2007 – 2008
Financial Report to the Board of Governors

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"*The Mission of McGill University is the advancement of learning through teaching, scholarship and service to society: by offering to outstanding undergraduate and graduate students the best education available; by carrying out scholarly activities judged to be excellent when measured against the highest international standards; and by providing service to society in those ways for which we are well-suited by virtue of our academic strengths.*"

McGill University

FINANCIAL REPORT TO THE BOARD OF GOVERNORS

Year Ended May 31, 2008

Part I: Financial and Operational Highlights

Part II: Audited Financial Statements – May 31, 2008

PART I

PART I: FINANCIAL AND OPERATIONAL HIGHLIGHTS

Overview

This financial report provides a summary of the financial activities of the Royal Institution for the Advancement of Learning / McGill University ("McGill") for the year June 1, 2007 to May 31, 2008 and presents the financial position of McGill as at May 31, 2008. A presentation of the four funds: Operating, Restricted, Plant, and Endowment is provided, including highlights of changes affecting the accumulated deficit in the Operating Fund. Changes from the 2007-2008 original Budget (document GD06-41) are also presented. The various balance sheet items are analyzed, and an estimate for McGill's ongoing deferred maintenance requirement is provided as well. The audited financial statements of McGill are included in *Part II.*

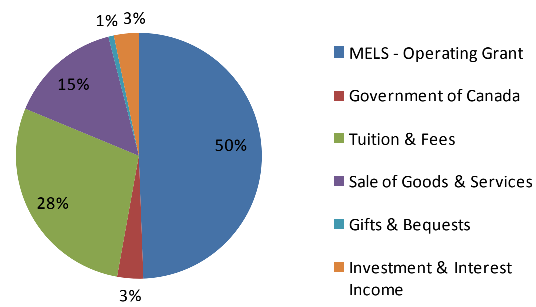
Sources of Revenue and Expenses

McGill's income is derived from various sources including:

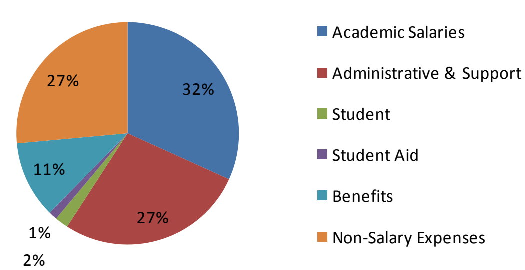
- Operating (Unrestricted) Fund – This fund derived 78% of its income from the Ministry of Education (MELS) operating grant, and tuition and fees. During the year, income from all unrestricted sources rose to $562.4 million as compared to $552.3 million (including an adjustment for the prior year of $8 million – see below), representing an increase of $18.1 million (3.3%), excluding the prior year adjustment.

  During the year, the University received additional operating grants relating to prior years' changes in student enrollments from MELS. As a result of this change, the May 31, 2007 Quebec government operating grant was restated and increased by $8 million, with an additional $6.2 million affecting the May 31, 2006 fiscal year. The restatement has resulted in a reduction of the opening accumulated operating deficit for the year ended May 31, 2008 to $43.8 million, as compared to the previously reported accumulated deficit of $58 million.

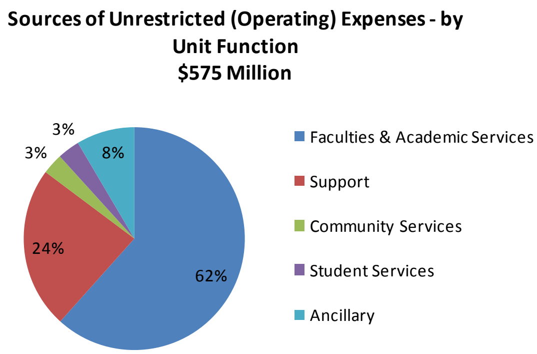
The following pie chart highlights the various sources of Operating (unrestricted) Fund revenue for the year ended May 31, 2008:



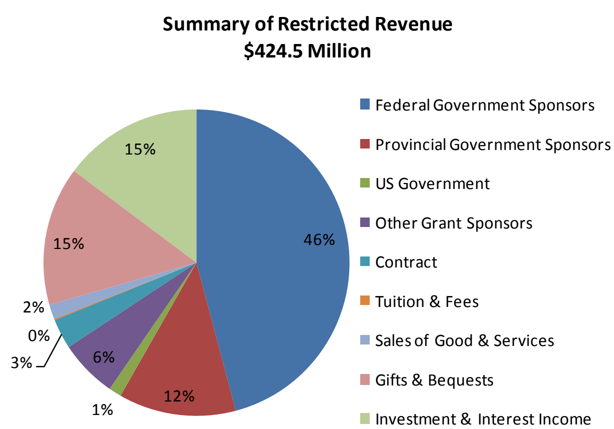
Total operating (unrestricted) expenditures required to fulfill McGill's teaching mission increased by $22.7 million (3.1%) over the prior year. Overall, total operating (unrestricted) expenses excluding operating transfers to other funds, increased to $575.4 million, as compared to $552.7 million in the prior year. Excluding the operating transfers, operating expenses in 2008 totaled $575.4 million as detailed below:



The total activities of the University are undertaken by various units/functions, including faculties, academic services (primarily libraries and information technology), and support units which account for 86% of total spending. The remaining units are considered self-financing, of which ancillary operations (i.e. bookstore, residences, parking, etc.) represent 8% of total expenses, as highlighted in the chart below.

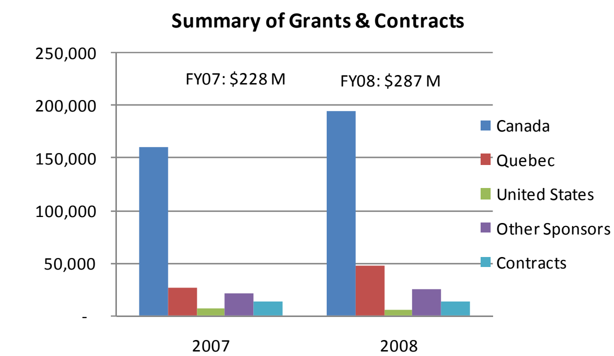


- <u>Restricted Fund</u> – Revenue is generated primarily for research purposes (69%), although restricted donations and endowment income account for an additional 29% of the total. This income is targeted to research, libraries, bursaries, scholarships, student loans, and other specific projects. Other sources of income account for 2%. Total restricted income for the year was $424.5 million, as compared to $339.3 million in the prior year. The chart below highlights the major sources of restricted revenues.



The increase of $85.2 million (25%) results primarily from an increase in research grant and contract revenues ($59.4 million). Gifts and bequests increased by $23.2 million, while the McGill Investment Pool (MIP) generated an additional $11.5 million, offset by a net decrease in other revenues of $8.9 million. The investment performance of the MIP will be highlighted in a separate detailed report, the *2007-2008 Report on Endowment Performance*, which will be presented to the Board of Governors later this fall.

Total revenue from grants and contracts totaled $287 million in 2008, an increase of $58.9 million (25.8%) from the prior year. Of the total increase, $31.3 million relates to direct grants, while $27.6 million is related to increased infrastructure grants. The following chart outlines the progression of grants and contracts over the last two years:

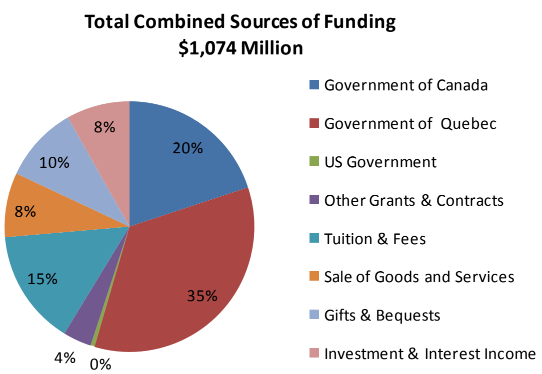


The Restricted Fund expenses include those with terms that are dictated by granting agencies (in the case of research grants or contracts) or the sponsoring party (i.e. donor gifts for student aid). These expenditures are classified as "restricted" due to the nature of the restriction imposed on the spending of these funds by individual grantors. Overall, restricted expenses increased to $360.6 million from a level of $314.7 million in the prior year. The majority of the $45.9 million increase is related to research activities commensurate with the increase in research revenues ($58.9 million). Of the total $361 million in expenses, approximately $172 million is spent on salaries and benefits (including student salaries and student aid of $73.3 million).
Of the total $189 million in non-salary expenses, over $75 million (40%) is spent on capital expenditures.

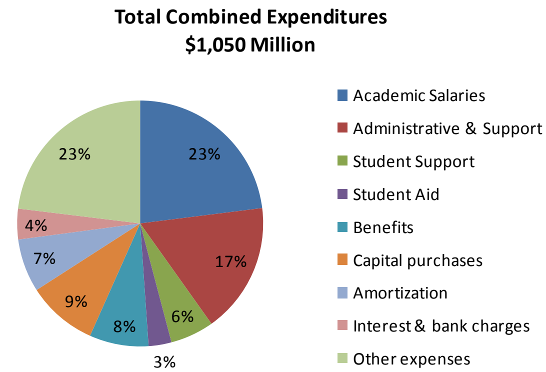
- Plant Fund – This fund derives its revenue from various sources including $40.9 million (75%) from provincial government grants, the majority of which (55%) is used to absorb the cost of long-term borrowing. The other major sources of revenues include $6.7 million from gifts and bequests received for specific capital projects, and $6.5 million from interest income charged to revenue-generating projects and unspent cash. Overall, revenue increased slightly to $54.4 million from $52.5 million in the prior year.

- Endowment Fund – This fund's only source of revenue is from gifts and bequests for designated endowed purposes. Total revenue in this fund was $32.7 million, as compared to $36.7 million in the prior year. All of this revenue resulted in the creation of individual endowments, of which the income generated is to be spent according to the Memorandum of Agreement entered into with donors.

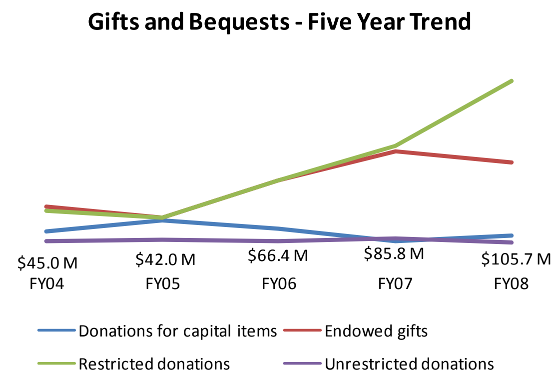
Total Combined Sources of Funding
The following pie chart presents a complete picture of the $1.1 billion total combined sources of funding generated to support McGill's mission.



Total Combined Expenditures
Total combined expenses incurred to support McGill's activities were $1.1 billion in 2008. The following pie chart illustrates the breakdown of these expenses.



Specific Sources of Funding
During 2007-2008, a total of $105.7 million in gifts and bequests revenue was generated for teaching and research activities. This represents a 23% increase over the prior year's totals ($85.8 million) of cash gifts and pledges, as illustrated in the chart below:



The Annual Report on Private Giving provides comprehensive details of the total gifts and bequests. Campaign McGill is expected to generate a total of $750 million. Once the campaign has ended, the steady state annual inflow of gifts and bequests is expected to exceed $100 million.

Overall, Plant Fund gifts are received for the purposes of acquiring specific assets and may also include contributions to finance specific buildings and other assets. During the year, several gifts totaling $6.7 million were received to upgrade the McIntyre, Bronfman, and Trottier buildings, as well as the Ludmer Research and Training building. Gifts for the Molson

Stadium and other athletics projects were also received. In the prior year, several large donations (totaling $4.7 million) were received for some of the same buildings and other renovation projects.

All donations received in the Endowment Fund were endowed, based on the specific wishes of the donors.

In addition to donations, the capital (i.e. fund balance) of the endowment was enhanced by total realized earnings of $67.1 million (2006-07: $56.1 million) generated by the McGill Investment Pool (MIP). The year-over-year increase of $11.0 million was a result of additional investment income ($1.2 million) and an increase in capital gains realized on the sale of investments ($9.8 million). The market value of the Endowment Fund investments decreased to $902.4 million at May 31, 2008, as compared to $913.8 million one year earlier, in large part due to a decrease in unrealized market value ($65.6 million) at year end. Consistent with McGill's policy of distributing 5% of investment earnings to the beneficiaries of the endowments, $44 million (2006-07: $41.5 million) was distributed in 2008. Amounts earned in excess of the amount distributed were returned to the Endowment Fund via an inter-fund transfer ($22.4 million). In the previous fiscal year, the amount returned to the Endowment Fund was $13.8 million.

Operating Results for 2008

The overall accumulated operating deficit position of the University is $60.1 million versus a budgeted $73.4 million. Although the increase in accumulated deficit of $16.3 million is $0.9 million greater than budgeted, the $14.2 million reduction in accumulated deficit resulted in a net increase of $2.1 million to the reported deficit of $58 million in fiscal 2007.

In 2008, overall operating revenues were $4.7 million greater than budgeted. The following individual items below represent changes between actual and budgeted revenues.

- Federal Indirect Cost of Research (-$0.6 million).
- MELS grant (-$1 million).
- International undergraduate tuition (-$1 million). This was offset by a net increase of $0.4 million in administrative fees.
- Sale of goods and services from core activities (+$1 million); sale from individual self-financing activities (+$3.0 million).
- Undergraduate gifts and bequests (-$0.5 million).
- Short-term interest (+$1.1 million).
- Investment income reported (+$2.3 million). This variance is due to the under-distributed endowment investment income which is effectively transferred back to the Endowment Fund.

The 2008 operating expenses were affected by the two significant expense components (salary and non-salary). The items below represent individual expense amounts incurred over amounts budgeted.

1) Salaries and benefits were $9.1 million greater than budgeted including the following significant items:

- Academic salaries (+$2.5 million) due to net arrivals (including fewer departures than anticipated).
- Administrative and support staff (+$0.2 million).
- Student support (+$3.5 million); spending supported by the increase in the sale of goods and services.
- Student aid (+$1.5 million); supported by use of prior year carryforwards.
- Overall benefits expense (+$1.4 million).

2) Non-salary expenses were ($8.9 million - non-salary net) lower than budgeted. The budgets at the local unit levels are primarily managed on a global basis, and as a result, the majority of the unit's

non-salary budgets are held in "other non-salary expenses," but are incurred in the various areas depending on the year.

- The variance in other non-salary expenses budgets ($29.7 million) was used to pay for spending (vs. budgets) in the following areas:

  - Materials, supplies, and publications: $3.2 million.
  - Professional fees: $7.8 million.
  - Travel: $4.2 million.
  - Capital purchases: $15.6 million

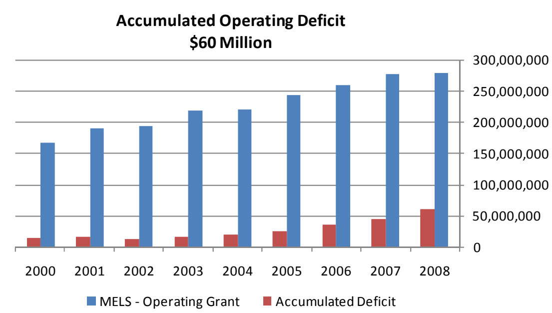
- The unspent budgets in building costs ($8.8 million) were largely offset by (above budget) contract services spending ($5 million).
- Energy costs benefitted from a $1.7 million valuation gain associated with a gas contract (derivative instrument).
- Overall interest costs were $1.4 million lower than budgeted in large part due to lower borrowing levels and lower cost of borrowings realized during the year.
- The cost of sales and services rendered were $3.5 million below budget due to better cost control in the residences and in other areas such as the Bookstore.
- Net inter-fund transfers out of the Operating Fund were $3.1 million greater than budgeted.

These activities translated into an increase in the accumulated operating deficit of $16.3 million (net of inter-fund transfers).

The 2007-2008 approved budget deficit was $15.4 million. In March 2008, our forecast of the year-end position indicated an increase of $1.5 million to the operating deficit, which was primarily affected by increased expenses.
At year-end, the annual operating deficit was $0.6 million lower than that forecasted in March and $0.9 million greater than originally budgeted, as a result of various changes in both revenue and expense spending in certain areas.

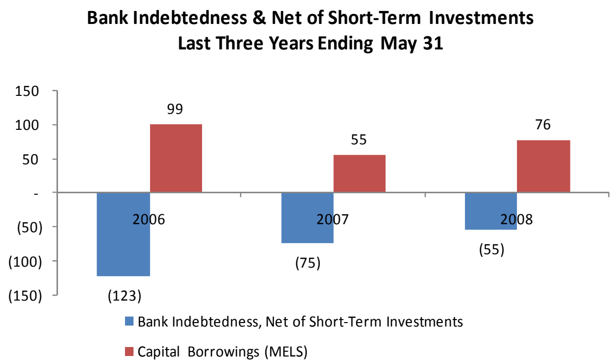
Accumulated Deficit – Operating Fund
The current year accumulated deficit has increased from its May 31, 2007 previously reported level of $58 million (excluding the effect of the prior period adjustment) to $60.1 million (as compared to a budgeted accumulated deficit of $73.4 million) as at May 31, 2008. The prior period adjustment, as described on page one, has resulted in a restatement of the opening accumulated operating deficit to $43.8 million from $58 million.

The following graph outlines the evolution of the Operating Fund accumulated deficit and that of the MELS operating grants.



Balance Sheet
McGill's four funds capture the total assets, liabilities, and fund balances.

- <u>Operating (Unrestricted) Fund</u> – This fund captures all of the working capital associated with the operations of McGill, including its overall cash position with outside lenders. The Board of Governors has authorized a maximum of $250 million in bank borrowings. As at May 31, 2008, McGill had a bank indebtedness of $79.9 million, as compared to $122.5 million one year earlier. Bank indebtedness, net of short-term investments, was $54.9 million (2007: $75 million). This decrease in bank indebtedness ($42.6 million) is due to the issuance of $75 million of long-term debt by the Province, offset by increases in accumulated deficit and campus renewal loans and decreases in non-cash working capital. The following chart outlines the progression of the cash position over the last three years, as compared to the level of capital borrowing on behalf of MELS. The timing of the issuance of long-term debt is totally dictated by the Ministère des Finances du Québec.

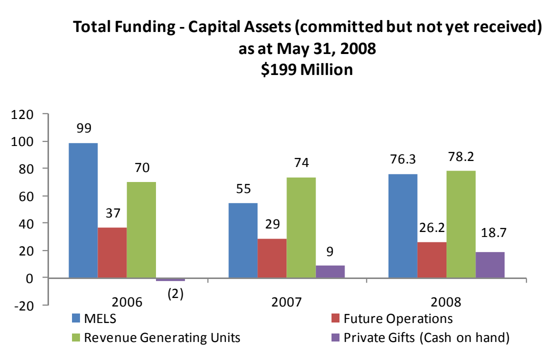


- Restricted Fund – The majority of the Restricted Fund assets are used to support restricted activities, as specified by the individual donors or granting agencies. Total Restricted Fund assets increased to $495.9 million, as compared to $459.2 million one year earlier. Of the total assets, $355.8 million is due from either granting agencies or donor pledges. Other assets include $6.4 million in investments and marketable securities, $4.1 million in student loans receivable and other assets, and $129.6 million in net cash received in advance of spending.

- Plant Fund – Total assets in this fund were $1.15 billion (net of "due to other funds") as at May 31, 2008, as compared to $1.13 billion one year earlier. Of the total, capital assets accounted for $1.1 billion as compared to $1.047 billion in 2005-2006. In addition, $4.1 million was held in cash and short-term deposits and marketable securities (excluding $32.6 million temporarily used to reduce overall bank borrowings), as a direct result of the bond proceeds generated in 2002-2003. Other assets amounted to $14.3 million. The majority of financing relating to the total $1.054 billion of Plant Fund assets (56%) is by way of long-term debt ($588 million) issued primarily through bonds, including the $150 million in McGill Senior Debentures. The remaining financing is by way of suppliers (2%) and capital fund balances (42%). During the year, total long-term debt increased by a net $11.3 million (prior year: $58.2 million), as new long-term debt was issued and applied against maturing bonds and outstanding capital borrowing.

The total funding for capital projects committed, but not yet received, at May 31, 2008 was $199.4 million. Of this total, $76.3 million is expected to be received from MELS relating to annual and specific capital grants. Total borrowings of $26.2 million remain for deferred maintenance / campus renewal and other projects, which will be repaid from future capital grants and internal sources. A total of $26.3 million is expected from future donations, while $7.6 million in private gifts has been received in advance for future projects from private gifts (resulting in a reduction in overall borrowings).

In addition to the above, it is expected that $78.2 million will be recovered in the future from revenue-generating units, such as residences, and other similar operations. These amounts were invested using the proceeds of the $150 million McGill Senior Debentures (Bond Fund).
The following bar chart outlines the three years of outstanding sources of funding which, when received, will reduce short-term borrowings.



- Endowment Fund – These assets stand at $902.4 million as at May 31, 2008, as compared to $913.8 million one year earlier. Included in the $902.4 million total is an unrealized market value of $105.1 million, as compared to $170.7 million in the prior year. In addition, the May 31, 2008 asset total includes $150.5 million in accumulated investment income. All of these assets are managed as part of the McGill Investment Pool.

Deferred Maintenance – Campus Renewal
McGill estimates that its outstanding deferred maintenance requirements total approximately $650 million. These requirements have been classified in four priority categories as follows:

Priority	Descriptor	Timeframe	Total
1	Urgent	1 yr	$139 M
2	Essential	1-2 yrs	$212 M
3	Desirable	5 yrs	$230 M
4	Planned	after 5 yrs	$ 69 M
			$650 M

In the fall of 2007, the Quebec government announced a new $1 billion funding plan for the university sector over 15 years to help address the deferred maintenance problem common to all universities. This new money will bring to approximately $25 million the annual amount available for deferred maintenance purposes which McGill has and will likely supplement, from time to time, with borrowings of up to $10 million per year.

University Services has initiated an estimated $100 million in deferred maintenance projects that will be undertaken over the next three years. With the funding that is available, it is anticipated that an additional $25 to $35 million worth of projects will be initiated each year from this point forward.

With the passage of time however, "essential" items will gradually become "urgent" issues, therefore, it is evident that more financial resources will be required to deal with the deferred maintenance problem, either acquired or internally generated. Furthermore, due to the difference between available capital funding and that needed to maintain our facilities, additional deferred maintenance items will continue to be added to our inventory over time. Overall, it is estimated that McGill would need to invest approximately $60 million per year in the maintenance and renovation of our infrastructure in order to reduce our maintenance backlog to an acceptable level in 15 years. Given our current level of capital funding for renovations and deferred maintenance, we would need an additional minimum amount of $25 million per year to achieve this.

Multi-Year Planning
Strategic planning and multi-year resource allocation have become very familiar terms to the McGill community.

McGill is engaged in a comprehensive, academically-driven planning process that will impact virtually every aspect of its operations including finances, administrative services, physical resources, and University goals and activities with respect to philanthropy and government relations. It is a demanding but crucial process as we aim to build on our exceptional teaching and research strengths for the future. The competition for talent and resources has never been as fierce – and this competition is worldwide. If we are to sustain and build on our academic strengths, impact, and reputation, consistent with our mission, we must be selective and strategic in our activities, investments, resource generation, and expenditures. The purpose of this process is to identify the academic priorities and objectives of every faculty and McGill as a whole, implement plans to achieve them, and measure our progress with discipline.

The implementation of the Academic Plan, included in the White Paper (McGill's Strategic Plan), necessitated upfront investments and consequently placed McGill in an operating deficit position in its initial years with the aim of re-establishing a balanced budget in the

Plan's latter years. This approach has been adopted by many North American research-intensive universities. Indeed, many have used this planning approach for some time as a means of improving academic quality and distinctiveness.

The purpose of the new investment is to enable McGill to achieve its academic goals, provide increased leveraging of resources, advance student and administrative support, and provide accountable and enhanced investment in new and current programs, technologies, administrative infrastructure, and other priority initiatives. It will support McGill in sustaining and advancing its leadership position amongst Canadian and North American public university peers.

McGill's multi-year Resource Planning Model has been created to support the Academic Plan. The Model assumes that we will fund our plans through reallocations and newly-generated revenue versus internal base budget reductions during the five-year planning horizon. Mechanisms have been built into the model to allow for the flexibility to introduce across-the-board and/or selective reductions in expense budgets should they prove to be necessary.

As indicated earlier, our May 31, 2008 accumulated operating deficit stands at $60.1 million, as compared to a budgeted $73.4 million, as at May 31, 2008. In the Provost's Fiscal 2009 Budget Report, a $10 million operating deficit was approved. The current multi-year plan calls for a balanced position by Fiscal 2011, assuming expectations prevail, at which time the accumulated operating deficit is likely to be approximately $75 million – based on the restated position.

Financial Position – Debt Rating View

In December 2007, Moody's Investors Services and Standard & Poor's Rating Service reaffirmed McGill's long-term debt ratings affecting $150 million of unsecured debentures.

Moody's confirmed an Aa1 rating and a continued stable outlook. It considers McGill to be one of Canada's most prominent and internationally renowned institutions and cites the following factors for the rating:

- Strong domestic and international student demand.
- Leading research role enhances strong competitive position – McGill is one of Canada's most prominent educational and research institutions.
- Government relationship – McGill benefits from a greater degree of independent financial strength than other Quebec universities.
- Governance and management – The University employs a multi-year strategic plan that integrates academic, research, and financial objectives. Debt management and investment policies are conservative.
- Operating performance – The University benefits from a diversity of revenue sources that buffer operations from reductions in any one source.
- Debt profile - McGill's low debt burden contributes to its strong credit profile.
- Balance sheet strength – McGill's substantial financial resources provide key support to the rating.

Standard & Poor's confirmed an AA- rating and continued a stable outlook in April 2008, citing that McGill has:

- Good balance sheet strength.
- Strong demand and research profile.
- Good operating and capital support from the province of Quebec (A+/Positive/A-1+).
- Relatively low debt, thereby maintaining its strong net creditor position.

Recent Developments

Over the past several months, potential changes have either been discussed or initiated by MELS which are expected to result in a different financial presentation than that currently adopted. These are as follows:

- As a result of directives issued by the Quebec Auditor General, MELS is expected to require that we adopt Generally Accepted Accounting Principles (GAAP) in the presentation of financial results for the current fiscal year. This change will bring about the recognition of significant liabilities on our balance sheet which MELS has dictated that we not record in the past. Note 2 of the Audited Financial Statements outline the current significant departures from GAAP. Although MELS has hired consultants to advise them on the impact of these changes, we believe that there will be a significant liability created due to our post-employment and retirement benefits. Over the course of the next months, we will work with our external professionals to identify the appropriate assumptions and parameters to be used in these calculations. It is still unclear as to what financial compensation will be provided from MELS to offset this likely (non-cash) increase to our accumulated deficit.

- MELS has also informed us of their strong intention to have all university fiscal financial year-ends coincide with their March 31 year-end. Consistent with this objective, they have passed legislation to change the University of Quebec's (U de Q) year-end from May 31 to March 31. Our current working assumption is that we will also be asked to change our year-end.

- Going forward, our budget model will need to incorporate new "non-cash" elements of expenditures which were previously accounted for on a cash (i.e. pay as you go) basis. For example, post-employment and retirement costs currently paid and expensed amount to $3.2 million, which is less than the future annual actuarial cost that we will be accounting for. MELS is also likely to adopt a different GAAP associated with restricted contributions (i.e. grants, restricted gifts, etc.). In the past, MELS required that the Restricted Fund method be chosen to account for restricted contributions. As a result, research grants, for example, are recorded on an accrual basis (prior to the receipt of cash) as award notices are confirmed. This method usually results in a fund balance at the end of the year, as revenues exceed expenses due to delays in spending. Under the alternative choice, i.e. deferral method, these same research grants would only be recognized to the extent expenses are incurred - resulting in a balance position. Any excess revenues received are reported on the balance sheet as deferred revenue. This will reduce the overall fund balance, as currently reported.

François R. Roy
Vice-Principal (Administration and Finance)

September 2008

PART II