

AUDITORS' REPORT

To the Minister of National Defence

We have audited the Balance Sheet of the Public Sector Pension Investment Board – Canadian Forces Pension Plan Account (the “Canadian Forces Pension Plan Account”) as at March 31, 2006 and the Statements of Net Income and Accumulated Net Income from Operations and of Changes in Net Assets for the year then ended. These financial statements are the responsibility of the Public Sector Pension Investment Board’s (“PSP Investments”) 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 Canadian Forces Pension Plan Account as at March 31, 2006 and the results of its operations and of changes in its net assets for the year then ended in accordance with Canadian generally accepted accounting principles. As required by the *Financial Administration Act*, we report that, in our opinion, these principles have been applied on a basis consistent with that of the preceding year.

Further, in our opinion, the transactions of the Canadian Forces Pension Plan Account that have come to our notice during our audit of the financial statements have, in all significant respects, been in accordance with the applicable provisions of Part X of the *Financial Administration Act* and, as appropriate, the *Public Sector Pension Investment Board Act* (the “Act”) and regulations and the by-laws of PSP Investments.

Chartered Accountants
Toronto, Ontario
April 28, 2006

BALANCE SHEET

As at March 31, 2006

(\$000's)	2006	2005
ASSETS		
Investments (Note 2)	\$5,699,169	\$3,964,971
Cash	22	-
Other assets	733	486
TOTAL ASSETS	\$5,699,924	\$3,965,457
LIABILITIES		
Investment-related liabilities (Note 2)	71,282	-
Accounts payable and accrued liabilities	6,768	2,030
Due to the Public Service Pension Plan Account (Note 5a)	3,124	2,071
	81,174	4,101
NET ASSETS	\$5,618,750	\$3,961,356
Accumulated net income from operations	\$1,398,309	\$ 568,650
Accumulated fund transfers	4,220,441	3,392,706
NET ASSETS	\$5,618,750	\$3,961,356

On behalf of the Board of Directors:

Lynn Loewen

Director and Chair of the Audit and Conflicts Committee

STATEMENT OF NET INCOME AND ACCUMULATED NET INCOME FROM OPERATIONS

For the year ended March 31, 2006

(\$000's)	2006	2005
INVESTMENT INCOME		
Interest and dividends	\$ 121,548	\$ 90,410
Net realized gains	495,456	95,773
Change in unrealized appreciation in value of investments	228,867	92,442
	845,871	278,625
EXPENSES		
Operating expenses (Note 5b)	8,056	4,348
External investment management fees	8,156	2,955
	16,212	7,303
NET INCOME FROM OPERATIONS	829,659	271,322
Accumulated net income from operations, beginning of year	568,650	297,328
Accumulated net income from operations, end of year	\$1,398,309	\$ 568,650

STATEMENT OF CHANGES IN NET ASSETS

For the year ended March 31, 2006

(\$000's)	2006	2005
NET ASSETS, BEGINNING OF YEAR	\$3,961,356	\$2,969,369
Fund transfers (Note 3)	827,735	720,665
Net income from operations	829,659	271,322
Increase in net assets for the year	1,657,394	991,987
NET ASSETS, END OF YEAR	\$5,618,750	\$3,961,356

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2006

ORGANIZATION

The Public Sector Pension Investment Board ("PSP Investments") was formed pursuant to the *Public Sector Pension Investment Board Act* (the "Act") with a mandate to invest the contributions of the Public Service, Canadian Forces and Royal Canadian Mounted Police pension plans in financial markets.

The Canadian Forces pension fund was established by amendments to the *Canadian Forces Superannuation Act*, to receive contributions and make benefit payments in respect of member service after April 1, 2000. The excess of contributions over benefits is transferred, by the Canadian Forces pension fund, to PSP Investments – Canadian Forces Pension Plan Account for investment. PSP Investments maintains records of the pension fund's net contributions, as well as the allocation of its investments and the results of its operations in each of the plan accounts.

PSP Investments is responsible for managing amounts that are transferred to it in the best interests of the beneficiaries and contributors under the *Canadian Forces Superannuation Act*. The amounts are to be invested with a view of achieving a maximum rate of return, without undue risk of loss, with regards to the funding, policies and requirements of the *Canadian Forces Superannuation Act*.

1 Summary of Significant Accounting Policies

Basis of Presentation

These financial statements present the financial position and operations of PSP Investments and its wholly-owned subsidiaries as they pertain to the investment of the excess funds transferred to it from the Canadian Forces fund. Accordingly, they do not reflect all of the assets, or the details of the pension contributions, payments and liabilities of the Canadian Forces pension fund. The statements have been prepared in accordance with Canadian generally accepted accounting principles and the requirements of the *Act*.

The financial statement presentation has been changed from the prior year's presentation. References to the "PSP Funds" have been eliminated in the current year's presentation. Whereas prior years' financial statements presented a statement of investment portfolio holding unit interests in the "PSP Funds", this has been replaced by Note 2(a), an investment portfolio depicting the effective asset class holdings and maintaining the respective fair value and cost of the underlying investments held by PSP Investments.

Comparative figures have been re-classified to conform to the current year's presentation.

Valuation of Investments

Investments for each asset class are recorded as of the trade date and are stated at fair value. Fair value is an estimate of the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. Fair value of investments in pooled funds is based on unit values, which reflect the quoted market prices or other generally accepted pricing methodologies for the underlying securities.

Income Recognition

The investment income has been allocated proportionately based on the asset value held by the Canadian Forces Pension Plan Account.

Investment income is recorded on the accrual basis and represents realized gains and losses on the disposal of investments, change in unrealized appreciation (depreciation) on investments held at the end of the year, interest income and dividends, and net operating income from private market real estate investments. These income items include the related distributions from pooled funds and limited partnerships.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2006

1 Summary of Significant Accounting Policies (continued)

Translation of Foreign Currencies

Transactions in foreign currencies are recorded at the rates of exchange on the transaction date. Investments denominated in foreign currencies and held at the end of the year are translated at exchange rates in effect at the year-end date. The resulting realized and unrealized gains and losses on foreign exchange are included in investment income.

Fund Transfers

Amounts received from the Canadian Forces pension fund are recorded on a cash basis.

Use of Estimates

In preparing these financial statements, management must make certain estimates and assumptions which can affect the reported values of assets and liabilities, related income and expenses and note disclosures. Actual results may differ from estimates.

2 Investments

(a) Investment Portfolio

The investment portfolio, as at March 31, is as follows:

(\$000's)	2006		2005	
	FAIR VALUE	COST	FAIR VALUE	COST
Developed World Equity				
Canadian Equity	\$1,902,816	\$1,640,080	\$1,588,060	\$1,315,515
US Large Cap Equity	532,942	493,229	473,730	469,420
EAFE Large Cap Equity	654,897	529,486	512,976	471,275
Small Cap Developed World Equity	408,490	369,933	21,531	19,265
Emerging Markets Equity	395,601	310,547	72,472	73,602
Private Equity	61,356	62,398	623	752
Nominal Fixed Income				
Cash Equivalents	79,890	79,890	89,610	89,610
Canadian Fixed Income	1,067,019	1,080,976	1,052,782	1,040,638
Real Return Assets				
World Inflation-linked Bonds	85,769	78,369	44,934	42,662
Real Estate	393,630	378,357	87,922	87,390
Absolute Return	116,759	112,954	20,331	20,759
INVESTMENTS	\$5,699,169	\$5,136,219	\$3,964,971	\$3,630,888
Investment-related liabilities (Note 6)	(71,282)	(71,282)	-	-
NET INVESTMENTS	\$5,627,887	\$5,064,937	\$3,964,971	\$3,630,888

World Government Bonds and Infrastructure were introduced as asset classes during the current fiscal year and no investments have been made as at March 31, 2006.

Direct investments, derivative contracts, and investment-related receivables and liabilities are classified by asset-mix category based on the intent of the investment strategies of the underlying portfolios of PSP Investments. In addition to the different asset classes outlined in the asset mix policy, PSP Investments employs a number of absolute return strategies.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2006

2 Investments (continued)

(b) Investment Asset Mix

PSP Investments has established a Statement of Investment Policies, Standards and Procedures (the "SIP&P"). The SIP&P sets out the manner in which the assets shall be invested for the three plan accounts. During the course of the year, PSP Investments modified its asset mix policy.

The investment asset mix, as set out in the SIP&P as at March 31, is as follows:

	2006		2005	
	ACTUAL ASSET MIX	POLICY PORTFOLIO	ACTUAL ASSET MIX	POLICY PORTFOLIO
Equities	70.2%	62.0%	67.3%	63.0%
Fixed Income	22.4	15.0	29.4	22.0
Real Return Assets	7.4	23.0	3.3	15.0
	100.0%	100.0%	100.0%	100.0%

Differences between the actual asset mix and the policy portfolio targets are due principally to target weights of certain asset classes which have yet to be attained. For instance, real return assets include real estate and infrastructure assets with policy portfolio target weights of 10% and 8%, respectively, and actual asset weights of only 7% and nil, respectively.

(c) Foreign Currency Risk

PSP Investments and its subsidiaries are exposed to currency risk through holdings of securities, units in pooled funds and units in limited partnerships of non-Canadian assets where investment values will fluctuate due to changes in foreign exchange rates. To mitigate this risk, PSP Investments may take, through derivative contracts, trading positions in foreign currencies.

The underlying net foreign currency exposures, as at March 31, were as follows:

CURRENCY (in Canadian \$)	2006		2005	
	FAIR VALUE (\$000's)	% OF TOTAL	FAIR VALUE (\$000's)	% OF TOTAL
US Dollar	\$1,183,460	57.0%	\$563,120	49.8%
Euro	321,113	15.4	196,178	17.3
Yen	188,158	9.1	101,813	9.0
British Pound	137,118	6.6	106,751	9.4
Other	247,141	11.9	163,574	14.5
	\$2,076,990	100.0%	\$1,131,436	100.0%

NOTES TO THE FINANCIAL STATEMENTS

For the year, ended March 31, 2006

3 Fund Transfers

During the year, PSP Investments received fund transfers of \$828 million (2005 – \$721 million) from the Canadian Forces pension fund. The transfers received are comprised of net current employer and employee contributions to the Canadian Forces pension plan.

4 Investment Performance

Portfolio and benchmark returns, for the year ended March 31, are as follows:

	2006		2005	
	PORTFOLIO RETURNS	BENCHMARK RETURNS	PORTFOLIO RETURNS	BENCHMARK RETURNS
Developed World Equity				
Canadian Equity	28.8%	28.7%	15.6%	13.9%
US Large Cap Equity	9.5%	7.7%	(0.6)%	(1.8)%
EAFE Large Cap Equity	20.8%	20.0%	4.3%	5.9%
Small Cap Developed World	18.6%	19.3%	n.a.	n.a.
Emerging Markets Equity	39.6%	42.6%	n.a.	n.a.
Private Equity	0.6%	n.a.	(33.8)%	n.a.
Nominal Fixed Income				
Cash Equivalents	2.7%	2.8%	2.9%	2.2%
Canadian Fixed Income	4.7%	4.9%	5.0%	5.0%
Real Return Assets				
World Inflation-linked Bonds	10.9%	11.8%	8.8%	9.2%
Real Estate	21.6%	8.3%	7.9%	6.7%
Total Return	19.1%	18.0%	7.9%	7.2%

Returns have been calculated in accordance with the performance calculation methodology recommended by the CFA Institute. Returns are presented gross of expenses.

PSP Investments has identified relevant benchmarking for each asset class. The asset class benchmark returns are used in evaluating the relative performance of each asset class.

The total benchmark return aggregates the asset class benchmark returns according to the weights under the actual asset mix. The return of the private equity asset class is not being measured against any benchmark during the ramp-up period as disclosed in PSP Investments' SIP&P. However, for purposes of calculating the total 2006 and 2005 benchmark returns, the actual private equity portfolio returns of 0.6% and (33.8)%, respectively, are used.

The total portfolio returns includes the performance impact of absolute return strategies. Hedging investment returns have been netted against respective hedged assets.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2006

5 Expenses

(a) Allocation of Expenses

The *Act* requires that the costs of operation of PSP Investments be charged to the three plans for which it provides investment services. Under section 4(3) of the *Act*, the president of the Treasury Board shall determine to which plan account these costs will be charged, in consultation with the Minister of National Defence and the Minister of Public Safety. An allocation policy has been developed which allocates the direct costs of investment activities, such as external investment management fees and custodial fees, to each plan account, and allocates, on a quarterly basis, operating expenses excluding custodial fees, based upon the asset value of each plan account.

Operating expenses, excluding custodial fees, have been allocated as follows:

	2006	2005
Public Service Pension Plan Account	72.2%	71.7%
Canadian Forces Pension Plan Account	20.5	20.9
Royal Canadian Mounted Police Pension Plan Account	7.3	7.4
	100.0%	100.0%

Expenses are financed by the Public Service Pension Plan Account, which is reimbursed by the other plan accounts on a quarterly basis.

(b) Operating Expenses

Operating expenses allocated to this plan account consist of the following:

(\$'000's)	2006	2005
Salaries and benefits	\$4,636	\$2,209
General operating expenses	2,291	1,502
Professional and consulting fees	1,129	637
	\$8,056	\$4,348

Further details of operating expenses are shown in the PSP Investments' financial statements.

6 PSP Capital Inc.

As of March 31, 2006, PSP Capital Inc., a wholly-owned subsidiary of PSP Investments, has \$350 million of short-term promissory notes outstanding with maturity dates within 60 to 90 days of issuance of which \$72 million has been allocated to the Canadian Forces Pension Plan Account. The capital raised was used primarily to finance real estate investments.

The operating expenses incurred by PSP Capital Inc. were allocated to each plan account as described in Note 5 (a).