

INDEPENDENT AUDITORS' REPORT

We have audited the accompanying statements of financial position of The Commonwealth Fund (the "Fund") as of June 30, 2003 and 2002, and the related statements of activities and of cash flows for the years then ended. These financial statements are the responsibility of the Fund'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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Fund at June 30, 2003 and 2002, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

A handwritten signature in cursive script that reads "Deloitte & Touche LLP".

Deloitte & Touche LLP

September 19, 2003

THE COMMONWEALTH FUND
STATEMENTS OF FINANCIAL POSITION
June 30, 2003 and 2002

	2003	2002
ASSETS		
Cash	\$ 29,138	\$ 17,671
Investments—At fair value (Notes 1 and 2)	498,148,956	506,879,212
Interest and Dividends Receivable	561,423	1,098,581
Prepaid Taxes—Net (Note 5)	131,218	277,918
Deferred Tax Asset (Note 5)	—	285,942
Recoverable Grants	350,000	350,000
Prepaid Insurance and Other Assets	153,769	210,625
Landmark Property at 1 East 75th Street		
At appraised value during 1953, the date of donation	275,000	275,000
Furniture, Equipment and Building Improvements		
At cost, net of accumulated depreciation of \$1,581,112 at June 30, 2003 and \$2,433,304 at June 30, 2002 (Note 1)	<u>4,602,389</u>	<u>3,919,962</u>
Total Assets	\$ 504,251,893	\$ 513,314,911
LIABILITIES AND NET ASSETS		
Liabilities:		
Accounts payable and accrued expenses	\$ 1,464,577	\$ 2,311,771
Program authorizations payable (Note 3)	18,751,005	18,270,882
Accrued postretirement benefits (Note 4)	1,765,517	2,052,010
Securities transactions payable—net	372,508	5,653,323
Deferred tax liability (Note 5)	<u>475,528</u>	<u>—</u>
Total liabilities	<u>22,829,135</u>	<u>28,287,986</u>
Net Assets:		
Unrestricted	481,020,758	484,474,925
Temporarily restricted (Note 7)	<u>402,000</u>	<u>552,000</u>
Total net assets	<u>481,422,758</u>	<u>485,026,925</u>
Total Liabilities and Net Assets	\$ 504,251,893	\$ 513,314,911

See notes to financial statements.

THE COMMONWEALTH FUND
STATEMENTS OF ACTIVITIES
Years Ended June 30, 2003 and 2002

	2003	2002
Revenues and Support:		
Interest and dividends	\$ 17,319,543	\$ 17,132,580
Contribution (Note 7)	10,000	2,449,124
Other revenue	22,177	3,149
Net assets released from restrictions (Note 7)	<u>150,000</u>	<u>—</u>
Total expenses	<u>17,501,720</u>	<u>19,584,853</u>
Expenses:		
Program authorizations and operating program	25,010,993	25,407,960
General administration	2,543,103	2,415,040
Investment management	2,629,145	2,271,948
Tax provision (benefit)—net (Note 5)	935,711	(455,338)
Unfunded retirement and other postretirement (Note 4)	<u>130,953</u>	<u>933,642</u>
Total expenses	<u>31,249,905</u>	<u>30,573,252</u>
Excess of expenses over revenues before net investment gains (losses)	<u>(13,748,185)</u>	<u>(10,988,399)</u>
Net investment gains (losses):		
Net realized losses on investment	(27,151,744)	(4,643,263)
Change in unrealized appreciation (depreciation) of investments	<u>37,445,762</u>	<u>(29,696,670)</u>
Total net investment gains (losses)	<u>10,294,018</u>	<u>(34,339,933)</u>
Changes in unrestricted net assets	<u>(3,454,167)</u>	<u>(45,328,332)</u>
Temporarily restricted contribution from bequest (Note 7)	—	552,000
Net assets released from restrictions (Note 7)	<u>(150,000)</u>	<u>—</u>
Changes in temporarily restricted assets	<u>(150,000)</u>	<u>552,000</u>
Changes in net assets	<u>(3,604,167)</u>	<u>(44,776,332)</u>
Net assets, beginning of year	<u>485,026,925</u>	<u>529,803,257</u>
Net assets, end of year	\$ 481,422,758	\$ 485,026,925

See notes to financial statements.

THE COMMONWEALTH FUND
STATEMENTS OF CASH FLOWS
Years Ended June 30, 2003 and 2002

	2003	2002
Cash flows from operating activities:		
Changes in net assets:	\$ (3,604,167)	\$ (44,776,332)
Net investment (gains) losses	(10,294,018)	34,339,933
Depreciation expense	406,680	768,188
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Decrease in interest and dividends receivable	537,158	629,424
Decrease (increase) in prepaid taxes—net	146,700	(202,316)
Decrease (increase) in deferred tax asset	285,942	(261,977)
Decrease in prepaid insurance and other assets	56,856	133,843
(Decrease) increase in accounts payable and accrued expenses	(847,194)	601,004
Increase in program authorizations payable	480,123	1,099,253
(Decrease) increase in accrued postretirement benefits	(286,493)	493,550
(Decrease) increase in securities transactions payable—net	(5,280,815)	5,512,590
Increase (decrease) in deferred tax liability	<u>475,528</u>	<u>(319,334)</u>
Net cash used in operating activities	<u>(17,923,700)</u>	<u>(1,982,174)</u>
Cash flows from investing activities:		
Purchase of furniture, equipment, and building improvements—net	(1,089,107)	(647,332)
Purchase of investments	(484,934,895)	(749,241,050)
Proceeds from the sale of investments	<u>503,959,169</u>	<u>751,855,628</u>
Net cash provided by investing activities	<u>17,935,167</u>	<u>1,967,246</u>
Net increase (decrease) in cash	11,467	(14,928)
Cash, beginning of year	<u>17,671</u>	<u>32,599</u>
Cash, end of year	<u>\$ 29,138</u>	<u>\$ 17,671</u>
Supplemental information		
Taxes paid	\$ 49,500	\$ 344,680

See notes to financial statements.

THE COMMONWEALTH FUND

NOTES TO FINANCIAL STATEMENTS

Years Ended June 30, 2003 and 2002

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Commonwealth Fund (the “Fund”) is a private foundation supporting independent research on health and social issues.

- a. *Investments* - Investments in equity securities with readily determinable fair values and all investments in debt securities are carried at fair value, which approximates market value. Assets with limited marketability, such as alternative asset limited partnerships, are stated at the Fund’s equity interest in the underlying net assets of the partnerships, which are stated at fair value as reported by the partnerships. Realized gains and losses on dispositions of investments are determined on the following bases: FIFO for actively managed equity and fixed income, average cost for commingled mutual funds, and specific identification basis for alternative assets.

In accordance with Financial Accounting Standards Board Statement No.133, *Accounting for Derivative Instruments and Hedging Activities*, the Fund records derivative instruments in the statements of financial position at their fair value, with changes in fair value being recorded in the statement of activities. The Fund does not hold or issue financial instruments, including derivatives, for trading purposes. Both realized and unrealized gains and losses are recognized in the statements of activities.

- b. *Fixed Assets* - Furniture, equipment, and building improvements are depreciated using the straight-line method over their estimated useful lives.
- c. *Contributions, Promises to Give, and Net Assets Classifications* - Contributions received and made, including unconditional promises to give, are recognized in the period incurred. The Fund reports contributions as restricted if received with a donor stipulation that limits the use of the donated assets. Unconditional promises to give for future periods are presented as program authorizations payable on the statement of financial position at fair values, which includes a discount for present value.
- d. *Use of Estimates* - The preparation of financial statements in conformity with generally accepted accounting principles requires the Fund’s management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and

liabilities at the date of the financial statements. Estimates also affect the reported amounts of additions to and deductions from the statement of activities. The calculation of the present value of program authorizations payable, present value of accumulated postretirement benefits, deferred Federal excise taxes, and the depreciable lives of fixed assets requires the significant use of estimates. Actual results could differ from those estimates.

- e. *Reclassifications* - Certain prior year's amounts have been reclassified to conform to the current year's presentation.

2. INVESTMENTS

Investments at June 30, 2003 and 2002 comprised the following:

	2003		2002	
	Fair Value	Cost	Fair Value	Cost
U.S. Equities	\$204,406,869	\$214,896,635	\$203,489,962	\$243,609,135
Non - U.S. Equities	100,628,294	92,578,688	54,623,652	51,635,737
Fixed income	79,075,285	77,792,969	157,230,687	152,801,073
Short-term	13,957,645	14,019,919	19,344,993	19,205,892
Marketable alternative equity	59,670,856	29,560,194	40,896,657	16,008,520
Nonmarketable alternative equity	10,200,114	18,172,907	11,744,061	18,771,284
Inflation hedge	30,209,893	27,351,262	19,549,200	18,577,565
	\$498,148,956	\$474,372,574	\$506,879,212	\$520,609,206

At June 30, 2003, the Fund had total unexpended commitments of approximately \$24.1 million in various limited partnership investments.

The Fund's investment managers may use futures contracts to manage asset allocation and to adjust the duration of the fixed income portfolio. In addition, investment managers may use foreign exchange forward contracts to minimize the exposure of certain Fund investments to adverse fluctuations in the financial and currency markets. The table below summarizes the Fund's outstanding positions in futures and forward contracts at June 30:

Contract type	2003		2002	
	Number of Long (Short) Contracts	Notional Amount	Number of Long (Short) Contracts	Notional Amount
30-year Treasury Bond futures	45	4,500,000	35	3,500,000
10-year Treasury Note futures	74	7,400,000	1	100,000
5-year Treasury Note futures	(78)	7,800,000	1	100,000
2-year Treasury Note futures	(30)	6,000,000	-	-

Included in short-term investments at June 30, 2003 is a variation amount receivable of approximately \$33,000, which represents funds due from brokers for excess amounts on deposit. At June 30, 2002, there was a variation amount payable of approximately \$12,000, which represented funds due to brokers for additional amounts required on deposit. Also included in short term investments are unrealized losses and gains on open futures contracts of approximately \$69,000 and \$70,000 at June 30, 2003 and June 30, 2002, respectively.

3. PROGRAM AUTHORIZATIONS PAYABLE

At June 30, 2003, program authorizations scheduled for payment at later dates were as follows:

July 1, 2003 through June 30, 2004	\$ 17,410,853
July 1, 2004 through June 30, 2005	1,311,929
July 1, 2005 through June 30, 2006	<u>56,127</u>
Gross program authorizations scheduled for payment at a later date	18,778,909
Less adjustment to present value	<u>27,904</u>
Program authorizations payable	<u>\$ 18,751,005</u>

A discount rate of 1.2% was used to determine the present value of the program authorizations payable at June 30, 2003.

4. Unfunded Retirement And Other Postretirement Benefits

The Fund has a noncontributory defined contribution retirement plan, covering all employees, under arrangements with Teachers Insurance and Annuity Association of America and College Retirement Equities Fund and Fidelity Investments. This plan provides for purchases of annuities and/or mutual funds for employees. The Fund's contributions approximated 20% and 19% of the participants' compensation for the years ended June 30, 2003 and 2002, respectively. Pension expense under this plan approximated \$938,000 and \$746,000 for the years ended June 30, 2003 and 2002, respectively. In addition, the plan allows employees to make voluntary tax-deferred purchases of these same annuities and/or mutual funds within the legal limits provided for under Federal law.

The Fund also has a group of former employees who retired prior to the inauguration of the above plan and certain other former employees to whom pension benefits have been approved, on an individual case basis, by the board of directors. Benefits under this program are paid directly by the Fund to these retirees. This pension expense is included in the Fund's unfunded retirement and other postretirement expense and approximated \$93,000 and \$107,000 for the years ended June

30, 2003 and 2002, respectively. In addition, the Fund provides health and life insurance to certain former employees.

Effective July 1, 1998, the Fund entered into deferred compensation agreements with certain senior executives that provides for unfunded deferred compensation computed as a percentage of salary. Such deferred compensation expense for the years ended June 30, 2003 and 2002 is recorded in the financial statements.

Effective July 1, 2001, the Fund established a fully-funded KEYSOP for certain key executives which exchanges deferred compensation benefits for options to purchase mutual funds. In addition, the KEYSOP awarded options to purchase mutual funds to certain employees in exchange for certain pension benefits. This expense and the related investments are recorded in the financial statements as of and for the years ended June 30, 2003 and 2002, respectively. The Fund no longer makes any contributions to this KEYSOP.

Effective July 9, 2002, the Fund established a Section 457 Plan for certain employees that provides for unfunded deferred compensation with employer contributions made within the legal limits provided for under Federal law.

The Fund provides postretirement medical insurance coverage for retirees who meet the eligibility criteria. The following data is for the Fund's postretirement medical plan for the years ended June 30, 2003 and 2002:

	2003	2002
Benefit obligation at June 30	\$1,492,410	\$1,689,435
Fair value of plan assets at June 30	—	—
Funded status	<u>\$(1,492,410)</u>	<u>\$(1,689,435)</u>
Accrued benefit cost recognized	\$1,765,517	\$2,052,010
Net periodic (benefit) expense	\$(197,025)	\$568,923
Employer contribution	\$89,468	\$75,373

Significant assumptions related to postretirement benefits as of June 30 were as follows:

	2003	2002
Discount rate	5.9%	7.0%
Health care cost trend rates - Initial	10.0%	9.5%
Health care cost trend rates - Ultimate	5.0%	5.5%

5. TAX STATUS

The Fund is exempt from Federal income taxes under Section 501(c)(3) of the Internal Revenue Code, but is subject to a 2% or 1% Federal excise tax, if certain criteria are met, on net investment income. For the years ended June 30, 2003 and 2002, that excise tax rate was 1% and 2%, respectively. The Fund is also subject to Federal and state taxes on unrelated business income. In addition, The Fund records deferred Federal excise taxes, based upon expected excise tax rates, on the unrealized appreciation or depreciation of investments being reported for financial reporting purposes in different periods than for tax purposes.

The Fund is required to make certain minimum distributions in accordance with a formula specified by the Internal Revenue Service. For the year ended June 30, 2003, distributions approximating \$27.9 million were made before the June 30, 2004 deadline to satisfy the minimum requirements of approximately \$23.1 million for fiscal year 2003.

In the Statements of Financial Position, the deferred tax liability of \$475,528 at June 30, 2003 resulted from Federal excise taxes on unrealized appreciation on investments. At June 30, 2002, the deferred tax asset of \$285,942 represented a federal excise tax benefit on the unrealized depreciation on investments.

For the years ended June 30, 2003 and 2002, the tax provision (benefit) - net was as follows:

	2003	2002
Excise taxes - current	\$129,680	\$123,838
Excise taxes - deferred	761,470	(605,276)
Unrelated business income taxes - current	44,561	2,135
Unrelated business income taxes - deferred	-	23,965
	<u>\$935,711</u>	<u>\$(455,338)</u>

6. FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value amounts have been determined by the Fund, using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that the Fund could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

All Financial Instruments Other Than Investments - The carrying amounts of these items are a reasonable estimate of their fair value.

Investments - For marketable securities held as investments, fair value equals quoted market price, if available. If a quoted market price is not available, fair value is estimated using quoted market price for similar securities. For alternative asset limited partnerships held as investments, fair value is estimated using private valuations of the securities or properties held in these partnerships. The carrying amount of these items is a reasonable estimate of their fair value. For futures and foreign exchange forward contracts, the fair value equals the quoted market price.

7. CONTRIBUTIONS RECEIVED

In fiscal years 1987 and 1988, the Fund received a total of \$15,415,804 as a grant from the James Picker Foundation, with an agreement that a designated portion of the Fund's grants be identified as "Picker Program Grants by the Commonwealth Fund." The Fund fulfills this obligation by making Picker Program Grants devoted to specific themes approved by the Fund's board of directors. For the years ended June 30, 2003 and 2002, Picker Program Grants totaled \$1,370,227 and \$942,000, respectively.

In April 1996, the Fund received The Health Services Improvement Fund, Inc.'s ("HSIF") assets and liabilities, \$1,721,016 and \$57,198, respectively, resulting in a \$1,663,818 increase in net assets. In accordance with the terms of an agreement with HSIF, this contribution enables the Fund to make Commonwealth Fund/HSIF grants to improve health care coverage, access, and quality in the New York City greater metropolitan region.

During the year ended June 30, 2002, the Fund received a bequest of \$3,001,124 from the estate of Professor Frances Cooke Macgregor as a contribution to the general endowment, with the amount of annual grants generated by this addition to the endowment to be governed by the Fund's overall annual payout policies. This gift was made with the provisions that in at least the five-year period following its receipt, grants made possible by it will be used to address iatrogenic medicine issues, and that grants made possible by the gift be designated "Frances Cooke Macgregor" grants. In keeping with this bequest, an amount of \$552,000 was recorded as a temporarily restricted net asset as of and for the year ended June 30, 2002.

During the year ended June 30, 2003, net assets released from donor restrictions were \$150,000.