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 Reserve Banks' financial statements are audited annually by an independent outside auditor retained by the Board of Governors. In addition, the Reserve Banks are subject to annual examination by the Board. As discussed in the chapter "Federal Reserve Banks," the Board's 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 Government Accountability Office. ■

Board of Governors Financial Statements

The financial statements of the Board for 2005 and 2004 were audited by KPMG LLP, independent auditors.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Financial Statements

To the Board of Governors of the Federal Reserve System:

We have audited the accompanying balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 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

	As of December 31, 2005	As of December 31, 2004
ASSETS		
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	52,044,367	65,818,839
NONCURRENT ASSETS		
Property and equipment, net (Note 3)	155,441,553	149,028,686
Art collections (Note 2)		
Total noncurrent assets	155,441,553	149,028,686
Total assets	$207,485,920	$214,847,525
LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS		
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	38,277,284	33,358,268
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	12,568,340	12,367,571
Total liabilities	50,845,624	45,725,839
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	156,640,296	169,121,686
Total liabilities and cumulative results of operations	$207,485,920	$214,847,525

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, 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	0	0
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

See accompanying notes to financial statements.

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	5,480,226	15,851,197
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	(19,367,373)	(11,711,856)
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital lease payments	(249,710)	(211,703)
Net cash used in financing activities	(249,710)	(211,703)
NET INCREASE (DECREASE) IN CASH	(14,136,857)	3,927,638
CASH BALANCE, Beginning of year	60,107,292	56,179,654
CASH BALANCE, End of year	$ 45,970,435	$ 60,107,292
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Capital lease obligations incurred	$ 0	$ 190,538

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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

(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

(4) ACCUMULATED RETIREMENT BENEFITS

The 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 noncontributory 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:

	2005	2004
Change in projected benefit obligation		
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	0	0
Plan amendments	0	0
Actuarial (gain)/loss	168,027	36,588
Benefits paid	(1,814)	0
Benefit obligation at end of year	$ 536,339	$ 140,953
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	1,814	0
Plan participants' contributions	0	0
Benefits paid	(1,814)	0
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
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)
Information for pension plans with an accumulated benefit obligation in excess of plan asset:		
Projected benefit obligation	$ 536,339	$ 140,953
Accumulated benefit obligation	278,252	33

	2005	2004
Weighted-average assumptions used to determine benefit obligation as of December 31		
Discount rate	5.75%	5.75%
Rate of compensation increase	4.50%	4.25%
Components of net periodic benefit cost		
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	0	0
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)
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31		
Discount rate	5.75%	6.25%
Rate of compensation increase	4.25%	4.00%

(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
Change in benefit obligation		
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	0	0
Plan amendments	(196,970)	0
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

	2005	2004
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contribution	284,485	253,717
Plan participants' contributions	0	0
Benefits paid	(284,485)	(253,717)
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
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)
Components of net periodic cost for year		
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.

(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	0
Miscellaneous	600,144	559,099
Total other revenues	$8,520,342	$8,336,581
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	$7,304,955	$6,515,129

(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.

Mimimum 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 judgement 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.

(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:

	2005	2004
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	$1,382,539	$ 637,890
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	$3,747,816	$3,493,555

(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:

	2005	2004
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	$ 5,135,921	$ 5,553,526
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	$743,346,004	$776,802,116

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.

KPMG

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

Exhibit I

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.
  - 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.

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.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

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

Federal Reserve Banks
Combined Financial Statements

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent auditors, for the years ended December 31, 2005 and 2004.

PRICEWATERHOUSECOOPERS

REPORT OF INDEPENDENT AUDITORS

To the Board of Governors of the Federal Reserve System
and the Board of Directors 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, 2005 and 2004, 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 combined financial statements are the responsibility of the Reserve Banks' management. Our responsibility is to express an opinion on these combined 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 combined 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 described in Note 3, these 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 accounting principles generally accepted in the United States of America.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the combined financial position of the Reserve Banks as of December 31, 2005 and 2004, and the combined results of their operations for the years then ended, on the basis of accounting described in Note 3.

March 23, 2006
Washington, D.C.

PricewaterhouseCoopers LLP

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION
December 31, 2005 and 2004

(in millions)

ASSETS	2005	2004
Gold certificates	$ 11,039	$ 11,041
Special drawing rights certificates	2,200	2,200
Coin	686	728
Items in process of collection	5,930	6,233
Loans to depository institutions	72	43
Securities purchased under agreements to resell	46,750	33,000
U.S. government securities, net	750,202	725,584
Investments denominated in foreign currencies	18,928	21,368
Accrued interest receivable	5,874	5,104
Bank premises and equipment, net	2,252	2,216
Other assets	3,394	3,350
Total assets	$847,327	$810,867
LIABILITIES AND CAPITAL		
LIABILITIES		
Federal Reserve notes outstanding, net	$758,359	$719,437
Securities sold under agreements to repurchase	30,505	30,783
Deposits		
Depository institutions	19,043	24,043
U.S. Treasury, general account	4,573	5,912
Other deposits	393	332
Deferred credit items	5,039	5,306
Interest on Federal Reserve notes due U.S. Treasury	1,784	329
Accrued benefit costs	913	891
Other liabilities	281	290
Total liabilities	820,890	787,323
CAPITAL		
Capital paid-in	13,536	11,914
Surplus	12,901	11,630
Total capital	26,437	23,544
Total liabilities and capital	$847,327	$810,867

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, 2005 and 2004

(in millions)

	2005	2004
Interest income		
Interest on U.S. government securities	$28,959	$22,344
Interest on investments denominated in foreign currencies	283	269
Interest on loans to depository institutions	7	3
Total interest income	29,249	22,616
Interest expense		
Interest expense on securities sold under agreements to repurchase	809	303
Net interest income	28,440	22,313
Other operating (loss) income		
Income from services	901	866
Reimbursable services to government agencies	396	370
Foreign currency (losses) gains, net	(2,723)	1,230
Other income	131	89
Total other operating (loss) income	(1,295)	2,555
Operating expenses		
Salaries and other benefits	1,709	1,604
Occupancy expense	228	222
Equipment expense	198	245
Assessments by the Board of Governors	743	776
Other expenses	747	578
Total operating expenses	3,625	3,425
Net income prior to distribution	$23,520	$21,443
Distribution of net income		
Dividends paid to member banks	$ 781	$ 582
Transferred to surplus	1,271	2,783
Payments to U.S. Treasury as interest on Federal Reserve notes	21,468	18,078
Total distribution	$23,520	$21,443

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, 2005 and 2004

(in millions)

	Capital paid-in	Surplus	Total capital
Balance at January 1, 2004 (176 million shares)	$ 8,847	$ 8,847	$17,694
Transferred to surplus	. . .	2,783	2,783
Net change in capital stock issued (61 million shares)	3,067	. . .	3,067
Balance at December 31, 2004 (238 million shares)	$11,914	$11,630	$23,544
Transferred to surplus	. . .	1,271	1,271
Net change in capital stock issued (32 million shares)	1,622	. . .	1,622
Balance at December 31, 2005 (270 million shares)	$13,536	$12,901	$26,437

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.

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. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership in the System. 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.

The System also consists, in part, of the Board of Governors of the Federal Reserve System (Board of Governors) and the Federal Open Market Committee (FOMC). The Board of Governors, an independent federal agency, is charged by the Federal Reserve Act with a number of specific duties, including general supervision over the Reserve Banks. 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.

(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 system, 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 and other entities; 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 Systm also provides certain services to foreign central banks, governments, and international official institutions.

In performing fiscal agency functions for the U.S. Treasury, seven Reserve Banks provide U.S. securities direct purchase and savings bond processing services. In March 2004, the U.S. Treasury provided an implementation plan for consolidating the provision of these services at two Reserve Banks. The costs for the associated restructuring for the affected Banks have been included in footnote 10.

The FOMC, in the conduct of monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and annually issues authorizations and directives to the FRBNY for its execution of

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

transactions. The FRBNY is authorized to conduct operations in domestic markets, including direct purchase and sale of U.S. government securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY executes these open market transactions and holds the resulting securities, with the exception of securities purchased under agreements to resell, 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. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange (F/X) and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is authorized to maintain reciprocal currency arrangements (F/X swaps) with two central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (ESF) through the Reserve Banks. In connection with its foreign currency activities, the FRBNY may enter into contracts that contain varying degrees of off-balance-sheet market risk, because they represent contractual commitments involving future settlement and counterparty credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

Although Reserve Banks are separate legal entities, in the interests of greater efficiency and effectiveness, they collaborate in the delivery of certain operations and services. The collaboration takes the form of centralized competency centers, operations sites, and product or service offices that have responsibility for the delivery of certain services on behalf of the Reserve Banks. Various operational and management models are used and are supported by service agreements between the Reserve Bank providing the service and the other eleven Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, Reserve Banks are billed for services provided to them by another Reserve Bank.

Beginning in 2005, the Reserve Banks adopted a new management model for providing check services to depository institutions. Under this new model, the Federal Reserve Bank of Atlanta (FRBA) has the overall responsibility for managing the Reserve Banks' provision of check services and recognizes total System check revenue on its Statements of Income. FRBA compensates the other eleven Banks for the costs incurred to provide check services.

(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 various accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* (*Financial Accounting Manual*), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the *Financial Accounting Manual* and the financial statements have been prepared in accordance with the *Financial Accounting Manual*.

Differences exist between the accounting principles and practices in the *Financial Accounting Manual* and those generally accepted in the United States (GAAP) primarily due to the unique nature of the Reserve Banks' powers and responsibilities as part of the nation's central bank. The primary difference is the presentation of all security holdings at amortized cost, rather than using the fair value presentation requirements in accordance with GAAP. Amortized cost more appropriately reflects the Reserve Banks' security holdings given their unique responsibility to conduct monetary policy. While the application of current market prices to the securities holdings 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 may involve transactions that result in gains or losses when holdings are sold prior to maturity. Decisions regarding security and foreign currency 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 securities and currencies are incidental to the open market operations and do not motivate these activities or policy decisions.

In addition, the Board of Governors and the Reserve Banks have elected not to present a Statement of Cash Flows because the liquidity and cash position of the Reserve Banks are not a primary concern given their unique powers and responsibilities. A Statement of Cash Flows, therefore, would not provide any additional meaningful information. Other information regarding the Reserve Banks' activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. There are no other significant differences between the policies outlined in the *Financial Accounting Manual* and GAAP.

The preparation of the 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 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.

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

(A) *Gold and Special Drawing Rights Certificates*

The Secretary of the U.S. Treasury is authorized to issue gold and special drawing rights (SDR) certificates to the Reserve Banks.

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 accounts are lowered. The value of gold for purposes of backing the gold certificates is set by law at 42\frac{2}{9}$ a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based on the average Federal Reserve notes outstanding in each Reserve Bank.

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 accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2005 or 2004.

(B) *Loans to Depository Institutions*

All depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of each 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 each of the Reserve Banks, subject to review and determination by the Board of Governors.

(C) *U.S. Government Securities and Investments Denominated in Foreign Currencies*

U.S. government 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. Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Foreign-currency-denominated assets are revalued daily at current foreign currency 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 (losses) gains, net."

Activity related to U.S. government securities, including the related premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings that occurs in April of each year. The settlement equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments in foreign-currency-denominated assets is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31.

(D) *Securities Purchased under Agreements to Resell, Securities Sold under Agreements to Repurchase, and Securities Lending*

The FRBNY may engage in tri-party purchases of securities under agreements to resell (tri-party agreements). Tri-party agreements are conducted with two commercial custodial banks that manage the clearing and settlement of collateral. Collateral is held in excess of the contract amount. Acceptable collateral under tri-party agreements primarily includes U.S. government securities, pass-through mortgage securities of the Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association, STRIP securities of the U.S. government. and "stripped" securities of other government agencies. The tri-party agreements are accounted for as financing transactions, with the associated interest income accrued over the life of the agreement.

Securities sold under agreements to repurchase are accounted for as financing transactions and the associated interest expense is recognized over the life of the transaction. These transactions are carried in the Statements of Condition at their contractual amounts and the related accrued interest is reported as a component of "Other liabilities."

U.S. government securities held in the SOMA are lent to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements in order to facilitate the effective functioning of the domestic securities market. Securities-lending transactions are fully collateralized by other U.S. government securities and the collateral taken is in excess of the market value of the securities loaned. The FRBNY charges the dealer or bank a fee for borrowing securities and the fees are reported as a component of "Other income" in the Statements of Income.

Activity related to U.S. government securities sold under agreements to repurchase and securities lending is allocated to each Reserve Bank on a percentage basis derived from the annual settlement of interdistrict clear-

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

ings. Securities purchased under agreements to resell are allocated to the FRBNY and not to the other banks.

(E) *Foreign Currency Swaps and Warehousing*

F/X swap arrangements are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. 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 the foreign currencies it may need to intervene to support the dollar and give the counterparty 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 counterparty (the drawer) and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. The FRBNY 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 U.S. Treasury, U.S. dollars for foreign currencies held by the U.S. 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 U.S. Treasury and ESF for financing purchases of foreign currencies and related international operations.

Foreign currency swaps and warehousing agreements are revalued daily at current market exchange rates. Activity related to these agreements, with the exception of the unrealized gains and losses resulting from the daily revaluation, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. Unrealized gains and losses resulting from the daily revaluation are allocated to the FRBNY and not to the other Reserve Banks.

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

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred. Capitalized assets, including software, buildings, leasehold improvements, furniture, and equipment are impaired when it is determined that the net realizable value is significatly less than book value and is not recoverable.

Costs incurred for software, either developed internally or acquired for internal use, during the application development stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years.

(G) *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.

Assets eligible to be pledged as collateral security include all Reserve Bank assets. 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. The par value of securities pledged for securities sold under agreements to repurchase is 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 for certain assets of the Reserve Banks to be 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 currency issued to the Reserve Banks but not in circulation, of $148,152 million and $128,933 million at December 31, 2005 and 2004, respectively.

At December 31, 2005 all Federal Reserve notes outstanding were fully collateralized. All gold certificates, all special drawing rights certificates, and $745,120 million of domestic securities and securities purchased under agreements to resell were pledged as collateral. At December 31, 2005 no loans or investments denominated in foreign currencies were pledged as collateral.

(H) *Items in Process of Collection and Deferred Credit Items*

The balance in the "Items in process of collection" line in the Statements of Condition primarily represents amounts that are attributable to checks deposited for collection by a depository institution and that, as of the balance sheet date, have not yet been collected from the payor depository institution. Deferred credit items are the counterpart liability to items in process of collection, and the amounts in this account arise from deferring credit for deposited items until the amounts are collected. The balances in both accounts can fluctuate and vary significantly from day to day.

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

(I) *Capital Paid-In*

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Banks in an amount equal to 6 percent of the capital and surplus of the member bank. These shares are nonvoting with a par value of $100 and may not be transferred or hypothecated. As a member bank's capital and surplus changes, its holdings of Reserve Bank stock must be adjusted. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. By law, each Reserve Bank is required to pay each member bank 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.

(J) *Surplus*

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

In the event of losses or an increase in capital paid-in at a Reserve Bank, payments to the U.S. Treasury are suspended and earnings are retained until the surplus is equal to the capital paid-in. Weekly payments to the U.S. Treasury may vary significantly.

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to U.S. Treasury in the following year. This amount is reported as "Payments to U.S. Treasury as interest on Federal Reserve notes."

(K) *Income and Costs Related to U.S. Treasury Services*

The 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.

(L) *Assessments by the Board of Governors*

The Board of Governors assesses the Reserve Banks to fund its operations based on each Reserve Bank's capital and surplus balances. The Board of Governors also assesses each Reserve Bank for the expenses incurred for the U.S. Treasury to issue and retire Federal Reserve notes based on each Reserve Bank's share of the number of notes comprising the System's net liability for Federal Reserve notes on December 31 of the previous year.

(M) *Taxes*

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. Real propery taxes were $32 million and $33 million for the years ended December 31, 2005 and 2004, respectively, and are reported as a component of "Occupancy expense."

(N) *Restructuring Charges*

In 2003, the System began the restructuring of several operations, primarily check, cash, and U.S. Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations. These restructuring activities continued in 2004 and 2005.

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

(4) U.S. GOVERNMENT SECURITIES, SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL, SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE, AND SECURITIES LENDING

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA.

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

	2005	2004
Par value		
U.S. government		
Bills	$271,270	$262,970
Notes	380,118	360,832
Bonds	92,827	94,017
Total par value	744,215	717,819
Unamortized premiums	8,813	9,405
Unaccreted discounts	(2,826)	(1,640)
Total	$750,202	$725,584

The maturity distribution of U.S. government securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase, that were held in the SOMA at December 31, 2005, was as follows (in millions):

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

Maturities of securities held	U.S. government securities (Par value)	Securities purchased under agreements to resell (Contract amount)	Securities sold under agreements to repurchase (Contract amount)
Within 15 days	$ 41,010	$46,750	$30,505
16 days to 90 days	172,264	...	...
91 days to 1 year	186,283	...	...
Over 1 year to 5 years	210,745	...	...
Over 5 years to 10 years	56,699	...	...
Over 10 years	77,214	...	...
Total	$744,215	$46,750	$30,505

At December 31, 2005 and 2004, U.S. government securities with par values of $3,776 million and $6,609 million, respectively, were loaned from the SOMA.

At December 31, 2005 and 2004, securities sold under agreements to repurchase with a contract amount of $30,505 million and $30,783 million, respectively, were outstanding. At December 31, 2005 and 2004, securities sold under agreements to repurchase with a par value of $30,559 million and $30,808 million, respectively, were outstanding.

(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 purchased under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Total investments denominated in foreign currencies, including accrued interest, and valued at current foreign currency market exchange rates at December 31, were as follows (in millions):

	2005	2004
European Union euro		
Foreign currency deposits	$ 5,424	$ 6,079
Securities purchased under agreements to resell	1,928	2,142
Government debt instruments	3,561	3,947
Japanese yen		
Foreign currency deposits	2,618	1,540
Government debt instruments	5,397	7,660
Total	$18,928	$21,368

The maturity distribution of investments denominated in foreign currencies at December 31, 2005, was as follows (in millions):

Maturities of investments denominated in foreign currencies	European euro	Japanese yen	Total
Within 15 days	$ 3,379	$2,617	$ 5,996
16 days to 90 days	2,574	679	3,253
91 days to 1 year	2,089	1,007	3,096
Over 1 year to 5 years	2,855	3,712	6,567
Over 5 years to 10 years	16	...	16
Total	$10,913	$8,015	$18,928

At December 31, 2005 and 2004, there were no material open foreign exchange contracts.

At December 31, 2005 and 2004, the warehousing facility was $5,000 million, with no balance outstanding.

(6) BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	Remaining useful life (range in years)	2005	2004
Bank premises and equipment			
Land	N/A	$ 295	$ 274
Buildings	1–50	1,787	1,631
Building machinery and equipment	1–20	387	373
Construction in progress	N/A	86	202
Furniture and equipment	1–19	1,162	1,200
Subtotal		$3,717	$3,680
Accumulated depreciation		(1,465)	(1,464)
Bank premises and equipment, net		$2,252	$2,216
Depreciation expense, for the years ended		$ 175	$ 179

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

	2005	2004
Bank premises and equipment	$10	$11
Accumulated depreciation	(5)	(6)
Capitalized leases, net	$ 5	$ 5

Certain of the Reserve Banks lease space to outside tenants with initial or remaining lease terms from 1 to 20 years. Rental income from such leases was $23 million and $21 million for the years ended December 31, 2005 and 2004, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2005, were (in millions):

2006	$ 21
2007	17
2008	16
2009	15
2010	14
Thereafter	60
Total	$143

The Reserve Banks have capitalized software assets, net of amortization, of $162 million and $170 million at December 31, 2005 and 2004, respectively. Amortization expense was $55 million and $56 million for the years ended December 31, 2005 and 2004, respectively. Capitalized software assets are reported as a component of "Other assets" and related amortization is reported as a component of "Other expenses."

Several Reserve Banks have impaired assets as a result of the System's restructuring plans, as discussed in footnote 10. Impaired assets include software, buildings, leasehold improvements, furniture, and equipment. Asset impairment losses related to the check and cash restructurings of $50 million and $21 million for the periods ending December 31, 2005 and 2004, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

(7) Commitments and Contingencies

At December 31, 2005, the Reserve Banks were obligated under noncancelable leases for premises and equipment with initital or remaining terms ranging from 1 to 18 years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $40 million and $70 million for the years ended December 31, 2005 and 2004, 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, 2005, were (in millions):

	Operating
2006	$ 11
2007	10
2008	8
2009	8
2010	7
Thereafter	109
	$153

At December 31, 2005, the Reserve Banks had other commitments and long-term obligations extending through the year 2017 with a remaining amount of $397 million. As of December 31, 2005, commitments of $185 million were recognized. Purchases of $144 million and $124 million were made against these commitments during 2005 and 2004, respectively. These commitments are for goods and services to maintain currency machines, for software licenses and maintenance, for services related to check processing equipment and transportation, and have variable and fixed components. The variable portion of the commitments is for additional services above fixed contractual service limits. The fixed payments for the next five years under these commitments are (in millions):

	Fixed commitment
2006	$50
2007	52
2008	38
2009	32
2010	27

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 three 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 Office of Employee Benefits of the Federal Reserve Employee Benefits System employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). Employees at certain compensation levels participate in the Benefit Equalization Retirement Plan (BEP) and certain Bank officers participate in the Supplemental Employee Retirement Plan (SERP).

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the System Plan and the costs associated with the Plan are not redistributed to other participating employers.

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

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

	2005	2004
Estimated actuarial present value of projected benefit obligation at January 1	$4,524	$3,930
Service cost—benefits earned during the period	123	116
Interest cost on projected benefit obligation	263	245
Actuarial loss	125	457
Contributions by plan participants	3	3
Special termination benefits loss	6	20
Benefits paid	(259)	(247)
Estimated actuarial present value of projected benefit obligation at December 31	$4,785	$4,524

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

	2005	2004
Estimated fair value of plan assets at January 1	$5,887	$5,703
Actual return on plan assets	237	428
Contributions by the employer	. . .	. . .
Contributions by plan participants	3	3
Benefits paid	(259)	(247)
Estimated fair value of plan assets at December 31	$5,868	$5,887
Funded status	$1,083	$1,362
Unrecognized prior service cost	149	173
Unrecognized net actuarial loss	1,496	1,182
Prepaid pension benefit costs	$2,728	$2,717

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

The accumulated benefit obligation for the System Plan was $4,162 million and $3,894 million at December 31, 2005 and 2004, respectively.

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

	2005	2004
Discount rate	5.75%	5.75%
Rate of compensation increase	4.50%	4.25%

Net periodic benefit costs are actually determined using a January 1 measurement date. The weighted-average assumptions used in developing net periodic benefit cost for the System Plan for the years at January 1 are as follows:

	2005	2004
Discount rate	5.75%	6.25%
Expected asset return	8.25%	8.25%
Rate of compensation increase	4.25%	4.00%

Discount rates reflect yields available on high quality corporate bonds that would generate the cash flows necessary to pay the plan's benefits when due.

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

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

	2005	2004
Service cost—benefits earned during the period	$ 123	$ 116
Interest cost on projected benefit obligation	263	245
Amortization of prior service cost	24	24
Recognized net loss	49	20
Expected return on plan assets	(476)	(462)
Net periodic pension benefit credit	(17)	(57)
Special termination benefits	6	20
Net periodic pension benefit credit	$ (11)	$ (37)

The recognition of special termination benefits is the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10.

Following is a summary of expected benefit payments excluding enhanced retirement benefits (in millions):

	Expected benefit payments
2006	$ 236
2007	242
2008	247
2009	253
2010	261
2011–2015	1,498
Total	$2,737

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

	2005	2004
Equities	65.9%	67.5%
Fixed income	32.0%	30.0%
Cash	2.1%	2.5%
Total	100.0%	100.0%

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

The Federal Reserve System does not expect to make a cash contribution to the System Plan during 2006.

The Reserve Banks' projected benefit obligation and net pension costs for the BEP and the SERP at December 31, 2005 and 2004, 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 for each of the years ended December 31, 2005 and 2004, and are reported as a component of "Salaries and other benefits." The Reserve Banks match employee contributions based on a specified formula. For the years ended December 31, 2005 and 2004, the Reserve Banks matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

(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.

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

	2005	2004
Accumulated postretirement benefit obligation at January 1	$869	$942
Service cost—benefits earned during the period	32	19
Interest cost of accumulated benefit obligation	49	52
Actuarial loss	45	10
Curtailment gain	. . .	(2)
Special termination loss	. . .	1
Contributions by plan participants	11	9
Benefits paid	(59)	(50)
Plan amendments	. . .	(112)
Accumulated postretirement benefit obligation at December 31	$947	$869

At December 31, 2005 and 2004, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.50 percent and 5.75 percent, respectively.

Discount rates reflect yields available on high quality corporate bonds that would generate the cash flows necessary to pay the plan's benefits when due.

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

	2005	2004
Fair value of plan assets at January 1	$ . . .	$ . . .
Contributions by the employer	48	42
Contributions by plan participants	11	8
Benefits paid	(59)	(50)
Fair value of plan assets at December 31	$ . . .	$ . . .
Unfunded postretirement benefit obligation	$947	$869
Unrecognized net curtailment gain	. . .	5
Unrecognized prior service cost	105	128
Unrecognized net actuarial loss	(277)	(247)
Accrued postretirement benefit costs	$775	$755

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

For measurement purposes, the assumed health care cost trend rates at December 31 are as follows:

	2005	2004
Health care cost trend rate assumed for next year	9.00%	9.00%
Rate to which the cost trend rate is assumed to increase (the ultimate trend rate)	5.00%	4.75%
Year that the rate reaches the ultimate trend rate	2011	2011

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

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, 2005 (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	$ 11	$(10)
Effect on accumulated postretirement benefit obligation	103	(86)

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

	2005	2004
Service cost—benefits earned during the period	$ 32	$ 19
Interest cost of accumulated benefit obligation	49	52
Amortization of prior service cost	(21)	(17)
Recognized net actuarial loss	13	8
Total periodic expense	73	62
Curtailment gain	(5)	(86)
Special termination loss	. . .	1
Net periodic postretirement benefit costs (credit)	$ 68	$(23)

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2005 and 2004, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.75 percent and 6.25 percent, respectively.

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

The 2005 service cost contains an adjustment by one Reserve Bank that resulted from a review of plan terms and assumptions. A plan amendment that modified the credited service period eligibility requirements created curtailment gains. The recognition of special termination losses is primarily the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 established a prescription drug benefit under Medicare (Medicare Part D) and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. The benefits provided by the Reserve Banks' plan to certain participants are at least actuarially equivalent to the Medicare Part D prescription drug benefit. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit costs.

Following is a summary of expected benefit payments (in millions):

	Without subsidy	With subsidy
2006	$ 54	$ 49
2007	57	52
2008	59	53
2009	62	56
2010	64	58
2011–2015	351	308
Total	$647	$576

Postemployment Benefits

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2005, measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Reserve Banks at December 31, 2005 and 2004, were $124 million and $128 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2005 and 2004 operating expenses were $14 million and $17 million, respectively, and are recorded as a component of "Salaries and other benefits."

10. BUSINESS RESTRUCTURING CHARGES

In 2003, several Reserve Banks announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Banks. In 2004 and 2005, additional consolidation and restructuring initiatives were announced in the check, cash, savings bonds, marketing, purchasing, and Treasury operations. These actions resulted in the following business restructuring charges (in millions):

	Total estimated costs
Employee separation	$60
Contract termination	1
Total	$61

	Accrued liability 12/31/04	Total charges	Total paid	Accrued liability 12/31/05
Employee separation	$28	$6	$(17)	$17
Contract termination	1	. . .	(1)	. . .
Total	$29	$6	$(18)	$17

Adjustments due to unrecognized accrued liabilities were offset against total charges. Without these offsets, total charges would have been $11 million in 2005.

Total employee separation costs are primarily severance costs related to staff reductions of approximately 2,411, including 348 and 945 staff reductions related to restructuring announced in 2005 and 2004, respectively. These costs are reported as a component of "Salaries and other benefits." Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Other expenses."

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

Future costs associated with the announced restructuring plans are estimed at $3 million.

The Reserve Banks anticipate substantially completing their announced plans in 2007.

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, inspections, evaluations, 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 conducts and supervises activities, that promote economy and efficiency and prevent and detect waste, fraud, and abuse in Board and Board-delegated programs and operations, and in activities administered or financed by the Board. The OIG keeps the Congress and the Chairman of the Board fully informed about serious abuses and deficiencies and about the status of any corrective actions.

During 2005, the OIG completed eleven audits, reviews, and other assessments and conducted a number of follow-up reviews to evaluate action taken on earlier recommendations. Some of these projects resulted in multiple reports. The OIG also closed seven investigations and performed numerous legislative and regulatory reviews.

Audits, Reviews, and Assessments Completed during 2005

Report title	Month issued
Review of Configuration Management (Restricted Report)	January
Review of the Board's Workers' Compensation Program	March
Audit of the FFIEC's Financial Statements (Year Ended December 31, 2004)	March
Audit of the Board's Financial Statements (Year Ended December 31, 2004)	April
Audit of the Board's Fixed Asset Management Process	May
Review of Board's Implementation of Software Security Reviews	May
Review of the Bank of Ephraim Failure	August
Evaluation of Service Credit Computations (Internal Report)	August
Agreed Upon Procedures Engagement Regarding Certain Personnel-Related Controls (Internal Report)	August
Audit of the Supervision and Regulation Function's Efforts to Implement Requirements of the Federal Information Security Management Act	September
Audit of the Board's Information Security Program	October

Government Accountability Office Reviews

Under the Federal Banking Agency Audit Act (Public Law 95–320), most Federal Reserve System operations are under the purview of the Government Accountability Office (GAO). In 2005, the GAO completed five reports on selected aspects of Federal Reserve operations (table). In addition, five projects concerning the Federal Reserve were in various stages of completion at year-end (table). The Federal Reserve also provided information to the GAO during the year on numerous other GAO investigations.

The reports are available directly from the GAO.

Reports Completed during 2005

Report title	Report number	Month issued (2005)
USA Patriot Act: Additional Guidance Could Improve Implementation of Regulations Related to Customer Identification and Information Sharing Procedures	GAO-05-412	May
Information Security Practices: Financial Market Organizations Have Taken Steps to Protect against Electronic Attacks, But Could Take Additional Actions	GAO-05-679R	June
Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority	GAO-05-621	September
Financial Audit: Bureau of the Public Debt's Fiscal Years 2005 and 2004 Schedules of Federal Debt	GAO-06-l69	November
International Remittances: Information on Products, Costs, and Consumer Disclosures	GA0-06-204	November

Projects Active at Year-End 2005

Subject of project	Month initiated
Bank Secrecy Act examinations	January 2004
Sections 330 and 361of the USA Patriot Act	September 2005
Diversity in the financial services sector	October 2005
Lending practices associated with alternative mortgage products	November 2005
Consolidated supervision of financial institutions	November 2005