Audit Report

OIG-05-015

Audit of the Exchange Stabilization Fund's Fiscal Years 2004 and 2003 Financial Statements

December 3, 2004

Office of Inspector General

Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

December 3, 2004

MEMORANDUM FOR RANDAL K. QUARLES
ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS

FROM: William H. Pugh, William H. Pugh
Deputy Assistant Inspector General
for Financial Management and Information
Technology Audits

SUBJECT: Audit of the Exchange Stabilization Fund's Fiscal Years 2004 and 2003 Financial Statements

I am pleased to transmit the attached audited Exchange Stabilization Fund (ESF) financial statements for fiscal years (FY) 2004 and 2003. We contracted with the independent certified public accounting firm of Clifton Gunderson LLP to audit ESF's FY 2004 financial statements. We audited ESF's FY 2003 financial statements and rendered an unqualified opinion thereon. The contract required that the audit be performed in accordance with generally accepted Government auditing standards and the *GAO/PCIE* Financial Audit Manual.

The following reports, prepared by Clifton Gunderson LLP, are incorporated in the attachment:

- Independent Auditor's Report;
- Independent Auditor's Report on Internal Control; and
- Independent Auditor's Report on Compliance with Laws and Regulations.

In its audit of ESF's financial statements, Clifton Gunderson LLP found:

- the financial statements present fairly, in all material respects, the financial position as of September 30, 2004, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America;
- no matters involving internal control and its operation that are considered material weaknesses; and
- no instances of reportable noncompliance with laws and regulations tested.

In connection with the contract, we reviewed Clifton Gunderson LLP's reports and related documentation and inquired of its representatives. Our review, as differentiated from an audit in accordance with generally accepted Government auditing standards, was not intended to enable us to express, and we do not express, an opinion on the financial statements or conclusions about the effectiveness of internal control or compliance with laws and regulations. Clifton Gunderson LLP is responsible for the attached auditor's reports dated October 22, 2004 and the conclusions expressed in the reports. However, our review disclosed no instances where Clifton Gunderson LLP did not comply, in all material respects, with generally accepted Government auditing standards.

Should you have any questions, please contact me at (202) 927-5400, or a member of your staff may contact Mike Fitzgerald, Director, Financial Audits at (202) 927-5789.

Attachment

DEPARTMENT OF THE TREASURY,
EXCHANGE STABILIZATION FUND
Washington, DC

FINANCIAL STATEMENTS

September 30, 2004 and 2003

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Independent Auditor's Report

To the Office of Inspector General
of the Department of the Treasury and the
Assistant Secretary for International Affairs

We have audited the accompanying statement of financial position of the U. S. Department of the Treasury's Exchange Stabilization Fund (ESF) as of September 30, 2004, and the related statements of income and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the ESF's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the ESF as of September 30, 2003 were audited by other auditors whose report dated December 5, 2003, expressed an unqualified opinion on those financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of 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 fiscal year 2004 financial statements referred to above present fairly, in all material respects, the financial position of the ESF as of September 30, 2004, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our reports dated October 22, 2004 on our consideration of ESF's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Our audit was performed for the purpose of forming an opinion on the accompanying financial statements taken as a whole. The policy and operations statements are presented for purposes of additional analysis and are not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion or any other form of assurance on it. However, we compared this information for consistency with the financial statements and, based on these limited procedures, we found no material inconsistencies.

Clifton Gunderson LLP

Calverton, Maryland
October 22, 2004

Clifton Gunderson LLP
Certified Public Accountants & Consultants

Independent Auditor's Report On Internal Control

To the Office of Inspector General
of the Department of the Treasury and the
Assistant Secretary for International Affairs

We have audited the financial statements of the U. S. Department of the Treasury's Exchange Stabilization Fund (ESF) as of and for the year ended September 30, 2004, and have issued our report thereon dated October 22, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

In planning and performing our audit, we considered ESF's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the management of ESF, the Department of the Treasury Office of Inspector General, Office of Management and Budget and Congress and is not intended to be and should not be used by anyone other than these specified parties.

Clifton Gunderson LLP

Calverton, Maryland
October 22, 2004

Independent Auditor's Report On Compliance With Laws and Regulations

To the Office of Inspector General
of the Department of the Treasury and the
Assistant Secretary for International Affairs

We have audited the financial statements of the U. S. Department of the Treasury's Exchange Stabilization Fund (ESF) as of and for the year ended September 30, 2004, and have issued our report thereon dated October 22, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

As part of obtaining reasonable assurance about whether ESF's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the management of ESF, the Department of the Treasury Office of Inspector General, Office of Management and Budget and Congress and is not intended to be and should not be used by anyone other than these specified parties.

Clifton Gunderson LLP

Calverton, Maryland
October 22, 2004

DEPARTMENT OF THE TREASURY
EXCHANGE STABILIZATION FUND
POLICY AND OPERATIONS STATEMENTS
Fiscal Year 2004

The Nature and Function of the Exchange Stabilization Fund

The Gold Reserve Act of 1934 established a fund to be operated by the Secretary of the Treasury, with the approval of the President. Section 10 of the Act provided that "For the purpose of stabilizing the exchange value of the dollar, the Secretary of the Treasury, with the approval of the President, directly or through such agencies as he may designate, is authorized, for the account of the fund established in this section, to deal in gold and foreign exchange and such other instruments of credit and securities as he may deem necessary to carry out the purpose of this section." To this end, the Congress, in 1934, appropriated to the Exchange Stabilization Fund (ESF) the sum of $2 billion out of the increment resulting from the reduction in the "weight of the gold dollar." Subsequent amendments to the Gold Reserve Act approved the operation of the ESF through June 30, 1945. Section 7 of the Bretton Woods Agreements Acts, approved July 31, 1945, continued its operations permanently.

The Bretton Woods Agreements Act also directed the Secretary of the Treasury to pay $1.8 billion from the ESF to the International Monetary Fund (IMF), for the initial U.S. quota subscription in the IMF, thereby reducing the ESF's appropriated capital to $200 million.

Reflecting termination of the fixed exchange rate system, legislation enacted in 1976 (P.L. 94-564, effective April 1, 1978, the date of entry into force of the Second Amendment of the IMF Articles of Agreement) amended the language of Section 10 of the Gold Reserve Act to specify that the ESF is to be utilized as the Secretary "may deem necessary to and consistent with the United States obligations in the International Monetary Fund." In 1977, P.L. 95-147 further amended Section 10 of the Gold Reserve Act. Following codification, Section 10 now provides as follows:

> Consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates, the Secretary or an agency designated by the Secretary, with the approval of the President, may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary. However, a loan or credit to a foreign entity or government of a foreign country may be made for more than 6 months in a 12-month period only if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months (31 U.S.C. 5302 (b)).

Pursuant to the Special Drawing Rights Act of 1968 (P.L. 90-349, amended by P.L. 94-564, which was approved October 18, 1976 and became effective April 1, 1978), Special Drawing Rights (SDRs) allocated by the IMF to the United States or otherwise acquired by the United States are resources of the ESF.

Section 286p of Title 22 of the United States Code allows for SDRs to be monetized/demonetized through the issuance/redemption by the Secretary of the Treasury of SDR certificates to the Federal Reserve Banks in exchange for dollars. The total amount of SDR certificates outstanding cannot exceed the dollar equivalent of ESF (i.e., U.S.) holdings of SDRs; such certificates are a liability of the ESF.

Foreign Currency Operations

During fiscal year 2004, the ESF engaged in no market transactions.

a. Euros and Japanese Yen

The ESF had a net valuation gain of $767 million on its holdings of euros and yen. The ESF had investment income of $256 million equivalent on its euro assets and $1 million equivalent on its yen assets.

b. Mexico

In December 2003, the Treasury and Federal Reserve Bank of New York renewed the Exchange Stabilization Agreement with Mexico for another year to December 2004.

SDR Operations

As of September 30, 2004, U.S. holdings (assets) of SDRs totaled SDR 8.7 billion ($12.8 billion equivalent), a net increase of SDR 264.7 million during Fiscal Year 2004. However, as the SDR appreciated against the dollar in this period, there was a net valuation gain of $334 million on U.S. holdings of SDRs. The ESF reimbursed the Treasury's General Fund $299.5 million for SDRs received from the IMF as remuneration on the U.S. reserve position in the IMF. The ESF earned interest of $213 million equivalent on its SDR holdings.

As of September 30, 2004, cumulative allocations to (liabilities of) the United States totaled SDR 4.9 billion ($7.2 billion equivalent). These liabilities would come due only in the event of liquidation of, or U.S. withdrawal from, the SDR Department of the IMF, or cancellation of SDRs.

There were $2.2 billion of SDR certificates that had been issued to the Federal Reserve System prior to Fiscal Year 2004 and remained outstanding at the end of the fiscal year.

Income and Expense

Interest revenue totaled $586.1 million, consisting of $116.2 million in interest on dollar holdings invested in U.S. Government securities, $213 million equivalent in interest on SDR holdings, and $257 million equivalent in interest on foreign currency investments.

Interest expense totaled $121.9 million, which included $121.5 million in interest charges on SDR Allocations and $0.4 million paid by the ESF to the Treasury General Fund on the dollar counterpart of SDRs received as remuneration on the U.S. reserve position in the IMF.

DEPARTMENT OF THE TREASURY
EXCHANGE STABILIZATION FUND
STATEMENTS OF FINANCIAL POSITION
(In Thousands)

As of September 30		**2004**		**2003**
Assets				
Cash and Cash Equivalents (Note 2)				
U.S. Government Securities	$	10,318,702	$	10,502,415
Foreign Currency Denominated Assets		5,300,126		6,056,320
Total Cash and Cash Equivalents		15,618,828		16,558,735
Other Foreign Currency Denominated Assets (Note 3)		3,583,758		3,543,260
Special Drawing Right Holdings (Note 4)		12,781,984		12,062,467
Investment Securities, Held to Maturity (Note 5)		10,636,979		8,951,912
Accrued Interest Receivable		168,074		102,567
Total Assets	$	42,789,623	$	41,218,941
Liabilities and Equity				
Liabilities				
Certificates Issued to Federal Reserve Banks (Note 6)	$	2,200,000	$	2,200,000
Special Drawing Right Allocations (Note 4)		7,197,361		7,005,299
Accrued Expenses and Other		23,618		18,181
Total Liabilities		9,420,979		9,223,480
Equity				
Appropriated Capital		200,000		200,000
Retained Earnings		33,168,644		31,795,461
Total Equity		33,368,644		31,995,461
Total Liabilities and Equity	$	42,789,623	$	41,218,941

These financial statements should be read only in connection with the accompanying notes to financial statements.

DEPARTMENT OF THE TREASURY
EXCHANGE STABILIZATION FUND
STATEMENTS OF INCOME AND RETAINED EARNINGS
(In Thousands)

Years Ended September 30	**2004**	**2003**
Interest Revenue:		
Interest on U. S. Government Securities	$ 116,178	$ 124,232
Interest on Foreign Currency Denominated Assets	161,028	193,875
Interest on Special Drawing Right Holdings	212,934	206,976
Interest on Investment Securities	95,985	71,970
Total Interest Revenue	586,125	597,053
Interest Expense		
Interest on Special Drawing Right Allocations	121,496	118,820
Interest on Special Drawing Right Received as Remuneration by the U.S. Treasury	359	577
Total Interest Expense	121,855	119,397
Net Interest Revenue	464,270	477,656
Net Gains		
Net Gains on Valuation of:		
Special Drawing Rights	142,145	395,793
Foreign Currency Denominated Assets	767,243	2,236,334
Total Net Gains	909,388	2,632,127
Other Expenses		
International Monetary Fund Annual Assessment	475	424
Net Income	1,373,183	3,109,359
Retained Earnings, Beginning of Year	31,795,461	28,686,102
Retained Earnings, End of Year	$ 33,168,644	$ 31,795,461

These financial statements should be read only in connection with the accompanying notes to financial statements.

DEPARTMENT OF THE TREASURY
EXCHANGE STABILIZATION FUND
STATEMENTS OF CASH FLOWS
(In Thousands)

Years Ended September 30	**2004**	**2003**
Cash Flows from Operating Activities:		
Interest Received on:		
U.S. Government Securities	$ 116,178	$ 124,232
Foreign Currency Denominated Assets	162,873	204,911
Investment Securities	115,667	97,249
Net Gain on Valuation of Foreign Currency Denominated Assets	767,243	2,236,334
Other	(76,412)	(32,534)
Net Cash Provided by Operating Activities	1,085,549	2,630,192
Cash Flows from Investing Activities:		
Net Increase in Foreign Currency Denominated Assets	(40,498)	(627,630)
Net Increase in Investment Securities	(1,685,067)	(886,351)
Purchases of Special Drawing Rights Received as Remuneration by the U.S. Treasury and Related Interest	(299,891)	(348,779)
Sales of Special Drawing Rights	-	1,010,008
Net Cash Used in Investing Activities	(2,025,456)	(852,752)
Net (Decrease) Increase in Cash and Cash Equivalents	(939,907)	1,777,440
Cash and Cash Equivalents, Beginning of Year	16,558,735	14,781,295
Cash and Cash Equivalents, End of Year	$ 15,618,828	$ 16,558,735
Reconciliation of Net Income to Net Cash Provided by Operating Activities		
Net Income	$ 1,373,183	$ 3,109,359
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Increase in Special Drawing Right Holdings Due to Valuation	(334,244)	(919,609)
Net Interest Received in Special Drawing Rights	(85,382)	(94,481)
(Increase) Decrease in Accrued Interest Receivable	(65,507)	16,398
Increase in Special Drawing Right Allocations Due to Valuation	192,062	524,740
Increase (Decrease) in Accrued Expenses and Other	5,437	(6,215)
Total Adjustments	(287,634)	(479,167)
Net Cash Provided by Operating Activities	$ 1,085,549	$ 2,630,192

These financial statements should be read only in connection with the accompanying notes to financial statements.

DEPARTMENT OF THE TREASURY
EXCHANGE STABILIZATION FUND
NOTES TO FINANCIAL STATEMENTS
(In Thousands)

September 30, 2004 and 2003

Note 1. Summary of Significant Accounting Policies

The Exchange Stabilization Fund (ESF) was established as a result of the Gold Reserve Act of 1934, as amended, to be operated by the Secretary of the Treasury, with the approval of the President, consistent with the obligations of the U.S. Government in the International Monetary Fund (IMF) on orderly exchange arrangements and a stable system of exchange rates. To this end, the Secretary of the Treasury may deal in gold, foreign exchange, and other instruments of credit and securities.

A. Basis of Accounting & Presentation

The ESF has historically prepared its financial statements in accordance with generally accepted accounting principles, based on accounting standards issued by the Financial Accounting Standards Board (FASB), the private-sector standards-setting body. The Federal Accounting Standards Advisory Board (FASAB) was designated by the American Institute of Certified Public Accountants (AICPA) as the standards-setting body for financial statements of federal government entities, with respect to the establishment of generally accepted accounting principles. FASAB has indicated, however, that financial statements prepared based upon accounting standards published by the FASB may also be regarded as in accordance with generally accepted accounting principles for those federal entities, such as the ESF, that have issued financial statements based upon FASB accounting standards in the past. Accordingly, consistent with historical reporting, the ESF financial statements are presented in accordance with accounting standards published by the FASB. In accordance with generally accepted accounting principles, the preparation of financial statements requires management estimates 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 and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

B. Fair Values of Financial Instruments

Cash and Cash Equivalents, which consist of U.S. Government securities and Foreign Currency Denominated Assets (FCDA), are reported in the Statement of Financial Position at amounts that approximate their fair values. The fair value of Investment Securities is based upon quoted market prices (See Note 5). FCDA, Other FCDAs, Special Drawing Right (SDR) Holdings, and SDR Allocations have been revalued in the Statement of Financial Position, using current exchange rates, to amounts which approximate fair value. The SDR Certificates issued to Federal Reserve Banks (FRB) are reflected on the Statement of Financial Position at their face value. It is not practicable to estimate the fair value of these Certificates issued to FRBs since these Certificates contain no specific terms of repayment.

Note 1. Summary of Significant Accounting Policies (Continued)

ESF enters into guarantee agreements which represent commitments by Treasury with lenders and/or investors that provide for repayment of all or part of the principal and/or interest on certain debt obligations of a borrower and /or issuer. The ESF is exposed to credit risk on guarantees in the event that it has to honor a guarantee and is unable to recover from the borrower the amounts advanced under the guarantee. It is not practicable to estimate the fair value of these guarantee agreements because no similar agreements that have comparable credit risk could be readily identified. Therefore, excessive costs would be incurred to estimate the fair value of these guarantee agreements.

C. Translation of Foreign Currency Denominated Assets and Liabilities

In accordance with Statement of Financial Accounting Standards (SFAS) No. 52, "Foreign Currency Translation", FCDA and liabilities are revalued daily to reflect current exchange rates in effect as of the reporting date. The gains or losses resulting from changes in exchange rates are reported separately in the Statement of Income and Retained Earnings.

D. U.S. Government Securities

ESF invests dollars in excess of its immediate needs in overnight, non-marketable U.S. Government securities issued by the Treasury. The interest rate paid on the investments is the overnight repurchase agreement rate as established by the Bureau of Public Debt.

Note 2. Cash and Cash Equivalents

Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash, and so near their maturity that they present insignificant risk of change in value due to changes in interest rates. Generally, only investments with original maturities of three months or less qualify under that definition. U.S. Government securities and FCDAs with original maturities of three months or less, except for foreign currencies acquired under swap agreements with developing countries, are treated as cash equivalents.

The ESF invests a portion of its European Euro holdings through repurchase agreements in securities issued by, and backed by the full faith and credit of the Federal Republic of Germany. As of September 30, 2004 and September 30, 2003 the amounts of repurchase agreements were approximately $1.9 billion. These repurchase agreements are considered to be FCDAs with original maturities of three months or less, which are treated as cash equivalents, as discussed above. Such investments are made by the Federal Reserve Bank of New York (FRBNY), as fiscal agent of the Treasury, in connection with the ESF's participation in such repurchase agreements. In this capacity, FRBNY enters into agreements under which German government securities are purchased from, and subsequently resold to, private counterparties. Such transactions are settled through a tri-party agent, Deutsche Bank. The securities are held by Deutsche Bank for FRBNY pending resale and are not transferred back to a private counterparty upon resale until cash has been received. The FRBNY instructs the tri-party agent on matters related to these investments.

Note 2. Cash and Cash Equivalents (Continued)

The amounts held as of September 30, 2004 and September 30, 2003 were as follows:

As of September 30 (In Thousands)	**2004**	**2003**
Cash and Cash Equivalents:		
U. S. Government Securities	$10,318,702	$10,502,415
FCDAs:		
European Euro	3,865,689	4,638,633
Japanese Yen	1,434,437	1,417,687
Total FCDAs	5,300,126	6,056,320
Total Cash and Cash Equivalents	$15,618,828	$16,558,735

Note 3. Other FCDAs

Operations of the ESF result in the holding of various foreign currencies. The ESF normally invests its foreign currency holdings in interest bearing assets issued by or held through foreign governments or monetary authorities. Other FCDAs are assets with maturities greater than three months, and include foreign currencies acquired under swap agreements with various countries (See Note 7).

As of September 30 (In Thousands)	**2004**	**2003**
Other FCDAs:		
European Euro	$ 3,583,758	$ 3,543,260
Total Other FCDAs	$ 3,583,758	$ 3,543,260

Note 4. Special Drawing Rights (SDR)

The SDR is an international reserve asset created by the IMF. It was created as a supplement to existing reserve assets, and on several occasions SDRs have been allocated by the IMF to members participating in the IMF's SDR department. Its value as a reserve asset derives, essentially, from the commitments of participants to hold and accept SDRs and to honor various obligations connected with its proper functioning as a reserve asset.

Note 4. Special Drawing Rights (SDR) (Continued)

Pursuant to the Special Drawing Act of 1968, as amended, SDRs allocated to or otherwise acquired by the United States are resources of ESF. SDRs, once allocated, are permanent resources unless:

a. they are canceled by an 85 percent majority decision of the total voting power of the Board of Governor's;

b. the SDR Department of the IMF is liquidated;

c. the IMF is liquidated; or

d. the United States chooses to withdraw from the IMF or terminate its participation in the SDR Department.

Except for the payment of interest and charges on SDR allocations to the United States, the payment of the ESF's liability related to the SDR allocations is conditional on events listed above, in which the United States has a substantial or controlling voice. Allocations of SDRs were made on January 1, 1970, 1971, 1972, 1979, 1980 and 1981. Since 1981, the IMF has made no further allocations of SDRs. As of September 30, 2004 and September 30, 2003, the amount of SDR allocations was the equivalent of $7.2 billion and $7 billion, respectively.

On a daily basis, the IMF calculates the value of the SDR using the market value, in terms of the U.S. dollar, of each of the four freely usable weighted currencies, as defined by the IMF. These currencies are the U.S. dollar, the European Euro (components consist of the French and German weights), the Japanese yen, and the pound sterling. The ESF's SDR holdings and allocations are revalued monthly based on the SDR valuation rate calculated by the IMF, and an unrealized gain or loss on revaluation is recognized.

During Fiscal Years (FY) 2004 and 2003, the ESF purchased, at the prevailing rates, $300 million and $348.1 million, respectively, equivalent of SDRs received from the IMF by the General Fund of the U.S. Government as remuneration (interest) on the U.S. reserve position in the IMF, and paid the General Fund $.4 million and $.6 million in fiscal years 2004 and 2003, respectively, in interest on dollars due the General Fund in return for SDRs received as remuneration. ESF did not sell or purchase SDRs from participating members during FY 2004, but sold SDRs to Argentina in FY 2003 in the amount of $1 billion.

Note 4. Special Drawing Rights (SDR) (Continued)

The following charts reflect the actual activity (i.e. amounts paid and received) related to SDRs during fiscal years 2004 and 2003.

As of September 30, 2004 (In Thousands)	**SDR**	**Dollar Equivalent**
Special Drawing Rights:		
Beginning Balance	8,436,531	$12,062,467
Interest Received on Holdings	138,902	202,232
Interest Paid on Allocations	(79,689)	(116,016)
Remunerations	205,782	299,532
IMF Annual Assessment	(320)	(475)
Net Gain on Valuation of Holdings	-	334,244
Ending Balance	8,701,206	$12,781,984

As of September 30, 2003 (In Thousands)	**SDR**	**Dollar Equivalent**
Special Drawing Rights:		
Beginning Balance	8,852,873	$11,709,606
Interest Received on Holdings	162,460	221,699
Interest Paid on Allocations	(92,393)	(126,139)
Remunerations	254,846	348,069
IMF Annual Assessment	(270)	(369)
Sales	(740,985)	(1,010,008)
Net Gain on Valuation of Holdings	-	919,609
Ending Balance	8,436,531	$12,062,467

Note 5. Investments and Related Interest

In accordance with SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities", securities that the ESF has both the positive intent and ability to hold to maturity are classified as investment securities held to maturity and carried at historical cost, adjusted for amortization of premiums and accretion of discounts. Interest on investment securities, amortization of premiums, and accretion of discounts are reported in interest on investment securities.

The following schedule shows investment securities at their amortized cost and by year of maturity as of September 30, 2004 and September 30, 2003. There are no securities maturing after ten years.

Note 5. Investments and Related Interest (Continued)

As of September 30 (In Thousands)	**2004**	**2003**
Securities, Held to Maturity:		
All Securities (at Amortized Cost)		
German Bonds	$ 1,712,442	$ 1,116,848
German Bubills	-	286,800
French Bonds	1,148,360	320,270
French Notes	639,470	170,142
Japanese T – Bills	3,674,860	3,634,258
Japanese Financing Bills	3,461,847	3,423,594
Total Amortized Cost	$ 10,636,979	$ 8,951,912
Maturing Within 1 Year		
Fair Value:		
German Bonds	$ 456,630	$ 196,458
German Bubills	-	286,813
French Bonds	132,045	84,898
French Notes	93,452	39,150
Japanese T-Bills	3,674,935	3,634,139
Japanese Financing Bills	3,461,862	3,423,630
Total Fair Value	$ 7,818,924	$ 7,665,088
Amortized Cost:		
German Bonds	$ 439,286	$ 189,833
German Bubills	-	286,800
French Bonds	125,286	81,616
French Notes	91,544	37,843
Japanese T – Bills	3,674,860	3,634,258
Japanese Financing Bills	3,461,847	3,423,594
Total Amortized Cost	$ 7,792,823	$ 7,653,944

Note 5. Investments and Related Interest (Continued)

Gross Unrealized Holdings Gain:

German Bonds	$ 17,344	$ 6,625
German Bubills	-	13
French Bonds	6,759	3,282
French Notes	1,908	1,307
Japanese T-Bills	75	(119)
Japanese Financing Bills	15	36
Total Gross Unrealized Holdings Gain	$ 26,101	$ 11,144

Maturing after 1 Year through 5 Years (German and French Bonds/Notes)

Fair Value:

German Bonds	$ 1,168,573	$ 832,458
French Bonds	1,075,760	254,297
French Notes	560,932	141,412
Total Fair Value	$ 2,805,265	$ 1,228,167

Amortized Cost:

German Bonds	$ 1,109,091	$ 773,061
French Bonds	1,023,074	238,654
French Notes	547,926	132,299
Total Amortized Cost	$ 2,680,091	$ 1,144,014

Gross Unrealized Holdings Gain:

German Bonds	$ 59,482	$ 59,397
French Bonds	52,686	15,643
French Notes	13,006	9,113
Total Gross Unrealized Holdings Gain	$ 125,174	$ 84,153

(Maturing after 5 Years through 10 Years (German Bonds only)

Total Fair Value	$ 182,880	$ 172,790
Total Amortized Cost	$ 164,065	$ 153,954
Total Gross Unrealized Holdings Gain	$ 18,815	$ 18,836

Note 6. Certificates Issued to Federal Reserve Banks

The Special Drawing Rights Act of 1968 authorized the Secretary of the Treasury to issue certificates, not to exceed the value of SDR holdings, to the Federal Reserve Bank in return for interest free dollar amounts equal to the face value of certificates issued (SDR monetization). The certificates may be issued for the purpose of financing the acquisition of SDRs from other countries or to provide resources for financing other ESF operations. Certificates issued are to be redeemed by ESF at such times and in such amounts as the Secretary of the Treasury may determine (SDR demonetization).

As of September 30, 2004 and September 30, 2003 the amounts of SDR certificates outstanding were $2.2 billion, while the value of SDR holdings was $12.8 billion and $12.1 billion, respectively, for a difference of $10.6 billion and $9.9 billion, respectively. During Fiscal Years 2004 and 2003, ESF transacted no monetizations or demonetizations.

Note 7. Foreign Currency Agreements and Guarantees

Foreign Currency Agreements represent swap agreements between Treasury and various countries that provide for drawings of dollars by those countries and/or drawings of foreign currencies by Treasury. Treasury enters into these agreements through the ESF. Any balances ESF may hold under such agreements are held for other than trading purposes and are reflected as Other Foreign Currency Denominated Assets in the Statement of Financial Position (See Note 3). ESF is exposed to credit risk on foreign currency agreements in the event of default by counterparties to the extent of any amounts that have been recorded in the Statement of Financial Position. Market risk occurs as a result of fluctuations in currency exchange rates. ESF is not exposed to market risk on foreign currency agreements that could occur as a result of fluctuations in currency exchange rates. Under these agreements, ESF will receive an agreed upon amount in dollars upon maturity regardless of currency fluctuations.

ESF enters into guarantee agreements which represent commitments by Treasury with lenders and/or investors that provide for repayment of all or part of the principal and/or interest on certain debt obligations of a borrower and/or issuer. ESF is exposed to credit risk on guarantees in the event it has to honor a guarantee and is unable to recover from the borrower amounts advanced under the guarantee.

ESF's foreign currency agreements and guarantees consisted of the following at September 30, 2004 and September 30, 2003:

In April 1994, Treasury signed the North American Framework Agreement, which includes an Exchange Stabilization Agreement (ESA), with Mexico. The ESA provides for a $3 billion standing swap line. The amounts and terms (including the assured source of repayment) of any new borrowings under the North American Framework Agreement would need to be negotiated. There were no drawings outstanding on these agreements as of September 30, 2004 and 2003. In December 2003, Treasury and FRB extended this agreement to December 2004.