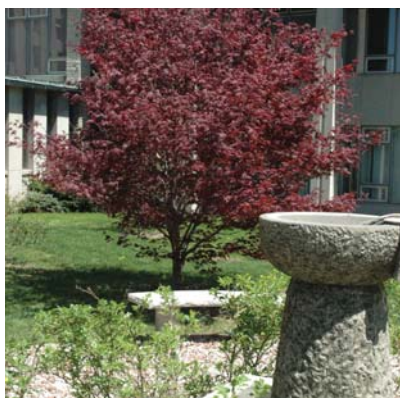




2005/2006 Annual Financial Report

Management's discussion and analysis

Measuring our Performance 2005/2006

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Executive Summary

Year after year, McMaster University is acknowledged as one of the most innovative universities in Canada. Innovation is reflected in the proven ability to link scholarship and teaching and continuously strive for excellence as a student-centered, research-intensive university.

In 2005/06, the quality and reputation of McMaster's academic and research programs was evidenced by further increases in the proportion of Ontario applicants naming McMaster as their first choice, a measurable increase in the undergraduate offer acceptance rate and maintenance of high research intensity.

The Provincial initiatives outlined in the "Reaching Higher" plan have stimulated growth in the University sector. McMaster University has achieved its growth targets with increases in full time equivalent student enrolment of over 6.4% and steady levels of research grants and contracts. McMaster's entering students are among the most highly qualified in the province.

In 2005/06, the University made important investments in capital infrastructure that will enhance the quality of the overall student experience. Significant renovations to the Burke Science Building included new classroom and laboratory space. The Health Sciences Library renovation was initiated and the Mills Library Learning Commons phase 1 renovations were undertaken. Significant construction progress was made on the new David Braley Athletic Complex and the design and planning was initiated for the new Ronald V. Joyce Stadium. The new Les Prince student residence was substantially completed and will be housing students for the 2006/07 academic year. Bridge financing has been provided internally for the residence during construction. Noteworthy donations received for both the stadium and the athletic complex, along with annual student levies and user fees, will provide the source for the external debt repayments once these complexes are complete.

In addition to capital infrastructure, and in order to continue to enhance the quality of the overall student experience, an additional \$38 million over 2004/05 was spent on instruction and academic services. McMaster University currently spends a total of 74% of its operating expenditures on instruction and academic services.

In pursuit of its goal to achieve the next level of research, McMaster implemented a new business structure for the wholly owned, McMaster Innovation Park (MIP). Two trusts, one to manage the operations and one to hold the land have been created. These trusts are separate legal entities, tightly bound and controlled by the University. In the context of this new governance structure, the University has now adopted the equity method of accounting to record its investment in MIP. During the year, MIP undertook demolition of much of the Longwood property and embarked on renovation of the office building. These costs were funded through grants provided by the province and the municipality.

In October 2002, \$120 million in senior unsecured 50-year debentures were issued. Proceeds from the debentures have been used to invest in academic and research facilities on campus. The sinking fund set up for repayment of the principal at maturity in 2052 now stands at \$9.5 million. No new external debt was acquired in 2005/06. The February 2006 rating from Standard and Poors confirmed the AA rating which reflects 'manageable debt burden, strong balance sheet, and an exceptional research profile.

McMaster continued to produce stable financial results in 2005/06. Operating grants and tuition fees increased by 12.1% and 5.1% respectively. There was a marginal increase of 1.2% in research overhead grants from the Federal Indirect Cost of Research Fund. Investment income recognized in the income statement at \$49 million is up 36% from \$36.1 million

in the previous year, reflecting strong capital market performance. The annual investment return was 14.2%, net of direct investment expenses of .3%. Receipts of donations and other grants of \$46.6 million are evidence of another successful year of fundraising.

2005/06 expenses increased by 8.6%. The largest increase was employee benefits costs, which increased from \$67.6 million to \$92 million. The increase is largely the result of the rising cost of providing employee future benefits which continues to put a significant strain on University resources.

The excess of revenue over expenses of \$8.6 million compares favorably to \$6.1 in 2004/05, due mainly to strong investment income growth. Net interfund transfers of \$8.3 million resulted in a net decrease in Unrestricted Net Assets from \$13.9 million to \$5.7 million as at April 30, 2006. The use of Unrestricted Net Assets supported current operations.

Despite these stable financial results, the University operating budget projects an annual deficit for 2006/07. Annual operating expenditures are projected to exceed operating revenues by \$10 million in 2006/07.

Projections indicate that costs will continue to rise faster than the increase in revenue which could impact the achievement of academic and research goals. This requires a significant review of University operations.

The University is now in the process of developing a Three Year Operating Plan that will support the academic and research mission of the University and ensure long term financial sustainability.

Total assets increased by 7.1% to \$1.5 billion. Current assets decreased approximately 7.6% due primarily to the continued expenditure of the proceeds from the debenture issue. Expenditures on capital assets were

\$127.6 million, with completion or substantial progress on a number of new or expanded buildings. After amortization of \$58.8 million, net capital assets increased by \$49.2 million to \$515.5 million.

Deferred contributions decreased by \$1.1 million to \$492.8 million reflecting both an increase in grants, donations and research contracts, offset by the transfer of the \$15 million provincial and municipal grants to McMaster Innovation Park.

Externally restricted non-expendable endowments received were significant at \$22.9 million. The receipt of the third installment (\$9 million endowed) of the \$105 million gift from Michael G. DeGroote and successful fundraising for the Ontario Trust for Student Support were the key factors.

This commentary and the attached audited financial statements show the year over year progress McMaster has made in achieving its goals of creativity, innovation and excellence in teaching and scholarship.

This commentary includes forward-looking statements which may involve, but are not limited to, comments with respect to the University's future objectives, strategies, targets or results. Readers of this commentary are advised not to place undue reliance on the forward-looking statements as a number of factors could cause actual future results to differ from the expectations or intentions expressed in the forward-looking comments. Future outcomes may be influenced by many factors, including but not limited to the critical risks identified by the University in its Enterprise-Wide Risk Management program, further discussed on page 18 of this report.



We are committed to
creativity, innovation
and excellence.

We value integrity,
quality, inclusiveness
and teamwork in
everything we do.

Mission, Vision, Goals and Targets

Mission At McMaster our purpose is the discovery, communication and preservation of knowledge. In our teaching, research and scholarship, we are committed to creativity, innovation and excellence. We value integrity, quality, inclusiveness and teamwork in everything we do. We inspire critical thinking, personal growth, and a passion for lifelong learning. We serve the social, cultural and economic needs of our community and our society.

Vision To achieve international distinction for creativity, innovation and excellence.

Strategic Goals approved by the Board of Governors in June 2003

- To provide an innovative and stimulating learning environment where students can prepare themselves to excel in life.
- To achieve the next level in research results and reputation by building on existing and emerging areas of excellence.
- To build an inclusive community with a shared purpose.

In order to sustain the academic mission of the University a strong financial position is required. The University has identified four key financial performance goals outlined below. This MD&A measures our 2005/06 performance against these goals.

Financial Performance Goals

- To achieve strong demand for McMaster programs and consistently achieve student enrolment targets
- To grow and diversify the revenue base
- To strategically deploy resources into priority areas
- To strengthen the financial position of the University and manage business risks

Strategic Planning and Management — Refining Directions

In 1995/96, the University undertook a comprehensive strategic planning process designed to establish the “direction” for the future success and prosperity of the University. The resultant document, published in December 1995 and entitled *Directions* outlines a clear mission and vision for McMaster and defines the basic goals and guiding planning principles that continue to shape the future of the University.

The *Directions* strategic plan complemented by the Academic Plan, the strategic priorities exercise and more recently the Graduate Education Plan and the Campus Plan have guided the University through challenging financial periods and allowed McMaster to move quickly to take advantage of new research and educational opportunities.

The *Refining Directions*, strategic planning exercise, was launched in the fall of 2002 with the dual objectives to evaluate the University’s success in meeting the goals established in *Directions* and to construct a strategic framework that would guide the University’s course for the next five to ten years.

Through the extensive *Refining Directions* consultation process there was wide-spread satisfaction with the mission and vision and in June 2003, the Board of Governors reaffirmed the mission and vision as set out in *Directions* and confirmed the University’s strategic position as a student-centered, research-intensive university. To achieve the mission, the Board of Governors has approved the *Refining Directions* framework that identifies three strategic goals with broad institutional targets:

- To provide an innovative and stimulating learning environment where students can prepare themselves to excel in life.
- To achieve the next level in research results and reputation by building on existing and emerging areas of excellence
- To build an inclusive community with shared purpose

In 2005/06, the University continued to focus on the implementation of *Refining Directions* with the initiation of the development of an Institutional Strategy Map. This map will allow the University to clarify the specific academic, scholarship and financial outcomes necessary to achieve the *Refining Directions* vision. The map will also clearly identify the key internal processes in which the University must excel to achieve strategic success. The Strategy Map will be supported by a key performance indicator report – or Balanced Scorecard. The Scorecard will monitor the results of current initiatives and those that will be undertaken during the next few years.

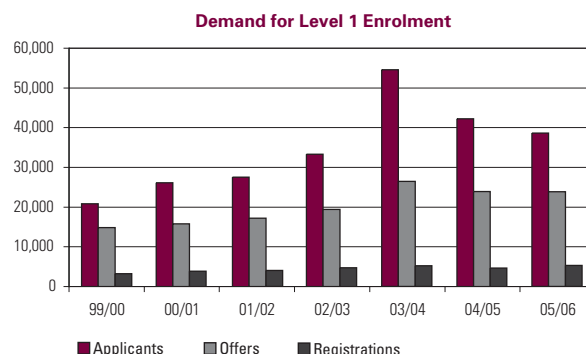
At the institution level, the University has implemented a planning, budgeting and control system governed by the University Planning Committee (“UPC”). The goals of this system are to integrate academic, strategic and financial planning institution-wide and to ensure fiscal accountability at all levels of the organization through aligning resources and management responsibilities. UPC has overall responsibility for implementing *Refining Directions*. At McMaster, operational responsibility is vested with the budget envelope managers and detailed implementation strategies are developed and executed at the Faculty and Business Unit level.

Despite the success of attracting students to McMaster, the success of research at McMaster and the budget planning that has taken place; the University faces real challenges in balancing inflating operating expenses, mainly compensation, utilities and deferred maintenance, with operating revenues. The University has embarked on the development of a Three Year Operating Budget Plan with the goal of creating a financially sustainable operating plan that achieves the goals of *Refining Directions*. The development of the financial plan will be carefully guided by the Institutional Strategy Map.

2005/06 Key Financial Indicators

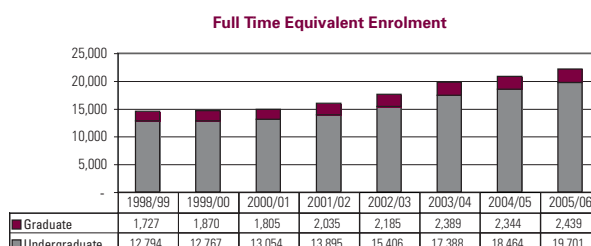
Achieve Demand for Programs

- In 2005/06, as expected, Ontario universities experienced a decrease in Level 1 applications. McMaster's 8.4% decrease from last year was similar to the province. Compared to 2002/03, McMaster experienced an application increase of 16%. The proportion of students naming McMaster as their first choice increased by 17.8% since 2004/05.
- The percentage of students who accepted offers made by McMaster was increased to 22.5% (19.5%-2004/05).



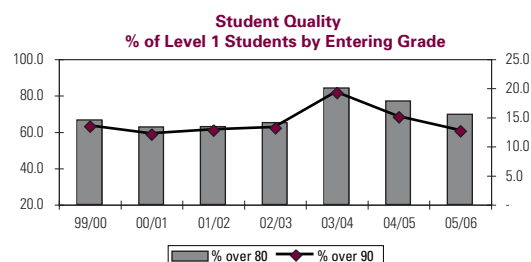
Achieve Targeted Enrolment Levels

- 6.4% annual increase in total 2005/06 full time equivalent (FTE) enrolment to 22,140 FTE's. Enrolment is ahead of target by 0.2%.
- 6.7% growth in undergraduate enrolment, and a 4.0% increase in graduate enrolment continued to provide access to a McMaster education to a growing number of quality students.



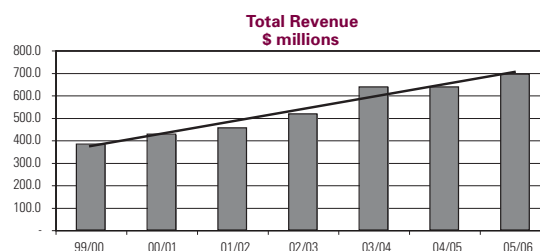
Attract High Quality Students

- In 2005/06 McMaster, like the Ontario aggregate, has experienced a decrease in student quality when compared to the 2003/04 double cohort year. Average entering grade in 2005/06 year was 82.9%.
- The percentage of Level 1 students with an entering average greater than 80%, while still above 2002/03, has decreased from 76.9% in 2004/05 to 69.7%.



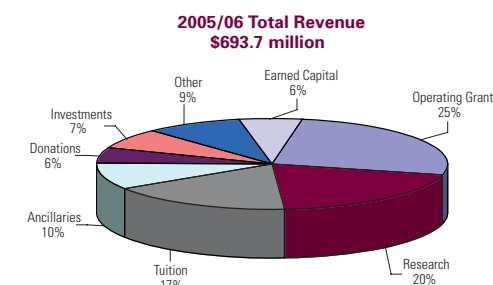
Grow the Revenue Base

- \$57 million or 9% annual growth in 2005/06 total revenue reflects increased student enrolment and strong growth in operating grants, donations, other grants, and investment income.
- Total revenue has grown steadily over the past 6 years to \$693.7 and has almost doubled from 1998/99 levels.
- Revenue per FTE at \$31.3K is above last year by 2.3%.



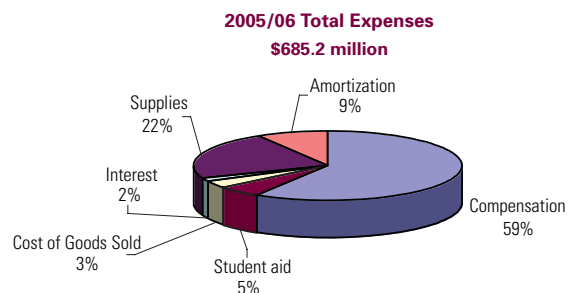
Diversify the Revenue Base

- McMaster continues to have a well-diversified revenue base which provides reduced dependency on any one revenue source and is an important source of future financial stability.
- Percentage of revenue received from operating grants decreased from 2004/05 mainly as a result of significant growth in investment income, donation and other revenue.



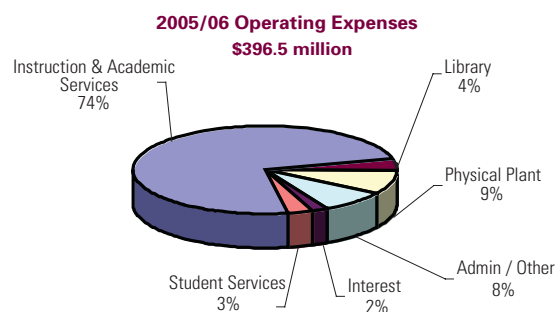
Strategic Deployment of Resources

- Total expenses are up by \$54 million or 8.6%, due mainly to growth in enrolment (6.4%), and other compensation expenses.
- Compensation costs are up by 15.2% mainly due to the increased costs of employee future benefits. 2006/07 will continue to focus on multi-year financial planning to manage the risk and the impact on operations of increases in employee future benefit long term liability.



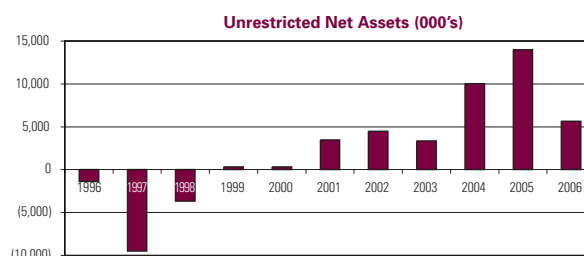
Strategic Deployment of Resources

- 74% of operating expense is invested into instruction and academic services in 2005/06, increased from 72% in the prior year. An additional \$38 million was spent in this category in 2005/06.
- The proportion of operating expenditures made in student services, library, physical plant and admin. each declined by 1% from the prior year.



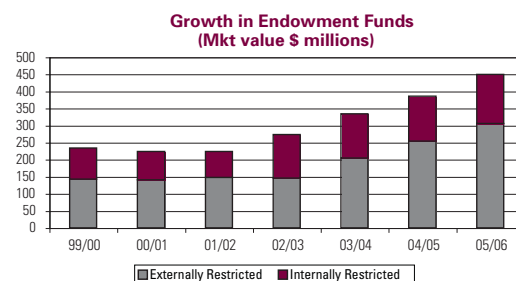
Strengthen Financial Position – prudent approach to financial management

- The reduction of \$8.3 million in Unrestricted Net Assets is due to a repayable advance of \$6 million to the Faculty of Science and a planned negative operating budget position of \$2.3 million.
- The negative budgeted operating position of \$2.3 million is mainly due to the planned use of previously recorded net assets to assist with balancing the 2005/06 budget.



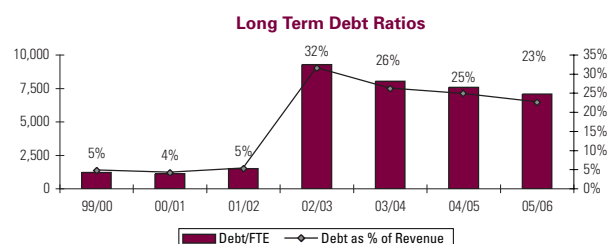
Strengthen Financial Position – continued growth in endowment funds

- At April 30, 2006, the market value of all endowment funds was \$449.2 million, up 16.5% from the previous year.
- Endowment per FTE student of \$20,300 is up by 9.5% compared to last year.
- Externally restricted endowments (including deferred donations) increased by 20.2%.
- 2005/06 annual net investment return was 14.2%.



Manage Business Risks – long term debt

- Long term debt of \$157 million is down marginally from 2004/05 as no new external financing was utilized.
- Long term debt per student at \$7,091 is down from the 2004/05 amount of \$7,593, due to unchanged borrowing and increased FTE's.
- Sinking funds of \$13.6 million mitigate debt financing risk, of which \$9.5 million is available to repay the \$120 million debenture principal in 2052.



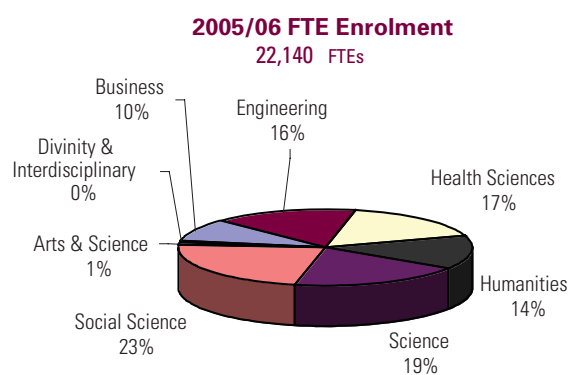
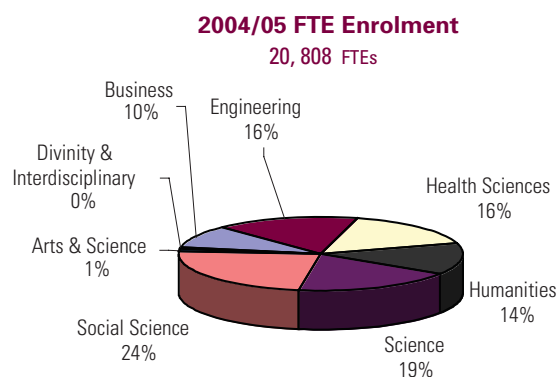
Demand for McMaster's Programs and Student Enrolment Targets

Over the past two years, McMaster has experienced an increase in demand for its programs in excess of the Ontario average. The percentage of McMaster offers that were accepted increased in 2005/06 to 22.5% compared with 19.5% in the prior year. Looking forward to 2006/07, applications are up and it is anticipated that the rate at which applicants will accept admission will also increase.

McMaster's culture of innovation in linking teaching and scholarship and its reputation for problem based learning and inquiry-based programs continues to be a strong attraction for high quality students. Although the overall entry grade for students coming directly from Ontario secondary schools decreased from 83.7% in 2004/05 to 82.9% in 2005/06, this is consistent with the experience in the rest of the province. Excluding the double-cohort year of 2003/04, it is important to note that McMaster experienced an increase of .6 percentage points, moving from 82.3% to 82.9% between 2002/03 and 2005/06. McMaster's percentage of Level 1 students with an entering average of greater than 80% decreased from 76.9% in 2004/05 to 69.7% in 2005/06.

Full time equivalent (FTE) enrolment in 2005/06 increased by 6.4% over the previous year and over 52% compared to the enrolment level in 1998/99, reflecting the alignment of Provincial government initiatives with McMaster's commitment to provide access to post secondary education to a growing number of qualified students.

Student enrolment in 2005/06 continues to be well distributed through the University's six Faculties. The chart below illustrates this breakdown and includes the very popular Arts and Science program and a small number of students enrolled at the McMaster University Divinity College (88) and new Interdisciplinary Graduate Programs (9). Growth in Health Sciences reflects the Ontario government decision to invest in new medical education spaces in the Michael G. DeGroote School of Medicine, the second largest medical school in Ontario, world-renowned for innovation in teaching doctors using a problem-based learning style.





Growth and Diversification of the Revenue Base

In 2005/06, the University's revenues grew to \$693.7 million, growth of 9% over 2004/05. Total revenue per FTE enrolment of \$31,300 per FTE student is higher than last year's \$30,600. McMaster's reliance on government grants decreased noticeably to 25% of total revenue compared to 27% in 2004/05, down from 29% in 1998/99. The University's ability to further diversify the revenue base in 2005/06 was aided by strong investment returns which boosted total recognized investment income by 36%. Total revenue over the time period from 1998/99 until 2005/06 has increased by over 97%. Diversification of the funding base has been achieved through continued increases in research funding and other sources of income generated by faculties, non-academic areas, fund-raising, investment income and ancillary operations.

Operating Grants Income

Provincial government operating grants of \$167.9 million have increased by 12.1% over last year. Increases in provincial operating grants relate to enrolment growth, enhanced funding for clinical and medical education, and 'Reaching Higher' provincial investments for quality, as well as the continuation of funding to compensate for the extended tuition freeze.

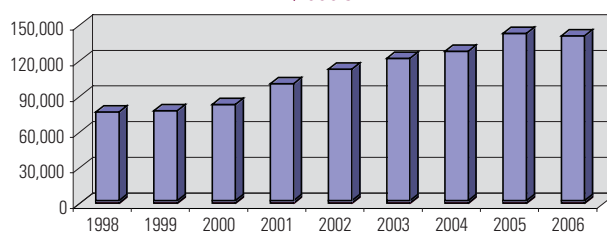
Research Grants and Contracts

Research revenue recognized over the past year has declined slightly from \$140.6 in 2004/05 to \$138.6 in 2005/06, which is a 1.4% decrease from 2004/05. Although research funding received grew by \$5.5

million, additional amounts were deferred due to the larger volume of expenditures that were of a capital (defer and amortize) rather than of a current nature (expense). Research growth over the past years has been dramatic and illustrates McMaster's success in creating internationally recognized centers of research excellence, building the infrastructure to support strategic research areas and integrating scholarship with teaching. This revenue has been an important driver in the University's total revenue growth and diversification.

In accordance with generally accepted accounting principles (GAAP), and as noted above, research revenue is recognized on the Statement of Operations in the year in which the expense occurs. Research revenue received, and not spent, or spent on capital projects is deferred and recorded as Deferred Contributions on the Statement of Financial Position. Research funding of \$168.4 (\$162.9 in 2004/05) million was received and \$29.4 (\$22.3 in 2004/05), million of that amount was deferred for future use.

**Research Revenue Recognized
\$ 000's**





University Research Funding Received

	Fiscal Year Ended April 30, 2006
	(\$ millions)
Federal Government	\$ 76.0
Province of Ontario	15.1
Other	77.3
Total Research Funds Received	168.4
Less amount deferred to future periods	(29.8)
Total Research Revenue Recognized	\$ 138.6

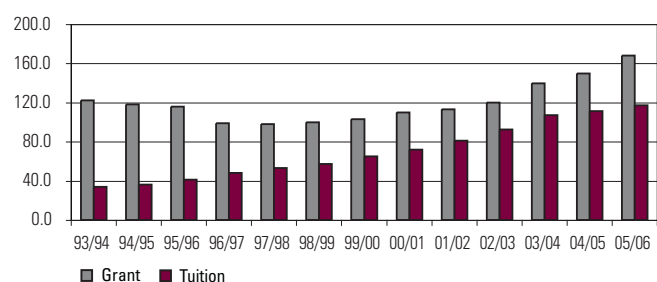
Research Overhead Grants

Research overhead grants assist the University in funding the indirect costs of research. In 2005/06, \$13.4 million was received compared to \$13.2 million in 2004/05. The Province and the Federal Government fund a portion of overhead costs associated with the federal research granting councils and eligible provincial research programs.

Tuition Fees

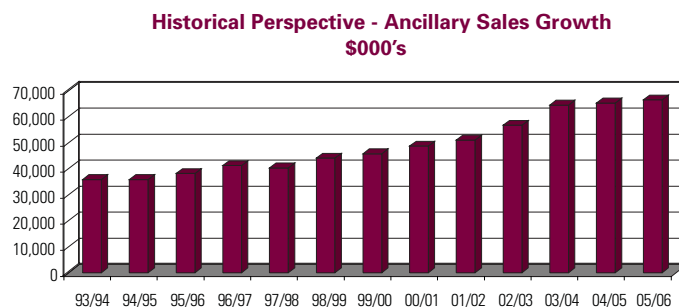
Revenue from tuition fees has increased by 5.1% in the fiscal year, as a result of a 6.4% growth in FTE students, partially offset by a slight change in mix toward proportionately greater undergraduate students. Domestic tuition fees remained frozen by the Province at prior years' levels. As a result of the provincial funding increase and the tuition freeze, the ratio of tuition to grant revenue has begun to increase after many years of significant decreases, as illustrated in the graph.

Historical Perspective on Operating Grant vs Tuition Income
\$ millions



Ancillary Operations

The University's ancillary operations have a mandate to provide excellent services, operate at break-even and cover all operating and capital costs through revenue earned. In addition, the Bookstore and Hospitality Services continue to provide a substantial contribution in support of essential soft Student Services. Sales by ancillary operations grew slightly by 2% to \$66.4 million in 2005/06.



A detailed breakdown of Ancillary revenues and year over year growth rates follows:

Sales by ancillary operations (\$ thousands)

	2005/06	2004/05	% Incr/-decr
Bookstore	20,575	20,742	-0.8%
Hospitality Services	16,737	15,626	7.1%
Housing and Conference Services	15,474	14,404	7.4%
Printing	5,132	5,312	-3.4%
Parking	3,333	3,432	-2.9%
Continuing Education	2,308	2,311	-0.1%
Telecommunications	1,320	1,185	11.4%
Student Health Services	1,417	2,016	-29.7%
Miscellaneous	143	136	5.1%
Total Ancillary Operations	66,439	65,164	2.0%

Hospitality Services revenue benefited from the 6.4% increase in enrolment. Housing and Conference Services benefited from rate increases and higher than budget occupancy. The decrease in Student Health Services reflects a revision of its operating procedures so that revenue is now recognized on a net basis and is not indicative of a reduction in the funding generated to support the program.

Investment Income

Investment income, recognized on the Statement of Operations for the year was \$49 million compared to \$36.1 million in 2004/05. In addition, \$17.5 million of investment income was added directly to Externally Restricted Endowments for capital protection as per University policy. The 2005/06 performance reflects strong investment markets compared to last year.

Investment returns generated on endowed funds are used in accordance with the designated purposes set out by either the donors or the Board of Governors. The University set the amount of annual income budgeted for expenditure on designated uses in 2005/06 at a maximum of 4% of the 3-year average market value of endowment capital. In 2005/06, approximately 3.6% (3.5% in 2004-05) of the University's expenses were funded through endowment income, a significant proportion of which was directed towards student scholarships and bursaries and support of direct faculty expenses.

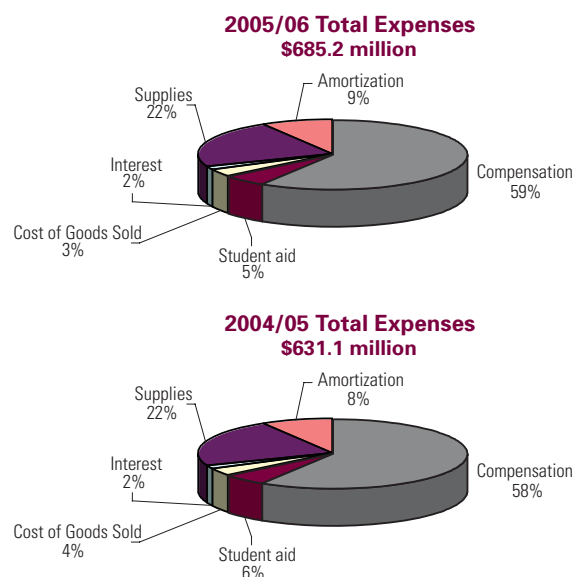
Other Sources of Revenue

Other sources of revenue include the \$61.9 million of other revenue earned through various non-degree educational and other revenue-generating activities. In 2005/06 the University recognized \$38.8 million of donations and other grants spent on restricted activities, of which \$15 million was flowed to MIP. This \$15 million received from the Province and the City had been previously recorded as a deferred contribution. The recognition of \$40.7 million of earned capital contributions, equivalent to the amortization of capital assets funded through deferred contributions, was included in 2005/06.



Strategic Deployment of Resources

Expenses for 2005/06 were \$685.2 million, representing an increase of 8.6% over 2004/05.



Compensation expenses as a percentage of total expenses increased from 58.4% to 58.8% due to higher employee benefit costs. After several years of sizable increases in student support, the proportion of expenses related to student aid declined slightly from 5.6% to 5.3% due to the discontinuance of the provincial Set Aside program. The proportion (22%) related to supplies and services was consistent with last year. On a functional basis, 74% (72% in 2004/05) of operating expenditures were invested into instruction and academic services and other programs.

Compensation

Total compensation expense of \$402.2 million represents 58.8% of total expenses. The increase of 15% over 2004/05 almost wholly results from salary adjustments and accelerating costs of providing employee pension and other retirement benefits. Salaries and wages increased by 3% with an increase of over 6% in operating fund salaries, offset by a slight reduction in salaries charged to the other funds. A total of 6,266 staff members were employed by McMaster University as at October 2005 (6,145 at October 2004), an increase of 2% with approximately 67% of these employees being involved in direct academic and research activities and 33% providing administrative support.

McMaster Faculty and Staff

as at October 2005

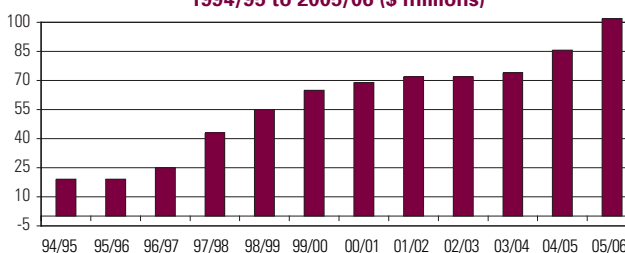
Academic (includes Faculty, PDFs, Librarians and Teaching Assistants)	3, 298	53%
Research Support	886	14%
Administrative Support	2,086	33%
	6,266	100%

Increasing compensation costs continue to put significant strain on financial resources. It is apparent that with costs escalating at a rate greater than revenue, measures will need to be developed and implemented to establish a long term sustainability strategy. In 2003/04 McMaster voluntarily resumed contributions to its salaried pension plan equivalent to 100% of employee contributions. Contributions to that plan have increased to 200% of employee contributions in 2005/06 and will increase to 300% of employee contributions in 2006/07. McMaster is actively developing a Three Year Operating Plan intended to ensure that increased future compensation costs are adequately provided for in the future.

Student Financial Aid

Student aid (scholarships and bursaries) of \$36.5 million (included in Supplies and Services) has increased by 3.6% over the previous year. McMaster is committed to assisting students in addressing the financial obligations associated with university study through increased bursary assistance. To provide support for funding this growing need for financial assistance, McMaster has increased its endowments held for scholarships and bursaries from \$86 million in 2004/05 to \$102 million in 2005/06. In May 2005, the Ontario Trust for Student Support was introduced. This new matching program has provided further donations and government matching funds for student financial aid.

**Funds Held for Scholarships and Bursaries
1994/95 to 2005/06 (\$ millions)**



Capital Planning and Management

McMaster's Campus Plan was approved by the Board of Governors in March 2002 and provides a comprehensive framework to guide capital development on campus. The plan is reviewed and revised annually as a part of the Annual Budget process to ensure that the University's physical infrastructure is an appropriate reflection of McMaster's academic excellence as new building and renovations occur. Under the plan, the University has embarked on extensive capital improvements designed to provide "state of the art" academic and research facilities necessary to support a leading-edge University. A significant number of the major buildings on campus have been renovated or expanded by projects which have been funded through a variety of government programs, such as SuperBuild, Canada Foundation for Innovation, as well as private donations and the proceeds of the \$120 million, unsecured debenture issue in 2002.

Investment in Capital Assets

McMaster invested almost \$128 million (\$114 after allowing for the transfer of the MIP land to the MIP trusts) in capital assets in 2005/06. Expenditures for completed building projects and construction in progress again accounted for over half of this total. Another \$45.4 million was spent on computers, furnishings, and other equipment and \$7.7 million was spent on the acquisition of library materials. Additional land and building was acquired in Hamilton for a family health clinic associated with the Faculty of Health Science.

The major building projects included the completion of the Les Prince student residence, the 2nd phase of the Burke Science Building renovations, significant progress on the David Braley Athletic Complex, the start of the Ronald V. Joyce Stadium, and completion of the final phase of the 3 part Energy Reduction Project.

Capital Asset Additions (\$ thousands)

	2005/06	2004/05
Land	770	—
Completed building projects & construction in process	73,590	43,676
Computers, furnishings and other equipment	45,441	38,486
McMaster Innovation Park - moved to Investments in 2005/06	(13,392)	13,392
Library materials	7,746	7,334
	114,155	102,888

Funding Source for Additions

Externally Funded - grants and donations	41,185	40,036
Externally Financed - debenture proceeds expended	28,578	25,002
McMaster Innovation Park - moved to Investments in 2005/06	(13,392)	13,392
Internally Funded - through operating and capital funds	57,784	24,458
	114,155	102,888



Financial Position and Management of Business Risks

McMaster's total assets at April 30, 2006 are \$1.5 billion compared to \$1.4 billion at the previous year end, a growth of 7.1%. Liabilities and deferred contributions of \$870.6 million are up by 6% over 2004/05, due primarily to an increase in accounts payable of \$28.4 million, and an increase in accrued employee future benefits of \$16.6 million. Total long-term debt per FTE student decreased from \$7,593 in 2004/05 to \$7,091, reflecting McMaster's increasing ability to fund expansion through fund-raising. A sinking fund has been established to repay the \$120 million of debentures in 2052.

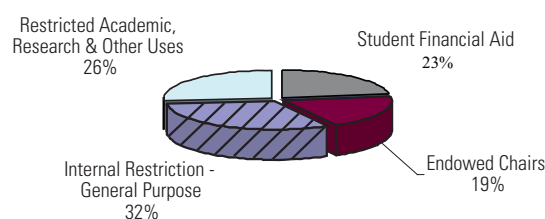
Net Assets as of April 30, 2006 of \$624.4 million increased by \$48.6 million from the prior year due primarily to an increase of \$25.8 million in the amount of net assets invested in capital assets and an increase of \$45.8 million in externally restricted endowments.

Internally and Externally Restricted Endowments

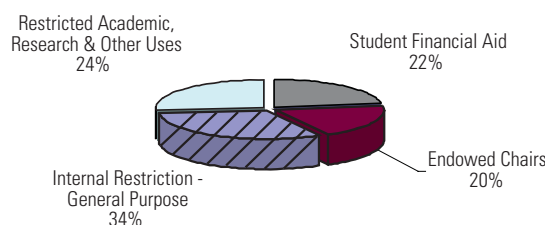
Endowments are comprised of restricted donations received by the University and unrestricted donations that have been internally designated by the Board of Governors. The Internally Restricted Endowment had a market value of \$143.9 million (2004/05 – \$131.5 million) and Externally Restricted Endowments, including deferred contributions, had a market value of \$305.4 million (2004/05 - \$254 million). The market

value of the University's total endowment of \$449.2 million as at April 30, 2006, has grown by 16.5% over 2004/05. Externally restricted expendable and non-expendable contributions of \$37.2 million and \$51 million of investment income exceeded expenditures from endowment funds of \$24.6 million.

**Endowment Funds at April 30, 2006
By Purpose**



**Endowment Funds at April 30, 2005
By Purpose**



McMaster's endowment fund investment policy requires diversification between fixed income (40%) and equity securities (60%) and generated an annual rate of return, measured at March 31, 2006, of 14% (2004/05 -7.1 %), which is 0.35% higher than the policy benchmark for that period. Under the direction of the Finance Committee of the Board of Governors, the University regularly reviews its asset mix and monitors the performance of its investment managers.

Investment returns on endowed funds support strategically important areas of expense, either by donor designation, or by internal Board of Governors designation. Funds held to support student scholarship and bursaries represent 23% of total internally and externally restricted endowments and funds held to support faculty salaries and research activities through the endowed chairs program represent 19% of the total endowment. Restricted Academic Research and other uses, has grown from 24% to 26%, mainly as a result of the DeGroote donations for medical research institutes and centres.

Employee Future Benefits

The funded status of the University's defined benefit pension plan, measured at April 30, 2006, is a deficit of \$92.4 million, compared to a deficit of \$133.2 last year, due to better than expected investment returns. Post retirement and other post employment benefit plans report a deficit of \$184.2 million, increasing from \$164 million last year. Recognizing the long-term nature of these liabilities, the University records the actuarially determined asset and liability values in its net asset position and the actuarially determined cost in its calculation of expenses. In these calculations, the University uses the corridor method to amortize any actuarial gains or losses, including changes resulting from adjustment of actuarial assumptions and investment experience gains and losses, over the average remaining service life of active employees.

The determination of the change in the funded status of the defined benefit pension plans maintained by the University from April 30, 2005 to April 30, 2006 and as disclosed in the 2005/06 audited financial statements follows:

Change in Funded Status of Pension Benefit Plans

\$ millions

Deficit as at April 30, 2005		(133.2)
Costs incurred during the period:		
Current service cost	(28.9)	
Interest on liabilities	(56.6)	
Actual return on plan assets	<u>100.0</u>	14.5
Actuarial gain related to change in assumptions		2.8
Plus: University contributions		23.5
Deficit as at April 30, 2006		(92.4)

No changes were made in 2006 to the discount rate of 5.5% or the expected long-term rate of return on plan assets at 7.0%. The actuarial gain of \$2.8 million reflects actual pension indexing that was less than previously assumed.

Pension expense recorded in 2005/06 of \$36.6 million is up from \$14 million from 2004/05.

The significant increase is due to a reduction in the discount rate used to calculate the expense from 6.00% to 5.50% and the requirement to amortize \$13.9 million of actuarial losses during the year. It is expected that the amortization of actuarial losses for 2006/07 will increase to approximately \$14.5 million.

The University completed and submitted funding valuations for its Salaried Pension Plan and Hourly Pension Plan as at July 1, 2003 and July 1, 2004, respectively, and the next valuations are required on July 1, 2006 and July 1, 2007, respectively. Based on

existing valuations, the University has completed a short-term funding plan that identified a planned level of contributions, that have been made prior to the July 2006 valuation. The University plans to make the deficit amortization payments required by the July 2006 valuation of the Salaried Pension plan from internally restricted endowed funds, to be repaid over a long term period. In addition to development of a short term funding plan, the University has completed a review of investment strategies and has made changes to the Salaried Pension Plan design to reduce future current service costs. Despite these changes, increasing pension service costs have caused significant pressure in University budgets.

The deficit status of the non-pension post retirement benefit plan as at April 30, 2005 of \$184.2 million is \$20.2 million greater deficit than as at April 30, 2005. The significant changes are outlined in the chart below.

Change in Funded Status of Non-Pension Benefit Plans	\$ millions
Deficit as at April 30, 2005	(164.0)
Current service and interest costs	(16.2)
Change in discount rate from 6.00% to 5.75%	(7.6)
Other minor experience adjustments	(0.3)
Less: University cash payments in the period	3.9
Deficit as at April 30, 2006	(184.2)

Consistent with the actuarial best practice to complete a valuation every three years, a full actuarial valuation was completed in May 2004 and those results have been extrapolated to determine the April 30, 2006 accrued non-pension benefit obligation. Based on advice from the actuary, the assumptions used to project the cost of future health benefits were increased in 2003/04 and a more conservative mortality table was incorporated into the calculation of the obligation. There has been no change in these assumptions in 2005/06. The discount rate is based on high quality corporate bond yields as at April 30, 2006, resulting in a reduction in the rate of 0.25%, which accounts for 40% of the increase in the liability.

Non-pension future employee benefit expense recorded in 2005/06 of \$20.5 million is up by

\$1.5 million from 2004/05. The increase reflects higher current service and interest costs as well as the requirement to amortize \$3.8 million of previously unamortized actuarial losses.

The University continues to fund post employment, non-pension benefits on a cash basis and has \$4.4 million budgeted for this purpose in 2006/07. This amount is in line with estimates provided in the extrapolated results. Expected cost increases for future years, as projected by the actuaries, are being incorporated into multi-year financial plans to ensure that funds are available to cover this increasing cost. During 2005/06, the University has made changes to the design of current post retirement benefit plans to obtain value for money, cost effectiveness and cohesion with its human resource strategic goals and objectives.

Enterprise-Wide Risk Management

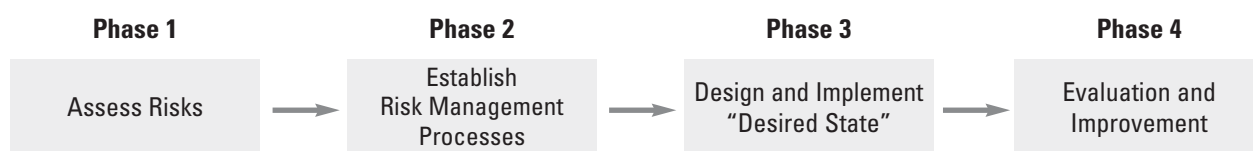
The University has initiated an enterprise-wide risk management program, which is a key component of *Refining Directions* and is defined as:

“a structured and disciplined approach that aligns strategy, processes, people, technology and knowledge with the purpose of evaluating and managing the uncertainties the enterprise faces.”

Risk and the mitigation thereof can be categorized into three distinct and interrelated components:

Financial /physical assets:	basic protection of University assets through insurance and other programs
Business processes:	internal controls and procedures in various processes designed to protect financial and physical assets, records and data in all forms related thereto
Enterprise-wide:	strategic measures taken at the enterprise-wide level to protect the institution’s assets, reputation and competitive position

A risk management program involves four distinct phases:



Since implementation of the risk management program in 2002, the University has:

- compiled a comprehensive understanding of its basic, process level and strategic risks
- developed a common language of risk terms and definitions
- prepared a methodology for capturing and quantifying risk ratings
- established an understanding of the relative prioritization of the risks
- compiled risk owners’ assessment of risk management effectiveness in achieving the desired state

In the process, the University has identified critical strategic risks and descriptions thereof as follows:

Environmental:

Government Policy: effects from changes in government policy or failure to react when required

Competitor: unanticipated actions of existing competitors and new market entrants

Reputation: failure to establish or maintain McMaster's reputation

Business processes:

Financial: inability to meet financial commitments because funding levels are outpaced by the costs of operation; or that resources are not effectively and efficiently deployed; or that equity is eroded due to government underfunding or capital maintenance; or that increased debt obligations reduce funding available to cover academic costs

Physical Infrastructure: failure to establish or maintain required non-technology physical assets

Student Satisfaction: failure to focus on students and addressing their issues and needs

Human Capital and Employee Relations: inability to attract, retain and develop appropriate academic and non-academic staff; and manage employee/labour relations effectively

Partnering: effects of actions taken by associated third parties and alliances which are not within limits of their authority or not performed in a manner consistent with policy

Leadership: failure to lead the University with the consequences of a lack of direction, focus, motivation to perform, credibility and trust

Change Readiness: inability of employees to implement process and program/service improvements efficiently to keep pace with changes in the marketplace

Technology: inability to maintain adequate systems and leverage advancements sufficiently

The risk management program is monitored semi annually on behalf of the Audit Committee by the Internal Audit Department and with the respective risk owners. In conducting this review, the risk categories have been grouped into two distinct groups:

This phase includes the review of the following risk categories and the update thereof has been completed to June, 2006:

- Group I:**
- Technology
 - Physical infrastructure
 - Student satisfaction
 - Financial
 - Human capital and employee relations
-

The update of the following categories will occur in the 4th quarter of calendar 2006:

- Group II:**
- Government policy
 - Partnering
 - Change readiness
 - Leadership
 - Reputation
 - Competitor
-

Formal presentation of the update of the program will occur at the December, 2006 meeting of the Audit Committee.



Basis of Presentation of University Financial Information in the Annual Financial Report

The audited financial statements are prepared as required by statute in accordance with generally accepted accounting principles ("GAAP") as prescribed by the Canadian Institute of Chartered Accountants under the Deferral Method of accounting ("deferral method") and with consolidation of all activity.

In contrast, the University's internal reports and budgets are prepared on a cash basis and pursuant to the concepts of fund accounting. Under this method, separate budgets and funds are set up for funds' activities, with each fund comprised of its own assets, liabilities, revenues and expenses.

Fund accounting enhances accountability and budgetary control of resources by ensuring that restricted grants and contributions are spent only for the purposes intended. To maintain control, the following segregated funds have been developed: General Operating, Research, Capital, Externally Restricted Trusts and Endowments, Internally Restricted Endowments and Ancillary Operations.

For external reporting under the deferral method, all funds are consolidated in the Statement of Operations rather than reported separately by fund. Accordingly, reconciliation between internal segregated fund reports with external reports prepared on a consolidated deferral method is complex.

Under the deferral method:

- grants and contributions with external restrictions are deferred when received, and recognized in the Statement of Operations in equivalent amounts to expenditures when and as these costs are incurred;
- capital acquisitions (and grants received to fund them) are not reflected in the Statement of Operations as incurred (in contrast to their recognition in internal fund accounting statements); and,
- these acquisitions (and the related grants) are capitalized on the Statement of Financial Position and reflected in the Statement of Operations as and when the respective asset and grant amortizations occur.

To recognize the Investment in Capital for assets purchased with internal unrestricted funds:

- an adjustment is made to charge Unrestricted Net Assets for the value of the purchase (which is, in contrast, reflected in fund accounting as a charge to the in-year operating statement); and,
- a corresponding adjustment is made to recognize the Investment in Capital Assets for the purchase value.

Further adjustments and transfers are made to align the respective segregated fund positions for activity among them in the year within the Statement of Changes in Net Assets.

	000's
Excess of revenue over expenses (per audited financial statements)	\$ 8,562
Adjustment for non-cash capital amortizations, net	18,053
	26,615
Fund alignment adjustments and transfers:	
Recognition of investment in capital assets purchased with internal funds	(46,398)
Transfer for future employee benefit costs charged to internally restricted net assets	30,312
Transfer to internally restricted net assets (Faculty of Science)	(6,000)
Transfer to internally restricted endowments for capital preservation	(12,863)
Net fund alignment adjustments and transfers	(34,949)
Net change in the year	(8,334)
Unrestricted net assets, beginning of year	13,985
Unrestricted net assets, end of year (per audited financial statements)	\$ 5,651

The above schedule represents (i) a reconciliation of the deferral-based Excess of Revenue over Expenses to the comparable fund-based results, and (ii) the continuity of Unrestricted Net Assets for 2005/06 (as excerpted from the Statement of Changes in Net Assets).

Financial Statements | April 30, 2006

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Statement of Management Responsibility

Management is responsible for the preparation of the financial statements and has prepared them in accordance with Canadian generally accepted accounting principles for not-for-profit organizations. Management believes the financial statements present fairly the financial position of the University as at April 30, 2006 and the results of its operations and its cash flows for the year then ended.

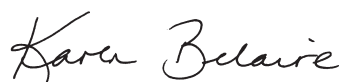
In fulfilling its responsibilities and recognizing the limits inherent in all systems, the University has developed and maintains a system of internal control designed to provide reasonable assurance that University assets are safeguarded from loss and that the accounting records are a reliable basis for the preparation of financial statements.

The Board of Governors carries out its responsibility for review of the financial statements principally through its Audit Committee. Members of the Audit Committee are not officers or employees of the University. The Audit Committee meets with management and the external auditors to discuss the results of audit examinations and financial reporting matters. The external auditors have full access to the Audit Committee, with and without the presence of management.

The financial statements for the year ended April 30, 2006 have been reported on by KPMG LLP, the auditors appointed under the University Act. The Auditors' Report outlines the scope of their examination and provides their opinion on the fairness of presentation of the information in the financial statements.



Dr. P. George
President and Vice-Chancellor
August 4, 2006



Ms. K. Belaire
Vice-President, Administration
August 4, 2006



Auditors' Report

To the Board of Governors
McMaster University

We have audited the statement of financial position of McMaster University as at April 30, 2006 and the statements of operations, changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the University's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance 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.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the University as at April 30, 2006 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

Chartered Accountants

Hamilton, Canada
August 4, 2006



McMaster University
Statement of Financial Position
April 30, 2006, with comparative figures for 2005
(in thousands of dollars)

	2006	2005
Assets		
Current assets:		
Cash and equivalents	\$ 89,231	\$ 114,405
Research grants receivable	71,196	61,581
Accounts receivable	37,486	38,577
Government grants receivable	4,918	5,337
Inventories	6,039	6,312
Prepaid expenses	907	713
	209,777	226,925
Investments (note 3)	538,112	477,143
Investment in McMaster Innovation Park (note 4)	13,461	—
Deferred pension asset (note 5)	162,784	175,890
Capital assets (note 6)	570,842	515,493
	1,285,199	1,168,526
Total Assets	\$ 1,494,976	\$ 1,395,451

McMaster University
Statement of Financial Position
April 30, 2006, with comparative figures for 2005
(in thousands of dollars)

	2006	2005
Liabilities, Deferred Contributions and Net Assets		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 84,010	\$ 55,527
Deferred revenue	28,267	20,688
Current portion of long-term debt (note 8)	881	828
	113,158	77,043
Deferred contributions (note 7):		
Deferred contributions for future expenses	208,189	209,743
Deferred capital contributions	284,591	284,159
	492,780	493,902
Long-term debt (note 8)	156,265	157,146
Accrued employee future benefits (note 5)	103,188	86,617
Decommissioning obligation (note 9)	5,163	4,913
Net assets:		
Unrestricted	5,651	13,985
Internally restricted (note 10)	93,327	104,247
Invested in capital assets (note 11)	136,396	121,443
Internally restricted endowments	143,878	131,515
Externally restricted endowments	245,170	204,640
	624,422	575,830
Commitments and contingencies (note 16)		
Total Liabilities, Deferred Contributions and Net Assets	\$ 1,494,976	\$ 1,395,451

McMaster University
Statement of Operations
For the year ended April 30, 2006, with comparative figures for 2005
(in thousands of dollars)

	2006	2005
Revenue		
Operating grants	\$ 167,864	\$ 149,787
Research grants and contracts	138,593	140,552
Tuition fees	116,963	111,246
Ancillary sales and services	66,439	65,164
Other revenue	61,900	59,158
Investment income, net	49,015	36,106
Donations and other grants	38,824	25,062
Research overhead grants	13,366	13,212
Amortization of deferred capital contributions	40,753	36,899
	693,717	637,186
Expenses		
Salaries and wages	310,585	300,976
Employee benefits	92,037	67,552
Supplies and services	212,312	198,611
Interest on long-term debt	11,383	10,256
Share in loss of McMaster Innovation Park	32	—
Amortization of capital assets	58,806	53,700
	685,155	631,095
Excess of revenue over expenses	\$ 8,562	\$ 6,091

See accompanying notes to financial statements

McMaster University
Statement of Changes in Net Assets
For the year ended April 30, 2006, with comparative figures for 2005
(in thousands of dollars)

	Unrestricted	Internally restricted			Invested in Capital Assets	Endowments		Total 2006	Total 2005
		Post Employment	Specific Purposes	McMaster Innovation Park		Internally Restricted	Externally Restricted		
Net assets, beginning of year	\$ 13,985	65,042	52,597	(13,392)	121,443	131,515	204,640	575,830	524,192
Excess (deficiency) of revenue over expenses	26,615	—	—	—	(18,053)	—	—	8,562	6,091
Endowment contributions:									
Contributions to restricted endowments	—	—	—	—	—	—	22,488	22,488	40,316
Income preserved for capital protection	—	—	—	—	—	—	17,542	17,542	5,231
Transfers and adjustments:									
McMaster Innovation Park (note 4)	—	—	—	13,392	(13,392)	—	—	—	—
Internally restricted net asset transfers	30,312	(31,304)	992	—	—	—	—	—	—
Internally restricted endowments (note 2(j))	(12,863)	—	—	—	—	12,863	—	—	—
Externally restricted endowments	—	—	—	—	—	(500)	500	—	—
Capital transactions from operating (note 11)	(46,398)	—	—	—	46,398	—	—	—	—
Advance to Faculty of Science (note 10)	(6,000)	—	6,000	—	—	—	—	—	—
Net change	(8,334)	(31,304)	6,992	13,392	14,953	12,363	40,530	48,592	51,638
Net assets, end of year	\$ 5,651	33,738	59,589	—	136,396	143,878	245,170	624,422	575,830

McMaster University
Statement of Cash Flows
For the year ended April 30, 2006, with comparative figures for 2005
(in thousands of dollars)

	2006	2005
Cash flows from operating activities		
Excess of revenue over expenses	\$ 8,562	\$ 6,091
Adjustments for non-cash items:		
Decrease in deferred pension asset	13,106	100
Increase in accrued employee future benefits	16,571	15,486
Amortization of capital assets	58,806	53,700
Amortization of deferred capital contributions	(40,753)	(36,899)
Share in loss of McMaster Innovation Park	32	—
Increase in decommissioning obligation	250	797
Net change in deferred contributions	(1,554)	10,985
Net change in non-cash working capital (note 12)	28,036	4,383
	83,056	54,643
Cash flows from financing and investing activities		
Deferred capital contributions	41,185	40,036
External endowment contributions	40,030	45,547
Repayment of long-term debt	(828)	(778)
Acquisition of capital assets	(127,547)	(102,888)
Net increase in investments	(60,969)	(61,285)
Increase in Investment in McMaster Innovation Park	(101)	—
	(108,230)	(79,368)
Net decrease in cash	(25,174)	(24,725)
Cash and equivalents, beginning of year	114,405	139,130
Cash and equivalents, end of year	\$ 89,231	\$ 114,405

See accompanying notes to financial statements

McMaster University
Notes to Financial Statements
For the year ended April 30, 2006

1. AUTHORITY AND PURPOSE:

McMaster University operates by authority of The McMaster University Act, 1976. It is governed by a Board of Governors and Senate, the powers and responsibility of which are set out in the Act. It is a comprehensive research university offering a broad range of undergraduate, graduate and continuing education programs and degrees. The University is exempt from income tax.

2. SIGNIFICANT ACCOUNTING POLICIES:

(a) Basis of presentation:

These financial statements include the accounts, transactions and operations for which the University has jurisdiction.

McMaster University controls the First Longwood Innovation Trust and the Gore District Land Trust which operates as the McMaster Innovation Park. The investment in McMaster Innovation Park is accounted for by the equity method. Additional information on the McMaster Innovation Park and the Trusts is found in note 4.

These financial statements do not include the accounts, transactions and operations of the following entities which are independently governed and managed:

- McMaster Divinity College
- McMaster Students Union, Inc.
- McMaster University Student Centre, Inc.
- McMaster Children's Centre, Inc.

These financial statements do not include the accounts, transactions and operations of the following related entities, which carry out certain fundraising and other activities, and are not material to these financial statements:

- The McMaster University Trust
- The McMaster University Foundation
- The McMaster University Hong Kong Foundation
- Friends of McMaster Incorporated
- Directors College (50% joint venture with the Conference Board of Canada)

Additional information on transactions with these related entities is included in note 17.

2. SIGNIFICANT ACCOUNTING POLICIES (continued):

(b) Revenue Recognition:

The University follows the deferral method of accounting for contributions. The principles of this method are summarized as follows:

Operating grants are recognized as revenue in the period received or receivable. Operating grants relating to a future period are recorded as deferred contributions and recognized as income in the periods to which they relate.

Tuition fees which relate to academic terms or parts thereof occurring after April 30 are recorded as deferred revenue.

Grants for sponsored research are recorded as deferred contributions. When research expenditures funded by such grants are incurred during the year, the equivalent amounts are brought into revenue.

Grants and donations received for the acquisition of capital asset purchases are deferred and recognized as revenue in the periods in which the amortization of the related capital assets are recorded.

Endowment donations and income preserved under the endowment capital protection policy are recorded as direct increases in externally restricted endowments. Income earned from the investment thereof, to the extent it is allocated, is recorded as deferred contributions and recorded as revenue in the periods in which the related expenses are incurred.

Other externally restricted contributions are recorded as deferred contributions and recognized as revenue in the periods in which the related expenses are incurred.

Gifts-in-kind are recorded at their fair market value on the date of receipt or at nominal value when fair market value cannot be reasonably determined. Pledges from fund raising and other donations, because of the uncertainty of receipt, are not recorded until the year of receipt of cash or other assets.

(c) Investments:

Investments with a term to maturity of 90 days or less on acquisition are included with cash and equivalents and are recorded at cost plus accrued income.

Long-term investments are carried at fair values. Changes in fair values are included in investment income.

Externally restricted investment income to the extent it is allocated is included with deferred contributions and recognized as revenue during the period in which it is earned.

Investment income related to internally restricted endowments is recorded as revenue during the period in which it is earned and is transferred from unrestricted net assets to internally restricted endowments.

(d) Inventories:

Bookstore, reactor and other inventories are recorded at the lower of cost and net realizable value.

(e) Capital Assets:

Capital assets are recorded at cost or, if donated, at the fair value on the date of receipt.

Amortization is recorded on a straight-line basis at the following annual rates:

Buildings	2.5% to 10%
Nuclear reactor asset retirement cost	4%
Site improvements	5%
Library materials	10%
Computing systems	10%
Equipment, furnishings and vehicles	20%
Computing equipment	33.3%

(f) Works of Art:

Works of art are charged to operations in the year of acquisition. During the year, \$124,000 (2005 – \$22,000) of works were purchased or donated.

(g) Contributed Services:

The University acknowledges the receipt of donated services. Donated services are not recognized in the financial statements because of the difficulty of determining their fair value.

(h) Ancillary Enterprises:

The ancillary enterprises are self-sustaining and are intended to operate on a break-even basis. Ancillary transactions include replacements and renovations of equipment and facilities. Operating results are transferred annually from unrestricted net assets to internally restricted net assets.

(i) Employee Future Benefits:

The University maintains two separate defined benefit registered plans providing pension benefits for its salaried and hourly full-time employees. Additional pension benefits are provided through non-registered defined benefit plans. Other defined benefit plans provide non-pension, retirement and post-employment benefits for substantially all full-time employees.

For purposes of calculating expected return on plan assets, registered pension plan assets are valued at a market related value (smoothed for the difference between actual and expected investment income over five years). The other pension and other post retirement and post-employment benefit plans are unfunded.

The costs of pension and other post-employment benefits (primarily medical benefits and dental care) related to the employees' current service are charged to income. The current service cost and the accrued benefit obligation are separately determined for each plan, on an actuarial basis using the projected benefit method prorated on service and management's estimates of investment yields, salary escalation, health care trend rates and other factors.

The corridor method is used to amortize actuarial gains or losses (such as changes in actuarial assumptions and experience gains or losses) over the average remaining service life of active employees. Under the corridor method, amortization is recorded only if the accumulated net actuarial gains or losses exceed 10% of the greater of the beginning of year accrued benefit obligation and the actuarial value of the plan assets. Any past service costs arising from plan amendments are amortized on a straight-line basis over the expected average remaining service life of active employees.

A valuation allowance is recorded against an accrued benefit asset if the asset, less unamortized past service costs and unamortized actuarial losses, exceeds the present value of future service costs of the current active employees.

2. SIGNIFICANT ACCOUNTING POLICIES (continued):

(j) Net Assets:

Net assets are classified as follows:

Unrestricted Net Assets: General funds available for future operations.

Internally Restricted: Funds allocated for specific purposes and unexpended budgets carried forward for future expenditures within budget units. The Board of Governors has approved a policy of permitting departments to carry forward unexpended budgets into the subsequent fiscal year for expenditure in that year. In addition, the University reserves other portions of fund balances for specific purposes approved by the Board of Governors.

Invested in Capital Assets: Internally generated funds invested in capital assets, exclusive of capital assets financed through long-term debt or capital contributions.

Internally Restricted Endowments: Unrestricted donations, bequests and other funds, which have been endowed by action of the Board of Governors, including unspent investment income.

Externally Restricted Endowments: Non-expendable donations and bequests and income preserved under the endowment capital protection policy as described in note 2(k) below.

(k) Endowment Capital Protection Policy:

In order to protect the capital value of endowment investments, a endowment capital protection policy limits the amount of income made available for spending to 4.0% (2005 – 4.5%) and requires the reinvestment of excess income.

In future years, should investment returns be insufficient to fund spending commitments, amounts will be transferred from accumulated net investment income. For individual endowment funds without sufficient accumulated excess investment income, temporary encroachment on capital is permitted. The encroached amount is recovered from future net investment income.

(l) Derivative Financial Instruments:

The University is party to certain interest rate swap contracts which are used to manage the exposure to fluctuations in interest rates. Payments and receipts under the contracts are recognized as adjustments to interest expense on long-term debt.

(m) Decommissioning Obligation:

Decommissioning obligations are recognized in the period in which they are incurred, if a reasonable estimate of a fair value can be determined. The associated asset retirement costs are capitalized as a part of the carrying amount of the asset and amortized over its remaining useful life. The liability and the related asset may be adjusted periodically due to changes in estimates until settlement of the obligation.

(n) Use of Estimates:

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts of assets and liabilities, the disclosure of contingent assets and liabilities and the amounts of revenues and expenses.

Significant items subject to such estimates and assumptions include the carrying amount of capital assets, valuation allowances for receivables, valuation of derivative financial instruments, assets and obligation related to employee future benefits and the decommissioning obligation. Actual results could differ from those estimates.

3. INVESTMENTS:

Details of investments are as follows:

	2006		2005	
(in thousands of dollars)	Fair Value	Cost	Fair Value	Cost
Equities:				
Canadian	\$ 111,137	\$ 86,211	\$ 88,327	\$ 70,282
United States	94,771	99,714	83,049	91,886
Non-North American	101,248	91,405	84,792	79,543
	307,156	277,330	256,168	241,711
Fixed income	228,493	229,998	219,606	213,475
Other	2,463	2,464	1,369	1,389
Total	\$ 538,112	\$ 509,792	\$ 477,143	\$ 456,575

Included in investments are the following accounts (at fair value) held for restricted purposes:

	2006	2005
(in thousands of dollars)		
Restricted for debt repayment sinking funds:		
Student residence mortgage due 2011 (note 8(a))	\$ 4,104	\$ 3,809
Debentures due 2052 (note 8(d))	9,469	8,275
Decommissioning obligation (note 9)	5,622	4,700
	\$ 19,195	\$ 16,784

4. INVESTMENT IN McMASTER INNOVATION PARK:

Details of the investment are as follows:

	2006
(in thousands of dollars)	
Balance, beginning of year	\$ —
Transfer from capital assets to Investment in McMaster Innovation Park	13,392
Amount allocated to land	101
Share in cumulative losses	(32)
Balance, end of year	\$ 13,461

The First Longwood Innovation Trust and The Gore District Land Trust were created effective January 1, 2006. In connection with their respective Trustee subsidiaries, The First Longwood Trustee Corporation and The Gore District Trustee Corporation (formerly the McMaster University Trustee Corporation), their mission is to develop, market and manage an entity for research, education, training, innovation, and commercialization, known as the McMaster Innovation Park. Any benefits, financial or otherwise are to be retained for the ultimate benefit of McMaster University.

As at April 30, 2005, McMaster University Trust Corporation (MUTC) held the land acquired for the development of McMaster Innovation Park. This land was consolidated and included in the capital assets of the University as at April 30, 2005.

Pertinent information from the Trusts' financial statements as at and for the period ended April 30, 2006 is as follows:

	2006
(in thousands of dollars)	
Total assets	\$ 27,412
Total liabilities	88
Total deferred contributions	13,863
Total net assets	13,461
	\$ 27,412
Results of operations:	
Total revenue	\$ 1,312
Total expenses	1,344
Excess of expenses over revenue	(32)
Cash flows:	
Cash flows from operating activities	\$ 465
Cash flows from financing and investing activities	8,131
Increase in cash	\$ 8,596

Included in accounts payable and accrued liabilities is \$8,454,000 owing to McMaster Innovation Park. McMaster's transactions with the McMaster Innovation Park include rental of space at a cost of \$36,000. The provision of management, consulting, administrative and accounting services was without charge.

5. EMPLOYEE FUTURE BENEFITS:

The University maintains defined benefit plans providing pension and other retirement and post-employment benefits including extended health care and dental to substantially all full-time employees.

The accrued benefit obligations as determined by independent actuaries and the fair values of the plan assets are as at April 30th.

(a) Information about the University's defined benefit plans as at April 30, in aggregate, is as follows:

	2006		2005	
(in thousands of dollars)	Pension Benefit Plans	Other Benefit Plans	Pension Benefit Plans	Other Benefit Plans
Accrued benefit obligation	\$ 1,059,903	\$ 184,157	\$ 1,014,467	\$ 164,015
Fair value of plan assets	967,460	—	881,288	—
Funded status – plan deficit	(92,443)	(184,157)	(133,179)	(164,015)
Reconciliation to deferred benefit asset/(liability):				
Unamortized past service cost	148	—	164	—
Unamortized actuarial loss	255,079	80,969	308,905	77,398
Deferred pension asset (Accrued employee future benefits)	\$ 162,784	\$ (103,188)	\$ 175,890	\$ (86,617)

Each of the plans included above and described in note 2(i) has accrued benefit obligations in excess of the fair value of plan assets at the measurement date.

(b) Included in the above accrued benefit obligation are the following amounts in respect of plans that are not funded:

	2006		2005	
(in thousands of dollars)	Pension Benefit Plans	Other Benefit Plans	Pension Benefit Plans	Other Benefit Plans
Accrued benefit obligation	\$ (65,365)	\$ (184,157)	\$ (65,756)	\$ (164,015)
Fair value of plan assets	—	—	—	—
Funded status – plan deficit	\$ (65,365)	\$ (184,157)	\$ (65,756)	\$ (164,015)

(c) Information about the plan assets for the pension benefit plans as at April 30, 2006 includes the following:

	Percentage of fair value of total plan	Target allocation percentage	Expected long-term rate of return
Equity securities	66%	65%	8.6%
Debt securities	33%	35%	4.8%
Other	1%	0%	3.0%

5. EMPLOYEE FUTURE BENEFITS (continued):

- (d) The significant actuarial assumptions adopted in measuring the University's accrued benefit obligations at April 30, 2006 are as follows:

	Pension Benefit Plans	Other Benefit Plans
Discount rate	5.5%	5.75%
Expected long-term rate of return on plan assets	7.0%	—
Rate of compensation increase	4.5%	4.5%

- (e) In 2006, the actuarially determined expense/(income) recognized for the University's benefit plans is as follows:

	2006		2005	
(in thousands of dollars)	Pension Benefit Plans	Other Benefit Plans	Pension Benefit Plans	Other Benefit Plans
Net benefit costs incurred	\$ 36,555	\$ 20,494	\$ 13,994	\$ 18,992

- (f) The significant actuarial assumptions adopted in measuring the University's actuarially determined income/(expense) recognized in the year are as follows:

	Pension Benefit Plans	Other Benefit Plans
Discount rate	5.5%	6.0%
Expected long-term rate of return on plan assets	7.0%	—
Rate of compensation increase	4.5%	4.5%

For measurement purposes, a 10% annual rate of increase on the 2003 per capita cost of medical benefits was assumed. The rate was assumed to decrease to 5% by 2009, and remain at that level thereafter. A 5% annual rate of increase is assumed for dental benefits.

- (g) The annual contributions and benefits paid are as follows:

	2006		2005	
(in thousands of dollars)	Pension Benefit Plans	Other Benefit Plans	Pension Benefit Plans	Other Benefit Plans
Employer contribution	\$ 23,449	\$ 3,923	\$ 13,896	\$ 3,506
Employee contribution	8,993	—	8,168	—
Benefits paid	41,837	3,923	40,162	3,506

- (h) The most recent actuarial valuation for the pension benefit plans for funding purposes for hourly-rated employees was completed and filed as at July 2004. The next required valuation will be filed as at July 1, 2007. The most recent actuarial valuation for the pension benefit plans for funding purposes for all other employees was completed as at July 2003 and the next required valuation will be filed as at July 1, 2006. The most recent valuation for financial statement purposes for other benefit plans was completed by an independent actuary as at May 1, 2004. The results of each of these valuations have been extrapolated to April 30, 2006.

6. CAPITAL ASSETS:

Capital assets consist of the following:

(in thousands of dollars)	Cost	Accumulated Amortization	2006 Net	2005 Net
Land	\$ 3,477	\$ —	\$ 3,477	\$ 2,707
Land - McMaster Innovation Park	—	—	—	13,392
Buildings	525,165	189,286	335,879	337,154
Equipment, furnishings and vehicles	261,259	187,849	73,410	76,786
Construction in progress	95,841	—	95,841	34,200
Library materials	111,367	76,672	34,695	33,247
Computing systems and equipment	110,461	84,408	26,053	16,343
Site improvements	6,412	5,129	1,283	1,451
Nuclear reactor asset retirement cost	213	9	204	213
	\$ 1,114,195	\$ 543,353	\$ 570,842	\$ 515,493

7. DEFERRED CONTRIBUTIONS AND DEFERRED CAPITAL CONTRIBUTIONS:

- (a) Deferred contributions represent unexpended amounts, which are subject to externally imposed restrictions. Changes during the year are as follows:

	2006	2005
(in thousands of dollars)		
Balance, beginning of year	\$ 209,743	\$ 198,758
Deferred and capital contributions received	234,854	240,009
Amounts recognized as revenue	(180,223)	(183,757)
Transferred to deferred capital contributions	(41,185)	(40,036)
Contributions to McMaster Innovation Park	(15,000)	—
Transferred to externally restricted endowments	—	(5,231)
Balance, end of year	\$ 208,189	\$ 209,743

- (b) Deferred contributions consist of the following:

	2006	2005
(in thousands of dollars)		
Research grants and contracts	\$ 136,022	\$ 137,407
Donations, other grants and investment income	60,193	48,976
Capital grants and donations	10,704	23,360
Other restricted funds	1,270	—
	\$ 208,189	\$ 209,743

- (c) Deferred capital contributions:

Deferred capital contributions represent the unamortized amount of donations and grants received for the purchase of capital assets. Unspent deferred capital contributions are included in deferred contributions for future expenses until such time as capital expenditures are incurred. Details of the change in the unamortized deferred capital contributions are as follows:

	2006	2005
(in thousands of dollars)		
Balance, beginning of year	\$ 284,159	\$ 281,022
Contribution transfers	41,185	40,036
Amount amortized to revenue	(40,753)	(36,899)
Balance, end of year	\$ 284,591	\$ 284,159

8. LONG-TERM DEBT:

Details of long-term debt are as follows:

(in thousands of dollars)	Maturity	Interest Rate	2006	2005
			Total Outstanding	Total Outstanding
Student residence mortgage (a)	2011	9.81%	\$ 11,544	\$ 11,544
Bank loan (b)	2012	6.25%	4,032	4,505
Mortgage loan	2016	5.38%	1,186	1,268
Bank loan (c)	2033	6.63%	20,384	20,657
Debentures (d)	2052	6.15%	120,000	120,000
			157,146	157,974
Principal due within one year			(881)	(828)
			<u>\$ 156,265</u>	<u>\$ 157,146</u>

Principal payments due in each of the following five years are as follows (in thousands of dollars):

2007	\$ 881
2008	937
2009	997
2010	1,060
2011	1,128

- (a) An internal sinking fund has been established to fund a portion of the principal repayment of the student residence mortgage upon maturity. Increases to the fund are charged to residence ancillary operations. The value of the sinking fund is \$4,104,000 (2005 – \$3,809,000) and is included in investments at April 30, 2006.
- (b) The bank loan maturing in 2012 is unsecured and is subject to a 10-year interest rate swap agreement with the lending institution whereby the University receives a fixed interest rate of 6.25% while paying a floating rate on the notional principal amount of \$5,500,000.

The fair value of the agreement as at April 30, 2006 was in a net unfavourable position amounting to \$191,140 (2005 – \$381,908) and was based on amounts quoted by the lending institution.

- (c) The floating rate bank term loan is unsecured and is being amortized over 30 years. The loan is subject to a 30 year interest rate swap agreement with the lending institution whereby the University receives a fixed interest rate of 6.384% while paying a floating (10 year) rate on the notional principal amount of \$20,954,441.

The fair value of the agreement as at April 30, 2006 was in a net unfavourable position amounting to \$3,163,401 (2005 – \$3,784,554) and was based on amounts quoted by the lending institution.

- (d) The unsecured debentures bear interest at 6.15% payable semi-annually in April and October. The proceeds of the issue are being used to finance capital projects including the University Student Centre, the Michael DeGroote Centre for Learning and Discovery and various other academic and research buildings.

An internal sinking fund has been established to provide funds to repay the debenture principal upon maturity. Increases to the sinking fund are charged to operations. The value of the sinking fund is \$9,469,000 (2005 – \$8,275,000) and is included in investments.

9. DECOMMISSIONING OBLIGATION:

It is expected that at some undeterminable future date the McMaster Nuclear Reactor will be decommissioned. Under an agreement with the Canadian Nuclear Safety Commission (CNSC), a trust fund has been set up. An amount is being contributed annually to provide for these costs. As at April 30, 2006, the value of the trust fund is \$5,622,000 (2005 – \$4,700,000). The related investments restricted by the Board of Governors exclusively for this purpose are included in long-term investments. In total, the net present value of the estimated costs for decommissioning, at April 30, 2006, is \$5,163,000 (2005 – \$4,913,000) using a risk free rate of 5.10%.

10. INTERNALLY RESTRICTED NET ASSETS:

Internally restricted net assets consist of the following:

	2006	2005
(in thousands of dollars)		
Post-employment benefits:		
Pensions	\$ 128,542	\$ 144,335
Other employee future benefits	(94,804)	(79,293)
	33,738	65,042
Specific purposes:		
Unexpended departmental budgets	54,691	43,098
Other specific purposes	4,898	9,499
McMaster Innovation Park	—	(13,392)
	59,589	39,205
	\$ 93,327	\$ 104,247

Included in unexpended departmental budgets is a \$6,000,000 (2005 – \$0) advance to the Faculty of Science from unrestricted net assets for which arrangements are being negotiated for recovery.

11. INVESTED IN CAPITAL ASSETS:

Invested in capital assets is calculated as follows:

	2006	2005
(in thousands of dollars)		
Capital assets, net	\$ 570,842	\$ 515,493
Less amounts financed by:		
Long-term debt, net of sinking funds and unspent debenture	136,152	109,891
Internal bridge financing for new residence	13,703	—
Unamortized deferred capital contributions	284,591	284,159
	\$ 136,396	\$ 121,443

Details of the transfer for capital transactions are as follows:

	2006	2005
(in thousands of dollars)		
Repayment of long-term debt	\$ 828	\$ 778
Change in sinking funds	1,489	882
Internal bridge financing for new residence	(13,703)	—
Internally funded capital assets	57,784	40,965
	\$ 46,398	\$ 42,625

12. NET CHANGE IN NON-CASH WORKING CAPITAL:

The net change in non-cash working capital consists of the following:

	2006	2005
(in thousands of dollars)		
Research grants receivable	\$ (9,615)	\$ (7,503)
Accounts receivable	1,091	(7,548)
Government grants receivable	419	13,173
Inventories	273	(143)
Prepaid expenses	(194)	260
Accounts payable and accrued liabilities	28,483	1,486
Deferred revenue	7,579	4,658
	<u>\$ 28,036</u>	<u>\$ 4,383</u>

13. PLEDGES RECEIVABLE:

Outstanding pledges expected to be received in future years, not included in revenue and accounts receivable, are \$60,594,000 (2005 – \$71,673,000).

14. ONTARIO STUDENT OPPORTUNITY TRUST FUND:

Externally restricted endowments include grants provided by the Government of Ontario from the Ontario Student Opportunity Trust Fund matching program to award student aid as a result of raising an equal amount of endowed donations.

(a) Ontario Student Opportunity Trust Fund – Phase I

The following schedule represents the changes for the year ended April 30, 2006 and 2005 in the first phase of the Ontario Student Opportunity Trust Fund (OSOTF I) balance:

	2006	2005
(in thousands of dollars)		
Endowment balance, beginning of year	\$ 31,670	\$ 31,297
Investment income (provided from) preservation of capital	977	1,728
Investment income transferred to expendable income	(132)	(1,355)
Balance, end of year	<u>\$ 32,515</u>	<u>\$ 31,670</u>

	2006	2005
Funds available for awards, beginning of year	\$ —	\$ —
Investment income	1,074	(208)
Bursaries awarded (2006 – 892 awards; 2005 – 683 awards)	(1,206)	(1,147)
Investment income transferred from preservation of capital	132	1,355
Funds available for awards, end of year	—	—
Total funds at book value	\$ 32,515	\$ 31,670

The market value of the endowment as at April 30, 2006 was \$33,393,000 (2005 – \$30,312,000).

(b) Ontario Student Opportunity Trust Fund – Phase II

The Ontario government requires separate reporting of balances as at April 30, and details of the changes in the balances for the period then ended with respect to the second phase of the Ontario Student Opportunity Trust Fund (OSOTF II) of McMaster University including Divinity College.

Certain cash donations received are eligible for matching by the Ministry of Training, Colleges and Universities (MTCU). The following is the schedule of changes in the endowment balance for the thirteen months ended April 30, 2006 and the twelve months ended March 31, 2005:

	2006	2005
(in thousands of dollars)		
Fund balance, beginning of year	\$ 6,579	\$ 2,291
Unmatched cash donations transferred to OTSS (note 15)	(1,010)	—
Investment income (preservation of capital)	420	—
Cash donations received	—	2,196
Funds received from MTCU	—	2,092
Fund balance, end of year	\$ 5,989	\$ 6,579

The following is the schedule of changes in the expendable funds for awards for the thirteen months ended April 30, 2006 and the twelve months ended March 31, 2005:

	2006	2005
(in thousands of dollars)		
Balance, beginning of year	\$ 82	\$ 39
Investment income for expenditures	140	96
Bursaries awarded (2006 – 177; 2005 – 34)	(209)	(53)
Balance, end of year	13	82
Fund balance, end of year	5,989	6,579
Total funds at book value	\$ 6,002	\$ 6,661

The market value of the endowment as at April 30, 2006 was \$5,937,000.

15. ONTARIO TRUST FOR STUDENT SUPPORT:

Externally restricted endowments include grants provided by the Government of Ontario from the Ontario Trust for Student Support (OTSS) matching program to award student aid as a result of raising an equal amount of endowed donations. The Ontario government requires separate reporting of balances as at March 31 and details of the changes in the balances for the year then ended.

The following is the schedule of donations received for the year ended March 31, 2006:

	2006
(in thousands of dollars)	
Cash donations eligible for matching	\$ 1,739
Unmatched cash donations transferred from OSOTF II	1,010
Eligible for matching	2,749
Unmatched cash donations	1,830
Cash donations total	\$ 4,579

Certain cash donations received are eligible for matching by the Ministry of Training, Colleges and Universities (MTCU). The following is the schedule of changes in the endowment balance for the year ended March 31, 2006:

	2006
(in thousands of dollars)	
Fund balance, beginning of year	\$ –
Cash donations received with annual matching ceiling	4,579
Funds received/receivable from MTCU	2,749
Preservation of capital	79
Fund balance, end of year	\$ 7,407

The following is the schedule of changes in the expendable funds for awards for the year ended March 31, 2006:

	2006
(in thousands of dollars)	
Balance, beginning of year	\$ –
Investment income for expenditures	101
Bursaries awarded (2006 – 22)	(33)
Balance, end of year	\$ 68

16. COMMITMENTS AND CONTINGENCIES:

(a) Canadian Universities Reciprocal Insurance Exchange:

The University is a member of the Canadian Universities Reciprocal Insurance Exchange (CURIE), a self-insurance cooperative comprised of over forty Canadian universities and colleges. CURIE insures property damage, general liability and errors and omissions risks. If premiums collected are insufficient to cover expenses and claims, the University may be requested to pay additional amounts.

(b) Outstanding legal claims:

The University is involved in certain legal matters and litigation in the normal course of operations. With respect to claims outstanding at April 30, 2006, the University believes it has valid defenses and appropriate insurance coverage in place. In the event that any claims are successful, the settlements of such claims are not expected to have a material effect on the financial position of the University.

(c) Capital commitments:

The estimated cost to complete approved major capital projects is \$99,700,000 at April 30, 2006 (2005 – \$104,000,000). These costs will be financed by unexpended departmental budget reserves, government grants, fundraising, student contributions, bank financing, the proceeds of the \$120,000,000 debenture issue and future ancillary operations revenue streams.

(d) Other commitments:

The total annual minimum lease payments in each of the next five years under various operating leases for office equipment and buildings are approximately as follows (in thousands of dollars):

2007	\$ 4,060
2008	4,060
2009	4,060
2010	3,800
2011	3,100

17. RELATED PARTY TRANSACTIONS:

In addition to transactions and balances with McMaster Innovation Park as disclosed in note 4, the University had funds donated from the fundraising organizations disclosed in note 2(a) during the year that amounted to \$341,000 (2005 – \$43,000). McMaster's share of the income earned in the joint venture amounted to \$75,000 (2005 – \$39,000).

18. FAIR VALUE OF FINANCIAL INSTRUMENTS:

The carrying values of cash and equivalents, accounts receivable, grants receivable, accounts payable and accrued liabilities approximate their fair value due to the relatively short periods to maturity of these items or because of the current nature of the terms on these instruments.

Information concerning the fair value of investments is disclosed in note 3.

In view of the relationships and the indefinite terms of the instrument, the fair value of the investment in McMaster Innovation Park is not determinable.

The fair values of the respective debt instruments are presented in the following table:

	2006		2005	
(in thousands of dollars)	Book Value	Fair Value	Book Value	Fair Value
Long term debt with fixed interest rates	\$ 132,730	\$ 151,190	\$ 132,812	\$ 150,991
Long term debt with variable interest rates				
(without consideration of interest rate swaps)	\$ 24,416	\$ 24,416	\$ 25,162	\$ 25,162

The fair value of these debt instruments was calculated using the future cash flows (principal and interest) of the actual outstanding debt instruments, discounted at current market rates available to the University for similar instruments.

Information concerning the fair values of the interest rate swap agreements is disclosed in notes 8(b) and 8(c).

19. COMPARATIVE FIGURES:

Certain comparative figures for 2005 have been reclassified to the financial presentation adopted in the current year.



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