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, 2004. Comparative information for the year ended June 30, 2003, 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 financial statements referred to above and appended were prepared in accordance with Governmental Accounting Standards Board (GASB) principles. During fiscal year 2002, the University adopted GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* and GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities,* as amended by subsequent GASB Statements Nos. 37 and 38.

Effective this year, the University implemented GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units.* This statement addresses which fund-raising, research, or other foundations should be included as component units and how these component units should be displayed in the financial statements. Under previous accounting standards, the University had no component units. Under the new standards, six foundations meet the criteria and are included this year as component units. The six foundations are the Alumni Association of the University of Virginia, the University of Virginia Darden School Foundation, the University of Virginia Health Services Foundation, the University of Virginia Law School Foundation, the University of Virginia Foundation, and the Virginia Athletics Foundation. The financial data of these six foundations are presented separately in the Combined Statements of Financial Position and the Combined Statements of Activities. Additional information about each of the foundations is contained in the footnotes. The remainder of this Management's Discussion and Analysis excludes the foundations except where specifically noted.

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 20,018 students and 2,026 instructional and research faculty members in ten separate schools, the University offers a wide diversity of degree programs, including doctorates in fifty-four 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 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. The University's Health System also has established 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, 2004, with total assets of $4.8 billion and liabilities of $1.1 billion, compared to total assets of $4.5 billion and liabilities of $1.0 billion at June 30, 2003. Net assets, which represent the residual interest in the University's assets after liabilities are deducted, are $3.7 billion. This is a 7.9 percent increase over fiscal year 2003's net assets of $3.4 billion. The increase in net assets results from the University's consolidated operations. Revenues, expenses, gains, and losses are summarized below:

SUMMARY OF THE INCREASE IN NET ASSETS (in thousands)	2004	2003
Total revenues before investment income	$ 1,646.5	$ 1,536.5
Total expenses	(1,629.4)	(1,504.5)
Increase in net assets before investment income	17.1	32.0
Investment income	255.4	189.7
TOTAL INCREASE IN NET ASSETS	**$ 272.5**	**$ 221.7**

Comparing fiscal 2004 to fiscal 2003, revenues before investment income increased 7.2 percent, while expenses increased 8.3 percent. Thus, expenses increased slightly more than revenues before net investment income. While net assets before investment income increased in fiscal 2004 by $17.1 million, the increase was about $15 million less than in fiscal 2003.

Several factors contributed to this difference. A total decrease of $17.6 million occurred in state appropriations and capital appropriations. Compensation expenses increased by 8.7 percent, and utility costs increased by 30 percent. However, the endowment's strong performance more than offset these other factors, contributing almost 94 percent to the total increase in net assets for fiscal 2004. The University's long-term investment strategy has been successful, as evidenced by its strong returns over time and its ability to weather poor market conditions in recent years.

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 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 No. 34. Consequently, the operating loss of $223 million does not account for these normal revenue sources. Adding the net non-operating revenues of $457 million for the fiscal year more than offsets the operating loss and results in an adjusted income figure of $234 million. This provides a more accurate picture of the University's total scope of operations.

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, 2004, and June 30, 2003 (restated), follows.

SUMMARY OF THE STATEMENT OF NET ASSETS (in thousands)	2004	2003	Increase/(Decrease) Amount	Increase/(Decrease) Percent
CURRENT ASSETS	**$ 827,214**	**$ 749,464**	**$ 77,750**	**10.4%**
NON-CURRENT ASSETS:				
Endowment and other long-term investments	2,511,497	2,243,615	267,882	11.9%
Capital assets, net	1,378,798	1,285,009	93,789	7.3%
Other	95,395	220,130	(124,735)	(56.7)%
TOTAL ASSETS	**4,812,904**	**4,498,218**	**314,686**	**7.0%**
Current liabilities	428,176	423,736	4,440	1.0%
Non-current liabilities	662,736	624,976	37,760	6.0%
TOTAL LIABILITIES	**1,090,912**	**1,048,712**	**42,200**	**4.0%**
NET ASSETS	**$ 3,721,992**	**$ 3,449,506**	**$ 272,486**	**7.9%**

A review of the University's Statement of Net Assets at June 30, 2004, 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, which totaled $827 million as compared to the previous year's $749 million, an increase of $78 million, or 10.4 percent, consist primarily of cash, operating investments, and accounts receivable. Accounts receivable increased by $30.4 million due primarily to an increase in patient care receivables. The total of cash, cash equivalents, and short-term investments increased by over $42.4 million, a 7.5 percent growth.

Current liabilities consist primarily of accounts payable and obligations under securities lending. Securities lending affects both current assets and current liabilities, as explained in Note 2 on Investment Risk. Obligations under securities lending decreased this year by $42.1 million. The other major fluctuation in current liabilities was an increase in the current portion of long-term liabilities. It rose $27.7 million, or 56.8 percent. Most of this increase, $19.7 million, originated from implementation of the University's commercial paper program.

From a liquidity perspective, current assets cover current liabilities 1.93 times, an indicator of good liquidity. This year's coverage is better than last year's rate of 1.77. Current assets also cover six months of total operating expenses, including depreciation. Excluding depreciation, current assets cover almost seven months of operating expenditures.

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 12.7 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 for all funds rose $65.7 million, or 34.6 percent.

Distribution. The University distributes endowment earnings in a way designed to balance the annual support required for operational needs against the requirement to preserve the future purchasing power of the endowment. The endowment spending rate policy is approved by the Board of Visitors and is based on total return, not just cash earnings. The total distribution for the Pooled Endowment Fund was $88.8 million, consisting of $13.6 million in current year's cash income and $75.2 million in net realized gains and asset appreciation.

Investments. The total for endowment investments on the Statement of Net Assets is $2.2 billion. The University's portion is approximately $1.98 billion, while the remainder of $227 million comprises endowment assets held on behalf of related foundations and others. For the previous fiscal year, $174 million of endowment assets was held on behalf of related foundations, so foundation endowment assets managed by the University increased by 30.4 percent. 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 $563 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, research efforts, and other important programs and activities. As of June 30, 2004, the remainder of the endowment (72 percent) was classified as restricted net assets with the breakdown as follows: $322 million of restricted non-expendable net assets; $1.1 billion of restricted expendable net assets, including $34 million of restricted life income funds. To this total of $2.2 billion of endowment held by the University should be added the $559 million endowment held by the six foundations now required by GASB Statement 39 to be reported as component units. The total endowment held by the University and these six foundations was valued on June 30, 2004, at $2.7 billion.

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, balanced with new construction.

Capital additions, net of retirements, were $113.4 million in 2004 and $148.9 million in 2003. 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, 2004, included the expansion of the University Hospital; construction of the John Paul Jones Arena; the replacement of the Observatory Hill dining facility; construction of Wilsdorf Hall for the School of Engineering and Applied Science; and the renovation of Fayerweather Hall for the art history program. Other projects that are in the design stage include the renovation and expansion of Rouss Hall for the McIntire School of Commerce; Ruffin Hall, the new studio art building; the expansion and renovation of the School of Architecture's Campbell Hall; construction of a new medical research building, MR-6; and development of the South Lawn Project.

Financial stewardship requires the effective management of resources, including the use of debt to finance capital projects. As evidence of the University's effective stewardship, Moody's Investors Service has assigned the University its highest credit rating (Aaa) for bonds backed by a broad revenue pledge. Another service, Fitch Ratings, assigned the University its highest AAA rating. Last 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 acknowledgement of the University's financial strength, these ratings enable the University to obtain future debt financing at optimum pricing. In addition to issuing its own bonds, the University implemented its commercial paper program in 2004. Total commercial paper draws of $19.7 million were made against a total authorization of $100 million. Commercial paper is a tool that provides bridge financing in the short term at optimum rates.

Debt additions totaled $20 million primarily as a result of the issuance of commercial paper. The University's debt portfolio contains a strategic mix of both variable- and fixed-rate obligations. The six foundations now required by GASB Statement No. 39 to be reported as component units held $114 million of long-term debt outstanding at June 30, 2004.

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, 2004 and 2003 (restated), are summarized below.

NET ASSETS (in thousands)	2004	2003	Increase/(Decrease) Amount	Increase/(Decrease) Percent
INVESTED IN CAPITAL ASSETS, NET OF RELATED DEBT	$ 955,092	$ 917,924	$ 37,168	4.0%
RESTRICTED				
Non-expendable	322,218	311,779	10,439	3.3%
Expendable	1,389,122	1,275,493	113,629	8.9%
UNRESTRICTED	1,055,560	944,310	111,250	11.8%
TOTAL NET ASSETS	**$ 3,721,992**	**$ 3,449,506**	**$ 272,486**	**7.9%**

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. These net assets increased $37 million or 4 percent, continuing steady but predictable growth in capital assets. In the previous fiscal year, the growth was 5.3 percent.

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

Restricted expendable net assets are subject to externally imposed restrictions governing 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.

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.

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. Given below is a summarized statement of the University's revenues, expenses, and changes in net assets for the years ended June 30, 2004, and June 30, 2003 (restated).

SUMMARY OF THE STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS			Increase/(Decrease)	
(in thousands)	**2004**	**2003**	**Amount**	**Percent**
Operating revenues	$ 1,381,573	$ 1,257,044	$ 124,529	9.9%
Operating expenses (Note 8)	1,604,674	1,492,784	111,890	7.5%
OPERATING LOSS	**(223,101)**	**(235,740)**	**12,639**	**5.4%**
NON-OPERATING REVENUES (EXPENSES)				
State appropriations (Note 7)	125,321	140,851	(15,530)	(11.0%)
Gifts	84,850	70,545	14,305	20.3%
Investment income	255,380	189,702	65,678	34.6%
Other net non-operating expenses	(8,644)	(11,742)	3,098	26.4%
NET NON-OPERATING REVENUES	**456,907**	**389,356**	**67,551**	**17.3%**
INCOME BEFORE OTHER REVENUES, EXPENSES, GAINS OR LOSSES	**233,806**	**153,616**	**80,190**	**52.2%**
Capital appropriations, gifts, and grants	40,604	37,883	2,721	7.2%
Additions to permanent endowments	10,215	30,170	(19,955)	(66.1%)
Special item: write down of equipment (Note 14)	(12,139)	–	(12,139)	–
TOTAL OTHER REVENUES	**38,680**	**68,053**	**(29,373)**	**(43.2%)**
Increase in net assets	272,486	221,669	50,817	22.9%
Net assets—beginning of year	3,449,506	3,227,837	221,669	6.9%
NET ASSETS—END OF YEAR	**$ 3,721,992**	**$ 3,449,506**	**$ 272,486**	**7.9%**

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

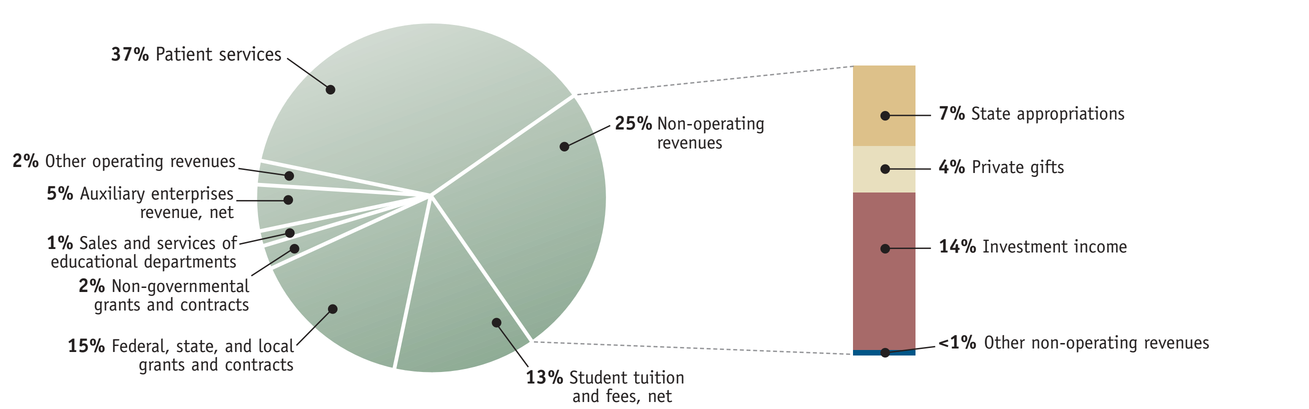
On the following page is a graphic illustration of revenues by source (both operating and non-operating), which are used to fund the University's operating activities for the fiscal years ended June 30, 2004 and 2003. As noted earlier, GASB Statement No. 34 requires state appropriations, gifts, and other significant revenues to be treated as non-operating revenues. Since these revenues support operating expenses, they are included in the charts.

SUMMARY OF REVENUES, TOTAL UNIVERSITY (in thousands)	2004	2003	Increase/(Decrease) Amount	Percent
OPERATING REVENUES				
Student tuition and fees, net	$ 233,786	$ 204,078	$ 29,708	14.6%
Federal, state, and local grants and contracts	281,260	253,733	27,527	10.8%
Non-governmental grants and contracts	42,316	46,573	(4,257)	(9.1%)
Sales and services of educational departments	21,650	19,905	1,745	8.8%
Auxiliary enterprises revenue, net	89,149	81,671	7,478	9.2%
Other operating revenues	26,834	13,193	13,641	103.4%
Patient services	686,578	637,891	48,687	7.6%
TOTAL OPERATING REVENUES	**1,381,573**	**1,257,044**	**124,529**	**9.9%**
NON-OPERATING REVENUES				
State appropriations	125,321	140,851	(15,530)	(11.0%)
Private gifts	84,850	70,545	14,305	20.3%
Investment income	255,380	189,702	65,678	34.6%
Other non-operating revenues	3,974	–	3,974	–
TOTAL NON-OPERATING REVENUES	**469,525**	**401,098**	**68,427**	**17.1%**
TOTAL UNIVERSITY REVENUES AVAILABLE FOR OPERATIONS	**$ 1,851,098**	**$ 1,658,142**	**$ 192,956**	**11.6%**

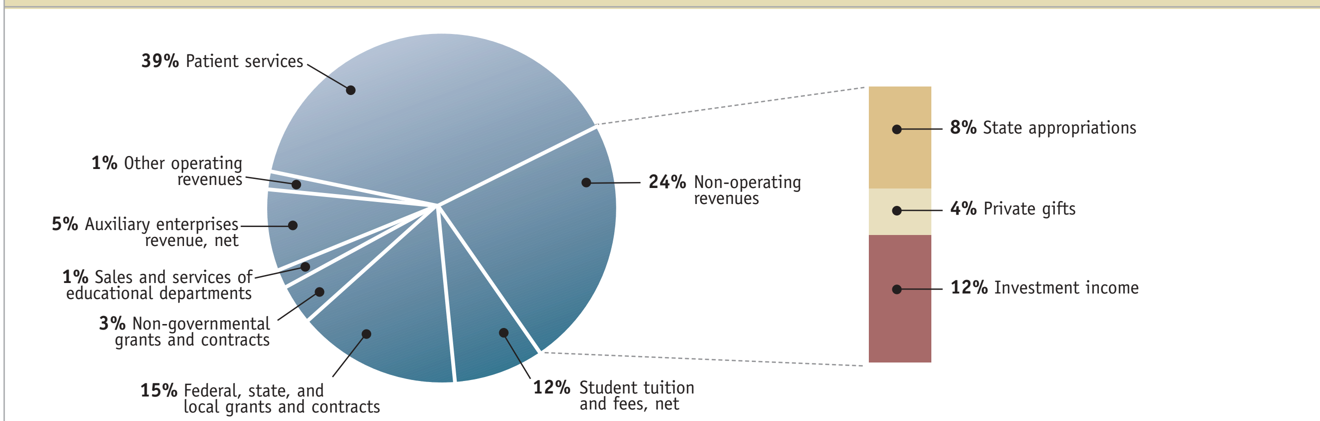
Patient services revenues accounted for 49.7 percent of the University's operating revenues and 37.1 percent of the operating and non-operating revenues combined. Additionally, state appropriations and student tuition and fees, which represent 6.8 percent and 12.6 percent of the University's total revenues, respectively, are used to fund current operations.

State appropriations decreased by $15.5 million, or 11 percent. This decrease continues a trend of declining state funding for operations. On the other hand, net tuition and fees increased by $29.7 million, or 14.6 percent. The Board of Visitors approved a tuition and fee increase last year to help offset the continued reductions in state funding.

TOTAL REVENUES 2004, TOTAL UNIVERSITY REVENUES AVAILABLE FOR OPERATIONS (in thousands) $ 1,851,098



TOTAL REVENUES 2003, TOTAL UNIVERSITY REVENUES AVAILABLE FOR OPERATIONS (in thousands) $ 1,658,142

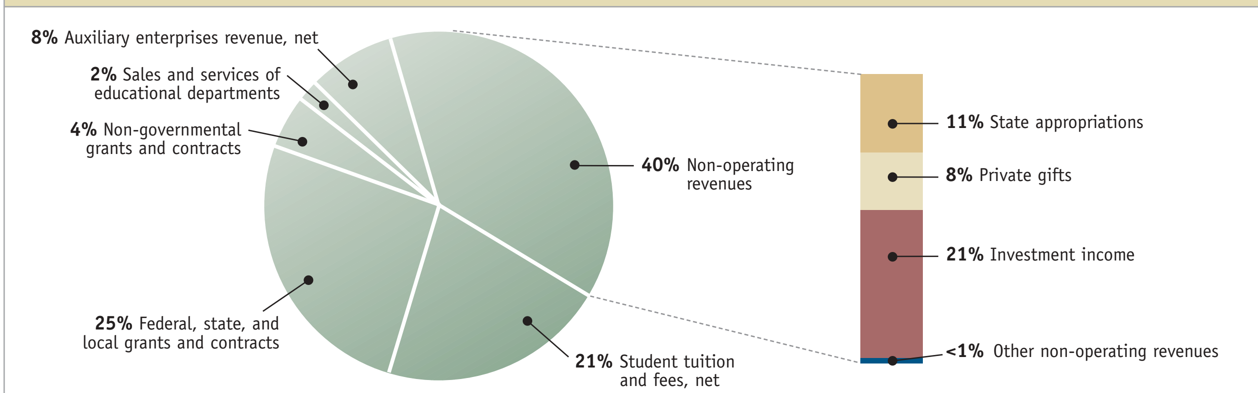


SUMMARY OF REVENUES, EXCLUDING THE MEDICAL CENTER

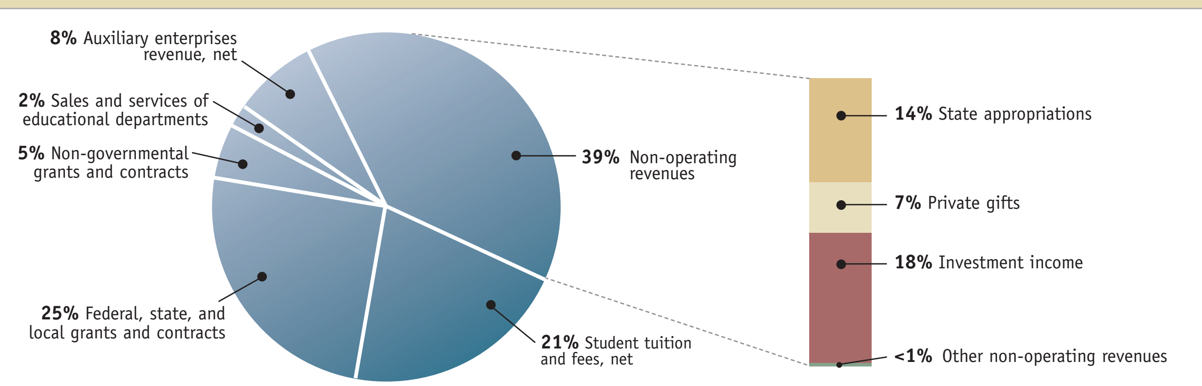
The University measures its performance both for the University as a whole and for the University without its Medical Center. The exclusion of the University's Medical Center provides a clearer view of the operations of the schools and colleges, as well as the central administration. The following is 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, 2004 and 2003 (restated).

SUMMARY OF REVENUES, EXCLUDING MEDICAL CENTER (in thousands)	2004	2003	Increase/(Decrease) Amount	Percent
OPERATING REVENUES				
Student tuition and fees, net	$ 233,786	$ 204,078	$ 29,708	14.6%
Federal, state, and local grants and contracts	281,260	253,733	27,527	10.8%
Non-governmental grants and contracts	42,316	46,573	(4,257)	(9.1%)
Sales and services of educational departments	21,650	19,905	1,745	8.8%
Auxiliary enterprises revenue, net	89,149	81,671	7,478	9.2%
TOTAL OPERATING REVENUES	**668,161**	**605,960**	**62,201**	**10.3%**
NON-OPERATING REVENUES				
State appropriations	125,321	140,851	(15,530)	(11.0%)
Private gifts	84,314	70,160	14,154	20.2%
Investment income	239,209	175,684	63,525	36.2%
Other non-operating revenues	6,266	258	6,008	2328.7%
TOTAL NON-OPERATING REVENUES	**455,110**	**386,953**	**68,157**	**17.6%**
TOTAL ACADEMIC REVENUES	**$1,123,271**	**$ 992,913**	**$ 130,358**	**13.1%**

TOTAL REVENUES 2004, EXCLUDING MEDICAL CENTER (in thousands) $ 1,123,271



TOTAL REVENUES 2003, EXCLUDING MEDICAL CENTER (in thousands) $ 992,913



The figures excluding the Medical Center demonstrate that the academic revenue streams are balanced but changing. Major sources for 2004 included federal, state, and local grants and contracts, 25 percent; net tuition and fees, 21 percent; investment income, 21 percent; and state appropriations, 11 percent. These percentages show a shift from last fiscal year, when 14 percent was provided by state appropriations. As noted earlier, state appropriations continue to decrease, while the performance of the endowment in 2004 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 39 percent of the University's academic division costs, 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 and additions to permanent endowment.

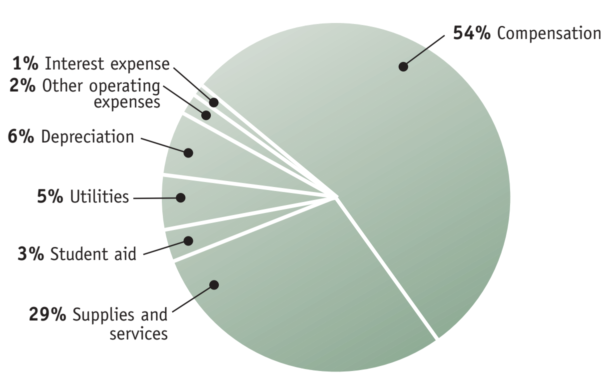
Revenues for all sponsored programs increased $23.3 million, or 7.7 percent, to a total of $323.6 million in 2004. This 7.7 percent increase is less than last year's 14.7 percent rise. This change was expected. While the National Institutes of Health (NIH) continues to provide substantial sponsored programs funding, that funding increased at a lesser rate than in recent years.

SUMMARY OF EXPENSES, TOTAL UNIVERSITY

A summary of the University's expenses, for the years ended June 30, 2004 and 2003 (restated), appears below.

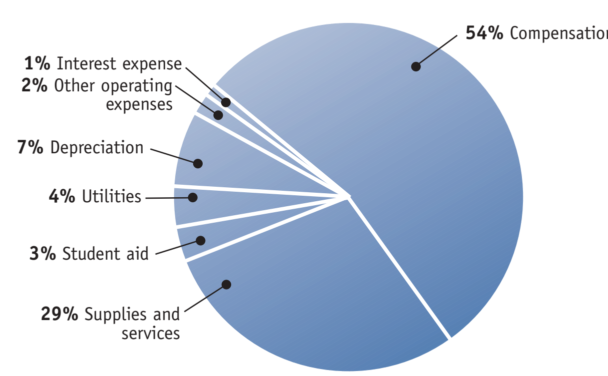
SUMMARY OF EXPENSES, TOTAL UNIVERSITY (in thousands)	2004	2003	Increase/(Decrease) Amount	Percent
OPERATING EXPENSES				
Compensation	$ 893,463	$ 822,201	$ 71,262	8.7%
Supplies and services	467,520	448,886	18,634	4.2%
Student aid	40,537	37,738	2,799	7.4%
Utilities	76,105	58,718	17,387	29.6%
Depreciation	102,597	99,915	2,682	2.7%
Other operating expenses	24,452	25,326	(874)	(3.5%)
TOTAL OPERATING EXPENSES	**1,604,674**	**1,492,784**	**111,890**	**7.5%**
NON-OPERATING EXPENSES				
Interest expense	12,618	11,467	1,151	10.0%
Other non-operating expenses	–	275	(275)	–
TOTAL NON-OPERATING EXPENSES	**12,618**	**11,742**	**876**	**7.5%**
TOTAL UNIVERSITY EXPENSES	**$1,617,292**	**$ 1,504,526**	**$ 112,766**	**7.5%**

TOTAL EXPENSES 2004, TOTAL UNIVERSITY



(in thousands) $ 1,617,292

TOTAL EXPENSES 2003, TOTAL UNIVERSITY



(in thousands) $ 1,504,526

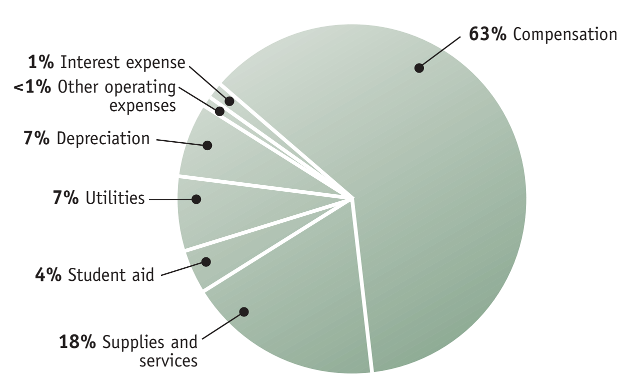
As a percentage, compensation (salaries and benefits) remained constant at 54 percent of total expenses. However, in dollars, compensation increased by $71.3 million as the Board of Visitors took action to address faculty and staff compensation levels that had fallen well below those of the University's national peers. For fiscal year 2004, the board supplemented the state's salary increases with an additional 1.75 percent in targeted, merit-based raises for teaching faculty.

Student aid expense increased $2.8 million, or 7.4 percent, as the University continued its commitment to meeting 100 percent of demonstrated need. Depreciation increased slightly by $2.7 million, or 2.7 percent. Interest expense on capital asset-related debt increased by 10 percent, or $1.2 million, because of the new debt issued in March 2003 for new construction. However, interest expense as a percentage of total expenses actually decreased to less than 1 percent. Interest is also less than 1 percent of operating revenues, highlighting the University's prudent use of debt financing.

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 42.5 percent, 13.5 percent, and 17.7 percent, respectively, of total operating expenses. When combined, these major functions account for 73.7 percent of the total, which is consistent with the mission-critical nature of instruction, research, and patient services for the University.

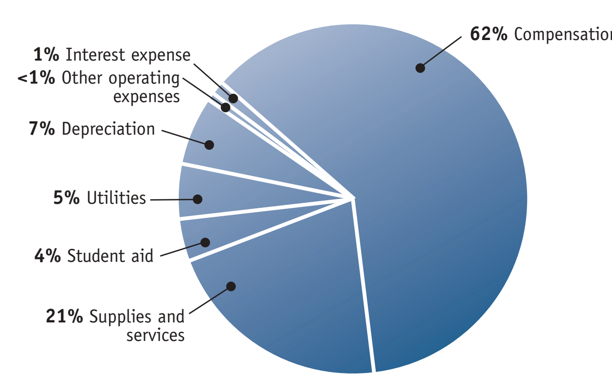
SUMMARY OF EXPENSES, EXCLUDING THE MEDICAL CENTER (in thousands)	2004	2003	Increase/(Decrease) Amount	Increase/(Decrease) Percent
OPERATING EXPENSES				
Compensation	$ 587,646	$ 544,870	$ 42,776	7.9%
Supplies and services	162,604	188,228	(25,624)	(13.6%)
Student aid	40,537	37,738	2,799	7.4%
Utilities	63,902	47,203	16,699	35.4%
Depreciation	64,942	63,941	1,001	1.6%
Other operating expenses	3,076	2,466	610	24.7%
TOTAL OPERATING EXPENSES	**922,707**	**884,446**	**38,261**	**4.3%**
NON-OPERATING EXPENSES				
Interest expense	8,298	7,039	1,259	17.9%
TOTAL NON-OPERATING EXPENSES	**8,298**	**7,039**	**1,259**	**17.9%**
TOTAL ACADEMIC EXPENSES	**$ 931,005**	**$ 891,485**	**$ 39,520**	**4.4%**

TOTAL EXPENSES 2004, EXCLUDING THE MEDICAL CENTER



(in thousands) $ 931,005

TOTAL EXPENSES 2003, EXCLUDING THE MEDICAL CENTER



(in thousands) $ 891,485

SUMMARY OF 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 categories 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, TOTAL UNIVERSITY (in thousands)	2004	2003	Increase/(Decrease) Amount	Percent
Cash flows from operating activities	$ (117,851)	$ (102,575)	$ (15,276)	(14.9%)
Cash flows from non-capital financing activities	207,063	239,178	(32,115)	(13.4%)
Cash flows from capital and related financing activities	(163,615)	(39,438)	(124,177)	(314.9%)
Cash flows from investing activities	67,106	(61,996)	129,102	208.2%
NET (DECREASE)/INCREASE IN CASH AND CASH EQUIVALENTS	**$ (7,297)**	**$ 35,169**	**$ (42,466)**	**(120.7%)**

The major shift in cash flow from 2003 to 2004 occurred in investing activities. In 2003, investing activities used $62 million; whereas, in 2004 investing activities provided $67 million, a $129 million change. This $129 million provided the cash to cover the acquisition and construction of capital assets without issuing any additional long-term debt, as outlined in the capital and related financing activities section.

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 its constituents. The University's financial position, as evidenced by the highest credit rating obtainable, provides a high degree of flexibility in securing capital funds on the most competitive terms. To fund its capital projects, the University anticipates issuing more bonds in the upcoming fiscal year. The issuance of long-term bonds and the use of the short-term commercial paper program, along with the ongoing efforts toward revenue diversification, will enable the University to obtain the necessary resources to support and maintain its level of excellence.

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. Also, the Board of Visitors is committed to restoring compensation levels in order to compete for the best faculty and staff. The University will continue to face competitive pressures related to attracting and retaining leading faculty and staff.

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 second year in a row, the University's 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 has announced its $3.0 billion capital campaign, which is on a scale not seen before in its history. Increasing tuition revenue to offset the state reductions will continue to be a focus of the board, with an emphasis on developing a long-term pricing policy. However, the University will not increase tuition without a corresponding focus on improving access and affordability for students. This year the board announced an ambitious new financial-aid program, AccessUVA, which commits $17.9 million annually when fully implemented. AccessUVA will offer to meet 100 percent of financial need, replace loans with grants for low-income students, and create a maximum loan cap for all students.

The University has joined two other leading institutions—Virginia Tech and the College of William and Mary—to ask the General Assembly to enact the Commonwealth Chartered Universities and Colleges Act. Under this new model, the institutions would craft a new relationship with the Commonwealth. In return for limits on future growth in appropriations, the institutions would be given more administrative autonomy, including the ability to set tuition levels, and would be free to achieve operational efficiencies that would reduce costs and streamline operations.

The University continues to execute its 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. The Board of Visitors has endorsed a proposal for the University to expand its research activities in line with the governor's request and the University's own mission.

The University's Medical Center is well positioned, although 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 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 experience. This year, the University made a commitment to guarantee housing to all second-year students who desire it. First-year students already live on Grounds. 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 establishment of a new financial-aid program; the beginning of a new, unprecedented capital campaign; and a continuing commitment to the core values of its founder, Thomas Jefferson, will serve the University well in the decades to come.