Financial Report

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

For the fiscal year ended June 30, 2004

During FY 04, the consolidated University achieved positive financial performance as measured by its growth in net assets. Total net assets increased $559.2 million during the course of the fiscal year principally due to investment performance and contributions. Penn concluded the fiscal year at June 30, 2004, with total assets of $8.6 billion, total liabilities of $2.7 billion, and net assets of $5.9 billion.

University total revenue increased $223.1 million, or 6.4% to over $3.72 billion. The Health System constituted 76% (or $169 million) of this overall growth in revenue due to increased adult admissions, patient volumes and overall patient activity. Sponsored program revenue (including indirect cost recovery), principally in the School of Medicine, grew $32.1 million, or 5.0%, year-over-year. Tuition and fees (net of student aid) grew $31.1 million (6.4%).

The strong support of our alumni, friends, corporations, foundations, and associations continued as contributions increased over FY 03 levels. Total gifts and pledges (excluding private grants) exceeded $253 million in FY 04. Operating contributions declined $12.7 million or 12.6% over FY 03 levels. Non-operating contributions -- which includes gifts for endowment and capital -- increased by $17.9 million.

Overall, total expenses increased $244.2 million or 7.0%. Consistent with educational financial reporting practices, expenses in the University’s audited financial statements are reported on a “functional” basis. Hospital and physician practice expenses accounted for 64% of total growth, increasing $156.1 million or 8.9%. Instruction and research-related expenses combined grew at an approximate 5% rate of growth. Management and general expenses increased $.2 million, or .14%, primarily due to increases in external insurance costs and depreciation.

Within the footnotes to the financial statements, the consolidated University expenses are reported on a “natural” classification basis. Overall, compensation (salary and benefits) increased 7.5% over FY 03 levels. Salaries experienced an increase of 6.5%, or $99.6 million, principally due to increased sponsored program activity at the University, and budgeted increases in the annual salary increase pool at both the University and Health System. Employee benefit costs increased 12.0% or $43.7 million over the prior year. The Health System accounted for 68% of the increase due to increased pension and medical costs. For the academic component of the University, employee benefits costs moderated over the prior year’s growth, principally due to the success in negotiating discounts with our benefits providers and more effective cost sharing achieved through benefit redesign.

The consolidated University achieved a positive increase in net assets from operating activities of $6.6 million, a decline of $21.2 million from FY 03. For the academic component, the decline can be attributed to the expenditure of operating gifts received and recorded in prior fiscal years as well as some non-recurring items. For the fourth consecutive year, the Health System generated positive net income from operations.
Consolidated University net assets from non-operating activities increased by $552.0 million due principally to gifts for capital and endowment (referenced above) and positive investment performance.

Penn’s total endowment exceeded $4.0 billion as of June 30, 2004. This is a remarkable accomplishment in light of the fact that the University’s endowment equaled $165 million twenty five years ago. This tremendous growth was achieved through shrewd investing and the generosity of alumni and other donors.

The endowment returned 16.8% for the fiscal year ending June 30, 2004. This return is roughly 2.5% ahead of the composite benchmark. Equity and credit strategies did particularly well as did non-dollar assets. Outperformance was driven by strong manager returns in international equities and in diversifying assets (hedge funds). Tactical asset allocation also contributed to performance.

Penn’s annualized performance for the three years ending June 30, 2004, is 6.9%. This is ahead of the composite benchmark by 3.5% and puts Penn in the top third of endowments with over one billion in assets.

Short-term working capital, measured by operating cash, grew by $139.6 million in part to advances received on grants and improvements in receivables at the University and improved patient receivables collections at the Health System. Days in accounts receivable at the Health System declined to 71 days at June 30, 2004.

Plant assets, net of depreciation, increased by $18.7 million. Significant capital expenditures incurred for the Academic Component in FY04 include: Hamilton College House renovations ($11.5 million), Harrison College House Renovations ($11.6 million,) and Life Sciences Building ($7.8 million); for the Health System, Operating Room renovations ($14.3 million), HUP equipment acquisitions ($8.4 million), Cardiac ICU ($7.0 million), and the Widener Building project ($5.7 million). Long-term debt decreased by $24.6 million due to the scheduled retirement of University and Health System debt, offset by some additional indebtedness incurred when refinancing two existing debt issues for the University.

Cash flow from operating activities totaled $328.1 million and exceeded FY 03 levels by $4.8 million. Purchase of property, plant and equipment exceeded $250.0 million, a decrease of $24.5 million from FY 03 activity.

CONSOLIDATED ACADEMIC COMPONENT (For the fiscal year ended June 30, 2004)

The Academic Component of the University concluded the fiscal year at June 30, 2004 with total assets of $6.7 billion, total liabilities of $1.4 billion, and net assets of $5.3 billion. Total net assets increased $474.5 million during the course of the fiscal year, principally to gifts for capital and endowment and strong investment performance.

In FY 04, the University experienced slower revenue growth than in the most recent prior fiscal years. Total revenue increased $56.2 million or 3.2% increase to over $1.8 billion. Sponsored programs revenue (including indirect cost recoveries) accounted for over 57% of the growth, led by the School of Medicine (+$23.6 million) and the School of Arts and Science (+$3.1 million). Tuition and fees, net of direct scholarship aid, grew by $31.1 million over the prior fiscal year period representing a 6.4% growth. Due to both increases in the quality of the student body and
a weakness in the economy, student aid increased at a faster rate (+$10.9 million, +8.8%) than tuition. Offsetting the increases noted above operating contributions, declined $12.7 million from FY 03, primarily due to differences in accounting for a significant contribution between the two fiscal years. Revenue growth was also dampened by a decline in investment income of $7.5 million due to the reduced spending rule distribution from the A.I.F. and lower short-term interest rates.

Total expenses increased $88.1 million, or 5.1%, fueled principally by the growth in salary and wages and current expenses. Salary and wages increased 5.1%, of which 1.7% was driven by salaries funded from grants. Larger discounts negotiated with benefit providers and benefit plan redesign (e.g. medical coverage and prescription plan) implemented in FY 03 helped reduce the rate of employee benefits expense growth to 6.5% in FY 04. In addition, interest expense declined by $1.4 million due to lower short term interest rates on variable rate debt and the refinancing of debt.

Net assets from operating activities decreased by $5.5 million, $31.9 million less than fiscal year 2003 levels. This decline is attributable to the expenditure of revenue (operating gifts) that was recognized in prior periods, the decline in the endowment payout, the difference in accounting treatment between fiscal years for a significant contribution, and two non-recurring events that resulted in write-offs in excess of $4.7 million. Total net assets from non operating activities increased by $480.0 million due to non-operating contributions and gains on investments.

Plant assets, net of depreciation, increased by $54.8 million. Long-term debt increased by $3.2 million following the incurrence of additional indebtedness during the refinancing of existing indebtedness. Short-term liquidity – Working Capital increased by $117.1 million. Cash flow from operating activities decreased by $35.0 million. Capital investment declined $25.5 million as several large-scale projects were completed (e.g. Quadrangle renovations).

Finally, in March, 2004, the University’s long-term debt rating was upgraded by Moody’s Investors Service from “A1” to “Aa3”.

UNIVERSITY OF PENNSYLVANIA HEALTH SYSTEM – PENN MEDICINE
(For the fiscal year ended June 30, 2004)

In FY 04, the University of Pennsylvania Health System (UPHS) continued to perform favorably, achieving a positive operating margin for the fourth consecutive year. The excess of revenue over expenses from operations (including investment income) totaled $55.4 million, which was $14.1 million higher than the prior fiscal year.

The excess of revenue over expenses from operations (including investment income) is before non-operating items including transfers to the University and School of Medicine ($35.7 million) and the recognition of income from discontinued operations due to the sale of Phoenixville Hospital in early FY 05. The net effect of the positive operating performance and non-operating items was an increase in unrestricted net assets of $31.7 million.

Total operating revenue increased $169.3 million, or 9.4%, largely due to favorable utilization trends, higher payment rates, and favorable payor mix and third party settlements. Inpatient activity (adult admissions) grew 2.3%, while outpatient activity increased 3.2% (excluding ER and ambulatory surgery) compared to the prior year. HUP experienced a slight decline in
intensity of service as measured by the Medicare Case Mix Index (CMI) offset by an increase in CMI at Presbyterian Medical Center.

Operating expenses were higher than the comparable prior year period by $155.2 million (8.8%). Salaries and wage increased 7.9% due to the budgeted FY 04 salary increase program. Employee benefits increased 19.6% driven by higher retirement and medical costs. Supplies and services increased 6.4% due to increased patient activity and usage of drug and blood products (volume and programmatic requirements). Malpractice expenses increased 23.9% as UPHS continued to be self-insured due to the continuing absence of a cost effective commercial alternative and the negative impact of the acceleration of claims and awards in our geographic area.

UPHS continued its efforts to increase strategically targeted programmatic capital investments that had been previously deferred. Purchases of property and equipment reached $98.8 million for FY 04, slightly exceeding the level for FY 03 ($97.7 million) and actual FY 04 depreciation and amortization ($89.9 million). Operating cash flow of $205.2 million represents an increase from the prior year as accounts receivable collections continue to decline (71 days compared to prior year levels of 74 days).

Short-term liquidity, as measured by operating cash and short-term investments, increased by $22.5 million to $114.1 million in FY 04. This stability was achieved following transfers to the School of Medicine and University ($35.7 million) and the continued investment in property, plant and equipment. In addition, the Health System established a board designated fund for the construction of the Riverview Center for Advanced Medicine and made an initial deposit of $22.5 million to this fund.

Long-term debt (current and long-term) decreased $24.0 million. The Health System's debt-to-capitalization ratio declined from 83.2% to 80.2% due to the repayments, as well as to a $31.7 million increase in unrestricted net assets.

Finally, in March, 2004, the Health System’s long-term debt rating was confirmed by Moody’s Investors Service and Standard & Poor’s Corporation at “A3” and “A” respectively.