

Budget and Finance

In his Chairman's Letter, Peter G. Peterson describes some of the strengths underlying the Council's financial position: a strong leader in our departing president, Leslie H. Gelb, and in our incoming president, Richard N. Haass; a committed and generous membership; and diverse sources of revenue. This year, the Council added an endowed chair in Africa Policy Studies; a senior fellowship in global health studies; two endowed lectureships; and broad support for its National, Term Member, and Studies Programs—to mention just a few areas of growth this year.

The Council's investment portfolio climbed to an all-time high, ending at just over \$150 million as of June 30, 2003. We thank William J. McDonough, chairman of the Finance and Budget Committee, J. Tomilson Hill, chairman of the Investment Subcommittee, and all members of the committee

and subcommittee more heartily each year—and we have good reason to do so! In this “unruly and dangerous world” that Les talks about, they have kept the Council sensibly and soundly prepared to fund ongoing programs and take on new ones without sacrificing quality or compromising goals.

And, thanks to the continuing combination of careful stewardship of Council resources; support from members, foundations, and others who support the Council's missions; keeping a close eye on expenditures; and maintaining a diverse array of resources, the Council maintained an operating surplus for this final year of Les's presidency.

Janice L. Murray
Senior Vice President and Treasurer

Statement of Financial Position

	2003	2002
Assets		
Cash and cash equivalents	\$ 9,206,300	\$ 10,304,000
Accounts receivable and prepaid expenses	1,127,900	1,191,100
Grants and contributions receivable, current portion (Note 5)	4,026,100	5,258,700
Inventories, at lower of cost or market	127,400	170,700
Grants and contributions receivable, long-term portion (Note 5)	2,880,400	1,346,600
Contributions receivable for endowment (Note 5)	1,303,000	1,116,000
Land, buildings and building improvements, and equipment, net (Note 6)	22,313,400	22,568,600
Investments (Note 3)	85,049,000	81,270,500
Investments to be held in perpetuity (Note 3)	65,085,700	60,917,300
Total assets	<u>\$191,119,200</u>	<u>\$184,143,500</u>
Liabilities and net assets		
Liabilities:		
Accounts payable and accrued expenses	\$ 2,837,700	\$ 3,764,300
Deferred subscription revenue	2,415,800	2,309,200
Accrued postretirement benefits (Note 8)	1,858,000	1,812,000
Total liabilities	<u>7,111,500</u>	<u>7,885,500</u>
Net assets (Notes 9 and 10):		
Unrestricted	79,214,200	75,143,800
Temporarily restricted	38,404,800	39,080,900
Permanently restricted	66,388,700	62,033,300
Total net assets	<u>184,007,700</u>	<u>176,258,000</u>
Total liabilities and net assets	<u>\$191,119,200</u>	<u>\$184,143,500</u>

See accompanying notes.

Statement of Activities

Year ended June 30, 2003, with summarized financial information for the year ended June 30, 2002

	2003			2002 Total
	Unrestricted	Temporarily Restricted	Permanently Restricted	
Operating revenue, support, and reclassifications				
Membership dues	\$ 3,505,100			\$ 3,354,900
Annual giving	3,571,400			3,184,900
Corporate memberships and related income	3,265,500			3,212,300
Meetings	21,300	\$ 120,000		274,200
International Affairs Fellowships		71,300		106,700
Grants and contributions for Studies		5,632,600		6,499,200
Other grants and contributions	745,400	1,142,800		1,100,700
<i>Foreign Affairs</i>	5,359,300			5,008,700
Book publication	37,800			43,600
Investment income allocation (<i>Note 4</i>)	3,600,000	3,187,000		6,317,700
Rental income	1,025,900			977,500
Miscellaneous	180,500	5,900		796,000
Total operating revenue and support	21,312,200	10,159,600		30,876,400
Net assets released from restrictions (<i>Note 9</i>)	10,159,200	(10,159,200)		—
Total operating revenue, support, and reclassifications	31,471,400	400		30,876,400
Operating expenses				
Program expenses:				
Studies Program	11,463,300			10,387,300
Meetings Program	3,280,200			3,124,500
<i>Foreign Affairs</i>	4,746,500			4,932,800
Book publication	606,200			596,000
National Program	769,300			627,700
Outreach Program	565,200			—
International Affairs Fellowships	1,114,200			563,700
Communications	850,700			735,600
Total program expenses	23,395,600			20,967,600
Supporting services:				
Management and general	3,820,100			3,868,400
Membership	798,600			629,600
Fund-raising:				
Development	303,700			308,100
Corporate Program	588,200			661,700
Total fund-raising	891,900			969,800
Total supporting services	5,510,600			5,467,800
Total operating expenses	28,906,200			26,435,400
Excess of operating revenue, support, and reclassifications over operating expenses	2,565,200	400		4,441,000

Statement of Activities (continued)

Year ended June 30, 2003, with summarized financial information for the year ended June 30, 2002

	2003			2002 Total	
	Unrestricted	Temporarily Restricted	Permanently Restricted		Total
Excess of operating revenue, support, and reclassifications over operating expenses brought forward	\$ 2,565,200	\$ 400		\$ 2,565,600	\$ 4,441,000
Nonoperating revenue (Note 2)					
Investment gain (loss) in excess of spending rate (Note 4)	1,505,200	(676,500)		828,700	(9,415,200)
Endowment contributions			\$ 4,355,400	4,355,400	1,307,900
Total nonoperating revenue	1,505,200	(676,500)	4,355,400	5,184,100	(8,107,300)
Change in net assets	4,070,400	(676,100)	4,355,400	7,749,700	(3,666,300)
Net assets, beginning of the year	75,143,800	39,080,900	62,033,300	176,258,000	179,924,300
Net assets, end of the year	\$79,214,200	\$38,404,800	\$66,388,700	\$184,007,700	\$176,258,000

See accompanying notes.

Statement of Cash Flows

Years ended June 30, 2003 and 2002

	2003	2002
Operating activities		
Change in net assets	\$ 7,749,700	\$(3,666,300)
Adjustments to reconcile change in net assets to net cash (used in) provided by operating activities:		
Depreciation	1,612,700	1,573,400
Net realized and unrealized (gain) loss on investments	(7,013,100)	4,968,500
Contributions restricted for investment in endowment	(4,355,400)	(1,307,900)
Changes in operating assets and liabilities:		
Accounts receivable and prepaid expenses	63,200	(563,700)
Grants and contributions receivable	(301,200)	(1,004,400)
Inventories	43,300	9,000
Accounts payable and accrued expenses	(926,600)	529,400
Deferred subscription revenue	106,600	(124,800)
Accrued postretirement benefits	46,000	12,000
Net cash (used in) provided by operating activities	(2,974,800)	425,200

Statement of Cash Flows (continued)

Years ended June 30, 2003 and 2002

	2003	2002
Investing activities		
Purchases of building improvements and equipment	\$ (1,357,500)	\$ (818,500)
Purchases of investments	(119,693,800)	(114,974,100)
Proceeds from sales of investments	118,760,000	108,321,900
Net cash used in investing activities	<u>(2,291,300)</u>	<u>(7,470,700)</u>
Financing activities		
Contributions restricted for investment in endowment	4,168,400	4,294,400
Net cash provided by financing activities	<u>4,168,400</u>	<u>4,294,400</u>
Net decrease in cash and cash equivalents	(1,097,700)	(2,751,100)
Cash and cash equivalents, beginning of year	10,304,000	13,055,100
Cash and cash equivalents, end of year	<u>\$ 9,206,300</u>	<u>\$ 10,304,000</u>
Supplemental disclosure of cash flow information		
Non-cash investing and financing activity:		
Contributions receivable for investment in endowment	\$ 1,303,000	\$ 1,116,000
<i>See accompanying notes.</i>		

Notes to Financial Statements

June 30, 2003

1. Organization

The Council on Foreign Relations, Inc. (the "Council"), headquartered in New York City, is a nonprofit and nonpartisan membership organization dedicated to improving the understanding of U.S. foreign policy and international affairs through the exchange of ideas. The Council, established in 1921, serves as a center for scholarship and policy analysis, mobilizing resident senior staff, members, and other experts in dialogue, study, and the publications programs. It serves as a membership organization, comprising an ever-more diverse and multiprofessional community of men and women involved in international affairs. The Council also serves as a public education organization, reaching out nationally and internationally to disseminate ideas and collaborate with other institutions.

The Council is a Section 501(c)(3) not-for-profit organization exempt from federal income taxes under Section 501(a) of the Internal Revenue Code (the "Code") and is a publicly supported organization as described in Section 509(a)(1) of the Code. The Council is also exempt from state and local income taxes. It is subject to tax on unrelated business income, which has not been significant.

2. Summary of Significant Accounting Policies**Fund Accounting and Net Asset Classifications**

The Council considers all contributions and grants to be available for unrestricted use unless specifically restricted by the donor or grantor. Endowment contributions are invested and, pursuant to the Council's 5% policy (see Note 4), an investment allocation is made for general purposes (unrestricted) and specific program activities (temporarily restricted).

In the accompanying financial statements, funds that have similar characteristics have been combined into three net asset classes: unrestricted, temporarily restricted, and permanently restricted.

Unrestricted net assets represent funds that are fully available, at the discretion of management and the Board of Directors, for the Council to utilize in any of its program or supporting services.

Temporarily restricted net assets comprise funds that are restricted by donors for a specific time period or purpose.

Permanently restricted net assets consist of funds that must be maintained intact in perpetuity, but permit the Council to expend part or all of the income derived from the investment of the donated assets for either specified or unspecified purposes.

Support and Revenue

Contributions, including a portion of membership dues, are recorded when received unconditionally, at their fair value. Gifts received with donor stipulations that limit the use of donated assets are reported as either temporarily or permanently restricted support. When a donor restriction expires, that is, when a time restriction ends or purpose restriction is fulfilled, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of activities as net assets released from restrictions. It is the Council's policy to imply a time restriction on gifts of long-lived assets and contributions to be used to acquire long-lived assets in the absence of explicit donor restrictions to that effect.

Conditional contributions, such as grants with matching requirements, are recognized in the appropriate net asset class when the conditions have been met.

Payments for subscriptions to *Foreign Affairs* are recognized as revenue over the period during which the subscriptions are fulfilled.

Cash and Cash Equivalents

The Council considers all highly liquid investments purchased with a maturity of three months or less, excluding cash equivalents held as investments, to be cash equivalents.

Investments

The Council's investments are recorded at their fair values, which are based on quoted market prices for individual debt and marketable equity securities. The Council's hedge funds, which consist of interests in investment limited partnerships and investment companies, are carried as follows:

- The Council's investments in investment companies, represented by share ownership, are carried at the aggregate net asset value of the shares held by the Council. The net asset value is based on the net market value of the investment company's investment portfolio as determined by the management of the investment company.
- The carrying values of investments in investment limited partnerships reflect the Council's net contributions to the respective partnerships and its share of realized and unrealized investment income and expenses of the respective partnerships. Investments held by the investment limited partnerships generally are carried at fair value as determined by the respective general partners.

Land, Buildings and Building Improvements, and Equipment

The Council follows the practice of capitalizing expenditures for land, buildings and building improvements, and equipment, and generally depreciates these assets on the straight-line basis over their estimated useful lives (see Note 6). The fair value of donated property and equipment is similarly capitalized and depreciated.

Measure of Operations

The Council includes in its definition of operations all revenues and expenses that are an integral part of its programs and supporting activities, including an authorized investment income allocation (see Note 4) and all contributions except for those that are restricted for capital expenditures or have been permanently restricted by donors. Investment income, including net realized and unrealized gains and losses, earned in excess of (or less than) the Council's aggregate authorized spending amount, contributions for capital expenditures, and contributions to permanently restricted net assets are recognized as nonoperating activity.

Use of 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 amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

2002 Summarized Financial Information

The accompanying financial statements include certain prior year summarized comparative information in total but not by net asset class. Such information does not include sufficient detail to constitute a presentation in conformity with accounting principles generally accepted in the United States. Accordingly, such information should be read in conjunction with the Council's financial statements for the year ended June 30, 2002, from which the summarized information was derived.

3. Investments

The components of the Council's long-term investments were as follows:

	June 30			
	2003		2002	
	Cost	Carrying Value	Cost	Carrying Value
Domestic equity securities	\$ 48,719,700	\$ 52,629,700	\$ 52,112,800	\$ 50,878,200
International equity securities	12,181,300	14,674,200	11,464,900	15,143,400
Foreign and corporate bonds	11,571,200	12,731,200	13,712,000	13,882,300
U.S. government agency obligations	12,988,200	14,945,200	12,527,400	12,665,600
Hedge funds	33,889,100	46,300,900	35,657,600	46,718,400
Money market funds	8,853,500	8,853,500	2,899,900	2,899,900
Total	\$128,203,000	\$150,134,700	\$128,374,600	\$142,187,800

The hedge funds in which the Council has invested may trade various financial instruments with off-balance sheet risk. These financial instruments include securities sold short and long, options contracts, and foreign currency forward contracts. Such transactions subject the hedge funds and their investors to market risk associated with changes in the value of the underlying securities, financial instruments, and foreign currencies, as well as the risk of loss if a counterparty fails to perform. The respective hedge fund managers endeavor to limit the risk associated with such transactions.

4. Investment Allocation

It is a Council policy to make an annual investment allocation for the support of operations at 5% of the average market value of the investments for the three previous years. Amounts allocated to the unrestricted and temporarily restricted net asset classes are at the discretion of the Council. Investment income has been reported as follows:

	Year ended June 30			2002 Total
	2003	Temporarily Restricted	Total	
Dividends and interest, net of investment expenses of \$1,163,700 and \$828,600 in 2003 and 2002, respectively	\$ 404,000	\$ 198,700	\$ 602,600	\$ 1,871,000
Net realized and unrealized gain (loss)	4,701,200	2,311,800	7,013,100	(4,968,500)
Total return on investments	5,105,200	2,510,500	7,615,700	(3,097,500)
Investment return used for current operations	(3,600,000)	(3,187,000)	(6,787,000)	(6,317,700)
Investment gain (loss) in excess of amounts used for current operations	\$ 1,505,200	\$ (676,500)	\$ 828,700	\$(9,415,200)

5. Grants and Contributions Receivable

Receivables consist substantially of promises to give and are due from individuals, corporations, and foundations. Contributions receivable for endowment and capital expenditures are primarily due within one year. Grants and contributions receivable are due to be collected as follows:

	June 30	
	2003	2002
Less than one year	\$5,329,100	\$6,374,700
One to five years	3,078,000	1,520,000
	8,407,100	7,894,700
Less discount (at rates varying from 1.5% to 6%)	197,600	173,400
Grants and contributions receivable, net	\$8,209,500	\$7,721,300

6. Land, Buildings and Building Improvements, and Equipment

Land, buildings and building improvements, and equipment, at cost, are summarized as follows:

	June 30		Estimated Useful Life
	2003	2002	
Land	\$ 1,854,300	\$ 1,854,300	
Buildings and building improvements	26,510,800	25,827,000	10–55 years
Equipment	8,161,700	7,488,000	3–15 years
	36,526,800	35,169,300	
Less accumulated depreciation	14,213,400	12,600,700	
	\$22,313,400	\$22,568,600	

7. Retirement Plan

The Council has a defined contribution retirement plan covering all employees who meet the minimum service requirements. Payments, which are 12.5% of each participant's salary for employees hired prior to July 1, 1998, and 10% for each participant hired after this date, are made to Teachers Insurance and Annuity Association and College Retirement Equity Fund to purchase individual annuities for plan members. The expense for the plan was \$831,200 for 2003 and \$786,300 for 2002. Participants must contribute 2.5% of their salaries and have the option to make additional contributions on their own behalf.

8. Other Postretirement Benefits

The Council provides certain health care and life insurance benefits for retired employees. Employees are eligible for those benefits when they meet the criteria for retirement under the pension plan.

The following table presents the plan's disclosures under the provisions of Statement of Financial Accounting Standards No. 132, *Employers' Disclosures About Pensions and Other Postretirement Benefits*, as accounted for under Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions*:

	June 30	
	2003	2002
Benefit obligation	\$2,889,000	\$2,348,000
Fair value of plan assets	—	—
Unfunded status	<u>\$2,889,000</u>	<u>\$2,348,000</u>
Accrued postretirement benefit cost in the statement of financial position	<u>\$1,858,000</u>	<u>\$1,812,000</u>
For the year ended		
Benefit cost	\$ 239,000	\$ 198,000
Benefits paid	\$ 193,000	\$ 186,000
Weighted-average assumptions		
Discount rate	6.25%	7.0%

For purposes of calculating the accumulated postretirement benefit obligation and the net periodic postretirement benefit cost, the average annual assumed rate of increase in the per capita cost of medical and dental benefits is 6% for 2003 and 2002 and decreasing to 5% in 2005 and thereafter.

9. Temporarily Restricted Net Assets

Temporarily restricted net assets are restricted for the following purposes or time periods:

	June 30	
	2003	2002
Studies	\$24,833,700	\$24,740,200
International Affairs Fellowships	4,000,600	4,212,800
Meetings	2,758,400	1,790,200
Studies—Next Generation	1,595,000	2,891,700
Capital expenditures	5,217,100	5,446,000
	<u>\$38,404,800</u>	<u>\$39,080,900</u>

Temporarily restricted net assets were released from restrictions for the fulfillment of the following during the years ended June 30:

	2003	2002
Purposes and time periods:		
Studies	\$ 7,540,600	\$8,050,800
International Affairs Fellowships	539,800	406,700
Meetings	474,200	504,000
Studies—Next Generation	1,296,700	264,300
Capital expenditures	228,900	231,600
Other	79,000	278,100
	<u>\$10,159,200</u>	<u>\$9,735,500</u>

The amounts released from restrictions of \$10,159,200 and \$9,735,500 in 2003 and 2002, respectively, primarily represent revenue recognized in prior years and expended in 2003 and 2002, respectively.

10. Permanently Restricted Net Assets

At June 30, 2003 and 2002, income earned on permanently restricted net assets is available for the following purposes:

	June 30	
	2003	2002
Studies	\$40,235,000	\$36,028,500
International Affairs Fellowships	6,066,200	6,066,100
Meetings	4,080,500	3,931,700
Library	1,021,000	1,021,000
Unrestricted as to use	14,986,000	14,986,000
	<u>\$66,388,700</u>	<u>\$62,033,300</u>



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REPORT OF INDEPENDENT AUDITORS

Board of Directors
 Council on Foreign Relations, Inc.

We have audited the accompanying statement of financial position of the Council on Foreign Relations, Inc. as of June 30, 2003, and the related statements of activities and cash flows for the year then ended. These financial statements are the responsibility of the Council's management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year summarized comparative information has been derived from the Council's 2002 financial statements and, in our report dated August 14, 2002, we expressed an unqualified opinion on those financial statements.

We conducted our audit in accordance with auditing standards generally accepted in 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. 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, the financial statements referred to above present fairly, in all material respects, the financial position of the Council on Foreign Relations, Inc. at June 30, 2003, 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.

August 8, 2003

A Member Firm of Ernst & Young Global