UNIVERSITY OF ALBERTA

Financial Statement Discussion and Analysis

For the Year Ended March 31, 2016

The financial statement discussion and analysis should be read in conjunction with the University of Alberta annual audited financial statements. The discussion and analysis and the audited financial statements are reviewed and approved by the University of Alberta Board of Governors on the recommendation of the University of Alberta Audit Committee. The university's financial statements have been prepared in accordance with Canadian Public Sector Accounting Standards.

For more in-depth discussion and analysis of the university's goals and objectives please refer to the following documents:
2016 Comprehensive Institutional Plan, Dare to Discover: A Vision for a Great University, Investment Reports.
http://uofa.ualberta.ca/reporting

The financial statement discussion and analysis provides an overview of the university's:

- Summary of Financial Results
- Revenue and Expense
- Capital Acquisitions
- Net Financial Assets
- Net Assets
- Areas of Significant Financial Risk

Change in accounting policy

Endowment contributions and associated investment income capitalized are recognized in the consolidated statement of operations in the period in which they are received. In prior years, such transactions were recognized as direct increases to endowment net assets. Unrealized gains and losses related to endowments are now recognized in the consolidated statement of remeasurement gains and losses.

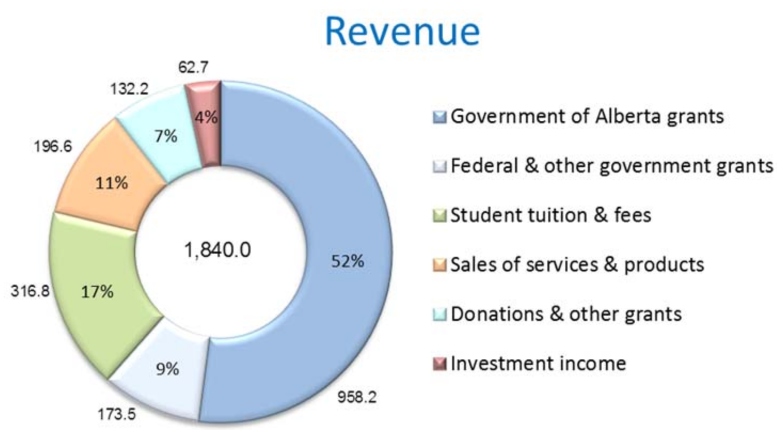
Comparative figures

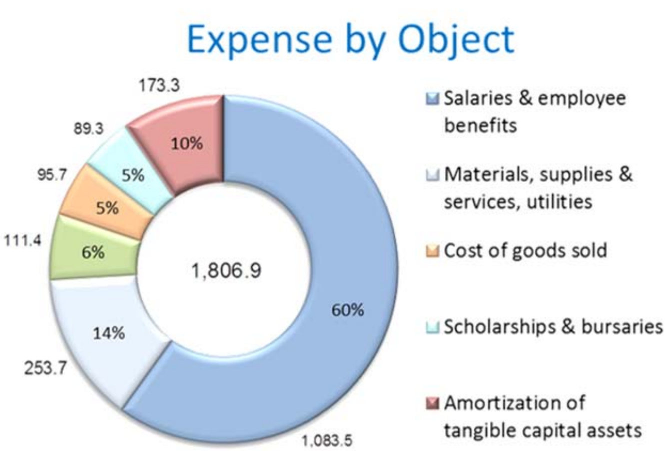
The net financial assets (net debt) model with reclassification of comparatives has been adopted for the presentation of the March 31, 2016 consolidated financial statements. In addition, certain other 2015 comparative figures have been reclassified to conform to the 2016 presentation.

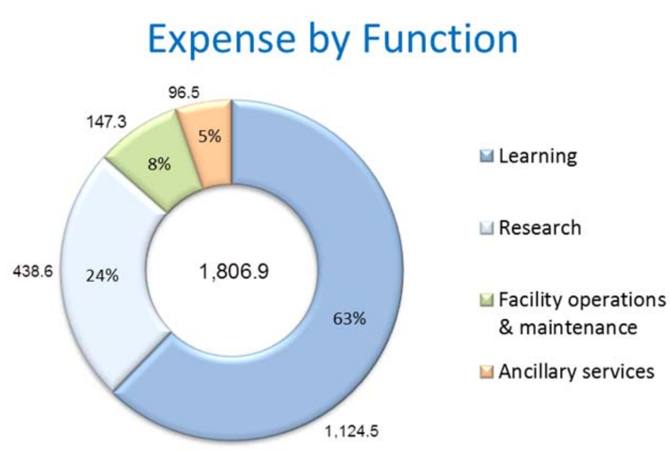
Summary of Financial Results

The university ended the year with an annual surplus of $62.4 million. Of this amount $29.3 million are donations directed to endowments and endowment capitalized investment income and therefore is not available for spending. The annual operating surplus of $33.1 million is more than the $23.2 million budget mainly due to a timing delay on expenditures by faculties and administrative units across the institution. Some of the expenditure timing delay is attributable to salary obligations that may arise from an academic salary settlement. The annual operating surplus was used for purchases of capital assets and debt repayment.

Net assets of $1,677.3 million decreased slightly from the prior year (2015: $1,688.7). The decrease is due to a decrease in endowment fair value partially offset by an increase in the investment in tangible capital assets.

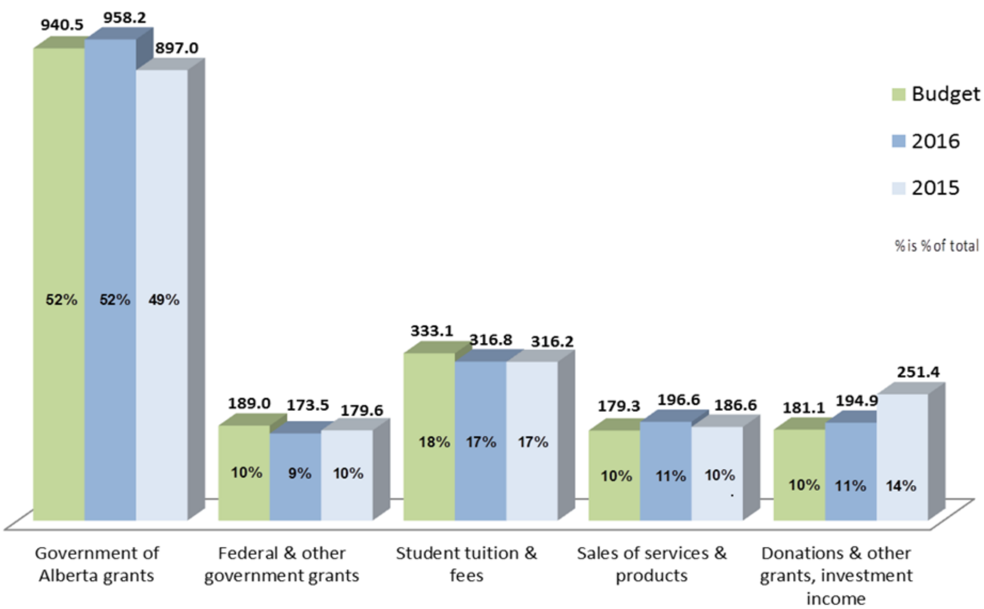






Revenue

Total revenue for the year was $1,840.0 million, an increase of $9.2 million over the prior year and $17.0 million (0.9%) more than budget. Government of Alberta grants are the single largest source of university revenue at 52% of total revenue.



Government of Alberta grants (GoA) represent the university's single largest source of funding for university activities. The GoA has increased the Campus Alberta (base operating) grant by 2%, while the university had budgeted for 0%. GoA grants are also more than budget due to base funding provided in place of tuition fee freezes.

Federal and other government grants primarily support the university's research activities. Grants are less than budget due to lower than budgeted research grants.

Student tuition and fees budgeted increase is based on the increase in instructional fees (linked to annual CPI increase), market modifiers, program differential fees and international student fees. Fees have been rolled back to 2014-15 levels and frozen causing a budget variance. GoA has replaced this funding with an infusion of cash that will show in grant revenues. Mandatory non-instructional fees have been rolled back and frozen as well, without replacing funding.

Sales of services and products revenues are generated by ancillary services and faculties and administrative units to both individuals and external organizations. Ancillary services generated sales of $92.2 million, while other units generated sales of $104.4 million. Sales revenue is more than budget due to a general increase across many faculties and administrative units.

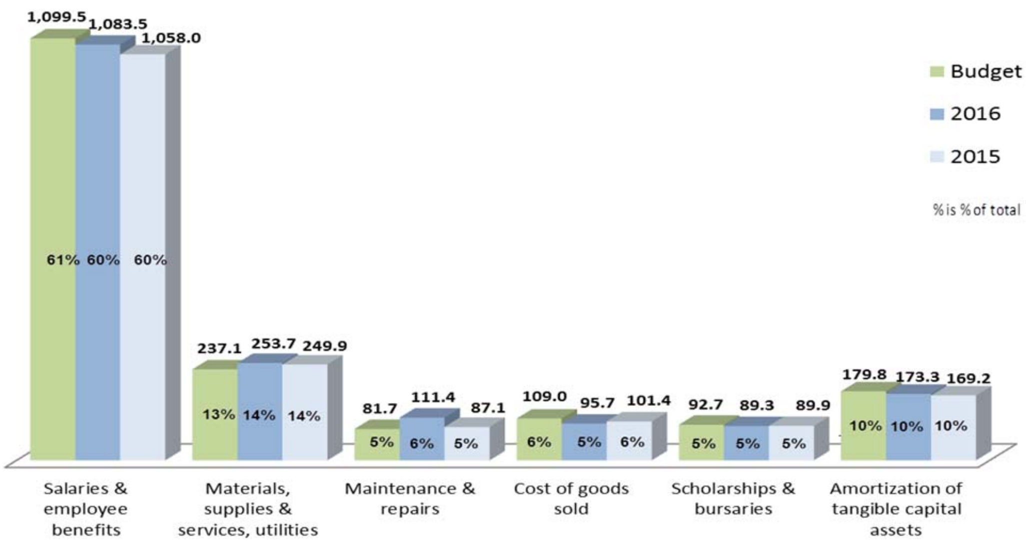
Donations and other grants support many university activities. Donations revenue is $24.9 million more than budget. Donations include an in kind donation of $13.0 million for the Students' Union Building renovations.

Investment income is $11.2 million less than budget mainly due to lower than budgeted endowment spending resulting in lower than budgeted revenue recognized. Investments fall into two categories, the Unitized Endowment Pool (UEP) and the Non-Endowed Investment Pool (NEIP). The UEP had a loss of (0.4%) (March 2015: 15.3% return) and represents the majority of the university's long-term investment strategy. The NEIP investments which are allocated to the short-, mid- and long-term investment strategies had a return of 0.6% (March 2015: 4.7% return).

Expense

Total expense for the year was $1,806.9 million, an increase of $51.4 million over the prior year and $7.1 million (0.4%) more than budget. Salaries and benefits are the single largest expense representing 60% of total expense.

Expense by Object



Salaries and employee benefits are less than budget. There has been no collective agreement in place since July 2015 for academic staff. Expense is less than budget in the research fund due to lower than budgeted research grants.

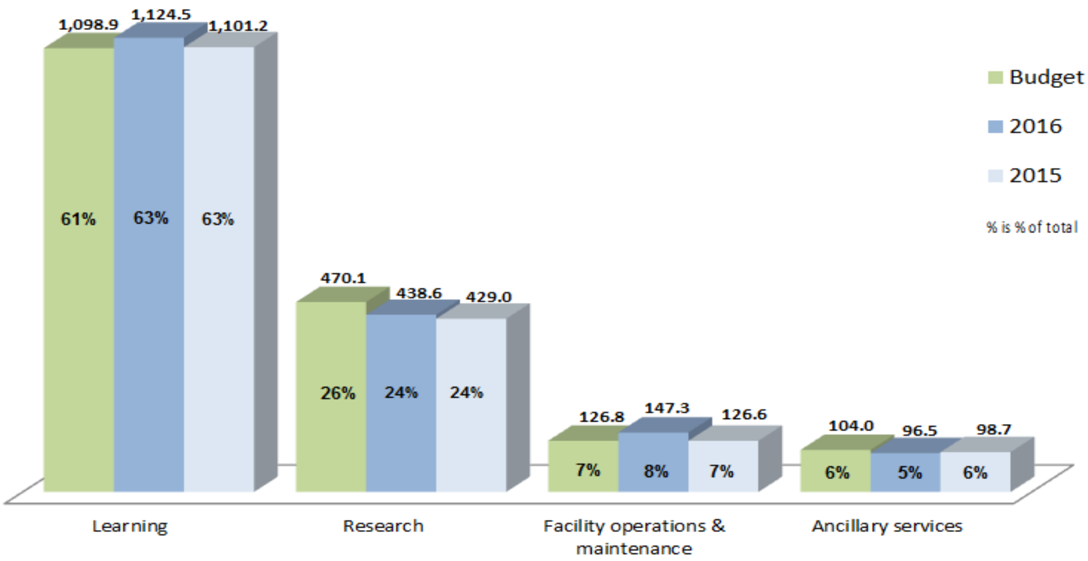
Materials, supplies and services are more than budget due to an increase in expenditures across the institution's operating funds. Utilities are less than budget due to lower rates and consumption. Expense is less than budget in the research fund due to lower than budgeted research grants.

Maintenance and repairs are more than budget due to a major renovation project which was funded, however not budgeted.

Cost of goods sold is less than budget in the Utilities ancillary due to lower utility rates.

Other remaining expenses are comparable to budget.

Expense by Function



Learning effectively represents the operating activities of the university and therefore a significant component of this category is staff salary and benefit costs. Learning also represents non-research activity funded though restricted grants and donations and includes undergraduate student scholarships, student bursaries, teaching and learning programs, and community service. This expense is comparable to budget.

Research activities expenses are funded by restricted grants and donations as well as internal funds designated for research related spending. This expense is less than budget due to lower than budgeted grants.

Facility operations and maintenance represents the cost of maintaining university facilities and grounds. This expense is more than budget due to a major renovation which was funded, however not budgeted.

Ancillary services include the university bookstore, parking services, utilities and student residences. Ancillary services are less than budget as a result of lower utility rates and a net overall lower than budgeted expenses across all ancillaries.

Capital Acquisitions

The university expended $149.9 million (2015: $200.7) on construction and other tangible capital asset acquisitions.

The most significant construction and capital asset acquisitions in 2016 are:

- Peter Lougheed Hall – a student residence associated with the University of Alberta's Peter Lougheed Leadership College.
- Students' Union Building – a significant renovation to update the building, including expanded social and study space.
- Donadeo Innovation Centre for Engineering – to support expanded educational and research activities.

(in millions of dollars)

Net Financial Assets (Net Debt)

The university's liquidity needs are met primarily through operating cash flows, working capital balances and capital expansion funding received through grants or long-term debt. Net financial assets (net debt) is a measure of an organizations ability to use its financial assets to cover liabilities and fund future operations. The university presents the net financial assets indicator as directed by the Controller of the Province of Alberta.

The university's presentation of net financial assets (net debt) includes $1,149.7 million of portfolio investments that are restricted for endowments. Endowment restricted investments represent contributions from donors that are required to be maintained intact in perpetuity, as well as capitalized investment income that is also required to be maintained in perpetuity to protect the economic value of the endowment. Therefore these investments cannot be used to pay for liabilities or future operating or capital purchases. As a result, university management also monitors an adjusted indicator, which management believes is important in evaluating the assets the university has available for future spending.

	2016	2015
Net financial assets (as presented in statement of financial position)	**$ 915.7**	$ 959.1
Less portfolio investments - restricted for endowments	**(1,149.7)**	(1,181.5)
Adjusted net financial assets (net debt)	**$ (234.0)**	$ (222.4)

The adjusted net financial assets (net debt) position indicates that the university has a deficiency. The deficiency can be attributed to employee future benefit liabilities (2016: $259.1; 2015: $253.4) which include the Universities Academic Pension Plan (UAPP) (2016: $170.7; 2015: $167.8) and other benefit plans such as supplementary retirement, long-term disability and early retirement (2016: $88.4; 2015: $85.6). The UAPP has a plan in place to address the unfunded liability and the university plans to use working capital to fund the other benefit plans (refer to the employee future benefit liabilities note in the financial statements for further information).

Net Assets

	2016				2015			
	Accumulated deficit from operations	**Investment in tangible capital assets**	**Endowments**	**Total**	Accumulated deficit from operations	Investment in tangible capital assets	Endowments	Total
Net assets, beginning of year	**$ (2.2)**	**$ 509.4**	**$ 1,181.5**	**$ 1,688.7**	$ (50.3)	$ 493.6	$ 993.7	$ 1,437.0
Annual operating surplus	**33.1**	**-**	**-**	**33.1**	75.3	-	-	75.3
Endowments								
New donations	**-**	**-**	**20.9**	**20.9**	-	-	79.7	79.7
Capitalized investment income	**-**	**-**	**8.4**	**8.4**	-	-	27.0	27.0
Transfer to endowments	**(0.8)**	**-**	**0.8**	**-**	(2.5)	-	2.5	-
Tangible capital assets, net	**(42.0)**	**42.0**	**-**	**-**	(15.8)	15.8	-	-
Change in accumulated remeasurement gains	**(11.9)**	**-**	**(61.9)**	**(73.8)**	(8.9)	-	78.6	69.7
Net assets, end of year	**$ (23.8)**	**$ 551.4**	**$ 1,149.7**	**$ 1,677.3**	$ (2.2)	$ 509.4	$ 1,181.5	$ 1,688.7
Net assets is comprised of:								
Accumulated surplus	**$ (42.0)**	**$ 551.4**	**$ 1,031.1**	**$ 1,540.5**	$ (32.2)	$ 509.4	$ 1,001.0	$ 1,478.2
Accumulated remeasurement gains	**18.2**	**-**	**118.6**	**136.8**	30.0	-	180.5	210.5
	$ (23.8)	**$ 551.4**	**$ 1,149.7**	**$ 1,677.3**	$ (2.2)	$ 509.4	$ 1,181.5	$ 1,688.7

Endowments consist of restricted donations and capitalized investment income which is required to be maintained intact in perpetuity to support donor specified activities. They support a variety of key initiatives in the areas of academic programs, chairs and professorships, research and scholarships. Endowment spending allocation was $35.7 million (2015: $33.2). Prior year endowment donations included the capitalization of an Access to the Future Fund grant ($54.4).

Tangible capital assets (net) include acquisitions, debt repayment, new financing and amortization.

The decrease in remeasurement gains is due to a decrease in fair value and recognizing realized gains into revenue. Of the $61.9 million change in accumulated remeasurement for endowments, $27.9 million is a decrease in fair value and $34.0 million is recognized into revenue ($25.6 deferred revenue (endowment spending allocation); $8.4 recognized as revenue and then capitalized to endowments).

Areas of Significant Financial Risk

The university operates in a complex environment and must deal with a variety of risks which it manages through its integrated enterprise risk management framework. The major risks that can affect the university from a financial perspective are as follows:

Provincial Funding

The Campus Alberta (base operating) grant was increased by 2% for both fiscal years 2016 and 2017. GoA grants represent the university's single largest source of funding for university activities, any reduction in the Campus Alberta or Academic Alternative Relationship Plans (AARP) grants result in significant budgetary pressure. AARP grants provide funding for a significant number of professors at the Faculty of Medicine and Dentistry permitting them to do teaching and research as well as clinical practice.

The university recognizes that funding models are changing for public universities throughout the global post-secondary sector and that universities are expected to generate a greater proportion than in the past of the operating revenues that sustain and enhance the quality of its research and the student experience. The university is pursuing steps which include but are not limited to growing its endowment, generating new net revenues, increasing federal government support for the indirect costs of research, and leveraging the establishment of its land trust. Initiatives to generate revenue are centered mainly in the faculties and include activities such as full cost recovery programs and expansion of international enrolment.

The GoA has signaled it will review the funding model and tuition regulation within the next year.

Salaries

The province is in the process of developing essential services legislation for Alberta's public sector that aligns with the Supreme Court decision on the right to strike. This new legislation will apply to non-academic staff at post-secondary institutions and therefore may have an impact on future salary negotiations.

Pension and Employee Future Benefits

The university currently carries a liability of approximately $259 million for employee future benefits, representing probable future payments for benefits earned to date. This balance can change for many reasons outside the university's control, including inflation and investment returns.

On the whole, the university's cost of benefits is expected to increase by between 5% and 7% per year in the upcoming years and this is not sustainable. Approximately 61% of the university's non-pension benefit costs relate to programs the university and its staff co-operatively manage and change through negotiation.

The largest of the unfunded liabilities is the university's share of the UAPP, which is approximately $171 million. Both the UAPP and PSPP deficiencies are expected to be eliminated within approximately 12 years, based on conditions at the time of the last actuarial valuations when the new contribution rates were set. The continuing increase in pension plan contributions represents a significant risk. Without structural reforms to the pension plans, the level of pension plan contributions as a percentage of total benefit costs could reduce other possible expenditures on staff.

Information Technology

The university spends approximately $95 million per year on information technology to develop and support systems. There are risks in this area that could result in financial and reputational issues.

Deferred Maintenance

The university's deferred maintenance is estimated at over $800 million. While the university is making progress on deferred maintenance on its older facilities, the overall amount of deferred maintenance remains relatively unchanged. This area remains a high priority as deferred maintenance puts some risk on the university's programs and initiatives. The continuation of appropriate levels of Infrastructure Maintenance Program funding is needed to avoid a return to increasing amounts of deferred maintenance.