

McGladrey & Pullen

Certified Public Accountants

The McKnight Foundation

Financial Report
December 31, 2006

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McGladrey & Pullen

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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, 2006 and 2005, 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, 2006 and 2005, 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
May 14, 2007

The McKnight Foundation

Statements of Financial Position
December 31, 2006 and 2005
(In Thousands)

Assets	2006	2005
Cash	\$ 81	\$ 65
Investments (Notes 1 and 2)		
Marketable securities, at fair value:		
Cash and short-term investments	108,588	114,177
Equity securities	1,420,991	1,332,186
Corporate debt securities	329,210	101,850
Mortgage-backed securities	124,614	306,702
Government securities	125,726	131,492
Private equity	93,706	53,238
Program-related	1,786	1,786
Total investments	2,204,621	2,041,431
Accrued Interest and Dividends Receivable	6,404	6,491
Other Assets	2,762	2,608
Total assets	\$ 2,213,868	\$ 2,050,595
Liabilities and Net Assets		
Liabilities		
Due to fiscal agents for securities with settlements pending (Note 1)	\$ 6,612	\$ 7,703
Accounts payable, accrued expenses, and other	2,610	2,206
Unpaid grants (Note 3):		
To be paid within one year	53,549	51,507
To be paid in excess of one year	46,135	53,203
Federal excise tax, current (Note 4)	520	986
Federal excise tax, deferred (Note 4)	6,205	3,637
Unrelated business income tax (Note 4)	271	259
Total liabilities	115,902	119,501
Unrestricted Net Assets		
Undesignated	2,086,277	1,920,455
Board-designated	11,689	10,639
Total net assets	2,097,966	1,931,094
	\$ 2,213,868	\$ 2,050,595

See Notes to Financial Statements.

The McKnight Foundation

Statements of Activities

Years Ended December 31, 2006 and 2005

(In Thousands)

	2006	2005
Revenues and gains:		
Investment income:		
Interest	\$ 37,350	\$ 30,836
Dividends	20,807	15,977
Other	(2,406)	(2,250)
Total interest and dividend income	55,751	44,563
Realized gain on sale of investments	57,053	152,874
Nontaxable realized gain on sale of investments	37,283	26,809
Unrealized gain (loss) on investments	125,930	(90,123)
Total investment gains	220,266	89,560
Net investment gain	276,017	134,123
Expenses:		
Grants appropriated, net of returns (Note 3)	88,456	109,217
Investment management fees	7,418	5,523
Administrative expenses	7,787	7,729
Federal excise tax (Note 4)	5,073	2,045
Unrelated business income tax (Note 4)	411	503
Total expenses	109,145	125,017
Increase in unrestricted net assets	166,872	9,106
Unrestricted net assets at beginning of year	1,931,094	1,921,988
Unrestricted net assets at end of year	\$ 2,097,966	\$ 1,931,094

See Notes to Financial Statements.

The McKnight Foundation

Statements of Cash Flows
 Years Ended December 31, 2006 and 2005
 (In Thousands)

	2006	2005
Cash Flows From Operating Activities		
Increase in unrestricted net assets	\$ 166,872	\$ 9,106
Adjustments to reconcile change in unrestricted net assets to net cash used in operating activities:		
Net realized and unrealized investment gain	(220,266)	(89,560)
Changes in operating assets and liabilities:		
Accrued interest and dividends receivable	87	(1,260)
Federal excise tax	(466)	295
Unrelated business income tax	12	259
Other assets	203	435
Unpaid grants	(5,026)	18,507
Deferred taxes	2,568	(1,750)
Accounts payable, accrued expenses, and other	404	287
Net cash used in operating activities	(55,612)	(63,681)
Case Flows From Investing Activities		
Purchase of property and equipment	(357)	(129)
Investments purchased	(1,018,235)	(1,489,402)
Investment sales and maturities	1,074,220	1,553,191
Net cash provided by investing activities	55,628	63,660
Net increase (decrease) in cash	16	(21)
Cash at Beginning of Year	65	86
Cash at End of Year	\$ 81	\$ 65

See Notes to Financial Statements.

The McKnight Foundation

Notes to Financial Statements (Dollars in Thousands)

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, 2006 and 2005. 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 for the change in fair value of investments.

The Foundation invests in private equity funds, which are not traded. 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. Such investments are valued at amounts reported to the Foundation quarterly by the fund managers. The investments of these funds include securities of companies that may not be immediately liquid. Accordingly, their values are based upon guidelines established by the investment managers. The guidelines vary by fund and investment type. Management believes this method provides a reasonable estimate of fair value. The estimated fair value of the Foundation's interest in such funds is \$93,706, and the amount of capital contributions paid by the Foundation through December 31, 2006, is \$102,117. As of December 31, 2006, the Foundation has committed to invest \$376,124 in such funds. Subsequent to December 31, 2006, the Foundation committed to invest an additional \$65,000 in such funds.

The McKnight Foundation

Notes to Financial Statements (Dollars in Thousands)

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

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 fair value adjustment is recorded directly to the invested asset and recognized as an unrealized gain or loss in the statement of activities. The Foundation uses derivative instruments principally to manage equity price risk in the Foundation's investment holdings.

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 agents 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.

Reclassifications: Certain amounts in the 2005 statement of financial position have been reclassified to be consistent with the presentation in 2006. These reclassifications had no impact on changes in net assets as previously presented.

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 \$37,283 and \$26,809 were recognized for the years ended December 31, 2006 and 2005, 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, 2006 and 2005, the Foundation held 90-day U.S. Treasury note futures to manage the risk.

The McKnight Foundation

Notes to Financial Statements (Dollars in Thousands)

Note 2. Derivatives (Continued)

The Foundation's enhanced asset allocation program uses a fund that owns financial futures contracts, options, and forward contracts 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.

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	
	2006	2005
Cash collateral pool:		
Futures	\$ 172	\$ 64

As of December 31, the Foundation also owns approximately 59 percent and 63 percent of a fund holding the following derivative financial instruments:

	Fair Value of Assets	
	2006	2005
Enhanced asset allocation program:		
Futures	\$ 624,754	\$ 539,065
Forward contracts	302,301	-
Options	362	-

Note 3. Grants

Grant commitments are recognized in the year authorized by the Foundation's Board of Directors. Unpaid grants at December 31, 2006, represent the present value of multiyear grants that are payable from 2007 to 2012. Present value is determined using discount rates ranging from 1.8 percent to 6.3 percent. Grant payments were \$93,454 and \$90,676 in 2006 and 2005, respectively.

The McKnight Foundation

Notes to Financial Statements (Dollars in Thousands)

Note 3. Grants (Continued)

The timing of unpaid grants is as follows as of December 31, 2006:

Less than one year	\$	53,549
One year to five years		51,489
Thereafter		546
Unamortized discount		(5,900)
	\$	<u>99,684</u>

Note 4. 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)(1).

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:

	2006	2005
Current	\$ 2,505	\$ 3,795
Deferred	2,568	(1,750)
	<u>\$ 5,073</u>	<u>\$ 2,045</u>

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

	2006	2005
Deferred tax liability	\$ 6,156	\$ 3,605
Accrued dividends	49	32
	<u>\$ 6,205</u>	<u>\$ 3,637</u>

The McKnight Foundation

Notes to Financial Statements
(Dollars in Thousands)

Note 4. 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:

	2006	2005
Increase in unrestricted net assets before excise tax and unrelated business income tax	\$ 172,356	\$ 11,654
Statutory rate	2%	2%
	3,447	233
Grants appropriated	1,769	2,184
Nontaxable realized gains	(746)	(536)
Administrative expenses, noninvestment income	150	140
Other	453	24
Federal excise tax expense	\$ 5,073	\$ 2,045

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 \$411 and \$503 in 2006 and 2005, respectively. The Foundation's unrelated business income tax expense differed from the statutory federal rate as follows:

	2006	2005
Unrelated business income before tax	\$ 1,356	\$ 934
Statutory rate	34%	34%
	461	318
State taxes (net of federal benefit)	81	56
Change in valuation allowance	-	(110)
Change in income	(131)	230
Rate reconciliation	-	9
Income tax expense	\$ 411	\$ 503

The McKnight Foundation

Notes to Financial Statements (Dollars in Thousands)

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 2006 and 2005, respectively, \$4,646 and \$4,522 of grants were paid to the Fund. Grants to be paid to the Fund are included in Note 3 and are as follows as of December 31, 2006:

Less than one year	\$	4,575
One year to five years		15,900
Thereafter		546
Unamortized discount		(2,642)
	\$	<u>18,379</u>

Pursuant to an administrative agreement, the Fund reimbursed the Foundation \$100 for each of the years ended December 31, 2006 and 2005, for administrative services provided by the Foundation.