Federal Reserve System Audits

Audits of the Federal Reserve System

The Board of Governors, the Federal Reserve Banks, and the Federal Reserve System as a whole are all subject to several levels of audit and review. The Board's financial statements, and its compliance with laws and regulations affecting those statements, are audited annually by an outside auditor retained by the Board's Office of Inspector General. The Office of Inspector General also audits and investigates the Board's programs and operations, as well as those Board functions delegated to the Reserve Banks.

The financial statements of the Reserve Banks are also audited annually by an independent outside auditor. In addition, the Reserve Banks are subject to annual examination by the Board. As discussed in the chapter ''Federal Reserve Banks,'' the Board examination includes a wide range of ongoing oversight activities conducted on and off site by staff of the Board's Division of Reserve Bank Operations and Payment Systems.

Federal Reserve operations are also subject to review by the General Accounting Office. ■

Board of Governors Financial Statements

The financial statements of the Board for 2003 and 2002 were audited by KPMG LLP, independent auditors.

KPMG LLP
2001 M Street NW
Washington, DC 20036

Independent Auditors' Report on Financial Statements

To the Board of Governors of the Federal Reserve System:

We have audited the accompanying balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2003 and 2002, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board at December 31, 2003 and 2002, and the results of its operations, and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we have also issued our reports dated April 2, 2004, on our consideration of the Board's internal control over financial reporting and its compliance with certain provisions of laws and regulations. Those reports are an integral part of an audit conducted in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

KPMG LLP

April 2, 2004

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEETS

	As of December 31, 2003	As of December 31, 2002
Assets		
Current Assets		
Cash	$ 56,179,654	$ 8,635,164
Accounts receivable	1,251,117	871,626
Prepaid expenses and other assets	2,614,354	801,031
Total current assets	60,045,125	10,307,821
Noncurrent Assets		
Property and equipment, net (Note 2)	149,595,059	143,971,006
Collections (Note 1)		
Total noncurrent assets	149,595,059	143,971,006
Total assets	$209,640,184	$154,278,827
Liabilities and Cumulative Results of Operations		
Current Liabilities		
Accounts payable and accrued liabilities	$ 15,347,390	$ 11,450,099
Accrued payroll and related taxes	5,056,647	8,102,710
Accrued annual leave	13,428,993	11,873,527
Capital lease payable (current portion)	206,590	50,546
Unearned revenues and other liabilities	390,698	442,066
Total current liabilities	34,430,318	31,918,948
Long-term Liabilities		
Capital lease payable (non-current portion)	763,699	32,153
Accumulated retirement benefit obligation (Note 3)	595,601	614,108
Accumulated postretirement benefit obligation (Note 4)	5,322,053	4,917,787
Accumulated postemployment benefit obligation (Note 5)	4,949,892	4,299,252
Total long-term liabilities	11,631,245	9,863,300
Total liabilities	46,061,563	41,782,248
Cumulative Results of Operations		
Working capital	25,821,397	(21,560,581)
Unfunded long-term liabilities	(10,867,546)	(9,831,147)
Net investment in property and equipment	148,624,770	143,888,307
Total cumulative results of operations	163,578,621	112,496,579
Total liabilities and cumulative results of operations	$209,640,184	$154,278,827

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF REVENUES AND EXPENSES AND CHANGES IN CUMULATIVE RESULTS OF OPERATIONS

	For the years ended December 31, 2003	2002
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	$297,020,200	$205,110,800
Other revenues (Note 6)	8,835,440	9,039,417
Total operating revenues	305,855,640	214,150,217
BOARD OPERATING EXPENSES		
Salaries	156,547,392	146,022,212
Retirement and insurance contributions	28,263,776	25,560,734
Contractual services and professional fees	17,501,035	18,073,228
Depreciation and net losses on disposals	12,194,612	12,426,581
Postage and supplies	8,175,120	5,961,699
Utilities	7,664,716	7,218,999
Travel	5,981,254	5,925,674
Software	5,910,128	6,822,066
Repairs and maintenance	4,029,441	4,666,439
Printing and binding	1,864,006	2,026,370
Other expenses (Note 6)	6,642,118	5,141,590
Total operating expenses	254,773,598	239,845,592
RESULTS OF OPERATIONS	51,082,042	(25,695,375)
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	508,144,248	429,568,393
Expenses for currency printing, issuance, retirement, and shipping	508,144,248	429,568,393
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES	0	0
TOTAL RESULTS OF OPERATIONS	51,082,042	(25,695,375)
CUMULATIVE RESULTS OF OPERATIONS, Beginning of year	112,496,579	138,191,954
CUMULATIVE RESULTS OF OPERATIONS, End of year	$163,578,621	$112,496,579

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF CASH FLOWS

	For the years ended December 31, 2003	2002
Cash Flows from Operating Activities		
Results of Operations	$51,082,042	$(25,695,375)
Adjustments to reconcile results of operations to net cash provided by (used in) operating activities:		
Depreciation and net losses on disposals	12,194,612	12,426,581
(Increase) decrease in assets:		
Accounts receivable, prepaid expenses, and other assets	(2,192,814)	518,815
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	3,897,291	(4,675,698)
Accrued payroll and related taxes	(3,046,063)	794,956
Accrued annual leave	1,555,466	1,141,171
Unearned revenues and other liabilities	(51,368)	50,494
Accumulated retirement benefit obligation	(18,507)	(37,520)
Accumulated postretirement benefit obligation	404,266	362,300
Accumulated postemployment benefit obligation	650,640	707,681
Net cash provided by (used in) operating activities	64,475,565	(14,406,595)
Cash Flows from Investing Activities		
Proceeds from disposals	15,790	5,200
Capital expenditures	(16,809,964)	(17,507,186)
Net cash provided by (used in) investing activities	(16,794,174)	(17,501,986)
Cash Flows from Financing Activities		
Capital lease payments	(136,901)	(244,819)
Net cash provided by (used in) financing activities	(136,901)	(244,819)
Net Increase (Decrease) in Cash	47,544,490	(32,153,400)
Cash Balance, Beginning of year	8,635,164	40,788,564
Cash Balance, End of year	$56,179,654	$ 8,635,164
Supplemental Disclosure of Cash Flow Information		
Capital lease obligations incurred	$ 1,024,491	$ 0

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED
DECEMBER 31, 2003 AND 2002

(1) Significant Accounting Policies

Organization—The Federal Reserve System was established by Congress in 1913 and consists of the Board of Governors (Board), the Federal Open Market Committee, the twelve regional Federal Reserve Banks, the Federal Advisory Council, and the private commercial banks that are members of the System. The Board, unlike the Reserve Banks, was established as a federal government agency and is supported by Washington staff numbering approximately 1,800, as it carries out its responsibilities in conjunction with other components of the Federal Reserve System.

The Board is required by the Federal Reserve Act to report its operations to the Speaker of the House of Representatives. The Act also requires the Board, each year, to order a financial audit of each Federal Reserve Bank and to publish each week a statement of the financial condition of each such Reserve Bank and a consolidated statement for all of the Reserve Banks. Accordingly, the Board believes that the best financial disclosure consistent with law is achieved by issuing separate financial statements for the Board and for the Reserve Banks. Therefore, the accompanying financial statements include only the operations and activities of the Board. Combined financial statements for the Federal Reserve Banks are included in the Board's annual report to the Speaker of the House of Representatives.

Basis of Accounting—The financial statements have been prepared on the accrual basis of accounting.

Revenues—Assessments for operating expenses and additions to property are based on expected cash needs. Amounts over or under assessed due to differences between actual and expected cash needs flow in to or out of ''Cumulative Results of Operations'' during the year.

Issuance and Redemption of Federal Reserve Notes—The Board incurs expenses and assesses the Federal Reserve Banks for currency printing, issuance, retirement, and shipping of Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are not Board operating transactions.

Property and Equipment—The Board's property, buildings and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 3 to 10 years for furniture and equipment and from 10 to 50 years for building equipment and structures. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized.

Collections—The Board has collections of works of art, historical treasures, and similar assets. These collections are maintained and held for public exhibition in furtherance of public service. Proceeds from any sales of collections are used to acquire other items for collections. As permitted by FAS 116, the cost of collections purchased by the Board is charged to expense in the year purchased and donated collection items are not recorded. The value of the Board's collections has not been determined.

Estimates—The preparation of 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 the 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.

Reclassifications—Certain 2002 amounts have been reclassified to conform with the 2003 presentation.

(2) Property and Equipment

The following is a summary of the components of the Board's property and equipment, at cost, net of accumulated depreciation.

	As of December 31, 2003	As of December 31, 2002
Land and improvements	$ 18,640,314	$ 18,640,314
Buildings	129,161,957	113,309,775
Furniture and equipment	43,890,215	37,044,828
Software	11,425,411	9,830,112
Construction in process	0	9,467,020
	203,117,897	188,292,049
Less accumulated depreciation	(53,522,838)	(44,321,043)
Property and equipment, net	$149,595,059	$143,971,006

Furniture and equipment includes $1,156,000 and $864,000 for capitalized leases as of December 31, 2003 and 2002, respectively. Accumulated depreciation includes $195,000 and $654,000 for capitalized leases as of December 31, 2003 and 2002, respectively. The Board paid interest related to these capital leases in the amount of $76,007 and $15,731 for 2003 and 2002, respectively.

The Board began the Eccles Building Infrastructure Enhancement Project in July 1999. This $12.5 million project, scheduled for nineteen phases over three and a half years, included asbestos removal, lighting and plumbing improvements, cabling and other enhancements. This project was completed in 2003.

During 2002, fully depreciated furniture and equipment totaling $22,350,000 was retired.

(3) Retirement Benefits

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). The System Plan is a multi-employer plan which covers employees of the Federal Reserve Banks, the Board, and the Plan Administrative Office.

Employees of the Board who became employed prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who became employed after 1983 are covered by a noncontributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers at amounts prescribed by the System Plan's administrator. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 2003 and 2002, and the Board was not assessed a contribution for these years. Excess Plan assets are expected to continue to fund future years' contributions. Because the plan is part of a multi-employer plan, information as to vested and nonvested benefits, as well as plan assets, as it relates solely to the Board, is not readily available.

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). The Board matches employee contributions to these plans. These defined benefit plans are administered by the Office of Personnel Management. The Board's contributions to these plans totaled $312,000 and $327,000 in 2003 and 2002, respectively. The Board has no liability for future payments to retirees under these programs, and it is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Under the Thrift Plan, members may contribute up to a fixed percentage of their salary. Board contributions are based upon a fixed percentage of each member's basic contribution and were $7,692,000 and $7,185,000 in 2003 and 2002, respectively.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan due to limitations imposed by Sections 401(a)(17), 415(b) and 415(e) of the Internal Revenue Code of 1986. Pension costs attributed to the BEP reduce the pension costs of the System Plan. Activity for the BEP for 2003 and 2002 is summarized in the following table:

	2003	2002
Change in benefit obligation		
Projected benefit obligation at beginning of year	$ 12,866	$ 2,125
Service cost	13,689	3,363
Interest cost	3,412	561
Plan participants' contributions	0	0
Plan amendments	0	2,852
Actuarial (gain)/loss	44,989	3,965
Benefits paid	0	0
Projected benefit obligation at end of year	$ 74,956	$ 12,866
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	0	0
Plan participants' contributions	0	0
Benefits paid	0	0
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	$ (74,956)	$ (12,866)
Unrecognized net actuarial (gain)/loss	(231,189)	(297,773)
Unrecognized prior service cost	(289,456)	(303,469)
Retirement benefit liability	$ (595,601)	$ (614,108)
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31		
Discount rate	6.75%	7.00%
Expected asset return	N/A	N/A
Salary scale	4.25%	4.50%
Corridor	10.00%	10.00%
Components of net periodic benefit cost		
Service cost	$ 13,689	$ 3,363
Interest cost	3,412	561
Expected return on plan assets	0	0
Amortization of prior service cost	(14,013)	(14,013)
Recognized actuarial (gain)/loss	$ (21,595)	$ (27,431)
Net periodic benefit cost	$ (18,507)	$ (37,520)

(4) Postretirement Benefits

The Board provides certain life insurance programs for its active employees and retirees. Activity for 2003 and 2002 is summarized in the following table:

	2003	2002
Change in benefit obligation		
Benefit obligation at beginning of year	$ 6,134,395	$ 5,868,425
Service cost	170,636	158,179
Interest cost	414,319	386,215
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	673,998	(63,554)
Benefits paid	(227,202)	(214,870)
Benefit obligation at end of year	$ 7,166,146	$ 6,134,395

	2003	2002
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	227,202	213,958
Plan participants' contributions	0	0
Benefits paid	(227,202)	(213,958)
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	$(7,166,146)	$(6,134,395)
Unrecognized net actuarial (gain)/loss	1,760,246	1,126,688
Unrecognized prior service cost	83,847	89,920
Prepaid/(accrued) postretirement benefit liability	$(5,322,053)	$(4,917,787)
Components of net periodic cost for year		
Service cost	$ 170,636	$ 158,179
Interest cost	414,319	386,215
Amortization of prior service cost	6,073	6,073
Amortization of (gains)/losses	40,440	26,706
Total net periodic cost	$ 631,468	$ 577,173

The liability and costs for the postretirement benefit plan were determined using discount rates of 6.25 percent and 6.75 percent as of December 31, 2003 and 2002, respectively. Unrecognized losses of $1,760,246 and $1,126,688 as of December 31, 2003 and 2002, respectively, result from changes in the discount rate used to measure the liabilities. Under Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, the Board may have to record some of these unrecognized losses in operations in future years. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 4.00 percent.

The above accumulated postretirement benefit obligation is related to the Board sponsored life insurance programs. The Board has no liability for future payments to employees who continue coverage under the federally sponsored life and health programs upon retiring. Contributions for active employees participating in federally sponsored health programs totaled $7,188,000 and $6,205,000 in 2003 and 2002, respectively.

(5) Postemployment Benefit Plan

The Board provides disability and survivor income benefits to eligible employees after employment but before retirement. Effective January 1, 1994, the Board adopted Statement of Financial Accounting Standards No. 112, *Employers' Accounting for Postemployment Benefits*, which requires that employers providing postemployment benefits to their employees accrue the cost of such benefits. Prior to January 1994, postemployment benefit expenses were recognized on a pay-as-you-go basis.

	2003	2002
Change in benefit obligation		
Benefit obligation at beginning of year	$4,299,252	$3,591,571
Service cost	955,926	891,192
Interest cost	157,545	166,520
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	(156,797)	(76,282)
Benefits paid	(306,034)	(273,749)
Benefit obligation at end of year	$4,949,892	$4,299,252
Weighted-average assumptions as of December 31		
Discount rate	6.25%	6.75%
Expected asset return	N/A	N/A
Salary scale	4.00%	4.25%
Corridor	10.00%	10.00%

(6) Other Revenues and Other Expenses

The following are summaries of the components of Other Revenues and Other Expenses.

	As of December 31,	
	2003	2002
Other revenues		
Data processing revenue	$4,639,084	$4,830,600
Rent	2,029,514	1,996,893
Subscription revenue	799,356	810,032
Reimbursable services to other agencies	588,894	788,095
Board sponsored conferences	275,110	115,965
National Information Center	24,422	30,334
Miscellaneous	479,060	467,498
Total Other Revenues	$8,835,440	$9,039,417

Other expenses		
Tuition, registration, and membership fees	$1,615,074	$1,642,013
Public transportation subsidy	732,124	745,973
Contingency operations	704,699	264,232
Subsidies and contributions	627,854	900,049
Meals and representation	534,618	378,387
Former employee related payments	507,082	158,066
Security investigations	473,659	229,387
Equipment and facilities rental	439,751	318,132
Administrative law judges	307,173	147,830
Miscellaneous	700,084	357,521
Total Other Expenses	$6,642,118	$5,141,590

(7) COMMITMENTS

The Board has entered into several operating leases to secure office, training and warehouse space for remaining periods ranging from one to four years. In addition, the Board has entered into an agreement with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, through the Federal Financial Institutions Examination Council (the "Council") to fund a portion of enhancements for a central data repository project through 2013.

Mimimum annual payments under the operating leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 2003, are as follows:

2004	$157,079
2005	163,363
2006	71,991
After 2006	0
	$392,433

Rental expenses under the operating leases were $156,000 in 2003 and 2002.

(8) FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

The Board is one of the five member agencies of the Council, and currently performs certain management functions for the Council. The five agencies which are represented on the Council are the Board, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision. The Board's financial statements do not include financial data for the Council. Activity related to the Board and Council for 2003 and 2002 is summarized in the following table:

	2003	2002
Board paid to the Council:		
Assessments for operating expenses of the Council	$ 105,920	$ 300,000
Central Data Repository	630,000	0
Uniform Bank Performance Report	201,666	0
Total Board paid to the Council	$ 937,586	$ 300,000
Council paid to the Board:		
Data processing related services	3,485,701	3,350,412
Administrative services	72,250	69,593
Total Council paid to the Board	$3,557,951	$3,420,005

(9) FEDERAL RESERVE BANKS

The Board performs certain functions for the Reserve Banks in conjunction with its responsibilities for the Federal Reserve System, and the Federal Reserve Banks provide certain administrative functions for the Board. Activity related to the Board and Reserve Banks for 2003 and 2002 is summarized in the following table:

	2003	2002
Board paid to the Reserve Banks:		
Assessments for employee benefits	$ 2,137,781	$ 2,014,839
Data processing and communication	1,963,247	2,154,087
Contingency site	704,699	264,232
Total Board paid to the Reserve Banks	$ 4,805,727	$ 4,433,158
Reserve Banks paid to the Board:		
Assessments for currency costs	$508,144,248	$429,568,393
Assessments for operating expenses of the Board	297,020,200	205,110,800
Data processing	1,484,015	1,281,759
Total Reserve Banks paid to the Board	$806,648,463	$635,960,952

KPMG LLP
2001 M Street NW
Washington, DC 20036

Independent Auditors' Report on Internal Control over Financial Reporting

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2003 and 2002, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended, and have issued our report thereon dated April 2, 2004. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

In planning and performing our fiscal year 2003 audit, we considered the Board's internal control over financial reporting by obtaining an understanding of the Board's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. The objective of our audit was not to provide assurance on the Board's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses under standards issued by the American Institute of Certified Public Accountants. Material weaknesses are conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of the members of the Board and its management, the Office of Inspector General, the U.S. Office of Management and Budget, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

April 2, 2004

KPMG LLP
2001 M Street NW
Washington, DC 20036

Independent Auditors' Report on Compliance with Laws and Regulations

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2003 and 2002, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended, and have issued our report thereon dated April 2, 2004. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

The management of the Board is responsible for complying with laws and regulations applicable to the Board. As part of obtaining reasonable assurance about whether the Board's 2003 financial statements are free of material misstatement, we performed tests of the Board's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the members of the Board and its management, the Office of Inspector General, the U.S. Office of Management and Budget, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

April 2, 2004

Federal Reserve Banks
Combined Financial Statements

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent auditors, for the years ended December 31, 2003 and 2002.

PRICEWATERHOUSECOOPERS

REPORT OF INDEPENDENT AUDITORS

To the Board of Governors of the Federal Reserve System
and the Board of Directors of each of the Federal Reserve Banks:

We have audited the accompanying combined statements of condition of the Federal Reserve Banks (the "Reserve Banks") as of December 31, 2003 and 2002, and the related combined statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Reserve Banks' management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 3, the combined financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of the Federal Reserve System, are set forth in the *Financial Accounting Manual for Federal Reserve Banks* and constitute a comprehensive basis of accounting other than generally accepted accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of the Reserve Banks as of December 31, 2003 and 2002, and the combined results of their operations for the years then ended, in comformity with the basis of accounting described in Note 3.

Washington, D.C.
March 26, 2004

PricewaterhouseCoopers LLP

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION
December 31, 2003 and 2002

(in millions)

ASSETS	2003	2002
Gold certificates	$ 11,039	$ 11,039
Special drawing rights certificates	2,200	2,200
Coin	722	988
Items in process of collection	7,793	10,291
Loans to depository institutions	62	40
Securities purchased under agreements to resell (tri-party)	43,750	39,500
U.S. government and federal agency securities, net	675,569	639,125
Investments denominated in foreign currencies	19,868	16,913
Accrued interest receivable	5,064	5,470
Bank premises and equipment, net	2,117	2,044
Other assets	3,303	3,367
Total assets	$771,487	$730,977
LIABILITIES AND CAPITAL		
LIABILITIES		
Federal Reserve notes outstanding, net	$689,757	$654,273
Securities sold under agreements to repurchase	25,652	21,091
Deposits		
Depository institutions	23,058	22,541
U.S. Treasury, general account	5,723	4,420
Other deposits	394	444
Deferred credit items	7,582	9,459
Interest on Federal Reserve notes due U.S. Treasury	428	838
Accrued benefit costs	956	915
Other liabilities	243	236
Total liabilities	753,793	714,217
CAPITAL		
Capital paid-in	8,847	8,380
Surplus	8,847	8,380
Total capital	17,694	16,760
Total liabilities and capital	$771,487	$730,977

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

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF INCOME
for the years ended December 31, 2003 and 2002

(in millions)

	2003	2002
Interest income		
Interest on U.S. government and federal agency securities	$22,597	$25,525
Interest on investments denominated in foreign currencies	260	272
Interest on loans to depository institutions	1	2
Total interest income	22,858	25,799
Interest expense		
Interest expense on securities sold under agreements to repurchase	215	13
Net interest income	22,643	25,786
Other operating income		
Income from services	887	916
Reimbursable services to government agencies	328	309
Foreign currency gains, net	2,695	2,083
Government securities gains, net	. . .	77
Other income	79	80
Total other operating income	3,989	3,465
Operating expenses		
Salaries and other benefits	1,817	1,377
Occupancy expense	213	208
Equipment expense	257	263
Assessments by Board of Governors	805	635
Other expenses	534	720
Total operating expenses	3,626	3,203
Net income prior to distribution	$23,006	$26,048
Distribution of net income		
Dividends paid to member banks	$ 518	$ 484
Transferred to surplus	467	1,068
Payments to U.S. Treasury as interest on Federal Reserve notes	22,021	24,496
Total distribution	$23,006	$26,048

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

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CHANGES IN CAPITAL
for the years ended December 31, 2003 and 2002

(in millions)

	Capital paid-in	Surplus	Total capital
Balance at January 1, 2002 (147 million shares)	$7,373	$7,312	$14,685
Net income transferred to surplus	. . .	1,068	1,068
Net change in capital stock issued (20 million shares)	1,007	. . .	1,007
Balance at December 31, 2002 (167 million shares)	$8,380	$8,380	$16,760
Net income transferred to surplus	. . .	467	467
Net change in capital stock issued (9 million shares)	467	. . .	467
Balance at December 31, 2003 (176 million shares)	$8,847	$8,847	$17,694

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

Notes to the Combined Financial Statements of the Federal Reserve Banks

(1) Structure

The twelve Federal Reserve Banks (Reserve Banks) are part of the Federal Reserve System (System) created by Congress under the Federal Reserve Act of 1913 (Federal Reserve Act) which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. Other major elements of the System are the Board of Governors of the Federal Reserve System (Board of Governors), the Federal Open Market Committee (FOMC) and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York (FRBNY) and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state-chartered bank that applies and is approved for membership in the System.

Although the Reserve Banks are chartered as independent organizations overseen by the Board of Governors, the Reserve Banks work jointly to carry out their statutory responsibilities. The majority of the assets, liabilities, and income of the Reserve Banks is derived from central bank activities and responsibilities with regard to monetary policy and currency. For this reason, the accompanying combined set of financial statements for the twelve independent Reserve Banks is prepared with adjustments to eliminate interdistrict accounts and transactions.

Board of Directors

The Reserve Banks serve twelve Federal Reserve Districts nationwide. In accordance with the Federal Reserve Act, supervision and control of each Reserve Bank is exercised by a Board of Directors. The Federal Reserve Act specifies the composition of the Board of Directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. Of the six elected by member banks, three represent the public and three represent member banks. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

(2) Operations and Services

The System performs a variety of services and operations. Functions include: formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse (ACH) operations and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

In performing fiscal agency functions for the U.S. Treasury, seven Reserve Banks provide U.S. securities direct purchase and savings bond processing services. In December 2003, the U.S. Treasury announced plans to consolidate the provision of these services at FRB Cleveland and Minneapolis. An implementation plan is expected to be announced in March 2004. At this time, the Banks have not developed a detailed estimate of the financial effect of the consolidation.

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of U.S. government and federal agency securities, matched sale–purchase transactions, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. FRBNY is also authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange (F/X) and securities contracts in, nine foreign currencies, maintain reciprocal currency arrangements (F/X swaps) with various central banks, and ''warehouse'' foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (ESF) through the Reserve Banks.

(3) SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* (*Financial Accounting Manual*), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the *Financial Accounting Manual*.

These combined financial statements have been prepared in accordance with the *Financial Accounting Manual*. Differences exist between the accounting principles and practices of the System and generally accepted accounting principles in the United States of America (GAAP). The primary differences are the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP, and the accounting for matched sale–purchase transactions as separate sales and purchases, rather than secured borrowings with pledged collateral, as is generally required by GAAP. In addition, the Board of Governors and the Reserve Banks have elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included, because the liquidity and cash position of the Reserve Banks are not of primary concern to users of these combined financial statements. Other information regarding the Reserve Banks' activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. A Statement of Cash Flows, therefore, would not provide any additional useful information. There are no other significant differences between the policies outlined in the *Financial Accounting Manual* and GAAP.

The preparation of the combined financial statements in conformity with the *Financial Accounting Manual* requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the combined financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

(A) *Gold Certificates*

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged and the Reserve Banks' gold certificate account is lowered. The value of gold for purposes of backing the gold certificates is set by law at $42 2/9 a fine troy ounce.

(B) *Special Drawing Rights Certificates*

Special drawing rights (SDRs) are issued by the International Monetary Fund (Fund) to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate account is increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. There were no SDR transactions in 2003 or 2002.

(C) *Loans to Depository Institutions*

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Banks, subject to review by the Board of Governors.

(D) *U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies*

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account (SOMA). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. Such authorizations are reviewed and approved annually by the FOMC.

In December 2002, matched sale–purchase (MSP) transactions were replaced with securities sold under agreements to repurchase. MSP transactions, accounted for as separate sale and purchase transactions, are transactions in which the FRBNY sells a security and buys it back at the rate specified at the commencement of the transaction. Securities sold under agreements to repurchase are treated as secured borrowing transactions with the associated interest expense recognized over the life of the transaction.

In addition to the aforementioned matched sale–purchase transactions and sales of securities under agreements to repurchase, the FRBNY may engage in tri-party purchases of securities under agreements to resell (tri-party agreements). Tri-party agreements are conducted with two custodial banks that manage the clearing and settlement of collateral. Acceptable collateral under tri-party agreements primarily includes U.S. government and agency securities, pass-through mortgage securities of Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association, STRIP securities of the U.S. government and "stripped" securities of other government agencies. The tri-party agreements are accounted for as financing transactions with the associated interest income accrued over the life of the agreements.

The FRBNY has sole authorization by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements on behalf of the System, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires FRBNY to take possession of collateral in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by FRBNY on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

F/X contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The Bank will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases of foreign currencies and related international operations.

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts which contain varying degrees of off-balance-sheet market risk, because they represent contractual commitments involving future settlement, and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that can result in gains or losses when holdings are sold prior to maturity. Decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

is accrued on a straight-line basis and is reported as "Interest on U.S. government and federal agency securities" or "Interest on investments denominated in foreign currencies," as appropriate. Income earned on securities lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses on the sales of U.S. government and federal agency securities are reported as "Government securities gains, net." Foreign-currency-denominated assets are revalued daily at current market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency gains (losses), net." Foreign currencies held through F/X swaps, when initiated by the counterparty, and warehousing arrangements are revalued daily with the unrealized gain or loss reported as a component of "Other assets" or "Other liabilities," as appropriate.

In 2003, additional interest income of $61 million, representing one day's interest on the SOMA portfolio, was accrued to reflect a change in interest accrual methods. Interest accruals and the amortization of premiums and discounts are now recognized beginning the day that a security is purchased and ending the day before the security matures or is sold. Previously, accruals and amortization began the day after the security was purchased and ended on the day that the security matured or was sold. The effect of this change was not material; therefore, it was included in the 2003 interest income.

(E) *Bank Premises, Equipment, and Software*

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the application stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years.

(F) *Federal Reserve Notes*

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In 2003, the Federal Reserve Act was amended to expand the assets eligible to be pledged as collateral security to include all Federal Reserve Bank assets. Prior to the amendment, only gold certificates, special drawing rights certificates, U.S. government and federal agency securities, securities purchased under agreements to resell, loans to depository institutions, and investments denominated in foreign currencies could be pledged as collateral. The collateral value is equal to the book value of the collateral tendered, with the exception of securities whose collateral value is equal to the par value of the securities tendered and securities purchased under agreements to resell, which are valued at the contract amount. The par value of securities pledged for securities sold under agreements to repurchase is similarly deducted. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides that certain assets of the Reserve Banks are jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents Federal Reserve notes outstanding reduced by the Reserve Banks' currency holdings of $110,176 million and $104,983 million at December 31, 2003 and 2002, respectively.

At December 31, 2003 all Federal Reserve notes outstanding were fully collateralized. All gold certificates, all special drawing rights certificates, and $676,518 million of domestic securities and securities purchased under agreements to resell were pledged as collateral. At December 31, 2003, no loans or investments denominated in foreign currencies were pledged as collateral.

(G) *Capital Paid-In*

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank's capital and surplus changes, its holdings of the Reserve Bank's stock must be adjusted. Member banks are those state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

(H) *Surplus*

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of

December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

In the event of losses, or a substantial increase in capital, a Reserve Bank will suspend its payments to the U.S. Treasury until such losses or increases in capital are recovered through subsequent earnings. Weekly payments to the U.S. Treasury may vary significantly.

(I) *Income and Costs Related to Treasury Services*

Reserve Banks are required by the Federal Reserve Act to serve as fiscal agents and depositories of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

(J) *Taxes*

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. Real propery taxes were $33 million and $32 million for the years ended December 31, 2003 and 2002, respectively, and are reported as a component of "Occupancy expense."

(K) *Recent Accounting Developments*

In May 2003, the Financial Accounting Standards Board issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150, which will become applicable for the Reserve Banks in 2004, establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and imposes certain additional disclosure requirements. When adopted, there may be situations in which a Reserve Bank has not yet processed a member bank's application to redeem its Reserve Bank stock. In those situations, this standard requires that the portion of the capital paid-in that is mandatorily redeemable be reclassified as debt.

(L) *2003 Restructuring Charges*

In 2003, the System restructured several operations, primarily in the check and currency services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations.

Footnote 10 describes the restructuring and provides information about Reserve Bank costs and liabilities associated with employee separations and contract terminations. The costs associated with the write-down of certain Reserve Bank assets are discussed in footnote 6. Costs and liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8 and those associated with enhanced postretirement benefits provided by the Reserve Banks are discussed in footnote 9.

(4) U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES

Securities bought outright are held in the SOMA at the FRBNY.

Total securities held in the SOMA at December 31 that were bought outright, were as follows (in millions):

	2003	2002
Par value		
Federal agency	$ . . .	$ 10
U.S. government		
Bills	244,833	226,682
Notes	323,361	297,893
Bonds	98,471	104,832
Total par value	666,665	629,417
Unamortized premiums	9,797	10,762
Unaccreted discounts	(893)	(1,054)
Total	$675,569	$639,125

As noted in footnote 3, the FRBNY replaced MSP transactions with securities sold under agreements to repurchase in December 2002. At December 31, 2003 and 2002, securities sold under agreements to repurchase with a contract amount of $25,652 million and $21,091 million, respectively, were outstanding. At December 31, 2003 and 2002, securities sold under agreements to repurchase with a par value of $25,658 million and $21,098 million, respectively, were outstanding.

The maturity distribution of U.S. government and federal agency securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase, which were held in the SOMA at December 31, 2003, was as follows (in millions):

Maturities of securities held	U.S. government securities (Par)	Securities purchased under agreements to resell (Contract amount)	Securities sold under agreements to repurchase (Contract amount)
Within 15 days	$ 47,733	$43,750	$25,652
16 days to 90 days	139,347	. . .	. . .
91 days to 1 year	164,071	. . .	. . .
Over 1 year to 5 years	187,056	. . .	. . .
Over 5 years to 10 years	51,312	. . .	. . .
Over 10 years	77,146	. . .	. . .
Total	$666,665	$43,750	$25,652

At December 31, 2003 and 2002, U.S. government securities with par values of $4,426 million and $1,841 million, respectively, were loaned from the SOMA.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

(5) INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and the Bank for International Settlements, and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities held under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Total investments denominated in foreign currencies, valued at current exchange rates at December 31, were as follows (in millions):

	2003	2002
European Union Euro		
Foreign currency deposits	$ 6,870	$ 5,580
Government debt instruments including agreements to resell	4,090	3,298
Japanese Yen		
Foreign currency deposits	1,475	1,789
Government debt instruments including agreements to resell	7,341	6,164
Accrued interest	92	82
Total	$19,868	$16,913

The maturity distribution of investments denominated in foreign currencies at December 31, 2003, was as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	
Within 1 year	$18,243
Over 1 year to 5 years	1,292
Over 5 years to 10 years	333
Over 10 years	. . .
Total	$19,868

At December 31, 2003 and 2002, there were no outstanding F/X swaps or material open foreign exchange contracts.

At December 31, 2003 and 2002, the warehousing facility was $5,000 million, with no balance outstanding.

(6) BANK PREMISES, EQUIPMENT, AND SOFTWARE

A summary of bank premises and equipment at December 31 is as follows (in millions):

	2003	2002
Bank premises and equipment		
Land	$ 244	$ 209
Buildings	1,559	1,514
Building machinery and equipment	364	345
Construction in progress	96	51
Furniture and equipment	1,334	1,362
Subtotal	3,597	3,481
Accumulated depreciation	(1,480)	(1,437)
Bank premises and equipment, net	$2,117	$2,044
Depreciation expense, for the years ended	$ 184	$ 187

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

	2003	2002
Bank premises and equipment	$36	$15
Accumulated depreciation	(27)	(12)
Capitalized leases, net	$ 9	$ 3

Certain of the Reserve Banks lease unused space to outside tenants. Those leases have terms ranging from 1 to 13 years. Rental income from such leases totaled $20 million and $21 million for the years ended December 31, 2003 and 2002, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2003, were (in millions):

2004	$18
2005	16
2006	13
2007	9
2008	8
Thereafter	34
Total	$98

The Reserve Banks have capitalized software assets, net of amortization, of $158 million and $141 million at December 31, 2003 and 2002, respectively. Amortization expense was $54 million and $45 million for the years ended December 31, 2003 and 2002, respectively.

Several Reserve Banks have impaired assets as a result of the System's restructuring plan, as discussed in footnote 10, or as a result of the System's decision to standardize check processing. Impaired assets include software, buildings, leasehold improvements, furniture, and equipment. Asset impairment losses related to the restructuring and check processing standardization of $11 million and $3 million, respectively, for the period ending December 31, 2003 were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

Three Reserve Banks are constructing new buildings, one to replace the head office and two to replace branch offices. At December 31, 2003, the contractual obligation for the property for the new head office building site was $18 million, none of which has been recognized. The obligation was satisfied in February 2004.

(7) COMMITMENTS AND CONTINGENCIES

At December 31, 2003, the Reserve Banks were obligated under noncancelable leases for premises and equipment with terms ranging from 1 to 20 years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $71 million and $70 million for the years ended December 31, 2003 and 2002, respectively. Certain of the Reserve Banks' leases have options to renew.

Future minimum rental payments under noncancelable operating and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2003, were (in millions):

	Operating	Capital
2004	$ 10.5	$ 2.7
2005	8.2	2.1
2006	7.3	1.9
2007	6.5	.6
2008	6.5	. . .
Thereafter	124.7	. . .
	$163.7	$ 7.3
Amount representing interest		(.5)
		$ 6.8

At December 31, 2003, the Reserve Banks had contractual commitments through the year 2008 totaling $153 million for the maintenance of currency machines, check-processing-related services, and check transportation services, none of which has been recognized. Three Reserve Banks contract for these services on behalf of the System and two of them allocate the costs to the other Reserve Banks.

Three Reserve Banks have additional contractual commitments through the year 2008 for software development and maintenance, architectural and contracting services, and building maintenance. At December 31, 2003, these contractual commitments totaled $169 million, none of which has been recognized.

The Reserve Banks are involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position or results of operations of the Reserve Banks.

(8) Retirement and Thrift Plans

Retirement Plans

The Reserve Banks currently offer two defined benefit retirement plans to their employees, based on length of service and level of compensation. Substantially all of the Reserve Banks', Board of Governors', and the Plan Administrative Office's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan) and the Benefit Equalization Retirement Plans offered by each individual Reserve Bank (BEP). In addition, certain Bank officers participate in a Supplemental Employee Retirement Plan (SERP).

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. Certain Board employees not covered by the Social Security Act also contribute to the plan. No separate accounting is maintained of assets contributed by the participating employers. FRBNY acts as a sponsor of the Plan for the System and costs associated with the Plan are not redistributed to other participating employers. The prepaid pension cost includes amounts related to the participating employees of all employers who participate in the plans.

Following is a reconciliation of the beginning and ending balances of the System Plan benefit obligation (in millions):

	2003	2002
Estimated actuarial present value of projected benefit obligation at January 1	$3,523	$3,091
Service cost—benefits earned during the period	109	104
Interest cost on projected benefit obligation	232	226
Actuarial loss	192	126
Contributions by plan participants	4	3
Benefits paid	(197)	(170)
Special termination loss/amendments	67	143
Estimated actuarial present value of projected benefit obligation at December 31	$3,930	$3,523

Following is a reconciliation of the beginning and ending balances of the System Plan assets, the funded status, and the prepaid pension benefit costs (in millions):

	2003	2002
Estimated fair value of plan assets at January 1	$4,997	$5,795
Actual return on plan assets	899	(631)
Contributions by plan participants	4	3
Employer contributions	. . .	. . .
Benefits paid	(197)	(170)
Estimated fair value of plan assets at December 31	$5,703	$4,997
Funded status	$1,774	$1,474
Unrecognized prior service cost	197	223
Unrecognized net actuarial loss	710	1,042
Prepaid pension benefit costs	2,681	2,739

Prepaid pension benefit costs are reported as a component of "Other assets."

The accumulated benefit obligation for the defined benefit pension plan was $3,456 million and $2,996 million at December 31, 2003, and 2002, respectively.

The weighted-average assumptions used in developing the pension benefit obligation for the System Plan as of December 31 are as follows:

	2003	2002
Discount rate	6.25%	6.75%
Rate of compensation increase	4.00%	4.25%

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The weighted-average assumptions used in developing net periodic benefit cost for the System Plan for the years ending December 31 are as follows:

	2003	2002
Discount rate	6.75%	7.00%
Expected asset return	8.50%	9.00%
Rate of compensation increase	4.25%	4.50%

The long-term rate of return on assets was based on a combination of methodologies including the System Plan's historical returns, surveys of other plans' expected rates of return, building a projected return for equities and fixed income investments based on real interest rates, inflation expectations and equity risk premiums and finally, surveys of expected returns in equity and fixed income markets.

The components of net periodic pension benefit cost (credit) for the System Plan as of December 31 are shown below (in millions):

	2003	2002
Service cost—benefits earned during the period	$ 109	$ 104
Interest cost on projected benefit obligation	232	226
Amortization of prior service cost	26	27
Recognized net loss	42	. . .
Expected return on plan assets	(418)	(514)
Net periodic pension benefit credit	(9)	(157)
Special termination benefits	67	. . .
Net periodic pension benefit cost (credit)	$ 58	$(157)

The recognition of special termination benefits is the result of enhanced retirement benefits provided to 1,184 System employees in conjunction with the restructuring disclosed in footnote 10. Net periodic pension benefit cost (credit) is reported as a component of "Salaries and other benefits."

The Federal Reserve System's pension plan weighted-average asset allocations at December 31, by asset category are as follows:

	2003	2002
Equities	61.9%	64.6%
Fixed income	34.8%	32.2%
Cash	3.3%	3.2%
Total	100.0%	100.0%

The System's Committee on Investment Performance (CIP) contracts with investment managers who are responsible for implementing the System Plan's investment policies. The managers' performance is measured against a trailing 36-month-benchmark of 60 percent of a market value weighted index of predominantly large capitalization stocks trading on the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers Automated Quotation National Market System and 40 percent of a broadly diversified investment-grade fixed income index (rebalanced monthly). The managers invest Plan funds within CIP-established guidelines for investment in equities and fixed income instruments. Equity investments can range between 40 percent and 80 percent of the portfolio. Investments, however, cannot be concentrated in particular industries and equity security holdings of any one company are limited. Fixed income securities must be investment grade and the effective duration of the fixed income portfolio must remain within a range of 67 percent and 150 percent of a broadly diversified investment-grade fixed income index. System Plan investment policies prohibit margin, short sale, foreign exchange, and commodities trading as well as investment in bank, bank holding company, savings and loan, and government securities dealer's stocks. In addition, investments in non-dollar denominated securities are prohibited; however, a small portion of the portfolio can be invested in American Depositary Receipts/Shares.

The Federal Reserve System does not expect to make a cash contribution to the Retirement Plan during 2004.

The Reserve Banks' projected benefit obligations and net pension costs for the BEP and the SERP at December 31, 2003 and 2002, and for the years then ended, are not material.

Thrift Plan

Employees of the Reserve Banks may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Reserve Banks' Thrift Plan contributions totaled $64 million and $63 million for the years ended December 31, 2003 and 2002, respectively, and are reported as a component of "Salaries and other benefits."

(9) POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Pensions

In addition to the Reserve Banks' retirement plans, employees who have met certain age and length of service requirements are eligible for both medical benefits and life insurance coverage during retirement.

The Reserve Banks fund benefits payable under the medical and life insurance plans as due and, accordingly, have no plan assets. Net postretirement benefit costs are actuarially determined using a January 1 measurement date.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Following is a reconciliation of beginning and ending balances of the benefit obligation (in millions):

	2003	2002
Accumulated postretirement benefit obligation at January 1	$742	$674
Service cost—benefits earned during the period	18	17
Interest cost of accumulated benefit obligation	50	47
Actuarial loss	157	49
Curtailment loss	7	. . .
Special termination loss	2	. . .
Contributions by plan participants	6	4
Benefits paid	(40)	(37)
Plan amendments	. . .	(12)
Accumulated postretirement benefit obligation at December 31	$942	$742

Following is a reconciliation of the beginning and ending balances of the plan assets, the unfunded postretirement benefit obligation and the accrued postretirement benefit costs (in millions):

	2003	2002
Fair value of plan assets at January 1	$ . . .	$ . . .
Contributions by the employer	34	33
Contributions by plan participants	6	4
Benefits paid	(40)	(37)
Fair value of plan assets at December 31	$ . . .	$ . . .
Unfunded postretirement benefit obligation	$942	$742
Unrecognized net curtailment gain	2	. . .
Unrecognized prior service cost	122	141
Unrecognized net actuarial loss	(246)	(93)
Accrued postretirement benefit costs	$820	$790

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs."

At December 31, 2003 and 2002, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 6.25 percent and 6.75 percent, respectively.

For measurement purposes, a 10.00 percent annual rate of increase in the cost of covered health care benefits was assumed for 2004. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.00 percent by 2011 and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2003 (in millions):

	One percentage point increase	One percentage point decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 10	$ (8)
Effect on accumulated postretirement benefit obligation	110	(98)

The following is a summary of the components of net periodic postretirement benefit costs for the years ended December 31 (in millions):

	2003	2002
Service cost—benefits earned during the period	$18	$17
Interest cost of accumulated benefit obligation	50	47
Amortization of prior service cost	(15)	(14)
Recognized net actuarial loss	4	2
Total periodic expense	57	52
Curtailment loss	5	. . .
Special termination loss	2	. . .
Net periodic postretirement benefit costs	$64	$52

Net periodic postretirement benefit costs are reported as a component of "Salaries and other benefits."

As a result of the enhanced retirement benefits provided to employees during the restructuring described in footnote 10, the postretirement plans of all of the Reserve Banks incurred special termination losses and the plans of four of the Reserve Banks were curtailed. The combined effect of the three curtailment losses and one gain on the benefit obligation was a loss of $7 million reflected above. One of the curtailment losses was offset by unrecognized actuarial gains. As a result, there were only two Banks with net curtailment losses, both of which were recognized in 2003. The net curtailment gains at the other two Reserve Banks will be recognized when the affected employees terminate employment in 2004.

Following the guidance of the Financial Accounting Standards Board, the Reserve Banks elected to defer recognition of the financial effects of the Medicare Prescription Drug Improvement and Modernization Act of 2003 until further guidance is issued. Neither the accumulated postretirement benefit obligation at December 31, 2003 nor the net periodic postretirement benefit cost for the year then ended reflect the effect of the Act on the plan.

Postemployment Benefits

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, disability benefits, and those workers' compensation expenses self-insured by individual Reserve Banks. Costs were projected using the

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Reserve Banks at December 31, 2003 and 2002, were $130 million and $121 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2003 and 2002 operating expenses were $26 million.

10. Restructuring Charges

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check and currency operations and staff reductions in various functions of the Bank. These actions resulted in the following business restructuring charges:

Major categories of expense (in millions):

	Total estimated costs
Employee separation	$37
Contract termination	1
Other	2
Total	$40

	Accrued liability 12/31/02	Total charges	Total paid	Accrued liability 12/31/03
Employee separation	$. . .	$36	$(7)	$29
Contract termination	. . .	1	. . .	1
Other	. . .	2	(2)	. . .
Total	$. . .	$39	$(9)	$30

Employee separation costs are primarily severance costs related to reductions of approximately 1,662 staff and are reported as a component of "Salaries and other benefits." Contract termination costs include the charges resulting from terminating existing lease and other contracts and other costs are primarily charges for System contract management. Contract termination and other costs are shown as a component of "Other expenses."

Costs associated with the write-downs of certain Bank assets, including software, buildings, leasehold improvements, furniture, and equipment are discussed in footnote 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8. Costs associated with enhanced postretirement benefits are disclosed in footnote 9.

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2004.

The Reserve Banks anticipate substantially completing announced plans by December 31, 2004.

Office of Inspector General Activities

The Board's Office of Inspector General (OIG) functions in accordance with the Inspector General Act of 1978, as amended. In addition to retaining an independent auditor each year to audit the Board's financial statements, the OIG plans and conducts audits and investigations of the Board's programs and operations and its delegated functions at the Federal Reserve Banks. The OIG also reviews existing and proposed legislation and regulations for economy and efficiency. It recommends policies, and it supervises and conducts activities that promote economy and efficiency and that prevent and detect waste, fraud, and abuse in Board and Board-delegated programs and operations, as well as in activities administered or financed by the Board. The OIG keeps the Congress and the Chairman of the Board fully informed about serious abuses and deficiencies and about the status of any corrective actions.

During 2003, the OIG completed seven audits, reviews, and other assessments and conducted a number of follow-up reviews to evaluate action taken on earlier recommendations. The OIG also closed ten investigations and performed numerous legislative and regulatory reviews.

Completed OIG Audits, Reviews, and Assessments, 2003

Report title	Report number	Month issued
Review of the Supervision of Hamilton Bancorp, Inc.	A0201	March
Audit of the FFIEC's Financial Statements (Years Ended 2001 and 2002)	A0210	March
Audit of the Board's Financial Statements (Years Ended 2001 and 2002)	A0210	March
Audit of the Retirement Plan Administration	A0208	July
Survey of Surveillance Activities	A0206	August
Report on the Evaluation of the Board's E-Government Initiatives	R0205	September
Audit of the Board's Information Security Program	A0302	September

General Accounting Office Reviews

Under the Federal Banking Agency Audit Act (Public Law 95–320), most of the operations of the Federal Reserve System are under the purview of the General Accounting Office (GAO). In 2003, the GAO completed six reports on selected aspects of Federal Reserve operations. Six projects concerning the Federal Reserve were in various stages of completion at year-end. The reports are available directly from the GAO.

Completed GAO Reports Relating to the Federal Reserve System, 2003

Report title	Report number	Date issued
Critical Infrastructure Protection: Efforts of the Financial Services Sector to Address Cyber Threats	GAO-03-173	1-30-03
Federal Reserve Banks: Areas for Improvement in Computer Controls	GAO-03-333R	2-10-03
Potential Terrorist Attacks: Additional Actions Needed to Better Prepare Critical Financial Market Participants	GAO-03-414	2-12-03
Information Security: Computer Controls Over Key Treasury Internet Payment System	GAO-03-837	7-30-03
Bank Tying: Additional Steps Needed to Ensure Effective Enforcement of Tying	GAO-04-3	10-10-03
Information Technology: Leadership Remains Key to Agencies Making Progress on Enterprise Architecture Efforts	GAO-04-40	11-17-03

Active GAO Projects Relating to the Federal Reserve System, Year-End 2003

Subject of project	Date initiated
Federal Reserve's relationship with U.S. Mint and BEP	7-30-02
Predatory home mortgage lending	1-23-03
Updates on impact of 9/11 attacks on U.S. financial markets	5-20-03
Illegal financial assets	5-23-03
Financial services regulation	7-17-03
Regulatory information sharing issues tied to insurance-related products	7-25-03