Financial Accounting Foundation

2002 Annual Report

Financial Accounting Standards Board

Governmental Accounting Standards Board

Fulfilling Our Critical Mission

Contents

Financial Accounting Foundation

The Financial Accounting Foundation, organized in 1972, is an independent, private-sector organization whose Trustees are responsible for overseeing, appointing and funding members of the Financial Accounting Standards Board, the Governmental Accounting Standards Board and their Advisory Councils.

Financial Accounting Standards Board

The Financial Accounting Standards Board, which began operations in 1973, establishes standards of financial accounting and reporting for private-sector entities, including businesses and not-for-profit organizations. Those standards are officially regarded as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants.

Financial Accounting Standards Advisory Council

The Financial Accounting Standards Advisory Council consults with the FASB on technical issues, project priorities, selection of task forces and other matters likely to concern the FASB.

Governmental Accounting Standards Board

The Governmental Accounting Standards Board, organized in 1984, establishes standards of financial accounting and reporting for state and local governmental entities. GASB pronouncements are recognized as authoritative by the American Institute of Certified Public Accountants.

Governmental Accounting Standards Advisory Council

The Governmental Accounting Standards Advisory Council consults with the GASB about technical issues and other matters as may be requested by the GASB or its Chairman, including selection and organization of task forces.

2002: A Year of Change

The year 2002 represented a defining period in the history of financial reporting as a string of accounting scandals unfolded and investor confidence suffered significantly. Throughout that crisis, the Financial Accounting Standards Board and Governmental Accounting Standards Board stood ready to do their parts in helping to restore the public's faith in financial reporting and the vitality of our capital markets. The Financial Accounting Foundation is proud of its Standards Boards and their unrelenting commitment to providing the nation with high-quality accounting standards.

Financial Accounting Foundation

The Financial Accounting Foundation (FAF), organized in 1972, comprises 16 Trustees representing a broad range of professional backgrounds. Trustees share a common understanding of the importance of independent, private-sector accounting standard setting to the efficiency of the U.S. capital markets.

The FAF has responsibilities for the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB) and their Advisory Councils, including oversight of the standard-setting process, selection of members and funding.

Manuel H. Johnson, FAF Chairman

"In the wake of the widely reported corporate scandals of last year, the entire U.S. financial reporting system was put under the microscope of the nation's leaders."

Stephen C. Patrick

Unprecedented is perhaps the single best word to describe the sea change brought to financial reporting in 2002.

In the wake of the widely reported corporate scandals of last year, the entire U.S. financial reporting system was put under the microscope of the nation's leaders, including the President and Congress—as well as the public and media.

What resulted was not only landmark legislation as encompassed in the Sarbanes-Oxley Act, but a thorough and ongoing self-examination undertaken by all participants in the financial reporting system—from CEOs to auditors to regulators to accounting standard setters.

Through this cathartic process, an even stronger accounting standard-setting body has emerged—one that should be well-positioned and better prepared to serve investors with the most credible, clear and comparable information possible to help bolster a recovering U.S. economy.

With every challenge and threat that has arisen has come the opportunity for our Standards Boards to rise to the occasion of fulfilling their critical missions in assuring that the U.S. accounting system can maintain its preeminent position as the world's best. The pages that follow will speak to the progress made in 2002 by both Boards as they made positive contributions to maintaining hard-earned, standard-setting reputations.

Constructive Change: From Chaos to Reform

The public's interest in accounting issues soared in 2002 as newspaper headlines blared, almost daily, about corporate financial misdeeds. As a result, investor confidence suffered and cries for reform were raised in many circles. Throughout the events that eventually led to important federal legislation, the FAF—in conjunction with the FASB as well as the GASB—worked diligently and vigilantly to preserve and protect the independence of its Standards Boards, emphasizing the critical role that neutrality plays in standard setting.

While putting independence and neutrality front and center throughout our discussions, we contributed to overall improvements in the standard-setting process. Our Trustees committed considerable time and effort to improving the efficiency and responsiveness of the FASB. For example, the FAF initiated a change in the FASB's decision-making voting process from the previous super majority of 5-2 to a simple majority of 4-3. This was aimed at providing key decisions on a timelier basis by effectively speeding up the issuance of standards without compromising their quality.

To increase the independence and self-governance of the FAF Trustee appointment process, the FAF's certificate of incorporation and by-laws were changed to require that non-governmental Trustees nominated by constituent organizations be approved by the Board of Trustees. Under the previous process, those Trustees were approved by a majority of the heads of those constituent organizations.

Douglas R. Ellsworth

Samuel A. DiPiazza, Jr., and Richard D. Johnson

"The new law provides for a mandatory, as opposed to voluntary, funding approach affecting all public companies on a proportionately equal basis."

Charting a New Course On a related constructive front, the FAF asked the FASB Chairman to undertake an extensive review of the FASB's operations, process and people to determine where greater efficiencies might be gained. This covered a spectrum of technical activities the FASB has had in progress and includes the new course it is charting for accounting standards in this country. I am pleased to report, as can be noted elsewhere in this publication under the FASB Chairman's Q&A, that much of the work on that project is now complete. The FASB has embarked on a continuous improvement effort in its standard-setting work and is implementing changes, where appropriate, to enhance the overall effectiveness of the organization.

Sarbanes-Oxley Act The wide-ranging Sarbanes-Oxley Act was designed to curb many of the infamous financial misdeeds that have been uncovered and reported on extensively over the past year. With respect to this federal legislation's impact on our standard-setting bodies, an important provision was the creation of a Public Company Accounting Oversight Board (PCAOB) as well as future funding ramifications for the FASB.

As a result of the new law, there will be a major, yet acceptable, change in funding for the FASB. To allay any past public concern about the FASB's perceived independence as the nation's primary accounting standard-setting body, the new law provides for a mandatory, as opposed to voluntary, funding approach affecting all public companies on a proportionately equal basis. Under terms of the Act, all public companies will be assessed a fee based on their market capitalization. The Act continues the tradition of private-sector funding for the standard-setting body and states that the fees shall not be considered public monies of the United States.

It also should be noted that while Sarbanes-Oxley impacts the FASB by providing a more stable funding source, we look forward to working with the Securities and Exchange Commission (SEC) and PCAOB in restoring the country's reputation as a leader in financial reporting.

While the new law impacts the FASB's financial resources by providing a more stable source of funding, the GASB continues to need your voluntary contributions for its important mission. Funding for the GASB continues to be a challenge and is greatly exacerbated by the current fiscal difficulties faced by state and local governments.

Stronger Accounting for Off-Balance-Sheet Structures and Loans Given the auditing failures and eroded corporate ethics that were exhibited in such infamous cases as the collapse of Enron and WorldCom—and led to other corporate accounting abuses over the past year—the FASB worked harder than ever to fulfill its longstanding mission of creating high-quality accounting standards.

"In what was a major step toward reducing existing accounting differences between the FASB and the IASB, both Boards issued a memorandum of understanding."

William H. Hansell

Adherence to such standards is essential to a healthy capital market system.

Arguably the most pressing issue involved off-balance-sheet structures involving so-called special-purpose entities—now referred to as variable interest entities (VIEs). In December 2002, the FASB wrapped up its fast-track project on VIEs, focusing on the issue of consolidation and which party bore the greatest financial risk or reward and, therefore, the need to communicate this information to investors.

The FASB also completed a related project that will improve disclosure requirements for guarantees, including loan guarantees. Financial statements will now provide a truer picture of a company's financial position and the risk it has assumed.

International Our global capital markets rely on clear, complete and comparable financial reporting. In what was a major step toward reducing existing accounting differences between the FASB and the International Accounting Standards Board (IASB), both Boards issued a memorandum of understanding in October to formalize the commitment of both bodies to align their standards. Such a pioneering agreement should lead to adoption of compatible, high-quality solutions to current and future accounting issues.

Stock Options Debate In response to a call for improved accounting for stock options voiced by investors and analysts, in 2002, the FASB began to consider revisiting the work it did in the 1990s when it proposed that companies treat stock options as an expense against earnings. Those discussions culminated in a recent decision by the FASB to put a project on its agenda that would seek to improve the accounting for stock-based compensation. As part of that project, the Board also will probe ways in which expense measurement might be enhanced. Convergence will be an additional consideration. A decision that favors expensing would be consistent with what the IASB has recently proposed.

"Principles" versus "Rules" To address concerns about the complexity of accounting standards and ways in which some preparers have attempted to "game" rule-laden accounting guidance—which was seen with Enron and WorldCom, among others, the FASB undertook a study to review the implications of adopting a more principles- versus rules-based approach to standard setting. The Board is continuing its review of this matter with the SEC and constituents.

Implementation of GASB's Reporting Model
The year 2002 painted a bleak picture for state and local government budgets as the economy slowed. Cities, towns and states across the country paid a hefty price as tax bases shrunk and revenues

"We applaud the ongoing work of the GASB and its staff on the successful implementation of the new reporting model."

Judith H. O'Dell

dwindled. The need for good governmental reporting grew stronger as the financial health of state and local governments became an important public concern. Despite the more difficult operating climate, state and local governments forged on in their implementation of the GASB's landmark reporting model, Statement 34. Overall, reports have been very enthusiastic from preparers who have completed the process and comments received from the user community also have been positive.

We applaud the ongoing work of the GASB and its staff on the successful implementation of the new reporting model. Additional standards that build on Statement 34's framework, as well as current issues—such as other postemployment benefits—will produce greater transparency and more meaningful financial reporting for the thousands of state and local governments across the United States.

New Board Appointments Following our April 2002 announcement, Robert H. Herz became Chairman of the FASB, succeeding Edmund L. Jenkins, effective July 1, 2002. Prior to his post at the FASB, Bob was a Senior Partner with PricewaterhouseCoopers.

We warmly welcomed Bob, who has already accomplished much in his brief time with us, and thanked Ed for his outstanding accomplishments at the Board, while making steady progress in Washington regarding the importance of independence in standard setting. The Trustees now are preparing to appoint replacements for two FASB members. John M. "Neel" Foster and John K. Wulff will depart the FASB in June 2003. Neel will have completed his two terms of service and John has announced his resignation to return to private industry. We thank Neel and John for their hard work and dedicated service.

As noted in last year's annual report with regard to the GASB, James M. Williams, formerly a partner and the National Director of Public Sector Accounting and Assurance Services with Ernst & Young, LLP, succeeded Edward M. Klasny as a Board member, effective July 1, 2002. Jim's expertise in governmental accounting already has been of solid benefit to the GASB.

Trustees Effective January 2003, the Foundation welcomed three new Trustees who we are privileged to have join the organization. They are Robert E. Denham, Senior Partner, Munger, Tolles & Olson LLP; Barbara H. Franklin, President and CEO, Barbara Franklin Enterprises; and Eugene D. O'Kelly, Chairman and CEO, KPMG LLP.

“Stable funding sources for both Boards will help us meet our obligation to serve the capital markets with high-quality standards for financial reporting.”

Lee N. Price

The FAF would like to express its gratitude to those Trustees who completed service in 2002 for their hard work and dedication to the organization. They are: John J. Brennan, Chairman and CEO, The Vanguard Group, Inc.; Peter C. Goldmark, former Chairman and CEO, International Herald Tribune; David S. Ruder, William W. Gurley Memorial Professor of Law, Northwestern University School of Law; and Steve M. Samek, former Partner, Andersen.

Financial Results The Management Discussion and Analysis section of this annual report includes comments on overall financial results. It was not a good year financially, as net assets declined by about $10 million. Reduced contributions from the public accounting profession, lower publication revenues, reserve fund investment losses and the need to record an additional minimum pension liability were significant factors in this decline. In the context of these negative results, we monitored costs carefully. Total expenses increased 3.3% and our major cost component, salaries and wages, increased only 2.5%.

Implementation of the mandated funding provisions of the Sarbanes-Oxley Act will help the FASB continue to fulfill its mission, and the Trustees are developing programs to improve funding for the GASB. Stable funding sources for both Boards will help us meet our obligation to serve the capital markets with high-quality standards for financial reporting. The transition to mandated funding and the time needed to implement the new system have caused certain funding sources to decline and brought about the need to access reserve funds.

Focused on Our Mission During 2002, the FASB continued to tirelessly work to strengthen accounting standards. We remain hopeful that reform efforts aimed at improving the auditing of financial statements, as contained in the Sarbanes-Oxley legislation, will succeed.

For our part, despite the unprecedented set of challenges that faced the financial reporting system, the people who make up our Standards Boards enabled us to remain on the road to fulfilling our critical mission.

Such dedication and responsiveness is admirable and bodes well for investors. My sincere gratitude is extended to both Boards, their staffs and Advisory Councils, as well as those who contributed and continue to participate in this ongoing process.

Manuel H. Johnson
Chairman, FAF

Financial Accounting Standards Board

Established in 1973, the Financial Accounting Standards Board (FASB) is an independent, private-sector organization whose mission is to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the economy because investors, creditors and other consumers of financial reports rely heavily on transparent, credible and comparable financial information. The FASB's standards are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants.

Robert H. Herz, FASB Chairman

"We are approaching our tasks and responsibilities with a sense of urgency and a dedication and commitment to making sure that we are doing everything possible."

FASB Directors, Sue Bielstein, Larry Smith and Kim Petrone

How did the accounting debacles of 2002 impact confidence in financial reporting?

The events of the past year have shaken investor confidence in our reporting system and in our capital markets. While many, if not most, of the problems stem from outright violations of rules and fraud and apparent audit and corporate governance failures, the problems have prompted broader questions about our corporate reporting system, including accounting standards and accounting standard setting. I believe those questions are appropriate, healthy and were probably overdue.

Just like the air, reliable financial reporting is a public good, and we must be committed to keeping it clean. All of us who are players in the system must rededicate ourselves to that proposition. The investing public is demanding this, the capital markets expect it and our country deserves nothing less.

What is the FASB doing to fulfill its critical mission as the U.S. standard setter?

We are approaching our tasks and responsibilities with a sense of urgency and a dedication and commitment to making sure that we are doing everything possible to play our role in improving the financial reporting system. This is manifested both in our many technical activities and in charting a new course for U.S. accounting standards.

The FASB has a number of important projects under way that should improve financial reporting. They include the application of the purchase method of accounting, reporting on financial performance, improving disclosures relating to the fair value of financial instruments and developing new disclosures relating to intangibles. We also significantly modified our agenda and priorities in direct response to issues that have come to light in the recent financial reporting scandals, including accounting for variable interest entities (frequently referred to as SPEs), guarantees, equity derivatives and obligations settleable in shares and the critical and broad area of revenue recognition.

On the subject of accounting reform, how do you view the Sarbanes-Oxley legislation impacting the FASB?

Almost everyone agrees that the FASB should be independent so that it can continue to develop standards in an objective and unbiased way. While various groups view that independence differently, I believe that the Sarbanes-Oxley legislation strikes an appropriate balance. It provides for mandatory funding of the FASB, but the legislative history behind the Act clearly emphasizes that such funding is not intended to federalize the organization or put the Board in a position that would subject it to additional political pressures.

FASB staff meets to discuss process efficiency initiatives.

"We have added a major project on revenue recognition to our agenda. Our objective is to develop a coherent, conceptually consistent model."

FASB staff, Todd Johnson and Dan Slayton

Variable interest entities (VIEs), also known as SPEs, posed major accounting concerns in 2002. How is the FASB improving guidance for VIEs?

The Enron debacle put this issue in the spotlight and questioned the appropriateness of the so-called "three-percent rule" that had evolved in practice.

In January 2003, we issued a final pronouncement on consolidation covering what we have termed "variable interest entities" (VIEs). VIEs encompass a wide variety of structures and arrangements, ranging from those used and controlled by a single sponsor in order to obtain off-balance-sheet financing, to large multiparty vehicles created to pool assets and issue market-based securities to a variety of investors.

Developing a single, consistent model for when those entities should be consolidated by another party was challenging. Despite that challenge, I believe the Board developed a workable model under which companies with investments or other relationships with a VIE would carefully need to assess their involvement to determine whether they are the "primary beneficiary" of that VIE and, therefore, would consolidate it. Although judgment will be required, we expect that by using this model, many, but certainly not all, of the VIEs that previously were not consolidated by any party will be consolidated in the future. We also have improved disclosures related to the use of and involvement with VIEs.

Revenue recognition is another important topic. What is the FASB doing to address it?

This is an area of continuing financial reporting problems and regular SEC enforcement actions. The existing accounting guidance is found across a variety of sources from several different bodies: EITF, AcSEC, SEC and the FASB. That guidance has been developed in an ad hoc fashion over the last 40 years. It is no wonder that past practice has resulted in apparently inconsistent models for recognizing revenue. To try to remedy this problem, we have added a major project on revenue recognition to our agenda. Our objective is to develop a coherent, conceptually consistent model that would replace much of the existing literature and serve as a "principles-based" source for developing future accounting guidance as new types of transactions emerge in the marketplace. In the meantime, the EITF and our staff continue to provide regular guidance on applying the current rules.

"In March 2003, the FASB initiated a project that seeks to improve the accounting and disclosures relating to stock-based compensation."

FASB staff, John Richter and Jim Parrott

What progress was made in 2002 on convergence of international accounting standards?

The FASB made significant headway in 2002 in support of convergence of global accounting standards. In September 2002, the FASB and the International Accounting Standards Board (IASB) held a joint meeting in Norwalk to discuss opportunities that would narrow existing differences between U.S. accounting standards and those of the IASB. Those discussions resulted in adoption of a short-term, joint project on eliminating selected differences that is part of the much larger, long-range convergence effort. The FASB and IASB also are working together on purchase method procedures for business combinations, financial performance reporting and revenue recognition. We also have agreed to try to align our future agendas as far as possible.

Important developments took place on the controversial subject of stock options in 2002. How are they impacting the FASB?

There were two important developments in 2002. First, more than 190 companies volunteered to expense employee stock options using the preferable fair value method under Statement 123. These companies comprise approximately 30% of the market value of the S&P 500. To address transition concerns for those companies, the Board provided presentation alternatives and required that all companies provide clearer and more prominent disclosures and to do so not only in annual reports but also in quarterly financial statements.

On a related subject, the IASB addressed the issue of accounting for share-based payments. The IASB concluded that the appropriate accounting for stock options is to measure compensation for the fair value of the options at the grant date and recognize it over the vesting period. While there are some significant differences between the particular methodologies proposed by the IASB and those under Statement 123, the fundamental conclusions are very similar.

The IASB issued an Exposure Draft on this subject and the FASB published a companion document in November 2002 seeking the public's views on the differences between FAS 123 and what was proposed by the IASB. The FASB received some 300 comment letters on this document.

What are FASB's plans for 2003 regarding stock options accounting?

The FASB's responsibility to the public is to provide users of financial statements with sound information to make informed decisions. Having analyzed the comment letters on the November 2002 document and responding to numerous requests from investors, financial analysts and other users of financial information, in March 2003, the FASB initiated a project that seeks to improve the accounting and disclosures relating to stock-based compensation.

"We are focused on three strategic goals—improvement, simplification and international convergence."

Terri Polley, FASAC Executive Director

FASB staff, Ron Bossio, Ron Lott and Annette Such

Among other issues, the Board is addressing whether to require that the cost of employee stock options be treated as an expense with a view to issuing an Exposure Draft later this year. A final Statement could become effective in 2004. As part of the project, the Board also will examine whether there are ways to improve the precision and consistency of measuring employee stock options. While a number of major companies have voluntarily opted to reflect these costs as an expense in reporting their earnings, other companies continue to show these costs in the footnotes to their financial statements. The Board believes there is a need for one consistent approach to recognize the costs associated with employee stock options.

A final comment on this important and controversial topic: We recognize that there are strong, heartfelt views on both sides of the expensing question that go well beyond the accounting issues. But our mission and critical role is to establish standards that improve accounting and financial reporting and, to that end, we felt it important to revisit this subject.

What is the FASB's position on recent criticisms about pension accounting?

In response to concerns raised by investors and analysts, the Board decided to add a project to its agenda that would seek to improve disclosures relating to employer pension plans. As part of this project, the Board will address perceived deficiencies in current pension accounting by identifying ways to enhance disclosures about pension costs, plan assets, obligations and funding requirements.

The Board expects to publish an Exposure Draft on pension accounting in the latter half of 2003 with the goal of issuing an accounting standard in 2004. We also are closely monitoring the IASB's project on improving employee pension accounting.

What is the FASB doing to improve its standard-setting approach, internal processes and timeliness?

To improve all aspects of our approach and processes, we are focused on three strategic goals—improvement, simplification and international convergence. These are the imperatives driving our agenda and that will shape our future standards.

At the FAF's request, in July 2002, we launched a series of wide-ranging reviews covering our agenda-setting and project-management processes. As part of that review, we examined whether a more "principles-based" approach to standard setting would improve financial reporting, *"With the help of the FAF and its support of a new voting process, we are increasing the timeliness of our standard-setting process."*

FASB Board members (from l to r) John "Neel" Foster, Edward Trott, Gary Schieneman, G. Michael Crooch, Robert Herz, Katherine Schipper and John Wulff

FASB staff, Patrick Durbin and Linda MacDonald

identified opportunities to increase international convergence, sought ways to increase investor and analyst input and addressed other internal organizational issues relating to staffing assignments, internal processes and constituent relations.

We made important progress on improving the timeliness and efficiency of our organization. With the help of the FAF and its support of a new voting process, we are increasing the timeliness of our standard-setting process. We also implemented a reorganization of our senior staff to enhance the FASB's focus and accountability. This involved reallocating the responsibilities of one director who headed research and technical activities into three different roles. One director focuses on major Board projects, another heads EITF and other implementation activities and a third oversees internal processes, staffing assignments and special projects. Lastly, Board meetings have been lengthened to cover more subject matter and speed progress.

What is the Board's position on "principles" versus "rules-based" accounting standards?

The FASB's standards are both principles- and rules-based. The complexity and length of standards often reflected the complexity of the transactions that have emerged in the marketplace and demands for detailed guidance and exceptions for particular circumstances. While the FASB has been reviewing the principles versus rules debate—most recently in connection with the Board's 2002 proposal on this subject—many of us believe that by eliminating or reducing the number of exceptions, standards can be structured around more clearly articulated objectives. However, reliance on such an approach would, amongst other things, require that companies and auditors exercise sound and honest judgment in preparing and auditing financial statements that adhere to the spirit of standards. The FASB will further examine this issue in 2003, along with the SEC, which under the Sarbanes-Oxley Act, must provide Congress with a report on this important subject.

Will you use constituent groups in a different manner in the future?

The Board receives significant and valuable input from various constituents and maintains productive relationships with numerous liaison groups. In an effort to encourage more active user involvement from members of the analyst and investor communities, the Board recently established a User Advisory Council that is made up of approximately 35 members who are investment and credit decision-makers.

FASAC

Richard J. Swift, FASAC Chairman

"The FASAC directed much attention to evaluating how FASAC works and how members can better assist the FASB."

The events of 2002 held immense significance for the accounting, auditing, investing and standard-setting professions. The collapse of Enron, WorldCom and others called into question the integrity of the auditing process and usefulness of accounting standards themselves.

The resulting political discourse led to the historic Sarbanes-Oxley Act of 2002 and creation of the Public Company Accounting Oversight Board (PCAOB) to regulate the accounting profession. Controversies led to changes in the leadership of the Securities and Exchange Commission and the new PCAOB itself.

In this atmosphere, the FASAC welcomed 11 new members, including the Chairman, in 2002. The FASAC's principal responsibility is to advise the FASB on matters of policy, procedure and agenda items, as requested by the Board. The FASB, under the leadership of its new Chairman, Robert Herz, initiated a wide-ranging study to assess the quality of its standards and the processes it uses to establish them. In addition, the FAF made changes to the governance of the FASB to streamline the process of standard setting.

As a result, FASAC directed much attention to evaluating how FASAC works and how members can better assist the FASB. FASAC members counseled the FASB on its initiatives concerning the Board's organization, procedures and on the proposed policy changes put forth by the FAF.

FASAC adjusted its membership slightly to increase input from users of financial information. FASAC is unique among the organizations that meet with the FASB in that membership is not limited to one industry or point of view. Members of FASAC include practitioners, preparers, users, academics and regulators. These differing points of view in one organization provide for balanced advice.

Despite many policy issues that required attention, FASAC also provided input on the FASB's technical projects, including:

- *Revenue recognition;*
- *Consolidation of variable interest entities;*
- *Financial performance reporting by business enterprises;*
- *Guarantor's accounting and disclosure requirements for guarantees;*
- *Obligations associated with disposal activities; and*
- *Statement 123 transition disclosures about the fair value of financial instruments.*

The Council also discussed the Board's ongoing efforts to codify and simplify the accounting literature, including its proposal on principles-based accounting standards. And, FASAC discussed emerging pension accounting issues prior to the Board's decision to add a project on pensions to its agenda.

In 2003, FASAC will continue to work with the FASB on its aggressive agenda. Our annual survey will assist the Board in establishing priorities in the year ahead. Although FASAC lost the counsel of seven experienced, dedicated members, we welcome our new members, who will provide unique, fresh viewpoints on the standard-setting process.

Richard J. Swift

Richard J. Swift
Chairman, FASAC

Governmental Accounting Standards Board

The Governmental Accounting Standards Board (GASB) was organized in 1984 by the Financial Accounting Foundation to establish standards of financial accounting and reporting for state and local governmental entities. Its standards guide the preparation of external financial reports of those entities. The GASB's function is important because external financial reporting can demonstrate financial accountability to the public and is the basis for investment, credit and many legislative and regulatory decisions. The GASB's authority for its standards has been recognized under Rules of Conduct of the American Institute of Certified Public Accountants. Also, legislation in many states requires compliance with GASB standards.

Tom L. Allen, GASB Chairman

GASB staff, Karl Johnson and Terry Patton

"High-quality financial reporting is of paramount public concern and that concern extends to state and local governments."

Michelle Czerkawski

We hear a lot about the need for corporate accountability. Why does good governmental reporting matter?

Now more than ever, high-quality financial reporting is of paramount public concern and that concern extends to state and local governments as well as to publicly traded companies. While 2002 did not bring a corporate-style crisis in confidence in the financial reports issued by state and local governments, governments have not been immune to reporting problems in the past. The current budgetary crisis many governments are facing increases the need for transparent and complete financial reporting for governments.

While there are some 13,000 public companies in the U.S., the number of state and local governments are more than six times that amount, totaling over 87,000. In addition to 50 state governments, there are tens of thousands of cities, counties, school districts and other types of local governments. These other types of governments include many special-purpose districts and public authorities that are created by states and localities to support housing, utilities, airports and hospitals.

Given the public's concern for transparent and credible accounting, what has GASB done to improve governmental financial reporting?

One of the reasons for improving financial reporting for governments is to give financial statement users information that not only tracks past financial performance, but also helps them project the financial condition of a government into the future. Improved disclosures are very helpful in that regard and Statement 38, which requires improved note disclosures for short- and long-term debt and other areas of interest to users, became effective in 2002 for the largest governmental entities. The Statement will be effective for medium and smaller governments in the next two years. Also, Statement 39 was issued in 2002 providing guidance on the reporting of legally separate organizations, such as university foundations, that raise or hold resources for governmental entities. In addition, Statement 40, which will require improved deposit and investment risk disclosures, was issued early in 2003.

The GASB also has several projects on its current agenda that will build upon the improved financial reporting resulting from the new reporting model's implementation. The completion of these projects, particularly the other postemployment benefits (OPEB) and economic condition projects, also will enhance the ability of financial statement users to assess the current and future economic condition of governments.

"The OPEB project has been one of the most important and challenging projects for the Board."

GASB staff, Dean Mead, David Bean and Ellen Falk

GASB just issued two Exposure Drafts on other postemployment benefits (OPEB). How will proposed standards impact governments, and why did the OPEB project take so long?

The OPEB project has been one of the most important and challenging projects for the Board. While we have worked on this project for a long time, it was set aside for several years to allow the Board and staff sufficient time to address the many issues associated with the new reporting model. In addition, the issuance of the OPEB Exposure Drafts that were planned for mid-2002 were delayed six months to allow field-testing on the small plan provision.

These Exposure Drafts, one for employers offering OPEB benefits and one for OPEB plans, propose reporting for these healthcare and other postemployment benefits in a manner similar to how governments are currently required to report pension benefits. Employers would accrue the cost of providing these benefits in a systematic manner over periods approximating the service lives of employees. These proposed standards also call for disclosures and required trend information that would reflect the funding status and progress made by governments to accumulate resources to pay these benefits as they come due.

Two planned OPEB public hearings as well as a user forum to discuss the two Exposure Drafts and a plain-language supplement for financial statement users will be important meetings for the Board in 2003. These meetings, along with the redeliberation of issues raised during due process feedback, will again demand much of the Board's attention in 2003.

How has the GASB taken into consideration the costs associated with implementing OPEB?

The GASB is particularly sensitive to the potential cost increase for governments complying with this proposed standard and made two modifications that could reduce the cost. The first allows governments with implicit rate subsidies to retirees not to account for these subsidies as OPEB, if the employer does not otherwise contribute toward the cost of these OPEB benefits. While this may not appear to affect government healthcare costs, retiree participation in healthcare plans normally increases the costs the government must pay for current active workers.

The second modification allows plans with fewer than 100 employees to apply certain simplifying changes regarding the selection of assumptions such that these calculations may be made by the government's own employees or other advisors in a more cost-effective manner than a full actuarial study. In addition, the Board has extended the maximum period between actuarial valuation from two to three years for many governments.

"Fiscal and calendar years ending in 2002 represented the initial required reporting years for the more than 1,500 state and local governments to comply with Statement 34."

GASB staff meets on technical agenda.

How far along is the new reporting model's implementation?

Fiscal and calendar years ending in 2002 represented the initial required reporting years for the more than 1,500 state and local governments with revenues over $100 million to comply with Statement 34, the new reporting model for governments. In addition, many governments early-implemented Statement 34 in 2002. As of January, the GASB was aware of 421 state and local governments that had implemented Statement 34 early. The mix of early implementation reports includes states (2), cities and towns (130), counties (32), colleges and universities (34), school districts (71) and many other types of special-purpose districts. Early implementers were located in 42 different states and included very small as well as very large entities. As GASB Chairman, I sent a letter of recognition and a special certificate to all governments that we know have implemented Statement 34 early.

Responses received from those who have implemented early generally have been very positive and have included favorable comments from city and county managers, governing board members and others interested in a government's finances.

Of course, the implementation efforts have required a lot of extra work and sometimes expense when consultants or others have been brought in to do the implementation work. Fortunately, this additional effort relates primarily to the initial implementation year, with little or no anticipated ongoing effort or cost. The GASB's outreach to assist financial statement users in understanding and using the new information contained in Statement 34 financial statements continues through training, the GASB's website and the user guides.

What are the key projects on which the GASB will focus in 2003?

As previously mentioned, one of the projects requiring the most Board and staff focus in 2003 will be the OPEB project. Two OPEB standards, one dealing with employers and another addressing plans, are expected to be issued by year-end. Other projects to be completed in 2003 include the issuance of a standard on deposit and investment risk disclosures during the first quarter of 2003. A standard on capital asset impairment is scheduled to be completed after the Board considers due process feedback from a currently issued Exposure Draft. In addition, a narrowly scoped project on budgetary reporting, begun late in 2002, will be completed during the second quarter of 2003. The GASB also is in the process of updating and reissuing all of its implementation guides.

Two key projects that will be the focus of the Board during 2003, but that will not result in Exposure Drafts until 2004, are the pollution remediation obligations and the derivatives and hedging

"GASB currently requires certain derivative disclosures but also plans to issue a Technical Bulletin in mid-2003 to require additional disclosures on the fair value of derivatives."

GASB staff, Ken Schermann and Jay Fountain

Roberta Reese

projects. Both of these projects are technically challenging projects that will require extensive Board and staff deliberation.

Also, the Board has a multiple-phase economic condition reporting project on its agenda. An Exposure Draft dealing with the long-term trend and other statistical information currently included along with the basic financial statements of many governments will be issued in mid-2003. Overall, we have a very aggressive GASB agenda for 2003.

With governments currently increasing their use of derivatives, what is the GASB doing to help disclose those risks?

GASB currently requires certain derivative disclosures but also plans to issue a Technical Bulletin in mid-2003 to require additional disclosures on the fair value of derivatives that are not reported in the statement of net assets. This Technical Bulletin will provide important additional disclosures about the risks assumed until the more comprehensive derivatives project is completed.

The GASB's original Concepts Statements identified performance information as one of the financial reporting objectives for governments. What is the status of the GASB's service efforts and accomplishments project?

The GASB continues its staff research efforts with the help of the Sloan Foundation grant even though the project is not on the Board's agenda as a current technical project. In its first two Concepts Statements, the GASB recognized the value to financial statement users of performance-based information. It also recognized that such information, particularly nonfinancial information, does not readily lend itself to financial reporting standards. Therefore, the GASB encouraged and continues to encourage experimentation in this area.

After two years of research, a staff research report on the results of citizen focus group reactions to performance measurement was issued in July 2002. Work continues on the preparation of a special report identifying suggested criteria for use by governments in developing a report on performance information. This special report, to be issued early in 2003, will provide a basis for further experimentation by state and local governments with performance reporting. As part of the Sloan Foundation grant, the GASB staff will monitor and assist in this experimentation. The staff will then evaluate the effectiveness and usefulness of this experimental performance-based external reporting and anticipates presenting its findings to the Board in 2005 for future agenda consideration.

GASB Board members (from l to r) Cynthia Green, Paul Reilly, Tom Allen, Richard Tracy, William Holder, James Williams and Edward Mazur

"The biggest challenge facing the GASB is one of ensuring a stable funding base to provide adequate resources to enable the continued effective operations of the Board."

What additional technical projects might the GASB tackle in your last year-and-a-half as Chairman?

Looking ahead to what is likely to come onto the technical agenda, there are two conceptual framework projects regarding communications methods and elements of financial reporting on which I hope we can make progress. Both projects have been on the Board's technical agenda at different times in recent years and both were pulled as multiple technical issues in other areas required the Board's more immediate attention. However, Concepts Statements play an important role in guiding Board deliberations and in informing and educating constituents, and both of these projects should be completed by the Board over the next couple of years. Unfortunately, both are very challenging projects and will not likely be completed during my term on the Board.

The next projects anticipated to be added to the agenda are fund balances/net assets classifications and intangible assets. It is my hope that the Board will be able to make good progress on these projects over the next year-and-a-half, as we are able to work them into the active technical agenda. In addition, an implementation guide for OPEB will require staff and Board attention as soon as final standards are issued on this project.

How is the Sarbanes-Oxley Act affecting the GASB?

There is no direct impact on the GASB's operations as a result of the passage of the Sarbanes-Oxley Act. However, unfortunate fallout from the legislation is an anticipated decline in the voluntary contributions to the GASB's operations from companies. This has come at a time when financial support from other contributors also has declined. Therefore, the biggest challenge facing the GASB is one of ensuring a stable funding base to provide adequate resources to enable the continued effective operations of the Board. A number of initiatives are under way by the FAF Trustees to address this fiscal challenge.

GASAC

"While providing valuable input to the GASB, FAF and various constituent groups, Council members made contributions on many fronts."

Harvey C. Eckert, GASAC Chairman

The string of accounting scandals taking place in 2002 served as a wake-up call for all participants in the financial reporting system—including state and local governments. Throughout the year, the GASAC supported the work of the GASB in promoting excellence in governmental accounting. Sound financial reporting plays a critical role in fulfilling a government's duty to be publicly accountable to those who make economic, social and political decisions.

In 2002, the GASAC conducted three meetings with its newly adopted one-and-a-half day format. Implementation of the new format was successfully accomplished and received enthusiastic support.

While providing valuable input to the GASB, FAF and various constituent groups, Council members made contributions on many fronts. Among those contributions was guidance for the GASAC's Communications/Public Relations Committee, which produced plain-language articles on key accounting subjects. The Executive Committee provided timely input that was utilized by several GASB task forces. Finally, the GASAC provided assistance to the FAF on potential contacts for fundraising efforts.

We tapped into the collective knowledge and experience of the Council at its first gathering of the year held in New York City. Seven new members were welcomed to the GASAC, and we heard from a variety of organizations through the Council's broad membership. Participants were then asked to provide assistance on the GASB's agenda-setting process through a prioritization exercise that covered a list of 25 potential agenda topics.

Separate meetings of the GASAC's three committees also were conducted as part of the overall session and contributed to the full Council's discussions.

A second GASAC meeting was held in Norwalk. The Council continued to participate in agenda prioritization exercises, and GASAC members completed a review of potential agenda topics and ranked those topics across three broad categories based on their importance.

Among subjects in the GASB's current project category were other postemployment benefits, note disclosure-deposit and investment risks and updates to Statement 34 implementation guides. A second set of topics covered long-term projects and included fiduciary responsibilities and presentation of fund balances. A third group of issues calling for future research efforts covered the conceptual framework, intangible assets and service efforts and accomplishments, among others.

The Council's hard work and commitment culminated in a joint meeting with the Association of School Business Officials (ASBO) held in Phoenix, Arizona. GASAC input was received on current agenda projects with discussion focused on the economic condition reporting and financial instruments projects.

The GASAC's meeting schedule for 2003 has been set and involves a March session in Norwalk, an August joint meeting with the National Association of State Auditors, Comptrollers and Treasurers (NASACT) to be convened in Harrisburg, Pennsylvania and a November gathering in New York City.

Our sincere appreciation for the GASAC's dedicated service goes out to all members, including departing members, for their valuable and timely advice to the GASB.

Harvey C. Eckert
Chairman, GASAC

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About FASB Members

Members of the Financial Accounting Standards Board serve full time and are required to sever all ties with the institutions they previously served.

Mr. Herz was Senior Partner with PricewaterhouseCoopers and its North America Theater Leader of Professional, Technical, Risk & Quality; *Mr. Crooch* was Partner and Director of the International Professional Standards Group at Arthur Andersen, LLP; *Mr. Foster* was Vice President and Treasurer of Compaq Computer Corporation; *Mr. Schieneman* was Director, Comparative Global Equity Analysis of Merrill Lynch & Co.; *Ms. Schipper* was L. Palmer Fox Professor of Business Administration at Duke University's School of Business; *Mr. Trott* was Head of the Accounting Group of KPMG's Department of Professional Practice; and *Mr. Wulff* was Chief Financial Officer of Union Carbide Corporation. Mr. Wulff will resign from the FASB to return to private industry, effective June 30, 2003.

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About GASB Members

Mr. Allen serves the GASB full time. All other members serve part time.

Prior to joining the GASB, *Mr. Allen* was the State Auditor of Utah; *Ms. Green* was the Vice President for State Studies of New York's Citizens Budget Commission; *Mr. Holder* is the Ernst & Young Professor of Accounting at the University of Southern California; *Mr. Mazur* is the Vice President for Administration and Finance of Virginia State University; *Mr. Reilly* is the retired Finance Director and Comptroller of the City of Madison, Wisconsin; *Mr. Tracy* is the Director of Audits for the City of Portland, Oregon; and *Mr. Williams* is a retired Partner and the former National Director of Public Sector Accounting and Assurance Services with Ernst & Young, LLP.

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2002 Documents

Financial Accounting Standards Board

Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*

Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*

Statement No. 147, *Acquisitions of Certain Financial Institutions*

Statement No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*

Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

Exposure Draft, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123,* Accounting for Stock-Based Compensation, *and Its Related Interpretations, and IASB Proposed IFRS,* Share-based Payment

Proposal, *Principles-Based Approach to U.S. Standard Setting*

Governmental Accounting Standards Board

Statement No. 39, *Determining Whether Certain Organizations Are Component Units*

Exposure Draft, *Deposit and Investment Risk Disclosures*

Exposure Draft, *Budgetary Comparison Schedules—Perspective Differences*

Exposure Draft, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*

Research Report, *Report on the GASB Citizen Discussion Groups on Performance Reporting*

Financial Information

Financial Contents

Management's Discussion and Analysis

Presentation

The Foundation's financial statements are presented in accordance with FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations.* The Statements of Activities segregate program expenses of the Standards Boards from support expenses of the Foundation. Program expenses include salaries, benefits and other operating expenses for the members and research and technical staffs of the Boards, and expenses for the production, marketing, publication distribution and library departments of the Foundation. Support expenses include costs for the finance, human resources, facilities management, information systems, public relations, development and general administration areas of the Foundation. The presentation is consistent with the single program notion of the Foundation, which is to establish and improve standards of financial accounting and reporting for private sector and state and local governmental entities.

Overall Financial Results

The year 2002 produced the Foundation's sixth consecutive annual operating deficit, and investment losses in each of the last three years have added to these deficits.

For 2002, the Foundation reported a decrease in unrestricted net assets of $10,099,000, which includes a $3,026,000 non-cash charge against otherwise unrestricted net assets to reflect the required additional minimum pension liability under its Employees' Pension plan. An increase in the accumulated benefit obligation under this plan for 2002, coupled with a decrease in the fair value of the plan's assets over the same time period, resulted in the required minimum pension liability charge. The total net asset decrease also reflects the operating deficit for the year of $4,322,000, and net investment losses of $2,751,000. Impacted by continued deteriorating financial market results and working capital requirements, reserve fund investment losses totaled $2,787,000 in 2002, compared to $1,375,000 for 2001. Investment income from cash equivalents and short-term investments totaled $36,000 in 2002, substantially lower than 2001's income of $124,000 due to significantly lower yields and a much lower level of funds available for investment.

Total net operating revenues decreased 11.1% for the year, due to a reduced level of contribution support on behalf of both Boards by the public accounting profession, and lower subscription and publication revenues for the FASB. Total expenses for the organization grew by 3.3% in 2002.

Salaries and benefits continue to comprise a substantial portion of total expenses, over 75% for each of the last three years. Total salaries increased by $377,000, or 2.5%, in 2002, reflecting merit increases for employees and temporary Board member vacancies for the FASB, which existed, and were filled, in 2001. These events were offset by lower salaries for the FASB research staff, driven by lower technical headcount during a portion of 2002, including practice fellow positions. Employee benefit costs increased by $399,000, or 14.8%, due primarily to actuarially determined pension expense under the Foundation's Employees' Pension Plan impacting comparative operating results by $349,000 for 2002. That plan had similarly determined pension income in 2001.

Total occupancy and equipment expenses in 2002 were $63,000, or 3.5%, higher than 2001. Depreciation and amortization expenses decreased $20,000, or 4.2%, in 2002.

Other operating expenses decreased $52,000, or 1.5%, in 2002. In 2001 the FASB incurred approximately $428,000 to produce a video program on high-quality financial reporting. No similar costs were incurred in 2002. The majority of the video expenses were offset by designated grants included in the FASB's net contributions for 2001. The impact of not having expenses for a video in 2002 was substantially offset by higher expenses for recruiting and placement of members and research staff personnel of the FASB and for legal advice and assistance. The increase in legal expenses in 2002 was attributable to, among other reasons, additional counsel sought to gauge the impact of the Sarbanes-Oxley Act of 2002 on the operations of the FASB and the Foundation. Operating costs in certain other areas were also somewhat higher in 2002 than they were in 2001.

A discussion of the Foundation's sources of revenues follows.

Contributions

Contributions for 2002 and 2001 are shown in the table below.

	FASB		GASB		Total	
(Dollars in thousands)	***2002***	2001	***2002***	2001	***2002***	2001
Gross contributions	***$ 5,305***	$ 6,624	***$2,176***	$2,285	***$ 7,481***	$ 8,909
Sales value of subscriptions provided to contributors	***(1,410)***	(1,511)	–	–	***(1,410)***	(1,511)
Net contributions	***$ 3,895***	$ 5,113	***$2,176***	$2,285	***$ 6,071***	$ 7,398

Management's Discussion and Analysis continued

Under a fund-raising program initiated in 2000, the Trustees participated in the solicitation of certain contributions for the benefit of the Foundation, rather than for specific support of either Board. This granted the Trustees discretion in allocating certain contributions.

Gross contributions to FASB decreased $1,319,000 in 2002 to $5,305,000. Contributions associated with the financial reporting video were $353,000 in 2001. The production of the video was completed in 2001, and all of the amounts recognized as contribution revenues for this project have also been included in other operating program expenses. Industry and bank contributions increased $73,000 to $2,087,000. Support from the public accounting profession decreased significantly in 2002, from $3,544,000 in 2001 to $2,463,000. This is due primarily to the fact that the AICPA did not meet its usual commitment of contributing $2 per member for 2002 and the loss of contributions from Andersen. Contributions from investment firms and other supporters decreased by approximately $109,000 in 2002. The value of contributed services was $151,000 higher for FASB in 2002, due primarily to the services of a practice fellow donated to the Board by a Big Four firm.

With the exception of contributed services, all of the contribution types mentioned above are expected to cease for the FASB sometime in 2003. These contribution sources are expected to be replaced by the system of mandatory fees assessed against issuers of securities, as provided by the Sarbanes-Oxley Act of 2002.

Total contributions to GASB decreased $109,000 during 2002 to $2,176,000. The Alfred P. Sloan Foundation gave $201,000 in 2002 as their second installment under a three-year conditional commitment to provide a total of $682,000 in support of the GASB's project on reporting performance measures. Having met the criteria for this program, a total of $239,000 of Sloan funds were recognized as contribution revenues during 2002, including certain amounts that were received in earlier years. Corresponding revenues for this project in 2001 were $141,000. The public accounting profession contributed $435,000 during 2002, a $135,000 decrease from the 2001 level. This is due mainly to the fact that the AICPA did not meet its usual commitment of contributing from the membership for 2002, and the loss of contributions from Andersen. State government support increased $25,000 in 2002 to $963,000. Securities, insurance and investor organizations and other supporters contributed $189,000 in 2002, a decrease of $19,000 from the 2001 level. The Government Finance Officers Association contribution increased $25,000 in 2002 to $182,000. In addition, the fund-raising program in effect over the last 3 years resulted in $168,000 of Foundation contributions being allocated to GASB for 2002, which compares to $271,000 for 2001. The decrease results primarily from several major Foundation contributors from 2001 designating that their 2002 gifts be applied exclusively to the FASB.

Subscription and Publication Sales

Total net subscription and publication sales were $13,602,000 in 2002, $1,137,000, or 7.7%, lower than 2001's amount of $14,739,000. Total subscription and publication sales decreased $1,313,000 or 7.9% in 2002, while direct costs of publications dropped $176,000, or 9.4%. A portion of the subscription and publication sales for both the FASB and GASB is always dependent upon the results of activities of the Boards' respective technical agendas.

FASB subscription and publication sales decreased $1,470,000 in 2002 to $13,348,000. Revenues earned from electronic licensing and royalty arrangements decreased by approximately $485,000, due to lower earnings from commercial publishers and the loss of license fees from Andersen. Sales of Statements, Interpretations and Technical Bulletins decreased by approximately $226,000 as 2001 revenues reflected the initial release of the Statements on business combinations. In addition, sales of *Original Pronouncements, Current Text* and other annual bound volumes decreased by approximately $282,000, as amounts committed to under year-to-year purchase agreements were sharply reduced. Sales derived from FASB's basic, comprehensive and loose-leaf subscription services declined by approximately $209,000, or 3.4%, in 2002, due in large part to complimentary subscriptions being provided to fewer contributors. The sales value of FASB complimentary subscriptions is reclassified from contributions to subscription and publication revenues. Sales of research and Special Reports, along with revenues garnered from seminars, public records and all other sources, were approximately $268,000 lower in 2002 due to smaller payments received under publications agreements with major public accounting firms.

The direct costs of $1,428,000 to produce and distribute FASB publications were $158,000 lower in 2002 due primarily to lower expenses associated with basic and comprehensive subscription products.

GASB subscription and publication sales increased $157,000, or 8.8%, in 2002. Sales of Statements, Special Reports and other final documents actually decreased by about $53,000. These document sales relate mainly to publications associated with the standards on the new reporting model for governmental entities that was introduced in 1999. Revenues from the *Codification* and *Original Pronouncements* annual editions were $153,000 higher in 2002. This resulted from a delay in the publishing of the second of two versions of the bound volumes in 2001, which impacted the timing of shipments and contributed to fewer sales of these products in that period. These annual editions are currently offered in two versions due to the incorporation of Statement No. 34 on the new reporting model and the multiple implementation dates of that standard. Revenues from electronic licensing and royalty agreements were flat against 2001 levels. Revenues earned from all other sources were approximately $57,000 greater for GASB in 2002, helped by a higher level of fees earned for speaking engagements.

Direct costs of $264,000 to produce and distribute GASB publications decreased $18,000 from 2001, resulting from higher 2001 printing and distribution costs for documents associated with the standards on the reporting model.

Investment Income and Losses

Cash Equivalents and Short-Term Investments

Investment income from cash equivalents and short-term investments decreased $88,000 in 2002, due to a significant decrease in the interest rate yields applicable to these funds and lower cash balances available for investment.

Reserve Fund Investments

The reserve fund was established at the end of 1981 to provide for the continuation of operations in the event of unforeseen contingencies or a prolonged business downturn. The Foundation's Trustees have adopted a policy establishing a targeted reserve fund level equal to one year of total operating expenses for the entire organization. The fund is also intended to finance major capital expenditures. Reserve fund assets are unrestricted, but require Board of Trustee approval for use in continuing operations. In order to meet various working capital requirements, a total of $3,750,000 was transferred from the reserve fund to operating cash at several points during 2002. In January 2003 an additional total of $1,750,000 was transferred from the reserve fund to operating cash to similarly meet working capital requirements. Additional transfers from the reserve fund are likely and will be made as required to meet operating expense needs until cash receipts from the fee assessments, as provided by the Sarbanes-Oxley Act of 2002, commence.

Reserve fund investments are maintained within the guidelines of the investment policy established by the Foundation's Finance Committee. At December 31, 2002, approximately 71% of the fund's market value was invested in an equity index fund, with the balance invested in a fixed income index fund. The transfers to operating cash of $3,750,000, together with investment losses of $2,787,000 for 2002 (including investment management fees of $50,000), reduced the reserve fund balance to $18,551,000 at December 31, 2002. Unrealized losses on the fund's equity index investments were responsible for the negative investment results in 2002.

Statements of Activities

Years Ended December 31 (dollars in thousands)	**2002**	2001
Operating revenues:		
Net contributions:		
FASB	**$ 3,895**	$ 5,113
GASB	**2,176**	2,285
	6,071	7,398
Subscription and publication sales:		
FASB	**13,348**	14,818
GASB	**1,946**	1,789
	15,294	16,607
Less – Direct costs of sales:		
FASB	**1,428**	1,586
GASB	**264**	282
	1,692	1,868
Net subscription and publication sales	**13,602**	14,739
Net operating revenues	**19,673**	22,137
Program expenses:		
Salaries and wages:		
FASB	**9,327**	9,296
GASB	**2,457**	2,371
Administrative	**1,523**	1,471
Total salaries and wages	**13,307**	13,138
Employee benefits (Note 3)	**2,597**	2,260
Occupancy and equipment expenses (Note 5)	**1,072**	1,031
Other operating expenses	**1,780**	1,916
Total program expenses	**18,756**	18,345
Support expenses:		
Salaries and wages	**1,932**	1,724
Employee benefits (Note 3)	**500**	438
Occupancy and equipment expenses (Note 5)	**806**	784
Depreciation and amortization	**455**	475
Other operating expenses	**1,546**	1,462
Total support expenses	**5,239**	4,883
Total expenses	**23,995**	23,228
Operating revenues less than expenses	**(4,322)**	(1,091)
Short-term investment income (Note 2)	**36**	124
Reserve fund investment losses (Note 2)	**(2,787)**	(1,375)
Provision for additional minimum pension liability (Note 3)	**(3,026)**	–
Decrease in unrestricted net assets	**(10,099)**	(2,342)
Net assets at beginning of year	**26,470**	28,812
Net assets at end of year	**$ 16,371**	$26,470

See notes to financial statements.

Statements of Financial Position

As of December 31 (dollars in thousands)	**2002**	2001
Current Assets:		
Cash and cash equivalents	**$ 229**	$ 1,363
Short-term investments (Note 2)	**2,158**	2,003
Contributions receivable	**1,698**	1,371
Subscription, publication and other receivables, net of allowance for doubtful accounts of $82,000 and $73,000	**2,437**	2,590
Inventories	**207**	181
Prepaid expenses and other current assets	**178**	103
Total current assets	**6,907**	7,611
Noncurrent Assets:		
Prepaid pension costs (Note 3)	**–**	1,590
Furniture, equipment and leasehold improvements, at cost net of accumulated depreciation and amortization (Note 4)	**842**	864
Intangible asset – additional pension accrual (Note 3)	**293**	–
Reserve fund investments (Note 2)	**18,551**	25,090
Total noncurrent assets	**19,686**	27,544
Total Assets	**$26,593**	$35,155
Current Liabilities:		
Accounts payable and other current liabilities	**$ 679**	$ 858
Accrued payroll and related benefits	**636**	548
Unearned publication and other deferred revenues	**4,298**	4,148
Total current liabilities	**5,613**	5,554
Noncurrent Liabilities:		
Accrued pension costs (Note 3)	**1,711**	–
Accrued postretirement health care costs (Note 3)	**1,734**	1,655
Accrued rent expense (Note 5)	**1,164**	1,476
Total noncurrent liabilities	**4,609**	3,131
Total Liabilities	**10,222**	8,685
Net Assets – Unrestricted	**$16,371**	$26,470

See notes to financial statements.

Statements of Cash Flows

Years Ended December 31 (dollars in thousands)	**2002**		2001	
Cash flows from operating activities:				
Cash received from contributors	$ 6,862		$ 9,293	
Cash received from publication sales	14,187		13,602	
Interest and dividend income received	616		838	
Cash paid to suppliers and employees	(25,433)		(24,538)	
Net cash used in operating activities		(3,768)		(805)
Cash flows from investing activities:				
Proceeds from sales or maturities of reserve fund investments	$ 8,061		$ 4,963	
Purchases of reserve fund investments	(4,839)		(4,819)	
Proceeds from maturities of short-term investments	125		2,550	
Purchases of short-term investments	(280)		(1,840)	
Purchases of furniture, equipment and leasehold improvements	(433)		(310)	
Net cash provided by investing activities		2,634		544
Net decrease in cash and cash equivalents		(1,134)		(261)
Cash and cash equivalents at beginning of period		1,363		1,624
Cash and cash equivalents at end of period		$ 229		$ 1,363
Reconciliation of change in net assets to net cash used in operating activities:				
Decrease in unrestricted net assets		$(10,099)		$(2,342)
Adjustments to reconcile change in net assets to net cash used in operating activities:				
Provision for additional minimum pension liability	3,026		–	
Depreciation and amortization	455		475	
Unrealized losses on reserve fund investments	2,533		1,867	
Losses on sales of reserve fund investments	784		166	
Provision for losses on accounts receivable	9		8	
Increase in contribution, subscription, publication and other receivables	(183)		(880)	
(Increase) decrease in inventories	(26)		39	
Increase in prepaid expenses and pension costs	(470)		(312)	
Increase in accounts payable, accrued expenses and employee benefit accruals	365		404	
Increase (decrease) in unearned publication and other deferred revenues	150		(98)	
Decrease in accrued rent expense	(312)		(132)	
Total adjustments		6,331		1,537
Net cash used in operating activities		$ (3,768)		$ (805)

See notes to financial statements.

Notes to Financial Statements

1 Nature of Activities and Summary of Significant Accounting Policies

Nature of Activities

The Financial Accounting Foundation, organized in 1972, is an independent, private-sector organization. The Foundation's Board of Trustees is responsible for overseeing, funding and appointing members of the following Boards and Councils:

- The Financial Accounting Standards Board, which establishes standards of financial accounting and reporting for private-sector entities, and the Financial Accounting Standards Advisory Council.
- The Governmental Accounting Standards Board, which establishes standards of financial accounting and reporting for state and local governmental entities, and the Governmental Accounting Standards Advisory Council.

The Foundation is incorporated under Delaware General Corporation Law to operate exclusively for charitable, educational, scientific and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code. The Foundation has obtained its funding from contributions and publication sales.

Accounting Policies

A summary of the Foundation's significant accounting policies follows.

Presentation

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and are presented pursuant to FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations.* The statements of activities are based on the concept that standard setting is the sole program of the Foundation. The statements set forth separately, where appropriate, revenues, costs of sales and certain program expenses of the Standards Boards, giving recognition to their distinct responsibilities as described in the Foundation's Certificate of Incorporation and By-Laws. Program expenses include salaries, benefits and other direct operating expenses for the Board members and research staffs, as well as expenses for the production, marketing, publication distribution and library departments of the Foundation. Foundation services for public relations, finance, human resources, facilities management, information systems, development and general administration are reflected as support expenses in the accompanying statements of activities. Fund-raising expenses, under the direction of the development office, totaled approximately $186,000 in 2002 and $218,000 in 2001.

The preparation of financial statements requires management to make estimates and assumptions that may affect the reported amounts of 1) assets and liabilities at the date of such statements and 2) revenues and expenses during the reporting period. Accordingly, actual results could differ from those estimates.

Contributions

The Foundation reports all contributions as an increase in unrestricted net assets, as certain donor-imposed restrictions on contributions received in 2002 and 2001 were met by the end of each period. Gross contributions to the FASB are reduced by the sales value of complimentary subscriptions provided to qualified contributors, the amounts of which are reclassified as subscription and publication revenues.

Many individuals have contributed significant amounts of time to the activities of the Foundation, the Standards Boards and the Advisory Councils without compensation. These individuals include certain members of the Foundation's Board of Trustees and participants of the following groups: FASAC and GASAC, the FASB's Emerging Issues Task Force and various other FASB and GASB working groups on technical projects. Many others contribute to the Standards Boards' processes by sending comment letters, appearing at public hearings and participating in field tests. Members of the Board of Trustees are eligible for compensation, with the option of waiving their right to be compensated. The financial statements reflect the value of contributed services, the majority of which represents waived Trustee compensation, that meet the recognition criteria of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made.* The value of contributed services recognized in the statements of activities was $292,000 and $140,000 in 2002 and 2001, respectively.

With the exception of contributed services, all other forms of contributions are expected to cease for the FASB sometime in 2003. These contribution sources are expected to be replaced by the system of mandatory fees assessed against issuers of securities, as provided by the Sarbanes-Oxley Act of 2002.

In the fourth quarter of 2000, the GASB received the second of two conditional commitments which provided for a total contribution of approximately $682,000 over a three-year period, beginning in January 2001, to fund research activities leading to the consideration of a technical project on performance measures of state and local governments. Conditional promises to contribute are recognized as revenues when the conditions on which they depend are substantially met. Accordingly, GASB contributions for 2002 and 2001 include $239,000 and $141,000, respectively, relating to these conditional commitments.

Contributions for FASB for 2001 include $353,000 relating to funds received and expended to develop a video program on the subject of high-quality financial reporting.

Subscription Plans, Loose-Leaf Services and License Agreements
Revenues from these publication sources are recognized over the life of the applicable subscription, loose-leaf service or license period. Costs for fulfillment and production of updates are charged to expense as incurred.

Cash and Cash Equivalents
For financial statement purposes, the Foundation considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. The carrying value of these investments approximates fair value due to the maturity period.

Investments
The Foundation's investments are reported at fair value, with carrying amounts determined using net asset figures reported by the custodian. See Note 2 for further information regarding investments.

Inventories
Certain publications, and specific other items held for resale, are included in inventories and carried at the lower of cost or market, with cost determined by the first-in, first-out method.

Furniture, Equipment and Leasehold Improvements
Furniture, equipment and leasehold improvements are stated at cost, less accumulated depreciation and amortization computed under the straight-line method. Furniture and equipment are depreciated over their estimated useful lives. Leasehold improvements are amortized over the shorter of their estimated useful lives or the remaining term of the current office lease, which extends until September 30, 2006.

2 Investments and Investment Income (Losses)

Investments are as follows:

At December 31	**2002**	2001
Short-term:		
Investment company mutual funds	**$ 2,158,000**	$ 2,003,000
Reserve fund:		
Common trust funds:		
Equity index fund	**$13,075,000**	$17,433,000
Fixed income index fund	**5,476,000**	7,555,000
Money market fund and other securities	**–**	102,000
	$18,551,000	$25,090,000

Investment income (losses) consist of the following:

Year ended December 31	**2002**	2001
Short-term:		
Interest, including return on cash equivalents	**$ 43,000**	$ 118,000
Net unrealized (losses) gains	**(7,000)**	6,000
Total short-term	**$ 36,000**	$ 124,000
Reserve fund:		
Interest and dividends	**$ 580,000**	$ 715,000
Net realized and unrealized losses	**(3,317,000)**	(2,032,000)
	(2,737,000)	(1,317,000)
Less: advisory fees	**(50,000)**	(58,000)
Total reserve fund	**$(2,787,000)**	$(1,375,000)

Reserve fund assets are maintained within the investment policy established by the Foundation's Finance Committee and are unrestricted, but require Board of Trustee approval for use in operations. During 2002 and 2001, a total of $3,750,000 and $800,000, respectively, was transferred from the reserve fund to operating cash to meet working capital requirements.

3 Employee Benefits

Employee benefits expense consists principally of payroll taxes, health care benefits for active and retired employees, and pension costs. The following amounts were charged (credited) to operations pursuant to the Foundation's pension plans and postretirement health care plan for the periods presented:

Year ended December 31	**2002**	2001
Defined contribution pension expense	**$1,051,000**	$1,022,000
Defined benefit pension expense (income)	**90,000**	(163,000)
Postretirement health care expense	**222,000**	208,000
	$1,363,000	$1,067,000

The principal actuarial assumptions utilized for 2002 and 2001 to determine costs and benefit obligations for the defined benefit pension plans and the postretirement health care plan are as follows (not all assumptions are applicable to all plans):

At December 31	***2002***	2001
Discount rate	***6.5%***	7.0%
Rate of increase in compensation levels	***5.0%***	5.0%
Long-term rate of return on assets	***8.0%***	9.0%
Health care cost trend rate	***7.5%***	8.0%

The health care cost trend rate declines gradually to an ultimate level of 5.0% after 2006.

Pension Plans

The Foundation sponsors defined contribution and defined benefit pension plans for its employees. Employer payments into the defined contribution plan are based on employees' current earnings. The defined benefit plans are designed to supplement the pension benefit otherwise provided by the defined contribution plan only if the employee's targeted pension benefit, as defined, is deemed not to have been met. The targeted pension benefit is an amount equal to 2% of an employee's highest average salary over any five-year period, multiplied by the years of credited service, up to 20 years. Employees do not contribute to the plans and pension benefits under the plans vest after five years of service.

The components of net periodic pension expense (income) for the defined benefit plans in 2002 and 2001 were as follows:

Year ended December 31	***2002***	2001
Service cost	***$ 32,000***	$ 64,000
Interest cost	***541,000***	504,000
Projected return on plan assets	***(662,000)***	(742,000)
Amortization of prior period net losses	***180,000***	3,000
Amortization of prior service (credit) cost	***(1,000)***	8,000
Defined benefit pension expense (income)	***$ 90,000***	$(163,000)

The change in plan assets and benefit obligations, funded status and reconciliation to amounts reported in the statements of financial position are as follows:

Year ended December 31	***2002***	2001
Change in plan assets		
Fair value of plan assets, beginning of year	***$ 7,509,000***	$8,384,000
Actual losses on plan assets	***(1,110,000)***	(606,000)
Benefits paid	***(319,000)***	(269,000)
Fair value of plan assets, end of year	***$ 6,080,000***	$7,509,000
Change in benefit obligation		
Projected benefit obligation, beginning of year	***7,919,000***	7,079,000
Service cost	***32,000***	64,000
Interest cost	***541,000***	504,000
Actuarial losses, net	***2,365,000***	717,000
Benefits paid	***(428,000)***	(445,000)
Projected benefit obligation, end of year	***$10,429,000***	$7,919,000
At December 31		
Funded status of plans	***(4,349,000)***	(410,000)
Unrecognized net losses	***5,761,000***	1,805,000
Unrecognized prior service cost	***196,000***	195,000
Net amount recognized	***$ 1,608,000***	$1,590,000
Amounts recognized in the financial statements		
Prepaid pension costs	—	$1,590,000
Intangible asset	***293,000***	—
Accrued pension costs	***(1,711,000)***	—
Provision for pension liability	***3,026,000***	—
Net amount recognized	***$1,608,000***	$1,590,000

The actuarial losses for the year ended December 31, 2002 result from, among other factors, changes in actuarial assumptions, including lowering the discount rate to 6.5%. The amounts recorded as intangible assets and as a provision in the statement of activities are as a result of measuring the additional minimum pension liability at December 31, 2002 for the Foundation's Employees' Pension Plan, in accordance with FASB Statements No. 87, *Employers' Accounting for Pensions,* and No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits.*

Notes to Financial Statements continued

The accumulated benefit obligation for the Employees' Pension Plan was $7,415,000 and $5,741,000 at December 31, 2002 and 2001, respectively. The projected benefit obligation and accumulated benefit obligation for the Supplemental Executive Retirement Plan, which is unfunded, was $347,000 and $191,000, respectively, as of December 31, 2002, and $328,000 and $186,000, respectively, as of December 31, 2001. Benefits paid under the unfunded plan aggregated $109,000 and $176,000 for the years ended December 31, 2002 and 2001, respectively.

Gains and losses subsequent to December 31, 1984, after the adoption of FASB Statement No. 87, that result from changes in actuarial assumptions and from actual experience different than that assumed, are amortized over a ten-year period. Prior service costs from plan amendments are being recognized over the employees' remaining service periods.

Health Care Plan

The Foundation sponsors a postretirement health care plan for all employees. Employees retiring after reaching age 55 with at least 10 years of service receive a one-time opportunity to elect continued coverage under the health care plan then in effect for active employees. The cost of coverage beyond the date of retirement is then shared between the Foundation and the retiree, with the Foundation responsible for the amount equal to its cost for the employee's coverage immediately prior to retirement. Premium increases for any reason beyond the retirement date are borne by the retiree. Decreases in premiums for any reason, including Medicare integration at age 65, would reduce retiree cost first, then the Foundation's cost.

The components of net periodic postretirement health care expense for 2002 and 2001 are as follows:

Year ended December 31	***2002***	2001
Service cost	***$ 67,000***	$ 62,000
Interest cost	***141,000***	135,000
Amortization of losses	***48,000***	45,000
Amortization of prior service credit	***(34,000)***	(34,000)
Net periodic postretirement health care expense	***$222,000***	$208,000

The change in benefit obligation, funded status and reconciliation to amounts reported in the statements of financial position are as follows:

	2002	2001
Change in benefit obligation		
Accumulated benefit obligation, beginning of year	***$ 2,086,000***	$ 1,933,000
Service cost	***67,000***	62,000
Interest cost	***141,000***	135,000
Actuarial losses	***281,000***	79,000
Benefits paid	***(143,000)***	(123,000)
Accumulated benefit obligation, end of year	***$ 2,432,000***	$ 2,086,000
At December 31		
Funded status of plan	***$(2,432,000)***	$(2,086,000)
Unrecognized net losses	***718,000***	485,000
Unrecognized prior service credit	***(20,000)***	(54,000)
Accrued postretirement health care cost	***$(1,734,000)***	$(1,655,000)

The Foundation funds retiree health care benefits on a cash basis. Gains and losses that occur because actual experience differs from that assumed, and from changes in actuarial assumptions, are amortized over 10 years. The change in the unrecognized prior service credit reflects the impact of plan amendments previously adopted and revisions in the measurement of benefit obligations for certain retirees.

A one-percentage-point change in the assumed health care cost trend rate would have the following effects on costs and benefit obligations at December 31, 2002:

	1-Percentage-Point Increase	*1-Percentage-Point Decrease*
Increase (decrease) in total amount of service and interest costs	***$20,000***	***$(18,000)***
Increase (decrease) in accumulated postretirement benefit obligation	***144,000***	***(126,000)***

4 Furniture, Equipment and Leasehold Improvements

These assets consist of the following :

At December 31	***2002***	2001
Furniture and equipment	***$ 4,903,000***	$ 4,509,000
Leasehold improvements	***2,382,000***	2,343,000
	7,285,000	6,852,000
Accumulated depreciation and amortization	***(6,443,000)***	(5,988,000)
	$ 842,000	$ 864,000

5 Lease Commitments

The Foundation occupies office space in a single building pursuant to an operating lease. Total rental expense for office space and equipment was $1,660,000 and $1,585,000 in 2002 and 2001, respectively. The operating lease for the Foundation's office space commenced April 15, 1988 and expires on September 30, 2006. Accrued rent expense for escalating minimum lease payments and initial rent abatement amounted to $1,164,000 and $1,476,000 at December 31, 2002 and 2001, respectively, and is included in non-current liabilities in the accompanying statements of financial position. The accrued rent expense is being amortized over the remaining term of the operating lease.

Future minimum payments under the operating lease for office space, including the Foundation's current pro rata share of real estate taxes and other operating expenses, are summarized as follows:

Year ended December 31	
2003	***$ 1,905,000***
2004	***1,905,000***
2005	***1,905,000***
2006	***1,429,000***
Total minimum lease payments	***$ 7,144,000***

Report of Management

The management of the Financial Accounting Foundation is responsible for the preparation of the accompanying financial statements. These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Management maintains a system of internal controls designed to ensure the integrity, objectivity and overall effectiveness of the financial reporting process.

The Trustees of the Foundation, through the Audit Committee, oversee 1) financial and accounting policies, practices and reports, 2) the system of accounting and internal controls and the competence of persons performing key functions within that system and 3) the scope and results of independent audits and any resulting comments from auditors addressing the adequacy of internal controls and quality of financial reporting. The Foundation's outside auditors render an objective, independent opinion on the financial statements prepared by management, and have direct access to the Audit Committee with and without the presence of management.

In response to recommendations made in recent years by the Blue Ribbon Committee of the New York Stock Exchange and the National Association of Securities Dealers, as well as related regulations issued by the Securities and Exchange Commission, the Audit Committee of the Foundation has in place a formal charter governing its operations. Although the Foundation is not a publicly owned entity, the Committee has determined that the organization should voluntarily comply with recommendations and rulings of this type where appropriate. The charter identifies the key functions, objectives, operating practices, membership requirements and duties and responsibilities of the Committee. Part of the Committee's responsibility is to regularly review the charter to identify areas requiring enhancement and/or clarification. This effort will continue in the future in light of audit committee provisions in the Sarbanes-Oxley Act of 2002, and the related Securities and Exchange Commission's rules. The Foundation's charter is available through the office of the Executive Vice President.

The Trustees have also adopted, and monitor, personnel policies designed to ensure that employees of the Foundation are free of conflicts of interest.

Manuel H. Johnson

Manuel H. Johnson, Chairman and President
Financial Accounting Foundation

Joseph LaGambina

Joseph S. LaGambina, Executive Vice President
Financial Accounting Foundation

Independent Auditor's Report

Board of Trustees
Financial Accounting Foundation

We have audited the accompanying statements of financial position of the Financial Accounting Foundation as of December 31, 2002 and 2001, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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 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 audits provide 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 Financial Accounting Foundation as of December 31, 2002 and 2001, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

McGladrey & Pullen, LLP

New Haven, Connecticut
February 27, 2003

Financial Accounting Foundation

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Design: Jack Hough Associates, Inc., Norwalk CT Photos pages 2 & 15: © Ron Stroud/Masterfile

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