

Northwest Area Foundation Treasurer's Report

The Northwest Area Foundation (NWAf) is committed to helping communities in our eight-state region reduce poverty. We pursue this mission through the delivery of three programs: Connections, Horizons, and Ventures. We support these programs in several ways: through 10-year partnership investments in the form of grants to community organizations; contracts with those who assist communities in building their capacities to design and lead poverty-reduction efforts; and through Foundation staff who work directly with communities. During fiscal year 2004, program costs were distributed in the following manner: 63.2 percent to Ventures, 22.9 percent to Connections, and 13.9 percent to Horizons.

As a private foundation, NWAf is required by the IRS to spend approximately 5 percent of its average asset value in "qualifying" distributions—grants and expenses that further our charitable mission. Private foundations have two fiscal years to meet each annual requirement. For the past two years, this "payout ratio" of qualifying distributions to asset value is 5.7 percent for FY04, and 4.2 percent for FY03.

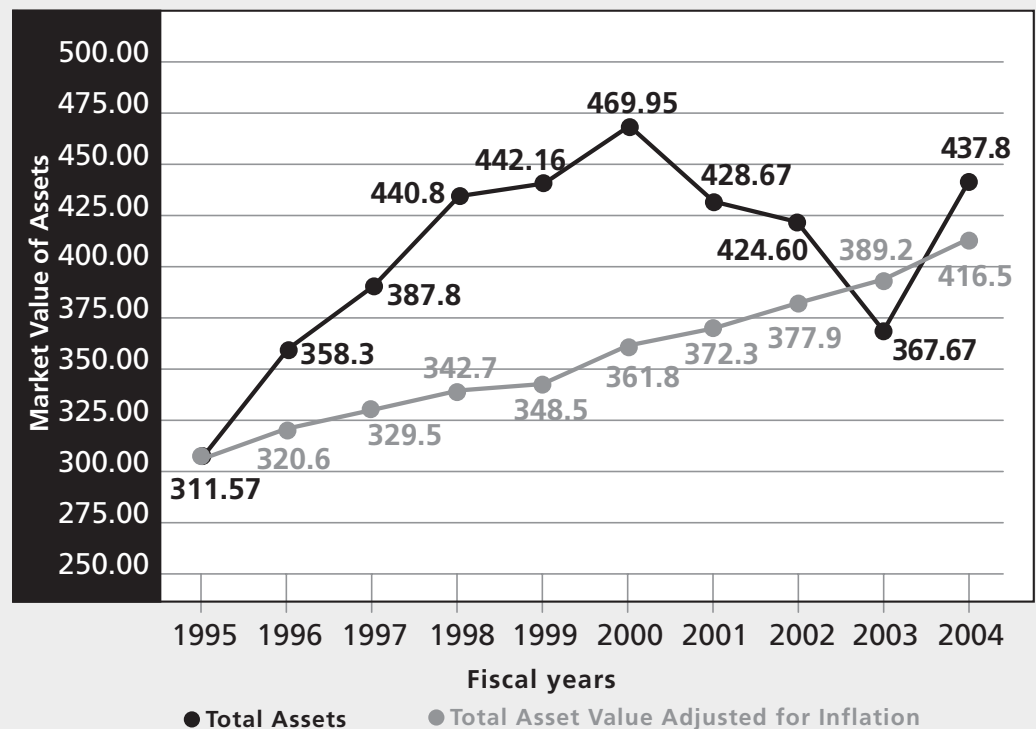
Change in Assets and Distributions Fiscal Year 1995 to Fiscal Year 2004

After enduring three difficult years, the financial markets finally rebounded in the fiscal year ended March 31, 2004. NWAf's investment performance produced a 27.3 percent return for the year—a welcomed change in performance. This return exceeded the Foundation's absolute return target of 7.2 percent (derived from the 5 percent payout requirement plus 0.5 percent for non-qualifying expenses plus inflation) by +20.1 percent. When compared to other foundations and endowments in the Independent Consultant's Cooperative Universe, the Foundation ranked 63rd, where 1 is best and 100 is worst. Positive performance for the year buoyed the Foundation's annualized performance over the seven-year period to +7.0 percent, as compared to the 7.8 percent target return for that period, making up some ground lost in the recent past.

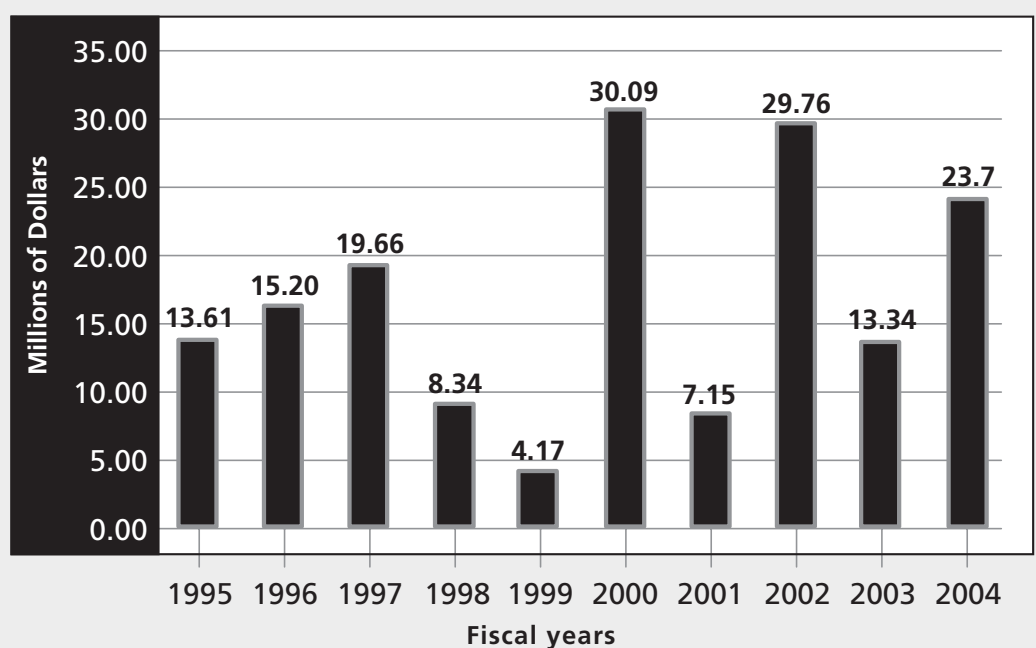
The value of the Foundation's total assets is used as a guide for planning charitable distributions and other expenses that "qualify" toward the 5 percent payout requirement. The first graph illustrates a 10-year review of asset values. It shows the steady rise in value during the very favorable market conditions of the mid- to late 1990s; the drop in value during the turbulent period of 2001–2003; and the much-needed rebound of 2004. Over the 10-year period, the market value of total assets has exceeded the FY95 value adjusted for inflation. In short, during this time period, the value of the Foundation's assets has retained purchasing power.

Distributions are also tied closely with the readiness of our community partners, and the direct delivery of NWAf services. The second graph illustrates the Foundation's distributions over the past 10 years. With all three programs now in full implementation, the Foundation was able to distribute more to communities through direct payment as well as through programmatic initiatives delivered directly by the Foundation.

Growth in Total Assets



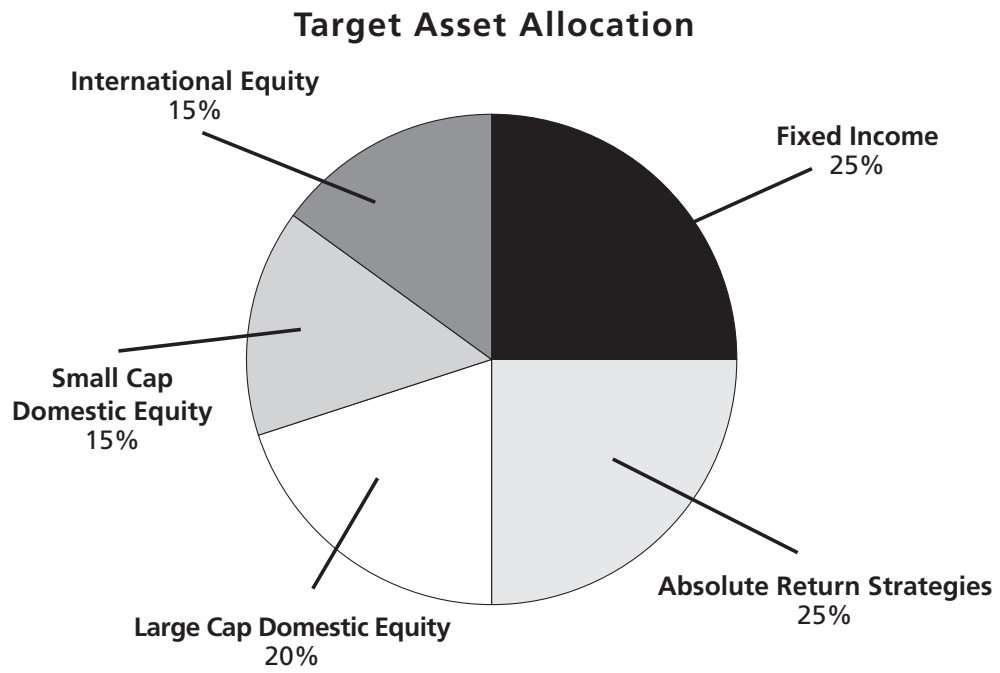
Total Grants and Qualifying Distributions*



*Includes program-related investments distributed in FY04.

Asset Allocation

The Northwest Area Foundation’s Investment Committee has taken great care to position the Foundation to withstand the volatility of financial markets. Investment policies of the Foundation mandate an investment portfolio that (a) complies with applicable private foundation and investment law, (b) provides financial resources to further the Foundation’s programs and mission to help communities reduce poverty, and (c) maintains a prudent level of risk. Investment policies, including asset allocation, are recommended by the Foundation’s investment consultant and approved by our Investment Committee, which reports to the Board of Directors. The following chart depicts the Foundation’s target allocation to several asset classes.



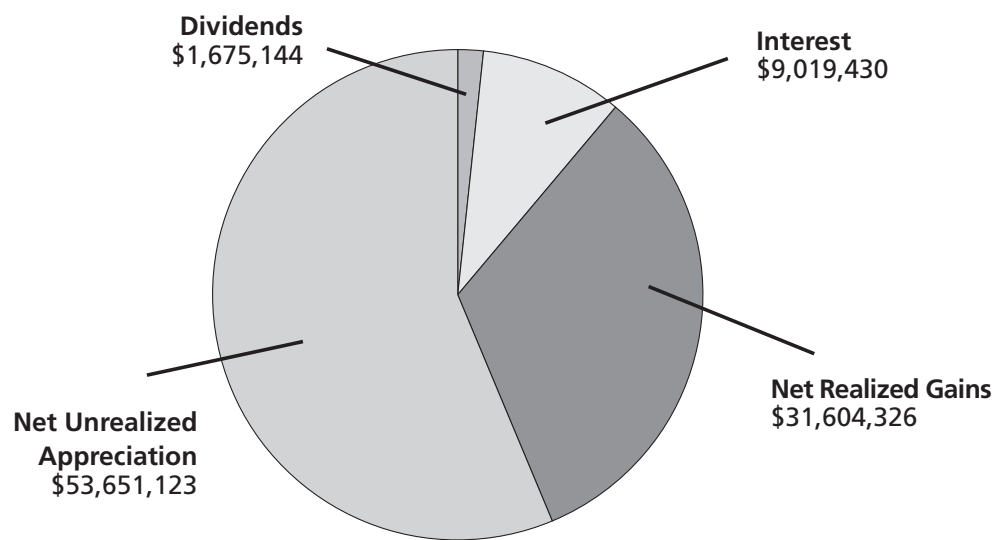
Revenue for Fiscal Year Ended

March 31, 2004

Total Revenue \$95,950,023

Diversification of the portfolio helps to even out the volatility that any segment of the financial market might experience in a given time period. This fiscal year all of the Foundation’s investment managers were able to create positive returns, resulting in a significant revenue stream for the Foundation. This performance helped to recoup some of the losses experienced in the more turbulent times of the recent past.

Revenues for Fiscal Year 2004



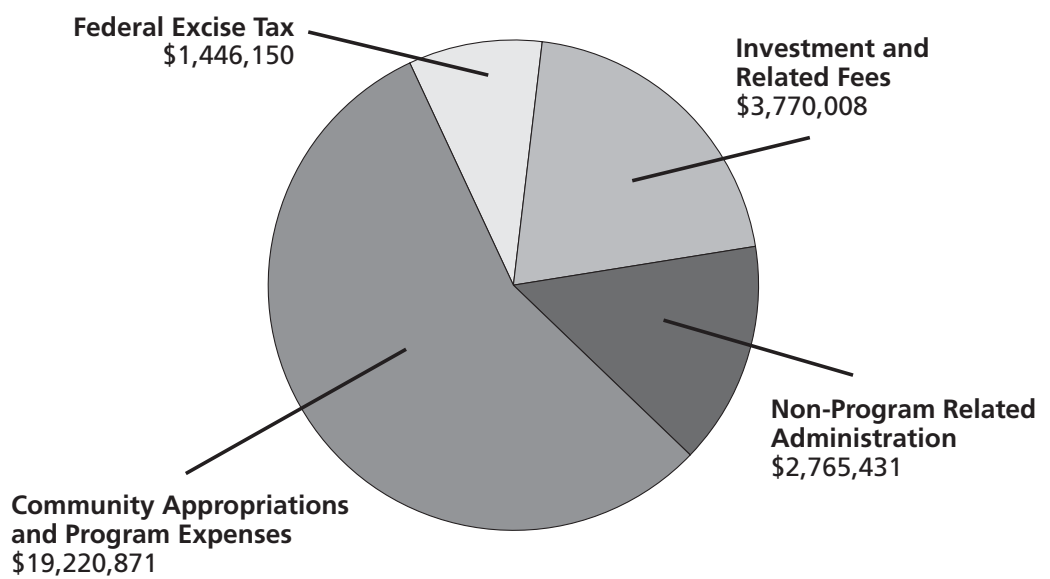
Expenses for Fiscal Year Ended

March 31, 2004*

Total Expenses \$27,202,460

Grants and direct program delivery expenses ebb and flow with the readiness of community partnerships and program service needs. This year, Community Appropriations and Program Expenses included grants of nearly \$15 million and direct program expenses of over \$4 million. In addition, \$2.2 million of program-related investments (loans) to nonprofit corporations were made, but are recorded as assets not as expenses. Non-program expenses included federal excise taxes, investment fees, and administrative costs related to running the Foundation (expenses in this category have been classified differently from previous years).

Expenses for Fiscal Year 2004



** Expenses include some grants or contracts to organizations with which a board member of the Northwest Area Foundation is associated as an employee, board member, officer, owner, etc. In no case, did a Foundation board member vote on a transaction to allocate funds to an organization with which he or she was associated. Please see the list below for the complete disclosure of all such cases.*

Director	Organization	Amount Paid
Bruce Brooks	United Way of King County	\$ 7,325
Cornelia Butler Flora	Heartland Center for Leadership Development	\$ 11,298
	Wallace House Foundation	\$ 67,000
	Iowa State University	\$218,000
Patricia Jensen	North Dakota State University	\$391,800
Kristin Martinez (former board member)	Investor’s Circle	\$ 6,795
Nick Smith	CDVCA	\$102,495
Antone Minthorn	Affiliated Tribes of NW Indians	\$188,125

For a copy of the Northwest Area Foundation’s conflict of interest policy, please refer to our website at http://www.nwaf.org/about/about_conflict_of_interest_policy.htm.

Report of Independent Auditors

To the Board of Directors of
Northwest Area Foundation

In our opinion, the accompanying statements of financial position and the related statements of activities and change in net assets and of cash flows present fairly, in all material respects, the financial position of Northwest Area Foundation at March 31, 2004 and 2003, and the change in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Foundation's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PRICEWATERHOUSECOOPERS LLP
Minneapolis, Minnesota
May 17, 2004

Northwest Area Foundation
(a Minnesota private nonprofit corporation)
Statement of Financial Position
March 31, 2004 and 2003

Assets	2004	2003
Cash	\$524,527	\$183,635
Receivable for securities with settlements pending	863,471	11,805
Accrued investment income	1,586,521	1,308,697
Investments, at fair value (cost value: 2004 - \$381,792,197; 2003 - \$365,176,530):		
Temporary cash investments	12,558,980	20,062,661
Fixed income	150,983,152	141,527,786
Domestic equities	79,911,422	49,399,006
International equities	85,962,609	54,503,487
Alternative investments	99,881,974	97,129,701
Total investments	<u>429,298,137</u>	<u>362,622,641</u>
Other assets	163,079	36,373
Program-related investments	3,183,000	1,000,000
Leasehold improvements, furniture and equipment, net of accumulated depreciation and amortization of \$1,681,341 and \$1,258,074 in 2004 and 2003 respectively	2,141,497	2,503,398
Total assets	<u>\$437,760,232</u>	<u>\$367,666,549</u>
 Liabilities and Net Assets		
Liabilities		
Accounts payable and other liabilities	\$488,387	\$354,046
Payable for securities with settlements pending	1,381,867	1,665,606
Unpaid grant commitments	629,264	52,000
Leasehold incentives	430,834	488,580
Deferred excise taxes	976,000	
Total liabilities	<u>3,906,352</u>	<u>2,560,232</u>
Net assets		
Unrestricted	423,529,586	354,782,023
Permanently restricted	10,324,294	10,324,294
Total net assets	<u>433,853,880</u>	<u>365,106,317</u>
Total liabilities and net assets	<u>\$437,760,232</u>	<u>\$367,666,549</u>

The accompanying notes are an integral part of the financial statements.

Statement of Activities and Change in Net Assets

For the years ended March 31, 2004 and 2003

	Year Ended March 31, 2004			Year Ended March 31, 2003			
	Unrestricted	Permanently Restricted	Total	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues:							
Dividends	\$1,675,144		\$1,675,144	\$1,747,965			\$1,747,965
Interest	9,019,430		9,019,430	10,071,305			10,071,305
Net appreciation (depreciation) in fair value of investments	85,255,449		85,255,449	(52,076,737)	\$350		(52,076,387)
Release of trust				61,273	(61,273)		
Other				48,647			48,647
Total revenues	<u>95,950,023</u>		<u>95,950,023</u>	<u>(40,147,547)</u>	<u>(60,923)</u>		<u>(40,208,470)</u>
Expenses:							
Program:							
Grants appropriated, net of cancellations and refunds	14,762,774		14,762,774	6,854,351			6,854,351
Program related administrative	4,458,097		4,458,097	4,025,372			4,025,372
Administrative:							
Nonprogram related administrative expenses	2,765,431		2,765,431	2,710,238			2,710,238
Investment and related fees	3,770,008		3,770,008	2,557,571			2,557,571
Federal excise tax provision (benefit)	1,446,150		1,446,150	(220,000)			(220,000)
Total expenses	<u>27,202,460</u>		<u>27,202,460</u>	<u>15,927,532</u>			<u>15,927,532</u>
Change in net assets	68,747,563		68,747,563	(56,075,079)	(60,923)		<u>(56,136,002)</u>
Net Assets:							
Net assets at beginning of year	<u>354,782,023</u>	<u>\$ 10,324,294</u>	<u>365,106,317</u>	<u>410,857,102</u>	<u>60,923</u>	<u>10,324,294</u>	<u>421,242,319</u>
Net assets at end of year	<u>\$423,529,586</u>	<u>\$ 10,324,294</u>	<u>\$433,853,880</u>	<u>\$354,782,023</u>	<u>\$-</u>	<u>\$ 10,324,294</u>	<u>\$365,106,317</u>

The accompanying notes are an integral part of these financial statements.

Statement of Cash Flows

For the years ended March 31, 2004 and 2003

	2004	2003
Cash flows from operating activities		
Change in net assets	\$68,747,563	\$(56,136,002)
Adjustments to reconcile change in net assets to net cash used in operating activities		
Depreciation and amortization	431,026	447,956
Net (appreciation) depreciation in fair value of investments	(85,255,449)	52,076,387
Deferred excise taxes	976,000	(395,000)
Change in other operating assets and liabilities:		
Accrued investment income	(277,824)	304,970
Other assets	(126,706)	172,387
Program-related investments	(2,183,000)	-
Accounts payable and other liabilities	134,341	(781,657)
Unpaid grant commitments	577,264	43,350
Leasehold Incentives	(57,746)	488,580
Net cash used in operating activities	<u>(17,034,531)</u>	<u>(3,779,029)</u>
Cash flows from investing activities		
Proceeds from sale of investments	185,802,988	23,546,348
Purchases of investments	(168,358,440)	(18,741,269)
Purchases of leasehold improvements, furniture and equipment	(69,125)	(872,395)
Net cash provided by investing activities	<u>17,375,423</u>	<u>3,932,684</u>
Net increase in cash	340,892	153,655
Cash		
Beginning of year	183,635	29,980
End of year	<u>\$ 524,527</u>	<u>\$ 183,635</u>
Supplemental disclosures of cash flow information		
Supplemental disclosure of noncash investing transactions		
Receivable for securities with settlements pending	\$ 851,666	\$ 11,805
Payable for securities with settlements pending	(283,739)	(152,119)
Cash paid for federal excise taxes	500,000	-

The accompanying notes are an integral part of these financial statements.

Notes to Financial Statements

1. Organization and Significant Accounting Policies

Northwest Area Foundation (the "Foundation") is a private foundation incorporated under the laws of Minnesota. The Foundation exists to help communities in its eight-state region reduce poverty by providing knowledge, financial resources (including grants), products, and services.

Basis of Presentation

In the financial statements, net assets that have similar characteristics have been combined into categories as follows:

- Unrestricted - Net assets that are not subject to donor-imposed stipulations.
- Temporarily restricted - Net assets whose use by the Foundation is subject to donor-imposed stipulations that can be fulfilled by actions of the Foundation pursuant to those stipulations or that expire by the passage of time.
- Permanently restricted - Net assets subject to donor-imposed stipulations that they be maintained permanently by the Foundation. The donors of these assets permit the Foundation to use all of the income earned on these investments.

Expenses are generally reported as decreases in unrestricted net assets.

Cash

Cash represents funds held for use in the operations of the Foundation with original maturities of three months or less. Temporary cash investments held by investment managers are classified as a component of investments.

Investments

Investments are carried at fair value (generally quoted market prices and appraised values). The cost of investments generally represents amounts paid for investments purchased. The cost of investments sold is determined on a specific identification basis.

Derivative financial instruments are carried at fair value and are included as alternative investments on the Statement of Financial Position. The Foundation's alternative investments represent a diversified portfolio of more than 70 hedge funds.

Program-related Investments

Program-related investments consist of both equity and debt positions in organizations that conduct activities that fulfill the charitable purposes of the Foundation. Program-related investments are initially recorded on the Statement of Financial Position at cost when approved. In the event that a program-related investment is subsequently determined to be uncollectible or the value is permanently impaired, the Foundation may record the uncollectible amount as a grant appropriation. During the period ended March 31, 2004, \$2,183,000 of program-related investments were made. These investments are recoverable over periods ranging from 8 to 19 years.

Accrued Investment Income

Accrued investment income includes interest and declared dividends not yet received. Interest income is recorded in the period in which it is earned, and dividend income is recorded on the ex dividend date.

Leasehold Improvements, Furniture and Equipment

Leasehold improvements, furniture and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is provided on a straight-line basis over the estimated useful lives of the respective assets ranging from three to ten years. Amortization of leasehold improvements is recorded on a straight-line basis over the shorter of the lease term or the estimated useful life of the improvement.

Leasehold Incentives

In May 2002, the Foundation received \$533,000 from its landlord for leasehold improvements. This amount has been deferred and is being amortized over the lease term of ten years.

Grants

Grant appropriations are charged to unrestricted net assets at the time the grants are approved by the President of the Foundation subject to the guidelines set forth by the Board of Directors. Conditional grants made are recognized as grant appropriations in the Statement of Activities and Change in Net Assets when the conditions are met. Cancellations of grants occur when the grantees do not meet the grant terms, and grants are refunded when grant program needs are less than the appropriated amount.

Federal Taxes

The Foundation qualifies as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code and is not subject to federal income taxes except for income from its unrelated business activities.

Under Section 4940 of the Internal Revenue Code, the Foundation is subject to a 2% excise tax on its taxable investment income received, which principally includes income from investments plus net realized capital gains. Net capital losses, however, are not deductible. Under certain circumstances, the Foundation may qualify for a 1% excise tax rate. An annual determination is made by the Foundation as to whether a 1% or 2% rate is applicable in each year. The Foundation applied the 1% and 2% excise tax rates for the years ended March 31, 2004 and 2003, respectively.

Deferred taxes result from certain income and expense items being accounted for in different time periods for financial statement purposes than for federal excise and income tax purposes. Deferred excise tax expense (benefit) arises from unrealized appreciation (depreciation) in fair value of investments and accrued investment income.

Use of Estimates

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Investments

Net appreciation (depreciation) in fair value of investments for the years ended March 31, 2004 and 2003, consist of the following:

Year ended March 31, 2004

Net realized gains on sales of investments	\$31,604,326
Net unrealized appreciation of investments	53,651,123
Net appreciation in fair value of investments	<u>\$85,255,449</u>

Year ended March 31, 2003

Net realized losses on sales of investments	\$(31,637,552)
Net unrealized depreciation of investments	(20,438,835)
Net depreciation in fair value of investments	<u>\$(52,076,387)</u>

3. Program-Related Investments

Program-related investments consist of the following at March 31:

	2004	2003
Northeast Ventures Corporation (equity)	\$1,000,000	\$1,000,000
Mid-Minnesota Community Development Corporation (debt)	1,000,000	-
Neighborhood Development Center (debt)	408,000	-
Montana Community Development Corporation (debt)	400,000	-
Development Corporation for Children (debt)	375,000	-
	<u>\$3,183,000</u>	<u>\$1,000,000</u>

Notes to Financial Statements
(continued)

4. Use of Financial Instruments

The Foundation's investment strategy incorporates certain financial instruments which involve, to varying degrees, elements of market risk and credit risk in excess of amounts recorded in its financial statements. These financial instruments may include equity, fixed income and foreign currency futures and options contracts, and foreign currency forward contracts. The Foundation uses derivatives to minimize the exposure of certain of its investments to adverse fluctuation in financial and currency markets, thus reducing portfolio risk. The Foundation has not designated any of its derivative financial instruments as hedging instruments.

Market risk represents potential loss from the decrease in the value of off-balance-sheet financial instruments. Credit risk represents potential

loss from possible nonperformance by obligors and counterparties on the terms of their contracts. Management does not anticipate that losses, if any, resulting from credit or market risk would materially affect the Foundation's financial position.

The Foundation's international fixed income portfolio uses derivatives, which are not considered hedges, to minimize foreign currency risks through forward contracts. These contracts mature in less than 60 days. The Foundation's domestic portfolio uses options to minimize volatility; they are marked to market and are listed as an offset to investments. Realized and unrealized gains and losses related to the above instruments are recorded when they occur.

5. Grants

Grant activity for the years ended March 31, 2004 and 2003, is summarized as follows:

	2004	2003
Unpaid commitments at beginning of year	\$ 52,000	\$ 8,650
Grant appropriations, net of cancellations and refunds	14,762,774	6,854,351
Payments	<u>(14,185,510)</u>	<u>(6,811,001)</u>
Unpaid commitments at end of year	<u>\$ 629,264</u>	<u>\$ 52,000</u>

Conditional grants made where conditions have not been met totaled \$34,902,000 and \$18,730,000 at March 31, 2004 and 2003, respectively.

6. Federal Excise Taxes and Distribution Requirements

Federal excise taxes for the years ended March 31, 2004 and 2003, consist of the following:

	2004	2003
Federal excise tax provision (benefit):		
Current	\$ 470,150	\$ 175,000
Deferred	976,000	(395,000)
Total	<u>\$ 1,446,150</u>	<u>\$ (220,000)</u>

The Foundation is subject to the distribution requirements of the Internal Revenue Code. Accordingly, it must make qualified distributions within one year after the end of each fiscal year of at least 5% of the average market

value of its assets as defined to avoid an additional excise tax. The Foundation has complied with these distribution requirements for the year ended March 31, 2004.

7. Capital Stock

Included in unrestricted net assets is capital stock which consists of ten shares of \$100 par value capital stock. The five trustees hold all ten shares as a unit (individuals do not hold separate identifiable shares). No dividends are paid on these shares, nor do any net earnings of the Foundation benefit any stockholder.

8. Program-related and Nonprogram-related Administrative Expenses

Program-related expenses relate to control and evaluation of grants, direct program services provided through the Foundation, as well as the salaries and expenses required to run the programs. Nonprogram-related administrative expenses include all expenses incidental to operating the organization, annual report and direct charitable expenses.

9. Employee Pension Plan

The Foundation has an employee pension plan operated as a self-funded money purchase plan. This is a defined noncontributory plan available to all employees who work a minimum of 1,000 hours per year. The plan provides for an annual contribution of 11% of each eligible participant's earned compensation up to \$200,000. The expense of the plan for the years ended March 31, 2004 and 2003, was \$219,213 and \$171,252, respectively.

10. Lease Commitments

In March 2001, the Foundation entered into a ten-year noncancellable operating lease for office space which commenced on May 6, 2002. Under this lease agreement, the Foundation pays operating costs for the leased property. This lease agreement has renewal options for up to ten additional years. Total rent expense was \$229,186 and \$239,361 for the years ended March 31, 2004 and 2003, respectively, net of amortization of the leasehold incentives of \$57,746 for the year ended March 31, 2004, and \$44,420 for the year ended March 31, 2003.

Future minimum rental payments at March 31, 2004, are as follows:

Fiscal Year Ending	
2005	\$ 282,490
2006	282,490
2007	282,490
2008	282,490
2009	282,490
Thereafter	<u>871,011</u>
Total	<u>\$2,283,461</u>

11. Contingencies

The Foundation is subject to various legal actions and claims arising during the normal course of operations. Management is unable at this time to estimate whether those legal actions and claims if disposed, either individually or in aggregate, will have a material adverse effect on the Foundation's financial position, change in net assets and cash flows.