

**McGladrey & Pullen**

Certified Public Accountants

## **The McKnight Foundation**

Financial Report  
December 31, 2007

## Contents

Independent Auditor's Report	1
Financial Statements	
Statements of financial position	2
Statements of activities	3
Statements of cash flows	4
Notes to financial statements	5 - 11

# McGladrey & Pullen

Certified Public Accountants

## Independent Auditor's Report

To the Audit Committee  
The McKnight Foundation

We have audited the accompanying statements of financial position of The McKnight Foundation (the Foundation) as of December 31, 2007 and 2006, 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, 2007 and 2006, 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 15, 2008

The McKnight Foundation

Statements of Financial Position  
December 31, 2007 and 2006  
(In Thousands)

<b>Assets</b>	<b>2007</b>	<b>2006</b>
Cash	\$ 47	\$ 81
Investments (Notes 1 and 2)		
Marketable securities, at fair value:		
Cash and short-term investments	286,004	108,588
Equity securities	1,359,816	1,420,991
Corporate debt securities	227,840	329,210
Mortgage-backed securities	126,072	124,614
Government securities	136,807	125,726
Private equity	171,005	93,706
Program-related	1,786	1,786
<b>Total investments</b>	<b>2,309,330</b>	<b>2,204,621</b>
Accrued Interest and Dividends Receivable	4,415	6,404
Refundable Federal Excise Tax (Note 4)	364	-
Refundable Unrelated Business Income Tax (Note 4)	122	-
Other Assets	2,596	2,762
<b>Total assets</b>	<b>\$ 2,316,874</b>	<b>\$ 2,213,868</b>
<b>Liabilities and Net Assets</b>		
Liabilities		
Due to fiscal agents for securities with settlements pending (Note 1)	\$ 4,746	\$ 6,612
Accounts payable, accrued expenses, and other	3,130	2,610
Unpaid grants (Note 3):		
To be paid within one year	60,706	53,549
To be paid after one year	56,986	46,135
Federal excise tax, current (Note 4)	-	520
Federal excise tax, deferred (Note 4)	4,869	6,205
Unrelated business income tax (Note 4)	-	271
<b>Total liabilities</b>	<b>130,437</b>	<b>115,902</b>
Unrestricted Net Assets		
Undesignated	2,174,354	2,086,277
Board-designated	12,083	11,689
<b>Total net assets</b>	<b>2,186,437</b>	<b>2,097,966</b>
	<b>\$ 2,316,874</b>	<b>\$ 2,213,868</b>

See Notes to Financial Statements.

The McKnight Foundation

Statements of Activities

Years Ended December 31, 2007 and 2006

(In Thousands)

	2007	2006
Revenues and gains:		
Investment income:		
Interest	\$ 37,400	\$ 37,350
Dividends	30,936	20,807
Other	(5,061)	(2,406)
<b>Total interest and dividend income</b>	<u>63,275</u>	<u>55,751</u>
Realized gain on sale of investments	223,479	57,053
Nontaxable realized gain on sale of investments (Note 4)	-	37,283
Unrealized gain (loss) on investments	(64,569)	125,930
<b>Total investment gains</b>	<u>158,910</u>	<u>220,266</u>
<b>Net investment gain</b>	<u>222,185</u>	<u>276,017</u>
Expenses:		
Grants appropriated, net of returns (Note 3)	111,652	88,456
Investment management fees	8,781	7,418
Administrative expenses	9,199	7,787
Federal excise tax (Note 4)	3,927	5,073
Unrelated business income tax (Note 4)	155	411
<b>Total expenses</b>	<u>133,714</u>	<u>109,145</u>
<b>Increase in unrestricted net assets</b>	<u>88,471</u>	<u>166,872</u>
Unrestricted net assets at beginning of year	2,097,966	1,931,094
Unrestricted net assets at end of year	<u>\$ 2,186,437</u>	<u>\$ 2,097,966</u>

See Notes to Financial Statements.

The McKnight Foundation

Statements of Cash Flows  
 Years Ended December 31, 2007 and 2006  
 (In Thousands)

	2007	2006
Cash Flows From Operating Activities		
Increase in unrestricted net assets	\$ 88,471	\$ 166,872
Adjustments to reconcile change in unrestricted net assets to net cash used in operating activities:		
Net realized and unrealized investment gain	(158,910)	(220,266)
Changes in operating assets and liabilities:		
Accrued interest and dividends receivable	1,989	87
Federal excise tax	(884)	(466)
Unrelated business income tax	(393)	12
Other assets	650	203
Unpaid grants	18,008	(5,026)
Deferred taxes	(1,336)	2,568
Accounts payable, accrued expenses, and other	520	404
<b>Net cash used in operating activities</b>	<b>(51,885)</b>	<b>(55,612)</b>
Cash Flows From Investing Activities		
Purchase of property and equipment	(484)	(357)
Investments purchased	(1,024,076)	(1,018,235)
Investment sales and maturities	1,076,411	1,074,220
<b>Net cash provided by investing activities</b>	<b>51,851</b>	<b>55,628</b>
<b>Net increase (decrease) in cash</b>	<b>(34)</b>	<b>16</b>
Cash at Beginning of Year	81	65
Cash at End of Year	<u>\$ 47</u>	<u>\$ 81</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 in marketable securities are stated at fair value, which is based upon quoted market prices. 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.

Most of the Foundation's marketable securities investments are held in trusts, partnerships and other funds. The fair value of marketable securities reported in the statements of financial position represent the Foundation's share of the marketable securities held within such funds. Equity securities as of December 31, 2007, include \$29,430 in a limited partnership that invests in hedge funds. The partnership's investments in these funds are stated at fair value based on the partnership's net contribution to the funds and its allocated share of their undistributed profits and losses, including realized and unrealized gains and losses. Underlying investments in these hedge funds are primarily marketable equity securities, but may also include private equities, fixed-income securities, futures, options and forward currency contracts. The hedge funds also engage in the short selling of securities and derivatives.

## 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)

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. Generally, the investments will be marked to market if quotations are available, subject to appropriate liquidity discounts. If no quotations are available, the investment manager will utilize the last sale price if an arm's length sale transaction has occurred or, if not available, review the activity in the underlying securities to see if an adjustment to cost is appropriate, or use such other alternative valuation methods as it deems appropriate in good faith. Investment interests in investment partnerships are valued by reference to the underlying investments as reported by general partners or managers of the portfolio partnership. Management believes these methods provide a reasonable estimate of fair value. The estimated fair value of the Foundation's interest in such funds is \$171,005, and the amount of capital contributions made by the Foundation through December 31, 2007, is \$172,858.

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 or estimated 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.

**New accounting pronouncements:** In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard No. 157 (SFAS 157), *Fair Value Measurements*. SFAS 157, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 does not require new fair value measurements and is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Foundation expects to implement SFAS 157 beginning in 2008, with no material effects to its 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 (Continued)

In December 2004, the FASB issued Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes — an interpretation of SFAS No. 109, Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 developed a two-step process to evaluate a tax position and also provides guidance on recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 will be effective for the first annual reporting period beginning after December 15, 2007. The Foundation expects to implement FIN 48 beginning in 2008, with no material effects to its financial statements.

The FASB recently issued a new standard that significantly expands the disclosures an entity is required to make regarding derivative instruments. Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, amends and expands the disclosure requirements of Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Foundation expects to implement SFAS 161 beginning in 2009 and has not yet determined the effect to its financial statements.

#### 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 \$3,109 and \$37,283 were recognized for the years ended December 31, 2007 and 2006, 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, 2007 and 2006, the Foundation held 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, 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.

## 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 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	
	2007	2006
Cash collateral pool:		
Futures	\$ 18	\$ 172

As of December 31, 2007 and 2006, respectively, the Foundation also owns approximately 44 percent and 59 percent of a fund. Based on the Foundation's ownership in the fund, the value of their investment in the fund includes the following derivative financial instruments:

	Fair Value of Assets	
	2007	2006
Enhanced asset allocation program:		
Futures — short	\$ (328,049)	\$ (164,342)
Futures — long	427,245	460,412
Forward contracts — short	(301,073)	(145,766)
Forward contracts — long	368,632	156,535
Options — short	(26)	-
Options — long	-	362

#### Note 3. Grants

Grant commitments are recognized in the year authorized by the Foundation's Board of Directors. Unpaid grants at December 31, 2007, represent the present value of multiyear grants that are payable from 2008 to 2012. Present value is determined using discount rates ranging from 1.8 percent to 6.3 percent. Grant payments were \$93,588 and \$93,454 in 2007 and 2006, respectively.

The timing of unpaid grants is as follows as of December 31, 2007:

Less than one year	\$ 60,706
One year to five years	61,898
Present value discount	(4,912)
	<u>\$ 117,692</u>

## The McKnight Foundation

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

#### 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:

	2007	2006
Current	\$ 5,263	\$ 2,505
Deferred	(1,336)	2,568
	<u>\$ 3,927</u>	<u>\$ 5,073</u>

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

	2007	2006
Deferred tax liability	\$ 4,864	\$ 6,156
Accrued dividends	5	49
	<u>\$ 4,869</u>	<u>\$ 6,205</u>

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:

	2007	2006
Increase in unrestricted net assets before excise tax and unrelated business income tax	\$ 92,553	\$ 172,356
Statutory rate	2%	2%
	<u>1,851</u>	<u>3,447</u>
Grants appropriated	2,233	1,769
Nontaxable realized gains	-	(746)
Administrative expenses, noninvestment income	176	150
Other	(333)	453
Federal excise tax expense	<u>\$ 3,927</u>	<u>\$ 5,073</u>

## The McKnight Foundation

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

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#### Note 4. Federal Taxes and Distribution Requirements (Continued)

The Pension Protection Act of 2006 expanded the base of the tax on the private foundation net investment income by including in its definition of net investment income, the income from futures and options. Previously, these items were included as nontaxable realized gains. As a result of this law change, the current-year futures and options are classified as realized taxable gains/losses, which had an immaterial impact on the Foundation's excise tax expense. This law and financial statement change is effective for the Foundation for the year beginning January 1, 2007.

**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 \$155 and \$411 in 2007 and 2006, respectively. The Foundation's unrelated business income tax expense differed from the statutory federal rate as follows:

	2007	2006
Unrelated business income before tax	\$ 1,359	\$ 1,356
Statutory rate	34%	34%
	<u>462</u>	<u>461</u>
State taxes (net of federal benefit)	82	81
Rate reconciliation	(389)	(131)
Income tax expense	<u>\$ 155</u>	<u>\$ 411</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 2007 and 2006, respectively, \$4,506 and \$4,646 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, 2007:

Less than one year	\$ 4,425
One year to five years	12,090
Present value discount	(1,660)
	<u>\$ 14,855</u>

Pursuant to an administrative agreement, the Fund reimbursed the Foundation \$100 for each of the years ended December 31, 2007 and 2006, for administrative services provided by the Foundation.

The McKnight Foundation

Notes to Financial Statements  
(Dollars in Thousands)

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**Note 6. Commitments**

As of December 31, 2007, the Foundation has committed to invest \$499,000 in private equity funds. The Foundation has also committed to invest \$50,000 in certain common stock as of December 31, 2007.