

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Financial Statements

December 31, 2005 and 2004

(With Independent Auditors' Report Thereon)



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, 2005 and 2004, 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 *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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Board's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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 of Governors of the Federal Reserve System, at December 31, 2005 and 2004, 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 reports dated May 31, 2006, on our consideration of the Board's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in assessing the results of our audits.

KPMG LLP

May 31, 2006

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEETS

	<u>As of December 31,</u>	
	<u>2005</u>	<u>2004</u>
<u>ASSETS</u>		
CURRENT ASSETS		
Cash	\$ 45,970,435	\$ 60,107,292
Accounts receivable	3,345,446	1,696,480
Prepaid expenses and other assets	2,728,486	4,015,067
Total current assets	<u>52,044,367</u>	<u>65,818,839</u>
NONCURRENT ASSETS		
Property and equipment, net (Note 3)	155,441,553	149,028,686
Art Collections (Note 2)		
Total noncurrent assets	<u>155,441,553</u>	<u>149,028,686</u>
Total assets	<u>\$ 207,485,920</u>	<u>\$ 214,847,525</u>
<u>LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS</u>		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	\$ 16,906,350	\$ 13,891,861
Accrued payroll and related taxes	4,860,572	4,552,039
Accrued annual leave	15,456,484	14,195,910
Capital lease payable (current portion)	270,167	250,794
Unearned revenues and other liabilities	783,711	467,664
Total current liabilities	<u>38,277,284</u>	<u>33,358,268</u>
LONG-TERM LIABILITIES		
Capital lease payable (non-current portion)	406,188	675,271
Accumulated retirement benefit obligation (Note 4)	813,497	594,169
Accumulated postretirement benefit obligation (Note 5)	6,237,290	5,789,566
Accumulated postemployment benefit obligation (Note 6)	5,111,365	5,308,565
Total long-term liabilities	<u>12,568,340</u>	<u>12,367,571</u>
Total liabilities	<u>50,845,624</u>	<u>45,725,839</u>
CUMULATIVE RESULTS OF OPERATIONS		
Working capital	14,037,250	32,711,365
Unfunded long-term liabilities	(12,162,152)	(11,692,300)
Net investment in property and equipment	154,765,198	148,102,621
Total cumulative results of operations	<u>156,640,296</u>	<u>169,121,686</u>
Total liabilities and cumulative results of operations	<u>\$ 207,485,920</u>	<u>\$ 214,847,525</u>

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,	
	2005	2004
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	\$ 265,742,100	\$ 272,331,500
Other revenues (Note 7)	8,520,342	8,336,581
Total operating revenues	274,262,442	280,668,081
BOARD OPERATING EXPENSES		
Salaries	174,523,825	166,797,724
Retirement and insurance	31,847,951	30,850,441
Contractual services and professional fees	24,695,564	24,835,904
Depreciation and net losses on disposals	12,954,506	12,445,708
Utilities	9,065,329	8,273,801
Travel	7,794,483	7,088,444
Software	6,052,617	6,302,695
Postage and supplies	7,169,829	6,116,355
Repairs and maintenance	3,361,179	3,954,263
Printing and binding	1,973,594	1,944,552
Other expenses (Note 7)	7,304,955	6,515,129
Total operating expenses	286,743,832	275,125,016
RESULTS OF OPERATIONS	(12,481,390)	5,543,065
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	477,087,471	503,784,304
Expenses for currency printing, issuance, retirement and shipping	477,087,471	503,784,304
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES	-	-
TOTAL RESULTS OF OPERATIONS	(12,481,390)	5,543,065
CUMULATIVE RESULTS OF OPERATIONS, Beginning of year	169,121,686	163,578,621
CUMULATIVE RESULTS OF OPERATIONS, End of year	\$ 156,640,296	\$ 169,121,686

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES		
RESULTS OF OPERATIONS	\$ (12,481,390)	\$ 5,543,065
Adjustments to reconcile results of operations to net cash provided by (used in) operating activities:		
Depreciation and net losses on disposals	12,954,506	12,445,708
Increase in assets:		
Accounts receivable, prepaid expenses and other assets	(362,385)	(1,846,076)
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	3,014,489	(1,455,529)
Accrued payroll and related taxes	308,533	(504,608)
Accrued annual leave	1,260,574	766,917
Unearned revenues and other liabilities	316,047	76,966
Accumulated retirement benefit obligation	219,328	(1,432)
Accumulated postretirement benefit obligation	447,724	467,513
Accumulated postemployment benefit obligation	(197,200)	358,673
Net cash provided by operating activities	<u>5,480,226</u>	<u>15,851,197</u>
 CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals	2,850	4,005
Capital expenditures	(19,370,223)	(11,715,861)
Net cash used in investing activities	<u>(19,367,373)</u>	<u>(11,711,856)</u>
 CASH FLOWS FROM FINANCING ACTIVITIES		
Capital lease payments	(249,710)	(211,703)
Net cash used in financing activities	<u>(249,710)</u>	<u>(211,703)</u>
 NET INCREASE (DECREASE) IN CASH	 (14,136,857)	 3,927,638
 CASH BALANCE, Beginning of year	 <u>60,107,292</u>	 <u>56,179,654</u>
 CASH BALANCE, End of year	 <u>\$ 45,970,435</u>	 <u>\$ 60,107,292</u>
 SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Capital lease obligations incurred	\$ -	\$ 190,538

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

(1) STRUCTURE

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 DC based 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 results of 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.

(2) SIGNIFICANT ACCOUNTING POLICIES

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 passed through Board accounts and 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.

Art 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 Statement of Financial Accounting Standards Number 116, *Accounting for Contributions Received and Contributions Made*, 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 2004 amounts have been reclassified to conform with the 2005 presentation.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

(3) 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,	
	2005	2004
Land	\$ 18,640,314	\$ 18,640,314
Buildings and improvements	135,152,735	132,891,551
Furniture and equipment	39,926,270	44,450,522
Software	12,990,050	12,207,125
Construction in process	13,928,149	4,380,259
	220,637,518	212,569,771
Less accumulated depreciation	(65,195,965)	(63,541,085)
Property and equipment, net	\$ 155,441,553	\$ 149,028,686

Furniture and equipment includes \$1,230,000 each year for capitalized leases as of December 31, 2005 and 2004. Accumulated depreciation includes \$612,000 and \$356,000 for capitalized leases as of December 31, 2005 and 2004, respectively. The Board paid interest related to these capital leases in the amount of \$83,000 and \$104,000 for 2005 and 2004, respectively.

Construction in process includes costs incurred in 2005 and 2004 for long-term security projects and building enhancements.

The future minimum lease payments required under the capital leases and the present value of the net minimum lease payments as of December 31, 2005, are as follows:

	Year Ending December 31	Amount
	2006	\$ 417,358
	2007	416,274
	2008	138,279
Total minimum lease payments		971,911
Less: Amount representing maintenance included in total amounts above		(207,125)
Net minimum lease payments		764,786
Less: Amount representing interest		(88,431)
Present value of net minimum lease payments		676,355
Less: Current maturities of capital lease obligations		(270,167)
Long-term capital lease obligations		\$ 406,188

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

(4) ACCUMULATED RETIREMENT BENEFITS

This following information provides disclosure requirements contained in Statement of Financial Accounting Standards No.132, *Employers' Disclosures about Pensions and Other Postretirement 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 Office of Employee Benefits.

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 non-contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 2005 and 2004, and the Board was not assessed a contribution for these years. 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). These defined benefit plans are administered by the U.S. Office of Personnel Management, which determines the required employer contribution levels. The Board's contributions to these plans totaled \$324,000 and \$330,000 in 2005 and 2004, respectively. The Board has no liability for future payments to retirees under these programs and is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Board contributions to members' accounts are based upon a fixed percentage of each member's basic contribution and were \$8,617,000 and \$8,314,000 in 2005 and 2004, 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. Activity for the BEP for 2005 and 2004 is summarized in the following table:

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

	2005	2004
<u>Change in Projected Benefit Obligation</u>		
Benefit obligation at beginning of year	\$ 140,953	\$ 74,956
Service cost	193,209	23,239
Interest cost	35,964	6,170
Plan participants' contributions	-	-
Plan amendments	-	-
Actuarial (gain)/loss	168,027	36,588
Benefits paid	(1,814)	-
Benefit obligation at end of year	\$ 536,339	\$ 140,953
<u>Change in Plan Assets</u>		
Fair value of plan assets at beginning of year	\$ -	\$ -
Actual return on plan assets	-	-
Employer contributions	1,814	-
Plan participants' contributions	-	-
Benefits paid	(1,814)	-
Fair value of plan assets at end of year	\$ -	\$ -
<u>Reconciliation of Funded Status at End of Year</u>		
Funded status	\$ (536,339)	\$ (140,953)
Unrecognized net actuarial (gain)/loss	(15,728)	(177,773)
Unrecognized prior service cost	(701,125)	(817,732)
Unrecognized net transition obligation	439,695	542,289
Retirement benefit liability	\$ (813,497)	\$ (594,169)
<u>Information for pension plans with an accumulated benefit obligation in excess of plan asset:</u>		
Projected benefit obligation	\$ 536,339	\$ 140,953
Accumulated benefit obligation	\$ 278,252	\$ 33
<u>Weighted-average assumptions used to determine benefit obligation as of December 31</u>		
Discount rate	5.75%	5.75%
Rate of compensation increase	4.50%	4.25%
<u>Components of Net Periodic Benefit Cost</u>		
Service cost - benefits earned during the period	\$ 193,209	\$ 23,239
Interest cost on projected benefit obligation	35,964	6,170
Expected return on plan assets	-	-
Amortization of prior service cost	(116,607)	(116,607)
Amortization of (gains)/losses	5,982	(16,828)
Amortization of initial (asset)/obligation	102,594	102,594
Net periodic benefit cost (credit)	\$ 221,142	\$ (1,432)
<u>Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31</u>		
Discount rate	5.75%	6.25%
Rate of compensation increase	4.25%	4.00%

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

(5) ACCUMULATED POSTRETIREMENT BENEFITS

This following information provides disclosure requirements contained in Statement of Financial Accounting Standards No.106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

The Board provides certain life insurance programs for its active employees and retirees. Activity for 2005 and 2004 is summarized in the following table:

	2005	2004
<u>Change in Benefit Obligation</u>		
Benefit obligation at beginning of year	\$ 8,404,552	\$ 7,166,146
Service cost	217,421	203,229
Interest cost	437,320	443,043
Plan participants' contributions	-	-
Plan amendments	(196,970)	-
Actuarial (gain)/loss	(304,006)	845,851
Benefits paid	(284,485)	(253,717)
Benefit obligation at end of year	\$ 8,273,832	\$ 8,404,552
<u>Change in Plan Assets</u>		
Fair value of plan assets at beginning of year	\$ -	\$ -
Actual return on plan assets	-	-
Employer contribution	284,485	253,717
Plan participants' contributions	-	-
Benefits paid	(284,485)	(253,717)
Fair value of plan assets at end of year	\$ -	\$ -
<u>Reconciliation of Funded Status at End of Year</u>		
Funded status	\$ (8,273,832)	\$ (8,404,551)
Unrecognized net actuarial (gain)/loss	2,145,920	2,537,211
Unrecognized prior service cost	(109,378)	77,774
Prepaid/(accrued) postretirement benefit liability	\$ (6,237,290)	\$ (5,789,566)
<u>Components of Net Periodic Cost for Year</u>		
Service cost	\$ 217,421	\$ 203,229
Interest cost	437,320	443,043
Amortization of prior service cost	(9,818)	6,073
Amortization of (gains)/losses	87,286	68,885
Total net periodic cost	\$ 732,209	\$ 721,230

The liability and costs for the postretirement benefit plan were determined using discount rates of 5.75 percent as of December 31, 2005 and 2004. Unrecognized losses of \$2,145,920 as of December 31, 2005 and \$2,537,211 as of December 31, 2004 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 4.25 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 \$8,933,000 and \$8,223,000 in 2005 and 2004, respectively.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

(6) ACCUMULATED POSTEMPLOYMENT BENEFIT PLAN

This following information provides disclosure requirements contained in Statement of Financial Accounting Standards No.112, *Employers' Accounting for Postemployment Benefits*.

The Board provides certain postemployment benefits to eligible former or inactive employees and their dependents during the period subsequent to employment but prior to retirement. Costs were projected using the same discount rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Board for the years ended December 31, 2005 and 2004, were \$155,800 and \$733,000, respectively.

(7) OTHER REVENUES AND OTHER EXPENSES

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

	For the years ended December 31,	
	2005	2004
Other Revenues		
Data processing revenue	\$ 3,788,217	\$ 3,984,610
Rent	2,433,833	2,332,089
Subscription revenue	782,743	787,053
Reimbursable services to other agencies	664,755	673,730
Board sponsored conferences	250,650	-
Miscellaneous	600,144	559,099
Total other revenues	<u>\$ 8,520,342</u>	<u>\$ 8,336,581</u>
Other Expenses		
Tuition, registration and membership fees	\$ 2,573,028	\$ 2,048,610
Contingency operations	956,476	782,052
Public transportation subsidy	691,264	800,724
Subsidies and contributions	656,150	635,336
Meals and representation	518,640	377,963
Equipment and facilities rental	336,342	307,999
Administrative law judges	268,228	492,155
Security investigations	184,880	286,711
Former employee related payments	319,461	205,627
Miscellaneous	800,486	577,952
Total other expenses	<u>\$ 7,304,955</u>	<u>\$ 6,515,129</u>

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004

(8) COMMITMENTS AND CONTINGENCIES

Leases

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.

Minimum annual payments under the operating leases having an initial or remaining noncancelable lease term in excess of one year are \$71,991 for 2006.

Rental expenses under the operating leases were \$157,000 in 2005 and \$156,000 in 2004.

Benefit Obligations

The Board is subject to potential liabilities for a supplemental benefit for certain employees that participate in CSRS and who meet certain other criteria. Based on information currently available, the exact amount of the additional pension liability as of December 31, 2005 is unknown. It is management's opinion that the additional liability, if any, will not have a materially adverse effect on the financial statements.

Litigation

The Board is subject to contingent liabilities which include litigation cases. These contingent liabilities arise in the normal course of operations and their ultimate disposition is unknown. Based on information currently available to management, it is management's opinion that the expected outcome of these matters, individually or in the aggregate, will not have a materially adverse effect on the financial statements. Management believes the Board has substantial defenses and that the likelihood of an adverse judgment is small.

One action pending in the United States District Court for the District of Columbia under Title VII of the Civil Rights Act of 1964, as amended, alleges discrimination on behalf of a class of African American secretaries at the Board. The case is a successor to an earlier lawsuit that was dismissed for failure to exhaust administrative remedies. Following a period of discovery on the issue of exhaustion of administrative remedies, the Board has moved to dismiss the action; that motion is pending. Should the case proceed beyond the motion to dismiss the Board believes it has substantial defenses and intends to defend the case vigorously.

Seven additional matters alleging employment discrimination are currently pending administrative resolution or have been resolved recently and could be the subject of an administrative appeal or a judicial action. The chances that any of these cases will result in court litigation cannot reasonably be estimated at this time. In five of these cases, there has not yet been an investigative report. Therefore, management is unable at this time to determine the potential for a materially adverse effect on the financial statements. Management believes the likelihood of an unfavorable outcome in the remaining two cases is remote.

**BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004**

(9) 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 2005 and 2004 is summarized in the following table:

	<u>2005</u>	<u>2004</u>
Board paid to the Council:		
Assessments for operating expenses of the Council	\$ 83,811	\$ 112,020
Central Data Repository	1,096,062	326,640
Uniform Bank Performance Report	202,666	199,230
Total Board paid to the Council	<u>\$ 1,382,539</u>	<u>\$ 637,890</u>
Council paid to the Board:		
Data processing related services	\$ 3,572,816	\$ 3,360,055
Administrative services	175,000	133,500
Total Council paid to the Board	<u>\$ 3,747,816</u>	<u>\$ 3,493,555</u>

(10) 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 2005 and 2004 is summarized in the following table:

	<u>2005</u>	<u>2004</u>
Board paid to the Reserve Banks:		
Assessments for employee benefits	\$ 2,072,595	\$ 2,151,078
Data processing and communication	2,106,850	1,920,996
Contingency site	956,476	1,481,452
Total Board paid to the Reserve Banks	<u>\$ 5,135,921</u>	<u>\$ 5,553,526</u>
Reserve Banks paid to the Board:		
Assessments for currency costs	\$ 477,087,471	\$ 503,784,304
Assessments for operating expenses of the Board	265,742,100	272,331,500
Data processing	516,433	686,312
Total Reserve Banks paid to the Board	<u>\$ 743,346,004</u>	<u>\$ 776,802,116</u>



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, 2005 and 2004, 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 May 31, 2006. 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 2005 audit, we considered the Board's internal control over financial reporting by obtaining an understanding of the Board's internal control, determining whether 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. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards*. 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 internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Board's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable 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. Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected.

In our 2005 audit, we noted certain matters, discussed in Exhibit I, involving the internal control over financial reporting and its operation that we consider to be a reportable condition. However, the reportable condition is not believed to be a material weakness. Management's responses to our findings are also included in Exhibit I.



We also noted certain additional matters that we reported to the management of the Board in a separate letter dated May 31, 2006.

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

KPMG LLP

May 31, 2006

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Reportable Condition

December 31, 2005

Improvement is needed in Internal Controls over Financial Reporting

Management is responsible for developing and maintaining effective internal controls to provide assurance that the Board has the ability to record, process, summarize, and report financial data consistent with the assertions of management in its financial statements.

The following paragraphs discuss weaknesses noted in the Board's internal control over financial reporting that could adversely affect the Board's ability to produce accurate and timely financial statements.

Controls over accounts payable and accrued liabilities

During our audit, we noted that the Board recorded material post closing entries amounting to \$1,957,836 to reduce liabilities, prepayments, and the related expenses as of December 31, 2005. Issues we identified that resulted in post closing entries included:

- Recording transactions as liabilities and prepaid expenses, although the Board did not receive the related goods/services prior to December 31, 2005.
- Recording transactions in both accounts payable and accrued liabilities. Therefore, these liabilities were duplicated in the financial statements.
- Recording transactions based on incorrect supporting documents or estimates provided by the operating divisions that differed significantly from the actual invoices.

We also noted that the Board received an invoice from the General Services Administration (GSA) in April 2006 for \$275,100 that might include some expenses for steam provided in 2005. The Board recorded an accrual for \$50,000 at December 31, 2005. However, management is unable to determine if an additional accrual is required for 2005 as the invoices received from GSA during 2005 and 2006 did not provide sufficient details on the billing period.

Control of Census Data

During our audit, we coordinated with the Office of Inspector General (OIG) to perform an analysis of the accuracy of the census data used by the Board's actuary in the pension benefit liability and noted that there were discrepancies between the Board's Human Resources database and the data used by the actuary. We noted that the Board has not established controls to verify the accuracy of the underlying data used by the actuary in the pension liability calculation.

Specifically, we noted the following:

- Of the 176 employees included in the Benefits Equalization Plan (BEP) liability:
 - One individual was retired and covered under the CSRS plan; accordingly he/she should not have been included in the BEP population. Also, the gender of the individual was reported incorrectly.
 - One individual was covered under the FERS plan and therefore does not qualify for the BEP.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Reportable Condition

December 31, 2005

- One individual was included twice in the BEP calculation.
 - Two individuals did not have retirement service credit dates in PeopleSoft.
 - Sixteen individuals had incorrect service credit dates in the data used by the actuary.
 - For two individuals, the total pay used in the actuarial calculations was incorrect because their variable pay amounts were not included.
- The 930 employees included by the actuary in the Board Postretirement Welfare Benefits Plan (BEGLI) calculation included two retired individuals who should not have been in the active file.
 - Of the 1,777 employees included in the Board Postemployment Benefit Plan (Long-term disability):
 - Three individuals who retired prior to January 1, 2005 were incorrectly included in the actuarial liability calculations.
 - Thirty individuals in the Board Plan had differences over 30 days that related to incorrect service credit dates.

We also noted that the actuary incorrectly included variable pay in the calculations for long-term disability.

Recommendations:

We recommend that the Board:

1. Establish policies and procedures for processing year-end accounts payables and accruals to include the requirements for management to review and approve all entries and supporting documents before they are recorded. Management should also perform a review of the year-end accounts payable listings and subsequent disbursements to ensure that the transactions reported at year end are appropriately stated. Further, a reconciliation of the GSA account should be performed timely, to identify any discrepancies on the invoices received.
2. Confirm the data used by the actuary in the pension liability calculation prior to recording the entries in the general ledger.
3. Implement recommendations made by the OIG in their report titled "*Evaluation of Service Credit Computations.*" This would include performing periodic reconciliations of the census data between the Board's system and the data used by the actuary; reducing or eliminating the number of data transcriptions; requiring automated verifications for all census data transmissions; and updating the existing service credit form to clearly document all prior government service.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Reportable Condition

December 31, 2005

Management Response

1. Concur. Management will strengthen its procedures for review and approval of year-end transactions for accounts payables and year-end accruals. In addition to strengthening our procedures, organizational changes have been made to enhance supervision in this area and additional resources will be devoted to this time-sensitive process. Accounting staff will provide additional training for division staff responsible for reporting year-end accruals and approval of accruals will require more senior staff approval both in the divisions and Accounting.

- 2 & 3. Concur. We support the recommendation and work is underway to enhance controls over these data. Management is working with the Office of Employee Benefits, the Federal Reserve's actuary, and the Federal Reserve's pension administrator to ensure data accuracy and the presence of appropriate controls over the exchange of census data among the various entities. The Office of Inspector General will review the work of the group and, where appropriate, provide comments to management on internal control issues. This same group is working to implement fully the recommendations provided by the Office of Inspector General in its report titled *Evaluation of Service Credit Computations*, and management has directed the pension administrator to implement appropriate changes to its automated systems and supporting processes.



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Independent Auditors' Report on Compliance and Other Matters

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, 2005 and 2004, 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 May 31 2006. 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, regulations, and contracts applicable to the Board. As part of obtaining reasonable assurance about whether the Board's 2005 financial statements are free of material misstatement, we performed tests of the Board's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to the Board. However, providing an opinion on compliance with laws, regulations, and contracts was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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

KPMG LLP

May 31, 2006