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 conducts audits, reviews, and investigations relating to the Board's programs and operations as well as to 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 2006 and 2005 were audited by KPMG LLP, independent auditors.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

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, 2006 and 2005, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows (hereinafter referred to as "financial statements") 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, 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, as of December 31, 2006 and 2005, and the results of its operations, and its cash flows, for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 3 to the financial statements, in 2006, the Board adopted the provisions of the Financial Accounting Standard Board Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans.*

In accordance with *Government Auditing Standards*, we have also issued our reports dated April 17, 2007, 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

April 17, 2007

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEETS

	As of December 31, 2006	As of December 31, 2005
ASSETS		
CURRENT ASSETS		
Cash	$ 60,030,706	$ 45,970,435
Accounts receivable	2,625,907	3,081,520
Prepaid expenses and other assets	4,260,507	2,992,412
Total current assets	66,917,120	52,044,367
NONCURRENT ASSETS		
Property and equipment, net (Note 4)	151,205,386	155,441,553
Total noncurrent assets	151,205,386	155,441,553
Total assets	$218,122,506	$207,485,920
LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 10,950,470	$ 16,906,350
Accrued payroll and related taxes	5,421,666	4,860,572
Accrued annual leave	16,334,512	15,456,484
Capital lease payable (current portion)	327,663	270,167
Unearned revenues and other liabilities	366,304	783,711
Total current liabilities	33,400,615	38,277,284
LONG-TERM LIABILITIES		
Capital lease payable (non-current portion)	108,755	406,188
Accumulated retirement benefit obligation (Note 5)	1,354,662	813,497
Accumulated postretirement benefit obligation (Note 6)	8,111,829	6,237,290
Accumulated postemployment benefit obligation (Note 7)	6,515,301	5,111,365
Total long-term liabilities	16,090,547	12,568,340
Total liabilities	49,491,162	50,845,624
CUMULATIVE RESULTS OF OPERATIONS		
Working capital	33,844,168	14,037,250
Unfunded long-term liabilities	(14,325,986)	(12,162,152)
Net investment in property and equipment	150,768,968	154,765,198
Accumulated other comprehensive income (loss) (Note 8)	(1,655,806)	. . .
Total cumulative results of operations	168,631,344	156,640,296
Total liabilities and cumulative results of operations	$218,122,506	$207,485,920

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, 2006	2005
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	$301,013,500	$265,742,100
Other revenues (Note 9)	8,508,949	8,520,342
Total operating revenues	309,522,449	274,262,442
BOARD OPERATING EXPENSES		
Salaries	182,239,595	174,523,825
Retirement and insurance	35,853,297	31,847,951
Contractual services and professional fees	23,944,564	24,695,564
Depreciation, amortization, and net losses on disposals	13,058,667	12,954,506
Utilities	9,185,840	9,065,329
Travel	8,820,503	7,613,280
Software	6,637,765	6,052,617
Postage and supplies	4,560,368	7,169,829
Repairs and maintenance	2,634,459	3,361,179
Printing and binding	1,505,470	1,973,594
Other expenses (Note 9)	7,435,067	7,486,158
Total operating expenses	295,875,595	286,743,832
RESULTS OF OPERATIONS	13,646,854	(12,481,390)
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	491,962,202	477,087,471
Expenses for currency printing, issuance, retirement, and shipping	491,962,202	477,087,471
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES	0	0
TOTAL RESULTS OF OPERATIONS	13,646,854	(12,481,390)
CUMULATIVE RESULTS OF OPERATIONS, Beginning of year	156,640,296	169,121,686
OTHER COMPREHENSIVE INCOME		
Adjustment to initially apply FASB Statement No. 158 (Note 8)	(1,655,806)	...
Total Other Compehensive Income	(1,655,806)	...
CUMULATIVE RESULTS OF OPERATIONS, End of year	$168,631,344	$156,640,296

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF CASH FLOWS

	For the years ended December 31, 2006	2005
Cash Flows from Operating Activities		
Results of Operations	$13,646,854	$(12,481,390)
Adjustments to reconcile results of operations to net cash provided by (used in) operating activities:		
Depreciation and net losses on disposals	13,058,667	12,954,506
Increase in assets:		
Accounts receivable, and prepaid expenses and other assets	(812,482)	(362,385)
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	(5,955,880)	3,014,489
Accrued payroll and related taxes	561,094	308,533
Accrued annual leave	878,028	1,260,574
Unearned revenues and other liabilities	(417,407)	316,047
Accumulated retirement benefit obligation	541,165	219,328
Accumulated postretirement benefit obligation	1,874,539	447,724
Accumulated postemployment benefit obligation	1,403,936	(197,200)
Accumulated other comprehensive income	(1,655,806)	...
Net cash provided by operating activities	23,122,708	5,480,226
Cash Flows from Investing Activities		
Proceeds from disposals	7,212	2,850
Capital expenditures	(8,829,712)	(19,370,223)
Net cash used in investing activities	(8,822,500)	(19,367,373)
Cash Flows from Financing Activities		
Capital lease payments	(239,937)	(249,710)
Net cash used in financing activities	(239,937)	(249,710)
Net Increase (Decrease) in Cash	14,060,271	(14,136,857)
Cash Balance, Beginning of year	45,970,435	60,107,292
Cash Balance, End of year	$60,030,706	$ 45,970,435

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, 2006 AND 2005

(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) Operations and Services

The Board's responsibilities require thorough analysis of domestic and international financial and economic developments. The Board carries out those responsibilities in conjunction with other components of the Federal Reserve System. The Board also supervises and regulates the operations of the Federal Reserve Banks, exercises broad responsibility in the nation's payments system, and administers most of the nation's laws regarding consumer credit protection. Policy regarding open market operations is established by the Federal Open Market Committee. However, the Board has sole authority over changes in reserve requirements, and it must approve any change in the discount rate initiated by a Federal Reserve Bank.

The Board also plays a major role in the supervision and regulation of the U.S. banking system. It has supervisory responsibilities for state-chartered banks that are members of the Federal Reserve System, bank holding companies, foreign activities of member banks, and U.S. activities of foreign banks.

(3) 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.

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 the Board account and are not Board operating transactions.

Property, Equipment, and Software—The Board's property, buildings, equipment, and software are stated at cost less accumulated depreciation and amortization. Depreciation and amortization 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, 10 to 50 years for building equipment and structures, and 2 to 10 years for software. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation or amortization 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 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 2005 amounts have been reclassified to conform with the 2006 presentation.

Implementation of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—The Board initially applied the provisions of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Balance Sheets, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard require applying the provisions as of the end of the year of initial implementation with no retrospective application.

(4) Property and Equipment

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

	As of December 31,	
	2006	2005
Land	$ 18,640,314	$ 18,640,314
Buildings and improvements	147,504,169	135,152,735
Furniture and equipment	47,271,434	39,926,270
Software in use	13,681,508	12,415,000
Software in process	941,912	575,050
Construction in process	360,966	13,928,149
	228,400,304	220,637,518
Less accumulated depreciation and amortization	(77,194,918)	(65,195,965)
Property and equipment, net	$151,205,386	$155,441,553

Furniture and equipment includes $1,230,000 each year for capitalized leases as of December 31, 2006 and 2005. Accumulated depreciation includes $867,000 and $612,000 for capitalized leases as of December 31, 2006 and 2005, respectively. The Board paid interest related to these capital leases in the amount of $54,000 and $83,000 for 2006 and 2005, respectively.

Construction in process includes costs incurred in 2006 and 2005 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, 2006, are as follows:

	Year ending December 31	Amount
	2007	$ 463,491
	2008	138,279
	2009	. . .
Total minimum lease payments		601,770
Less: Amount representing maintenance included in total amounts above		(130,540)
Net minimum lease payments		471,230
Less: Amount representing interest		(34,812)
Present value of net minimum lease payments		436,418
Less: Current maturities of capital lease obligations		(327,663)
Long-term capital lease obligations		$ 108,755

(5) 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. No separate accounting is maintained of assets contributed by the participating employers. The Federal Reserve Bank of New York acts as a sponsor of the System Plan, and the costs associated with the Plan are not redistributed to other participating employers.

Employees of the Board who became employed prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who became employed after 1983 are covered by a non-contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 2006 and 2005, 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 non-vested benefits, as well as plan assets, as it relates solely to the Board, is not readily available.

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 2006 and 2005 is summarized in the following table:

	2006	2005
Change in projected benefit obligation		
Benefit obligation at beginning of year	$ 536,339	$ 140,953
Service cost	185,483	193,209
Interest cost	45,004	35,964
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	596,114	168,027
Benefits paid	(8,278)	(1,814)
Benefit obligation at end of year	$1,354,662	$ 536,339
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	8,278	1,814
Plan participants' contributions	0	0
Benefits paid	(8,278)	(1,814)
Fair value of plan assets at end of year	$ 0	$ 0

	2006	2005
Reconciliation of funded status at end of year		
Funded status	$(1,354,662)	$ (536,339)
Unrecognized net actuarial (gain)/ loss	580,386	(15,728)
Unrecognized prior service cost	(247,417)	(261,430)
Unrecognized net transition obligation	0	0
Prepaid/(Accrued) pension cost	$ (1,021,693)	$ (813,497)
Amounts recognized in the financial statements consist of		
Prepaid benefit cost	$ 0	$ 0
Accrued benefit liability	(1,021,693)	(813,497)
Intangible asset	0	0
Accumulated other comprehensive income	(332,969)	0
Net amount recognized	$ (1,354,662)	$ (813,497)
Information for pension plans with an accumulated benefit obligation in excess of plan asset:		
Projected benefit obligation	$ 1,354,662	$ 536,339
Accumulated benefit obligation	$ 546,854	$ 278,252
Weighted-average assumptions used to determine benefit obligation as of December 31		
Discount rate	5.75%	5.75%
Rate of compensation increase	4.50%	4.50%
Components of net periodic benefit cost		
Service cost—benefits earned during the period	$ 185,483	$ 193,209
Interest cost on projected benefit obligation	45,004	35,964
Expected return on plan assets	0	0
Amortization of prior service cost	(14,013)	(14,013)
Amortization of (gains)/losses	0	5,982
Amortization of initial (asset)/obligation	0	0
Net periodic benefit cost (credit)	$ 216,474	$ 221,142
Additional information:		
Increase in minimum liability included in other comprehensive income	$ 0	$ 0

	2006	2005
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31		
Discount rate	5.75%	5.75%
Rate of compensation increase	4.50%	4.25%

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 $334,000 and $324,000 in 2006 and 2005, 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 $8,964,000 and $8,617,000 in 2006 and 2005, respectively.

(6) Accumulated Postretirement Benefits

The 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 2006 and 2005 is summarized in the following table:

	2006	2005
Change in benefit obligation		
Benefit obligation at beginning of year	$ 8,273,831	$ 8,404,551
Service cost	230,567	217,421
Interest cost	470,256	437,320
Plan participants' contributions	0	0
Plan amendments	0	(196,970)
Actuarial (gain)/loss	(603,500)	(304,006)
Benefits paid	(259,325)	(284,485)
Benefit obligation at end of year	$ 8,111,829	$ 8,273,831
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contribution	259,325	284,485
Plan participants' contributions	0	0
Benefits paid	(259,325)	(284,485)
Fair value of plan assets at end of year	$ 0	$ 0

	2006	2005
Reconciliation of funded status at end of year		
Benefit obligations	$(8,111,829)	$(8,273,832)
Unrecognized net actuarial (gain)/loss	0	2,145,920
Unrecognized prior service cost	0	(109,378)
Amount recognized at end of year	$(8,111,829)	$(6,237,290)
Amounts recognized in the financial statements consist of:		
Liability	$(8,111,829)	$ 0
Accrued benefit cost	0	(6,237,290)
Accumulated other comprehensive income	0	0
Net amount recognized	$(8,111,829)	$(6,237,290)
Amounts recognized in accumulated other comprehensive income consist of:		
Net actuarial loss/(gain)	$1,422,398	$ 0
Prior service cost/(credit)	(99,560)	0
Transition obligation/(asset)	0	0
Deferred curtailment (gain)/loss	0	0
	$1,322,838	$ 0
Expected cash flows		
Expected employer contributions:		
2007	$ 274,901	
Expected benefit payments:		
2007	$ 274,901	
2008	$ 296,030	
2009	$ 325,793	
2010	$ 350,050	
2011	$ 364,265	
2012-2016	$ 2,132,108	

The liability and costs for the postretirement benefit plan were determined using discount rates of 5.75 percent as of December 31, 2006 and 2005. Unrecognized losses of $2,145,920 as of December 31, 2005 result from changes in the discount rate used to measure the liabilities. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 4.50 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 $9,607,000 and $8,933,000 in 2006 and 2005, respectively.

(7) Accumulated Postemployment Benefit Plan

The 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, 2006 and 2005, were $1,963,000 and $155,800, respectively.

(8) Accumulated Other Comprehensive Income

Following is a reconciliation of beginning and ending balances of accumulated other comprehensive income.

	Amount related to defined benefit retirement plans	Amount related to postretirement benefits other than pensions
Balance January 1, 2006	$(1,021,693)	$(6,788,992)
Adjustment to initially apply Statement No. 158	(332,969)	(1,322,837)
Balance December 31, 2006	$(1,354,662)	$(8,111,829)

	Total accumulated other comprehensive income (loss)
Balance January 1, 2006	$(7,810,685)
Adjustment to initially apply Statement No. 158	(1,655,806)
Balance December 31, 2006	$(9,466,491)

Additional detail regarding the classification of accumulated other comprehensive income is included in note 6.

(9) Other Revenues and Other Expenses

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

	For the years ended December 31, 2006	2005
Other revenues		
Data processing revenue	$4,180,692	$3,788,217
Rent	2,450,576	2,433,833
Subscription revenue	716,294	782,743
Reimbursable services to other agencies	599,827	664,755
Board sponsored conferences	0	250,650
Miscellaneous	561,560	600,144
Total other revenues	$8,508,949	$8,520,342
Other expenses		
Tuition, registration, and membership fees	$2,676,871	$2,573,028
Contingency operations	1,087,429	956,476
Public transportation subsidy	988,950	872,467
Subsidies and contributions	706,497	656,150
Meals and representation	529,557	518,640
Equipment and facilities rental	393,122	336,342
Administrative law judges	105,587	268,228
Security investigations	236,448	184,880
Former employee related payments	19,296	319,461
Miscellaneous	691,309	800,486
Total other expenses	$7,435,067	$7,486,158

(10) 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. Minimum annual payments under the operating leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 2006, are as follows:

2007	$ 176,807
2008	183,880
2009	191,235
2010	198,884
2011	84,218
	$ 835,024

Rental expenses under the operating leases were $193,000 in 2006 and $157,000 in 2005.

Commitments

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 and maintenance fees for a central data repository project through 2013. Estimated Board expense to support this effort is $7.5 million.

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 remote.

One action currently pending in U.S. District Court for the District of Columbia alleges discrimination on behalf of a class of African American secretaries at the Board under Title VII of the Civil Rights Act of 1964, as amended. On January 31, 2007, the action was dismissed for failure to exhaust administrative remedies. The plaintiffs have moved to alter or amend judgment on this ruling; that motion is pending. Should the case be reinstated either as a result of the pending motion or following appeal, the Board believes it has substantial defenses and intends to defend the case vigorously.

Four additional actions are pending in the United States District Court for the District of Columbia under Title VII of the Civil Rights Act of 1964, as amended and/or the Age Discrimination in Employment Act. All four are believed to be without merit and are being vigorously contested.

Five additional matters alleging employment discrimination are currently pending administrative resolution. One case is related to, and likely will be joined with, a case currently pending in district court. In that and another case 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 that the likelihood of an unfavorable outcome in the remaining three cases is remote.

(11) 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 2006 and 2005 is summarized in the following table:

	2006	2005
Board paid to the Council:		
Assessments for operating expenses of the Council	$ 109,760	$ 83,811
Central Data Repository	740,003	1,096,062
Uniform Bank Performance Report	204,617	202,666
Total Board paid to the Council	$1,054,380	$1,382,539
Council paid to the Board:		
Data processing related services	$3,429,499	$3,572,816
Administrative services	183,000	175,000
Total Council paid to the Board	$3,612,499	$3,747,816
Accounts receivable due from the Council	$ 395,551	$ 277,589
Accounts payable due to the Council	$ 54,870	$ 104,864

(12) 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 to the Board. Activity related to the Board and Reserve Banks for 2006 and 2005 is summarized in the following table:

	2006	2005
Board paid to the Reserve Banks:		
Assessments for employee benefits	$ 2,380,474	$ 2,072,595
Data processing and communication	2,161,298	2,106,850
Contingency site	1,087,429	956,476
Total Board paid to the Reserve Banks	$ 5,629,201	$ 5,135,921
Reserve Banks paid to the Board:		
Assessments for currency costs	$491,962,202	$477,087,471
Assessments for operating expenses of the Board	301,013,500	265,742,100
Data processing	731,999	516,433
Total Reserve Banks paid to the Board	$793,707,701	$743,346,004
Accounts receivable due from Federal Reserve Banks	$ 854,142	$ 145,142
Accounts payable due to Federal Reserve Banks	$ 12,417	$ 0

(13) Noncash Financing Activities

In 2005, the Board billed a federal government agency $1,096,557 for rent and leasehold improvements. In 2006, the federal government agency provided equipment, software, and services valued at $392,301 to the Board and paid the balance of $704,256 in 2006. In 2006, the Board billed the same agency $143,772 for rent, and the agency provided telecommunication equipment and services valued at $124,720 to the Board and paid the balance of $19,052 in 2006.

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, 2006 and 2005, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows (hereinafter referred to as "financial statements") for the years then ended, and have issued our report thereon dated April 17, 2007.

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.

The management of the Board is responsible for establishing and maintaining effective internal control. In planning and performing our 2006 audit, we considered the Board's internal control over financial reporting as a basis for designing 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 express an opinion on the effectiveness of the Board's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Board's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Board's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Board's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Board's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the third paragraph above and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.

In our 2006 audit, we noted a matter described in Exhibit I involving internal control over financial reporting that we consider to be a significant deficiency. We believe that this significant deficiency is not a material weakness. Exhibit II presents the status of the prior year finding.

The Board's response to the findings identified in our audit is presented in the Exhibit I. We did not audit the Board's response and, accordingly, we express no opinion on it.

We noted certain additional matters that we have reported to the management of the Board in a separate letter dated April 17, 2007.

This report is intended solely for the information and use of the Board's management, the Office of Inspector General, the U.S. 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

April 17, 2007

Exhibit I

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Significant Deficiency
December 31, 2006

Improvement is needed in Internal Controls over Financial Reporting

Management is responsible for developing and maintaining effective internal controls to provide reasonable assurance that the Board has the ability to initiate, authorize, record, process, and report financial data reliably in accordance with generally accepted accounting principles. Internal controls help ensure that reliable and timely information is obtained, maintained, reported, and used for decision making.

Appropriate internal controls should be integrated into each policy and procedure established by the Board to direct and guide its operations. Monitoring the effectiveness of internal controls should occur in the normal course of business throughout the year. Periodic reviews, reconciliations, or comparisons of data should be included as part of staff's regularly assigned duties. In addition, periodic assessments should be integrated into management's continuous monitoring of internal controls to help provide assurance that weaknesses in the design or operation of internal control, which could adversely affect the Board's ability to meet its financial reporting objectives, are prevented or detected in a timely manner.

Board management is committed to improving its internal control environment as demonstrated by its ability to resolve prior year findings.

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. None of these deficiencies individually would be considered a significant deficiency. However, the combination of these deficiencies is considered to be a significant deficiency.

Recording Accounts Payable, Accrued Liabilities, and Prepaid Expenses

During 2006, the Management Division identified and processed transactions and journal entries to reclassify/and or correct several transactions that were initially coded to a different general ledger account or recorded in a different accounting period. We noted that the original transactions were initially reviewed and approved by a supervisor, and all the required changes were not identified during this initial review as follows.

- Two disbursements totaling $11,230, of the 115 disbursement transactions tested totaling $18,473,927, were initially recorded in different general ledger accounts or were 2007 transactions that were recorded as 2006 transactions. One transaction for $5,980 was identified and adjusted during management's review prior to year end, and one transaction for $5,250 was corrected as a post closing entry.
- Two accounts payable transactions totaling $45,709, of the 21 accounts payable invoices tested totaling $2,969,595, were received in 2006 for services to be provided in 2007. These were initially recorded as accounts payable in 2006. Both transactions were corrected as a post closing entry.
- One prepaid expense totaling $11,927, of the 19 prepaid expenses tested totaling $1,758,579, was a 2007 invoice that was paid in 2006 and was initially recorded as 2006 expense. This was subsequently identified and adjusted during management's review prior to year end.

We commend the Board for identifying most of these entries prior to year end. However, the Board should strengthen its procedures for posting and reviewing all entries to ensure initial posting to the proper accounts and accounting period.

Posting Accrued Annual Leave

We noted that the annual leave accrual was overstated by $301,600 at December 31, 2006, because the annual leave report did not reflect the proper year end information for all employees. The Board subsequently recorded a post closing entry to reflect the appropriate amounts.

Billing of Accounts Receivable

We noted that the Board did not record a year-end receivable from the Bank for International Settlements (BIS) for $157,317 representing services performed in 2006. Although the invoice for the 2006 services was not finalized, recorded, and submitted until 2007, this amount should have been recorded as a receivable at December 31, 2006. As a result of our audit, the Board recorded a post closing entry for this amount.

Monitoring Miscellaneous Receivables

During our audit, we noted that the Board does not have specific policies and procedures for monitoring miscellaneous receivables related to relocation expenses to determine if amounts are considered collectible and appropriately recorded. As a result of our audit, the Board recorded post closing entries to write off three accounts receivables amounting to $105,599 for relocation expenses that were not considered collectible.

Recording Property Transactions

During our audit of property and equipment, we noted that the Board inappropriately processed property and equipment additions and adjustments as follows.

- Two assets purchased for $113,016 in 2006 were recorded at an acquisition value of $109,259. As a result, the asset was overstated by $3,757.
- Three assets valued at $329,375 were put into service with the incorrect in-service dates. As a result, the 2006 depreciation expense was overstated by $25,700.
- One asset was placed in service on March 1, 2006 for $811,756, but did not have any depreciation recorded in 2006. As a result, the Board's depreciation expense was understated by $20,294.
- Three adjustments related to 22 assets acquired via trade-in were overstated on the depreciation schedule in 2005. As a result, depreciation for 2005 was overstated by $27,294 and correspondingly understated by the same amount in 2006.

During our physical inspection test work of property and equipment, we noted that one of the 22 items inspected, valued at $76,744, was included on the asset listing for the Board's contingency site, although it was physically located in the Board's Washington, DC, facility. Our inspection also found that the asset tag number for one item valued at $7,042 was not identified in the Board's financial system.

Recording Financial Statement Disclosures

During our audit, we noted instances where the Board needs to improve its preparation and review process for the financial statements as follows.

- Assets traded in for other assets were incorrectly recorded as *Proceeds from Disposals* and *Capital Expenditures* in the Statement of Cash Flows. The entries, totaling $159,519, represent non-cash transactions and should not have been included in the *Proceeds from Disposals* or the *Capital Expenditures* sections of the Statement of Cash Flows.
- In Footnote 4, *Property and Equipment,* Construction in Process was initially reported as zero, and in the corresponding roll-forward schedule, the balance was $360,966.
- In Footnote 7, *Accumulated Postemployment Benefit Plan,* the Board initially understated the accrued postemployment benefits costs for FY2006. The Board originally reported $1,828,000. However, this amount did not reflect the external actuary's revised calculation, which resulted in an upward adjustment of $134,000.

The Board subsequently made all necessary adjustments in the financial statements.

Recommendations

To strengthen internal controls over financial reporting, we recommend that the Board:

- Strengthen the control process over the initial input and review of disbursement transactions to ensure that they are properly coded and recorded in the general ledger. We also recommend that management conduct periodic training for all relevant personnel, including end users, to help ensure the proper use of general ledger accounts.
- Enhance the process for determining the accrued annual leave to ensure that the reports generated include the appropriate amounts as of the end of the reporting period. The process should include matching a selection of employees' leave balances and other information included in the report to data in the Board's Human Resources system.
- Implement policies and procedures that require the calculation and reconciliation of amounts due from BIS on a regular basis. Once amounts due are determined, the applicable adjustments should be promptly recorded in the general ledger.
- Enhance its policies and procedures to include a documented periodic review and analysis of all accounts receivables, to determine if an allowance is required or if the amounts should be written off. Further, management should also review the accounting treatment required for all transactions.
- Strengthen its policies and procedures to improve communication between the divisions and the accounting staff to ensure the appropriate accounting entries for property transactions are recorded timely in the general ledger. The communications should include, but not be limited to: when the asset was placed in service, the cost of the asset, the asset's location and tag number, and any additional information necessary for the accounting division to make the appropriate entries. The Board should also enhance its review and approval procedures over property transactions to ensure that the appropriate entries have been recorded.
- Strengthen its process over the preparation and review of the financial statements to ensure information is accurately reported.

Management's Response

KPMG offers six recommendations aimed at strengthening the Board's internal controls over financial reporting. In its discussion of these recommendations and the supporting audit findings, KPMG does not consider any individual finding to be a significant deficiency. In combination, however, KPMG concludes that the audit findings represent a significant deficiency. While management does not concur with this conclusion, we do agree that KPMG's recommendations will strengthen the Board's system of internal controls, and we will implement the recommended actions.

Exhibit II

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
STATUS OF PRIOR YEAR REPORTABLE CONDITION

December 31, 2006

Reported Issue	Prior Year Recommendation	2006 Status
Improvement is needed in Internal Control over Financial Reporting		
Control over accounts payable and accrued liabilities	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.	Significant Deficiency (see revised comment in Exhibit I).
Control of Census Data	2. Confirm the data used by the actuary in the pension liability calculation prior to recording the entries in the general ledger.	Completed.
	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.	Substantially resolved. See revised comment in the 2006 management letter.

KPMG

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, 2006 and 2005, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows (hereinafter referred to as "financial statements") for the years then ended, and have issued our report thereon dated April 17, 2007.

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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

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 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 the 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 those provisions 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's management, the Office of Inspector General, the U.S. 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

April 17, 2007

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, 2006 and 2005.

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, 2006 and 2005, 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, 2006 and 2005, and the combined results of their operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

March 30, 2007
Washington, D.C.

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION

(in millions)

	December 31, 2006	December 31, 2005
Assets		
Gold certificates	$ 11,037	$ 11,039
Special drawing rights certificates	2,200	2,200
Coin	801	686
Items in process of collection	3,486	5,930
Loans to depository institutions	67	72
Securities purchased under agreements to resell	40,750	46,750
U.S. government securities, net	783,619	750,202
Investments denominated in foreign currencies	20,482	18,928
Accrued interest receivable	6,761	5,874
Bank premises and equipment, net	2,376	2,252
Other assets	1,785	3,394
Total assets	$873,364	$847,327
Liabilities and Capital		
Liabilities		
Federal Reserve notes outstanding, net	$783,019	$758,359
Securities sold under agreements to repurchase	29,615	30,505
Deposits		
Depository institutions	18,699	19,043
U.S. Treasury, general account	4,708	4,573
Other deposits	349	393
Deferred credit items	3,813	5,039
Interest on Federal Reserve notes due to U.S. Treasury	908	1,784
Accrued benefit costs	1,314	913
Other liabilities	291	281
Total liabilities	842,716	820,890
Capital		
Capital paid-in	15,324	13,536
Surplus (including accumulated other comprehensive loss of $1,849 million at December 31, 2006)	15,324	12,901
Total capital	30,648	26,437
Total liabilities and capital	$873,364	$847,327

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

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF INCOME

(in millions)

	For the years ended December 31, 2006	2005
Interest income		
Interest on U.S. government securities	$36,452	$28,959
Interest on investments denominated in foreign currencies	369	283
Interest on loans to depository institutions	12	7
Total interest income	36,833	29,249
Interest expense		
Interest expense on securities sold under agreements to repurchase	1,342	809
Net interest income	35,491	28,440
Other operating income (loss)		
Income from services	908	901
Reimbursable services to government agencies	426	396
Foreign currency gains (losses), net	1,186	(2,723)
Other income	144	131
Total other operating income (loss)	2,664	(1,295)
Operating expenses		
Salaries and other benefits	1,880	1,709
Occupancy expense	240	228
Equipment expense	212	198
Assessments by the Board of Governors	793	743
Other expenses	835	747
Total operating expenses	3,960	3,625
Net income prior to distribution	$34,195	$23,520
Distribution of net income		
Dividends paid to member banks	$ 871	$ 781
Transferred to surplus	4,272	1,271
Payments to U.S. Treasury as interest on Federal Reserve notes	29,052	21,468
Total distribution	$34,195	$23,520

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, 2006 and 2005

(in millions)

	Capital paid-in	Surplus: Net income retained	Surplus: Accumulated other comprehensive loss	Surplus: Total surplus	Total capital
Balance at January 1, 2005 (238 million shares)	$11,914	$11,630	$ . . .	$11,630	$23,544
Net change in capital stock issued (32 million shares)	1,622	. . .	. . .	. . .	1,622
Transferred to surplus	. . .	1,271	. . .	1,271	1,271
Balance at December 31, 2005 (270 million shares)	$13,536	$12,901	$ . . .	$12,901	$26,437
Net change in capital stock issued (36 million shares)	1,788	. . .	. . .	. . .	1,788
Transferred to surplus	. . .	4,272	. . .	4,272	4,272
Adjustment to initially apply FASB Statement No. 158	. . .	. . .	(1,849)	(1,849)	(1,849)
Balance at December 31, 2006 (306 million shares)	$15,324	$17,173	$ (1,849)	$15,324	$30,648

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 are 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 of the Federal Reserve System ("Board of Governors") to represent the public, 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 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 Reserve Banks perform a variety of services and operations. Functions include participation in formulating and conducting monetary policy; participation in the payments system including large-dollar transfers of funds, automated clearinghouse ("ACH") operations, and check collection; distribution of coin and currency; performance of fiscal agency functions for the U.S. Treasury, certain federal agencies, and other entities; serving as the federal government's bank; provision of short-term loans to depository institutions; service to the consumer and the community by providing educational materials and information regarding consumer laws; and supervision of bank holding companies, state member banks, and U.S. offices of foreign banking organizations. The Reserve Banks also provide certain services to foreign central banks, governments, and international official institutions.

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 transactions. The FRBNY is authorized and directed by the FOMC to conduct operations in domestic markets, including the 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 at the direction of the FOMC and holds the resulting securities, with the exception of securities purchased under agree-

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

ments 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 ("FX") and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements ("FX 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 transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

Although the 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 operations 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, the Reserve Banks are billed for services provided to them by another Reserve Bank.

During 2005, the Federal Reserve Bank of Atlanta ("FRBA") was assigned the overall responsibility for managing the Reserve Banks' provision of check services to depository institutions and, as a result, recognizes total System check revenue on its Statements of Income. Because the other eleven Reserve Banks incur costs to provide check services, a policy was adopted by the Reserve Banks in 2005 that required that the FRBA compensate the other Reserve Banks for costs incurred to provide check services. In 2006 this policy was extended to the ACH services, which are managed by the FRBA, as well as to Fedwire funds transfer and securities transfer services, which are managed by the FRBNY. The FRBA and the FRBNY compensate the other Reserve Banks for the costs incurred to provide these 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 considers to be appropriate for the nature and function of a central bank, which differ significantly from those of 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 of the 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 generally accepted accounting principles in the United States of America ("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 securities holdings at amortized cost, rather than using the fair value presentation required by GAAP. Amortized cost more appropriately reflects the Reserve Banks' securities 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 securities 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, the 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. The 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 reduced. The value of gold for purposes of backing the gold certificates is set by law at $42 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.

SDR certificates 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. SDR certificates 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. When SDR certificates are issued to the Reserve Banks, 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 each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2006 or 2005.

(B) *Loans to Depository Institutions*

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. Outstanding loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Bank, 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 gains (losses), net" in the Statements of Income.

Activity related to U.S. government securities, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each of the Reserve Banks 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 denominated in foreign currencies 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 reported in the Statements of Condition at their contractual amounts and the related accrued interest payable is reported as a component of "Other liabilities."

U.S. government securities held in the SOMA are lent to U.S. government securities dealers 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 a fee for borrowing securities and the fees are reported as a component of "Other income."

Activity related to securities sold under agreements to repurchase and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from the

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

annual settlement of interdistrict clearings. Securities purchased under agreements to resell are allocated to the FRBNY and not to the other Reserve Banks.

(E) *FX Swap Arrangements and Warehousing Agreements*

FX swap arrangements are contractual agreements between two parties, the FRBNY and an authorized foreign central bank, 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 authorized foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the FX swap arrangements can be initiated by either party acting as drawer, and must be agreed to by the drawee party. The FX swap arrangements 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 FX swap arrangement 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.

FX swap arrangements 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 allocated 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 the estimated useful lives of the assets, which range from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are depreciated over the remaining useful life of the asset or, if appropriate, over the unique useful life of the alteration, renovation, or improvement. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred.

Costs incurred for software during the application development stage, either developed internally or acquired for internal use, 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. Maintenance costs related to software are charged to expense in the year incurred.

Capitalized assets including software, buildings, leasehold improvements, furniture, and equipment are impaired when events or changes in circumstances indicate that the carrying amount of assets or asset groups is not recoverable and significantly exceeds their fair value.

(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 and their designees) to the Reserve Banks upon deposit with such agents of specified classes of collateral, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral 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 include all of the Reserve Banks' assets. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, for which the 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 collateral for 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 issued to 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, Federal Reserve notes are obligations of the United States and are backed by the full faith and credit of the United States government.

"Federal Reserve notes outstanding, net" in the Statements of Condition represents Federal Reserve notes outstanding, reduced by the currency issued to the Reserve Banks but not in circulation, of $175,661 million and $148,152 million at December 31, 2006 and 2005, respectively.

At December 31, 2006, all Federal Reserve notes were fully collateralized. All gold certificates, all special drawing right certificates, and $769,782 million of domestic securities and securities purchased under agreements to resell were pledged as collateral. At December 31, 2006, no loans or investments denominated in foreign currencies were pledged as collateral.

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

"Items in process of collection" in the Statements of Condition primarily represents amounts attributable to checks that have been deposited for collection and that, as of the balance sheet date, have not yet been presented to the paying bank. "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 vary significantly.

(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 the Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31 of each year. 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.

Accumulated other comprehensive income is treated as a component of surplus in the Statements of Condition and the Statements of Changes in Capital. The balance of accumulated other comprehensive income is comprised of expenses, gains, and losses related to defined benefit pension plans and other postretirement benefit plans that under accounting principles are included in comprehensive income but excluded from net income. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 8, 9, and 10.

(K) *Interest on Federal Reserve Notes*

The Board of Governors requires the Reserve Banks to transfer excess earnings to the U.S. Treasury as interest on Federal Reserve notes, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. This amount is reported as a component of "Payments to U.S. Treasury as interest on Federal Reserve notes" in the Statements of Income and is reported as a liability in the Statements of Condition. Weekly payments to the U.S. Treasury may vary significantly.

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.

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 the U.S. Treasury in the following year.

Due to the substantial increase in capital paid-in at one Reserve Bank, surplus was not equated to capital at December 31, 2005. The amount of additional surplus required due to these events exceeded the Bank's earnings in 2005.

(L) *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.

(M) *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 as of December 31 of the previous year. 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.

(N) *Taxes*

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property and sales taxes on certain construction projects. Real property taxes were $33 million and $32 million for the years ended December 31, 2006 and 2005, respectively, and are reported as a component of "Occupancy expense."

(O) *Restructuring Charges*

In 2003, the Reserve Banks 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 some locations. These restructuring activities continued in 2004 through 2006.

Note 11 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 impairment of certain of the Reserve Banks' assets are discussed in Note 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs and liabilities associated with enhanced post-retirement benefits are discussed in Note 9.

(P) *Implementation of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*

The Reserve Banks initially applied the provisions of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Statements of Condition, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard require applying the provisions as of

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

the end of the year of initial implementation with no retrospective application. The incremental effects on the line items in the Statement of Condition at December 31, 2006, were as follows (in millions):

	Before Application of Statement 158	Adjustments	After Application of Statement 158
Other Assets	$ 3,277	$ (1,492)	$ 1,785
Total assets	$874,856	$ (1,492)	$873,364
Accrued benefit costs	957	357	1,314
Total liabilities	$842,359	$ 357	$842,716
Surplus	17,173	(1,849)	15,324
Total capital	$ 32,497	$ (1,849)	$ 30,648

(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):

	2006	2005
Par value		
U.S. government		
Bills	$277,019	$271,270
Notes	402,367	380,118
Bonds	99,528	92,827
Total par value	778,914	744,215
Unamortized premiums	8,708	8,813
Unaccreted discounts	(4,003)	(2,826)
Total	$783,619	$750,202

At December 31, 2006 and 2005, the fair value of the U.S. government securities held in the SOMA, excluding accrued interest, was $795,900 million and $767,472 million, respectively, as determined by reference to quoted prices for identical securities.

Although the fair value of security holdings can be substantially greater or less than the carrying value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as a central bank, to meet its financial obligations and responsibilities, and should not be misunderstood as representing a risk to the Reserve Banks, their shareholders, or the public. The fair value is presented solely for informational purposes.

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, 2006, was as follows (in millions):

	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	$ 40,588	$40,750	$29,615
16 days to 90 days	180,893	...	...
91 days to 1 year	185,132	...	...
Over 1 year to 5 years	224,177	...	...
Over 5 years to 10 years	67,645	...	...
Over 10 years	80,479	...	...
Total	$778,914	$40,750	$29,615

At December 31, 2006 and 2005, U.S. government securities with par values of $6,855 million and $3,776 million, respectively, were loaned from the SOMA.

At December 31, 2006 and 2005, the total contract amount of securities sold under agreements to repurchase was $29,615 million and $30,505 million, respectively. At December 31, 2006 and 2005, securities sold under agreements to repurchase with a par value of $29,676 million and $30,559 million, respectively, were outstanding. The contract amount for securities sold under agreements to repurchase approximates fair value.

(5) INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and with 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 issuing 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):

	2006	2005
European Union euro		
Foreign currency deposits	$ 6,242	$ 5,424
Securities purchased under agreements to resell	2,214	1,928
Government debt instruments	4,074	3,561
Japanese yen		
Foreign currency deposits	2,601	2,618
Government debt instruments	5,351	5,397
Total	$20,482	$18,928

At December 31, 2006 and 2005, the fair value of the total System investments denominated in foreign currencies, including accrued interest, was $20,434 million and $18,965 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as a central bank, to meet its financial obligations and responsibilities.

The maturity distribution of investments denominated in foreign currencies at December 31, 2006, was as follows (in millions):

	European euro	Japanese yen	Total
Within 15 days	$ 4,359	$2,601	$ 6,960
16 days to 90 days	2,378	1,208	3,586
91 days to 1 year	2,442	2,213	4,655
Over 1 year to 5 years	3,351	1,930	5,281
Over 5 years to 10 years	...	...	...
Over 10 years	...	...	...
Total	$12,530	$7,952	$20,482

At December 31, 2006 and 2005, there were no material open foreign exchange contracts.

At December 31, 2006 and 2005, 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):

	2006	2005
Bank premises and equipment		
Land	$ 306	$ 295
Buildings	1,817	1,787
Building machinery and equipment	393	387
Construction in progress	220	86
Furniture and equipment	1,156	1,162
Subtotal	3,892	3,717
Accumulated depreciation	(1,516)	(1,465)
Bank premises and equipment, net	$2,376	$2,252
Depreciation expense, for the year ended December 31	$ 186	$ 175

The Federal Reserve Bank of Kansas City (FRBKC) is constructing a new building to replace its head office. Approximately $29 million of costs associated with the acquisition of land and site preparation for the new building are included in the “Land” account, and approximately $114 million of costs associated with the construction of the new building are included in the “Construction in progress” account. In July 2005, the FRBKC completed the sale and leaseback of its head office, and will lease the space from the purchaser until the new building is completed in 2008.

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

	2006	2005
Leased premises and equipment under capital leases	$12	$10
Accumulated depreciation	(6)	(5)
Leased premises and equipment under capital leases, net	$ 6	$ 5

Certain of the Reserve Banks lease space to outside tenants with remaining lease terms ranging from one to fourteen years. Rental income from such leases was $25 million and $23 million for the years ended December 31, 2006 and 2005, respectively, and is reported as a component of “Other income.” Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2006, are as follows (in millions):

2007	$ 23
2008	23
2009	22
2010	21
2011	18
Thereafter	70
Total	$177

The Reserve Banks have capitalized software assets, net of amortization, of $155 million and $162 million at December 31, 2006 and 2005, respectively. Amortization expense was $66 million and $55 million for the years ended December 31, 2006 and 2005, respectively. Capitalized software assets are reported as a component of “Other assets” and the related amortization is reported as a component of “Other expenses.”

Several of the Reserve Banks have impaired assets as a result of the System’s restructuring plan, as discussed in Note 11. Impaired assets include software, buildings, leasehold improvements, furniture, and equipment. Asset impairment losses related to the check and cash restructurings of $15 million and $50 million for the periods ending December 31, 2006 and 2005, 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, 2006, the Reserve Banks were obligated under noncancelable leases for premises and equipment with remaining terms ranging from one to approximately seventeen 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 $31 million and $26 million for the years ended December 31, 2006 and 2005, respectively. Certain of the Reserve Banks’ leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2006 are as follows (in millions):

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

	Operating
2007	$ 12
2008	9
2009	8
2010	8
2011	7
Thereafter	102
Future minimum rental payments	$146

At December 31, 2006, the Reserve Banks had other commitments and long-term obligations extending through the year 2017 with a remaining amount of $336 million. As of December 31, 2006, commitments of $219 million were recognized. Purchases of $92 million and $98 million were made against these commitments during 2006 and 2005, 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/or 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 as follows (in millions):

	Fixed commitment
2007	$30
2008	36
2009	32
2010	28
2011	29

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 System's 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 Reserve Bank officers participate in the Supplemental Employee Retirement Plan ("SERP").

The System Plan is a multi-employer plan with contributions funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors, 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 the 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):

	2006	2005
Estimated actuarial present value of projected benefit obligation at January 1	$4,785	$4,524
Service cost—benefits earned during the period	134	123
Interest cost on projected benefit obligation	278	263
Actuarial loss	132	125
Contributions by plan participants	3	3
Special termination benefits loss	3	6
Benefits paid	(254)	(259)
Plan amendments	66	. . .
Estimated actuarial present value of projected benefit obligation at December 31	$5,147	$4,785

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

	2006	2005
Estimated fair value of plan assets at January 1	$5,868	$5,887
Actual return on plan assets	713	237
Contributions by the employer	. . .	. . .
Contributions by plan participants	3	3
Benefits paid	(254)	(259)
Estimated fair value of plan assets at December 31	$6,330	$5,868
Funded status	$1,183	$1,083
Unrecognized prior service cost		149
Unrecognized net actuarial loss		1,496
Prepaid pension benefit costs		$2,728
Amounts included in accumulated other comprehensive loss (in millions)		
Prior service cost	(191)	
Net actuarial loss	(1,301)	
Total accumulated other comprehensive loss	$(1,492)	

Prepaid pension benefit costs are reported as "Other assets" in the Statements of Condition.

The accumulated benefit obligation for the System Plan, which differs from the estimated actuarial present value of the projected benefit obligation because it is based on current rather than future compensation levels, was $4,522 million and $4,162 million at December 31, 2006 and 2005, respectively.

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

	2006	2005
Discount rate	6.00%	5.75%
Rate of compensation increase	4.50%	4.50%

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

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

	2006	2005
Discount rate	5.75%	5.75%
Expected asset return	8.00%	8.25%
Rate of compensation increase	4.50%	4.25%

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

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

	2006	2005
Service cost—benefits earned during the period	$ 134	$ 123
Interest cost on projected benefit obligation	278	263
Amortization of prior service cost	23	24
Amortization of actuarial loss	75	49
Expected return on plan assets	(460)	(476)
Net periodic pension expense/ (credit)	50	(17)
Special termination benefits losses	3	6
Total periodic pension expense/ (credit)	$ 53	$ (11)
Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic pension expense in 2007 (in millions):		
Prior service cost	$ 29	
Actuarial loss	66	
Total	$ 95	

The recognition of special termination benefits losses is the result of enhanced retirement benefits provided to employees during the restructuring described in Note 11.

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

	Expected benefit payments
2007	$ 260
2008	270
2009	281
2010	294
2011	306
2012–2016	1,764
Total	$3,175

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

	2006	2005
Equities	64.3%	66.2%
Fixed income	34.4%	31.7%
Cash	1.3%	2.1%
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 securities 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.

Contributions to the System Plan may be determined using different assumptions than those required for financial reporting. The System does not expect to make a cash contribution to the System Plan during 2007.

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

The Reserve Banks' projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2006 and 2005, 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 $66 million and $63 million for the years ended December 31, 2006 and 2005, respectively, and are reported as a component of "Salaries and other benefits" in the Statements of Income. The Reserve Banks match employee contributions based on a specified formula. For the years ended December 31, 2006 and 2005, 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):

	2006	2005
Accumulated postretirement benefit obligation at January 1	$ 947	$869
Service cost—benefits earned during the period	27	32
Interest cost of accumulated benefit obligation	54	49
Actuarial loss	188	45
Contributions by plan participants	13	11
Benefits paid	(60)	(59)
Plan amendments	(5)	. . .
Accumulated postretirement benefit obligation at December 31	$1,164	$947

At December 31, 2006 and 2005, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 5.50 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):

	2006	2005
Fair value of plan assets at January 1	$ . . .	$ . . .
Contributions by the employer	47	48
Contributions by plan participants	13	11
Benefits paid	(60)	(59)
Fair value of plan assets at December 31	$ . . .	$ . . .
Unfunded postretirement benefit obligation	$1,164	$947
Unrecognized prior service cost		105
Unrecognized net actuarial loss		(277)
Accrued postretirement benefit costs		$775
Amounts included in accumulated other comprehensive loss (in millions):		
Prior service cost	$ 85	
Net actuarial loss	(443)	
Deferred curtailment gain	1	
Total accumulated other comprehensive loss	$ (357)	

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs" in the Statements of Condition.

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

	2006	2005
Health care cost trend rate assumed for next year	9.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2012	2011

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, 2006 (in millions):

	One percentage point increase	One percentage point decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit expense	$ 12	$ (10)
Effect on accumulated postretirement benefit obligation	128	(111)

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

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

	2006	2005
Service cost—benefits earned during the period	$ 27	$ 32
Interest cost on accumulated benefit obligation	54	49
Amortization of prior service cost	(23)	(21)
Amortization of actuarial loss	22	13
Total periodic expense	80	73
Curtailment gain	. . .	(5)
Net periodic postretirement benefit expense	$ 80	$ 68

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic benefit expense in 2007 (in millions):	
Prior service cost	(22)
Actuarial loss	45
Total	$ 23

Net postretirement benefit expense is actuarially determined using a January 1 measurement date. At January 1, 2006 and 2005, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit expense were 5.50 percent and 5.75 percent, respectively.

Net periodic postretirement benefit expense is reported as a component of "Salaries and other benefits" in the Statements of Income.

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 in 2005. A deferred curtailment gain, which was recorded in 2006 as a component of accumulated other comprehensive loss, is expected to be recognized in net income in 2008 when the related employees terminate employment.

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 under 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 expense.

The Reserve Banks account for the Medicare subsidies as a reduction to benefits payments. The Reserve Banks expect to receive approximately $4 million in subsidies in the year ending December 31, 2007 that relate to benefit payments made in the year ended December 31, 2006.

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

	Without subsidy	With subsidy
2007	$ 63	$ 58
2008	68	62
2009	73	68
2010	79	72
2011	84	77
2012–2016	476	430
Total	$843	$767

Postemployment Benefits

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2006 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, 2006 and 2005 were $126 million and $124 million, respectively. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2006 and 2005 operating expenses was $20 million and $14 million, respectively, and is recorded as a component of "Salaries and other benefits" in the Statements of Income.

(10) ACCUMULATED OTHER COMPREHENSIVE INCOME

Following is a reconciliation of beginning and ending balances of accumulated other comprehensive loss:

	Amount Related to Defined Benefit Retirement Plans	Amount Related to Post-retirement Benefits Other than Pensions	Total Accumulated Other Comprehensive Loss
Balance at December 31, 2005	$ . . .	$ . . .	$ . . .
Adjustment to initially apply FASB Statement No. 158	(1,492)	(357)	(1,849)
Balance at December 31, 2006	$ (1,492)	$ (357)	$ (1,849)

Additional detail regarding the classification of accumulated other comprehensive income is included in notes 8 and 9.

(11) 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 Bank. In 2004 through 2006, additional consolidation and restructuring

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

initiatives were announced in the check, cash, purchasing, and Treasury operations. These actions resulted in the following business restructuring charges (in millions):

	Total estimated costs
Employee separation	$49
Contract termination	1
Other	1
Total	$51

	Accrued liability 12/31/05	Year-ended 12/31/2006 Total charges	Total paid	Accrued liability 12/31/06
Employee separation	$17	$9	$(12)	$14
Contract termination	. . .	. . .	. . .	. . .
Other	. . .	. . .	. . .	. . .
Total	$17	$9	$(12)	$14

Adjustments to the accrued liability due to changes in the estimated restructuring costs were offset against total charges. Without these offsets, total charges would have been $10 million in 2006.

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 1,949, including 286 and 292 staff reductions related to restructuring announced in 2006 and 2005, respectively. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of “Salaries and other benefits” in the Statements of Income. Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of “Other expenses.” Other costs include the continuation of a noncancelable lease agreement and associated facility maintenance and are shown as a component of “Occupancy expenses.”

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

Future costs associated with the announced restructuring plans are estimated at $4 million.

The Reserve Banks anticipate substantially completing their announced plans in 2008.

Office of Inspector General Activities

The Board of Governors' 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, reviews, and investigations relating to 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 their impact on the economy and efficiency of the Board's programs and operations. It recommends policies, and it supervises and conducts activities to promote economy and efficiency and to prevent and detect waste, fraud, and abuse in Board and Board-delegated programs and operations, as well as in activities administered or financed by the Board. The OIG keeps the Congress and the Chairman of the Board of Governors fully informed about serious abuses and deficiencies and about the status of any corrective actions.

During 2006, the OIG completed eight audits, reviews, and other assessments and conducted a number of follow-up reviews to evaluate action taken on earlier recommendations. The OIG also closed eight investigations and performed numerous legislative and regulatory reviews.

OIG Audits, Reviews, and Assessments Completed during 2006

Report title	Month issued
External Quality Control Review of the National Science Foundation Inspector General Audit Organization	February
Audit of the FFIEC's Financial Statements (Year Ended December 31, 2005)	March
Inspection of the Board's Security Services Unit	March
Audit of the Board's Implementation of Electronic Authentication Requirements	March
Audit of the Board's Financial Statements (Year Ended December 31, 2005)	May
Audit of the Board's Information Security Program	September
Security Control Review of the Common Document and Text Repository System (Internal Report)	October
Audit of the Board's Payroll Process	December

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 2006, the GAO completed six reports on selected aspects of Federal Reserve operations (table). In addition, seven 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 2006

Report title	Report number	Month issued (2006)
Credit Cards: Customized Minimum Payment Disclosure Would Provide More Information to Consumers, but Impact Could Vary	GAO-06-434	April
Bank Secrecy Act: Opportunities Exist for FinCEN and the Banking Regulators to Further Strengthen the Framework for Consistent BSA Oversight	GAO-06-386	May
Information Security: Federal Reserve Needs to Address Treasury Auction Systems	GAO-06-659	August
Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved	GAO-06-1021	September
Minority Banks: Regulators Need to Better Assess Effectiveness of Support Efforts	GAO-07-6	October
Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers	GAO-06-929	October

Projects Active at Year-End 2006

Subject of project	Month initiated
Consolidated supervision of financial institutions	November 2005
Prompt Corrective Action (PCA) program	March 2006
Basel II Capital Accord	March 2006
Financial markets preparedness	March 2006
Financial regulatory agencies’ performance pay systems	May 2006
Financial regulatory agencies’ compensation programs	May 2006
Hedge funds and federal regulatory oversight	October 2006