Carnegie Mellon

2004 annual report

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The David A. Tepper School of Business at Carnegie Mellon

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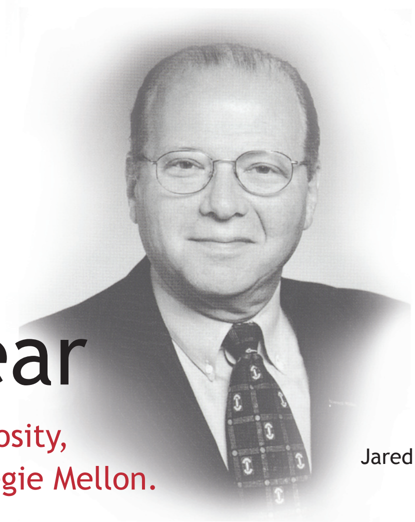


Jared L. Cohon

2004 was a year of new initiatives, inspiring generosity, and more faculty accomplishments at Carnegie Mellon.

Building International Partnerships: Qatar, Athens and Asia

This year, we began an important partnership in Qatar, a country committed to creating a superb higher-education system that will benefit the entire Middle East. In many ways, it will benefit the whole world.

Carnegie Mellon is among the leading American universities invited to work with Qatar to meet this bold objective. Generously sponsored by the Qatar Foundation, we are now offering undergraduate degree programs in business and in computer science. Chuck Thorpe, the former director of our Robotics Institute, is the first dean of Carnegie Mellon's Qatar campus, located in Education City, near Doha. He is rightly proud of the diversity and talent of the first freshman class of 41 students; 73 percent are women, and 58 percent are Qatari citizens. Some have international backgrounds, while others are new to an American-style education and mixed male-and-female classes. By all accounts, they are a lively and engaging group, serious about their studies, and full of fresh perspectives—just as any Carnegie Mellon entering class should be.

The Qatar initiative is the latest example of Carnegie Mellon's ability to act quickly and innovatively, outside the standard playbook of most universities. This partnership with the Qatar Foundation extends our international reach; we can actively engage a large and entirely new population of students in a part of the world where American cultural values and intentions are widely misunderstood. Our presence there will help satisfy a hunger for learning in a region where 40 percent of the population is under 14 years old, and where economic development lags far behind much of the rest of the world. These young people need more higher-education opportunities that will help them compete in the global economy. We are an important part of their future, and they are an important part of ours.

I believe that, along with the content of their courses and the high standards we require, our Qatar students will benefit from firsthand experience of the values of an American university: the commitment to freedom of thought and expression and to equality of opportunity for all men and women. Our U.S. campuses will learn from our Qatar students, too, as we arrange opportunities for cultural exchange, team projects, and dialogue with students in Pittsburgh and the Silicon Valley.

In April, we reached another international milestone at the commencement of the first 19 enthusiastic graduates of the joint master's program in information networking with Athens Information Technology and our Information Networking Institute. We also saw progress with new partners in other parts of the world who have sought our help in building or enhancing their institutions of higher learning. In South Korea, Singapore and Taiwan, we are working with local universities and organizations to educate more young people in software engineering, business and computer science. The Million Book Project, led by Herbert A. Simon Professor of Computer Science and Robotics Raj Reddy and Dean of Libraries Gloriana St. Clair, will be a free, global, online research library; they are working closely with organizations in India and China to accomplish this ambitious goal.

With our new Qatar campus, this growing network of international relationships will, I believe, serve us well in shaping our institutional future; it will help us fulfill our educational and research missions more richly than ever, and create a Carnegie Mellon community on a global scale.

Strengthening Business Education

Another thrilling event this year came in March when David Tepper and his wife, Marlene, stepped forward with a transformational gift of $55 million. In recognition of their extraordinary generosity, we renamed our Graduate School of Industrial Administration the David A. Tepper School of Business. David, a Pittsburgh native and a 1982 MBA graduate, is a brilliantly successful investment manager, who was engaged and excited by Dean Kenneth Dunn's vision for the school. This gift is an inspiring act of philanthropy, rare in a couple as young as the Teppers, and is the largest gift in our university's history.

The Tepper School's aim is to "own the space where business and technology intersect"—that is, to provide the students with analytical and organizational tools to run a successful business and experiences that cultivate a sophistication about technology as an engine of growth and productivity. The Teppers' generosity will help make this happen. We are very grateful.

The Posner Center

This past May, we dedicated the Posner Center—an elegant addition to the campus that houses the Posner Collection of rare scientific and literary books, manuscripts and works of art. The building was given by Henry and Helen Posner, Jr., in memory of Henry's parents, Henry and Ida Posner, Sr., who had assembled this superb collection. The building also contains a well-appointed meeting room that will be used by the board of trustees and many campus groups. The Posners have added magnificently to the beauty of our campus and created a new cultural asset for Pittsburgh with this new center.

Achievements and Milestones

There were many other achievements worth celebrating, and I can only name a few:

- We celebrated the opening of the Steinbrenner Institute for Environmental Education and Research, established by a generous gift from Jan and trustee Lowell Steinbrenner. The institute has already encouraged broader thinking and action on environmental issues among students in every college.
- The Carnegie Mellon Red Team made international headlines when the Carnegie Mellon robotic vehicle "Sandstorm" easily outpaced the competition in a race in the Mojave desert last October. The Department of Defense is sponsoring the competition to build a vehicle that can navigate autonomously for many miles in rugged territory; the next race will take place in October 2005. Fredkin Professor Red Whitaker leads a team of very determined students, and has assembled a group of corporate partners, who contribute money, time, equipment, skill and endless enthusiasm to this project. They are capturing the imagination of the world.
- We enrolled one of the most diverse and accomplished freshman classes in our history. These impressive young people have already had an impact; it is going to be a great four years.
- We opened the nation's first LEED-certified "green" dorm, New House, which was praised by the U.S. Building Council for its design, sustainable construction methods and energy efficiency.
- Students at the schools of Music and Drama collaborated on a brilliant production of the Weill and Brecht opera "The Rise and Fall of the City of Mahagonny"; it was one of the hottest tickets in town, with some critics proclaiming it the cultural event of the year. The School of Art was also well represented in international exhibitions this year, notably in the Whitney Biennial in New York, which included works by three Carnegie Mellon faculty and graduates.

- We launched a new university magazine, Carnegie Mellon Today, in both print and online versions. After just three issues, we believe we are succeeding in connecting alumni and other readers with the dynamic life of fellow graduates and the students and faculty on all our campuses.

- Also this year, we launched a new branding campaign, "The Da Vinci Effect." This campaign evokes the creative energy and range of accomplishments of Leonardo da Vinci as a symbol of this university. The campaign dramatizes wonderfully well how Carnegie Mellon's unique mix of arts and sciences is a productive setting for generating new ideas and educating future leaders.

- Many people gave generously to Carnegie Mellon last year. Gifts to the Annual Fund exceeded $5.3 million, the highest total in our history. The Jerry and Carolyn Holleran Scholarship Challenge was also extremely successful, allowing us to establish 25 new endowed scholarship funds. We are most appreciative of the confidence alumni and friends are showing by their increasing support.

Finally, it was a year of inspiring research successes. The faculty and their research teams continue to push forward, coming up with problem-solving innovations and again focusing our attention on how much the world benefits from Carnegie Mellon's collaborative, interdisciplinary approach. In cybersecurity, in computational bioinformatics, in public policy, in financial economics we saw breakthroughs large and small that advanced knowledge and have disproportionate impact on how we live and work. To take just three—out of many—examples:

- Richard McCullough, dean of the Mellon College of Science and a world leader in polymer science, headed a project that developed a powerful, one-step "chain growth" method to produce electrically conductive plastics more easily. This technology will have many research and commercial applications, from static-free flooring to more reliable cell phones.

- Yoky Matsuoka, named Anna Loomis McCandless Professor in 2004, is head of the Neurobotics Laboratory at the Robotics Institute; her group has constructed an anatomically correct robotic hand as a way to further understand how the human brain controls finger movements. The group has also developed other wearable assistive devices to restore movements in hands and arms. This work will someday help individuals with strokes, spinal cord injuries and traumatic brain injuries to move naturally using their own neural signals. It is one of many medical robotics technologies under development here that will improve the everyday quality of life for the aging and the disabled.

- Marcel Just, the Hebb Professor of Psychology and director of the Center for Cognitive Brain Imaging, uses functional magnetic resonance imaging to study the brain and cognitive functions; he and his group have gained insight into topics as diverse as how we learn and process language to the limits of multi-tasking, and, most recently, the locations of brain activity associated with autism.

It is my privilege to work closely every day with these brilliant men and women who pursue research and teaching with such energy and distinction. Their enthusiasm and their dedication give me absolute confidence that, as many milestones as we passed in 2004, many more years of achievement lie ahead.

Jared L. Cohon

The Posner Center

An Elegant New Addition to the Campus

A 1914 facsimile of the Gutenberg Bible, hand-colored and illuminated on vellum

Introduction

Carnegie Mellon's financial position has been strengthened significantly this year, with steady growth taking place in all areas of our diverse revenue portfolio. The examples President Cohon described of achievements during this past year illustrate ways in which we believe Carnegie Mellon is creating a disproportionate impact. Our financial management strategy in support of this work is to seek every opportunity to solidify and expand our revenue and net asset base, while monitoring and containing our operating expenses across the campus.

During fiscal 2004 the consolidated university achieved positive financial performance with a net increase in operations of $11.6 million and overall growth in net assets of $158.6 million. The total investment portfolio of $975.6 million at June 30, 2004, reflects an increase of 143.5 million from the prior year. The university's overall asset base at June 30, 2004, was $1.7 billion, a strong increase over the $1.5 billion reported at June 30, 2003.

Overview of Statement of Financial Position

During fiscal 2004, Carnegie Mellon continued to strengthen its balance sheet. Total assets at June 30, 2004, were $1.7 billion, 11% higher than the prior year.

- Cash and cash equivalents increased by approximately $4 million, which was principally from advance payments received for sponsored projects.
- Investments, which represent 58% of total assets, increased by $143 million, or 17%. This increase in assets was primarily due to an increase in the endowment from improved market performance and the excess of positive returns and gifts over distributions.
- Additions for buildings and equipment were $43.9 million in fiscal 2004, including movable equipment of $19.6 million, and buildings and construction of $24.3 million. These additions were offset by an increase of $40.2 million in accumulated depreciation. Movable equipment spending remained consistent with the prior year. The primary increase in buildings was a result of the completion of the Posner Center, which houses the Posner collection of rare books and artifacts, and made possible by a gift from Henry and Helen Posner, Jr. The build out of the lower level of the University Center was also completed during fiscal 2004.

Total liabilities at June 30, 2004, were $464.4 million, which is 3% higher than the prior year.

- External debt outstanding at June 30, 2004, was $306.1 million, representing 66% of total liabilities. Long-term debt decreased by $2.3 million from $308.4 million at June 30, 2003, principally due to a decrease in capital lease obligations. Virtually all of the university's outstanding debt matures in 2025 and beyond.
- Accounts payable and other liabilities increased $9.9 million from the prior year as a result of increases in accruals for postretirement benefits, paid time off and general accounts payable.

Total net assets at June 30, 2004, were $1.2 billion, which is 15% higher than the prior year, reflecting strong market performance, successful fundraising and management's commitment to control costs of operations.

Summary of Net Assets

($ in thousands)

	2004	2003	2002	2001	2000
Unrestricted	$ 602,255	$ 540,858	$ 529,254	$ 594,793	$ 622,760
Temporarily Restricted	274,535	206,526	229,054	286,527	358,422
Permanently Restricted	329,241	300,019	287,878	272,302	253,724
Total Net Assets	**$ 1,206,031**	**$ 1,047,403**	**$ 1,046,186**	**$ 1,153,622**	**$ 1,234,906**

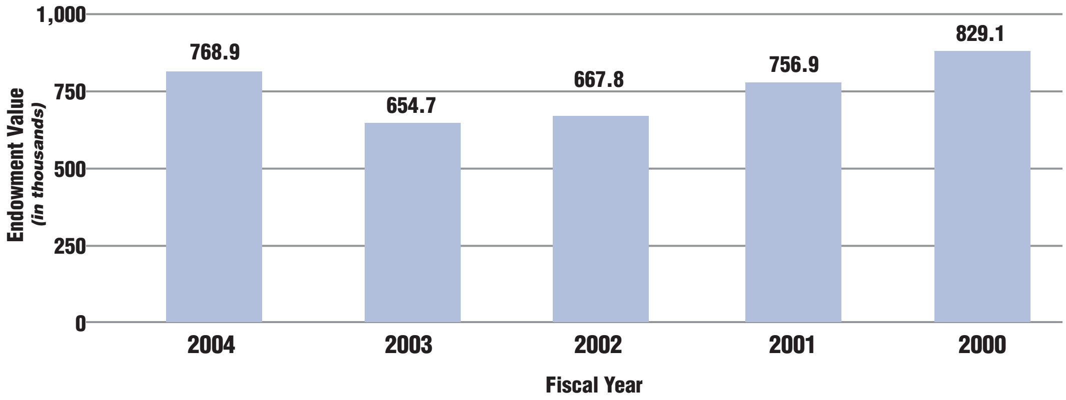
Investments

The investment performance of Carnegie Mellon's long-term fund, for the fiscal year ending June 30, 2004, was 20%. This return is indicative of the favorable performance from the financial markets in general, and better than bench mark performance by most of the fund's money managers.

Carnegie Mellon invests its endowment together with a portion of its working capital reserve in a diversified long-term fund. Distributions from the endowment provide a key source of funds to support a variety of activities and programs, from general operations to very specific needs, such as scholarships and professorships. During the past five years, the university has reduced the policy distribution rate to its current level of 5.0% and altered the long-term fund's asset allocation to position the fund for higher expected long-term growth. These policy changes, together with the continued generosity of Carnegie Mellon's friends and supporters, will help to maintain and increase the endowment's ability to fund initiatives that support Carnegie Mellon's strategic plan.

The twelve-month return for the Nasdaq composite was 26.8%; the S&P 500 Index advanced 19.1%; the MSCI All World Free excluding US index gained 32.5% while the Lehman Aggregate Bond Index was basically flat at plus 0.3%.

The endowment's market value grew by $114.3 million and was valued at $768.9 million at June 30, 2004. The gain in market value reflects the net impact of $131.2 million in investment gains and $19.6 million in gifts and other additions, less $36.5 million in distributions to support university operations.



During the year, Carnegie Mellon continued to implement its growth oriented investment policy for the long-term fund. In broad terms, the policy calls for allocations of 80% in equity-based assets and a 20% reserve composed of 15% fixed income and 5% hedge funds. The allocation to equity-based assets positions the overall portfolio to benefit from the expected long-term relative outperformance of equities. Carnegie Mellon has also made significant progress in expanding its allocation to alternative non-liquid investment funds and was successful in gaining access to several high quality venture capital and private equity funds.

Carnegie Mellon remains mindful of its stewardship responsibility for the university's long-term investments and that these funds must adequately meet the needs of current and future generations of Carnegie Mellon students. We are confident that with the continued generosity and support from the university's donors and friends, the endowment will be able to provide for current operating needs and generate additional resources for the university's future growth.

Overview of Statements of Activities

Financial Highlights

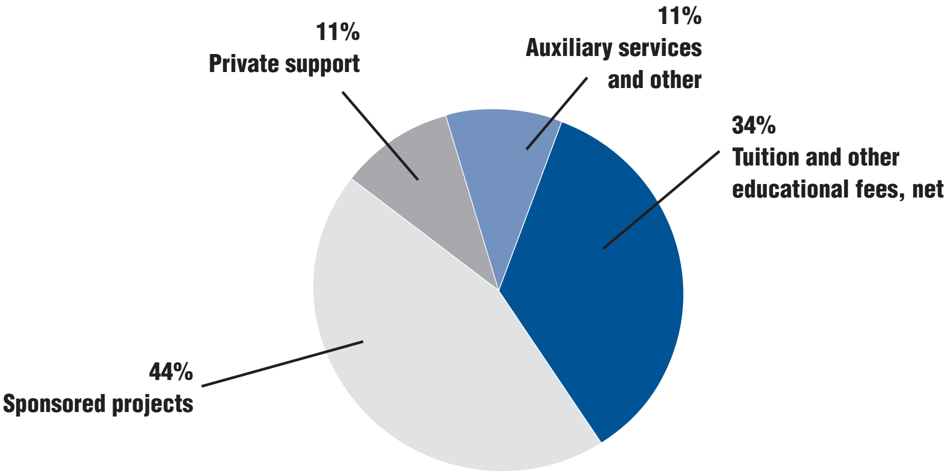
($ in thousands)

	2004	2003	2002	2001	2000
Operating revenue	$ 631,710	$ 576,993	$ 553,432	$ 484,503	$ 458,846
Operating expenses	620,076	559,755	551,006	482,981	449,442
Increase from operations	**$ 11,634**	**$ 17,238**	**$ 2,426**	**$ 1,522**	**$ 9,404**
Change in unrestricted net assets from non-operating activities	**49,763**	**(5,634)**	**(67,965)**	**(29,489)**	**24,563**
Change in temporarily restricted net assets	**68,009**	**(22,528)**	**(57,473)**	**(71,895)**	**16,667**
Change in permanently restricted net assets	**29,222**	**12,141**	**15,576**	**18,578**	**26,871**
Increase (decrease) in net assets	**$ 158,628**	**$ 1,217**	**$ (107,436)**	**$ (81,284)**	**$ 77,505**

Operations for the year ended June 30, 2004, produced positive results exceeding budgeted expectations. Carnegie Mellon, like its peer institutions, remains dependent on four major categories of revenue: tuition and other educational fees (net of financial aid), research (more precisely defined as sponsored projects), private support (composed of investment income, contributions and net assets released from restrictions), and revenue generated by sales of auxiliary services, such as housing and meals, and other revenue sources. The fiscal 2004 results continue to reflect strong performance in our core education and research activities, leaving the relative proportions of the four revenue streams fundamentally unchanged.

Operating Revenues

Fiscal 2004 Operating Revenue



Tuition and other educational fees, net of financial aid increased 11% to $217.2 million. The growth in tuition and other educational fees, net of financial aid, was consistent with increases in tuition rates, the number of graduate students, and the increased demand for executive education. This growth further illustrates the tangible impact of the continuing demand for Carnegie Mellon's flourishing educational and research programs. The following tables provide detailed information of enrolled students, including undergraduate, graduate and non-degree, in the fall semesters of 2003 and 2002 by school and undergraduate admissions information.

Fall 2003 and 2002 Semester Enrollment

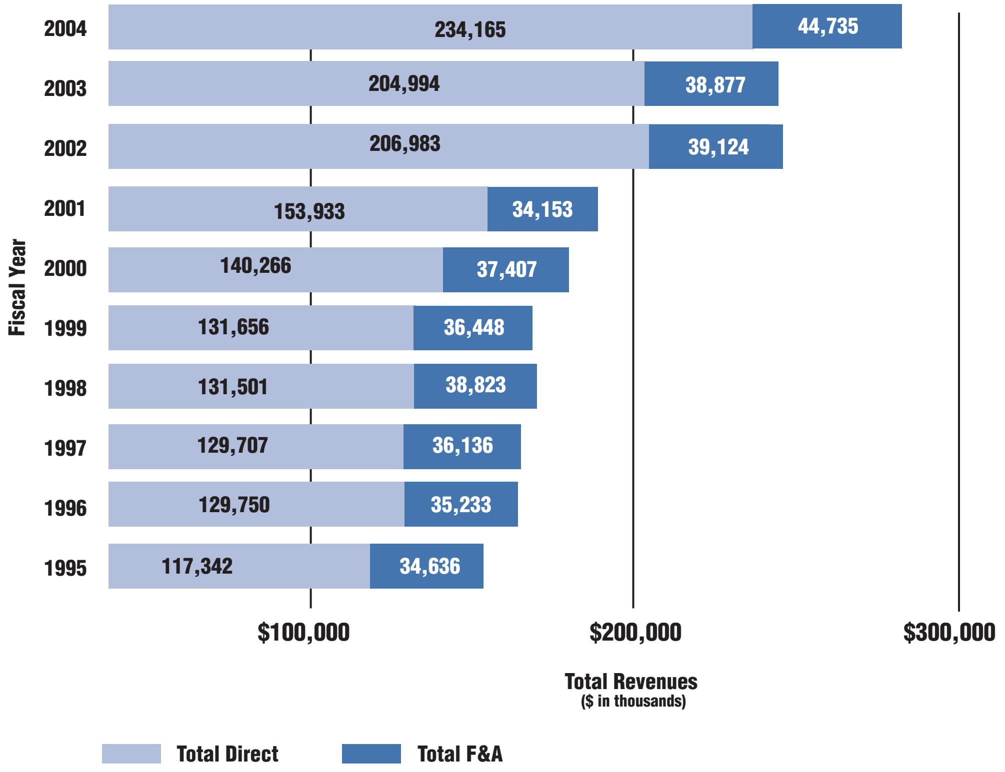
School	2003-2004 Undergraduate	2003-2004 Graduate	Total Number of Students	Percentage	2002-2003 Undergraduate	2002-2003 Graduate
Carnegie Institute of Technology	1,447	857	2,304	24%	1,433	800
David A. Tepper School of Business	488	1,070	1,558	16%	475	1,021
College of Humanities	1,043	258	1,301	13%	1,055	256
College of Fine Arts	968	241	1,209	12%	1,009	211
School of Computer Science	547	641	1,188	12%	542	562
Mellon College of Science	591	235	826	8%	590	213
Interdisciplinary	253	490	743	8%	243	445
H. John Heinz III School of Public Policy and Management	—	480	480	5%	—	518
Non-Degree & Other	—	—	147	2%	—	—
Total	5,337	4,272	9,756	100%	5,347	4,026

Undergraduate Admissions - Fall Semester

	2003-2004	2002-2003	2001-2002	2000-2001	1999-2000
Applications	14,467	14,271	16,696	14,621	14,130
Acceptances	5,561	5,440	5,211	5,241	5,358
Matriculations	1,341	1,365	1,318	1,329	1,254

In fiscal 2004, **sponsored projects activity** provided $278.9 million or 44% of Carnegie Mellon's total operating revenues, which represents 14% growth over the prior year. In fiscal 2004, our figures included increased support over prior year operations of 28% from the National Science Foundation and 9% from the Department of Health and Human Services. This was the result of increasing national recognition of the achievements of our faculty and their ability to consistently prevail over other proposers in rigorous, peer-reviewed national competitions. As shown in the chart below, over the past ten years this revenue stream has grown 84%, from $151.9 million to $278.9 million.

Sponsored Projects Revenue



In fiscal 2004 we have rebounded to the levels of **contributions** experienced prior to the economic downturn in 2001. This strong fundraising performance is expected to continue for the next several years due to the fact that the university has just begun a new, multi-year fundraising campaign.

Summary of Contributions

($ in thousands)

	2004	2003	2002	2001	2000
Unrestricted	$10,782	$9,149	$10,520	$31,009	$18,862
Temporarily Restricted	21,435	14,521	10,404	14,316	12,002
Permanently Restricted	29,396	12,413	14,595	18,563	26,444
Total Contributions	**$61,613**	**$36,083**	**$35,519**	**$63,888**	**$57,308**

Expenses

In fiscal 2004 operating expenses totaled $620.1 million, or an 11% increase over fiscal 2003, primarily attributable to our growth in sponsored projects. Personnel costs remained our largest single expense category. Expense growth in all categories is directly aligned with growth in the university's primary revenue streams.

Conclusion

The fiscal 2004 results presented here confirm Carnegie Mellon's commitment to furthering our core educational mission and maintaining sound business practices. Our reputation for quality in undergraduate education remains strong, with approximately 14,500 applications for the 2003-2004 freshman class of 1,341. Our research base is growing rapidly and we are attracting and retaining faculty whose reputations rank among the best in the nation. Our international programs are adding a new and exciting dimension to complement the diversity and multiculturalism we believe is so important within our campus community, and we are contributing our expertise and leadership to several important Pittsburgh regional initiatives.

Building on many years of sound financial performance, we intend to turn our focus in the coming years to the next phase of improving our campus facilities and developing stronger recognition and support for our programs among our alumni and the broader Carnegie Mellon community throughout the world. Our highest priority in financial management is to provide our faculty and students with the resources they need as they continue to outperform their peers and bring greater recognition to Carnegie Mellon for the contributions they are making to society.

Deborah J. Moon

DEBORAH J. MOON
Controller and Acting Chief Financial Officer
Carnegie Mellon University
October 12, 2004

JOHN M. MAZUR
Treasurer and Chief Investment Officer
Carnegie Mellon University
October 12, 2004

INDEPENDENT AUDITOR'S REPORT

Qatar Campus

An International Partnership with the Qatar Foundation

To the Board of Trustees
Carnegie Mellon University and Subsidiaries
Pittsburgh, Pennsylvania

We have audited the accompanying consolidated statements of financial position of Carnegie Mellon University and subsidiaries as of June 30, 2004 and 2003, and the related consolidated statements of activities and cash flows for the years then ended. These consolidated financial statements are the responsibility of the university's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Carnegie Mellon University and subsidiaries as of June 30, 2004 and 2003, and the changes in their net assets and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche L.L.P.

Deloitte & Touche LLP

Pittsburgh, Pennsylvania

October 12, 2004

Consolidated Statements of Financial Position

June 30, 2004 and 2003

($ in thousands)

	2004	2003
Assets		
Cash and cash equivalents	$ 74,294	$ 69,889
Accrued interest and dividends	2,406	2,650
Accounts receivable, net (Note C)	74,176	65,633
Pledges receivable, net (Note D)	47,339	36,950
Loans receivable, net (Note C)	17,827	15,119
Investments (Note E)	975,597	832,138
Assets held in trust by others	5,287	12,238
Other assets	16,704	11,339
Land, buildings and equipment, net (Note H)	456,768	453,053
Total assets	**$ 1,670,398**	**$ 1,499,009**
Liabilities		
Accounts payable and other liabilities	$ 68,574	$ 58,699
Deferred revenue	54,910	52,085
Federal loan programs	14,324	14,077
Present value of future annuities payable	20,461	18,360
Long-term debt (Note I)	306,098	308,385
Total liabilities	**$ 464,367**	**$ 451,606**
Net assets		
Unrestricted	$ 602,255	$ 540,858
Temporarily restricted	274,535	206,526
Permanently restricted	329,241	300,019
Total net assets	**$ 1,206,031**	**$ 1,047,403**
Total liabilities and net assets	**$ 1,670,398**	**$ 1,499,009**

See Notes to Consolidated Financial Statements.

Consolidated Statements of Activities

For the Year Ended June 30, 2004

($ in thousands)

	2004			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenue and other support:				
Tuition and other educational fees, net of financial aid	$217,214	—	—	$217,214
Sponsored projects (Note G)	278,900	—	—	278,900
Investment income	25,057	6,041	(174)	30,924
Contributions (Note D)	10,782	21,435	29,396	61,613
Auxiliary services	35,280	—	—	35,280
Other sources	34,294	2,221	—	36,515
Net assets released from restrictions	30,183	(30,183)	—	—
Total revenue and other support	**$ 631,710**	**$ (486)**	**$ 29,222**	**$ 660,446**
Expenses:				
Salaries	$ 325,578	—	—	$ 325,578
Benefits	66,643	—	—	66,643
Supplies and services	116,167	—	—	116,167
Occupancy and related expenses	36,812	—	—	36,812
Other operating expenses	29,500	—	—	29,500
Depreciation and amortization	40,200	—	—	40,200
Interest expense	5,176	—	—	5,176
Total expenses	**$ 620,076**	—	—	**$ 620,076**
Increase (decrease) in net assets before nonoperating activities	**$ 11,634**	**$ (486)**	**$ 29,222**	**$ 40,370**
Nonoperating activities:				
Net realized (loss) gain on investments	$ (2,510)	$ 14,470	—	$ 11,960
Unrealized gain on investments	48,857	60,212	—	109,069
Other sources	(2,771)	—	—	(2,771)
Net assets released from restrictions	6,187	(6,187)	—	—
Total nonoperating activities	**$ 49,763**	**$ 68,495**	—	**$ 118,258**
Increase in net assets	**61,397**	**68,009**	**29,222**	**158,628**
Net assets, June 30, 2003	**540,858**	**206,526**	**300,019**	**1,047,403**
Net assets, June 30, 2004	**$ 602,255**	**$ 274,535**	**$ 329,241**	**$ 1,206,031**

See Notes to Consolidated Financial Statements.

Consolidated Statements of Activities

For the Year Ended June 30, 2003
($ in thousands)

	2003			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenue and other support:				
Tuition and other educational fees, net of financial aid	$ 196,153	—	—	$ 196,153
Sponsored projects (Note G)	243,871	—	—	243,871
Investment income	31,306	5,690	(272)	36,724
Contributions (Note D)	9,149	14,521	12,413	36,083
Auxiliary services	32,950	—	—	32,950
Other sources	25,689	5,779	—	31,468
Net assets released from restrictions	37,875	(37,875)	—	—
Total revenue and other support	**$ 576,993**	**$ (11,885)**	**$ 12,141**	**$ 577,249**
Expenses:				
Salaries	$ 296,635	—	—	$ 296,635
Benefits	55,233	—	—	55,233
Supplies and services	99,010	—	—	99,010
Occupancy and related expenses	35,994	—	—	35,994
Other operating expenses	28,247	—	—	28,247
Depreciation and amortization	38,819	—	—	38,819
Interest expense	5,817	—	—	5,817
Total expenses	**$ 559,755**	—	—	**$ 559,755**
Increase (decrease) in net assets before nonoperating activities	**$ 17,238**	**$ (11,885)**	**$ 12,141**	**$ 17,494**
Nonoperating activities:				
Net realized loss on investments	$ (25,120)	(7,792)	—	$ (32,912)
Unrealized gain on investments	7,498	10,316	—	17,814
Other sources	(1,179)	—	—	(1,179)
Net assets released from restrictions	13,167	(13,167)	—	—
Total nonoperating activities	**$ (5,634)**	**$ (10,643)**	**—**	**$ (16,277)**
Increase (decrease) in net assets	**11,604**	**(22,528)**	**12,141**	**1,217**
Net assets, June 30, 2002	**529,254**	**229,054**	**287,878**	**1,046,186**
Net assets, June 30, 2003	**$ 540,858**	**$ 206,526**	**$ 300,019**	**$ 1,047,403**

See Notes to Consolidated Financial Statements.

Consolidated Statements of Cash Flows

For the Years Ended June 30, 2004 and 2003

($ in thousands)

	2004	2003
Cash flows from operating activities:		
Increase in net assets	$ 158,628	$ 1,217
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Realized (gains) losses on investments	(25,354)	13,537
Unrealized gains on investments	(106,614)	(17,432)
Depreciation and amortization	40,200	38,819
Gifts in kind	(903)	(1,529)
Loss on asset dispositions	761	1,898
Contributions for land, buildings, equipment and permanent endowment	(25,578)	(12,429)
Contributions held in perpetual trusts	(515)	—
Changes in assets and liabilities:		
Decrease (increase) in:		
Accrued interest and dividends	244	534
Accounts receivable, net	(8,543)	(19,646)
Pledges receivable, net	(10,389)	957
Other assets	(5,365)	(919)
Increase (decrease) in:		
Accounts payable and other liabilities	9,875	1,924
Deferred revenue	2,825	16,009
Federal loan programs	247	(189)
Present value of future annuities payable	2,101	(1,834)
Other, net	23	355
Net cash provided by operating activities	**$ 31,643**	**$ 21,272**
Cash flows from investing activities:		
Proceeds from sale and maturity of investments	1,813,666	2,822,273
Purchases of investments	(1,825,156)	(2,804,274)
Purchases of land, buildings and equipment	(43,897)	(55,984)
Proceeds from sale of land, buildings and equipment	124	122
Disbursements of loans to students	(6,519)	(4,640)
Repayments of loans from students	3,767	3,705
Net cash used for investing activities	**$ (58,015)**	**$ (38,798)**
Cash flows from financing activities:		
Withdrawal of trusteed bond funds for construction	7,489	21,260
Repayments of long-term debt	(2,290)	(2,160)
Contributions for land, buildings, equipment and permanent endowment	25,578	12,429
Net cash provided by financing activities	**$ 30,777**	**$ 31,529**
Net increase in cash and cash equivalents	**4,405**	**14,003**
Cash and cash equivalents at beginning of year	**69,889**	**55,886**
Cash and cash equivalents at end of year	**$ 74,294**	**$ 69,889**

See Notes to Consolidated Financial Statements.

Notes to Consolidated Financial Statements

June 30, 2004 and 2003

Note A—Carnegie Mellon

Carnegie Mellon University ("Carnegie Mellon") is a private, not-for-profit educational and research institution. Carnegie Mellon currently enrolls about 9,700 students and grants approximately 2,700 bachelor's, master's and doctor's degrees each year. (Approximately 89% of undergraduate students are from the United States. International students comprise approximately 11% of undergraduate, 32% of master's and 59% of Ph.D. students.)

A substantial portion of Carnegie Mellon's revenues is from sponsored research and other projects under federal, state, industrial and other contracts.

Note B—Summary of Significant Accounting Policies

Basis of Accounting and Reporting

The accompanying consolidated financial statements have been prepared on the accrual basis and include the accounts of Carnegie Mellon and its wholly owned subsidiaries. The accounts of the wholly owned subsidiaries are not significant; and, intercompany transactions have been eliminated in consolidation.

Carnegie Mellon's net assets and revenues, expenses, gains and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, net assets and changes therein are classified and reported as follows:

Unrestricted net assets — Net assets that are not subject to donor-imposed stipulations.

Temporarily restricted net assets — Net assets subject to donor-imposed or legal stipulations that may or will be met either by actions of Carnegie Mellon and/or the passage of time.

Permanently restricted net assets — Net assets subject to donor-imposed stipulations that the assets be maintained permanently. Generally, the donors of these assets permit Carnegie Mellon to use all or part of the income earned on the related investments for general or specific purposes.

Revenues are reported as increases in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments and other assets or liabilities are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law. Expirations of temporary restrictions on net assets are reported as net assets released from restrictions between applicable classes of net assets.

Income and realized net gains and losses on investments are reported as follows:

- As changes in permanently restricted net assets if so restricted by the donor;
- As changes in temporarily restricted net assets if the terms of the gift or relevant state law impose restrictions on the use of the income or gains and losses; and
- As changes in unrestricted net assets in all other cases.

Equity securities with readily determinable fair values and all debt securities are measured at fair value with gains and losses reported in the statement of activities.

Carrying values of accounts and loans receivable approximate their fair values.

Fund Accounting

In order to ensure observance of limitations and restrictions placed on the use of the resources available to Carnegie Mellon, the internal operating accounts are maintained in accordance with the principles of fund accounting. This is the procedure by which resources for various purposes are classified into funds that are in accordance with activities or objectives specified. These financial statements, however, have been prepared to focus on the entity as a whole and to present transactions according to the existence or absence of donor-imposed restrictions.

Student Financial Aid

Tuition and other educational fees are reported net of student financial aid of $65.6 million and $57.6 million in the years ended June 30, 2004 and 2003, respectively.

Sponsored Project Revenues

Sponsored project revenues include research and other programs sponsored by government and private sources. Direct sponsored project revenues represent reimbursement of costs incurred in direct support of sponsored projects. Such revenue is recognized when the direct costs are incurred. In addition, sponsored projects normally provide for the recovery of indirect costs supporting the project. Indirect sponsored project revenues are recorded at rates established in advance by Carnegie Mellon through negotiations with the United States Government and other sponsors. Amounts received from sponsors under agreements that require the exchange of assets, rights or other privileges between Carnegie Mellon and the sponsor are recorded as deferred revenue until the contract terms are fulfilled.

Contributions with Restrictions Met in the Same Year

Contributions received with donor-imposed restrictions that are met in the same year as received are reported as revenues of the temporarily restricted net asset class, and a release of restriction is made to unrestricted net assets to reflect the satisfaction or expiration of such restrictions.

Contributions for Plant Activities

Donors' contributions to fund construction projects are classified as temporarily restricted net assets until the facility is placed in service. At that time, the temporarily restricted net assets are released from restriction and replenish unrestricted net asset balances designated for plant activities.

Operations

Revenues received and expenses incurred in conducting the programs and services of Carnegie Mellon are presented in the financial statements as operating activities. Nonoperating results include realized and unrealized gains and losses due to investment results, certain investee operating results, and non-recurring or unusual expenses and additions. In addition, net assets released from donor restrictions for buildings are released into nonoperating activities when the building is put into service.

Cash Equivalents

Cash equivalents include U.S. treasury obligations, commercial paper and corporate notes with maturities of three months or less, except that such instruments purchased with endowment and annuity and life income assets on deposit with trustees are classified as investments.

Investments

Debt and equity securities held by Carnegie Mellon are carried at market values as established by the major securities markets. Diversified, non-liquid holdings are carried at market values based upon financial information provided by the portfolio managers. Investments received as a gift are reflected as contributions at their fair market value at the date of the gift. Carnegie Mellon utilizes various investment instruments. Investment securities, in general, are exposed to various risks, such as interest rate, credit and overall market volatility. Due to the level of risk associated with certain investment securities, changes in the values of investment securities will occur in the near term and it is reasonably possible that such changes could materially affect the amounts reported in the statements of financial position.

Endowment

Investment policy for endowment assets is the responsibility of the Investment Committee of the Board of Trustees. Substantially all endowment assets are managed by outside investment managers and held in custody by an outside trustee.

Endowment net assets classified as unrestricted include Carnegie Mellon funds and unrestricted gifts from donors, and any accumulated income and appreciation thereon, which is intended to remain in the endowment for the long-term support of Carnegie Mellon activities, but may be expended under trustee authorization.

Temporarily restricted endowment net assets include certain expendable gifts, and any retained income and appreciation thereon, that are restricted by the donor to a specific purpose. When the temporary restrictions on these funds have been met, the gifts ordinarily remain in the endowment to continue supporting the same activities as those specified by the donors; however, by trustee designation, the funds are reclassified to unrestricted endowment net assets.

This classification also includes all expendable, accumulated appreciation of $215 million and $153 million on permanent endowment assets as of June 30, 2004 and 2003, respectively. The Trustees of Carnegie Mellon must annually authorize release of endowment gains according to Pennsylvania law.

Permanently restricted endowment net assets include those assets that must be invested in perpetuity to provide a permanent source of income.

All endowment funds participate in a Carnegie Mellon investment pool. The investment pool provides income to its respective participants. Such income is used for the specific purpose prescribed by the donor or, if the purpose was not prescribed by the donor, the income is deemed unrestricted and used for general purposes. New endowment funds or additions to existing funds are assigned shares in the investment pool based upon the per share market value at the end of the previous month. Income distributions from the investment pool are based upon the number of shares held by each participant and the approved spending rate (see Note F). Income distributions from the investment pool are based upon the "total return concept." The annual income distributed from the investment pool includes interest and dividends and could include a portion of the accumulated capital gains. Any capital gains not distributed currently are reinvested in the investment pool and are available for distribution from the endowment assets in future years.

Land, Buildings and Equipment

Land, buildings and equipment are recorded at cost at the date of acquisition or, if acquired by gift, at the estimated fair market value as of the date of the gift. Additions to plant assets are capitalized while scheduled maintenance and minor renovations are charged to operations. Buildings and equipment are reflected net of accumulated depreciation which is calculated on a straight-line basis over the estimated economic lives. Carnegie Mellon reviews its land, buildings and equipment and other long-lived assets for impairment whenever events or circumstances indicate that the carrying amount may not be recoverable.

Split Interest Agreements

Carnegie Mellon's split interest agreements with donors consist primarily of gift annuities, unitrusts, lead trusts, charitable remainder annuity trusts and life income agreements. Assets held under these agreements are included in investments. Generally, contribution revenues are recognized at the dates the agreements are established after recording liabilities for the present value of the estimated future payments to be made to the beneficiaries. The liabilities are adjusted during the term of the trusts for changes in the value of the assets, accretion of the discount and other changes in the estimates of future benefits. Distributions from the trusts are recorded as contributions and the carrying value of the assets is adjusted for changes in the fair value of the trust assets.

Assets Held In Trust By Others

Assets Held In Trust By Others includes proceeds from the issuance of bonds in 2002 (see Note I), which were held by a trustee under the bond indenture for future capital expenditures that were spent during fiscal 2004, and the value of Carnegie Mellon's beneficial interest in perpetual trusts held by outside trustees. The present values of the trust's estimated future cash receipts, which were measured by the fair value of the assets contributed to the trust, are recognized as assets and contribution revenues at the dates the trusts are established.

Income Taxes

Carnegie Mellon is a not-for-profit organization as described in section 501(c)(3) of the Internal Revenue Code and is generally exempt from income taxes on related income pursuant to Section 501(a) of the Code.

Reclassifications

Certain 2003 amounts have been reclassified to conform with the 2004 presentation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Note C—Accounts and Loans Receivable

Accounts receivable at June 30, 2004 and 2003, consist of the following:

$ in thousands	2004	2003
Sponsored project grants and contracts:		
Federal	$ 50,544	$ 35,748
Other	16,576	26,043
Total sponsored projects	**$ 67,120**	**$ 61,791**
Student accounts	8,135	6,652
Other	5,263	4,528
	80,518	72,971
Allowance for doubtful accounts	(6,342)	(7,338)
Net accounts receivable	**$ 74,176**	**$ 65,633**

Loans receivable are primarily student loans made under a federal loan program, and are reported net of an allowance for doubtful accounts of approximately $1.6 million, as of June 30, 2004 and 2003.

Note D—Pledges Receivable and Contributions

Pledges and outside trusts as of June 30, 2004 and 2003, are discounted to the present value of future cash flows and are due as follows:

$ in thousands		2004		
	Discount Rate	Temporarily Restricted	Permanently Restricted	Total
In one year or less	2.1%	$ 4,250	$ 7,464	$ 11,714
Between one year and five years	2.7-3.8%	4,923	20,460	25,383
More than five years	4.2%	8,001	4,393	12,394
Present value of pledges		$ 17,174	$ 32,317	$ 49,491
Less allowance for unfulfilled pledges		(687)	(1,465)	(2,152)
Pledges receivable, net of allowance		**$ 16,487**	**$ 30,852**	**$ 47,339**

$ in thousands		2003		
	Discount Rate	Temporarily Restricted	Permanently Restricted	Total
In one year or less	1.0%	$ 9,379	$ 4,785	$ 14,164
Between one year and five years	1.7%	6,974	10,028	17,002
More than five years	2.8%	2,985	4,331	7,316
Present value of pledges		$ 19,338	$ 19,144	$ 38,482
Less allowance for unfulfilled pledges		(773)	(759)	(1,532)
Pledges receivable, net of allowance		**$ 18,565**	**$ 18,385**	**$ 36,950**

Pledges receivable as of June 30, 2004 and 2003, net of allowances, are intended for the endowment in the amounts of $30.9 million and $18.4 million, respectively, capital projects in the amounts of $1.2 million and $6.3 million, respectively, and other donor restricted purposes in the amounts of $15.2 million and $12.2 million, respectively.

Contribution revenue includes gifts, unconditional pledges to give and grants. Contributions are recorded in the appropriate net asset category based upon the intent of the donor or grantor. Contributions for the years ended June 30, 2004 and 2003 are as follows:

$ in thousands		2004	
	Gifts/Grants	Change in Pledges Receivable	Total
Unrestricted	$ 10,782		$ 10,782
Temporarily restricted	23,512	$ (2,077)	21,435
Permanently restricted	16,930	12,466	29,396
Total	**$ 51,224**	**$ 10,389**	**$ 61,613**

$ in thousands		2003	
	Gifts/Grants	Change in Pledges Receivable	Total
Unrestricted	$ 9,149		$ 9,149
Temporarily restricted	17,701	$ (3,180)	14,521
Permanently restricted	10,190	2,223	12,413
Total	**$ 37,040**	**$ (957)**	**$ 36,083**

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 Carnegie Mellon were approximately $60.8 million as of June 30, 2004. Subsequent to June 30, 2004, Carnegie Mellon received $10 million for which conditions have been met.

Carnegie Mellon generally reports foundation grants as exchange contracts and accordingly, reports such revenues as sponsored project revenue in the accompanying Consolidated Statements of Activities. These revenues were $5.9 million and $5.8 million in the years ended June 30, 2004 and 2003, respectively.

Note E—Investments

Investments by major category at June 30, 2004 and 2003, are as follows:

$ in thousands	2004	2003
Restricted cash and equivalents	$ 40,715	$ 50,388
Fixed income	255,952	234,029
Common stock	544,369	424,040
Other investments	134,561	123,681
Total investments	**$ 975,597**	**$ 832,138**

Investments are held for the following purposes:

$ in thousands	2004	2003
Endowment	$ 763,718	$ 651,197
Reserves for debt service	102,272	112,035
Life income trusts	27,793	26,694
Other	81,814	42,212
Total investments	**$ 975,597**	**$ 832,138**

Nearly all fixed income securities are U.S. investment grade and high yield bonds, asset backed securities, and United States Treasury and Agency obligations at June 30, 2004 and 2003. Common stock investments are composed of approximately 74% domestic equities and 26% international and emerging market equities at June 30, 2004. At June 30, 2003 approximately 69% of common stock investments consisted of domestic equities while the remaining 31% included international and emerging market equities. Other investments are largely investments in domestic buyout funds, venture capital, hedge funds and real estate.

The allocation to each major category represents the actual allocation of all investment pools on a combined basis. Each investment pool maintains a unique investment strategy. Actual allocations on a combined basis should not be interpreted as an investment allocation policy for a particular investment pool. In addition, the above asset category allocations do not reflect the effective allocation exposures resulting from investment strategies that include derivatives. The following schedule summarizes the investment return for the years ended June 30, 2004 and 2003:

$ in thousands	2004	2003
Dividends and interest	$ 17,779	$ 17,730
Net realized gains (losses) on sale of securities	25,354	(13,537)
Unrealized gain	106,614	17,432
Total return on investments	**$ 149,747**	**$ 21,625**

Operating investment income includes dividends and interest earned on unrestricted funds, and unrestricted accumulated gains utilized for current operations in the amount of $13.4 million and $19.4 million in the years ended June 30, 2004 and 2003, respectively.

Carnegie Mellon and certain of its outside investment managers purchase and sell derivative instruments in order to manage interest rate and foreign currency risk and market positions.

Carnegie Mellon's international portfolios maintain market benchmarks, for performance evaluation and risk control purposes, that are unhedged with respect to foreign currencies. Unhedged benchmarks reflect the full impact of foreign currency fluctuations stemming from the benchmarks' foreign currency positions. Investment managers of these international portfolios have the discretion to manage the portfolios' foreign currencies, relative to the currency exposures in their unhedged benchmarks, to protect the portfolios from potential foreign currency losses and to benefit from potential foreign currency gains. Carnegie Mellon's investment managers understand that they are assuming active management risks to the extent that they assume foreign currency exposures that differ from the foreign currency exposures in their relevant market benchmarks (as documented in the formal investment guidelines for each manager). Carnegie Mellon had foreign exchange contracts totaling $7.1 million and $5.9 million at June 30, 2004 and 2003, respectively. Certain of these foreign exchange contracts are entered into with respect to pending settlements of foreign securities transactions.

Investment managers purchase and sell interest rate futures to control the risk of fluctuations in market interest rates, relative to portfolio benchmarks, on the university's fixed income investments. At June 30, 2004 and 2003, the notional value of interest rate futures was $2.5 million and $0.1 million, respectively.

Certain domestic equity investment managers purchase S&P 500 futures contracts to obtain cost-efficient exposure to the S&P 500 Index when the S&P 500 Index is the portfolio benchmark. At June 30, 2004 and 2003, the notional value of S&P 500 futures contracts was $71.3 million and $54.5 million, respectively.

Gains or losses from derivative instruments are reported as realized and unrealized gains or losses in the statement of activities. The market value of all derivative instruments is included in the market value of the investments.

Under the terms of certain limited partnership agreements, Carnegie Mellon is obligated to periodically advance additional funding for private-equity and real estate investments. At June 30, 2004, Carnegie Mellon had commitments of approximately $62 million for which capital calls had not been exercised. Such commitments generally have fixed expiration dates or other termination clauses. Carnegie Mellon maintains sufficient liquidity in its investment portfolio to cover such calls.

Note F–Endowments

The following table provides a summary of the changes in value of the endowment assets excluding pledges for the years ended June 30:

$ in thousands	2004	2003
Beginning of year endowment value	**$ 654,678**	**$ 667,807**
Gifts and other additions:		
Contributions (excluding pledges)	17,895	11,459
Terminated life income trusts and income and gains reinvested	1,396	946
Other transfers	350	—
Total gifts and other additions	**$ 19,641**	**$12,405**
Investment income:		
Interest and dividends	$ 12,165	$ 12,200
Realized gain (loss) on sale of securities	22,419	(12,268)
Unrealized gain	96,569	16,271
Total investment income	**$ 131,153**	**$ 16,203**
Income distributed for operating purposes:		
Cash and accrued interest and dividends	$ (12,107)	$ (12,071)
Accumulated realized investment gains	(24,375)	(29,666)
Total income distributed	(36,482)	**(41,737)**
End of year endowment value	**$ 768,990**	**$ 654,678**

Endowment net assets at June 30 are classified as follows:

$ in thousands	2004	2003
Unrestricted	$ 264,254	$ 230,792
Temporarily restricted	215,487	153,273
Permanently restricted	289,249	270,613
Total	**$ 768,990**	**$ 654,678**

Carnegie Mellon maintains a total return spending policy. Endowment income distributions can consist of dividend and interest income and a withdrawal of accumulated capital gains when necessary. The main objective of the total return spending policy is to separate spending policy from investment policy. Separating spending policy from investment policy permits asset allocation decisions to be made independently of the need for current income. The spending rate for endowment is determined annually as a percentage of the trailing three year average of December 31 endowment market values. For fiscal 2004 and 2003, the spending rate was set at 5.0% and 5.1%, respectively. The actual spending rate based on average annual endowment market value for the year was 5.1% in fiscal 2004, compared to 6.3% in fiscal 2003.

Note G–Sponsored Project Revenues

The major components of sponsored projects revenue for the years ended June 30, 2004 and 2003, are as follows:

$ in thousands	2004	2003
Federal		
Direct	$ 196,590	$ 176,871
Indirect	40,180	35,014
Total Federal	**$ 236,770**	**$ 211,885**
State, industrial and other		
Direct	$ 37,575	$ 28,123
Indirect	4,555	3,863
Total state, industrial and other	**42,130**	**31,986**
Total sponsored projects revenue	**$ 278,900**	**$ 243,871**

Note H–Land, Buildings and Equipment

Land, buildings and equipment at June 30 consist of the following:

$ in thousands	2004	2003
Buildings	$ 607,778	$ 576,487
Utilities and building-related assets	51,441	50,830
Moveable equipment	255,148	263,593
Subtotal	**$ 914,367**	**$ 890,910**
Accumulated depreciation	(467,489)	(454,956)
Subtotal	**$ 446,878**	**$ 435,954**
Land	7,323	7,323
Construction in progress	2,567	9,776
Land, buildings and equipment, net	**$ 456,768**	**$ 453,053**

Buildings include $22.3 million in 2004 and 2003 representing the present value of minimum lease payments under capital lease arrangements.

Note I–Long-Term Debt

Long-term debt consists of the following as of June 30:

$ in thousands	Interest %	2004	2003
Pennsylvania Higher Education Facilities Authority, Variable Rate Refunding Bonds, Series 1995	Variable	$ 176,800	$ 176,800
Allegheny County Higher Education Building Authority, Variable Rate University Revenue Bonds, Series 1998	Variable	78,000	78,000
Allegheny County Higher Education Building Authority, University Revenue Bonds, Series 2002	5.125 - 5.5	43,844	43,815
Dormitory bonds/mortgage notes	2.75 - 3.50	2,726	2,904
Subtotal - bonds and mortgages		**$ 301,370**	**$ 301,519**
Capital lease obligations	5.0 - 7.5	4,728	6,866
Total long-term debt		**$ 306,098**	**$ 308,385**

On November 1, 1995, Carnegie Mellon issued through the Pennsylvania Higher Education Facilities Authority $176.8 million of Carnegie Mellon University Variable Rate Revenue Refunding Bonds, Series 1995 (the "1995 Bonds"). The proceeds of the 1995 Bonds were used to repay the Washington County Higher Education Pooled Equipment Leasing program debt and the Pennsylvania Higher Education Facilities Authority Variable Rate Option Revenue Bonds, First Series of 1985. The $176.8 million debt issue consists of $50 million Series 1995A due 2025, $50 million Series 1995B due 2027, $50 million Series 1995C due 2029, and $26.8 million Series 1995D due 2030. The 1995 Bonds have certain financial covenants consistent with similar types of financing arrangements. The 1995 Bonds structured as multiple mode obligations currently bear interest at a variable market rate determined daily by the bonds' remarketing agent. Interest was charged at rates ranging from 0.45% to 1.3% during the year.

On December 30, 1998, Carnegie Mellon issued through the Allegheny County Higher Education Building Authority $88 million of Carnegie Mellon University Variable Rate Revenue Bonds, Series 1998 (the "1998 Bonds"). The proceeds of the 1998 Bonds were used to fund capital projects. The 1998 Bonds structured as multiple mode obligations currently bear interest at a variable market rate determined daily by the bonds' remarketing agent. Interest was charged at rates ranging from 0.5% to 1.5% during the year.

To provide further security for the 1995 Bonds and 1998 Bonds, Carnegie Mellon and the trustees have entered into 364 day Standby Bond Purchase agreements, which have been renewed annually.

On March 27, 2002, Carnegie Mellon issued, through the Allegheny County Higher Education Building Authority, University Revenue Bonds, Series 2002, with a face value of $44.665 million (the "2002 Bonds"). The proceeds of the 2002 Bonds were used to fund capital projects. The 2002 Bonds mature at $5 million in 2027, $7.665 million in 2028 and $32 million in 2032. The 2002 Bonds bear fixed rates of interest, and the effective interest rate on the 2002 Bonds, including the effect of the original issue discount, is 5.34%.

The dormitory bonds and mortgage notes mature in varying amounts through 2024 and bear interest at fixed rates that range from 2.75% through 3.5%. Facilities of Carnegie Mellon and the revenues thereon are pledged as collateral on the dormitory bonds and mortgage notes.

Carnegie Mellon's investments include $11.7 million required under its various debt agreements to be held until the related debt is retired. An additional $90.6 million has been designated by management as a reserve to meet future debt service requirements.

Carnegie Mellon guarantees the payment of principal and interest due on $19.3 million RIDC Regional Growth Fund Revenue Refunding Bonds (Carnegie Mellon University Software Engineering Institute Facility), Series 1995, issued through the Pennsylvania Higher Educational Facilities Authority. These bonds, which had principal outstanding of $4.7 and $6.8 million as of June 30, 2004 and 2003, respectively, were issued to refinance a prior debt issue used for construction of a building in accordance with the research contract for the Software Engineering Institute. Carnegie Mellon had a capital lease obligation in connection with this transaction in the amount of $3.2 million and $5.4 million at June 30, 2004 and 2003, respectively. The lease concludes in fiscal 2006 and has an interest rate of 5%.

On July 15, 1995, Carnegie Mellon and the Urban Redevelopment Authority of Pittsburgh entered into a capital lease for the land and buildings that are known as the National Robotics Engineering Consortium. The lease term currently extends to fiscal 2005. The lease obligation was $1.4 million as of June 30, 2004 and 2003, respectively. The interest rate on the lease is 7.5%. Contract and grant revenues will support the payments on this lease.

The fair value of Carnegie Mellon's long-term debt obligations as of June 30, 2004 and 2003, is approximately $308.7 million and $311.1 million, respectively.

Interest paid for the years ended June 30, 2004 and 2003, totaled $5.2 million and $6.1 million, respectively. In the years ended June 30, 2004 and 2003, interest of approximately $43,000 and $318,000, respectively, was capitalized as part of the cost of building construction.

Aggregate maturities of bonds and mortgages for each of the five years ending June 30 are as follows:

$ in thousands	
2005	$ 159
2006	140
2007	144
2008	148
2009	153
Thereafter	300,626
Total	**$ 301,370**

Note J–Expenses by Functional Category

Operating expenses by functional category for the years ended June 30, 2004 and 2003, are as follows:

$ in thousands	2004	2003
Instruction and departmental research	$ 222,442	$ 212,484
Sponsored projects	235,413	206,336
Academic support	51,621	44,910
Student services	28,134	26,478
Administration and institutional support	51,476	39,232
Auxiliary services and activities	30,990	30,315
Total	**$ 620,076**	**$ 559,755**

Note K–Commitments and Contingencies

Carnegie Mellon is a defendant in a number of legal actions seeking damages and other relief. While the final outcome of each action cannot be determined at this time, legal counsel and management are of the opinion that the liability, if any, in these legal actions will not have a material effect on Carnegie Mellon's financial statements.

Carnegie Mellon and its affiliates receive significant financial assistance from the federal government, including the sponsorship of federal research projects. Research grants and contracts normally provide for the recovery of direct and indirect costs. Entitlement to the recovery of the applicable direct and related indirect costs is generally conditioned upon compliance with the terms and conditions of the grant agreements and applicable federal regulations, including the expenditure of the resources for eligible purposes. Substantially all grants and Carnegie Mellon's indirect cost rate are subject to financial and compliance reviews and audits by the grantors. In management's opinion, the likelihood of an adverse material outcome upon its financial position from those reviews and audits is remote.

Lease expense was $9.3 million and $9.2 million for the years ending June 30, 2004 and 2003, respectively. Future minimum lease payments at June 30, 2004, are as follows:

$ in thousands	Operating Leases	Capital Leases
2005	$ 4,832	$ 2,477
2006	1,766	1,100
2007	1,464	117
2008	1,350	109
2009	1,258	1,500
Thereafter	1,271	—
Total	11,941	5,303
Less amount representing interest		(575)
Present value of minimum capitalized lease payments		**$ 4,728**

In 2003 Carnegie Mellon entered into lease agreements with the Regional Industrial Development Corporation of Southwestern Pennsylvania in connection with construction of a new building on the Carnegie Mellon campus. Carnegie Mellon has committed to occupying a minimum amount of space in the new building once completed, although the actual space to be occupied may ultimately be reduced if additional tenants are secured. If Carnegie Mellon were to occupy the full committed amount, lease payments would be approximately $2.2 million annually for 10 years commencing December 2004.

Note L–Retirement Plans and Other Post-Employment Benefits

Carnegie Mellon has various pension and retirement programs covering substantially all of its employees. The two principal pension programs are a defined contribution plan sponsored by the university, and the Central Pension Fund of the International Union of Operating Engineers, a multi-employer plan, with some prior credits held by the SEIU National Industry Pension Fund. Annual contributions are made to the plans equal to amounts accrued for pension expense. Such plans are fully funded on a current basis. Retirement plan expense for the years ended June 30, 2004 and 2003, totaled $19.2 million and $17.0 million, respectively.

Carnegie Mellon provides certain health care benefits for eligible retired employees. The table below sets forth the health care plan's funded status at June 30, 2004 and 2003:

$ in thousands	2004	2003
Benefit obligation	$ 24,173	$21,440
Unrecognized actuarial loss	(9,818)	(9,865)
Unrecognized net transition obligation	(1,856)	(2,062)
Accrued benefit cost	**$ 12,499**	**$ 9,513**

The net periodic benefit cost for the years ended June 30 is as follows:

$ in thousands	2004	2003
Benefit cost	$ 3,497	$ 2,006
Employer contribution	510	365
Plan participants' contributions	227	150
Benefits paid	737	515

The reconciliation of the accumulated benefit obligation at June 30, 2004 and 2003, was as follows:

$ in thousands	2004	2003
Benefit obligation, beginning of year	$ 21,440	$ 11,979
Service cost	1,184	629
Interest cost	1,378	1,003
Assumption changes and actuarial loss	681	8,194
Benefit payments	(510)	(365)
Benefit obligation, end of year	**$ 24,173**	**$ 21,440**

The assumed discount rate used for calculating the benefit obligation was 6.0% for 2004 and 5.5% for 2003. An 11% annual rate of increase in the per capita cost of covered healthcare benefits was assumed for 2004. The rate was assumed to decrease gradually to 5.0% for 2009 and remain at that level thereafter.

The health care cost trend rate assumption has a significant effect on the amounts reported. Increasing the assumed healthcare cost trend rate by 1% in each year would increase the benefit obligation as of June 30, 2004, by $4.4 million and increase the aggregrate service cost and interest cost components for 2004 by $0.5 million. Decreasing the assumed health care cost trend rate by 1% in each year would decrease the benefit obligation as of June 30, 2004, by $3.5 million and decrease the aggregate service cost and interest cost components for 2004 by $0.4 million.

The expected return on plan assets for both 2004 and 2003 was 8.75% and was used in determining the benefit cost. Total contributions for each of the years ended June 30, 2004 and 2003, to fund the liability, totaled $0.7 million and $0.5 million, respectively.

Expected benefits to be paid in future fiscal years are as follows:

($ in thousands) June 30	Retiree Contributions	Employer Payments	Total Expected Benefit Payments
2005	$ 458	$ 688	$ 1,146
2006	571	791	1,362
2007	677	888	1,565
2008	794	981	1,775
2009	923	1,091	2,014
2010-2014	6,336	6,937	13,273

In conjuction with an agreement made with the federal government, the university has established a separate trust, which is available to general creditors only in the event of insolvency. Assets in the trust to fund post-retirement health care and other post-employment benefits are $9.9 million and $8.5 million at June 30, 2004 and 2003, respectively. These assets are reflected as investments in the accompanying Consolidated Statements of Financial Position.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") was signed into law. Under the provisions of the Act, sponsors of retiree health plans that provide a benefit at least actuarially equivalent to the Medicare drug benefit created by the Act will receive an annual subsidy from the federal government. Carnegie Mellon, as it is allowed to, has elected to defer recognition of the impacts of the Act on Carnegie Mellon's obligations under its plan, due to the lack of clear authoritative accounting guidance in regard to how this issue should be treated at this time. As such, the obligation measure presented above does not reflect the potential effects of the Act on the plan.

Note M–Related Party Transactions

Sponsored research revenue for fiscal 2004 and 2003 includes $19.2 million and $9.9 million, respectively, in research funding received from MPC Corporation (“MPC”), a nonprofit corporate joint venture of Carnegie Mellon and the University of Pittsburgh. The funding primarily represents federal funding under a $62.1 million contract received by MPC, for which MPC has subcontracted to Carnegie Mellon for the construction of a supercomputer and related activities.

In June 2002 Carnegie Mellon sold the net assets of Carnegie Technology Education (“CTE”), a wholly owned subsidiary, to iCarnegie, Inc. (“iCarnegie”) in exchange for stock representing an approximate 41% interest in iCarnegie, approximately $5.8 million in notes, and certain license royalties. Carnegie Mellon’s interest in iCarnegie has a carrying value of $0 as of June 30, 2004 and 2003, and the notes from iCarnegie are fully reserved. Subsequent to June 30, 2004, Carnegie Mellon converted $3.7 million of the outstanding notes to equity. Upon this conversion, Carnegie Mellon’s interest in iCarnegie is approximately 85%.

Note N–Guarantees

In November 2002 the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 45 (“FIN 45”), “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.” FIN 45 elaborates on the disclosure to be made by a guarantor in its financial statements abouts its obligations under certain guarantees that are issued. It also clarifies that an organization is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee.

In the ordinary course of business, Carnegie Mellon enters into contracts with third parties pursuant to which the third parties provide services on behalf of Carnegie Mellon. Such contracts may provide for Carnegie Mellon to indemnify the third party service provider under certain circumstances. The terms of indemnity vary from contract to contract and the amount of the indemnification liability, if any, cannot be determined.

Carnegie Mellon provides indemnification to trustees, officers, and in some cases employees and agents against certain liabilities incurred as a result of their service on behalf of or at the request of Carnegie Mellon and also advances on behalf of covered individuals’ costs incurred in defending against certain claims.

Carnegie Mellon provides indemnification in connection with bond offerings in which it is involved. The indemnifications relate to losses, claims, damages, liabilities, and other expenses incurred by underwriters that would arise as a result of any untrue statements or material omissions made by Carnegie Mellon. Due to the nature of these indemnification provisions, it is not possible to quantify the aggregate exposure to Carnegie Mellon resulting from them.

Note O–Subsequent Events

On September 14, 2004, Carnegie Mellon received $20 million from the Bill & Melinda Gates Foundation to help fund construction of a new building dedicated to expanding the horizons of computer science. The new facility, to be named the Gates Center of Computer Science, will enable Carnegie Mellon to broaden its leadership in this crucial field by providing more space to nurture important ongoing and new endeavors. The estimated cost of the new building is $50 million.

Carnegie Mellon has committed to a swap transaction that will obligate Carnegie Mellon to make fixed payments of 3.0267% to a counterparty in exchange for a variable payment equivalent to 67% of LIBOR on a notional amount of $50 million. The effective date of the swap was October 1, 2004. The transaction’s term is fifteen years with an option on the part of the counterparty to cancel the swap at any time after the expiration of ten years.

The Red Team Accepts the Grand Challenge

Carnegie Mellon's Red Team

Administration

Jared L. Cohon
President

Mark S. Kamlet
Provost

Duane A. Adams
Vice Provost for Research

Randal E. Bryant
Dean, School of Computer Science

Mary Jo Dively
Vice President and General Counsel

Kenneth B. Dunn
Dean, David A. Tepper School of Business

William F. Elliott
Vice President for Enrollment

M. Christina Gabriel
Vice Provost and Chief Technology Officer

Pradeep K. Khosla
Dean, Carnegie Institute of Technology

Robert W. Kiger
Director, Hunt Institute for Botanical Documentation

Robbee Baker Kosak
Vice President for University Advancement

John P. Lehoczky
Dean, College of Humanities and Social Sciences

John M. Mazur
Treasurer and Chief Investment Officer

Richard D. McCullough
Dean, Mellon College of Science

Deborah J. Moon
Controller and Acting Chief Financial Officer

James H. Morris
Dean, West Coast Campus

Michael C. Murphy
Dean, Student Affairs

Indira Nair
Vice Provost for Education

Paul D. Nielsen
Chief Executive Officer and Director, Software Engineering Institute

Martin Prekop
Dean, College of Fine Arts

Joel Smith
Vice Provost and Chief Information Officer

Gloriana St. Clair
Dean, University Libraries

Charles E. Thorpe
Dean, Qatar Campus

Mark G. Wessel
Dean, H. John Heinz III School of Public Policy and Management

*Alumnus(a)

Facts and Figures

TYPE OF UNIVERSITY
Private, coeducational, granting about 2,700 bachelor's, master's and doctor's degrees each year.

NUMBER OF COLLEGES AND SCHOOLS
Seven — the Carnegie Institute of Technology (engineering); the College of Fine Arts, the College of Humanities and Social Sciences (liberal arts and professional studies); the David A. Tepper School of Business [formerly Graduate School of Industrial Administration (GSIA)]; the H. John Heinz III School of Public Policy and Management; the Mellon College of Science; the School of Computer Science.

PHYSICAL SIZE
110-acre main campus; 77 buildings; 2 branch campuses.

LOCATION
Main campus: Five miles east of downtown Pittsburgh, bordered by 500-acre Schenley Park and three culturally active residential neighborhoods.

Branch campuses: Doha, Qatar, and Moffett Field within the NASA Ames Research Center, California

NUMBER OF STUDENTS
5,337 undergraduates; 2,880 master's and 1,392 doctoral students.

NUMBER OF FACULTY
1,233 full-time and 194 part-time faculty; 23 administrative faculty.

ATHLETICS
Team name is "The Tartans"; NCAA Division III classification; founding member of the University Athletic Association; 17 varsity sports; more than 60 intramural sports.

NUMBER OF ALUMNI
66,869

COMPUTERS
There are thousands of high-powered computer work stations and personal computers on our campuses; all student rooms and apartments and all academic and research facilities are linked to the university's Andrew computing network. Recognized twice as the "Most Wired College" by Yahoo! Internet Life, Carnegie Mellon boasts a university-wide wireless network with access available to all buildings on campus.

HISTORY
Founded in 1900 by industrialist and philanthropist Andrew Carnegie as a technical school for working-class Pittsburgh; became Carnegie Institute of Technology, or "Tech," in 1912; merged with the Mellon Institute of Research in 1967 to become Carnegie Mellon University.

FOUNDER'S MOTTO
"My Heart Is in the Work," as inscribed by founder Andrew Carnegie in his "contract" to the city of Pittsburgh written in 1900.

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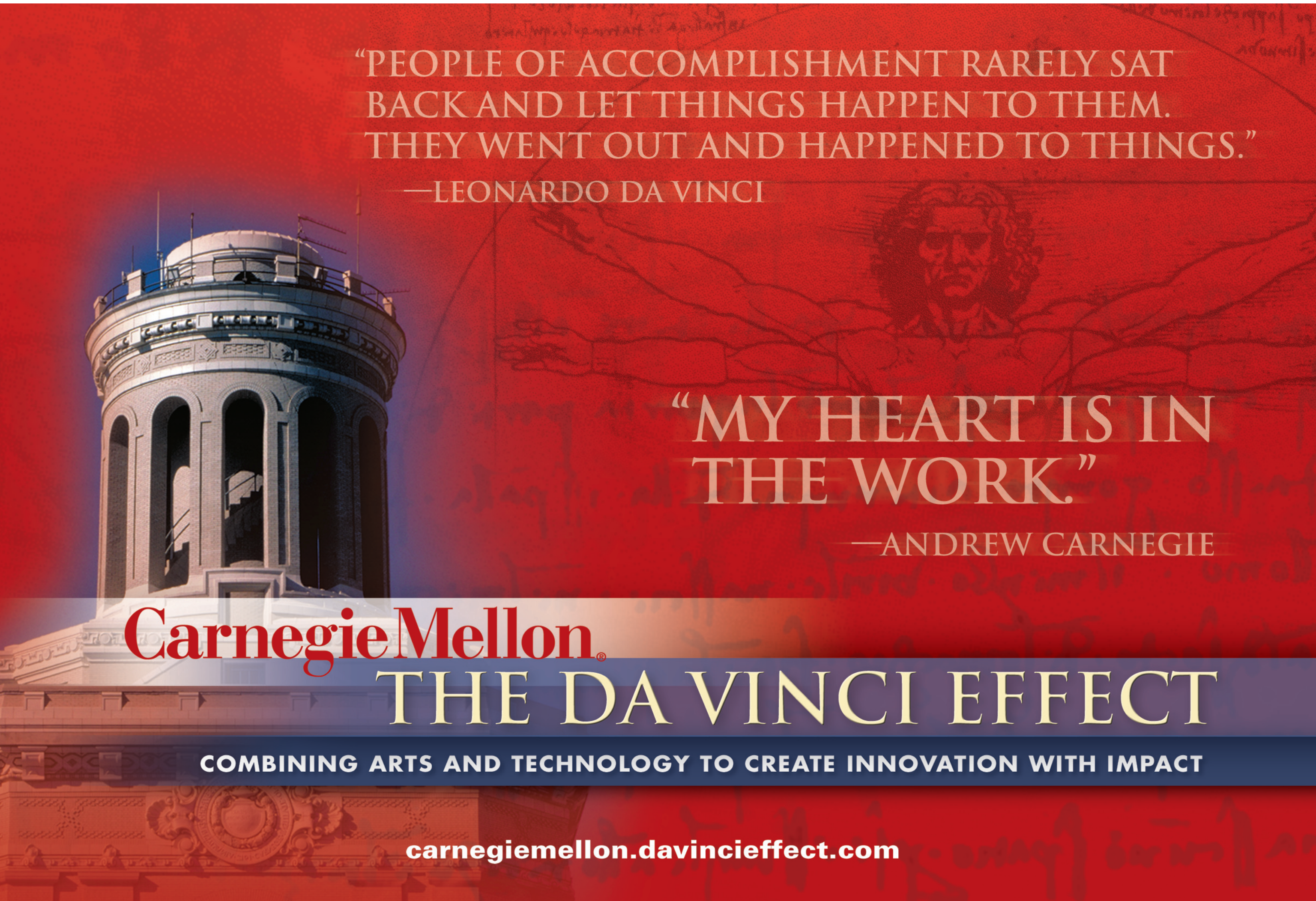

Produced by The Communications Design Group for the Office of the President. October, 2004. 04287