BUDGET *and* FINANCE

Fiscal year 2004 was another year of solid growth for the Council in its portfolio and other revenue streams, especially *Foreign Affairs*, the Corporate Program, and annual giving, even as the Council went through a period of major transition in the financial area consistent with the direction of changes in governance for not-for-profit entities. The Council's newly formed Audit Committee, chaired by John Biggs, engaged a new audit firm, Deloitte & Touche. We thank Ernst & Young for its long and dedicated service as the Council's audit firm.

In his Chairman's Letter, Peter G. Peterson noted William J. McDonough's contributions as chairman of the Finance and Budget Committee. Those of us who worked closely with him over the years join Pete in expressing our gratitude and appreciation for his sterling oversight of the Council's finances. We are equally fortunate in welcoming Board member Michael Moskow, his successor as chair of this committee.

Janice L. Murray
Senior Vice President and Treasurer

STATEMENT OF FINANCIAL POSITION

	June 30, 2004
Assets	
Cash and cash equivalents	$ 3,431,700
Accounts receivable and prepaid expenses	1,463,200
Grants and contributions receivable (*Note 5*)	3,331,100
Contributions receivable for endowment (*Note 5*)	2,742,200
Inventories	98,500
Investments (*Note 3*)	169,039,900
Land, buildings and building improvements, and equipment, net (*Note 6*)	25,069,500
Total	$ 205,176,100
Liabilities and net assets	
Liabilities:	
Accounts payable and accrued expenses	$ 4,743,800
Deferred subscription revenue	2,315,000
Accrued postretirement benefits (*Note 8*)	1,971,000
Total liabilities	9,029,800
Net assets (*Notes 9, 10, and 12*):	
Unrestricted	88,378,200
Temporarily restricted	38,200,600
Permanently restricted	69,567,500
Total net assets	196,146,300
Total	$ 205,176,100

See notes to financial statements.

STATEMENT OF ACTIVITIES

Year ended June 30, 2004

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Operating revenue, support, and reclassifications				
Membership dues	$ 3,612,200			$ 3,612,200
Annual giving	3,720,300			3,720,300
Corporate memberships and related income	4,429,500			4,429,500
Meetings	26,800	127,500		154,300
International Affairs Fellowships		80,000		80,000
Grants and contributions for Studies	279,800	2,406,800		2,686,600
Other grants and contributions	65,900	236,100		302,000
Foreign Affairs	6,605,800			6,605,800
Book publication	46,900			46,900
Investment income allocation (*Note 4*)	3,326,000	3,324,700		6,650,700
Rental income	794,500			794,500
Miscellaneous	175,800	36,500		212,300
Total operating revenue and support	23,083,500	6,211,600		29,295,100
Net assets released from restrictions (*Note 9*)	9,383,900	(9,383,900)		—
Total operating revenue, support, and reclassifications	32,467,400	(3,172,300)		29,295,100
Operating expenses				
Program expenses:				
Studies Program	11,560,400			11,560,400
Meetings Program	3,333,800			3,333,800
Foreign Affairs	5,171,900			5,171,900
Book publication	407,300			407,300
National Program	775,300			775,300
Websites	651,200			651,200
International Affairs Fellowships	995,200			995,200
Communications	834,800			834,800
Total program expenses	23,729,900			23,729,900
Supporting services:				
Management and general	4,228,800			4,228,800
Membership	835,500			835,500
Fund-raising:				
Development	318,000			318,000
Corporate Program	826,300			826,300
Total fund-raising	1,144,300			1,144,300
Total supporting services	6,208,600			6,208,600
Total operating expenses	29,938,500			29,938,500
Excess of operating revenue, support, and reclassifications over operating expenses	2,528,900	(3,172,300)		(643,400)
Nonoperating revenue (*Note 2*)				
Investment gain in excess of spending rate (*Note 4*)	8,823,800	2,968,100		11,797,900
Endowment contributions			3,178,800	3,178,800
Total nonoperating revenue	8,823,800	2,968,100	3,178,800	14,970,700
Change in net assets	11,352,700	(204,200)	3,178,800	14,327,300
Net assets, beginning of year	79,214,200	38,404,800	66,388,700	184,007,700
Prior period adjustments (*Note 12*)	(2,188,700)			(2,188,700)
Net assets, beginning of year as adjusted	77,025,500	38,404,800	66,388,700	181,819,000
Net assets, end of year	$ 88,378,200	$ 38,200,600	$ 69,567,500	$ 196,146,300

See notes to financial statements.

STATEMENT OF CASH FLOWS

	Year ended June 30, 2004
Cash flows from operating activities:	
Change in net assets	$ 14,327,300
Prior period adjustments	(2,188,700)
Adjustments to reconcile change in net assets to net cash (used in) provided by operating activities:	
Depreciation	1,677,600
Net realized and unrealized gain on investments	(17,964,000)
Non-cash equivalents income-net	(992,000)
Contributions restricted for investment in endowment	(3,178,800)
Changes in operating assets and liabilities:	
Accounts receivable and prepaid expenses	(397,200)
Grants and contributions receivable	3,575,400
Contribution receivable for endowment	(1,439,200)
Inventories	28,900
Accounts payable and accrued expenses	1,479,100
Deferred subscription revenue	(100,800)
Accrued postretirement benefits	113,000
Net cash used in operating activities	(5,059,400)
Cash flows from investing activities:	
Purchases of building improvements and equipment	(4,433,700)
Purchases of investments	(197,545,800)
Proceeds from sales of investments	197,596,600
Net cash used in investing activities	(4,382,900)
Cash flows from financing activities:	
Contributions restricted for investment in endowment	3,178,800
Net decrease in cash and cash equivalents	(6,263,500)
Cash and cash equivalents, beginning of year	9,695,200
Cash and cash equivalents, end of year	$ 3,431,700

See notes to financial statements.

NOTES TO FINANCIAL STATEMENTS

Year ended June 30, 2004

1. ORGANIZATION

Founded in 1921, the Council on Foreign Relations, Inc. (the “Council”), is an independent, national membership organization and a nonpartisan center for scholars dedicated to producing and disseminating ideas so that individual and corporate members, as well as policymakers, journalists, students, and interested citizens in the United States and other countries, can better understand the world and the foreign policy choices facing the United States and other governments. The Council does this by convening meetings; conducting a wide-ranging Studies program; publishing *Foreign Affairs*, the preeminent journal covering international affairs and U.S. foreign policy; maintaining a diverse membership; sponsoring Independent Task Forces and Special Reports; and providing up-to-date information about the world and U.S. foreign policy on the Council’s website, www.cfr.org.

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

Basis of Accounting—The financial statements are prepared on the accrual basis of accounting.

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.

Deferred Compensation—The Council has deferred compensation arrangements with current employees. Investment earnings accrue to the benefit of the employees. The bonus payments and accrued earnings are included in accounts payable and accrued expenses in the financial statements.

Inventory—Inventory is comprised of paper that is stored off-site and used in the printing of the bimonthly publication *Foreign Affairs*. Inventory is carried at cost.

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% spending 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.

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 activities.

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.

Allocation of Expenses—The cost of providing the various programs and the supporting services has been summarized on a functional basis in the statement of activities. Accordingly, certain costs have been allocated by management among the programs and supporting services benefited as a percentage of all direct program expenses.

Recent Accounting Pronouncements—In December 2003, the FASB issued SFAS No. 132 (Revised), *Employer's Disclosure about Pensions and Other Postretirement Benefits*, an amendment of FASB Statements No. 87, 88, and 106 ("SFAS No. 132-R"). SFAS No. 132-R retains disclosure requirements of the original statement and requires additional disclosers relating to assets, obligations, cash flows, and net periodic benefit costs. The adoption of the disclosure provisions of SFAS No. 132-R did not have a material effect on the Council's financial statements.

3. INVESTMENTS

The components of the Council's long-term investments as of June 30, 2004:

	Cost	Carrying Value
Domestic equity securities	$ 45,086,700	$ 56,316,900
International equity securities	16,365,100	22,873,300
Foreign and corporate bonds	4,484,300	4,500,100
U.S. government agency obligations	22,654,700	22,644,400
Hedge funds	33,428,400	50,242,900
Money market funds	12,462,300	12,462,300
Total	$ 134,481,500	$ 169,039,900

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 Council policy to make an annual investment allocation for the support of operations up to 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:

	Unrestricted	Temporarily Restricted	Total
Dividends and interest, net of investment expenses of $1,366,200	$ 315,300	$ 163,300	$ 478,600
Net realized and unrealized gain (loss)	11,834,500	6,129,500	17,964,000
Total return on investments	12,149,800	6,292,800	18,442,600
Investment return used for current operations	(3,326,000)	(3,324,700)	(6,650,700)
Investment gain (loss) in excess of amounts used for current operations	$ 8,823,800	$ 2,968,100	$11,791,900

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, which represents $2,742,200 of the gross receivables, are due primarily within one year. Grants and contributions receivable as of June 30, 2004, are due to be collected as follows:

Less than one year	$ 4,211,400
One to five years	1,950,000
	6,161,400
Less discount (at rates varying from 1.5% to 6%)	88,100
Grants and contributions receivable, net	$ 6,073,300

6. LAND, BUILDINGS AND BUILDING IMPROVEMENTS, AND EQUIPMENT

Land, buildings and building improvements, and equipment, at cost, as of June 30, 2004, are summarized as follows:

		Estimated Useful Life
Land	$ 1,854,3000	
Buildings and building improvements	30,516,800	10–55 years
Equipment	8,589,400	3–15 years
	40,960,500	
Less accumulated depreciation	15,891,000	
	$ 25,069,500	

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 $921,800 for 2004. Participants must contribute 2.5% of their salaries and have the option to make additional contributions to a supplemental pension plan on their own behalf.

8. OTHER POSTRETIREMENT BENEFITS

The Council provides medical benefits for their retired employees. Employees are eligible for those benefits when they meet the criteria for retirement under the Postretirement Plan (the Plan).

The following information presents the Plan's disclosures under the provisions of SFAS No. 132-R.

Obligations and funded status as determined as of the end of the year measurement date:

Benefit obligation, end of year	$(3,332,000)
Net amount recognized in the statements of financial position	$(1,971,000)

The Council funds expenses and benefit payments as they are incurred annually and has not contributed funds to separate trusteed accounts to fund the accumulated postretirement benefit obligations. The discount rate used to determine the end of year obligation is 6.50%. The postretirement benefits paid during the year ended June 30, 2004, was $213,000.

The postretirement benefit cost for the year ended June 30, 2004, was $113,000 and was based on actuarial assumptions and a discount rate set as of the beginning of the year. The discount rate was 6.25% and the projected credit unit method was used for determining benefits earned during the year.

Assumed health care cost trend rates at June 30, 2004:

Health care cost trend rate assumed for next year	10%
Rate to which the cost trend rate is assumed to decline	5%
Year that the rate reaches the ultimate trend rate	2009

Increasing the assumed medical care cost trend rates by 1% in each year would increase the accumulated postretirement benefit obligation at June 30, 2004, by $29,200.

The following postretirement benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

Years ending June 30,	
2005	$ 209,000
2006	233,000
2007	245,000
2008	248,000
2009	252,000
2010–2014	1,301,000

9. TEMPORARILY RESTRICTED NET ASSETS

Temporarily restricted net assets as of June 30, 2004, are restricted for the following purposes or time periods:

Studies	$22,942,000
International Affairs Fellowships	4,200,500
Meetings	3,162,500
Studies—Next Generation	1,320,200
Capital expenditures	5,001,400
Other	1,574,000
	$38,200,600

Temporarily restricted net assets were released from restrictions for the fulfillment of the following during the years ended June 30, 2004:

Purposes and time periods:	
Studies	$ 7,854,000
International Affairs Fellowships	537,400
Meetings	454,600
Studies—Next Generation	42,800
Capital expenditures	217,400
Other	277,700
	$ 9,383,900

The amounts released from restrictions represent revenue recognized in prior years and expended in the current year. Some amounts of restricted gifts are received and spent in the same year and are also included in the release from restrictions.

10. PERMANENTLY RESTRICTED NET ASSETS

At June 30, 2004, income earned on permanently restricted net assets is available for the following purposes:

Studies	$43,398,300
International Affairs Fellowships	6,066,100
Meetings	4,096,100
Library	1,021,000
Unrestricted as to use	14,986,000
	$69,567,500

11. COMMITMENTS

The Council leases certain office facilities and equipment under capital and operating lease arrangements.

Future minimum payments for capital and non-cancellable operating leases as of June 30, 2004, are as follows:

Year ending June 30,	
2005	$229,300
2006	33,200
2007	32,200
2008	20,100
2009	1,800
Total	$316,600

Rent expense under the operating leases was $324,772 for the year ended June 30, 2004.

12. PRIOR YEAR ADJUSTMENTS

Subsequent to the issuance of the Council's 2003 financial statements, the Council's management discovered that a pledge from a donor in the amount of $2,000,000 that had previously been recorded as a receivable and unrestricted net assets was to be paid from the donor's will. In accordance with Financial Accounting Standards, No. 116, *Accounting for Contributions Received and Contributions Made*, intentions to give are not unconditional promises to give and therefore should not be recognized until such conditionals are met. As a result, beginning unrestricted net assets have been adjusted to reflect the $2,000,000 write-off. In addition, certain revenues from corporate memberships and rental activities had not been prorated between the fiscal periods over which the income was to be earned. At June 30, 2003, $94,600 of rental income and $85,300 of corporate memberships should have been deferred and recognized as revenues in fiscal 2004. As a result, beginning unrestricted net assets have been reduced to reflect the deferral of such income in the amount of $179,900. Lastly, certain pledges had not been discounted at the appropriate discount rate at June 30, 2003, and were overstated. As a result, beginning unrestricted net assets have been reduced by $8,800.

Beginning unrestricted net assets at July 1, 2003, as previously reported	$79,214,200
Prior period adjustment, write-off receivable balance	(2,000,000)
Prior period adjustment, corporate memberships and rental activities	(179,900)
Prior period adjustment, discount rate for pledges	(8,800)
Adjusted beginning unrestricted net assets at July 1, 2003	$77,025,500

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Council on Foreign Relations, Inc.

We have audited the accompanying statement of financial position of the Council on Foreign Relations, Inc. (the "Council"), as of June 30, 2004, 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.

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, 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.

Deloitte & Touche LLP

August 24, 2004

Member of
Deloitte Touche Tohmatsu