

2002 FINANCIAL REVIEW

STANFORD UNIVERSITY

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The 2001–2002 fiscal year (FY02) was a challenging one for higher education institutions, including Stanford (the University). Many universities experienced negative investment returns for the second year in a row, reflecting the continuing decline in equity market values.

Stanford's consolidated net assets declined \$461 million in FY02 to end the year at \$11.1 billion, following a decline of \$591 million in fiscal year 2000–2001 (FY01). Although weak investment performance over the past two years has offset some of the strong investment performance of the late 1990s, Stanford's consolidated net assets at the end of FY02 have increased more than \$4 billion (57%) since the beginning of fiscal year 1997–1998 (FY98). See Figure 1.

In FY02, Stanford University, including its Hospitals, had consolidated excess operating revenues over expenses of \$34 million, as compared to \$46 million in FY01. However, the University, excluding the Hospitals, incurred a deficit in FY02 of \$17 million as compared to an excess of \$59 million in FY01. The Hospitals' operating results improved to an excess of \$51 million in FY02, as compared to a deficit of \$13 million in FY01. The Hospitals have improved their financial performance despite rising costs and less than comparable increases in federal and state support for academic medical centers.

The remainder of this review is focused on the FY02 financial results of the University, excluding the Hospitals. See the inserts on pages 22 and 23 for the Hospitals' separate discussion on financial results.

University

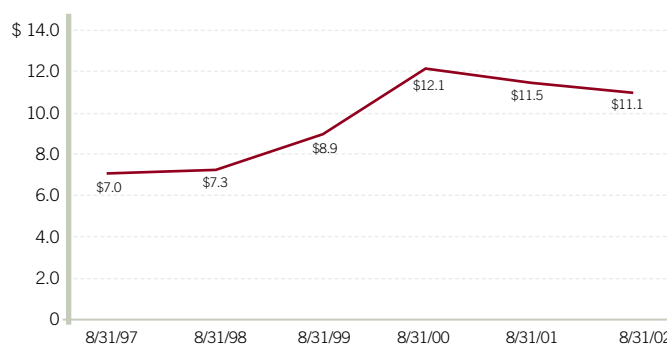
The prolonged weak investment environment, the increasing need of Stanford students for financial aid, and the pressure of increasing health care benefit costs negatively impacted the University's financial operations in FY02. Overall University gifts and pledges as calculated on an accrual basis were \$105 million lower in FY02 than in FY01. In addition, the University absorbed new commitments, including operating costs for newly constructed buildings and investments in support of The Campaign for Undergraduate Education (CUE). CUE has raised more than 75% of its \$1 billion goal in gifts and pledges as of October 2002.

The University is taking a number of steps to reduce expenditures and to conserve resources in light of anticipated continuing declines in investment income and expendable gifts:

“General Funds” budget allocations to departments across the University were reduced by \$16.3 million (4%) for 2002–2003 (FY03). General Funds are unrestricted funds that can be used for any University purpose and are derived primarily from tuition, unrestricted endowment payout, and indirect cost recovery. Academic units averaged cuts of 3%, and administrative unit cuts ranged from 3% to 10%. In addition, all departments have been asked to submit proposals for 5% to 10% General Funds budget reductions in 2003–2004 (FY04).

FIGURE 1

CONSOLIDATED NET ASSETS (IN BILLIONS)



A Universitywide hiring freeze was initiated October 25, 2002, which requires senior management approval of all hires. This measure was designed to reduce the rate of growth of new staff.

The timeline for major new facilities has been stretched in order to reduce annual capital expenditures.

Despite the challenging economic environment, Stanford continued to successfully pursue its teaching and research missions. FY02 highlights included:

Continued success of The Campaign for Undergraduate Education. The Campaign celebrated its second anniversary in October of 2002, having raised \$797 million in gifts and pledges toward its five-year, \$1 billion goal. As part of the Campaign, more than 8,000 alumni and friends attended “Think Again” events in 12 cities across the United States.

Continued strength in undergraduate applications. Stanford continues to be among the most competitive institutions for undergraduate admission nationwide. In FY02, 12.7% of applicants were offered admission, compared with 12.5% in 2001, and 13% in 2000. In addition, the “yield rate”—the number of accepted students who attend—increased to 69.2% in FY02 from 67.5% in FY01. The Class of 2006 is among the University’s most academically distinguished and culturally and ethnically diverse.

Continued capital improvement. Stanford continues to sustain and enhance its physical plant. The new Mechanical Engineering Research Laboratory opened its doors in FY02, as did the new Allene G. Vaden Health Center for student health services and the new home for the Career Development Center and the Office of Accessible Education. Wallenberg Hall, a technically advanced building, opened in October 2002 as a global learning center designed to explore the use of technology in education. New on-campus housing and renovations of existing facilities for 600 students were completed and occupied in Escondido Village, reflecting the University’s commitment to house more of its students on campus. In FY02, work began on the Lorry I. Lokey Laboratory Building, a new research facility for chemistry and biological sciences. Work continues on the James Clark Center, which will house the innovative Program for Bioengineering, Biomedicine, and Biosciences. The Medical Center will be enhanced by the opening in 2003 of the new Center for Cancer Treatment & Prevention/Ambulatory Care Pavilion.

Statement of Activities

The Statement of Activities details operating revenues and expenses and other nonoperating changes during the year and reports a total decline in the University’s net assets of \$576 million in FY02 compared to a \$571 million decrease in FY01. The decrease in net assets is primarily attributable to the decline in public and private equity market values. Total investment losses of \$300 million were recognized in FY02 as compared to \$497 million in FY01. Additionally, gifts and pledges recorded in the financial statements were down from \$457 million in FY01 to \$352 million in FY02.

Unrestricted Net Assets—Operating Activities

Operating activities include all revenues and expenses that are used to support current-year teaching and research efforts and other University priorities. Compared to FY01, total University revenues increased 5.4% to \$2.1 billion, and total expenses increased 9.5% to approximately \$2.1 billion. In FY02, expenses exceeded revenues, resulting in a decrease in net assets of \$17 million related to operations. Operating activities in FY01 resulted in an increase in net assets of \$59 million. Highlights of the University's operating activities are summarized below:

The components of the \$2.1 billion in University operating revenues are shown in Figure 2.

Student income represented 14% of University operating revenues and increased 1.7% to \$305 million in FY02. Contributing to this increase was the tuition rate increase of 6% for undergraduates and most graduate programs. In addition, room and board rates increased an average of 3.4%, and the University increased its student housing stock. Offsetting tuition and room and board revenues is financial aid, which increased by 16% to a total of \$107 million in FY02.

Sponsored research support represented 38% of University operating revenue and increased 10% to \$802 million in FY02. The University's direct cost reimbursement was up \$39 million, due largely to higher levels of research activity. The School of Medicine experienced growth in research activity of 11% in FY02, and research activity in the schools of Earth Sciences, Engineering, Education, and Humanities and Sciences also grew by more than 5%. The University's direct cost reimbursement for the Stanford Linear Accelerator Center (SLAC) activity was up \$22 million to \$228 million, due largely to accelerator improvement projects supported by the Department of Energy. Indirect cost recovery was also up 10%, due to increased research volume. The indirect cost rate for FY02 was comparable to the prior year's rate.

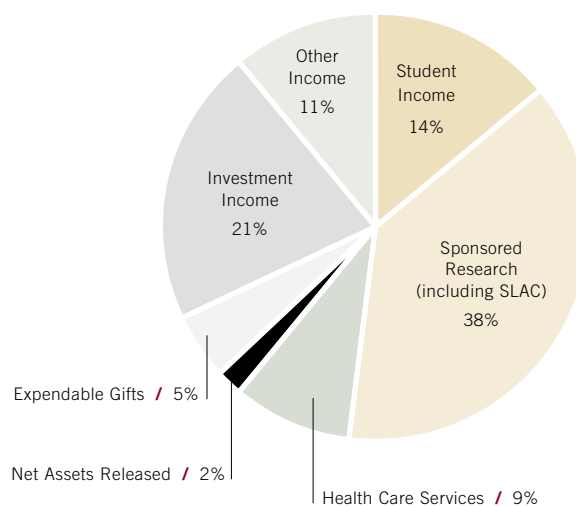
Health care services increased \$19.5 million, or 11.9%, to \$183 million in FY02.

Expendable gifts in support of operations decreased \$7 million to \$104 million in FY02. These gifts are immediately expendable for purposes described by the donor.

Investment income represented 21% of University revenue. Endowment income distributed for operations was \$378 million in FY02, equal to 4.6% of total endowment value at the beginning of the year, and up from \$354 million, or 3.9%, in FY01. The University applies a "smoothing formula" in determining the endowment distribution to ease the highs and lows created by a volatile investment market. Net assets of the University's endowment declined 7.7% to \$7.6 billion at August 31, 2002 due to a decline in equity market values and amounts distributed from the endowment to support operations. The endowment represents approximately 72% of the University's net assets and is a significant source of revenue for the University, covering 17.7% of expenses in FY02.

FIGURE 2

UNIVERSITY OPERATING REVENUES FY02 (\$2.1 BILLION)

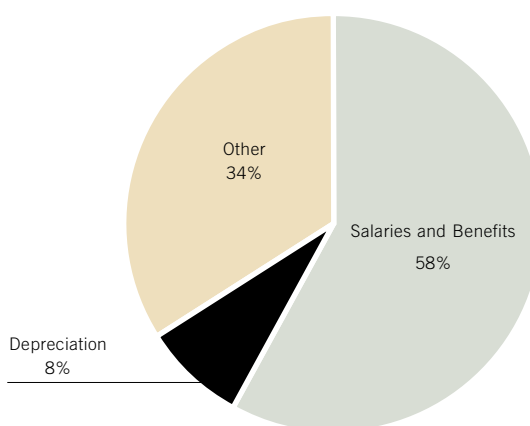


The market downturn contributed to a decline in other investment income, as well. The payout to operations from the Expendable Funds Pool (“EFP”) was approximately \$37 million in FY02, compared to \$42 million in FY01.

Special program fees and other income totaled \$239 million in FY02, compared to \$238 million in FY01. This classification includes the external revenues generated by auxiliary enterprises and service centers and special programs, including technology licensing, executive education programs, and corporate affiliates programs. This includes the operations of residential housing and dining (other than room and board revenues from students), catering services, revenues from the Stanford West Apartments, and revenues from intercollegiate athletic activities.

Total expenses increased \$185 million, or 9.5%, to \$2.1 billion in FY02. As depicted in Figure 3, salaries and benefits comprise approximately 58% of the University’s total expenses, depreciation expense was 8%, and other operating expenses represented 34%.

FIGURE 3
UNIVERSITY OPERATING EXPENSES FY02 (\$2.1 BILLION)



HOSPITALS

The financial results and financial position of Stanford Hospital and Clinics (“SHC”) and Lucile Packard Children’s Hospital (“LPCH”) are combined in the University’s financial statements under the “Hospitals” column. The University’s investment in UCSF Stanford Health Care and its share of the joint venture’s results are recorded on the equity method and are also included in the “Hospitals” column.

SHC and LPCH combined recorded an excess of revenues over expenses from operations of \$51 million in FY02, compared with a \$13 million operating deficit in FY01. Despite the current year’s strong financial results, the health care environment remains volatile, and the administrations of both institutions remain braced for continuing challenges. SHC and LPCH continue to be adversely affected by insufficient federal and state reimbursement, especially for academic medical centers, and by labor shortages in skilled positions. The net income for FY02 is in contrast to years of deficit and will make possible a much-needed reinvestment in the Hospitals.

Operational improvements, including improved payor contract rates, enhanced revenue cycle performance, cost reductions, program development, and increased volume in key areas, accounted for the turnaround. Specifically, the Hospitals have focused programmatically on areas of health care appropriate for a distinguished academic medical center with a high degree of expertise in particular specialties. In addition, average patient occupancy increased from 65% in FY01 to 75% in FY02. Enhanced purchasing procedures resulted in a decrease in supply costs. In light of the challenges inherent in health care, management continues to implement operational improvements intended to enhance quality of care and financial performance. SHC and LPCH are committed to providing high-quality health care services in addition to furthering their mission in education and innovative research.

Total salaries and benefits increased 12.7% in FY02. Additional staff was hired to support growth in research and clinical activities, and the University filled a number of open positions that had been difficult to fill prior to the recession in Silicon Valley. In addition, health benefit costs for employees and retirees increased 47% in FY02 from FY01.

Depreciation expense increased 22% as a result of the completion of major projects that were placed in service during FY01 and FY02. Depreciation expense has also continued to increase because of the change in useful lives and the method of computing depreciation based on componentization, both of which were adopted in FY00.

Other operating expenses increased 1.9%. Costs for subcontracted services and research activities increased because of growth in sponsored research projects. Repairs and maintenance increased more than \$5 million in FY02 from FY01 because of new facilities, which also resulted in higher utility costs. Other operating expenses included a one-time \$10 million contribution from Stanford to the Palo Alto Unified School District to help fund a new middle school in Palo Alto.

Other Changes in Unrestricted Net Assets

Unrestricted net assets of the University decreased by \$624 million, including the operating deficit of \$17 million. Most changes in unrestricted net assets were caused by decreases in the value of investments and withdrawals from the endowment totaling \$687 million. Withdrawals from the endowment partially funded the payout to operations from investments of the endowment and EFP. Stanford utilizes dividends, interest, rents, royalties, and realized capital gains to fund the payout to operations. In years of average or better market performance, the University's investment returns exceed the amount of the predetermined payout, and the excess is reinvested. In FY02, the University utilized endowment income of \$221 million and withdrew previously reinvested

Effective September 1, 2001, the University is the sole corporate member of both SHC and LPCH. As in the past, the Hospitals will work together on shared issues and will continue to share services, including laboratory, operating room, general services, information technology, and other services. SHC and LPCH are co-obligated on outstanding bonds and certificates.

On November 15, 2001, the Lucile Packard Foundation for Children's Health announced the five-year, \$500 million Campaign for Lucile Packard Children's Hospital. This campaign benefits LPCH and the University School of Medicine by supporting efforts to improve children's health. To date, the initiative has received an inaugural grant of \$100 million from the David and Lucile Packard Foundation, a promise of \$200 million in matching funds also from the David and Lucile Packard Foundation, and additional pledges of \$153 million.

In FY02, SHC welcomed a new president and CEO, and a new management team is being developed. During the year, groundwork was laid for major strategic planning efforts related to financing, information technology, facilities, and for the organization as a whole.

UCSF Stanford Health Care As of August 31, 2002, the University's investment in UCSF Stanford Health Care was \$7 million. Final dissolution of the joint venture is anticipated to occur during FY03 and depends upon, among other things, statutory filings and approvals from regulatory agencies.

gains of \$157 million to meet the \$378 million payout to operations. Total investment returns of the EFP were \$9.8 million in FY02, requiring a withdrawal of more than \$36.3 million from the endowment to meet the distribution required by Board of Trustees (“the Board”) policy.

Temporarily Restricted Net Assets

Temporarily restricted net assets decreased by \$36 million to \$461 million in FY02. The University received \$100 million of new temporarily restricted gifts and pledges. During the year, \$117 million of temporarily restricted net assets were released from their restrictions and utilized to fund operating activities and capital expenditures.

Permanently Restricted Net Assets

Permanently restricted net assets increased by \$84 million to \$2.8 billion during FY02. The increase was due primarily to the receipt of \$142 million in new gifts and pledges to the endowment, which were offset by negative investment returns and unfavorable actuarial adjustments on living trust investments.

Statement of Financial Position

The University’s financial position remains strong despite the impact of negative investment returns over the past two years. In FY02, total University assets declined \$860 million to \$12.8 billion, and total University liabilities decreased \$285 million to \$2.2 billion. As depicted in Figure 1, while consolidated net assets have declined over the last two years, they have increased more than \$4 billion since the beginning of FY98. Highlights of the Statement of Financial Position are as follows:

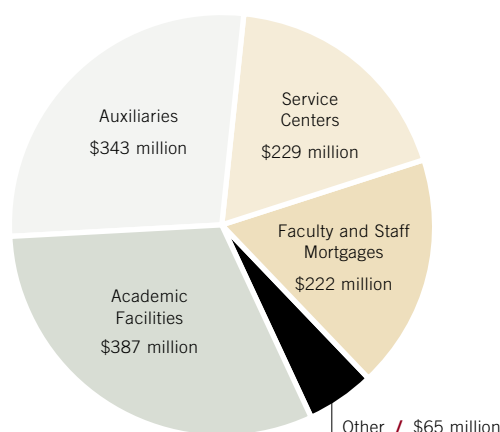
Total investments, primarily consisting of endowment assets and expendable funds, decreased by \$650 million, or 6.6%, to \$9.2 billion.

Net pledges receivable decreased approximately \$56 million to \$464 million for FY02. There were fewer new pledges in FY02 than in FY01, and additional valuation allowances were recorded for pledges that may not be collectible or may take longer to collect.

Plant facilities, net of accumulated depreciation, grew 8.6% to \$2.2 billion. New additions to plant facilities in FY02 totaled \$359 million, bringing total plant facilities before accumulated depreciation to \$3.7 billion. As previously discussed, several new academic, support, and housing facilities were completed in FY02.

Notes and bonds payable were \$1.2 billion at August 31, 2002, an increase of \$29 million from FY01. As of August 31, 2002, \$387 million in debt has been allocated to academic facilities, such as the new Mechanical Engineering Research Laboratory; \$343 million

FIGURE 4
USES OF DEBT (\$1.2 BILLION)



to auxiliaries, primarily residential housing and dining facilities, and the Stanford West Apartments; \$229 million to service centers, primarily for utility infrastructure projects, information technology, and communications purposes; \$222 million to faculty and staff mortgage loans; and the remaining \$65 million to other miscellaneous projects. See Figure 4. The University's debt ratios are within the guidelines of the debt policy approved by the Board. The debt policy specifies the amount and type of debt Stanford may incur and preserves the University's long-term debt capacity, financial flexibility, and access to capital markets.

Conclusion

The University sustained substantial losses in the value of its investments during the last two years and recorded its first operating deficit in many years. Despite a second consecutive year of investment losses, the University remains in a much stronger financial position than five years ago. In addition, the University is undertaking a number of steps to respond to the challenging economic environment. With the continued support of the faculty, staff, students, trustees, alumni, and other friends, our strong financial base will facilitate the University continuing to offer an unparalleled education to future generations of students. Stanford's commitment to excellence in teaching and research is unwavering.



RANDALL S. LIVINGSTON
Vice President for Business Affairs
and Chief Financial Officer



M. SUZANNE CALANDRA
Controller

SELECTED FINANCIAL DATA

Fiscal years ended August 31
(in millions of dollars)

	2002	2001	2000	1999	1998
FINANCIAL:					
PRINCIPAL SOURCES OF OPERATING REVENUES:					
Student tuition and fees, net of student financial aid (A)	\$ 305	\$ 300	\$ 280	\$ 268	\$266
Sponsored research support	802	727	674	634	636
Patient Care (B)	1,177	1,005	362	-	-
Expendable gifts in support of operations	104	111	113	97	78
Endowment income in support of operations	454	445	514	403	264
PRINCIPAL PURPOSES OF EXPENDITURES:					
Instruction and departmental research	681	655	610	558	507
Organized research (direct costs)	707	628	581	520	525
Health care services (B)	1,019	935	397	-	-
Libraries	101	105	93	75	71
Administration, development, and general	238	217	183	185	146
FINANCIAL POSITION HIGHLIGHTS:					
Pledges receivable, net	513	527	481	177	172
Investments at fair value	9,520	10,141	10,784	7,807	6,097
Plant facilities, net of accumulated depreciation	2,527	2,365	2,204	1,718	1,498
Equity investment in related health care entities (B)	7	5	20	452	476
Notes and bonds payable:					
University	1,246	1,218	1,135	1,126	961
Hospital	224	228	235	-	-
University endowment, end of year	7,613	8,250	8,886	6,227	4,745
Total net assets	11,073	11,534	12,125	8,938	7,285

	2002	2001	2000	1999	1998
STUDENTS:					
ENROLLMENT: (C)					
Undergraduate	6,731	6,637	6,548	6,594	6,591
Graduate	7,608	7,536	7,700	7,625	7,553
DEGREES CONFERRED:					
Bachelor's degrees	1,692	1,676	1,737	1,687	1,694
Advanced degrees	2,777	2,936	2,904	2,909	2,859
FACULTY:					
Members of the Academic Council	1,377	1,384	1,368	1,364	1,535
ANNUAL UNDERGRADUATE TUITION RATE	\$25,917	\$24,441	\$23,058	\$22,110	\$21,300

(A) Financial aid is reported as a reduction of student income in the statements of activities.

(B) Beginning in fiscal year 2000, health care activities have been reported on a consolidated basis. Prior to that, they were reported on an equity basis.

(C) Enrollment for fall quarter immediately following fiscal year end.

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

At August 31, 2002 and 2001
(in thousands of dollars)

	2002			2001
	UNIVERSITY	HOSPITALS	CONSOLIDATED	CONSOLIDATED
ASSETS				
Cash and cash equivalents	\$ 345,784	\$ 176,411	\$ 522,195	\$ 817,343
Accounts receivable, net	160,348	184,948	345,296	333,871
Receivables (payables) from SHC and LPCH, net	8,720	(8,720)	-	-
Inventories, prepaid expenses, and other assets	34,739	31,255	65,994	69,779
Pledges receivable, net	463,726	49,408	513,134	527,284
Student loans receivable, net	68,072	-	68,072	74,185
Faculty and staff mortgages and other loans receivable, net	257,956	-	257,956	211,358
Investments at fair value, including securities pledged or on loan of \$30,200 and \$389,936 for 2002 and 2001, respectively	9,221,048	298,668	9,519,716	10,140,812
Investment in UCSF Stanford Health Care	-	6,547	6,547	5,443
Plant facilities, net of accumulated depreciation	2,228,948	298,506	2,527,454	2,364,912
Collections of works of art	-	-	-	-
Total assets	\$ 12,789,341	\$ 1,037,023	\$ 13,826,364	\$ 14,544,987
LIABILITIES AND NET ASSETS				
LIABILITIES:				
Accounts payable and accrued expenses	\$ 622,254	\$ 311,266	\$ 933,520	\$ 732,838
Liabilities under security agreements	28,845	-	28,845	511,507
Income beneficiary share of living trust investments	267,514	-	267,514	271,046
Notes and bonds payable	1,246,281	224,265	1,470,546	1,445,491
U.S. Government refundable loan funds	52,705	-	52,705	50,256
Total liabilities	2,217,599	535,531	2,753,130	3,011,138
NET ASSETS:				
Unrestricted	7,278,420	341,815	7,620,235	8,190,557
Temporarily restricted	460,960	69,097	530,057	525,896
Permanently restricted	2,832,362	90,580	2,922,942	2,817,396
Total net assets	10,571,742	501,492	11,073,234	11,533,849
Total liabilities and net assets	\$ 12,789,341	\$ 1,037,023	\$ 13,826,364	\$ 14,544,987

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF ACTIVITIES

Years ended August 31, 2002 and 2001
(in thousands of dollars)

STANFORD UNIVERSITY

	2002			2001
	UNIVERSITY	HOSPITALS	CONSOLIDATED	CONSOLIDATED
UNRESTRICTED NET ASSETS ACTIVITY				
REVENUES:				
Student income:				
Undergraduate programs	\$ 175,508	\$ –	\$ 175,508	\$ 161,164
Graduate programs	157,752	–	157,752	157,241
Room and board	78,273	–	78,273	72,967
Student financial aid	(106,693)	–	(106,693)	(91,671)
Total student income	304,840	–	304,840	299,701
Sponsored research support (primarily federal):				
Direct costs—University	439,837	–	439,837	400,344
Direct costs—Stanford Linear Accelerator Center	227,809	–	227,809	205,480
Indirect costs	133,956	–	133,956	121,659
Total sponsored research support	801,602	–	801,602	727,483
Health care services:				
Patient care, net	–	1,177,419	1,177,419	1,004,928
Physicians' services and support—SHC and LPCH, net	178,913	(178,913)	–	–
Physicians' services and support—other facilities, net	3,883	–	3,883	5,215
Total health care services	182,796	998,506	1,181,302	1,010,143
Expendable gifts in support of operations	104,310	–	104,310	111,412
Investment income distributed for operations:				
Endowment	377,765	–	377,765	354,441
Expendable Funds Pool and other investment income	69,450	6,759	76,209	90,413
Total investment income distributed for operations	447,215	6,759	453,974	444,854
Special program fees and other income	238,846	52,809	291,655	274,358
Net assets released from restrictions	39,827	11,829	51,656	64,262
Total revenues	2,119,436	1,069,903	3,189,339	2,932,213
EXPENSES:				
Salaries and benefits	1,239,629	526,339	1,765,968	1,587,145
Depreciation	175,854	50,154	226,008	192,494
Other operating expenses	721,313	442,236	1,163,549	1,106,581
Total expenses	2,136,796	1,018,729	3,155,525	2,886,220
Excess (deficit) of revenues over expenses	\$ (17,360)	\$ 51,174	\$ 33,814	\$ 45,993

The accompanying notes are an integral part of these consolidated financial statements.

Years ended August 31, 2002 and 2001
(in thousands of dollars)

	2002		2001	
	UNIVERSITY	HOSPITALS	CONSOLIDATED	CONSOLIDATED
UNRESTRICTED NET ASSETS ACTIVITY (continued)				
Excess (deficit) of revenues over expenses	\$ (17,360)	\$ 51,174	\$ 33,814	\$ 45,993
Other changes in unrestricted net assets:				
Expendable gifts invested in the endowment	6,127	–	6,127	5,884
Investment losses and net withdrawals from the endowment	(687,469)	(4,836)	(692,305)	(930,227)
Change in equity investment in UCSF Stanford Health Care	–	1,104	1,104	(14,620)
Capital and other gifts released from restrictions	76,789	3,352	80,141	50,444
Other	(1,988)	2,785	797	19,010
Net change in unrestricted net assets	(623,901)	53,579	(570,322)	(823,516)
TEMPORARILY RESTRICTED NET ASSETS ACTIVITY				
Gifts and pledges, net	99,538	41,750	141,288	167,316
Investment income (loss)	(2,415)	4,492	2,077	(19,105)
Living trust investment loss and actuarial adjustment	(3,952)	–	(3,952)	(5,744)
Net assets released to operations	(39,827)	(11,829)	(51,656)	(64,262)
Capital and other gifts released to unrestricted net assets	(76,789)	(3,352)	(80,141)	(50,444)
Other	(12,810)	9,355	(3,455)	(5,689)
Net change in temporarily restricted net assets	(36,255)	40,416	4,161	22,072
PERMANENTLY RESTRICTED NET ASSETS ACTIVITY				
Gifts and pledges, net	141,741	32,021	173,762	211,903
Investment loss	(39,535)	(1,209)	(40,744)	(35,889)
Living trust investment income (loss) and actuarial adjustment	(13,560)	–	(13,560)	18,601
Other	(4,279)	(9,633)	(13,912)	15,898
Net change in permanently restricted net assets	84,367	21,179	105,546	210,513
Net change in total net assets	(575,789)	115,174	(460,615)	(590,931)
Total net assets, beginning of year	11,147,531	386,318	11,533,849	12,124,780
Total net assets, end of year	\$ 10,571,742	\$ 501,492	\$ 11,073,234	\$ 11,533,849

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended August 31, 2002 and 2001
(in thousands of dollars)

	2002			2001
	UNIVERSITY	HOSPITALS	CONSOLIDATED	CONSOLIDATED
CASH FLOW FROM OPERATING ACTIVITIES				
Change in net assets	\$ (575,789)	\$ 115,174	\$ (460,615)	\$ (590,931)
Adjustments to reconcile change in net assets to net cash provided by (used for) operating activities:				
Depreciation, amortization, and loss on disposal of fixed assets	183,420	50,154	233,574	205,247
Net realized and unrealized losses on investments and security agreements	588,782	5,395	594,177	785,585
Net realized and unrealized losses (gains) on derivatives	(4,200)	45	(4,155)	9,315
Actuarial change on living trust obligations	(27,607)	–	(27,607)	(733)
Equity in UCSF Stanford Health Care	–	(1,104)	(1,104)	(2,124)
Permanently restricted investment income reinvested	(1,968)	(3,842)	(5,810)	(2,599)
Gifts restricted for long-term investments	(242,096)	–	(242,096)	(231,246)
Net (increase) decrease in accounts receivable, pledges receivable, and receivables from SHC and LPCH	32,111	(57,084)	(24,973)	25,413
Increase in U.S. Government refundable loan funds	2,449	–	2,449	945
(Increase) decrease in inventories, prepaid expenses, and other assets	10,684	(6,900)	3,784	(7,150)
Increase (decrease) in accounts payable and accrued expenses	28,044	30,096	58,140	(79,439)
Net cash provided by (used for) operating activities	(6,170)	131,934	125,764	112,283
CASH FLOW FROM INVESTING ACTIVITIES				
Land, building, and equipment purchases	(358,987)	(36,936)	(395,923)	(343,567)
Student, faculty, and other loans:				
New loans made	(82,155)	–	(82,155)	(81,131)
Principal collected	41,670	–	41,670	43,428
Purchases of investments	(4,865,776)	(73,902)	(4,939,678)	(3,975,503)
Sales and maturities of investments	5,066,931	39,153	5,106,084	3,936,145
Cash transferred from UCSF Stanford Health Care	–	–	–	41,130
Net cash used for investing activities	(198,317)	(71,685)	(270,002)	(379,498)
CASH FLOW FROM FINANCING ACTIVITIES				
Gifts and reinvested income of endowment, capital projects, and other restricted purposes	310,248	–	310,248	197,328
Increase in investment income for restricted purposes	1,968	3,842	5,810	2,599
Proceeds from borrowing	73,390	–	73,390	307,224
Repayment of notes and bonds payable	(44,764)	(3,570)	(48,334)	(170,404)
Liabilities under security agreements	(492,024)	–	(492,024)	214,145
Net cash provided by (used for) financing activities	(151,182)	272	(150,910)	550,892
Increase (decrease) in cash and cash equivalents	(355,669)	60,521	(295,148)	283,677
Cash and cash equivalents, beginning of year	701,453	115,890	817,343	533,666
Cash and cash equivalents, end of year	\$ 345,784	\$ 176,411	\$ 522,195	\$ 817,343
SUPPLEMENTAL DATA:				
Gifts of equipment	\$ 326	\$ 707	\$ 1,033	\$ 1,553
Interest paid during the year	61,495	12,888	74,383	74,668
Reduction in debt related to real estate partnerships	–	–	–	60,412

The accompanying notes are an integral part of these consolidated financial statements.

1. Basis of Presentation and Significant Accounting Policies

Basis of Presentation > The consolidated financial statements include the accounts of Stanford University (the University), Stanford Hospital and Clinics (SHC), Lucile Salter Packard Children's Hospital at Stanford (LPCCH), and other majority-owned or controlled entities. All significant inter-entity transactions and balances have been eliminated upon consolidation. Certain prior year amounts have been reclassified to conform to the current year's presentation.

University The University is a private, not-for-profit educational institution, founded in 1885 by Senator Leland and Mrs. Jane Stanford in memory of their son, Leland Stanford, Jr. A Board of Trustees (the Board) governs the University, which is organized into seven schools with approximately 1,700 faculty and more than 14,300 graduate and undergraduate students. The "University" category presented in the financial statements comprises all the accounts of the University, including Stanford Alumni Association (SAA), the Hoover Institution and other institutes and research centers, and Stanford Linear Accelerator Center (SLAC).

The University manages and operates SLAC for the Department of Energy (DOE) under a management and operating contract; therefore, the revenues and expenditures of SLAC are included in the statement of activities. SLAC is a federally funded research and development center owned by the DOE and, accordingly, the assets and liabilities are not included in the University's statement of financial position.

Hospitals The "Hospitals" category presented in the financial statements includes SHC, LPCCH, and the University's investment in UCSF Stanford Health Care, a nonprofit corporation controlled jointly by the University and the Regents of the University of California (UC). The University's investment in UCSF Stanford Health Care is presented in these financial statements based on the equity method of accounting. The health care activities of SHC and LPCCH (the Hospitals), including revenues, expenses, assets, and liabilities, are consolidated in these financial statements (see Note 2).

Basis of Accounting > The financial statements are prepared in accordance with generally accepted accounting principles. These principles require management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

For financial reporting purposes, net assets and revenues, expenses, gains, and losses are classified in one of three categories—unrestricted, temporarily restricted, or permanently restricted.

Unrestricted Net Assets Unrestricted net assets are expendable resources used to support the University's core activities of teaching and research or the Hospitals' patient care, teaching, and research missions. These net assets may be designated by the University or the Hospitals for specific purposes under internal operating and administrative arrangements or be subject to contractual agreements with external parties. Donor-restricted contributions that relate to the University's or the Hospitals' core activities and are received and expended, or deemed expended due to the nature of donors' restrictions are classified as unrestricted. Donor-restricted resources intended for

capital projects are released from their temporary restrictions and reclassified as unrestricted support when spent. All expenses are recorded as a reduction of unrestricted net assets. Unrestricted net assets include funds designated for operations, plant facilities, endowment gains, and funds functioning as endowment.

Management considers all revenues and expenses to be related to operations except investment losses and net withdrawals from the endowment, capital gifts and other gifts released from restrictions, expendable gifts invested in the endowment, and certain other nonoperating changes, which are reported in other changes in unrestricted net assets.

Temporarily Restricted Net Assets Temporarily restricted net assets include investments and pledges that are subject to donor-imposed restrictions that expire in accordance with donor restrictions. Donor restrictions may include the passage of time, payment of pledges, or specific actions undertaken by the University or the Hospitals. When the donor restriction is met, the assets are released and reclassified to unrestricted support. Temporarily restricted net assets are comprised of approximately 40% in capital projects and 60% in other institutional support.

Permanently Restricted Net Assets Permanently restricted net assets consist principally of endowment funds, which are subject to donor-imposed restrictions requiring that the principal be invested in perpetuity.

Cash and Cash Equivalents > Cash and cash equivalents including u.s. Treasury bills, bankers' acceptances, commercial paper, certificates of deposit, money market funds, and other short-term investments with remaining maturities of 90 days or less at the time of purchase, are carried at cost, which approximates market. Cash and cash equivalent amounts held in the endowment, as well as certain cash restricted in its use by the Hospitals, are classified as investments.

Student Loans Receivable > Student loans receivable are carried at cost, less an allowance for doubtful accounts. Determination of the fair value of student loans receivable is considered impractical due to donor-restricted and federally sponsored student loans with mandated interest rates and repayment terms subject to significant restrictions as to their transfer and disposition.

Investments > Investments are generally recorded at fair value. The values of fixed income and publicly traded equity securities are based on quoted market prices and exchange rates, if applicable. Assets held by other trustees, limited partnerships, real estate and improvements, and other investments are recorded based on estimated fair values. Methods for determining estimated fair values include discounted cash flows and estimates provided by trustees and general partners. The estimated fair values of certain of these investments are based on valuations provided by the external investment managers as of June 30, adjusted for cash receipts, cash disbursements, and securities distributions through August 31. The University believes the carrying amounts of these financial instruments are a reasonable estimate of fair value. Because the limited partnership investments are not readily marketable, their estimated value is subject to uncertainty and therefore may differ from the value that would have been used had a ready market for such investments existed. Such difference could be material. Undeveloped land is reported at cost. Donated assets are recorded at fair value at the date of donation. Estimates of fair value involve assumptions and estimation methods that are uncertain and, therefore, the estimates could differ from actual results. Securities transactions are reported on a trade-date basis.

Derivatives > Derivative financial instruments are recorded at fair value with the resulting gain or loss recognized in the consolidated statement of activities (see Note 6).

Plant Facilities > Plant facilities are recorded at cost or fair value at date of donation. Interest for construction financing is capitalized as a cost of construction. Depreciation is computed using the straight-line method over the estimated useful lives of the assets.

The useful lives used in calculating depreciation for years ended August 31, 2002 and 2001 are as follows:

	<u>UNIVERSITY</u>	<u>HOSPITALS</u>
Buildings	20–40 years	7–40 years
Land and building improvements	10–40 years	10–40 years
Equipment and books	3–10 years	3–20 years

Collections of Works of Art > Art objects and collections are not capitalized, as the University uses the proceeds from any sales of such items to acquire other art or collection pieces.

Self-insurance > The University self-insures up to specified limits for unemployment, disability, property losses, and general and professional liability losses. The Hospitals self-insure up to specified limits for workers’ compensation and medical malpractice losses. Third-party insurance is purchased to cover liabilities above specific per-claim exposures. Estimates of retained exposures are accrued.

Student Income > Financial assistance in the form of scholarship and fellowship grants that cover a portion of tuition, living, and other costs is reflected as a reduction in student income.

Health Care Services > The Hospitals derive a majority of patient-care revenue from contractual agreements with Medicare, Medi-Cal, and certain other contracted rate payors. Payments under these agreements and programs are based on a percentage of charges, per diem, per discharge, per service, a fee schedule, or cost reimbursement or capitation methodology.

Charity Care > SHC and LPCH provide care to patients who meet certain criteria under its charity-care policy without charge or at amounts less than its established rates. Amounts determined to qualify as charity care are not reported as net patient service revenue. SHC and LPCH also provide services to other indigent patients under Medi-Cal and other publicly sponsored programs, which reimburse at amounts less than the cost of the services provided to the recipients. The difference between the cost of services provided to these indigent persons and the expected reimbursement is included in the estimated cost of charity care. The amount of charity care services, quantified at established rates, was \$10,291,000 and \$5,448,000 for the years ended August 31, 2002 and 2001, respectively. Estimated cost in excess of reimbursement for Medi-Cal and county services provided by the Hospitals for the years ended August 31, 2002 and 2001 was \$63,869,000 and \$40,525,000, respectively (unaudited).

Tax Status > The University and the Hospitals are exempt from federal income tax to the extent provided by Section 501(c) (3) of the Internal Revenue Code.

Separate Hospital Financial Statements > Each of the Hospitals prepares separate, stand-alone financial statements. For purposes of presentation of the Hospitals' balance sheets, statements of operations and changes in net assets, and statements of cash flows in these consolidated financial statements, conforming reclassifications have been made to the Hospitals' revenues and expenses and inter-entity receivables and payables consistent with categories in the consolidated financial statements.

During the year ended August 31, 2002, the hospitals restated their opening net assets as of September 1, 2001 to correct certain identified errors. The net effect of these restatements was to increase the consolidated change in net assets by approximately \$2.4 million. The consolidated financial statements were not restated because the adjustments were not material. The adjustments are reported in other changes in unrestricted, temporarily restricted, and permanently restricted net assets in the 2002 "Hospitals" column in the accompanying consolidated financial statements.

2. Health Care Entities

The Hospitals are California nonprofit, public-benefit corporations. The University is the sole member of the Hospitals. Prior to September 1, 2001, SHC was the sole member of LPCH.

The Hospitals support the mission of medical education and clinical research of the University's School of Medicine. They operate two licensed acute care and specialty hospitals on the Stanford campus and numerous physician clinics on the campus, in community settings, and in association with regional hospitals in the San Francisco Bay area. SHC also is the sole shareholder of a captive insurance company and a medical practice facility.

The University has entered into various operating agreements with the Hospitals for professional services of faculty members of the Stanford University School of Medicine, telecommunications services, and other services and facilities charges. Revenues and expenses related to these agreements are eliminated in consolidation. The Hospitals' investments, with a combined market value of \$218,612,000 and \$182,465,000 at August 31, 2002 and 2001, respectively, are managed by the University.

University's Investment in UCSF Stanford Health Care > UCSF Stanford Health Care operated the clinical facilities of Stanford Health Services, the predecessor of SHC, LPCH, and the University of California, San Francisco Medical Center (UCSF), from November 1, 1997 through March 31, 2000. Effective March 31, 2000, the operating activities of UCSF Stanford Health Care were terminated. On April 1, 2000, UCSF Stanford Health Care transferred the operations of its clinical facilities to SHC, LPCH, and UC.

The following table summarizes the University's investment in UCSF Stanford Health Care and the net assets of UCSF Stanford Health Care as of August 31, 2002 and 2001, in thousands of dollars:

	<u>UNAUDITED</u>	
	<u>2002</u>	<u>2001</u>
University's investment in UCSF Stanford Health Care	\$ 6,547	\$ 5,443
Net assets of UCSF Stanford Health Care	\$ 12,003	\$ 12,336

Final dissolution of UCSF Stanford Health Care is anticipated to occur on or about March 31, 2003, and depends upon, among other things, statutory filings and approvals. Net ongoing operating costs of UCSF Stanford Health Care subsequent to March 31, 2000 continue to be borne by the University and UC.

3. Accounts Receivable

Accounts receivable at August 31, 2002 and 2001, in thousands of dollars, are as follows:

	<u>2002</u>	<u>2001</u>
UNIVERSITY:		
U.S. Government	\$ 43,208	\$ 51,229
Due from brokers	63,846	47,466
Accrued interest on investments	17,836	18,779
Non-government sponsors	16,126	14,398
Student	2,297	3,246
Other	19,292	25,607
	162,605	160,725
Less allowances for losses	2,257	2,000
	160,348	158,725
HOSPITALS:		
Hospitals' gross patient receivables	523,651	394,729
Other	11,266	11,917
	534,917	406,646
Less contractual and bad debt allowances	349,969	231,500
	184,948	175,146
Consolidated accounts receivable	\$ 345,296	\$ 333,871

4. Pledges Receivable

Unconditional promises are included in the financial statements as pledges receivable and are classified as temporarily restricted or permanently restricted, depending upon donor requirements. Conditional promises, which depend on the occurrence of a specified future and uncertain event, such as matching gifts from other donors, are recognized when the conditions are substantially met. Total combined conditional pledges for the University and Hospitals for August 31, 2002 and 2001 were approximately \$384,000,000 and \$270,000,000, respectively. Pledges are recorded at the present value of the discounted future cash flows, net of allowances. At August 31, 2002 and 2001, pledges receivable are as follows, in thousands of dollars:

	UNIVERSITY	2002 HOSPITALS	CONSOLIDATED	2001 CONSOLIDATED
One year or less	\$ 49,679	\$ 32,798	\$ 82,477	\$ 75,109
Between one year and five years	402,899	20,284	423,183	435,942
More than five years	228,822	4,921	233,743	254,980
	681,400	58,003	739,403	766,031
Less discount/allowance	217,674	8,595	226,269	238,747
Pledges receivable	\$ 463,726	\$ 49,408	\$ 513,134	\$ 527,284

5. Faculty and Staff Mortgages

In a program to attract and retain excellent faculty and senior staff, the University provides home mortgage financing assistance. Notes amounting to \$256,143,000 and \$208,259,000 at August 31, 2002 and 2001, respectively, from University faculty and staff are included in "Faculty and staff mortgages and other loans receivable, net" in the consolidated statements of financial position and are collateralized by deeds of trust on properties concentrated in the region surrounding the University.

6. Investments

Investments held by the University and the Hospitals at August 31, 2002 and 2001 are reported as follows, in thousands of dollars:

	2002			2001
	UNIVERSITY	HOSPITALS	CONSOLIDATED	CONSOLIDATED
Cash and short-term investments	\$ 503,023	\$ 167,216	\$ 670,239	\$ 738,575
Bonds and mutual funds	1,520,718	32,424	1,553,142	1,293,251
Public equities and mutual funds	3,588,653	16,921	3,605,574	4,506,243
Assets held by other trustees (net of income beneficiary share of \$40,625 and \$38,948 at August 31, 2002 and 2001, respectively)	82,106	-	82,106	96,528
Real estate and improvements, including Stanford Shopping Center and Research Park	1,020,012	-	1,020,012	949,493
Limited partnership investments	2,537,800	-	2,537,800	2,494,535
Other	50,843	-	50,843	62,187
	9,303,155	216,561	9,519,716	10,140,812
The Hospitals' investment in University's Merged Endowment Pool	(82,107)	82,107	-	-
Investments at fair value	\$ 9,221,048	\$ 298,668	\$ 9,519,716	\$ 10,140,812

The University reports endowment cash and short-term investments as investments.

Total investment return (loss) reflected in the statement of activities for the years ended August 31, 2002 and 2001, in thousands of dollars, is as follows:

	2002			2001
	UNIVERSITY	HOSPITALS	CONSOLIDATED	CONSOLIDATED
Investment income	\$ 289,066	\$ 10,601	\$ 299,667	\$ 285,075
Net realized and unrealized gains (losses)	(588,782)	(5,395)	(594,177)	(785,585)
Total investment return (loss)	\$ (299,716)	\$ 5,206	\$ (294,510)	\$ (500,510)

Recognized investment losses and utilized prior years' gains that were not reported in operating activities amounted to \$747,484,000 and \$945,364,000 for the years ended August 31, 2002 and 2001, respectively.

As indicated in the following table, as of August 31, 2002 and 2001, in thousands of dollars, the University's investments are invested in the Expendable Funds Pool (EFP), the Merged Endowment Pool, or in specific instruments to comply with donor requirements:

	<u>2002</u>	<u>2001</u>
UNIVERSITY:		
Expendable Funds Pool	\$ 1,041,658	\$ 1,099,178
Merged Endowment Pool	7,305,562	7,811,508
Living trusts	508,281	539,623
Other investments	1,064,653	1,085,436
	9,920,154	10,535,745
Less funds cross-invested in endowment pools (including the Hospitals' investment of \$82,107 and \$47,257 in 2002 and 2001, respectively, in the University's Merged Endowment Pool)	699,106	664,247
	9,221,048	9,871,498
HOSPITALS:		
Investments	298,668	269,314
Investments at fair value	\$ 9,519,716	\$ 10,140,812

The EFP is a pool of funds that is intended to provide adequate liquidity as well as an opportunity for the University to earn long-term growth on a portion of the pool. Approximately one-fourth of the EFP is invested in short-term or highly liquid securities and is included in the statement of position as cash and cash equivalents. Approximately one-fourth of the EFP is invested in fixed-income securities, and the balance is cross-invested in the Merged Endowment Pool. The Board has established a policy for the distribution of the investment returns of the EFP. The policy requires that an amount based upon a range of preset interest rates be made available to support current operations. The difference between the actual return of this pool and the required distribution amount is deposited or withdrawn from funds functioning as endowment. For the years ended August 31, 2002 and 2001, the results of the EFP, in thousands of dollars, are as follows:

	<u>2002</u>	<u>2001</u>
Total investment return of the EFP	\$ 9,769	\$ 35,529
Less distribution to fund holders and operations	46,119	54,936
Amounts withdrawn from the endowment	\$ (36,350)	\$ (19,407)

The University's endowment is invested with the objective of maximizing long-term total return. The University's policy governing the amounts paid annually from the endowment to support current operations is designed to protect the value of the endowment against the expected impact of inflation and to provide real growth of the endowment, while also funding a relatively constant portion of the University's current operating expenditures. The sources of the payout are earned income on the endowment assets (interest, dividends, rents, and royalties), previously reinvested income, and a portion of realized capital gains.

To meet the Board-authorized payout rate, income, gains, and previously reinvested endowment income were distributed for operations in fiscal years 2002 and 2001, as follows, in thousands of dollars:

	<u>2002</u>	<u>2001</u>
Endowment income	\$ 220,973	\$ 215,989
Realized gains and previously reinvested income	156,792	138,452
Approved payout	\$ 377,765	\$ 354,441

The University utilizes derivatives and other strategies to manage market risks, including interest rate and foreign currency risks, and to achieve efficient exposure to certain asset classes. Foreign currency forward contracts are used primarily for the purpose of minimizing the risk to the University of adverse changes in the relationship between currencies. Interest rate swaps are used to manage the interest rate exposure of the University's commercial paper (see Note 8). Options and futures contracts are used for the purpose of reducing the risk level of its investments or serving as a temporary surrogate for investment in stocks and bonds.

At August 31, 2002, the University's derivative positions included foreign currency forward contracts, interest rate swaps, and options and futures contracts. The fair value (loss) of these derivatives was \$ (12,569,000) and \$14,507,000 at August 31, 2002 and 2001, respectively.

Foreign currency forward contracts, interest rate swaps, stock lending, and repurchase agreements necessarily involve counterparty credit risk. The University seeks to control this risk by entering into transactions with high quality counterparties and through counterparty credit evaluations and approvals, counterparty credit limits, and exposure monitoring. With respect to securities lending and repurchase agreements, it is the University's policy to require receipt of collateral on each contract equal to a minimum of 102% of the security loaned.

7. Plant Facilities

Plant facilities at August 31, 2002 and 2001, in thousands of dollars, are as follows:

	UNIVERSITY	2002 HOSPITALS	CONSOLIDATED	2001 CONSOLIDATED
Land and improvements	\$ 199,448	\$ 5,885	\$ 205,333	\$ 148,382
Buildings	2,141,890	446,167	2,588,057	2,400,873
Equipment and books	1,092,091	291,473	1,383,564	1,293,462
Construction in progress	224,524	59,576	284,100	238,780
Plant facilities	3,657,953	803,101	4,461,054	4,081,497
Less accumulated depreciation	1,429,005	504,595	1,933,600	1,716,585
Plant facilities, net of accumulated depreciation	\$ 2,228,948	\$ 298,506	\$ 2,527,454	\$ 2,364,912

8. University Notes and Bonds Payable

Notes and bonds payable at August 31, 2002 and 2001, in thousands of dollars, are as follows:

	2002	2001
TAX-EXEMPT:		
California Educational Facilities Authority (CEFA):		
Revenue Bonds, Series M, N, O, P, Q, and R due serially to 2032, with interest from 4.0% to 5.35%	\$ 621,760	\$ 637,250
Revenue Bonds, Series L with variable interest rates	115,033	99,543
Department of Education Bonds of 1963 to 1984 due serially to 2024, with interest from 3.0% to 3.5%	2,554	3,222
TAXABLE:		
Stanford University Bonds due 2024, with fixed interest of 6.875%	150,000	150,000
Medium Term Notes (\$150,000 authorized) due to 2026, with fixed interest from 5.85% to 7.65%	150,000	142,100
Stanford University Bonds PARS 2002A due 2032, with variable interest rates	50,000	-
Commercial Paper, with variable interest rates	128,500	155,000
Other, with various interest rates	27,834	29,726
University notes and bonds payable before net premiums	1,245,681	1,216,841
Net unamortized premiums	600	815
University notes and bonds payable	\$ 1,246,281	\$ 1,217,656

At August 31, 2002 and 2001, the fair value of these debt instruments approximated their recorded value.

The University incurred interest expense of approximately \$51,287,000 and \$53,787,000 for fiscal years 2002 and 2001, respectively, which is net of approximately \$10,207,000 and \$7,029,000, respectively, in interest capitalized as a cost of construction.

Scheduled principal payments on notes and bonds, in thousands of dollars, are:

<u>YEAR</u>	<u>PRINCIPAL</u>
2003 Commercial Paper	\$ 128,500
2003 Other	2,994
2004	1,057
2005	15,309
2006	965
2007	870
Thereafter	1,095,986
Total	\$ 1,245,681

The University has a commercial paper credit facility that provides for borrowings up to \$200,000,000. The outstanding balance at August 31, 2002 was \$128,500,000. The weighted average days to maturity are 88.21, and the weighted average effective interest rate is 1.8%. The University uses interest rate swaps to manage the interest rate exposure of its commercial paper program (see Note 6).

In October 2001, the University issued \$15,490,000 in CEFA L-9 Refunding Revenue Bonds at an initial interest rate of 1.85%, for refunding \$5,590,000 of CEFA J Revenue Bonds and \$9,900,000 of CEFA M Revenue Bonds.

In April 2002, the University issued \$50,000,000 in taxable Bonds Series 2002A. The bonds were initially issued as Periodic Auction Reset Securities (PARS) at a rate of 1.80%. The PARS rate is determined by periodic auction. The bonds may be redeemed at the option of the University, in whole or in part, on the interest payment date immediately following the end of an auction period, as defined in the bond's official statement. The bonds will be due on March 15, 2032.

9. Hospitals' Notes and Bonds Payable

Bonds and certificates at August 31, 2002 and 2001, in thousands of dollars, are as follows:

	<u>2002</u>	<u>2001</u>
Fixed Rate Revenue Bonds 1998 Series B, payable in annual amounts through 2013, with an average interest rate of 5%	\$ 186,265	\$ 188,935
1993 Variable Rate Certificates of Participation, payable in annual amounts through 2023, with an average interest rate of 3%	38,000	38,900
Hospitals' notes and bonds payable	\$ 224,265	\$ 227,835

The bonds and certificates are unsecured joint obligations of the Hospitals (the Obligated Group). Payments of principal and interest on the bonds and certificates are insured by municipal bond guaranty policies. The Master Trust Indenture of the Obligated Group includes, among other things, limitations on additional indebtedness, liens on property, restrictions on disposition or transfer of assets, and compliance with certain financial ratios. The Hospitals may redeem the bonds and certificates, in whole or in part, prior to the stated maturities. Redemption of the bonds requires a premium of up to 1%.

Holders of the certificates have the option to tender the certificates weekly. In order to ensure the availability of funds to purchase any certificates tendered that the remarketing agent is unable to remarket, LPCH has obtained a bank credit agreement that expires beginning in September 2003, unless extended by mutual agreement. Other arrangements provide for liquidity through the life of the certificate. LPCH has the option to convert the certificates to a fixed rate.

Estimated principal payments on bonds and certificates, in thousands of dollars, are summarized below:

<u>YEAR</u>	<u>PRINCIPAL</u>
2003	\$ 3,800
2004	4,045
2005	4,190
2006	4,445
2007	4,610
Thereafter	203,175
Total	\$ 224,265

The fair value of these debt instruments is estimated based on the quoted market prices for the same or similar issues and on the current rates offered to the Hospitals for debt of the same remaining maturities. The estimated fair value of the debt instruments as of August 31, 2002 and 2001 approximated the recorded value.

At August 31, 2002, the Obligated Group had swap agreements expiring through 2023 to pay a fixed interest rate of 6.22%. The fair value of the interest rate swap is the estimated amount that the Hospitals would currently pay to terminate the swap agreement at the reporting date, taking into account current interest rates and current creditworthiness of the swap counterparties. The estimated fair value of the interest rate swap was a liability of \$8,295,000 as of August 31, 2002. The effect of the interest rate swap, utilized to offset variable-rate funding, was to increase interest expense by \$2,024,000 for 2002.

The University is not an obligor or guarantor with respect to any obligations of the Obligated Group.

10. Liabilities Under Security Agreements

At August 31, 2002 and 2001, the University held \$251,000 and \$372,962,000, respectively, of short-term U.S. Government obligations and cash as collateral deposits for certain securities loaned temporarily to brokers. These amounts are included as assets and liabilities in the University's financial statements. In addition, at August 31, 2002 and 2001, the University sold securities subject to obligations to repurchase them at a future date in the amount of \$28,594,000 and \$28,469,000, respectively. These borrowings have been accounted for as financing transactions and bear interest at rates of 1.97% and 3.9%, respectively. The estimated market value of securities on loan and pledged under repurchase agreements at August 31, 2002 and 2001 was \$30,200,000 and \$389,936,000, respectively.

The University sells securities "short" in order to enhance investment returns and manage market exposure. At August 31, 2002, there were no securities sold short. At August 31, 2001, the fair market value of such securities was \$110,076,000.

11. University Endowment

The University manages a substantial portion of its financial resources within its endowment. These assets include pure endowment, term endowments, funds functioning as endowment, and funds subject to living trust agreements. Depending on the nature of the donor's stipulation, these resources are recorded as permanently restricted, temporarily restricted, or unrestricted net assets.

Pure endowment funds are subject to the restrictions of the gift instruments requiring that the principal be invested in perpetuity and that only the income and an appropriate portion of gains be spent as provided for under the California Uniform Management of Institutional Funds Act (CUMIFA). In the absence of further donor restrictions, the amount of gains that are to be expended in a given year is determined through the endowment payout policy discussed in Note 6. The University classifies the original endowment gift and any donor-imposed restricted gains as permanently restricted net assets. The University reports the reinvested realized and unrealized gains, which are not subject to donor restriction, as unrestricted net assets. While such gains are not reported as permanently restricted net assets, their expenditures may be limited in part due to the provisions of CUMIFA.

Term endowments are similar to other endowment funds except that, upon the passage of a stated period of time or the occurrence of a particular event, all or part of the principal may be expended. These resources are classified as temporarily restricted net assets.

Funds functioning as endowment are unrestricted University resources designated as endowment by the Board and are invested in the endowment for long-term appreciation and current income. However, these assets remain available and may be spent at the Board's discretion. Funds functioning as endowment are recorded as unrestricted net assets.

Funds subject to living trust agreements represent trusts with living income beneficiaries where the University has a residual interest. The investments of these funds are recorded at their fair market value. The discounted present value of any income beneficiary interest is reported as a liability in the statement of financial position based on actuarial tables established by the Internal Revenue Service. Gifts subject to such agreements are recorded as revenue net of the income beneficiary share at the date of gift. Actuarial gains or losses are included in living trust investment income and actuarial adjustment. Resources that are expendable upon maturity are classified as temporarily restricted net assets; all others are classified as permanently restricted net assets.

Changes in the University's endowment, excluding pledges, for the years ended August 31, 2002 and 2001, in thousands of dollars, are as follows:

	<u>2002</u>	<u>2001</u>
Endowment, beginning of year	\$ 8,249,551	\$ 8,885,905
INVESTMENT RETURNS:		
Earned endowment income (including \$1,819 and \$3,957 reinvested in endowment, as required by donors, in 2002 and 2001, respectively)	222,792	219,946
Change in net realized and unrealized appreciation of investments during the year	(577,326)	(737,553)
Total investment losses	(354,534)	(517,607)
Amounts distributed for operations	(377,765)	(354,441)
Gifts (net of \$10,769 and \$47,420 in pledges in 2002 and 2001, respectively)	130,612	158,159
Funds invested in (withdrawn from) endowment	(12,454)	102,911
Distribution from endowment to fund EFP shortfall	(36,350)	(19,407)
Actuarial adjustment on living trusts	26,697	733
Other changes	(12,988)	(6,702)
Net decrease in endowment	(636,782)	(636,354)
Endowment, end of year	\$ 7,612,769	\$ 8,249,551

12. University Gifts and Pledges

The University's Office of Development (OOD) reports total gifts based on contributions received in cash or property during the fiscal year. Gifts and pledges reported for financial statement purposes are recorded on the accrual basis. The following summarizes gifts and pledges received for the years ended August 31, 2002 and 2001, per the statement of activities reconciled to the cash basis (as reported by OOD), in thousands of dollars:

	<u>2002</u>	<u>2001</u>
Expendable gifts in support of operations	\$ 104,310	\$ 111,412
Expendable gifts invested in the endowment	6,127	5,884
Temporarily restricted - general	54,814	100,651
Temporarily restricted - capital	44,724	41,162
Permanently restricted - endowment	141,725	198,165
Permanently restricted - student loans	16	83
Total per statement of activities	351,716	457,357
ADJUSTMENTS TO GIFT TOTAL AS REPORTED BY OOD:		
Pledges	(158,491)	(215,384)
Payments made on pledges	214,144	177,502
Non-government grants, recorded as sponsored research support	48,741	48,865
Other	(1,341)	626
Total as reported by OOD	\$ 454,769	\$ 468,966

Gifts restricted to particular purposes are used for those purposes subject to the University's restricted fund policy, adopted by the Board in 1995. That policy states that 6% of the expenditure from restricted funds, with exceptions for some categories of funds, is separated out as a space and infrastructure charge. The policy also provides that no interest is credited to gifts that are fully expendable.

13. Functional Expenses

Expenses for each of the years ended August 31, 2002 and 2001, are categorized on a functional basis as follows, in thousands of dollars:

	<u>2002</u>	<u>2001</u>
UNIVERSITY:		
Organized research (direct costs)	\$ 707,343	\$ 627,962
Instruction and departmental research	681,068	655,208
Auxiliary activities	333,296	280,332
Administration and general	176,607	160,865
Libraries	101,153	105,441
Development	60,839	56,129
Student services	58,897	53,171
SLAC construction	17,593	12,433
	2,136,796	1,951,541
HOSPITALS:		
Health care services	1,018,729	934,679
Total consolidated expenses	\$ 3,155,525	\$ 2,886,220

Depreciation, interest, and plant operations and maintenance expenses are allocated to program and supporting activities, except for SLAC construction. Auxiliary activities include housing and dining services, intercollegiate athletics, Stanford Alumni Association, other activities, and certain patient care provided by the School of Medicine.

14. University Retirement Plans

The University provides retirement benefits through both contributory and noncontributory retirement plans for substantially all of its employees. In addition to providing retirement benefits, the University provides certain health care benefits for retired employees (other post-retirement benefits).

Retirement Plans > Retirement benefits for certain nonexempt employees are provided through a noncontributory defined benefit pension plan. The University recognized a credit to net benefit expense related to the defined benefit pension plan of \$3,542,000 and \$11,016,000 for the years ended August 31, 2002 and 2001, respectively. Effective January 1, 2001, for those who were both eligible employees and participants in the plan on that date, benefits for each year of service prior to 1992 are based on 1992 earnings. New plan participants are limited. The University's policy is to fund pension costs in accordance with the Employee Retirement Income Security Act minimum funding requirements.

The University offers a defined contribution plan to eligible faculty and staff. University and participant contributions are invested in annuities and mutual funds. University contributions under this plan amounted to approximately \$60,296,000 and \$54,496,000 for the years ended August 31, 2002 and 2001, respectively.

Other Post-Retirement Benefit Plans > The University's employees may become eligible for other post-retirement benefits upon retirement. Retiree health plans are paid for in part by retiree contributions, which are adjusted annually. Benefits are provided through various insurance companies whose charges are based either on the benefits paid during the year or annual premiums. Health benefits are provided to retirees and their covered dependents. The University recognizes the cost of post-retirement benefits over the periods that employees render service. The University recognizes the prior service obligation over 20 years.

Beginning January 1, 1999, the University capped its health care benefits plan subsidy for post-65 benefits for non-Medicare+ Choice programs. The University's subsidy for post-65 benefits for non-Medicare+ Choice programs was increased effective January 1, 2001. Effective January 1, 2002, the University removed the cap and provided a subsidy equal to the lowest cost plan for non-Medicare+ Choice programs. For the fiscal year beginning September 1, 2003, the University has adopted a fixed subsidy plan designed to cap its contribution. University contributions for pre-Medicare plans will be capped at \$3,800 for retirees and \$3,200 for spouses, and contributions for post-Medicare plans will be capped at \$2,500 for retirees and \$2,000 for spouses.

The change in pension and other post-retirement plan assets and the related change in benefit obligation, in thousands of dollars, as of and for the years ended August 31, 2002 and 2001, are as follows:

	PENSION		OTHER POST-RETIREMENT	
	2002	2001	2002	2001
CHANGE IN PLAN ASSETS				
Fair value of plan assets at beginning of year	\$ 255,925	\$ 284,642	\$ 25,587	\$ 28,103
Actual return on plan assets	(8,909)	(13,022)	(1,054)	(2,516)
Employer contributions	-	-	9,144	6,843
Plan participants' contributions	-	-	3,810	2,575
Benefits paid	(14,417)	(15,695)	(9,697)	(9,418)
Fair value of plan assets at end of year	\$ 232,599	\$ 255,925	\$ 27,790	\$ 25,587
CHANGE IN BENEFIT OBLIGATION				
Benefit obligation at beginning of year	\$ 217,638	\$ 194,559	\$ 157,486	\$ 103,566
Service cost	4,879	4,699	5,864	3,678
Interest cost	14,542	14,961	10,807	7,551
Plan participants' contributions	-	-	3,810	2,575
Amendments	-	10,724	-	34,756
Actuarial loss	15,494	8,390	124,242	14,778
Benefits paid	(14,417)	(15,695)	(9,697)	(9,418)
Benefit obligation at end of year	\$ 238,136	\$ 217,638	\$ 292,512	\$ 157,486

The accrued benefit asset (cost), in thousands of dollars, was determined as follows at August 31, 2002 and 2001:

	PENSION		OTHER POST-RETIREMENT	
	2002	2001	2002	2001
Plan assets minus benefit obligation	\$ (5,537)	\$ 38,287	\$ (264,722)	\$ (131,899)
Unrecognized transition (asset) liability	(4)	(905)	31,001	31,080
Unrecognized prior service cost	9,743	10,980	33,446	36,818
Unrecognized net actuarial (gain) loss	3,675	(44,027)	158,002	31,387
Accrued benefit asset (cost) recorded in the statement of financial position	\$ 7,877	\$ 4,335	\$ (42,273)	\$ (32,614)

The discount rate, expected rate of return on plan assets, and the projected covered payroll growth rates used in determining the above accrued benefit costs are as follows for the years ended August 31, 2002 and 2001:

	PENSION		OTHER POST-RETIREMENT	
	2002	2001	2002	2001
Discount rate	7.00%	7.00%	7.00%	7.00%
Expected return on plan assets	8.75%	8.75%	8.75%	8.75%
Covered payroll growth rate	5.00%	5.00%	N/A	N/A

The assumed health care cost trend rate used to measure the accumulated post-retirement benefit obligation was as follows:

	AUGUST 31, 2002			AUGUST 31, 2001
	MEDICAL		DENTAL	MEDICAL AND DENTAL
	PRE-65	POST-65		
2002 to 2003				10%
2003 to 2004	14%	16%	8%	9%
2004 to 2005	13%	15%	7.5%	8%
2005 to 2006	12%	13%	7%	7%
2006 to 2007	11%	12%	6.5%	6%
2007 to 2008	10%	11%	6%	5.5%
2008 to 2009	9%	10%	5.5%	
2009 to 2010	8%	9%	5.5%	
2010 to 2011	7%	8%	5.5%	
2011 to 2012	6%	7%	5.5%	
2012 to 2013	5.5%	6%	5.5%	
2013 and later	5.5%	5.5%	5.5%	

Net benefit (income) expense related to the plans for the years ended August 31, 2002 and 2001, in thousands of dollars, includes the following components:

	PENSION		OTHER POST-RETIREMENT	
	2002	2001	2002	2001
Service cost	\$ 4,879	\$ 4,699	\$ 5,864	\$ 3,678
Interest cost	14,542	14,961	10,807	7,551
Expected return on plan assets	(21,470)	(24,353)	(2,239)	(2,459)
Amortization of transition (asset) liability	(901)	(901)	2,568	2,568
Amortization of prior service cost	1,237	1,237	3,372	212
Recognized net actuarial (gain) loss	(1,829)	(6,659)	920	81
Net periodic benefit (income) expense	\$ (3,542)	\$ (11,016)	\$ 21,292	\$ 11,631

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. Increasing the health care cost trend rate by 1% in each future year would increase the accumulated post-retirement benefit obligation by \$49,339,000 and the aggregate service and interest cost by \$3,482,000. Decreasing the health care cost trend rate by 1% in each future year would decrease the accumulated post-retirement benefit obligation by \$39,681,000 and the aggregate service and interest cost by \$2,717,000.

15. Hospitals' Retirement Plan

The Hospitals provide retirement benefits through defined benefit and defined contribution retirement plans covering substantially all employees.

Defined Benefit Plans > Certain employees of the Hospitals are covered by a noncontributory, defined benefit pension plan (SHC Staff Pension Plan). Benefits of certain prior employees of LPCH are covered by a frozen defined benefit plan. Benefit obligations of the LPCH plan at August 31, 2002 were \$4,596,000, offset by \$4,305,000 of plan assets, and at August 31, 2001 were \$4,675,000, offset by \$4,644,000 of plan assets. Benefits are based on years of service and the employee's compensation. Contributions to the plans are based on actuarially determined amounts sufficient to meet the benefits to be paid to plan participants.

Benefits accumulated through March 31, 2000 (other than benefits under the frozen LPCH plan), have been included in the benefit obligation recorded on the books of UCSF Stanford Health Care. Those obligations and related plan assets were transferred to and assumed by SHC and UC on December 3, 2002. In anticipation of such transfer and assumption, the Hospitals recorded the net periodic benefit gain allocated to the Hospitals, service costs incurred since March 31, 2000, and other pension costs related to benefits accumulated since March 31, 2000. As a result, a net prepaid pension benefit of \$2,742,000 and \$1,871,000 was recorded by the Hospitals in 2002 and 2001, respectively.

Defined Contribution Plan > Employer contributions to the defined contribution retirement plan are based on a percentage of participant annual compensation. Employer contributions to this plan totaling \$21,596,000 and \$19,900,000 are included in the employee benefits expense at August 31, 2002 and 2001, respectively.

Post-Retirement Medical Benefit Plan > The Hospitals currently provide health insurance coverage for employees upon retirement as early as age 55, with years of service as defined by specific criteria. The health insurance coverage for retirees who are under age 65 is the same as that provided to active employees. A Medicare supplement option is provided for retirees over age 65. The obligation for these benefits has been recorded in the accompanying consolidated statement of financial position.

The plan assets and benefit obligation presented below include the portion of the UCSF Stanford Health Care pension plan related to the Hospitals' employees, the frozen LCH plan, and the SHC Staff Pension Plan. The net periodic pension cost and post-retirement medical benefit cost include the following components, in thousands of dollars, as of and for the years ended August 31, 2002 and 2001:

	PENSION BENEFITS		POST-RETIREMENT MEDICAL BENEFITS	
	2002	2001	2002	2001
CHANGE IN PLAN ASSETS				
Fair value of plan assets at beginning of year	\$ 112,868	\$ 129,165	\$ -	\$ -
Actual return on plan assets	(7,759)	(10,952)	-	-
Employer contributions	533	527	3,051	2,727
Benefits paid	(4,815)	(5,872)	(3,051)	(2,727)
Fair value of plan assets at end of year	\$ 100,827	\$ 112,868	\$ -	\$ -
CHANGE IN BENEFIT OBLIGATION				
Benefit obligation at beginning of year	\$ 113,907	\$ 99,815	\$ 64,839	\$ 49,812
Service cost	1,893	1,764	1,962	1,958
Interest cost	8,021	7,669	4,597	3,777
Actuarial loss	3,675	10,531	3,301	12,019
Benefits paid	(4,815)	(5,872)	(3,051)	(2,727)
Benefit obligation at end of year	\$ 122,681	\$ 113,907	\$ 71,648	\$ 64,839

The accrued benefit asset (cost), in thousands of dollars, was determined as follows at August 31, 2002 and 2001:

	PENSION BENEFITS		POST-RETIREMENT MEDICAL BENEFITS	
	2002	2001	2002	2001
Plan assets minus benefit obligation	\$ (21,854)	\$ (1,039)	\$ (71,648)	\$ (64,839)
Unrecognized prior service cost	-	-	2,684	3,317
Unrecognized (gain) loss	10,209	(11,436)	10,356	7,628
Accrued benefit cost recorded in the statement of financial position	(11,645)	(12,475)	(58,608)	(53,894)
Less: Accrued benefit cost at UCSF Stanford Health Care	14,998	14,998	-	-
Accrued benefit asset (cost) recorded by the Hospitals	\$ 3,353	\$ 2,523	\$ (58,608)	\$ (53,894)

Net benefit (income) expense related to the plans for the years ended August 31, 2002 and 2001, in thousands of dollars, includes the following components:

	PENSION BENEFITS		POST-RETIREMENT MEDICAL BENEFITS	
	2002	2001	2002	2001
Service cost	\$ 1,893	\$ 1,764	\$ 1,962	\$ 1,958
Interest cost	8,021	7,669	4,597	3,777
Expected return on plan assets	(9,602)	(9,422)	-	-
Amortization of prior service cost	-	-	633	(587)
Recognized net actuarial (gain) loss	(576)	(1,237)	573	(330)
Net periodic benefit (income) expense	\$ (264)	\$ (1,226)	\$ 7,765	\$ 4,818

The discount rate, expected rate of return on plan assets, and the projected covered payroll growth rates used in determining the above accrued benefit costs are as follows for the years ended August 31, 2002 and 2001:

	PENSION		OTHER POST-RETIREMENT	
	2002	2001	2002	2001
Discount rate	7.00%	7.25%	7.00%	7.25%
Expected return on plan assets	8.00%	8.00%	N/A	N/A
Covered payroll growth rate	5.50%	5.50%	N/A	N/A

The assumed health care cost trend rate used to measure the accumulated post-retirement benefit obligation at August 31, 2002 was 13% for the year ended August 31, 2003. The rate was assumed to decrease by 2% for the next two years and 1% for the subsequent four years, and to remain at 5% thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for the medical benefit plan. Increasing the health care cost trend rate by 1% in each future year would increase the accumulated post-retirement benefit obligation by \$4,246,000 and the aggregate service and interest cost by \$301,000. Decreasing the health care cost trend rate by 1% in each future year would decrease the accumulated post-retirement benefit obligation by \$3,744,000 and the aggregate service and interest cost by \$272,000.

16. Commitments and Contingencies

Management is of the opinion that none of the following commitments and contingencies will have a material adverse effect on the University's consolidated financial position.

Sponsored Projects > The University conducts substantial research for the federal government pursuant to contracts and grants from federal agencies and departments. The University records reimbursements of direct and indirect costs (facilities and administrative costs) from grants and contracts as operating revenues. The Office of Naval Research is the University's cognizant federal agency for determining indirect cost rates charged to federally sponsored agreements. It is supported by the Defense Contract Audit Agency, which has the responsibility for auditing direct and indirect charges under those agreements. Direct and indirect costs recovered by the University in support of sponsored research are subject to audit and adjustment.

Hospitals > Cost reports filed under the Medicare program for services based upon cost reimbursement are subject to audit. The estimated amounts due to or from the program are reviewed and adjusted annually based upon the status of such audits and subsequent appeals.

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time. Recently, government activity has increased with respect to investigations and allegations concerning possible violations by health care providers. These regulations could result in the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. The Hospitals are subject to similar regulatory reviews, and while such reviews may result in repayments and/or civil remedies that could have a material effect on the Hospitals' financial results of operations in a given period, management believes that such repayments and/or civil remedies would not have a materially adverse effect on the Hospitals' financial position.

Substantially all of the Hospitals' employees are covered under union contract arrangements, and the Hospitals are therefore subject to labor stoppages when contracts expire. One of the contracts is expired and currently under negotiation. Management does not believe that negotiation of this contract will have a material impact on the Hospitals' financial position.

HIPAA > The Health Insurance Portability and Accountability Act ("HIPAA") was enacted on August 21, 1996 to assure health insurance portability, reduce health care fraud and abuse, guarantee security and privacy of health information, and enforce standards for health information. Organizations are required to be in compliance with certain HIPAA privacy provisions beginning in April 2003. Organizations are subject to significant fines and penalties if they are found not to be compliant with the provisions outlined in the regulations. Management is in the

process of evaluating the impact of this legislation on its operations, including future financial commitments that will be required to comply with the legislation. The Administrative Simplification Compliance Act was enacted in December 2001, which delays implementation of the HIPPA transaction and code set standards by one year. Under this Administrative Simplification Compliance Act, the new compliance date for these transaction and code set standards will be October 16, 2003.

Litigation > The University and the Hospitals are defendants in a number of other legal actions. While the final outcome cannot be determined at this time, management is of the opinion that the liability, if any, resulting from these legal actions will not have a materially adverse effect on the University's consolidated financial position.

Contractual Commitments > At August 31, 2002, the University had contractual obligations of approximately \$138,965,000 in connection with major construction projects. Remaining expenditures on construction in progress are estimated to be \$338,125,000, which will be financed with certain unexpended plant funds, gifts, and debt.

At August 31, 2002, the remaining commitment on contracts for the construction and remodeling of hospital facilities was approximately \$122,491,000.

The University is the sole member of Stanford Hospital and Clinics and Lucile Packard Children's Hospital; however, each of the Hospitals has its own separate management with responsibility for its own financial reporting.

Management of the University and the Hospitals are responsible for the integrity and objectivity of their respective portions of these financial statements. The University oversees the process of consolidating the Hospitals' information into the consolidated financial statements. Management of each entity represents that with respect to their financial information the consolidated financial statements on the preceding pages have been prepared in conformity with generally accepted accounting principles.

In accumulating and controlling financial data, management of the University and the Hospitals maintain separate systems of internal accounting controls. Management of the respective entities believe that effective internal controls are maintained and communication of accounting and business policies, by selection and training of qualified personnel and by programs of internal audits, give reasonable assurance at reasonable cost that assets are protected and that transactions and events are recorded properly.

The accompanying consolidated financial statements have been audited by the University's and Hospitals' independent accountants, PricewaterhouseCoopers LLP. Their report expresses an informed judgment as to whether the consolidated financial statements, considered in their entirety, present fairly, in conformity with generally accepted accounting principles, the consolidated financial position and changes in net assets and cash flows. The independent accountants' opinion is based on audit procedures described in their report, which include obtaining an understanding of systems, procedures, and internal accounting controls, and performing tests and other audit procedures to provide reasonable assurance that the financial statements are neither materially misleading nor contain material errors. While the independent accountants make extensive tests of procedures and controls, it is neither practical nor necessary for them to scrutinize a large portion of transactions.

The Board of Trustees for the University and the separate Boards of Directors for the Hospitals, through their respective Audit Committees, comprised of trustees and directors not employed by the University or the Hospitals, are responsible for engaging the independent accountants and meeting with management, internal auditors, and the independent accountants to independently assess whether each is carrying out its responsibility and to discuss auditing, internal control, and financial reporting matters. Both the internal auditors and the independent accountants have full and free access to the respective Audit Committees. Both meet with the respective Audit Committees at least annually, with and without each other, and without the presence of management representatives.



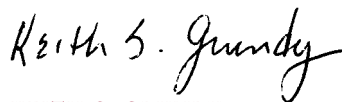
RANDALL S. LIVINGSTON
Vice President for Business Affairs
and Chief Financial Officer
Stanford University



M. SUZANNE CALANDRA
Controller
Stanford University



ROY T. SANTARELLA
Chief Financial Officer
Stanford Hospital and Clinics



KEITH S. GRUNDY
Chief Financial Officer
Lucile Salter Packard Children's Hospital

To The Board of Trustees
Stanford University
Stanford, California

In our opinion, the accompanying consolidated statements of financial position and the related consolidated statements of activities and cash flows, which appear on pages 27 through 52, present fairly, in all material respects, the financial position of Stanford University at August 31, 2002 and 2001, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the University's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

San Francisco, California
December 16, 2002

REPORT FROM THE
STANFORD MANAGEMENT COMPANY

STANFORD UNIVERSITY > 2002

The Stanford Management Company (SMC) was established in 1991 to manage Stanford's financial and real estate assets. SMC is a division of the University with oversight by a Board of Directors appointed by the University Board of Trustees. The SMC board consists of investment and real estate professionals, the University President, Chief Financial Officer, Chair of the Board of Trustees, and the CEO of SMC. The board approves SMC asset allocation targets, oversees the hiring of external asset managers, and evaluates the performance of SMC investments and professionals. The Management Company oversees approximately \$9.7 billion of endowment and trust assets, temporarily invested expendable funds, and commercial real estate investments, including the Stanford Research Park and the Stanford Shopping Center.

The majority of the University's endowment assets are invested through the Merged Endowment Pool (MEP), which is a diversified portfolio of actively managed financial and real estate assets valued at \$7.6 billion as of June 30, 2002. The following discussion of investment returns and assets refers to the MEP only. MEP performance measurements are calculated on the 12 months ended June 30, 2002 to be comparable to the results of other endowments and foundations. The MEP generated a -2.6% investment return for the 12 months ended June 30, 2002. The MEP's well-diversified mix of assets protected the portfolio in an extremely difficult period for world financial markets. During the same 12-month period, the S&P U.S. stock index fell 18%, and the NASDAQ U.S. stock index fell 32%. The -2.6% one-year return placed Stanford in the top quartile of university and college endowments reporting to the survey conducted by consulting firm Cambridge Associates. Over the past 10 years, the MEP has achieved an annualized rate of return of 14.6%. This investment performance places Stanford in the top 5% of all reporting colleges and universities over the same period, according to Cambridge.

The environment during the past year was one of extreme volatility in virtually all asset classes. Sharp declines in asset values resulted from broad-based market movements, as well as highly specific events. SMC, with assistance from the board, actively managed the endowment through this environment while remaining committed to a long-term investment strategy. The MEP portfolio is constructed on a foundation of modern portfolio theory and strategic asset allocation and is continuously tested through the rigors of state-of-the-art risk management techniques. The portfolio is designed to optimize long-term returns, create consistent annual payout to the University's operating budget, and preserve purchasing power for future generations of Stanford faculty and students.

Since March of 2000, the financial markets have created challenges for all investors. SMC has responded to this environment by remaining committed to our managers, who have demonstrated consistent strategies and excellent returns over a long period of time. The Management Company has invested substantially in increased risk management by hiring additional professionals and implementing new information technology systems. The investment decision process at SMC involves an ongoing review of all portfolio assumptions, a detailed analysis of interim returns, and an in-depth dialogue with the board.

Stanford MEP Asset Allocation > Given the perpetual nature of the University, SMC's investment horizon is very long-term. Our objective is to generate optimal total return relative to an appropriate level of risk for Stanford. SMC re-evaluates portfolio asset allocation each June, reviewing with the SMC board expected risk, return, and correlation among asset classes in the process of confirming current strategic asset allocation targets or setting new targets. The process takes into consideration an analysis of the historical characteristics of asset classes, as well as a review of current market trends. Recently, the process has become complicated by the highly volatile performance of several asset classes, particularly alternative asset categories such as Private Equity. In previous years, allocations to Domestic Public Equity and International Public Equity were reported as two separate asset classes. SMC has moved toward a more global view of the public equity markets and now treats all public equities as components of a single Public Equity asset class. The most significant changes in MEP targets in the June 2000 period include a decrease in Private Equity and increases in Absolute Return and Public Equity. The adjustment in exposure to Public Equity is of particular note. In June of 2000, the portfolio allocation to Public Equity stood at 47%. However, after reviewing various measures of long-term, risk-adjusted returns relative to investment alternatives, SMC decided to lower the allocation to Public Equity to 32% as presented in the 2001 annual report. This represented a significant decrease in Public Equity exposure at a point when SMC perceived increased risk and reversion to mean returns for the asset sector. Since that time, dramatic revaluations have occurred in the public markets, and SMC has moved aggressively to bring the Public Equity allocation up to its current 40% target.

The asset allocation targets for the MEP as of June 30, 2002 are listed below:

STANFORD MEP LONG-TERM POLICY TARGETS

Asset Class	Strategic Allocation
Public Equity	40%
Real Estate	16%
Private Equity	10%
Natural Resources	7%
Absolute Return	15%
Fixed Income	12%
	100%

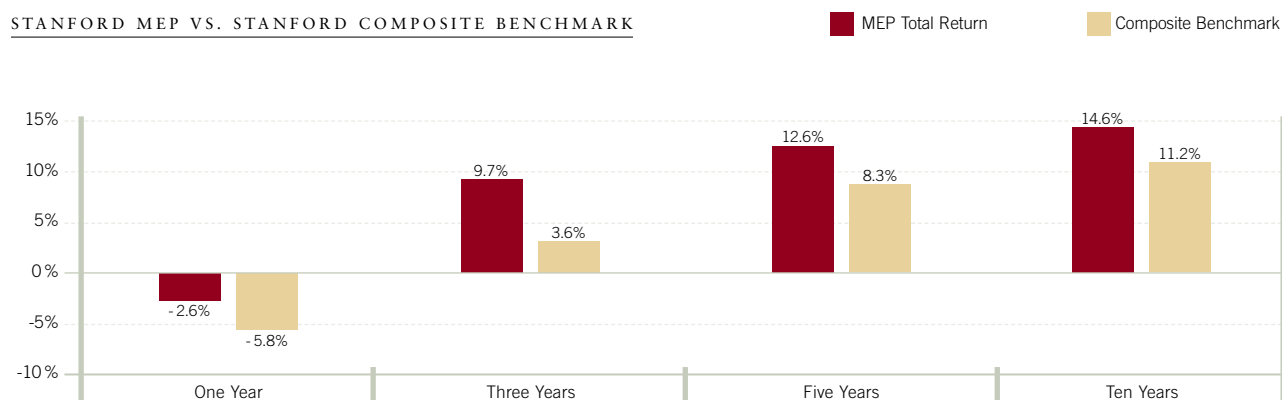
Stanford MEP Performance Compared to Inflation > The table below outlines annualized returns for various periods ending June 30, 2002 and illustrates the performance of the MEP in a long-term context. Stanford's objective is to return a minimum of 6.25% over the rate of inflation. If this real return target is achieved over time, the value of the endowment will be maintained net of annual payouts to support endowed activities. Over the past three-, five-, and 10-year periods, Stanford's annualized real return has substantially exceeded the 6.25% target.

STANFORD MEP PERFORMANCE COMPARED TO INFLATION

	One Year	Three Years	Five Years	Ten Years
Nominal MEP Return	- 2.6%	9.7%	12.6%	14.6%
GDP Deflator	1.1%	1.9%	1.7%	1.9%
Real MEP Return	- 3.7%	7.8%	10.9%	12.7%

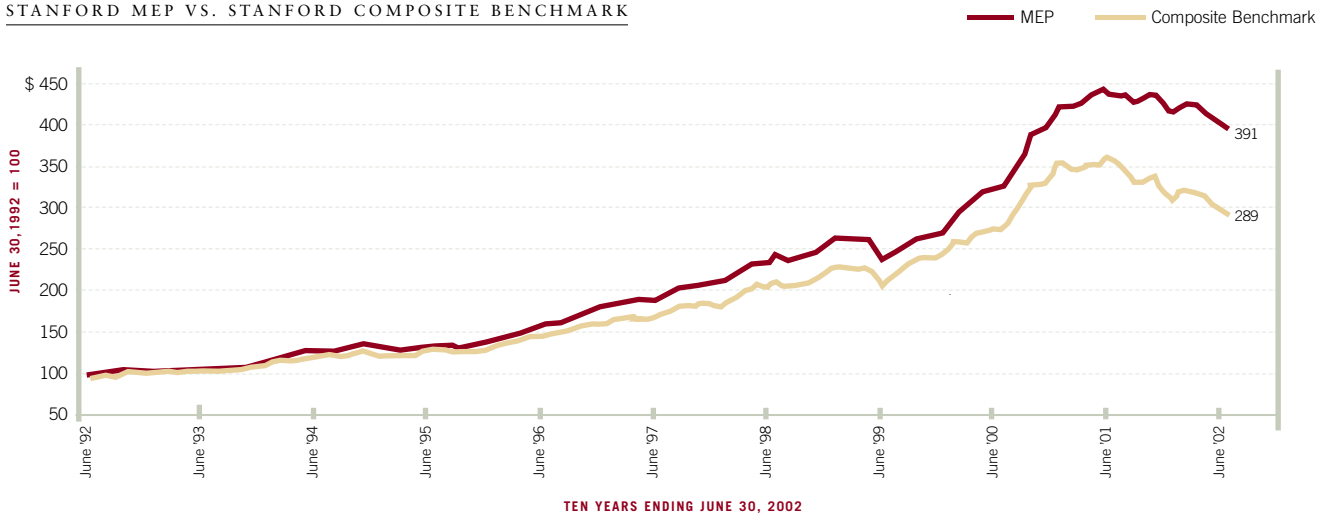
Stanford MEP Performance Compared to Benchmarks > SMC evaluates the performance of investment managers by comparing their returns to benchmarks that are appropriate for each individual asset class. SMC may alter an asset class benchmark to allow for a change in investment style, a shift in mix within an asset category, or to account for the impact of leverage. The SMC board reviews asset class benchmarks on an annual basis to ensure comparability. SMC evaluates overall portfolio performance by comparison to a composite benchmark, which represents a blending of the benchmark returns for each asset class weighted by the strategic allocations above. In the table below, actual performance, net of management fees, is compared to the composite benchmark for periods ended June 30, 2002.

STANFORD MEP VS. STANFORD COMPOSITE BENCHMARK



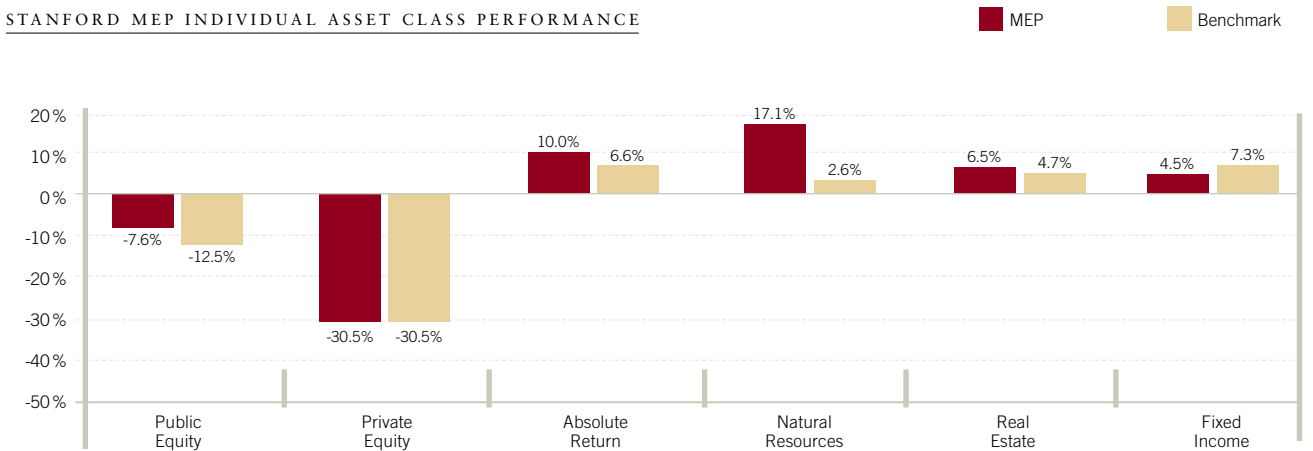
SMC's effectiveness in implementing the multi-asset class approach, through superior manager selection, has resulted in a consistent and long-term performance advantage over the composite benchmark.

The cumulative return chart below compares the growth of \$100 in Stanford's endowment with that of the composite benchmark over the past 10 years:



The performance advantage during this 10-year period relative to benchmark returns has added in excess of \$1.5 billion to the value of the endowment.

Stanford MEP Individual Asset Class Performance > The performance of individual asset classes for the 12 months ended June 30, 2002 relative to each asset class benchmark is illustrated in the graph below:



Although relative performance of asset classes versus benchmarks continues to be positive, the portfolio has exhibited negative absolute returns in more than one asset category for two consecutive years. This is a marked contrast to the late 1990s, when substantially all asset classes contributed positive returns. This volatility in the global market environment places renewed emphasis on the importance of diversification within the portfolio.

The last two years of negative investment performance provide a stark contrast to the previous bull market period from 1982 to 2000, when substantially all financial assets exhibited double-digit annual investment returns. The bull market was a period of protracted interest rate declines, valuation expansion, and seemingly unsustainable economic over-expansion. The view at SMC is that the tailwinds of the bull market have become the headwinds of today's challenging investment environment. Over the past two years, the markets have experienced an overall compression in financial and real estate asset returns that has caused investors to re-examine their investment strategies. For example, many institutions have reacted to today's environment by allocating substantial additional assets to alternative asset categories that are often limited in their investment opportunity and capacity to absorb additional capital. As a result of these trends, SMC has re-examined our assumptions for relative risk-adjusted returns among asset classes and the impact of manager fees on net returns in alternative asset classes.

Stanford's Public Equity portfolio has been deliberately overweighted in value stocks for the last nine years. This value tilt has been effective in offsetting the heavy growth stock concentration in the Venture Capital portfolio and has provided substantial cushion to the dramatic decline in global equity markets. The portfolio also benefited from a substantial weighting to smaller market capitalization stocks. Finally, the Public Equity performance benefited from the introduction of specialist strategies and high-yield bonds into the portfolio, particularly during the later part of the June 30, 2002 period. The impact of these factors, combined with strong performance by managers, accounted for the out-performance in the Public Equity asset class.

Private Equity, a combination of venture capital and leveraged buyout limited partnerships, accounted for the largest negative contribution to portfolio return. Continuing a trend that started in the fall of 2000, venture capital partnerships marked down private investments (reversed accounting gains) which were valued during the NASDAQ bubble environment of the late 1990s. We anticipate venture partnerships may incur further write-downs in the next 12 months. Additionally, SMC is cautious in the current venture capital environment due to the substantial "overhang" of capital raised by venture partnerships in 1999-2001. However, Venture Capital has been a very successful asset class for Stanford when evaluated over the longer term. Over the past eight years, venture capital investment gains have added more than \$2 billion to the value of the endowment. SMC will continue to allocate capital to this asset sector by maintaining relationships with proven private equity funds and by selectively establishing investment positions in new funds.

The Absolute Return portfolio is constructed to provide returns that are substantially uncorrelated to the equity markets. The portfolio includes qualitative and fundamental equity hedge fund strategies, distressed debt, fixed income relative value, and multistrategy arbitrage funds. Results for the period ended June 30, 2002 demonstrate the successful execution of these strategies as the portfolio showed substantial positive returns amidst a bearish market climate. SMC remains committed to a well-diversified Absolute Return portfolio, but cautious about the environment due to substantial increases in cash flows from institutional investors into some investment strategies.

The Natural Resources portfolio comprises domestic and international investments in timber, direct oil and gas assets, and oil and gas private equity partnerships. The portfolio's strong relative returns this period reflect excellent manager performance in combination with strong oil and gas prices. SMC continues to build a diverse portfolio of outstanding managers in the oil, gas, energy, and timber industries.

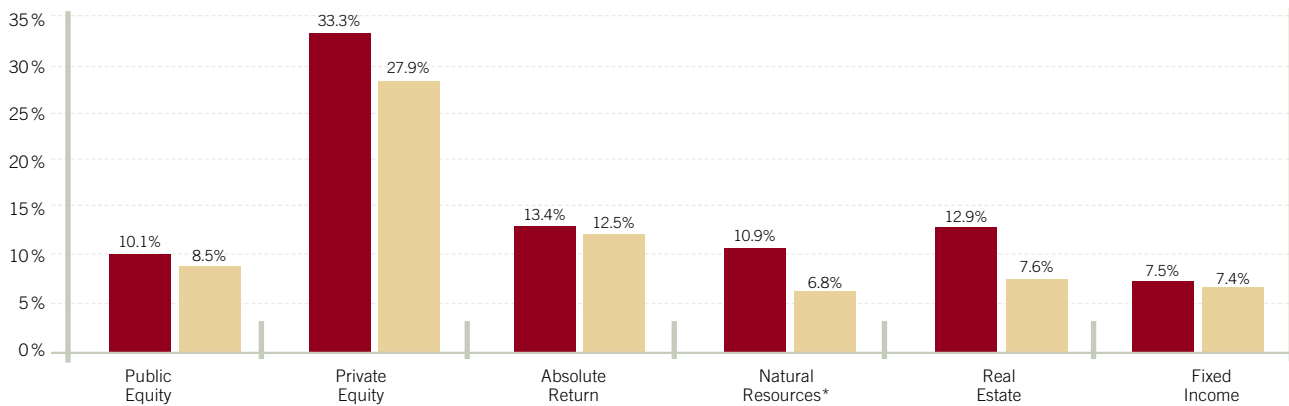
Stanford's endowment has a substantially larger commitment to Real Estate than our peer institutions. The strategy of overweighting real estate investments is based on SMC's extensive experience in real estate development and management of University lands. SMC's core competency in these areas provides a significant advantage when evaluating real estate investments. The portfolio includes direct investments in commercial and residential real estate development, limited partnership positions in real estate opportunity funds, and publicly traded real estate investment trusts. The MEP also includes the Stanford Shopping Center and a portion of the Stanford Research Park. SMC strives to invest in real estate assets outside of the San Francisco Bay Area and Santa Clara County to provide economic diversification and seismic risk mitigation. The Real Estate portfolio demonstrated strong returns relative to benchmark for the period.

Stanford's Fixed Income portfolio was the only asset class to demonstrate returns less than benchmark. This weak relative performance resulted from losses associated with corporate bonds in the aftermath of corporate malfeasance such as the Enron and WorldCom cases. Total losses attributed to these events were minimal on an overall MEP portfolio basis, but had a material impact within the fixed income asset class. As a result of this experience and increased volatility in the fixed income markets, SMC has outsourced management of the Fixed Income portfolio.

Ten-year asset class returns relative to benchmark illustrate the value of SMC's ability to both shift investment style/strategies and identify outstanding managers in each asset class as outlined below:

STANFORD MEP TEN-YEAR ASSET CLASS RETURNS VS. BENCHMARK

■ MEP ■ Benchmark



* Natural Resources since inception (nine-year return).

Although SMC is disappointed to show negative investment performance under any circumstances, it is during difficult periods such as the past two years when we most acutely appreciate the positive impact of our diversified investment strategy. Over the past 10 years, the endowment has moved away from a dominant dependence on public stocks to a much more diversified set of financial and real estate assets. During the late 1990s this was, at times, an unpopular investment strategy as the stock market was rising in excess of 20% per year. Over the past two years, however, the U.S. stock market is down more than 30% (June 30, 2000–June 30, 2002) while the endowment is down less than 5%. We are also pleased with the portfolio's performance during a two-year period that has been characterized by repeated challenges to the U.S. financial markets, including a significant recession, the terrorist attacks of September 11, the bursting of the dot-com and telecom bubbles, corporate malfeasance, and political turmoil in the Middle East. Each of these unexpected crises represents another stress test to a portfolio built to withstand the unexpected. While we remain vigilant for the next crisis, as long-term investors we endeavor to turn short-term challenges into successful investment strategies. As an integral component of one of the world's great universities, the Stanford Management Company remains energetically committed to our mission: the pursuit of optimized risk-adjusted investment strategies that preserve the long-term purchasing power of the endowment for future generations.

Michael G. McCaffery

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