

# McGladrey & Pullen

Certified Public Accountants

## The McKnight Foundation

Financial Report  
December 31, 2005

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# McGladrey & Pullen

Certified Public Accountants

## Independent Auditor's Report

To the Audit Committee  
The McKnight Foundation  
Minneapolis, Minnesota

We have audited the accompanying statements of financial position of The McKnight Foundation (the Foundation) as of December 31, 2005 and 2004, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these 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, the financial statements referred to above present fairly, in all material respects, the financial position of The McKnight Foundation as of December 31, 2005 and 2004, and its activities and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*McGladrey & Pullen, LLP*

Minneapolis, Minnesota  
April 25, 2006

The McKnight Foundation

Statements of Financial Position  
December 31, 2005 and 2004  
(In Thousands)

<b>Assets</b>	2005	2004
Cash	\$ 65	\$ 86
Investments, at fair value (Notes 1 and 2):		
Cash and short-term investments	114,177	231,002
Equity securities	1,332,186	1,100,748
Corporate debt securities	408,552	531,476
Government securities	131,492	167,697
Private equity	53,238	32,654
Program-related	1,786	1,946
<b>Total investments</b>	<b>2,041,431</b>	<b>2,065,523</b>
Accrued Interest and Dividends Receivable	6,491	5,231
Other Assets	2,608	2,914
	<b>\$ 2,050,595</b>	<b>\$ 2,073,754</b>
<b>Liabilities and Net Assets</b>		
<b>Liabilities</b>		
Due to fiscal agents for securities with settlements pending (Note 1)	\$ 7,703	\$ 57,566
Accounts payable and accrued expenses	1,769	1,420
Unpaid grants (Note 4):		
To be paid within one year	51,507	51,764
To be paid in excess of one year	53,203	34,439
Advance from lessor	437	499
Federal excise tax, current (Note 3)	986	691
Federal excise tax, deferred (Note 3)	3,637	5,387
Unrelated business income tax (Note 3)	259	-
<b>Total liabilities</b>	<b>119,501</b>	<b>151,766</b>
Unrestricted Net Assets		
Undesignated	1,920,455	1,911,427
Board-designated	10,639	10,561
<b>Total net assets</b>	<b>1,931,094</b>	<b>1,921,988</b>
	<b>\$ 2,050,595</b>	<b>\$ 2,073,754</b>

See Notes to Financial Statements.

The McKnight Foundation

Statements of Activities

Years Ended December 31, 2005 and 2004

(In Thousands)

	2005	2004
Revenues and gains:		
Investment income:		
Interest	\$ 30,836	\$ 24,632
Dividends	15,977	14,856
Other	(2,250)	(1,251)
<b>Total interest and dividend income</b>	<b>44,563</b>	<b>38,237</b>
Realized gain on sale of investments	152,874	113,460
Nontaxable realized gain on sale of investments	26,809	45,874
Unrealized gain (loss) on investments	(90,123)	7,776
<b>Total investment gains</b>	<b>89,560</b>	<b>167,110</b>
<b>Net investment gain</b>	<b>134,123</b>	<b>205,347</b>
Expenses:		
Grants appropriated, net of returns (Note 4)	109,217	62,667
Investment management fees	5,523	5,394
Administrative expenses	7,729	7,777
Federal excise tax (Note 3)	2,045	3,059
Miscellaneous tax	503	471
<b>Total expenses</b>	<b>125,017</b>	<b>79,368</b>
<b>Increase in unrestricted net assets</b>	<b>9,106</b>	<b>125,979</b>
Unrestricted net assets at beginning of year	1,921,988	1,796,009
Unrestricted net assets at end of year	<b>\$ 1,931,094</b>	<b>\$ 1,921,988</b>

See Notes to Financial Statements.

The McKnight Foundation

Statements of Cash Flows  
 Years Ended December 31, 2005 and 2004  
 (In Thousands)

	2005	2004
Cash Flows From Operating Activities		
Increase in unrestricted net assets	\$ 9,106	\$ 125,979
Adjustments to reconcile change in unrestricted net assets to net cash used in operating activities:		
Net realized and unrealized investment gain	(89,560)	(167,110)
Changes in operating assets and liabilities:		
Accrued interest and dividends receivable	(1,260)	(3,105)
Refundable federal excise tax	295	1,483
Unrelated business income tax	259	-
Other assets	435	447
Unpaid grants	18,507	(23,115)
Deferred taxes	(1,750)	127
Accounts payable and accrued expenses	287	(326)
<b>Net cash used in operating activities</b>	<b>(63,681)</b>	<b>(65,620)</b>
Case Flows From Investing Activities		
Purchase of property and equipment	(129)	(134)
Investments purchased	(1,489,402)	(907,928)
Investment sales and maturities	1,553,191	973,682
<b>Net cash provided by investing activities</b>	<b>63,660</b>	<b>65,620</b>
<b>Net decrease in cash</b>	<b>(21)</b>	<b>-</b>
Cash at Beginning of Year	86	86
Cash at End of Year	<u>\$ 65</u>	<u>\$ 86</u>

See Notes to Financial Statements.

## The McKnight Foundation

### Notes to Financial Statements (Dollars in Thousands)

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#### Note 1. Nature of the Foundation and Significant Accounting Policies

**Nature of the Foundation:** The McKnight Foundation (the Foundation) is an exempt private foundation that seeks to improve the quality of life for present and future generations. The Foundation supports efforts to strengthen communities, families and individuals, particularly those in need; contributes to the arts; encourages preservation of the natural environment; and promotes scientific research in selected fields. The Foundation's primary geographic focus in its human services and arts grant-making is the state of Minnesota.

The Foundation is tax-exempt under Section 501(c)(3) of the Internal Revenue Code and the applicable Minnesota statutes. The Foundation is a private foundation under Section 509(a) of the Code and pays federal excise taxes on taxable investment income.

**Management estimates:** The preparation of financial statements requires management to make estimates and assumptions. These affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Cash:** For cash flow statement reporting purposes, the Foundation considers all bank demand accounts to be cash.

**Concentrations and credit risk:** The Foundation maintains its cash in bank deposit accounts, which frequently exceed federally insured limits. The Foundation has not experienced any losses in such accounts.

The Foundation invests in various securities, including U.S. government securities and domestic and foreign corporate debt and equity securities. 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, it is reasonably possible that changes in the values of investment securities could occur in the near term and that such changes could materially affect the value of investments.

**Investments:** Investments are stated at fair value, which is based upon quoted market prices for substantially all investments at December 31, 2005 and 2004. Interest and dividend income is recorded when earned. Realized gains and losses are recorded as the difference between historical cost and fair value when an investment is sold. Unrealized gains and losses are recorded as the change in fair value of investments.

The Foundation invests in private equity funds, which are not traded. Custodians calculate the fair value of the Foundation's interest in the private equity funds quarterly. The investment mix, which is very diverse, is at the direction of several fund managers and includes partnerships, venture capital, buyouts and others, utilizing various strategies. As of December 31, 2005, the Foundation has committed to invest \$242,100 in the funds. The estimated fair value of the Foundation's interest in the funds is \$53,238, and the amount of capital contributions paid by the Foundation through December 31, 2005, is \$62,661.

The Foundation accounts for derivative instruments in accordance with Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This pronouncement requires that all derivative instruments be recognized in the statements of financial position at fair value. The Foundation uses derivative instruments principally to manage equity price risk in the Foundation's investment holdings.

## The McKnight Foundation

### Notes to Financial Statements (Dollars in Thousands)

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#### Note 1. Nature of the Foundation and Significant Accounting Policies (Continued)

**Foreign currency translation:** The assets denominated in a foreign currency are translated into U.S. dollars at the current rate of exchange on the last day of the reporting period. Revenues are translated using the actual rate on the day of the transaction. Revenues from private equity funds denominated in a foreign currency are translated using the weighted-average actual rate during the quarterly reporting period.

**Fair value of financial instruments:** Financial Accounting Standards Board (FASB) Statement No. 107, *Disclosures About Fair Value of Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized in the statement of financial position, for which it is practicable to estimate that value. Statement No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. For all financial instruments other than investments, the carrying value is a reasonable estimate of fair value because of the short-term nature of the financial instruments. Investments are carried at fair value.

**Amounts due to fiscal agent for securities with settlements pending:** The amounts due to fiscal agents for securities with settlements pending result from the sales or purchases of securities made prior to the end of the fiscal year, but settled after the fiscal year-end.

#### Note 2. Derivatives

The Foundation uses derivative instruments principally to manage equity price risk in the Foundation's investment holdings. The following is a summary of the Foundation's risk management strategy and the effect on the financial statements.

**Equity risk management:** The Foundation manages an investment portfolio. As part of the Foundation's strategy to manage the equity price risk inherent in the portfolio, the Foundation may enter into hedging transactions, using derivatives, to protect the fair value of investments in the portfolio or the anticipated future cash flows associated with the forecasted purchases or sales of certain investments. The derivative instruments are recorded at fair value in the accompanying statements of financial position, and the related gains and losses are immediately recognized in income. Net realized gains of approximately \$26,809 and \$45,874 were recognized for the years ended December 31, 2005 and 2004, respectively.

The Foundation manages its interest rate risk on a cash collateral pool included in the investment portfolio through the use of U.S. Treasury note futures. Possible risk arises from movement of securities' values and interest rates and the resultant inability of counterparties to meet the terms of the contracts. At December 31, 2005 and 2004, the Foundation held short 90-day U.S. Treasury note futures to manage the risk.

The Foundation's enhanced asset allocation program uses a fund that owns financial futures contracts and options to adjust the relative exposure to fixed-income and equity markets. These contracts settle daily; therefore, the average fair value of these contracts is established daily and the contract is marked to the market. The futures contracts are exchange-traded with counterparties with good credit standing and are fully collateralized.

The Foundation manages an international portfolio that invests in debt and equity securities denominated in various foreign currencies. The Foundation manages the exposure of foreign currency fluctuations through the use of foreign currency forward contracts by anticipating future sources and uses of funds and comparing those to various exchange rates for the most advantageous position.

The McKnight Foundation

Notes to Financial Statements  
(Dollars in Thousands)

**Note 2. Derivatives (Continued)**

**Fair value of derivative instruments:** The fair value of derivatives reflects the price that a third party would be willing to pay or receive in arm's-length transactions and includes mark-to-market adjustments to reflect the effects of changes in the related index. Fair value for derivatives is determined based on position valuation, principally based on liquid market pricing as evidenced by exchange-traded prices. The following table summarizes the estimated fair value of the Foundation's derivative financial instruments:

	Fair Value of Assets	
	2005	2004
Cash collateral pool:		
Futures	\$ 64	\$ 286
Enhanced asset allocation program:		
Futures	539,065	499,426
Options	-	7,156
International portfolio:		
Foreign currency forward contracts receivable	-	4,350
Foreign currency forward contracts payable	-	4,415

**Note 3. Federal Taxes and Distribution Requirements**

**Federal excise taxes:** The Foundation is subject to a 2 percent excise tax on its taxable investment income, which principally includes income from investments plus net realized capital gains (net capital losses, however, are not deductible). Tax on net investment income is reduced from 2 percent to 1 percent for any taxable year in which the Foundation's qualifying distributions meet certain requirements prescribed by Internal Revenue Code Section 4940(e)(l).

Deferred federal excise taxes based on the 2 percent rate are computed on the differences between the carrying value and tax basis of the Foundation's investments, as well as temporary differences in income recognition.

The composition of federal excise tax expense is as follows for the years ended December 31:

	2005	2004
Current	\$ 3,795	\$ 2,932
Deferred	(1,750)	127
	<u>\$ 2,045</u>	<u>\$ 3,059</u>

The deferred tax liabilities are as follows for the years ended December 31:

	2005	2004
Deferred tax liability	\$ 3,605	\$ 5,387
Accrued dividends	32	-
	<u>\$ 3,637</u>	<u>\$ 5,387</u>

The McKnight Foundation

Notes to Financial Statements  
(Dollars in Thousands)

**Note 3. Federal Taxes and Distribution Requirements (Continued)**

The federal excise tax provision differs from the amount of federal excise tax determined by applying the U.S. federal excise income tax rate to the pretax change in unrestricted net assets due to the following for the years ended December 31:

	2005	2004
Increase in unrestricted net assets before excise tax	\$ 11,151	\$ 129,038
Statutory rate	2%	2%
	223	2,581
Grants appropriated	2,184	1,253
Nontaxable realized gains	(536)	(917)
Administrative expenses, noninvestment income	140	143
Other	34	(1)
Federal excise tax expense	\$ 2,045	\$ 3,059

**Distribution requirements:** The Foundation is subject to distribution requirements of the Internal Revenue Code. Accordingly, it must distribute, within one year after the end of each fiscal year, 5 percent of the fair market value of its investment assets, as defined. The investments includable for the 5 percent distribution requirement are exclusive of those investments deemed to be held for charitable activities (representing 1.5 percent of the investments) or other program-related investments. Qualifying distributions are determined on a cash basis and include grant payments and certain other expenses incurred by the Foundation.

**Unrelated business income taxes:** In accordance with Section 511(a)(1) of the Code, the Foundation is subject to corporate tax rates on net income earned from unrelated business activities. The Foundation's investments produce minimal amounts of unrelated business income. The provision for income taxes relating to unrelated business income was \$503 and \$-0- in 2005 and 2004, respectively. The Foundation's unrelated business income tax expense differed from the statutory federal rate as follows:

	2005	2004
Unrelated business income before tax	\$ 934	\$ (6)
Statutory rate	34%	34%
	318	(2)
State taxes (net of federal benefit)	56	-
Change in valuation allowance	(110)	(20)
Change in income	230	22
Rate reconciliation	9	-
Income tax expense	\$ 503	\$ -

As of December 31, 2005 and 2004, the Foundation had valuation allowances of \$-0- and \$110, respectively, on the unrelated business income net operating losses. Realization of deferred tax assets is dependent upon sufficient future unrelated business income that is reasonably expected to occur during the periods when net operating losses are expected to be available to reduce taxable income.

## The McKnight Foundation

### Notes to Financial Statements (Dollars in Thousands)

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#### Note 4. Grants

Grant commitments are recognized in the year authorized by the Foundation's Board of Directors. Unpaid grants at December 31, 2005, represent the present value of multiyear grants that are payable from 2006 to 2012. Present value is determined using discount rates ranging from 1.8 percent to 6.3 percent. Grant payments were \$90,676 and \$85,852 in 2005 and 2004, respectively.

The timing of unpaid grants is as follows as of December 31, 2005:

Less than one year	\$	51,507
One year to five years		56,927
Thereafter		3,242
Unamortized discount		(6,966)
	\$	<u>104,710</u>

#### Note 5. Related Parties

The Foundation has agreed to provide grants to The McKnight Endowment Fund for Neuroscience (the Fund) annually through 2012, for the purpose of funding and administering neuroscience awards. During 2005 and 2004, respectively, \$4,522 and \$4,250 of grants were provided to the Fund. Grants to be paid to the Fund are included in Note 4 and are as follows as of December 31, 2005:

Less than one year	\$	4,575
One year to five years		17,850
Thereafter		3,242
Unamortized discount		(3,878)
	\$	<u>21,789</u>

Pursuant to an administrative agreement, the Fund reimbursed the Foundation \$100 for each of the years ended December 31, 2005 and 2004, for administrative services provided by the Foundation.