

INDEPENDENT AUDITORS' REPORT

We have audited the accompanying statement of financial position of The Commonwealth Fund (the "Fund") as of June 30, 2004 and the related statements of activities and of cash flows for the year then ended. The financial statements of The Commonwealth Fund as of June 30, 2003 and for the year then ended were audited by other auditors whose report dated September 19, 2003 expressed an unqualified opinion on those statements. 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 audit.

We conducted our audit 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 audit provides 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, 2004 and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.



September 30, 2004

THE COMMONWEALTH FUND

STATEMENTS OF FINANCIAL POSITION JUNE 30, 2004 AND 2003

	2004	2003
ASSETS		
CASH	\$ 477,521	\$ 29,138
INVESTMENTS - At fair value (Notes 1 and 2)	572,128,427	498,148,956
INTEREST AND DIVIDENDS RECEIVABLE	157,031	561,423
PREPAID TAXES - Net (Note 5)	-	131,218
PREPAID INSURANCE AND OTHER ASSETS	183,687	153,769
RECOVERABLE GRANTS	350,000	350,000
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 \$1,571,924 at June 30, 2004 and \$1,581,112 at June 30, 2003 (Note 1)	4,471,000	4,602,389
TOTAL ASSETS	\$ 578,042,666	\$ 504,251,893
LIABILITIES AND NET ASSETS		
LIABILITIES:		
Accounts payable and accrued expenses	\$ 1,027,586	\$ 1,464,577
Taxes payable - net	875,221	-
Securities transactions payable - net	205,443	372,508
Program authorizations payable (Note 3)	17,573,288	18,751,005
Accrued postretirement benefits (Note 4)	1,925,002	1,765,517
Deferred tax liability (Note 5)	1,531,576	475,528
Total liabilities	23,138,116	22,829,135
NET ASSETS:		
Unrestricted	554,687,761	481,020,758
Temporarily restricted (Note 7)	216,789	402,000
Total net assets	554,904,550	481,422,758
TOTAL LIABILITIES AND NET ASSETS	\$ 578,042,666	\$ 504,251,893

See notes to financial statements.

THE COMMONWEALTH FUND

STATEMENTS OF ACTIVITIES YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
REVENUES AND SUPPORT:		
Interest and dividends	\$ 25,501,155	\$ 17,319,543
Contribution and other revenue (Note 7)	4,266	32,177
Net assets released from restrictions (Note 7)	<u>285,211</u>	<u>150,000</u>
Total revenues and support	<u>25,790,632</u>	<u>17,501,720</u>
EXPENSES:		
Program authorizations and operating program	21,215,335	25,010,993
General administration	2,578,849	2,543,103
Investment management	3,005,826	2,629,145
Taxes (Note 5)	2,168,405	935,711
Unfunded retirement and other postretirement (Note 4)	<u>367,862</u>	<u>130,953</u>
Total expenses	<u>29,336,277</u>	<u>31,249,905</u>
EXCESS OF EXPENSES OVER REVENUES BEFORE NET INVESTMENT GAINS	<u>(3,545,645)</u>	<u>(13,748,185)</u>
NET INVESTMENT GAINS:		
Net realized gains (losses) on investments	24,314,863	(27,151,744)
Change in unrealized appreciation of investments	<u>52,897,785</u>	<u>37,445,762</u>
Total net investment gains	<u>77,212,648</u>	<u>10,294,018</u>
CHANGES IN UNRESTRICTED NET ASSETS	<u>73,667,003</u>	<u>(3,454,167)</u>
TEMPORARILY RESTRICTED CONTRIBUTION FROM BEQUEST (Note 7)	100,000	-
NET ASSETS RELEASED FROM RESTRICTIONS (Note 7)	<u>(285,211)</u>	<u>(150,000)</u>
CHANGES IN TEMPORARILY RESTRICTED NET ASSETS	<u>(185,211)</u>	<u>(150,000)</u>
CHANGES IN NET ASSETS:	73,481,792	(3,604,167)
Net assets, beginning of year	<u>481,422,758</u>	<u>485,026,925</u>
Net assets, end of year	<u>\$ 554,904,550</u>	<u>\$ 481,422,758</u>

See notes to financial statements.

THE COMMONWEALTH FUND

STATEMENTS OF CASH FLOWS YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Change in net assets:	\$ 73,481,792	\$ (3,604,167)
Net investment gains	(77,212,648)	(10,294,018)
Depreciation expense	347,871	406,680
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Decrease in interest and dividends receivable	404,392	537,158
Decrease in prepaid taxes - net	131,218	146,700
Decrease in deferred tax asset	-	285,942
(Increase) decrease in prepaid insurance and other assets	(29,918)	56,856
Decrease in accounts payable and accrued expenses	(436,991)	(847,194)
Increase in taxes payable - net	875,221	-
(Decrease) increase in program authorizations payable	(1,177,717)	480,123
Increase (decrease) in accrued postretirement benefits	159,485	(286,493)
Decrease in securities transactions payable - net	(167,065)	(5,280,815)
Increase in deferred tax liability	1,056,048	475,528
	<u>(2,568,312)</u>	<u>(17,923,700)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of furniture, equipment, and building improvements - net	(217,057)	(1,089,107)
Purchase of investments	(427,900,969)	(484,934,895)
Proceeds from the sale of investments	431,134,721	503,959,169
	<u>3,016,695</u>	<u>17,935,167</u>
Net cash used in operating activities		
Net cash provided by investing activities		
	<u>3,016,695</u>	<u>17,935,167</u>
NET INCREASE IN CASH	448,383	11,467
CASH, BEGINNING OF YEAR	<u>29,138</u>	<u>17,671</u>
CASH, END OF YEAR	<u>\$ 477,521</u>	<u>\$ 29,138</u>
SUPPLEMENTAL INFORMATION -		
Taxes paid	<u>\$ 105,918</u>	<u>\$ 49,500</u>

See notes to financial statements.

NOTES TO FINANCIAL STATEMENTS
Years Ended June 30, 2004 and 2003

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.

2. INVESTMENTS

Investments at June 30, 2004 and 2003 comprised the following:

	2004		2003	
	Fair Value	Cost	Fair Value	Cost
U.S. Equities	\$ 222,120,398	\$ 199,573,796	\$ 204,406,869	\$ 214,896,635
Non - U.S. Equities	115,787,460	85,420,609	100,628,294	92,578,688
Fixed income	68,882,700	68,427,970	79,075,285	77,792,969
Short-term	24,156,609	24,156,609	13,957,645	14,019,919
Marketable alternative equity	65,567,269	42,140,486	59,670,856	29,560,194
Nonmarketable alternative equity	11,017,563	14,857,943	10,200,114	18,172,907
Inflation hedge	64,596,428	60,972,222	30,209,893	27,351,262
	<u>\$ 572,128,427</u>	<u>\$ 495,549,635</u>	<u>\$ 498,148,956</u>	<u>\$ 474,372,574</u>

At June 30, 2004, the Fund had total unexpended commitments of approximately \$32.8 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. At June 30, 2004, the Fund had no outstanding derivative positions. The table below summarizes the Fund's outstanding positions in futures and forward contracts at June 30, 2003:

Contract type	2003	
	Number of Long (Short) Contracts	Notional Amount
30-year Treasury Bond futures	45	4,500,000
10-year Treasury Note futures	74	7,400,000
5-year Treasury Note futures	(78)	7,800,000
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. Also included in short term investments at June 30, 2003 are unrealized losses on open futures contracts of approximately \$69,000.

3. PROGRAM AUTHORIZATIONS PAYABLE

At June 30, 2004, program authorizations scheduled for payment at later dates were as follows:

July 1, 2004 through June 30, 2005	\$ 14,005,290
July 1, 2005 through June 30, 2006	3,560,293
Thereafter	<u>114,401</u>
Gross program authorizations scheduled for payment at a later date	17,679,984
Less adjustment to present value	<u>106,696</u>
Program authorizations payable	<u><u>\$ 17,573,288</u></u>

A discount rate of 2.09% was used to determine the present value of the program authorizations payable at June 30, 2004.

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 19% and 20% of the participants' compensation for the years ended June 30, 2004 and 2003, respectively. Pension expense under this plan approximated \$878,000 and \$938,000 for the years ended June 30, 2004 and 2003, 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 approximated \$60,000 and \$93,000 for the years ended June 30, 2004 and 2003, 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. There were no deferred compensation contributions for the year ended June 30, 2004.

Effective July 1, 2001, the Fund established a fully-funded Key Employee Stock Option Plan (“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. The Fund no longer makes contributions to the KEYSOP.

Effective July 9, 2002, the Fund established a Section 457 Plan for certain employees that provides for unfunded benefits 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, 2004 and 2003:

	2004	2003
Benefit obligation at June 30	\$ 1,754,507	\$ 1,492,410
Fair value of plan assets at June 30	<u>-</u>	<u>-</u>
Funded status	1,754,507	1,492,410
Actuarial loss	<u>170,495</u>	<u>273,107</u>
Accrued benefit cost recognized	<u>\$ 1,925,002</u>	<u>\$ 1,765,517</u>
Net periodic expense (benefit)	262,097	(197,025)
Employer contribution	102,612	89,468

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

	2004	2003
Discount rate	5.33%	5.90%
Health care cost trend rates – Initial	7.10	10.00
Health care cost trend rates – Ultimate	7.20	5.00

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 1% or 2% Federal excise tax, if certain criteria are met, on net investment income. For the years ended June 30, 2004 and 2003, that excise tax rate was 2% and 1%, 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, 2004, distributions approximating \$200,000 are required to be made by June 30, 2005 to satisfy the minimum requirements of approximately \$25.9 million for the year ended June 30, 2004.

In the Statements of Financial Position, the deferred tax liability of \$1,531,576 and \$475,528 at June 30, 2004 and 2003, respectively, resulted from Federal excise taxes on unrealized appreciation of investments.

For the years ended June 30, 2004 and 2003, the tax provision was as follows:

	2004	2003
Excise taxes - current	\$ 1,023,977	\$ 129,680
Excise taxes - deferred	1,056,048	761,470
Unrelated business income taxes - current	88,380	44,561
	<u>\$ 2,168,405</u>	<u>\$ 935,711</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, 2004 and 2003, Picker program grants totaled approximately \$1,350,000 and \$1,370,000, 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. An additional amount of \$ 100,000 was received during the year ended June 30, 2004. 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 initial amount of \$552,000 was recorded as a temporarily restricted net asset as of and for the year ended June 30, 2002.

During the years ended June 30, 2004 and 2003, net assets released from donor restrictions were \$285,211 and \$150,000, respectively.