

# **The Commonwealth Fund**

## **INDEPENDENT AUDITORS' REPORT**

### **Financial Statements**

#### **Years Ended June 30, 2005 and 2004**

We have audited the accompanying statements of financial position of The Commonwealth Fund (the "Fund") as of June 30, 2005 and 2004 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 audit.

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 audits 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, 2005 and 2004 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.



*September 23, 2005*

# THE COMMONWEALTH FUND

## STATEMENTS OF FINANCIAL POSITION JUNE 30, 2005 AND 2004

	2005	2004
<b>ASSETS</b>		
CASH	\$ 496,911	\$ 477,521
INVESTMENTS - At fair value (Notes 1 and 2)	608,341,012	572,128,427
INTEREST AND DIVIDENDS RECEIVABLE	130,281	157,031
PREPAID TAXES - Net (Note 5)	377,905	-
PROCEEDS RECEIVABLE FROM SECURITY SALES - NET	134,397	-
PREPAID INSURANCE AND OTHER ASSETS	31,341	183,687
RECOVERABLE GRANTS	100,526	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 \$ 1,562,270 at June 30, 2005 and \$1,571,924 at June 30, 2004 (Note 1)	<u>4,516,149</u>	<u>4,471,000</u>
TOTAL ASSETS	<u>\$ 614,403,522</u>	<u>\$ 578,042,666</u>
<b>LIABILITIES AND NET ASSETS</b>		
<b>LIABILITIES:</b>		
Accounts payable and accrued expenses	\$ 1,169,113	\$ 1,027,586
Taxes payable - net	-	875,221
Securities transactions payable - net	-	205,443
Program authorizations payable (Note 3)	17,439,498	17,573,288
Accrued postretirement benefits (Note 4)	2,194,182	1,925,002
Deferred tax liability (Note 5)	<u>2,388,052</u>	<u>1,531,576</u>
Total liabilities	<u>23,190,845</u>	<u>23,138,116</u>
<b>NET ASSETS:</b>		
Unrestricted	591,168,084	554,687,761
Temporarily restricted (Note 7)	<u>44,593</u>	<u>216,789</u>
Total net assets	<u>591,212,677</u>	<u>554,904,550</u>
TOTAL LIABILITIES AND NET ASSETS	<u>\$ 614,403,522</u>	<u>\$ 578,042,666</u>

See notes to financial statements.

# THE COMMONWEALTH FUND

## STATEMENTS OF ACTIVITIES YEARS ENDED JUNE 30, 2005 AND 2004

	2005	2004
REVENUES AND SUPPORT:		
Interest and dividends	\$ 9,054,636	\$ 25,501,155
Contribution and other revenue (Note 7)	3,073	4,266
Net assets released from restrictions (Note 7)	<u>172,196</u>	<u>285,211</u>
Total revenues and support	<u>9,229,905</u>	<u>25,790,632</u>
EXPENSES:		
Program authorizations and operating program	21,463,712	21,215,335
General administration	2,516,350	2,578,849
Investment management	3,270,239	3,005,826
Taxes (Note 5)	1,054,799	2,168,405
Unfunded retirement and other postretirement (Note 4)	<u>593,834</u>	<u>367,862</u>
Total expenses	<u>28,898,934</u>	<u>29,336,277</u>
EXCESS OF EXPENSES OVER REVENUES BEFORE NET INVESTMENT GAINS	<u>(19,669,029)</u>	<u>(3,545,645)</u>
NET INVESTMENT GAINS:		
Net realized gains on investments	13,345,794	24,314,863
Change in unrealized appreciation of investments	<u>42,803,558</u>	<u>52,897,785</u>
Total net investment gains	<u>56,149,352</u>	<u>77,212,648</u>
CHANGES IN UNRESTRICTED NET ASSETS	<u>36,480,323</u>	<u>73,667,003</u>
TEMPORARILY RESTRICTED CONTRIBUTION FROM BEQUEST (Note 7)	-	100,000
NET ASSETS RELEASED FROM RESTRICTIONS (Note 7)	<u>(172,196)</u>	<u>(285,211)</u>
CHANGES IN TEMPORARILY RESTRICTED NET ASSETS	<u>(172,196)</u>	<u>(185,211)</u>
CHANGES IN NET ASSETS:	36,308,127	73,481,792
Net assets, beginning of year	<u>554,904,550</u>	<u>481,422,758</u>
Net assets, end of year	<u>\$ 591,212,677</u>	<u>\$ 554,904,550</u>

See notes to financial statements.

# THE COMMONWEALTH FUND

## STATEMENTS OF CASH FLOWS YEARS ENDED JUNE 30, 2005 AND 2004

	<b>2005</b>	<b>2004</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Change in net assets:	\$ 36,308,127	\$ 73,481,792
Net investment gains	(56,149,352)	(77,212,648)
Depreciation expense	268,665	347,871
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Decrease in interest and dividends receivable	26,750	404,392
(Increase) decrease in prepaid taxes - net	(377,905)	131,218
Increase in proceeds receivable from securities sales - net	(134,397)	-
Decrease (increase) in prepaid insurance and other assets	152,346	(29,918)
Decrease in recoverable grants	249,474	-
Increase (decrease) in accounts payable and accrued expenses	104,771	(436,991)
(Decrease) increase in taxes payable - net	(875,221)	875,221
Increase (decrease) increase in program authorizations payable	(133,790)	(1,177,717)
Increase in accrued postretirement benefits	269,180	159,485
Decrease in securities transactions payable - net	(205,443)	(167,065)
Increase in deferred tax liability	856,476	1,056,048
	<u>(19,640,319)</u>	<u>(2,568,312)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of furniture, equipment, and building improvements - net	(313,815)	(217,057)
Purchase of investments	(391,325,556)	(427,900,969)
Proceeds from the sale of investments	411,299,080	431,134,721
	<u>19,659,709</u>	<u>3,016,695</u>
<b>NET INCREASE IN CASH</b>	<b>19,390</b>	<b>448,383</b>
<b>CASH, BEGINNING OF YEAR</b>	<b><u>477,521</u></b>	<b><u>29,138</u></b>
<b>CASH, END OF YEAR</b>	<b><u>\$ 496,911</u></b>	<b><u>\$ 477,521</u></b>
<b>SUPPLEMENTAL INFORMATION -</b>		
Taxes paid: excise and unrelated business income	<u>\$ 1,451,449</u>	<u>\$ 105,918</u>

See notes to financial statements.

# The Commonwealth Fund

## NOTES TO FINANCIAL STATEMENTS Years Ended June 30, 2005 and 2004

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### 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, 2005 and 2004 comprised the following:

	2005		2004	
	Fair Value	Cost	Fair Value	Cost
U.S. Equities	\$ 183,218,869	\$ 157,581,858	\$ 222,120,398	\$ 199,573,796
Non - U.S. Equities	139,418,015	86,726,067	115,787,460	85,420,609
Fixed income	89,458,155	92,583,406	68,882,700	68,427,970
Short-term	16,769,839	16,769,839	24,156,609	24,156,609
Marketable alternative equity	72,222,771	42,111,141	65,567,269	42,140,486
Nonmarketable alternative equity	15,451,026	17,443,048	11,017,563	14,857,943
Inflation hedge	91,802,337	75,723,063	64,596,428	60,972,222
	<u>\$ 608,341,012</u>	<u>\$ 488,938,422</u>	<u>\$ 572,128,427</u>	<u>\$ 495,549,635</u>

At June 30, 2005, the Fund had total unexpended commitments of approximately \$54.4 million in various nonmarketable alternative equity 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, 2005 and 2004, the Fund had no outstanding derivative positions.

## 3. PROGRAM AUTHORIZATIONS PAYABLE

At June 30, 2005, program authorizations scheduled for payment at later dates were as follows:

July 1, 2005 through June 30, 2006	\$ 13,996,966
July 1, 2006 through June 30, 2007	3,341,690
Thereafter	<u>204,532</u>
Gross program authorizations scheduled for payment at a later date	17,543,188
Less adjustment to present value	<u>103,690</u>
Program authorizations payable	<u>\$ 17,439,498</u>

A discount rate of 2.83% was used to determine the present value of the program authorizations payable at June 30, 2005.

#### **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% of the participants' compensation for the years ended June 30, 2005 and 2004, respectively. Pension expense under this plan was approximately \$925,000 and \$878,000 for the years ended June 30, 2005 and 2004, 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. These pension payments approximated \$62,000 and \$60,000 for the years ended June 30, 2005 and 2004, 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. Deferred compensation contributions were \$ 22,175 for the year ended June 30, 2005; there were no 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 postretirement medical plan, which is measured as of the end of each fiscal year, is an unfunded plan, with 100% of the benefits paid by the Fund on a pay-as-you-go basis. Such

payments approximated \$110,000 and \$103,000 for the years ended June 30, 2005 and 2004, respectively.

Expected contributions under the postretirement medical plan for the fiscal year ended June 30, 2006 are expected to be approximately \$125,000. Additional required disclosure on the Fund's postretirement medical plan for the years ended June 30, 2005 and 2004 is as follows:

	<b>2005</b>	<b>2004</b>
Benefit obligation at June 30	\$ 2,133,837	\$ 1,754,507
Fair value of plan assets at June 30	<u>-</u>	<u>-</u>
Status - unfunded	2,133,837	1,754,507
Actuarial loss	<u>60,345</u>	<u>170,495</u>
Accrued benefit cost recognized	<u>\$ 2,194,182</u>	<u>\$ 1,925,002</u>
Net periodic expense	379,331	262,097
Employer contribution	110,151	102,612

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

	<b>2005</b>	<b>2004</b>
Discount rate	4.28%	5.33%
Health care cost trend rates—Initial	7.30	7.10
Health care cost trend rates—Ultimate	7.10	7.20

At June 30, 2005, benefits expected to be paid in future years are approximately as follows:

Year ended June 30, 2006	\$ 125,000
Year ended June 30, 2007	\$ 135,000
Year ended June 30, 2008	\$ 149,000
Year ended June 30, 2009	\$ 162,000
Year ended June 30, 2010	\$ 194,000
Five years ended June 30, 2015	\$ 871,000

## 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, 2005 and 2004, that excise tax rate was 2%. 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, 2005, distributions approximating \$4.7 million are required to be made by June 30, 2006 to satisfy the minimum requirements of approximately \$29.2 million for the year ended June 30, 2005.

In the Statements of Financial Position, the deferred tax liability of \$2,338,052 and \$1,531,576 at June 30, 2005 and 2004, respectively, resulted from expected Federal excise taxes on unrealized appreciation of investments.

For the years ended June 30, 2005 and 2004, the tax provision was as follows:

	2005	2004
Excise taxes - current	\$ 124,812	\$ 1,023,977
Excise taxes - deferred	856,476	1,056,048
Unrelated business income taxes - current	73,511	88,380
	<u>\$ 1,054,799</u>	<u>\$ 2,168,405</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, 2005 and 2004, net assets released from donor restrictions were \$172,196 and \$285,211, respectively.