

The University of Virginia

Management's Discussion and Analysis (Unaudited)

Introduction

This report, Management's Discussion and Analysis (Unaudited), provides an overview of the financial position and results of activities of the University of Virginia (the "University") for the year ended June 30, 2002. It has been prepared by management and is required supplemental information to the financial statements and the footnotes that follow this section. Comparative information for the year ended June 30, 2001, has been provided in a few select instances.

The referenced financial statements were prepared in accordance with Governmental Accounting Standards Board (GASB) principles. During fiscal year 2002, the University adopted 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.

These GASB statements establish standards for the preparation of public college and university financial statements that focus on aggregate operations, versus the previous model, which focused on accountability of individual fund groups. As a result, the financial statements for fiscal year 2002 are not comparable to the financial statements produced for previous fiscal years.

The University of Virginia is an agency of the Commonwealth of Virginia and is governed by the University's Board of Visitors. The Commonwealth of Virginia issues its own financial statements, which include the University as a component unit.

The University is a comprehensive public institution of higher learning with approximately 19,200 students and 2,000 instructional and research faculty members. The University's ten schools offer a broad range of degrees, including forty-eight baccalaureate programs, ninety-four master's programs, six educational specialist programs, and fifty-five doctoral programs, as well as the J.D. degree in law and the M.D. degree in medicine.

Dedicated to the four primary missions of instruction, research, public service, and patient care, the University is recognized internationally for the quality of its students, faculty, and programs. It consistently ranks among the nation's top universities, both for its overall academic offerings and for its strengths in specific disciplines. Cutting-edge research is a hallmark of all areas of the University, including the University Health System, which maintains a tradition of excellence in teaching, advancement of medical science, and clinical care. With a network of some 550 physicians, the University's academic medical center has been named one of the Top 100 Hospitals for the third year in a row.

Financial Highlights

The University's financial position remained strong at June 30, 2002, with total assets of \$3.94 billion and liabilities of \$710 million. Net assets, which represents

the residual interest in the University's assets after liabilities are deducted, are \$3.23 billion. This is a 1.2 percent increase over last fiscal year's restated net assets of \$3.19 billion. The increase in net assets is primarily attributable to a large endowment gift to the Medical Center. This offsets the academic division's reduction in net assets, which resulted from the downturn in the financial markets and implementation of our endowment income distribution policy. For fiscal year 2002, the Medical Center's net assets increased by \$72.2 million, or 16.1 percent from the previous 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 Government Accounting Standards Board (GASB) principles.

Adopting the new GASB standards resulted in the following changes to the financial statements:

- Revenues and expenses are now categorized as either operating or non-operating. For example, state appropriations, gifts, and investment income (loss) are now considered non-operating revenues (expenses). These non-operating revenues totaled \$289 million for the fiscal year. Non-operating expenses, which consist of interest expense and a one-time loss on the sale of an affiliated company, totaled \$25 million.
- Depreciation expense and accumulated depreciation have been recorded for the first time.
- A statement of cash flows is now required.
- Scholarships and fellowships applied to student accounts are now shown as a reduction of student tuition and auxiliary fee revenues, while stipends and other payments made directly to students continue to be presented as scholarship and fellowship expenses. Previously, all scholarships and fellowships were presented as expenses. This year scholarship allowances are \$34 million.

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.

**SUMMARY OF THE
STATEMENT OF NET ASSETS (in thousands)**

<i>TOTAL UNIVERSITY</i>	2002
Current assets	\$ 591,445
Non-current assets:	
Endowment & other long-term investments	2,021,568
Capital assets, net	1,198,072
Other	126,183
Total assets	3,937,268
Current liabilities	370,766
Non-current liabilities	339,606
Total liabilities	710,372
Net assets	\$ 3,226,896

Current assets. Current assets, which consist primarily of cash, operating investments, and accounts receivable, totaled \$591 million. Total current assets cover current liabilities 1.6 times, an indicator of good liquidity. The \$591 million also represents coverage of approximately 4.9 months of total expenses (including depreciation). Excluding depreciation increases coverage to 5.3 months of expenses.

Current liabilities. Current liabilities consist primarily of accounts payable, accrued compensation, and deposits held in custody for others. Total current liabilities are \$371 million. It should be noted that deposits held in custody increased this year as affiliated foundations invested more of their funds with the University's endowment pool.

Endowment

The endowment is the largest of the non-current assets.

Performance. As outlined in the footnotes, 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 -0.1 percent, essentially a breakeven performance, which is particularly notable given the decline in value of the financial markets. Included in the calculation of this performance figure are realized and unrealized gains and losses, along with investment income.

Distribution. The University distributes endowment earnings in a way that balances the annual support required for operational needs against the requirement to preserve the purchasing power of the endowment for the future. The endowment spending rate policy is approved by the Board of Visitors and is based on total return and not annual earnings. The total distribution for the Pooled Endowment Fund was \$78.8 million, consisting of \$23.8 million in current year's investment income and \$55 million in investment asset appreciation.

Balance. The total endowment investment balance on the Statement of Net Assets is \$1.8 billion. The University's portion is approximately \$1.7 billion, while the difference of \$100 million comprises endowment assets 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 \$502 million, or 29 percent, can be classified as unrestricted net assets. From this unrestricted endowment, a significant portion of the unrestricted income is internally designated by the University for scholarships, fellowships, professorships, research efforts, and other important programs and activities.

As of June 30, 2002, the remainder of the endowment (71 percent) was restricted as follows: \$282 million of restricted non-expendable net assets, \$902 million of restricted expendable net assets, and \$33 million of restricted life income funds.

Capital and Debt Activities

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

Capital additions. Capital additions, net of retirements, were \$150 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. Examples of new additions were the Darden School expansion and the new medical research facility, MR-5.

Work in progress. At June 30, 2002, work in progress included construction of the Special Collections Library, renovation of Clark Hall, and renovation of the Miller Center.

The University takes seriously its role of financial stewardship and works hard to manage its resources effectively, including the prudent use of debt to finance capital projects. 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., has also assigned the University its highest rating (AAA). In addition to being an official acknowledgment of the University's strong financial position and financial management, these ratings enable the University to obtain future debt financing at optimum pricing.

Long-term debt. The University's long-term debt decreased from \$351 million to \$337 million this year, a drop of \$14 million, or 4 percent.

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, 2002, are summarized below.

NET ASSETS (in thousands)	2002
Invested in capital assets, net of related debt	\$ 868,783
Restricted:	
Non-expendable	282,440
Expendable	1,201,241
Unrestricted	874,432
Total net assets	\$ 3,226,896

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

The Statement of Revenues, Expenses, and Changes in Net Assets presents the University's results of financial activity for the year.

One of the University's strengths is its diverse streams of revenues, which allow it to weather difficult economic times. On the following page is a graphic illustration of revenues by source (both operating and non-operating), which were used to fund the University's operating activities for the year ended June 30, 2002. As noted previously, GASB Statement No. 35 requires state appropriations, gifts, and other significant recurring revenues to be treated as non-operating revenues. However, these revenues do support operating expenses. Therefore, they are included in the chart.

SUMMARY OF THE STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS (in thousands)

TOTAL UNIVERSITY	2002
Operating revenues	\$ 1,117,007
Operating expenses	1,434,993
Operating income (loss)	(317,986)
Non-operating revenues (expenses)	
State appropriations	176,177
Gifts	65,016
Investment income	26,975
Other net non-operating expenses	(3,891)
Net non-operating revenues	264,277
Capital appropriations, gifts, and grants	28,104
Additions to permanent endowments	63,701
Increase in net assets	38,096
Net assets—beginning of year	3,188,800
Net assets—end of year	\$ 3,226,896

Patient services revenue accounts for 40 percent of the University's operating and non-operating revenues combined. Additionally, state appropriations and student tuition and fees, comprising 12 percent and 13 percent, respectively, of the University's total revenues, are used to fund current operations.

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. On the following page is a graphic illustration of University revenues by source (both operating and non-operating), which were used to fund operating activities other than the hospitals and similar activities, for the year ended June 30, 2002.

Excluding the Medical Center, the chart illustrates the balanced revenue streams for the academic division. To highlight the major sources: 28 percent is comprised of federal, state, and local grants and contracts; 22 percent is net tuition and fees; and 22 percent is state appropriations.

The University continues to make revenue diversification an ongoing priority, along with cost containment. This is necessary as the University continues to face significant financial pressure with state budget reductions, increased compensation and benefit costs, and volatile technology, energy, and water prices.

While tuition and state appropriations fund a large percentage of University costs, private support has been, and will continue to be, essential to the University's academic excellence.

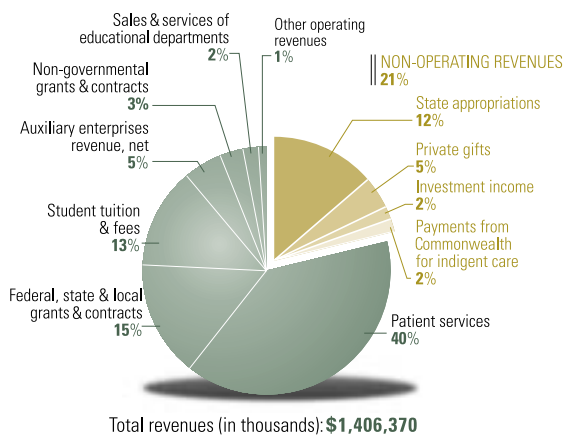
Revenues for sponsored research programs increased \$15.2 million, or 6.2 percent, to a total of \$261.8 million in 2002. While a number of schools are integral to the research mission of the University, the Medical School accounts for about 60 percent of grant awards.

A summary of the University's expenses, both with and without the Medical Center, for the year ended June 30, 2002, can be viewed at the top of the following page.

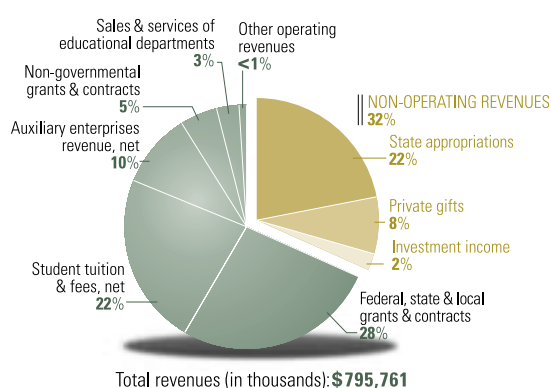
Compensation and benefits for the academic division continue to account for approximately 60 percent of total expenses. In the academic division, student aid comprises 4 percent of total expenses under the new GASB model. Depreciation is recorded this year for the first time and makes up 8 percent of the total. Notably, interest expense is only 1 percent of total expenses.

STATEMENT OF REVENUES (in thousands)

<i>TOTAL UNIVERSITY</i>		2002
OPERATING REVENUES		
Student tuition & fees, net	\$	177,913
Federal, state & local grants & contracts		218,256
Non-governmental grants & contracts		43,558
Sales & services of educational departments		21,464
Auxiliary enterprises revenue, net		77,070
Other operating revenues		10,374
Patient services		568,372
Total operating revenues		1,117,007
NON-OPERATING REVENUES		
State appropriations		176,177
Private gifts		65,016
Investment income		26,975
Payments from Commonwealth for indigent care		21,195
Total non-operating revenues	\$	289,363

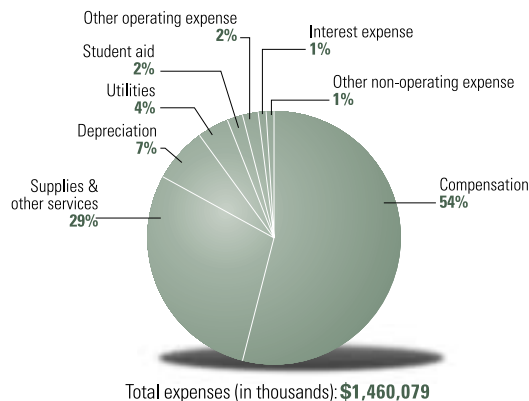


<i>ACADEMIC DIVISION</i>		2002
OPERATING REVENUES		
Student tuition & fees, net	\$	177,913
Federal, state & local grants & contracts		218,257
Non-governmental grants & contracts		43,558
Sales & services of educational departments		21,464
Auxiliary enterprises revenue, net		77,070
Other operating revenues		9
Total operating revenues		538,271
NON-OPERATING REVENUES		
State appropriations		176,177
Private gifts		64,576
Investment income		16,737
Total non-operating revenues	\$	257,490

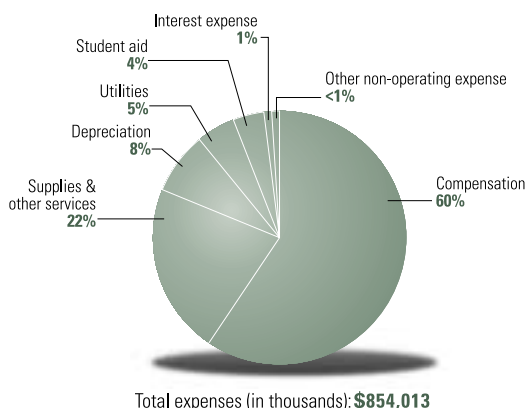


SUMMARY OF EXPENSES (in thousands)

<i>TOTAL UNIVERSITY</i>		2002
OPERATING EXPENSES		
Compensation	\$	796,959
Supplies & other services		426,501
Student aid		34,156
Utilities		56,227
Depreciation		98,628
Other operating expense		22,522
Total operating expenses		1,434,993
NON-OPERATING EXPENSES		
Interest expense		12,038
Other non-operating expense		13,048
Total non-operating expenses	\$	25,086



<i>ACADEMIC DIVISION</i>		2002
OPERATING EXPENSES		
Compensation	\$	511,342
Supplies & other services		190,215
Student aid		34,156
Utilities		45,207
Depreciation		64,266
Total operating expenses		845,186
NON-OPERATING EXPENSES		
Interest expense		7,425
Other		1,402
Total non-operating expenses	\$	8,827



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 comprise 41 percent, 16 percent, and 14 percent, respectively, of total operating expenses. When combined, these major functions account for 71 percent of the total, which is consistent with the mission-critical nature of instruction, research, and patient services for the institution.

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 promulgate 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.

State appropriations, gifts, and investment income are reported as non-operating revenues. For higher education institutions, these cash inflows are critical to funding the operations of the University.

SUMMARY OF THE STATEMENT OF CASH FLOWS (in thousands)

<i>TOTAL UNIVERSITY</i>		2002
Cash flows from operating activities	\$	(191,681)
Cash flows from non-capital financing activities		314,211
Cash flows from capital and related financing activities		(160,072)
Cash flows from investing activities		56,955
Net increase in cash and cash equivalents	\$	19,413

Future Economic Outlook

Executive management believes that the University is well positioned to maintain its strong financial condition and to continue providing excellent service to its students, patients, the research community, the state, and the nation. The University's financial position, as evidenced by its Aaa rating from Moody's Investors Service and AAA rating from Fitch, Inc., provides a high degree of flexibility in obtaining funds on competitive terms. This flexibility, along with ongoing efforts toward revenue diversification and cost containment, will enable the University to obtain the necessary resources to sustain excellence.

The University will continue to face competitive pressures related to attracting and retaining leading faculty and staff. Moreover, the cost of the University's health benefits has increased significantly and will probably continue to increase in the coming years with the rising cost of medical care and prescription drugs.

A major factor in the University's future will continue to be its relationship with the Commonwealth of Virginia. There is a direct connection between the decrease in state support and the University's ability to enhance, let alone protect, its core academic programs. As state appropriations decrease to record levels, the University must again turn to the generous support of its alumni and other supporters. Economic pressures affecting donors may influence the future level of support the University receives from corporate and individual giving. Also, the institution must now turn to increases in tuition to help offset the reductions. A mid-academic year tuition increase is being implemented for the first time in recent history to generate additional revenue. Because of the current state budget environment, the Board plans to look carefully at its long-term tuition pricing policy over the next few months. The University will continue to be a good value for students and parents in the higher education marketplace, but it is now clear that tuition must become a much more important revenue stream in the years ahead.

The University continues to execute its long-range plan to modernize and expand its complement of older teaching and research facilities with a balance of new construction. This strategy addresses the University's growth and the expanding role of technology in teaching and research methodologies. With the recent passage of the state's bonds for higher education construction, funds will be available to help the University meet these critical needs. Moreover, the University has debt capacity to issue its own bonds to build the facilities that will enable it to enhance its national standing.

The University's Medical Center is well positioned, although ongoing constraints on revenue are expected with the continued fiscal pressures on managed care and on employers and federal and state governments. After the sale of Blue Ridge Health Alliance (BRHA), the Medical Center was able to negotiate a new contract with Southern Health Services, Inc. The term of this contract is for five years and includes increased reimbursement rates more favorable to the Medical Center. In addition, the Medical Center plans to begin a major expansion of its University Hospital facility. The expansion project will increase the number of operating rooms and thereby increase the hospital's census and net revenue. Management believes that much of the financial pressure can be offset by growth in patient volume and continued efforts to contain increases 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 that insulates the University's operations from temporary market volatility.

Research continues to grow at 5 to 8 percent per year. Student demand for admission to the University's programs remains exceptionally strong.

As management wrestles with today's uncertain economic factors, the University's prudent use of resources, cost-containment efforts, and development of other sources of revenues will strengthen the institution and will ensure that it is well positioned to take advantage of the next upturn in the business cycle.