Financial Report

UNIVERSITY OF PENNSYLVANIA - CONSOLIDATED FINANCIAL RESULTS (ACADEMIC & HEALTH SERVICES COMPONENT)

For the fiscal year ended June 30, 2002

During FY 02, the consolidated University achieved positive financial performance despite the volatility in the economy and financial markets created by the events of 9/11 and their aftermath. Total net assets increased $125.6 million to a total of almost $5.2 billion at June 30, 2002.

In FY 02, the University experienced a $168.5 million or 5.3% increase in total revenue to over $3.35 billion. The Health Services Component constituted 46% (or $77.3 million) of this overall growth in revenue due to growth in inpatient volumes and overall patient activity. Sponsored programs revenue (including indirect cost recovery), principally in the School of Medicine, represented the next largest component of growth ($76.5 million) for a 15.2% increase year over year.

Despite the uncertainty of the economy, contributions remained strong at the University. Operating contributions grew almost 12% over FY 01 levels, while non-operating contributions – gifts for endowment and capital – grew 15.5%. Total gifts and pledges (excluding private grants) exceeded $296.3 million in FY 02.

Overall, total expenses increased $203.6 million or 6.6%. Consistent with accounting guidelines, expenses in the University’s audited financial statements are reported on a functional basis. Similar to our revenue growth, research related program expenses grew 13.7% over the prior fiscal year. Expenses related to instruction represented the second fastest category of growth, increasing for 9.3% or $53.4 million. Management and general expenses increased $13.1 million or 9.2%, reflecting the complexities of managing a wide and diverse enterprise and the increasing compliance mandates from federal and state regulatory bodies.

Within the footnotes to the financial statements, the consolidated University expenses are reported on a natural classification basis. Overall, compensation (salary and benefits) increased 9.5% over FY 01 levels. Salary and wages experienced an increase of 8.4% due to both increased sponsored program activity at the University and market based nursing and allied health personnel wage increases at the Health Services Component. Employee benefits grew 18% over FY 01 levels due in part to the growing workforce and rising benefit costs related to health care.

The consolidated University achieved a positive increase in net assets from operating activities of $40.4 million, a decline of $35.1 million from FY 01. Much of the decline can be attributed to one-time, non-recurring items from both fiscal years at the University and the overall decline in other investment income. The Health Services Component generated positive net income from operations for the second consecutive year, exceeding its FY 01 levels by $5.6 million. Total net assets increased by $125.6 million due principally to non-operating contributions, particularly the $100 million gift from the Annenberg Foundation received at the end of FY 02.

The impact of the 9/11 tragedy, along with continuing corporate scandals, wreaked havoc on the financial markets. The University’s endowment performed well in this volatile climate achieving
a return of .1%, exceeding its benchmark by 6.8%. Based on preliminary data, the University performed in the top quartile of endowments over $1 billion during FY 02.

Short-term working capital, measured by operating cash, grew by $37.5 million in part to advances received on grants and improvements in receivables at the University and improved patient receivables collections at the Health Services Components. Days in accounts receivable at the Health Services Component declined to 75.6 days at June 30, 2002.

Plant assets increased by $114.3 million, net of depreciation of $179.8 million. Significant capital expenditures incurred in FY02 include: Huntsman Hall ($50.7 million), Quadrangle renovations ($24.1 million) and the Potttruck Fitness Center ($11.8) million. Long-term debt increased by $45.0 million as a result of additional debt incurred to finance the high rise sprinkler installation, the interim construction financing for the K-8 school and various Health Services’ capital equipment needs.

Cash flow from operating activities totaled $263.7 million and exceeded FY 01 levels by $19.1 million due in large part to the continued improved financial performance at the Health Services Component. Purchase of property, plant and equipment exceeded $290.5 million, a slight decrease of $8.3 million from FY 01 activity.

In FY 02, due to the increasing stabilization of the Health Services financial profile, Moody’s Investors Service revised its outlook of the University from “negative” to “stable” and confirmed the “A1” rating on its outstanding long term debt. In addition, Standard & Poor’s reaffirmed its “AA” rating with a “stable” outlook.

CONSOLIDATED ACADEMIC COMPONENT (For the fiscal year ended June 30, 2002)

In FY 02, the University experienced a $107.4 million or 7.1% increase in total revenue to over $1.6 billion. Sponsored programs revenue accounted for over 70% of the growth. Tuition and fees, net of direct scholarship aid, grew by $20.7 million over the prior fiscal year period representing 19% of the overall growth. Operating contributions represented the third largest contributor to overall revenue growth, exceeding $92 million for FY02. Revenue growth was dampened by declines in other operating investment income ($9.3 million) due to lower short term interest rates, executive education programs ($3.9 million), and independent operations ($4.2 million) including University owned hotels ($1.2 million).

Overall, total expenses increased 9.0% fueled principally by the growth in salary and wages and employee benefits. Salary and wages increased 9.3% over FY 01 levels due to both increased sponsored program activity, which accounted for 40% of the growth, and an increase in non-grant funded positions. Employee benefits grew 27% over FY 01 levels. When adjusting for a one-time gain experienced in FY 01 for a change in pension plan options for police and other non-exempt employees, the growth can be restated to 20%. This growth is primarily attributable to headcount increases and spiraling medical care costs. The benefits plan redesign implemented in FY 02 effective for FY 03 should help reduce the rate of growth of medical care costs. Overall growth in current expense was mitigated by the successful efforts to reduce utility costs through conservation and other measures. In FY 02, utility costs declined by $13.6 million over FY 01 levels. In addition, interest expense declined by $5.1 million due to lower short term interest rates on variable rate debt and the impact of the refinancing plan implemented in FY 02.
The academic component of the University achieved a positive increase in net assets from operating activities of $17.8 million, a decline of $24.6 million from FY 01. When adjusting for the impact of one-time non-recurring items from both fiscal years, this difference is reduced to $3.8 million, much of which is explained by the decline in other investment income. Total net assets increased by $91.9 million due principally to non-operating contributions.

The University's endowment performed well in the volatile financial markets achieving a return of .1%, exceeding its benchmark by 6.8%. To put volatility in perspective, the single month of June wiped out a 4.4% return achieved during the prior 11 months of the fiscal year. Nevertheless, the endowment performance is very likely to place the University in the top quartile of endowments over $1 billion. Short-term working capital, measured by operating cash, grew by $22.1 million in part to advances received on grants and improvements in receivables.

Plant assets increased by $116.6 million, net of depreciation of $94.4 million. Long-term debt increased by $33.1 million as a result of additional debt incurred to finance the high rise sprinkler installation and the interim debt that financed the construction of the K-8 school. The amount due the University from the Health Services Component declined to $24.9 million consistent with the agreed upon target for the end of FY 02.

**UNIVERSITY OF PENNSYLVANIA HEALTH SYSTEM – PENN MEDICINE HEALTH SERVICES COMPONENT (For the fiscal year ended June 30, 2002)**

In FY 02, the Health Services Component (HSC) continued its recent favorable financial trends, achieving a positive operating margin for the second consecutive year since commencing its financial recovery program in FY 2000. The excess of revenue over expenses from operations totaled $54.1 million, $3.7 million less than the prior fiscal year. However, when excluding investment income from operating revenue, the excess of revenue over expenses from operations totaled $27.3 million, and was favorable to budget by $2.6 million, and favorable to the prior fiscal year by $2.1 million.

In addition, non-operating revenue totaled $22.2 million primarily the result of the recognition of the $19.7 million ($16.0 million received to date) bequest from a former Pennsylvania Hospital volunteer. Combining operating performance with non-operating performance produced total excess of revenue over expenses of $76.3 million, compared to $64.7 million in FY 02.

Favorable operating performance was the net result of increases in operating revenue slightly outpacing increases in operating expenses. Operating revenue increased 4.6% largely due to favorable payment rates and utilization trends, which saw growth in inpatient activity (1.98%), ambulatory surgeries (2.34%) and outpatient visits (2.46%).

HSC achieved favorable results despite substantial operating pressures. Total operating expenses were higher than the comparable prior year period by $82.8 million (5.0%). Salaries and wage increased 9.2% as a result of market-based nursing and allied health personnel wage increases ($20.5 million). HSC also experience increases in supplies and services ($15.2 million) from increased volume and intensity of service, and an increase in the provision for bad debts, ($54.1 million) resulting from the establishment of incremental bad debt allowances.
HSC continued its efforts to increase strategically targeted programmatic capital investments that had been deferred during its period of financial stress. Purchases of property and equipment reached $80.0 million for FY 02, significantly exceeding the level for FY01 ($44.8 million), although still less than actual depreciation of $83.1 million. The capability to ramp up capital spending has been significantly aided by the improvement in overall operating cash flow, which reached $172.6 during FY 02. This improvement has occurred in large part due to the significant progress achieved in accounts receivable collections, as days revenue in accounts receivable was reduced to 75.6, (10.4 days and 23.9 days lower than June 30, 2001 and 2000, respectively).

Short-term liquidity, as measured by operating cash and short-term investments, improved by $15.4 million. This improvement was achieved despite the ramp up in capital spending, transfers to the School of Medicine ($35.3 million), and a reduction in HSC’s liability to the University ($24.9 million) in accordance with the agreed upon repayment schedule.

Long-term debt and notes payable (current and long-term) increased $11.9 million. In April 2002, HSC executed a $30.0 million equipment capital lease and in June 2002 incurred incremental borrowing associated with the term loan refinancing and ambulatory surgery center ($8.1 million). These borrowings were offset by the January 1, 2002 regularly scheduled principal payment on long term debt ($13.6 million), the final note payment to the Presbyterian Foundation ($8.0 million), and scheduled payment on the note to the First Hospital Foundation ($4.2 million). Despite this slight increase in debt, HSC’s debt to capitalization ratio declined to 84.2% due to its favorable growth in unrestricted net assets.

In FY 02, in recognition of its continued financial progress, Moody’s Investors Service revised its outlook of HSC from “negative” to “stable” and confirmed the “A3” rating on the outstanding long term debt of HSC. In addition, Standard & Poor’s reaffirmed its “A” rating with a “stable” outlook.