
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 2002 were audited by KPMG LLP, independent auditors.



2001 M Street, N.W.
Washington, D.C. 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, 2002 and 2001, 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 *Government Auditing Standards*, issued by the Comptroller General of the United States. 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board at December 31, 2002 and 2001, and its results of 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 March 28, 2003 on our consideration of the Board's internal control over financial reporting and its compliance with 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

March 28, 2003



KPMG LLP, KPMG LLP, a U.S. limited liability partnership, is
a member of KPMG International, a Swiss association.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
BALANCE SHEETS

	As of December 31,	
	2002	2001
ASSETS		
CURRENT ASSETS		
Cash	\$ 8,635,164	\$ 40,788,564
Accounts receivable	871,626	1,325,065
Prepaid expenses and other assets	801,031	866,407
Total current assets	10,307,821	42,980,036
PROPERTY AND EQUIPMENT, NET (Note 5)	143,971,006	138,895,601
Total assets	\$154,278,827	\$181,875,637
LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	\$ 11,450,099	\$ 16,125,797
Accrued payroll and related taxes	8,102,710	7,307,754
Accrued annual leave	11,873,527	10,732,356
Capital lease payable (current portion)	50,546	247,242
Unearned revenues and other liabilities	442,066	391,572
Total current liabilities	31,918,948	34,804,721
LONG-TERM LIABILITIES		
Capital lease payable (non-current portion)	32,153	80,276
Accumulated retirement benefit obligation (Note 2)	614,108	651,628
Accumulated postretirement benefit obligation (Note 3)	4,917,787	4,555,487
Accumulated postemployment benefit obligation (Note 4)	4,299,252	3,591,571
Total long-term liabilities	9,863,300	8,878,962
Total liabilities	41,782,248	43,683,683
CUMULATIVE RESULTS OF OPERATIONS		
Working capital	(21,560,581)	8,422,557
Unfunded long-term liabilities	(9,831,147)	(8,798,686)
Net investment in property and equipment	143,888,307	138,568,083
Total cumulative results of operations	112,496,579	138,191,954
Total liabilities and cumulative results of operations	\$154,278,827	\$181,875,637

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,	
	2002	2001
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures.....	\$205,110,800	\$295,055,600
Other revenues (Note 6).....	<u>9,039,417</u>	<u>8,747,799</u>
Total operating revenues	<u>214,150,217</u>	<u>303,803,399</u>
BOARD OPERATING EXPENSES		
Salaries	146,022,212	132,647,612
Retirement and insurance contributions.....	25,560,734	22,277,244
Contractual services and professional fees	18,073,228	19,339,948
Depreciation and net losses on disposals.....	12,426,581	10,394,156
Utilities	7,218,999	5,880,777
Software	6,822,066	5,415,856
Postage and supplies	5,961,699	8,252,490
Travel	5,925,674	5,037,577
Repairs and maintenance.....	4,666,439	4,201,386
Printing and binding	2,026,370	2,095,676
Equipment and facilities rental.....	318,132	3,830,557
Other expenses (Note 6).....	<u>4,823,458</u>	<u>4,157,305</u>
Total operating expenses	<u>239,845,592</u>	<u>223,530,584</u>
RESULTS OF OPERATIONS	<u>(25,695,375)</u>	<u>80,272,815</u>
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	429,568,393	338,537,426
Expenses for currency printing, issuance, retirement, and shipping	<u>429,568,393</u>	<u>338,537,426</u>
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES	<u>0</u>	<u>0</u>
TOTAL RESULTS OF OPERATIONS	<u>(25,695,375)</u>	<u>80,272,815</u>
CUMULATIVE RESULTS OF OPERATIONS, Beginning of year	<u>138,191,954</u>	<u>57,919,139</u>
CUMULATIVE RESULTS OF OPERATIONS, End of year	<u>\$112,496,579</u>	<u>\$138,191,954</u>

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES		
RESULTS OF OPERATIONS	\$(25,695,375)	\$80,272,815
Adjustments to reconcile results of operations to net cash provided by (used in) operating activities:		
Depreciation and net losses on disposals	12,426,581	10,394,156
(Increase) decrease in assets:		
Accounts receivable, prepaid expenses, and other assets	518,815	(24,805)
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	(4,675,698)	5,423,057
Accrued payroll and related taxes	794,956	1,266,793
Accrued annual leave	1,141,171	2,239,628
Unearned revenues and other liabilities	50,494	(1,652,588)
Accumulated retirement benefit obligation	(37,520)	(43,154)
Accumulated postretirement benefit obligation	362,300	489,783
Accumulated postemployment benefit obligation	707,681	482,115
Net cash provided by (used in) operating activities	(14,406,595)	98,847,800
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals	5,200	119,013
Capital expenditures	(17,507,186)	(80,886,996)
Net cash provided by (used in) investing activities	(17,501,986)	(80,767,983)
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital lease payable	(244,819)	(133,505)
Net cash provided by (used in) financing activities	(244,819)	(133,505)
NET INCREASE (DECREASE) IN CASH	(32,153,400)	17,946,312
CASH BALANCE, Beginning of year	40,788,564	22,842,252
CASH BALANCE, End of year	\$ 8,635,164	\$40,788,564

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2002 AND 2001

(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 about 1,700, 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. A combined financial statement 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 into "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.

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 2001 amounts have been reclassified to conform with the 2002 presentation.

(2) 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 entered on duty prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who entered on duty 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 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 2002 and 2001, 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 \$327,000 and \$308,000 in 2002 and 2001, 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 \$7,185,000 and \$5,540,000 in 2002 and 2001, 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 2002 and 2001 is summarized in the following table:

	<u>2002</u>	<u>2001</u>
<i>Change in benefit obligation</i>		
Projected benefit obligation at beginning of year ..	\$ 2,125	\$ 1,804
Service cost	3,363	450
Interest cost	561	112
Plan participants' contributions	0	0
Plan amendments	2,852	0
Actuarial (gain)/loss	3,965	(241)
Benefits paid	<u>0</u>	<u>0</u>
Projected benefit obligation at end of year	<u>\$ 12,866</u>	<u>\$ 2,125</u>
<i>Change in plan assets</i>		
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	<u>0</u>	<u>0</u>
Fair value of plan assets at end of year	<u>\$ 0</u>	<u>\$ 0</u>
<i>Reconciliation of funded status at end of year</i>		
Funded status	\$ (12,866)	\$ (2,125)
Unrecognized net actuarial (gain)/loss	(297,773)	(329,169)
Unrecognized prior service cost	(1,050,946)	(1,170,405)
Unrecognized net transition (asset)/obligation	<u>747,477</u>	<u>850,071</u>
Postretirement benefit liability	<u>\$ (614,108)</u>	<u>\$ (651,628)</u>
<i>Weighted-average assumptions as of December 31</i>		
Discount rate	6.75%	7.00%
Expected asset return ...	N/A	N/A
Salary scale	4.25%	4.50%
Corridor	10.00%	10.00%
<i>Components of net periodic benefit cost</i>		
Service cost	\$ 3,363	\$ 450
Interest cost	561	112
Expected return on plan assets	0	0
Amortization of prior service cost ..	(116,607)	(116,848)
Recognized actuarial (gain)/loss	(27,431)	(29,462)
Amortization of net transition (asset)/obligation	<u>102,594</u>	<u>102,594</u>
Net periodic benefit cost	<u>\$ (37,520)</u>	<u>\$ (43,154)</u>

(3) POSTRETIREMENT BENEFITS

The Board provides certain life insurance programs for its active employees and retirees. Activity for 2002 and 2001 is summarized in the following table:

	<u>2002</u>	<u>2001</u>
<i>Change in benefit obligation</i>		
Benefit obligation at beginning of year ..	\$ 5,868,425	\$ 4,255,290
Service cost	158,179	133,550
Interest cost	386,215	345,753
Plan participants' contributions	0	0
Plan amendments	0	95,993
Actuarial (gain)/loss	(63,554)	1,037,839
Benefits paid	<u>(214,870)</u>	<u>0</u>
Benefit obligation at end of year	<u>\$ 6,134,395</u>	<u>\$ 5,868,425</u>
<i>Change in plan assets</i>		
Fair value of plan assets at beginning of year	\$ 0	\$ 0
Actual return on plan assets	0	0
Employer contributions ..	213,958	0
Plan participants' contributions	0	0
Benefits paid	<u>(213,958)</u>	<u>0</u>
Fair value of plan assets at end of year	<u>\$ 0</u>	<u>\$ 0</u>
<i>Reconciliation of funded status at end of year</i>		
Funded status	\$ (6,134,395)	\$ (5,868,425)
Unrecognized net actuarial (gain)/loss	1,126,688	1,216,945
Unrecognized prior service cost	89,920	95,993
Unrecognized net transition obligation	0	0
Prepaid/(accrued) postretirement benefit liability	<u>\$ (4,917,787)</u>	<u>\$ (4,555,487)</u>
<i>Components of net periodic cost for year</i>		
Service cost	\$ 158,179	\$ 133,550
Interest cost	386,215	345,756
Amortization of prior service cost	6,073	0
Amortization of (gains)/losses	<u>26,706</u>	<u>10,477</u>
Total net periodic cost	<u>\$ 577,173</u>	<u>\$ 489,783</u>

The liability and costs for the postretirement benefit plan were determined using discount rates of 6.75 percent and 7.00 percent as of December 31, 2002 and 2001, respectively. Unrecognized losses of \$1,126,688 and \$1,216,945 as of December 31, 2002 and 2001, 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 4.25 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 \$6,205,000 and \$5,364,000 in 2002 and 2001, respectively.

(4) 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.

	<u>2002</u>	<u>2001</u>
<i>Change in benefit obligation</i>		
Benefit obligation at beginning of year	\$3,591,571	\$3,109,456
Service cost	891,192	755,135
Interest cost	166,520	115,142
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss ...	(76,282)	(129,585)
Benefits paid	<u>(273,749)</u>	<u>(258,577)</u>
Benefit obligation at end of year	<u>\$4,299,252</u>	<u>\$3,591,571</u>
 <i>Weighted-average assumptions as of December 31</i>		
Discount rate	6.75%	7.00%
Expected asset return ..	N/A	N/A
Salary scale	4.25%	4.50%
Corridor	10.00%	10.00%

(5) PROPERTY AND EQUIPMENT

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

	As of December 31,	
	2002	2001
Land and improvements ...	\$ 18,640,314	\$ 18,640,314
Buildings	113,309,775	104,403,830
Furniture and equipment	37,044,828	54,301,936
Software	9,830,112	9,215,280
Construction in process	<u>9,467,020</u>	<u>6,901,864</u>
	188,292,049	193,463,224
Less accumulated depreciation	<u>(44,321,043)</u>	<u>(54,567,623)</u>
Property and equipment, net ...	<u>\$143,971,006</u>	<u>\$138,895,601</u>

Furniture and equipment includes \$864,000 for capitalized leases as of December 31, 2002 and 2001, respectively. Accumulated depreciation includes \$654,000 and \$510,000 for capitalized leases as of December 31, 2002 and 2001, respectively. The Board paid interest related to these capital leases in the amount of \$15,731 and \$32,201 for 2002 and 2001, 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, includes asbestos removal, lighting and plumbing improvements, cabling and other enhancements. Multiple phases will be in process at the same time.

In 2001, the Board purchased land and building located at 1709 New York Avenue, N.W., Washington, DC. This purchase increased land and improvements by \$17,339,000 and buildings by \$48,727,000 for 2001.

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

(6) OTHER REVENUES AND OTHER EXPENSES

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

	As of December 31,	
	2002	2001
<i>Other revenues</i>		
Data processing revenue	\$4,830,600	\$4,427,360
Rent	1,996,893	664,537
Subscription revenue	810,032	869,595
Reimbursable services to other agencies ...	788,095	568,753
Board sponsored conferences	115,965	240,967
National Information Center	30,334	25,591
Miscellaneous	<u>467,498</u>	<u>1,950,996</u>
Total Other Revenues	<u>\$9,039,417</u>	<u>\$8,747,799</u>

Other expenses

Tuition, registration, and membership fees	\$1,642,013	\$1,472,539
Subsidies and contributions	900,049	851,225
Public transportation subsidy	745,973	484,618
Meals and representation ...	378,387	438,748
Contingency operations	264,232	180,871
Security investigations	229,387	108,981
Miscellaneous	<u>663,417</u>	<u>620,323</u>
Total Other Expenses	<u>\$4,823,458</u>	<u>\$4,157,305</u>

(7) COMMITMENTS

The Board has entered into several operating leases to secure office, training and warehouse space for periods ranging from one to ten years. Minimum future commitments under those leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 2002, are as follows:

2003	\$151,038
2004	157,079
2005	163,363
2006	71,991
	<u>\$543,471</u>

Rental expenses under the operating leases were \$156,000 and \$171,000 in 2002 and 2001, respectively.

(8) FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

The Board is one of the five member agencies of the Federal Financial Institutions Examination Council (the "Council"), and currently performs certain management functions for the Council. Activity related to the Board and Council for 2002 and 2001 is summarized in the following table:

	<u>2002</u>	<u>2001</u>
<i>Board paid to the Council:</i>		
Assessments for operating expenses of the Council	\$ 300,000	\$ 293,000
Total Board paid to the Council	<u>\$ 300,000</u>	<u>\$ 293,000</u>
<i>Council paid to the Board:</i>		
Data processing related services	3,350,412	2,788,243
Administrative services	<u>69,593</u>	<u>66,117</u>
Total Council paid to the Board	<u>\$3,420,005</u>	<u>\$2,854,360</u>

(9) FEDERAL RESERVE BANKS

The Board performs certain transactions 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 2002 and 2001 is summarized in the following table:

	<u>2002</u>	<u>2001</u>
<i>Board paid to the Reserve Banks:</i>		
Assessments for employee benefits ..	\$ 2,014,839	\$ 1,859,752
Data processing and communication	2,154,087	2,469,052
Contingency site	<u>264,232</u>	<u>180,871</u>
Total Board paid to the Reserve Banks	<u>\$ 4,433,158</u>	<u>\$ 4,509,675</u>
<i>Reserve Banks paid to the Board:</i>		
Assessments for currency costs	\$429,568,393	\$338,537,426
Assessments for operating expenses of the Board	205,110,800	295,055,600
Data processing	<u>1,281,759</u>	<u>1,499,559</u>
Total Reserve Banks paid to the Board	<u>\$635,960,952</u>	<u>\$635,092,585</u>



2001 M Street, N.W.
Washington, D.C. 20036

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL
OVER FINANCIAL REPORTING

To the Board of Governors of the
Federal Reserve System

We have audited the financial statements of the Board of Governors of the Federal Reserve System (the Board) as of and for the years ended December 31, 2002 and 2001, and have issued our report thereon dated March 28, 2003. We conducted our audit 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 2002 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 internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in internal control over financial reporting that might be material weaknesses under standards established 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. We noted no matters involving 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 Board and management, the U.S. Office of Management and Budget, 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

March 28, 2003



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a member of KPMG International, a Swiss association.



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Washington, D.C. 20036

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE
WITH LAWS AND REGULATIONS

To the Board of Governors of the
Federal Reserve System

We have audited the financial statements of the Board of Governors of the Federal Reserve System (the Board) as of and for the years ended December 31, 2002 and 2001, and have issued our report thereon dated March 28, 2003. 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 2002 financial statements are free of material misstatement, we performed tests of its 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 Board and management, the U.S. Office of Management and Budget, 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

March 28, 2003



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Federal Reserve Banks Combined Financial Statements

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent accountants, for the years ended December 31, 2002 and 2001.



REPORT OF INDEPENDENT ACCOUNTANTS

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, 2002 and 2001, 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, 2002 and 2001, and the combined results of their operations for the years then ended, in conformity with the basis of accounting described in Note 3.

Washington, D.C.
March 7, 2003

PRICEWATERHOUSECOOPERS LLP

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION
December 31, 2002 and 2001

(in millions)

ASSETS	2002	2001
Gold certificates	\$ 11,039	\$ 11,045
Special drawing rights certificates	2,200	2,200
Coin	988	1,047
Items in process of collection	10,291	3,188
Loans to depository institutions	40	34
Securities purchased under agreements to resell (tri-party)	39,500	50,250
U.S. government and federal agency securities, net	639,125	561,701
Investments denominated in foreign currencies	16,913	14,559
Accrued interest receivable	5,470	5,729
Bank premises and equipment, net	2,044	2,021
Other assets	3,367	3,175
Total assets	<u>\$730,977</u>	<u>\$654,949</u>
LIABILITIES AND CAPITAL		
LIABILITIES		
Federal Reserve notes outstanding, net	\$654,273	\$611,757
Securities sold under agreements to repurchase	21,091	. . .
Deposits		
Depository institutions	22,541	17,478
U.S. Treasury, general account	4,420	6,645
Other deposits	444	287
Deferred credit items	9,459	2,490
Interest on Federal Reserve notes due U.S. Treasury	838	498
Accrued benefit costs	915	882
Other liabilities	236	227
Total liabilities	<u>714,217</u>	<u>640,264</u>
CAPITAL		
Capital paid-in	8,380	7,373
Surplus	8,380	7,312
Total capital	<u>16,760</u>	<u>14,685</u>
Total liabilities and capital	<u>\$730,977</u>	<u>\$654,949</u>

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, 2002 and 2001

(in millions)

	<u>2002</u>	<u>2001</u>
Interest income		
Interest on U.S. government and federal agency securities	\$25,525	\$30,523
Interest on investments denominated in foreign currencies	272	331
Interest on loans to depository institutions	<u>2</u>	<u>13</u>
Total interest income	<u>25,799</u>	<u>30,867</u>
Interest expense:		
Interest expense on securities sold under agreements to repurchase	13	. . .
Net interest income	<u>25,786</u>	<u>30,867</u>
Other operating income		
Income from services	916	926
Reimbursable services to government agencies	309	286
Foreign currency gains (losses), net	2,083	(1,435)
Government securities gains, net	77	316
Other income	<u>80</u>	<u>108</u>
Total other operating income	<u>3,465</u>	<u>201</u>
Operating expenses		
Salaries and other benefits	1,532	1,285
Occupancy expense	208	204
Equipment expense	263	268
Assessments by Board of Governors	635	634
Other expenses	<u>565</u>	<u>642</u>
Total operating expenses	<u>3,203</u>	<u>3,033</u>
Net income prior to distribution	<u>\$26,048</u>	<u>\$28,035</u>
Distribution of net income		
Dividends paid to member banks	\$ 484	\$ 428
Transferred to surplus	1,068	518
Payments to U.S. Treasury as interest on Federal Reserve notes	<u>24,496</u>	<u>27,089</u>
Total distribution	<u>\$26,048</u>	<u>\$28,035</u>

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, 2002 and 2001

(in millions)

	Capital paid-in	Surplus	Total capital
Balance at January 1, 2001			
(139 million shares)	\$6,997	\$6,794	\$13,791
Net income transferred to surplus .....	...	518	518
Net change in capital stock issued			
(8 million shares)	<u>376</u>	<u>...</u>	<u>376</u>
Balance at December 31, 2001			
(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)	<u>1,007</u>	<u>...</u>	<u>1,007</u>
Balance at December 31, 2002			
(167 million shares)	<u>\$8,380</u>	<u>\$8,380</u>	<u>\$16,760</u>

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

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 to 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, as 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. Therefore, a Statement of Cash Flows 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 \$42½ 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 SDRs, at the direction of the U.S. Treasury, for the purpose of financing SDR certificate acquisitions or for financing exchange stabilization operations.

(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. Reserve Banks retain the option to impose a surcharge above the basic rate in certain circumstances.

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

(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 engages 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 repurchase agreements primarily includes U.S. Government and agency securities, pass-through mortgage securities of GNMA, FHLMC, and FNMA, 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, main-

tains 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 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

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

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.

(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 2 to 50 years. New assets, 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.

(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 accordance with the Federal Reserve Act, 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 are pledged as collateral for Federal Reserve notes. 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 \$104,983 million and \$139,783 million at December 31, 2002 and 2001, respectively.

At December 31, 2002, all gold certificates, all special drawing rights certificates, and \$644,458 million of domestic securities and securities purchased under agreements to resell were pledged as collateral. At December 31, 2002, 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 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. Surplus was not equated to capital at December 31, 2001 at one Reserve Bank where the amount of additional surplus required exceeded the Bank’s net income.

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.

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

(J) Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property, which are reported as a component of "Occupancy expense."

(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, 2002 and 2001, that were bought outright, were as follows (in millions):

	<u>2002</u>	<u>2001</u>
Par value		
Federal agency	\$ 10	\$ 10
U.S. government		
Bills	226,682	182,074
Notes	297,893	265,941
Bonds	<u>104,832</u>	<u>103,660</u>
Total par value	629,417	551,685
Unamortized premiums	10,762	11,302
Unaccreted discounts	<u>(1,054)</u>	<u>(1,286)</u>
Total	<u>\$639,125</u>	<u>\$561,701</u>

The maturity distribution of U.S. government and federal agency securities bought outright and securities purchased under agreements to resell, which were held in the SOMA at December 31, 2002, was as follows (in millions):

Maturities of securities held	U.S. government securities (Par)	Federal agency obligations (Par)	Total
Within 15 days ...	\$ 27,444	\$. . .	\$ 27,444
16 days to 90 days .	154,225	. . .	154,225
91 days to 1 year ..	141,840	10	141,850
Over 1 year to			
5 years	172,758	. . .	172,758
Over 5 years to			
10 years	53,300	. . .	53,300
Over 10 years	79,840	. . .	79,840
Total	<u>\$629,407</u>	<u>\$10</u>	<u>\$629,417</u>

Maturities of securities held	Repurchase agreements (Contract amount)
Within 15 days	\$25,500
16 days to 90 days	14,000
91 days to 1 year .....	. . .
Over 1 year to 5 years .....	. . .
Over 5 years to 10 years .....	. . .
Over 10 years .....	. . .
Total	<u>\$39,500</u>

Securities purchased under agreements to resell at December 31, 2002 and 2001 were \$39,500 million and \$50,250 million, respectively, and consisted entirely of agreements through third party custodial arrangements.

As mentioned in footnote 3, in December 2002, the FRBNY replaced MSP transactions with securities sold under agreements to repurchase. At December 31, 2002, securities sold under agreements to repurchase with a contract amount of \$21,091 million and a par value of \$21,098 million were outstanding. At December 31, 2001, MSP transactions involving U.S. government securities with a par value of \$23,188 million were outstanding. Securities sold under agreements to repurchase and MSP transactions are generally overnight arrangements.

At December 31, 2002 and 2001, U.S. government securities with par values of \$1,841 million and \$7,345 million, respectively, were loaned from the SOMA.

(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):

	<u>2002</u>	<u>2001</u>
European Union Euro		
Foreign currency deposits	\$ 5,580	\$ 4,593
Government debt instruments including agreements to resell	3,298	2,695
Japanese Yen		
Foreign currency deposits	1,789	1,891
Government debt instruments including agreements to resell	6,164	5,315
Accrued interest	<u>82</u>	<u>65</u>
Total	<u>\$16,913</u>	<u>\$14,559</u>

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

The maturity distribution of investments denominated in foreign currencies at December 31, 2002, was as follows (in millions):

<u>Maturities of Investments Denominated in Foreign Currencies</u>	
Within 1 year	\$15,611
Over 1 year to 5 years	904
Over 5 years to 10 years	398
Total	<u>\$16,913</u>

At December 31, 2002 and 2001, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 2002 and 2001, the warehousing facility was \$5,000 million, with a zero balance outstanding.

(6) BANK PREMISES AND EQUIPMENT

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

	<u>2002</u>	<u>2001</u>
Bank premises and equipment		
Land	\$ 209	\$ 201
Buildings	1,514	1,478
Building machinery and equipment	345	329
Construction in progress	51	32
Furniture and equipment	<u>1,362</u>	<u>1,365</u>
	3,481	3,405
Accumulated depreciation	<u>(1,437)</u>	<u>(1,384)</u>
Bank premises and equipment, net	<u>\$2,044</u>	<u>\$2,021</u>

Depreciation expense was \$187 million and \$186 million for the years ended December 31, 2002 and 2001, respectively.

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

	<u>2002</u>	<u>2001</u>
Bank premises and equipment	\$15	\$21
Accumulated depreciation	<u>(12)</u>	<u>(14)</u>
Capitalized leases, net	<u>\$ 3</u>	<u>\$ 7</u>

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 \$21 million and \$20 million for the years ended December 31, 2002 and 2001, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2002, were (in millions):

2003	\$17
2004	15
2005	12
2006	9
2007	6
Thereafter	<u>21</u>
Total	<u>\$80</u>

(7) COMMITMENTS AND CONTINGENCIES

At December 31, 2002, the Reserve Banks were obligated under noncancelable leases for premises and equipment with terms ranging from 1 to approximately 21 years. These leases provide for increased rentals 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 \$70 million and \$69 million for the years ended December 31, 2002 and 2001, respectively. Certain of the Reserve Banks' leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with terms of one year or more, at December 31, 2002, were (in millions):

	<u>Operating</u>	<u>Capital</u>
2003	\$ 11.0	\$ 6.3
2004	10.2	6.2
2005	8.8	.4
2006	7.4	.4
2007	6.6	. . .
Thereafter	<u>\$130.8</u>	. . .
	<u>\$174.8</u>	<u>\$13.3</u>
Amount representing interest . . .		<u>(1.1)</u>
		<u>\$12.2</u>

At December 31, 2002, the Reserve Banks had contractual commitments through the year 2007 totaling \$119.7 million for the maintenance of currency machines and check-processing-related services, \$118.7 million of which has not been recognized. Two Reserve Banks contract for these services on behalf of the System.

Three Reserve Banks have additional contractual commitments through the year 2007 for software maintenance, architectural services, and check transportation services. At December 31, 2002, these contractual commitments totaled \$160.8 million, \$143.7 million of which has not 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

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

Retirement Plan for Employees of the Federal Reserve System (System Plan) and the Benefit Equalization Retirement Plans offered by each individual Reserve Bank (BEP) and 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. 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 this Plan. The prepaid pension cost includes amounts related to employees participating in the plans from the 12 Reserve Banks, the Board of Governors, and the Plan Administrative Office.

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

	<u>2002</u>	<u>2001</u>
Estimated actuarial present value of projected benefit obligation at January 1	\$3,091	\$2,810
Service cost—benefits earned during the period	104	85
Interest cost on projected benefit obligation	226	207
Actuarial loss	126	125
Contributions by plan participants	3	3
Benefits paid	(170)	(139)
Plan amendments	143	...
Estimated actuarial present value of projected benefit obligation at December 31	<u>\$3,523</u>	<u>\$3,091</u>

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):

	<u>2002</u>	<u>2001</u>
Estimated fair value of plan assets at January 1	\$5,795	\$6,176
Actual return on plan assets	(631)	(245)
Contributions by plan participants	3	3
Benefits paid	(170)	(139)
Estimated fair value of plan assets at December 31	<u>\$4,997</u>	<u>\$5,795</u>
Funded status	\$1,474	\$2,703
Unrecognized prior service cost	223	107
Unrecognized net actuarial loss/(gain)	<u>1,042</u>	<u>(228)</u>
Prepaid pension benefit costs	<u>2,739</u>	<u>2,582</u>

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

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

	<u>2002</u>	<u>2001</u>
Discount rate	6.75%	7.00%
Expected long-term rate of return on plan assets	9.00%	9.00%
Rate of compensation increase	4.25%	4.50%

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

	<u>2002</u>	<u>2001</u>
Service cost—benefits earned during the period	\$ 104	\$ 85
Interest cost on projected benefit obligation	226	207
Amortization of initial net transition obligation	...	(45)
Amortization of prior service cost	27	16
Recognized net (gain)	...	(44)
Expected return on plan assets	(514)	(550)
Net periodic pension benefit (credit)	<u>\$(157)</u>	<u>\$(331)</u>

Net periodic pension benefit (credit) is reported as a component of "Salaries and other benefits."

The Reserve Banks' projected benefit obligation and net pension costs for the BEP at December 31, 2002 and 2001, and for the SERP at December 31, 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 \$63 million and \$50 million for the years ended December 31, 2002 and 2001, 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):

	2002	2001
Accumulated postretirement benefit obligation at January 1	\$674	\$644
Service cost—benefits earned during the period	17	16
Interest cost of accumulated benefit obligation	47	47
Actuarial loss	49	54
Contributions by plan participants	4	4
Benefits paid	(37)	(31)
Plan amendments, curtailments, and special termination benefits	(12)	(60)
Accumulated postretirement benefit obligation at December 31	<u>\$742</u>	<u>\$674</u>

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):

	2002	2001
Fair value of plan assets at January 1	\$. . .	\$. . .
Contributions by the employer	33	27
Contributions by plan participants	4	4
Benefits paid	(37)	(31)
Fair value of plan assets at December 31	<u>\$. . .</u>	<u>\$. . .</u>
Unfunded postretirement benefit obligation	\$742	\$674
Unrecognized prior service cost	141	146
Unrecognized net actuarial gain/(loss)	(93)	(48)
Accrued postretirement benefit costs	<u>\$790</u>	<u>\$772</u>

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

At December 31, 2002 and 2001, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 6.75 percent and 7.00 percent, respectively.

For measurement purposes, a 9.00 percent annual rate of increase in the cost of covered health care benefits was assumed for 2003. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.00 percent by 2008, 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, 2002 (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	\$ 9	\$ (8)
Effect on accumulated postretirement benefit obligation	94	(81)

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

	2002	2001
Service cost—benefits earned during the period	\$17	\$16
Interest cost of accumulated benefit obligation	47	47
Amortization of prior service cost	(14)	(9)
Recognized net actuarial loss/(gain)	<u>2</u>	<u>(1)</u>
Net periodic postretirement benefit costs	<u>\$52</u>	<u>\$53</u>

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

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 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, 2002 and 2001, were \$121 million and \$110 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2002 and 2001 operating expenses were \$26 million and \$21 million, respectively.

(10) SUBSEQUENT EVENT

In January 2003, the System decided to restructure its check collection operations. The restructuring plans include streamlining the check management structure, reducing staff, decreasing the number of check-processing locations and increasing processing capacity in other locations. The restructuring, which is expected to begin in 2003 and conclude by the end of 2004, will result in the Reserve Banks discontinuing check operations in thirteen offices, increasing check processing capacity in nine offices, and consolidating check adjustment functions in twelve offices. At this time, the Reserve Banks have not developed detailed estimates of the cost of the restructuring plan in the aggregate or for the individual Reserve Banks affected.

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 of Governors fully informed about serious abuses and deficiencies and about the status of any corrective actions.

During 2002, the OIG completed eleven audits, reviews, and other assessments (table) and conducted a number of follow-up reviews to evaluate action taken on earlier recommendations. The OIG also closed twenty-seven investigations and performed numerous legislative and regulatory reviews.

Completed OIG Audits, Reviews, and Assessments, 2002

Report title	Report number	Month issued
Audit of Board's Government Travel Card Program	A0011	January
Audit of the FFIEC's Financial Statements (Years Ended 2000 and 2001) . .	A0115	February
Bond Life Cycle Assessment	R0103	February
Audit of the Board's Financial Statements (Years Ended 2000 and 2001) . .	A0115BD	March
Audit of the Board's Use of and Controls over Purchase Cards	A0109	May
Review of the Eccles Building Project—Phase 3	R0202	May
Board's Recruiting Process Assessment	R0203	May
Review of Integrating Support Services into the Management Division	R0204	June
Business Process Review of the Board's Publications Program—Phase 3 . . .	R0201	June
Audit of the Board's Information Security Program	A0205	September
Report on the Failure of the Oakwood Deposit Bank Company	A0202	October

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 2002, the GAO completed four reports

on selected aspects of Federal Reserve operations (table). Seven projects concerning the Federal Reserve were in various stages of completion at year-end (table). The reports are available directly from the GAO.

Completed GAO Reports Relating to the Federal Reserve System, 2002

Report title	Report number	Date issued
Payment Systems: Central Bank Roles Vary, but Goals Are the Same	GAO-02-303	2-25-02
Federal Reserve Banks: Areas for Improvement in Computer Controls	GAO-02-832R	7-30-02
Federal Reserve System: The Surplus Account	GAO-02-939	9-18-02
Federal Reserve System: Update on GAO's 1996 Recommendations	GAO-02-774	9-25-02

Active GAO Projects Relating to the Federal Reserve System, Year-End 2002

Subject of project	Date initiated
Supervisory and regulatory policies regarding cyber-threats	5-24-02
Business continuity planning and security issues for Fedwire	5-30-02
Risk assessment, security, and controls for the pay.gov system	7-30-02
Federal Reserve's relationship with U.S. Mint and BEP	7-30-02
Prevention and identification of illegal tying	9-24-02
Role investment banks play in design and marketing various types of financial transactions	10-25-02
Progress with implementing information technology enterprise architectures	10-29-02