twenty-nine majors, including preprofessional programs in dentistry, forestry, law, medicine, physical therapy, and veterinary medicine. Degrees include the bachelor of arts, the bachelor of science, and the bachelor of science in nursing.

Higher Education Restructuring

On July 1, 2006, Virginia higher education formally entered the new era created by the Restructured Higher Education Financial and Administrative Operations Act, which gives all sixteen public colleges and universities new freedom from state control in areas such as spending, tuition, and personnel management while also requiring the schools to meet specific goals set by the state. The University of Virginia has been granted the highest of three levels of autonomy available under the new system.

The management agreement that the University has executed with the state reestablishes its authority not only to set its own tuition for a more stable funding stream, but also makes possible the establishment of streamlined processes in the areas of finance and accounting, construction and leasing, information technology, procurement, and human resources. In exchange for greater autonomy, the University has agreed to meet several state goals, including submitting a six-year financial plan for General Assembly approval every two years, meeting financial and administrative performance standards, working actively with K-12 schools to improve student achievement, stimulating economic development in distressed areas of the state, meeting enrollment demands, making college affordable for all Virginia students, and enrolling more transfer students from Virginia's community colleges.

FINANCIAL HIGHLIGHTS

For the fiscal year ended June 30, 2007:

• The Board of Visitors has committed to increasing faculty compensation, with a goal to rank in the top twenty among the Association of American Universities (AAU) institutions. As a result of these compensation increases, the University has already raised its AAU faculty compensation ranking from thirtieth in 2002–03 to a tie for twentieth in 2006–07.

• The University received its largest single gift ever this past year from alumnus Frank Batten. With this $100 million gift, the University will create a new school called the Frank Batten School for Leadership and Public Policy. The primary goal of the Batten School will be to supply the nation with visionary leaders who can drive the policy innovation process, energize organizations, build inclusive coalitions and translate good ideas into action.

• The Board of Visitors approved our first debt derivatives, to lock in an interest rate for our anticipated bond issuance in spring 2008, using derivatives contracts established in 2003 and governed by the University's Debt and Interest Rate Risk Policies.

• The Board of Visitors adjusted the endowment spending rate to 4.5 percent after year end to provide additional restricted and unrestricted funds to its schools and departments beginning with the fiscal year ending June 30, 2008.

As a result of these strategic decisions and its day-to-day operations, the University realized a significant increase in net assets of $907 million. Some of the factors that led to this increase in net assets are outlined in the summary table below.

SUMMARY OF THE INCREASE IN NET ASSETS *(in thousands)*	2007	2006	INCREASE AMOUNT	INCREASE PERCENT
Total revenues before investment income	$ 2,124,426	$ 1,871,207	$ 253,219	13.5%
Total expenses	1,938,821	1,841,553	97,268	5.3%
Increase in net assets before investment income	**185,605**	**29,654**	**155,951**	**525.9%**
Investment income	721,505	367,761	353,744	96.2%
TOTAL INCREASE IN NET ASSETS	**$ 907,110**	**$ 397,415**	**$ 509,695**	**128.3%**

• Revenues before investment income rose 13.5 percent against a rise in expenditures of 5.3 percent, leading to an overall increase before investment income of $156 million.

• Annual investment income almost doubled from $368 to $722 million as the University's endowment investments earned a 25 percent return for the fiscal year.

• The investment income helped net assets increase by $907 million, which was $510 million, or 128 percent, more than last year's increase in net assets.

• The total return on net assets was 20.4 percent.

Overall, the primary factor in the University's net asset growth continues to be the performance of the endowment and its resultant investment income.

USING THE FINANCIAL STATEMENTS

The University's financial report includes five financial statements and related notes:

1. The Statement of Net Assets for the University of Virginia
2. The Combined Statements of Financial Position for the Component Units of the University of Virginia
3. The Statement of Revenues, Expenses, and Changes in Net Assets for the University of Virginia
4. The Combined Statements of Activities for the Component Units of the University of Virginia
5. The Statement of Cash Flows for the University of Virginia

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. These principles 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. Although seven related foundations are reported in the component unit financial statements, identified under guidance from GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, this Management's Discussion and Analysis excludes them except where specifically noted.

STATEMENT OF NET ASSETS

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, 2007, and June 30, 2006 (restated), follows.

SUMMARY OF THE STATEMENT OF NET ASSETS *(in thousands)*	2007	2006	INCREASE	
			AMOUNT	PERCENT
Current assets	$ 1,194,340	$ 922,607	$ 271,733	29.5%
Noncurrent assets				
Endowment and other long-term investments	3,354,704	2,773,862	580,842	20.9%
Capital assets, net	1,811,254	1,642,295	168,959	10.3%
Other	114,290	107,309	6,981	6.5%
Total assets	**6,474,588**	**5,446,073**	**1,028,515**	**18.9%**
Current liabilities	558,853	437,379	121,474	27.8%
Noncurrent liabilities	560,710	560,779	(69)	(0.0%)
Total liabilities	**1,119,563**	**998,158**	**121,405**	**12.2%**
NET ASSETS	**$ 5,355,025**	**$ 4,447,915**	**$ 907,110**	**20.4%**

This summary shows that the University's financial condition continues to strengthen, primarily due to the increasing value of the endowment and the endowment's continued strong returns.

CURRENT ASSETS AND LIABILITIES

Current assets, which totaled $1.2 billion as compared to the previous year's $923 million, consist primarily of cash and cash equivalents, short-term investments, and accounts receivable. The increase in current assets of $272 million, or 29.5 percent, resulted primarily from an increase of $140 million in cash and cash equivalents, and an increase of $112 million in short-term investments. These increases were a direct result of an increase in gift revenues and a 5.4 percent aggregate cash performance with the University of Virginia Investment Managment Company (UVIMCO).

Current liabilities, which consist primarily of accounts payable, obligations under securities lending, deferred revenue, and commercial paper, increased by $121 million, or 27.8 percent. There were two major reasons for this change. The University issued additional commercial paper this year for bridge financing purposes on a number of construction projects, for an increase of $38 million. Accounts payable and other accrued liabilities increased by $52 million, or 27.5 percent. This increase was mainly due to additional accrued compensation at June 30.

From a liquidity perspective, current assets cover current liabilities 2.1 times, an indicator of good liquidity and the ability to weather short-term demands on working capital. This rate of coverage remains virtually unchanged from last year. Current assets also cover seven and a half months of total operating expenses, including depreciation, an increase over last year's six months of coverage.

ENDOWMENT AND OTHER INVESTMENTS

Performance. At June 30, 2007, the major portion of the University's endowment was maintained in a long-term investment pool managed by UVIMCO. The annual return for the long-term investment pool this year was 25 percent, a significant improvement compared with last year's return of 14.6 percent. Included in the calculation of this performance figure are realized and unrealized gains and losses, along with cash income. With this return, total investment income rose $354 million, or 96.2 percent.

Distribution. The University distributes endowment earnings with the objective of balancing the annual support needed for operational purposes against the preservation of the future purchasing power of the endowment. The endowment spending policy is approved by the Board of Visitors and is based on total return, not just cash earnings. The total distribution for the University's endowment was $100 million, an increase of $8 million over last year's distribution of $92 million. This increase is due to the continued growth of the University's endowment.

Endowment investments. The total for endowment investments on the Statement of Net Assets is $3.1 billion, an increase from last year's $2.5 billion.

From a net assets perspective, earnings from the endowment, while expendable, are mostly restricted as to use by the donors. It is important to note that of the University's endowment funds, only $864 million, or 28 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, and research activities.

Including endowment investments held by the seven related foundations reported as component units, the combined University system endowment was approximately $4.4 billion as of June 30, 2007.

CAPITAL AND DEBT ACTIVITIES

One of the critical factors in sustaining 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, construct new facilities, and fund its deferred maintenance commitments.

Capital additions before depreciation were $313 million in 2007. 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.

Projects that were in progress at June 30, 2007, included the South Lawn Project, the Arts Grounds Parking Garage, the Rouss Hall Complex for the McIntire School of Commerce, the Carter-Harrison Research Building for the School of Medicine, the Campbell Hall additions, the Claude Moore Nursing Education Building, the Observatory Hill Residence Hall, Ruffin Hall, the U.Va. Hospital expansion and renovation, and the Varsity Hall renovation. Also, the John Paul Jones Arena was completed and opened for business in July 2006.

Other projects in the design stage at June 30, 2007, include Bavaro Hall, the Claude Moore Medical Education Building, the U.Va. Hospital bed expansion and infrastructure project, the Emily C. Couric Clinical Cancer Center, and the College at Wise's Arts Center and Crockett Hall.

Financial stewardship requires the effective management of resources, including the use of debt to finance capital projects. As evidence of the University's financial strength, Moody's Investors Service has assigned the University its highest credit rating (Aaa) for bonds backed by a broad revenue pledge. Standard and Poor's and Fitch Ratings have also assigned their AAA ratings to the University. The University of Virginia is one of only two public institutions with the highest bond ratings from all three agencies. Besides being an official acknowledgement of the University's financial strength, these ratings enable the University to obtain debt financing at optimum pricing. In addition to issuing its own bonds, the University is utilizing its commercial paper program for short-term bridge financing.

The University's debt portfolio contains a strategic mix of both variable- and fixed-rate obligations. In December 2006, when tax-exempt borrowing rates, both spot and forward rates, fell to thirty-year lows, the University executed its first debt derivative to hedge the anticipated bond issuance in spring 2008. The University executed a forward rate lock, which was permitted by University policy, to protect itself from potential future increases in interest rates.

NET ASSETS

Net assets represent the residual interest in the University's assets after liabilities are deducted. The University's net assets at June 30, 2007, and June 30, 2006 (restated), are summarized below.

NET ASSETS *(in thousands)*	2007	2006	INCREASE	
			AMOUNT	PERCENT
Invested in capital assets, net of related debt	$ 1,226,529	$ 1,116,746	$ 109,783	9.8%
Restricted				
Nonexpendable	369,874	350,474	19,400	5.5%
Expendable	2,203,057	1,701,167	501,890	29.5%
Unrestricted	1,555,565	1,279,528	276,037	21.6%
TOTAL NET ASSETS	**$ 5,355,025**	**$ 4,447,915**	**$ 907,110**	**20.4%**

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. Net capital assets increased $110 million, or 9.8 percent, in the current fiscal year compared with 10.2 percent growth in the previous year. This growth is largely due to the ongoing construction of several academic buildings.

Restricted nonexpendable net assets comprise the University's permanent endowment funds.

Restricted expendable net assets are subject to externally imposed restrictions on their use. This category of net assets includes permanent endowment fund earnings that can be spent, but only in accordance with restrictions imposed by external parties. This net asset category grew 29.5 percent, or a significant $502 million, primarily due to the investment performance of the University's endowment.

Unrestricted net assets are not subject to externally imposed stipulations. The majority of the University's unrestricted net assets have been designated for various instruction and research programs and initiatives, as well as capital projects. This year, unrestricted net assets increased by 21.6 percent, or $276 million. Increases in unrestricted funds are particularly important because they can be used for University priorities.

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

The Statement of Revenues, Expenses, and Changes in Net Assets presents the University's results of activities for the year. Presented below is a summarized statement of the University's revenues, expenses, and changes in net assets for the years ended June 30, 2007, and June 30, 2006 (restated).

SUMMARY OF THE STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS *(in thousands)*	2007	2006	INCREASE	
			AMOUNT	PERCENT
Operating revenues	$ 1,610,313	$ 1,537,029	$ 73,284	4.8%
Operating expenses	1,911,742	1,807,858	103,884	5.7%
Operating loss	**(301,429)**	**(270,829)**	**(30,600)**	**11.3%**
Nonoperating revenues (expenses)				
State appropriations	170,439	158,192	12,247	7.7%
Gifts	148,073	116,023	32,050	27.6%
Investment income	721,505	367,761	353,744	96.2%
Other net nonoperating expenses	(27,079)	(33,695)	6,616	(19.6%)
Net nonoperating revenues	**1,012,938**	**608,281**	**404,657**	**66.5%**
Income before other revenues, expenses, gains, or losses	**711,509**	**337,452**	**374,057**	**110.8%**
Capital appropriations, gifts, and grants	176,651	43,031	133,620	310.5%
Additions to permanent endowments	18,950	16,932	2,018	11.9%
Total other revenues	**195,601**	**59,963**	**135,638**	**226.2%**
Increase in net assets	**907,110**	**397,415**	**509,695**	**128.3%**
Net assets—beginning of year	4,447,915	4,050,500	397,415	9.8%
NET ASSETS—END OF YEAR	**$ 5,355,025**	**$ 4,447,915**	**$ 907,110**	**20.4%**

Under GASB principles, revenues and expenses are categorized as either operating or nonoperating. Significant recurring sources of the University's revenues, including state appropriations, gifts, and investment income, are considered nonoperating, as defined by GASB Statement No. 34. Consequently, the operating loss of $301 million does not consider these revenue sources. Adding the net nonoperating revenues of $1.0 billion for the fiscal year more than offsets the operating loss and results in an adjusted income figure of $712 million. This provides a more accurate picture of the University's total scope and results of operations.

REVENUES

The University strives to maintain a diverse stream of revenues, which allows it to weather difficult economic times.

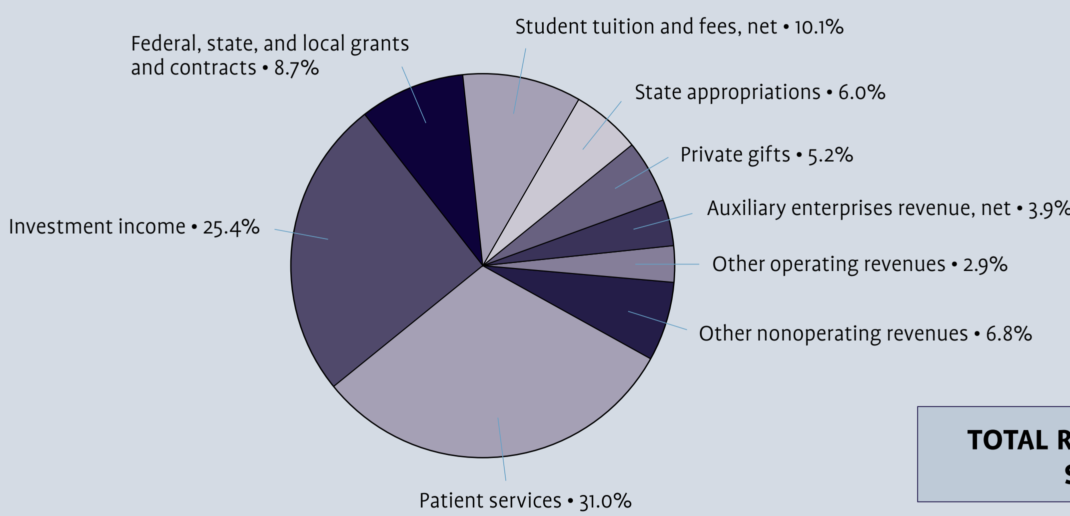
SUMMARY OF REVENUES, TOTAL UNIVERSITY

A summary of the University's revenues, for the years ended June 30, 2007, and 2006 (restated).

SUMMARY OF REVENUES *(in thousands)*	2007			2006			TOTAL INSTITUTION INCREASE (DECREASE)	
	ACADEMIC DIVISION & WISE	MEDICAL CENTER	TOTAL INSTITUTION	ACADEMIC DIVISION & WISE	MEDICAL CENTER	TOTAL INSTITUTION	AMOUNT	PERCENT
Operating revenues								
Student tuition and fees, net	$ 287,474	$ —	$ 287,474	$ 263,728	$ —	$ 263,728	$ 23,746	9.0%
Federal, state, and local grants and contracts	248,310	—	248,310	257,078	—	257,078	(8,768)	(3.4%)
Nongovernmental grants and contracts	39,174	—	39,174	39,358	—	39,358	(184)	(0.5%)
Sales and services of educational departments	19,540	—	19,540	18,866	—	18,866	674	3.6%
Auxiliary enterprises revenue, net	110,910	—	110,910	101,093	—	101,093	9,817	9.7%
Other operating revenues	210	22,294	22,504	—	37,414	37,414	(14,910)	(39.9%)
Patient services	—	882,401	882,401	—	819,492	819,492	62,909	7.7%
Total operating revenues	**$ 705,618**	**$ 904,695**	**$ 1,610,313**	**$ 680,123**	**$ 856,906**	**$ 1,537,029**	**$ 73,284**	**4.8%**
Nonoperating revenues								
State appropriations	$ 170,439	$ —	$ 170,439	$ 158,192	$ —	$ 158,192	$ 12,247	7.7%
Private gifts	142,252	5,821	148,073	115,252	771	116,023	32,050	27.6%
Investment income	663,364	58,141	721,505	338,801	28,960	367,761	353,744	96.2%
Other nonoperating revenues	171,030	24,571	195,601	59,963	—	59,963	135,638	226.2%
Total nonoperating revenues	**$ 1,147,085**	**$ 88,533**	**$ 1,235,618**	**$ 672,208**	**$ 29,731**	**$ 701,939**	**$ 533,679**	**76.0%**
TOTAL REVENUES	**$1,852,703**	**$ 993,228**	**$ 2,845,931**	**$ 1,352,331**	**$ 886,637**	**$ 2,238,968**	**$ 606,963**	**27.1%**

Below is a graph of revenues (by both operating and nonoperating sources), which were used to fund the University's operating activities for the fiscal year ended June 30, 2007. As noted earlier, GASB Statement No. 34 requires state appropriations, gifts, and investment income to be treated as nonoperating revenues.

TOTAL UNIVERSITY REVENUES • FISCAL YEAR 2007 *(in thousands)*



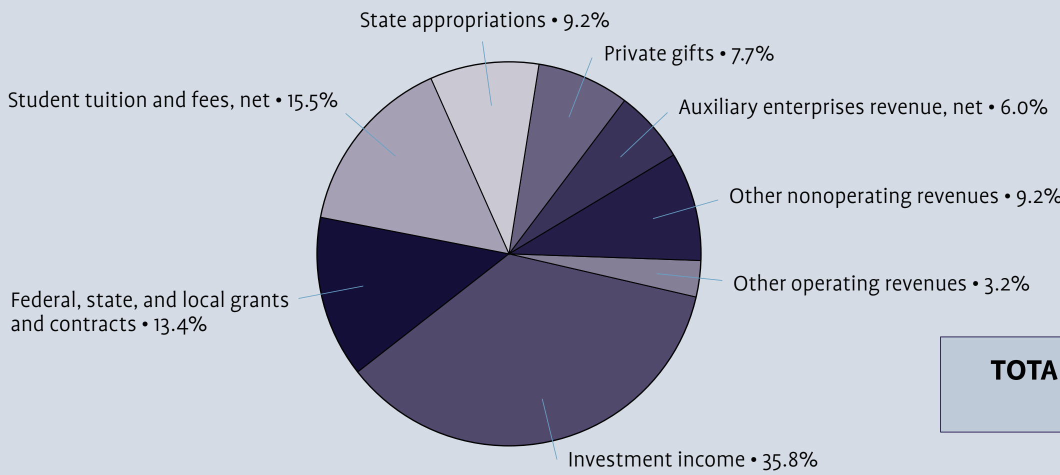
TOTAL REVENUE *(in thousands)*
$2,845,931

Patient services revenues accounted for 54.8 percent of the University's operating revenues and 31.0 percent of the operating and nonoperating revenues combined. State appropriations and student tuition and fees, which represent 6.0 percent and 10.1 percent, respectively, of the University's total revenues, are used to fund current operations.

State appropriations increased by $12.2 million, or 7.7 percent. The increases were for faculty and staff salaries, research support, and operations and maintenance funding for new facilities. Net tuition and fees increased by 9.0 percent as the tuition increases were approved for the first time by both the General Assembly and the Board of Visitors under Restructuring. This increase is in accordance with the University's six-year plan as submitted to the state.

Excluding the Medical Center data provides a clearer picture of the academic revenue streams. Major sources for 2007 included investment income, 35.8 percent; federal, state, and local grants and contracts, 13.4 percent; net tuition and fees, 15.5 percent; and state appropriations, 9.2 percent. This year, the percentage of revenue from investment income is significantly higher due to the 25 percent return on the University's endowment.

ACADEMIC AND WISE REVENUES • FISCAL YEAR 2007 *(in thousands)*



TOTAL REVENUE *(in thousands)*
$1,852,703

The University continues to emphasize revenue diversification, along with cost containment, as ongoing priorities. This is necessary as the University continues to face significant financial pressure with increased compensation and benefit costs, particularly health insurance, as well as escalating technology, construction and energy prices. Private support has been, and will continue to be, essential to maintaining the University's academic excellence. Private support comes in the form of gifts including additions to permanent endowment. Private gifts increased by $32 million, or 27.6 percent, as the capital campaign progressed.

Revenues from all sponsored programs decreased slightly this year by $9 million, or 3.9 percent, to a total of $287 million in 2007. The University fully anticipated this decrease, noting last year that the federal budget cuts in sponsors such as the National Institutes of Health and the Department of Health and Human Services would begin to take effect in fiscal year 2007. For the upcoming fiscal year, 2007–08, the University is projecting sponsored programs to recover and increase slightly.

EXPENSES

The University continues to be a good steward in the judicious expenditure of funds.

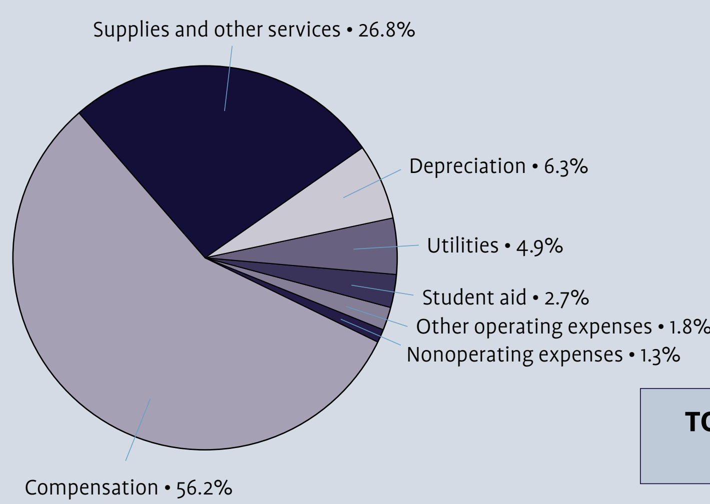
SUMMARY OF EXPENSES, TOTAL UNIVERSITY

A summary of the University's expenses, for the years ended June 30, 2007, and 2006 (restated).

SUMMARY OF EXPENSES *(in thousands)*	2007			2006			TOTAL INSTITUTION INCREASE (DECREASE)	
	ACADEMIC DIVISION & WISE	MEDICAL CENTER	TOTAL INSTITUTION	ACADEMIC DIVISION & WISE	MEDICAL CENTER	TOTAL INSTITUTION	AMOUNT	PERCENT
Operating expenses								
Compensation	$ 712,847	$ 376,787	$1,089,634	$ 663,025	$ 352,088	$1,015,113	$ 74,521	7.3%
Supplies and other services	134,885	383,784	518,669	138,868	369,283	508,151	10,518	2.1%
Student aid	51,406	—	51,406	46,474	—	46,474	4,932	10.6%
Utilities	81,791	13,426	95,217	76,878	14,485	91,363	3,854	4.2%
Depreciation	73,503	48,267	121,770	65,692	45,962	111,654	10,116	9.1%
Other operating expense	2,203	32,843	35,046	2,817	32,286	35,103	(57)	-0.2%
Total operating expenses	**1,056,635**	**855,107**	**1,911,742**	**993,754**	**814,104**	**1,807,858**	**103,884**	**5.7%**
Nonoperating expenses								
Interest expense	17,935	5,954	23,889	10,484	4,712	15,196	8,693	57.2%
Other nonoperating expense	1,234	1,956	3,190	14,586	3,913	18,499	(15,309)	-82.8%
Total nonoperating expenses	**19,169**	**7,910**	**27,079**	**25,070**	**8,625**	**33,695**	**(6,616)**	**-19.6%**
TOTAL UNIVERSITY EXPENSES	**$1,075,804**	**$ 863,017**	**$1,938,821**	**$1,018,824**	**$ 822,729**	**$1,841,553**	**$ 97,268**	**5.3%**

Following is a graphic illustration of expenses (both operating and nonoperating) for the fiscal year ended June 30, 2007.

TOTAL UNIVERSITY EXPENSES • FISCAL YEAR 2007 *(in thousands)*

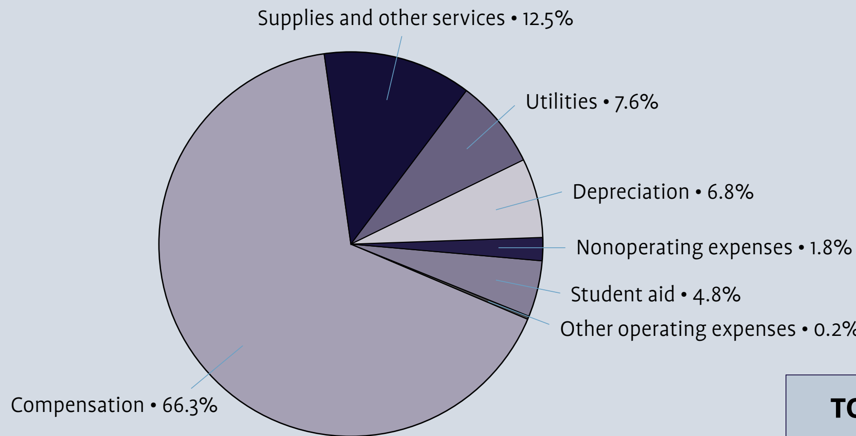


TOTAL EXPENSES *(in thousands)*
$1,938,821

As a percentage of total expenses, compensation (salaries and benefits) remained almost constant. However, in dollars, compensation increased by $75 million, or 7.3 percent, as the Board of Visitors continued its goal of raising faculty and staff compensation.

Student aid expense increased to $51.4 million, a change of $5 million, or 10.6 percent, as the University expanded its commitment to AccessUVa, our landmark financial aid program. Depreciation increased by $10 million, or 9.1 percent, driven by the increase in depreciable capital assets. Interest expense increased by $9 million, from $15 million to $24 million.

ACADEMIC AND WISE EXPENSES • FISCAL YEAR 2007 *(in thousands)*



TOTAL EXPENSES *(in thousands)*
$1,075,804

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 notes to the financial statements. Expenses for patient services, instruction, and research account for 44.7 percent, 14.2 percent, and 13.5 percent, respectively, of total operating expenses. When combined, these major functions account for 72.4 percent of the total, which is consistent with the mission-critical nature of instruction, research, and patient services for the University.

SUMMARY OF STATEMENT OF CASH FLOWS

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

SUMMARY OF THE STATEMENT OF CASH FLOWS *(in thousands)*	2007	2006	INCREASE (DECREASE) AMOUNT	INCREASE (DECREASE) PERCENT
Cash flows from operating activities	$ (134,905)	$ (149,551)	$ 14,646	9.8%
Cash flows from noncapital financing activities	345,229	286,010	59,219	20.7%
Cash flows from capital and related financing activities	(87,821)	(158,283)	70,462	44.5%
Cash flows from investing activities	76,446	70,801	5,645	8.0%
NET INCREASE IN CASH AND CASH EQUIVALENTS	**198,949**	**48,977**	**149,972**	**306.2%**

Cash flows from operating activities are different from the operating loss on the Statement of Revenues, Expenses, and Changes in Net Assets because items such as depreciation expense do not have a cash effect and because the latter statement is prepared on the accrual basis, versus cash basis, of accounting. Another difference between the two statements is, that on the latter statement, state appropriations, gifts, and investment income are considered nonoperating revenues. However, on the Statement of Cash Flows, state appropriations and gifts are reflected under noncapital financing activities, while investment income resides under investing activities. For the fiscal year, cash flows from operating activities increased by $15 million, or 9.8 percent, due primarily to increased tuition and fees and increased receipts from patient services.

Noncapital financing activities produced a cash flow increase of 20.7 percent, or $59 million, over last year due to increased receipts in state appropriations and noncapital gifts, grants, and endowments. Gifts to the overall University system are likely to continue to increase as the capital campaign continues. Gift revenue for the significant affiliated foundations is reflected in the component unit financial statements.

Cash flows from capital and related financing activities increased by $70 million, or 44.5 percent. In this category there were wide fluctuations between the two years as capital appropriations increased a substantial $93 million while proceeds from capital debt decreased by $174 million; this comparison was skewed by the University's bond issuance in fiscal year 2005. Correspondingly, there was a significant reduction in the principal paid on capital debt and leases.

FUTURE ECONOMIC OUTLOOK

The University remains well positioned financially to continue providing excellent programs and service to its constituents. The University's financial position, as evidenced by the highest credit rating obtainable, provides a high degree of accessibility to capital funds on the most competitive terms. The issuance of long-term bonds and the use of its expanded short-term commercial paper program, along with continued efforts toward revenue diversification, will enable the University to obtain the resources to support and maintain its level of excellence.

However, the University faces a period of unprecedented challenges with meeting the state's restructuring goals; the impending retirement of many faculty and staff; increasing expectations from all constituents, particularly our students and their parents; changes in the demographics of our incoming students; continuing capital construction; and increased compliance requests by the federal government.

To help plan for these challenges, the president created the Commission on the Future of the University. This commission is cochaired by the executive vice president and chief operating officer and the executive vice president and provost. Several subcommittees have been staffed and provided reports to the commission. The Subcommittee on Fiscal Resources has considered multiple facets of institutional resources and the University's capacity to support its long-term ambitions. Its report provides an overview of institutional and Medical Center financial planning, philanthropic capacity and strategies, and the advantages and disadvantages of the current school-based development foundation structure. The academic division's long-range plan goes through fiscal year 2015–16 and the Medical Center's extends through fiscal year 2012–13. Some of the initiatives and projects confirmed in the commission's report are given below:

AccessUVa. In the continued implementation of AccessUVa, as of the 2007–08 academic year, the University will offer 100 percent of demonstrated need to all undergraduates and will provide full grant funding for low-income undergraduate students. In addition, the University will cap need-based loans for all its undergraduate students and continue its financial literacy program.

Competitive Compensation. For the fiscal year 2006–07, the University's average faculty salary has increased to a tie for twentieth among its AAU peers. The goal first set by the Board of Visitors four years ago was to move into the top twenty of AAU institutions. The board continues to make this a top priority.

Deferred Maintenance. In February 2005, the Board of Visitors approved making ongoing maintenance investments to protect its education and general physical assets and make one-time investments to reduce the backlog of deferred maintenance to reasonable levels based on industry standards. Within ten years, annual maintenance spending will be increased by $15 million. To achieve this, the University is adding $1.5 million each year for the next ten years.

Investment in Student Information Technology. In June 2007, the Board of Visitors officially approved an investment in a new student information system. The University chose PeopleSoft Campus Solutions to replace its aging Integrated Student Information System to provide enhanced services to its students and faculty, and to provide stronger security over student data.

Implementation of the Health System Decade Plan. The Decade Plan is a joint planning effort of the School of Medicine, the School of Nursing, the Health Sciences Library, the Medical Center, and the Health Services Foundation. It outlines how the Health System will create innovation in the areas of patient service, translational research from cell to bedside, and professionalism in teaching and service to the community. Challenges exist due to cost pressure on pharmaceutical and medical devices, along with a shortage of health care workers. The Medical Center is adding seventy-two new beds, along with additional support space to meet growing demand for critical care at an average cost of $1 million per bed.

Restructuring and New Investment Legislation. The University will receive additional financial benefits under its restructuring authority. Nongeneral fund balances previously deposited and invested with the State Treasury will be transferred to, and invested by, the University. With additional flexibility provided by investment legislation requested by the University in the spring of 2007, management will now have the ability to invest operating funds prudently in equities in addition to the previous portfolio of cash and fixed-income instruments.

To meet these and other challenges, University management launched the University's $3 billion capital campaign in fiscal year 2007. It is one of the largest in higher education. Second, the University successfully negotiated its management agreement with the Commonwealth of Virginia under the Restructured Higher Education Financial and Administrative Operations Act. Now in effect, the Act provides for additional autonomy in the areas of procurement, capital projects, information technology, human resources, and finance. Creating and now implementing this new relationship with the Commonwealth of Virginia improves the outlook for the University's future. Third, the Commission on the Future of the University emphasizes and rededicates the institution to its varied public missions. It is very clear that the University of Virginia will remain a public institution, fulfilling the public educational vision of its founder, while using its additional autonomy to streamline operations and carry out its missions of excellent instruction, research, patient care, and public service.

Management Responsibility

October 12, 2007

To the President and Board of Visitors of the University of Virginia:

We are pleased to submit the annual Financial Report of the University of Virginia for the year ended June 30, 2007. Management is responsible for the objectivity and integrity of the accompanying financial statements, which have been prepared in conformance with the Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. The financial statements, of necessity, included management's estimates and judgments relating to matters not concluded by year-end. Financial information contained elsewhere in the annual Financial Report is consistent with that included in the financial statements.

Management is responsible for maintaining the University's system of internal control that includes careful selection and development of employees, proper division of duties, and written accounting and operating policies and procedures augmented by a continuing internal audit program. Although there are inherent limitations to the effectiveness of any system of accounting controls, management believes that the University's system provides reasonable, but not absolute, assurance that assets are safeguarded from unauthorized use or disposition and that the accounting records are sufficiently reliable to permit the preparation of financial statements that conform in all material respects with generally accepted accounting principles.

The Auditor of Public Accounts for the Commonwealth of Virginia, using independent certified public accountants for the audits of component units, provides an independent opinion regarding the fair presentation in the financial statements of the University's financial position. Their examination was made in accordance with generally accepted government auditing standards and included a review of the system of internal accounting controls to the extent they considered necessary to determine the audit procedures required to support their opinion. The Audit Committee of the Board of Visitors meets periodically and privately with the independent auditors, the internal auditors, and the financial officers of the University to review matters relating to the quality of the University's financial reporting, the internal accounting controls, and the scope and results of audit examinations. The committee also reviews the scope and quality of the internal auditing program.

Respectfully submitted,

Stephen A. Kimata
Assistant Vice President for Finance
and University Comptroller

YSReynolds

Yoke San L. Reynolds
Vice President and Chief Financial Officer

Auditor's Opinion

October 12, 2007

The Honorable Timothy M. Kaine
Governor of Virginia

The Honorable Thomas K. Norment, Jr.
Chairman, Joint Legislative Audit and Review Commission

Board of Visitors
University of Virginia

INDEPENDENT AUDITOR'S REPORT ON FINANCIAL STATEMENTS

We have audited the accompanying financial statements of the business-type activities and aggregate discretely presented component units of the University of Virginia, a component unit of the Commonwealth of Virginia, as of and for the year ended June 30, 2007, which collectively comprise the University's basic financial statements, as listed in the table of contents. These financial statements are the responsibility of the University's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the component units of the University, which are discussed in Note 1. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates the amounts included for the component units of the University, is based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of the component units of the University that were audited by other auditors upon whose reports we are relying were audited in accordance with auditing standards generally accepted in the United States of America, but not in accordance with *Government Auditing Standards*. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the business-type activities and aggregate discretely presented component units of the University as of June 30, 2007, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 44 through 53 is not a required part of the basic financial statements, but is supplementary information required by the accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 12, 2007, on our consideration of the University of Virginia's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Walter J. Kucharski
Auditor of Public Accounts