Audit Report

OIG-13-019

Audit of the Exchange Stabilization Fund's Fiscal Years 2012 and 2011 Financial Statements

December 5, 2012

Office of Inspector General

Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

December 5, 2012

MEMORANDUM FOR MARK SOBEL
DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL MONETARY AND FINANCIAL POLICY

FROM: Michael Fitzgerald
Director, Financial Audits

SUBJECT: Audit of the Exchange Stabilization Fund's Fiscal Years 2012 and 2011 Financial Statements

I am pleased to transmit the attached audited Exchange Stabilization Fund (ESF) financial statement for fiscal years 2012 and 2011. Under a contract monitored by the Office of Inspector General, KPMG LLP, an independent certified public accounting firm, performed an audit of the financial statements of ESF as of September 30, 2012 and 2011 and for the years then ended. The contract required that the audit be performed in accordance with generally accepted government auditing standards; applicable provisions of Office of Management and Budget Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements,* as amended; and the *GAO/PCIE Financial Audit Manual*.

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

- Independent Auditors' Report;
- Independent Auditors' Report on Internal Control Over Financial Reporting; and
- Independent Auditors' Report on Compliance and Other Matters.

In its audit, KPMG LLP found:

- the financial statements were fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles;
- no deficiencies in internal control over financial reporting that are considered material weaknesses; and
- no instances of reportable noncompliance with laws and regulations tested.

In connection with the contract, we reviewed KPMG LLP's reports and related documentation and inquired of its representatives. Our review, as differentiated from an audit performed in accordance with generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on the financial statements or conclusions about the effectiveness of internal control or compliance with laws and regulations. KPMG LLP is responsible for the attached auditors' reports dated December 3, 2012 and the conclusions expressed in the reports. However, our review disclosed no instances where KPMG LLP did not comply, in all material respects, with generally accepted government auditing standards.

Should you have any questions, please contact me at (202) 927-5789, or a member of your staff may contact Catherine Yi, Manager, Financial Audits at (202) 927-5591.

Attachment

DEPARTMENT OF THE TREASURY
EXCHANGE STABILIZATION FUND

Financial Report

Fiscal Year 2012

DEPARTMENT OF THE TREASURY
EXCHANGE STABILIZATION FUND

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EXCHANGE STABILIZATION FUND
POLICY AND OPERATIONS STATEMENTS
FISCAL YEAR 2012

The Nature and Function of the Exchange Stabilization Fund

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

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

Reflecting termination of the fixed exchange rate system, legislation enacted in 1976 (P.L. 94-564, October 19, 1976) amended the language of Section 10 of the Gold Reserve Act to specify that the ESF is to be utilized as the Secretary "may deem necessary to and consistent with the United States obligations in the International Monetary Fund." This amendment became effective on April 1, 1978, the date of entry into force of the Second Amendment of the IMF Articles of Agreement. In 1977, P.L. 95-147 further amended Section 10 of the Gold Reserve Act. Following codification, Section 10 now provides in relevant part:

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

Pursuant to the Special Drawing Rights Act of 1968 (P.L. 90-349, amended by P.L. 94-564), Special Drawing Rights (SDRs) allocated by the IMF to the United States or otherwise acquired by the United States are resources of the ESF.

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

I. Foreign Currency Operations

a. Euros and Japanese Yen

The ESF had a net valuation loss of $356 million on its holdings of euros and yen. The ESF had investment income of $164.4 million equivalent on its euro and yen assets.

b. Mexico

In November 2011, the Treasury and Federal Reserve Bank of New York, acting as Treasury's fiscal agent, renewed the Exchange Stabilization Agreement with Mexico for another year to December 2012.

II. SDR Operations

As of September 30, 2012, U.S. holdings (assets) of SDRs totaled SDR 35.8 billion ($55.2 billion equivalent), a net change of 0 SDR during Fiscal Year 2012. However, as the SDR appreciated against the dollar in this period, there was a net valuation loss of $695.8 million on U.S. holdings of SDRs. The ESF reimbursed the Treasury's General Fund $52.1 million for SDRs received from the IMF as remuneration on the U.S. reserve position in the IMF. The ESF earned interest of $79.6 million equivalent on its SDR holdings.

As of September 30, 2012, cumulative allocations to (liabilities of) the United States totaled SDR 35.3 billion ($54.5 billion equivalent). These liabilities would come due only in the event of liquidation of, or U.S. withdrawal from, the SDR Department of the IMF, or cancellation of SDRs.

There were $5.2 billion of SDR certificates that had been issued to the Federal Reserve System prior to fiscal year 2012.

III. Income and Expense

Interest revenue totaled $255.2 million, consisting of $11.2 million in interest on dollar holdings invested in U.S. Government securities, $79.6 million equivalent in interest on SDR holdings, and $164.4 million equivalent in interest on foreign currency investments.

Interest expense totaled $78.6 million, primarily representing interest charges on SDR Allocations.

KPMG LLP
Suite 12000
1801 K Street, NW
Washington, DC 20006

Independent Auditors' Report

Inspector General
U.S. Department of the Treasury:

We have audited the accompanying statements of financial position of the U.S. Department of the Treasury's Exchange Stabilization Fund ("ESF") as of September 30, 2012 and 2011, and the related statements of income and comprehensive income and retained earnings, and cash flows, (hereinafter referred to as "financial statements" or "basic financial statements") for the years then ended. These financial statements are the responsibility of the ESF's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget ("OMB") Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the ESF's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 Exchange Stabilization Fund as of September 30, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements as a whole. The information in the Policy and Operations Statements section on pages 1 and 2 is presented for the purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

In accordance with *Government Auditing Standards*, we have also issued our reports dated December 3, 2012, on our consideration of the ESF's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in assessing the results of our audits.

KPMG LLP

December 3, 2012

KPMG LLP
Suite 12000
1801 K Street, NW
Washington, DC 20006

Independent Auditors' Report on Internal Control Over Financial Reporting

Inspector General
U.S. Department of the Treasury:

We have audited the statements of financial position of the U.S. Department of the Treasury's Exchange Stabilization Fund ("ESF") as of September 30, 2012 and 2011 and the related statements of income and comprehensive income and retained earnings, and cash flows (hereinafter referred to as "financial statements") for the years then ended, and have issued our report thereon dated December 3, 2012.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the ESF is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our fiscal year 2012 audit, we considered the ESF's internal control over financial reporting by obtaining an understanding of the design effectiveness of the ESF's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the ESF's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the ESF's internal control over financial reporting. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the third paragraph of this report and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. In our fiscal year 2012 audit, we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of the addressee, ESF's management, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

December 3, 2012

KPMG LLP
Suite 12000
1801 K Street, NW
Washington, DC 20006

Independent Auditors' Report on Compliance and Other Matters

Inspector General
U.S. Department of the Treasury:

We have audited the statements of financial position of the U.S. Department of the Treasury's Exchange Stabilization Fund ("ESF") as of September 30, 2012 and 2011, and the related statements of income and comprehensive income and retained earnings, and cash flows (hereinafter referred to as "financial statements") for the years then ended, and have issued our report thereon dated December 3, 2012.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the ESF is responsible for complying with laws, regulations, and contracts applicable to the ESF. As part of obtaining reasonable assurance about whether the ESF's financial statements are free of material misstatement, we performed tests of the ESF's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to the ESF. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph of this report, disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 07-04.

This report is intended solely for the information and use of the addressee, ESF's management, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

December 3, 2012

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

As of September 30		**2012**		**2011**
Assets				
Cash and Cash Equivalents (Note 2)	$	32,433,191	$	30,974,114
Securities Purchased Under Agreement to Resell (Note 3)		771,360		2,505,269
Investment Securities and Other Foreign Currency Denominated Assets (Note 5)		15,326,015		15,671,256
Special Drawing Right Holdings (Note 4)		55,232,490		55,875,301
Interest Receivable		89,819		114,112
Interest Receivable on Special Drawing Right Holdings		7,123		35,607
Total Assets	$	103,859,998	$	105,175,659
Liabilities and Equity				
Liabilities:				
Special Drawing Rights Certificates Issued to Federal Reserve Banks (Note 7)	$	5,200,000	$	5,200,000
Special Drawing Right Allocations (Note 4)		54,463,490		55,149,673
Interest Payable on Special Drawing Right Allocations		7,024		35,145
Other		266		313
Total Liabilities		59,670,780		60,385,131
Commitments and Contingencies (Note 9)				
Equity:				
Appropriated Capital		200,000		200,000
Retained Earnings		43,634,321		43,823,544
Accumulated Other Comprehensive Income (Notes 1 and 6)		354,897		766,984
Total Equity		44,189,218		44,790,528
Total Liabilities and Equity	$	103,859,998	$	105,175,659

See accompanying notes to financial statements.

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

For the years-ended September 30	2012	2011
Interest Income		
Interest on Cash and Cash Equivalents	$ 23,158	$ 47,459
Interest on Securities Purchased Under Agreement to Resell	4,704	19,175
Interest on Investment Securities and Other Foreign Currency Denominated Assets	147,702	198,123
Interest on Special Drawing Right Holdings	79,639	250,143
Total Interest Income	255,203	514,900
Interest Expense		
Interest on Special Drawing Right Allocations	(78,565)	(243,958)
Interest on Special Drawing Right - Remuneration due to the U.S. Treasury	(2)	(3)
Total Interest Expense	(78,567)	(243,961)
Net Interest Income	176,636	270,939
Net Gains/(Losses)		
Gain/(Loss) on Foreign Currency Valuation of:		
Special Drawing Rights Holdings	(695,209)	230,832
Special Drawing Rights Allocations	685,644	(193,105)
Investment Securities and Other Foreign Currency Denominated Assets, net	(178,338)	1,171,738
Securities Purchased Under Agreement to Resell	(177,365)	(27,973)
Total Net Gains/(Losses)	(365,268)	1,181,492
Other Expenses		
International Monetary Fund Annual Assessment	(591)	(881)
Net Income/(Loss)	(189,223)	1,451,550
Other Comprehensive Income		
Unrealized Holding Loss (Notes 1 and 6)	(412,087)	(405,609)
Comprehensive Income/(Loss)	$ (601,310)	$ 1,045,941
Retained Earnings, Beginning of Year	$ 43,823,544	$ 42,371,994
Net Income/(Loss)	(189,223)	1,451,550
Retained Earnings, End of Year	$ 43,634,321	$ 43,823,544

See accompanying notes to financial statements.

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

For the years-ended September 30		2012		2011
Cash Flows from Operating Activities:				
Interest Received on:				
Cash and Cash Equivalents	$	24,141	$	46,599
Securities Purchased Under Agreement to Resell		4,788		19,124
Investment Securities and Other Foreign Currency Denominated Assets		220,076		241,541
Other		(3,650)		(7,759)
Net Cash Provided by Operating Activities		245,355		299,505
Cash Flows from Investing Activities:				
Net Purchases/(Maturities) of Securities Purchased Under Agreement to Resell		1,556,544		(30,099)
Purchases of Investment Securities and Foreign Currency Denominated Assets		(9,924,743)		(10,155,496)
Maturities of Investment Securities and Foreign Currency Denominated Assets		9,807,509		10,298,549
Reimbursement for Remuneration Received		(52,139)		(63,077)
Purchase of Special Drawing Rights		-		(140,775)
IMF Quota Increase		-		1,974,719
Other		638		751
Net Cash provided by Investing Activities		1,387,809		1,884,572
Effect of Exchange Rate on Cash		(174,087)		269,041
Net Increase in Cash and Cash Equivalents		1,459,077		2,453,118
Cash and Cash Equivalents, Beginning of Year		30,974,114		28,520,996
Cash and Cash Equivalents, End of Year	$	32,433,191	$	30,974,114
Reconciliation of Net Income/(Loss) to Net Cash Provided by Operating Activities				
Net Income/(Loss)	$	(189,223)	$	1,451,550
Adjustments to Reconcile Net Income/(Loss) to Net Cash Provided by Operating Activities:				
Net Exchange Rate (Gain)/Loss on Repos, FCDAs, and Investment Securities		355,703		(1,143,765)
Decrease (Increase) in Special Drawing Right Holdings Due to Valuation		695,756		(229,412)
Net Increase in Special Drawing Rights Holdings		(1,444)		(7,033)
(Increase)/Decrease in Accrued Interest Receivable		52,777		(7,307)
Amortization of Bond Premium/Discount (net)		46,138		36,017
(Decrease)/Increase in Special Drawing Right Allocations Due to Valuation		(686,184)		191,764
(Decrease)/Increase in Accrued Interest Payable and Other		(28,168)		7,691
Total Adjustments		434,578		(1,152,045)
Net Cash Provided by Operating Activities	$	245,355	$	299,505

See accompanying notes to financial statements.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Entity

The Exchange Stablization Fund (ESF) was originally established pursuant to section 10 of the Gold Reserve Act of 1934 for the purpose of stabilizing the exchange value of the dollar. Section 10 has been amended several times since 1934. This section currently authorizes the Secretary, with the approval of the President, to deal in gold, foreign exchange, and instruments of credit and securities consistent with US obligations in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates. 31 U.S.C. 5302(b).

The Federal Reserve Bank of New York (FRBNY) acts as the fiscal agent for the ESF, as permitted by the Federal Reserve Act. As the fiscal agent, the FRBNY plays a significant role in the processing of foreign currency transactions that the Secretary of the Treasury authorizes. The manager of the ESF foreign currency portfolio at the FRBNY consults regularly with the Federal Open Market Committee and the U.S. Department of the Treasury (Treasury) about the disposition of investments and the status of the portfolio. The level and currency composition of the ESF foreign currency portfolio are the products of Treasury policy determinations. The ESF management is responsible for the record keeping and investment decisions for foreign currency transaction activity carried out by the FRBNY.

By law, the ESF is not available to pay administrative expenses. Instead the Treasury's Office of International Affairs has responsibility for managing ESF operations, and Treasury's Deputy Chief Financial Office provides the recordkeeping and financial reporting services for the ESF. These Treasury offices bear all administrative expenses of the ESF. Accordingly, there are no administrative expenses reported in the financial statements.

B. Basis of Accounting and Presentation

The ESF has historically prepared its financial statements in accordance with generally accepted accounting principles, based on accounting standards issued by the Financial Accounting Standards Board (FASB), the private-sector standards-setting body.

C. Risks and Uncertainties

The ESF faces certain risks and uncertainties as a result of holding foreign currency securities. The price of ESF's holdings of such securities may widely fluctuate as result of volatility in foreign currency markets and changes in real and perceived credit of ESF's counterparties.

Credit risk related to its holdings, is the potential, no matter how remote, for financial loss from a failure of a borrower or counterparty to perform in accordance with underlying contractual obligations.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates are used in the preparation of amounts related to the valuation of investments and contingent liabilities. Actual results could differ from those estimates.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

D. Cash and Cash Equivalents

Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash, and so near their maturity that they present insignificant risk of change in value due to changes in interest rates. Cash and Cash Equivalents consist of the following:

- U.S. Government Securities
- Short-term Foreign Currency Denominated Assets (FCDAs) – including deposits and securities denominated in both euro and yen

E. Investments

Held-to-maturity securities are those securities in which the entity has the ability and intent to hold the security until maturity. Held-to-maturity securities are recorded at amortized cost, adjusted for the amortization and accretion of premiums or discounts.

Trading securities are bought and held principally for the purpose of selling them in the near term. ESF has no securities classified as trading.

Available-for-sale securities are those which are neither trading nor held-to-maturity. ESF's Other FCDAs and Investment Securities are classified as available-for-sale. Available-for-sale securities are recorded at fair value. Unrealized holding gains and losses on available-for-sale securities, including gains and losses related to foreign currency valuation, are excluded from earnings and are reported as a separate component of accumulated other comprehensive income until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific-identification basis.

Interest on investments, amortization of premiums, and accretion of discounts are reported in Interest Income and are recognized on an accrual basis. Premiums and discounts are amortized or accreted over the life of the related investment security as an adjustment to yield using the effective–interest method.

Foreign currency assets (FCA) include interest-bearing foreign deposit accounts and investments in foreign government securities.

FCAs also include FCDAs reported as Cash and Cash Equivalents, Other FCDAs, and Investment Securities. These categorizations are based on maturity. FCDAs have terms of 3 months or less. Other FCDAs have terms of less than or equal to a year but greater than 3 months and Investment Securities have terms greater than a year.

F. Securities Purchased Under Agreement to Resell

Securities Purchased Under Agreement to Resell, generally have agreement terms that do not exceed 90 days, and these are generally treated as collateralized financial transactions and are carried at amounts at which the securities were acquired, adjusted for translation gains/losses if such agreements pertained to FCAs.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

G. Foreign Currency Valuations

In accordance with Foreign Currency Matters (FASB ASC 830), FCAs as well as Special Drawing Rights and related accrued interest receivable or payable, discussed below, are revalued to reflect current exchange rates in effect as of the reporting date. Such gains or losses, recognized in the period of the fluctuations, are reported on the Statements of Income and Comprehensive Income and Retained Earnings as Gains (Losses) on Foreign Currency Valuation. Gains and losses related to foreign currency valuations of Investment Securities and Other FCDAs are excluded from earnings and are reported as a component of other comprehensive income until realized.

H. Other-than-temporary-Impairment

A decline in the market value (either due to credit, price or currency) of any investment below cost that is deemed to be other-than-temporary is accounted for as an impairment and the carrying value is reduced to fair value for financial statement reporting purposes. The impairment is charged to earnings and the charge establishes a new cost basis for the investment. To determine whether impairment is other-than-temporary, the ESF considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to year-end, forecasted performance of the investee and the general market condition in the geographic area or industry the investee operates in. ESF regularly evaluates whether unrealized losses on investment securities indicate other-than-temporary impairment that would require recognition in the financial statements.

I. Fair Values of Financial Instruments

Fair Value Measurements and Disclosures (FASB ASC 820-10) establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the ESF has the ability to access at the measurement date.

- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

- Level 3 inputs are unobservable inputs for the asset or liability.

All of the ESF's investments, except for the Securities Purchased under Agreement to Resell, are Level 1 measurements since these financial assets are traded in active markets where quotable values are readily available. Securities Purchased under Agreement to Resell are considered Level 2 as they are not traded on active exchanges; however, there are similar securities that can be used to estimate fair value.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

J. Special Drawing Right Certificates Issued to Federal Reserve Banks

Special Drawing Right Certificates issued to Federal Reserve Banks (FRB) are reflected on the Statements of Financial Position at their face value. Under the terms of the agreement, there is no set repayment date and no interest accrued while certificates remain outstanding. As a result, the carrying amount represents the face value.

K. U.S. Government Securities

The ESF invests dollars in excess of its immediate needs in overnight, nonmarketable U.S. government securities issued by the Treasury. The interest rate earned on the investments is equal to the overnight repurchase agreement rate as established by the Treasury's Bureau of Public Debt.

L. Other Comprehensive Income

Accumulated Other Comprehensive Income (Loss) is made up only of changes in the fair value of investments classified as available-for-sale. Unrealized gains and losses, if any, would subsequently be reclassified into income in the same period the underlying investment is either sold or transferred to the trading classification.

M. Tax-Exempt Status

As a component of the Treasury, which is a federal agency, the ESF is not subject to federal, state, or local income taxes, and accordingly, no provision for income taxes is recorded.

N. Reclassifications

Certain reclassifications have been made to prior year amounts to conform to the current year presentation. On the Statement of Cash Flows, in the adjustments to reconcile net income/(loss) to net cash provided by operating activities, amortization of bond premium/discount (net) has been separately disclosed. Amounts have been reclassified from net exchange rate gain (loss) on Repos, FCDAs, and Investment Securities to amortization of bond premium/discount (net).

NOTE 2 – CASH AND CASH EQUIVALENTS

Cash and cash equivalent amounts held as of September 30, 2012 and 2011 are as follows:

September 30 (In Thousands)	2012	2011
Cash and cash equivalents:		
U. S. government securities	$ 22,680,149	$ 22,721,204
Short-term FCDAs:		
European euro	5,809,970	4,277,368
Japanese yen	3,943,072	3,975,542
Total short-term FCDAs	9,753,042	8,252,910
Total cash and cash equivalents	$ 32,433,191	$ 30,974,114

On March 17, 2011 the Treasury Secretary authorized an intervention by the FRBNY in the form of a sale of $500 million equivalent of Japanese yen, held by the ESF, against U.S. dollars. On March 17, 2011, the G-7 finance ministers and central bank governors issued a statement that “excess volatility and disorderly movements in exchange rates” arising from events in Japan had “adverse implications for economic and financial stability.” On, March 18, 2011, the FRBNY sold the $500 million equivalent of yen. Actual settlement occurred on, March 23, 2011, and the ESF invested the $500 million proceeds in the special overnight Treasury securities in which all its U.S. dollars are invested.

NOTE 3 – SECURITIES PURCHASED UNDER AGREEMENT TO RESELL

The FRBNY, on behalf of ESF, enters into transactions to purchase foreign-currency-denominated government-debt securities under agreements to resell for which the accepted collateral is the debt instruments, denominated in Euros, and issued or guaranteed in full by European governments. These agreements are subject to daily margining requirements.

NOTE 4 – SPECIAL DRAWING RIGHTS

The SDR is an international reserve asset created by the International Monetary Fund (IMF) in 1969 to supplement the existing reserve assets of IMF member countries, including the United States. In addition to its role as a supplementary reserve asset, the SDR serves as a means of payment within the IMF, as well as the unit of account for the IMF and several other international organizations. SDRs may be held only by the official sector – IMF member countries and certain institutions designated by the IMF as prescribed holders. On several occasions SDRs have been allocated by the IMF to members participating in the IMF’s SDR Department, including the United States. SDR transactions by the United States require the explicit authorization of the Secretary of the Treasury.

The SDR’s value is based on a weighted average of a basket of key international reserve currencies issued by IMF members (or monetary unions that include IMF members) which have been determined by the IMF to be freely usable currencies. These currencies are the U.S. dollar, the Euro, the Japanese yen, and

NOTE 4 – SPECIAL DRAWING RIGHTS (Continued)

the pound sterling. The SDR carries a variable interest rate, calculated weekly as a weighted average of short-term interest rates of the SDR basket of currencies. The ESF's SDR Allocations and Holdings (see below) are revalued monthly, based on the SDR valuation rate calculated by the IMF, and unrealized gains or losses on revaluation are recognized. SDR Holdings and SDR Allocations are reported as an asset and liability respectively in the financial statements of the ESF.

SDR Allocations

SDRs, once allocated to the United States, are permanent resources unless:

a. They are canceled by an 85 percent majority decision of the total voting power of the Board of Governors of the IMF;

b. The SDR Department of the IMF is liquidated;

c. The IMF is liquidated; or

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

Due to the fact that the SDRs are able to be withdrawn, the ESF carries a liability related to such allocations.

Except for the payment of interest and charges on SDR allocations to the United States, the payment of the ESF's liability related to the SDR allocations is conditional on events listed above, in which the United States has a controlling voice. Allocations of SDRs were made during 1970, 1971, 1972, 1979, 1980, 1981, and 2009.

As of September 30, 2012 and 2011, the value of SDR allocations to the United States was the equivalent of $54.5 billion and $55.1 billion, respectively.

SDR Holdings

Pursuant to the Special Drawing Rights Act of 1968, as amended, SDRs allocated by the IMF to, or otherwise acquired by the United States are also resources (holdings) of the ESF. SDR Holdings represent transactions resulting from these SDR activities, primarily the result of IMF allocations. Other transactions reported in this account are recorded as they are incurred and include any SDR acquisitions and sales, interest received on SDR Holdings, interest charges on SDR Allocations, and other SDR related activities, as well as valuation adjustments.

On May 11, 2011, 25 million SDRs were purchased from the Bank of International Settlements. On June 29, 2011 two separate transactions with the Bank of International Settlements took place; 35 million and 28.435 million SDRs were purchased respectively.

NOTE 4 – SPECIAL DRAWING RIGHTS (Continued)

Pursuant to the Supplemental Appropriations Act, 2009 (P.L. 111-32), the United States consented to an increase in its quota in the International Monetary Fund. Twenty-five percent of the quota was paid by the United States using SDRs (equivalent to SDR 1,243.275 million).

Other SDR Activities

The U.S. Government receives remuneration in SDRs from the IMF on the U.S. claim on the IMF, represented by the U.S. Reserve Position. ESF is the only agency within Treasury permitted to transact in SDRs. SDRs received become the resources of ESF, as required by law, and ESF pays the dollar equivalent to the U. S. Government's Treasury General Account (TGA). The ESF's receipt of the SDRs and payment of the dollar equivalent to the TGA are not simultaneous. Typically, the payment is several weeks after the receipt of SDRs from the IMF. Therefore, the ESF must reimburse the TGA the interest it earned on the dollar equivalent of the SDRs held on behalf of the TGA during the period which elapsed between the receipt of the SDRs and the dollar payment to the TGA.

ESF paid to the TGA $1,450 and $2,700 in fiscal years 2012 and 2011, respectively, in interest due on the transferred dollars. The ESF did not sell SDRs to any participating members during fiscal year 2012 or 2011.

The following schedule reflects the activity related to SDR Holdings during fiscal years 2012 and 2011 in SDR and dollar equivalent.

September 30 (SDR In Thousands)	**2012**	**2011**
Beginning balance	35,780,344	36,891,687
Interest credits on holdings	69,637	153,817
Interest charges on allocations	(68,711)	(149,380)
Remuneration	33,464	39,533
IMF annual assessment	(412)	(473)
IMF Quota Increase	-	(1,243,275)
Purchases	-	88,435
Total SDR - Holdings	35,814,322	35,780,344

September 30 (Dollar Equivalent In Thousands)	**2012**	**2011**
Beginning balance	$ 55,875,301	$ 57,410,474
Interest credits on holdings	108,670	244,771
Interest charges on allocations	(107,226)	(237,739)
Remuneration	52,139	63,077
IMF annual assessment	(638)	(750)
IMF Quota Increase	-	(1,974,719)
Purchases	-	140,775
Net gain/(loss) on valuation of holdings	(695,756)	229,412
Total Dollar Equivalent – Holdings	$ 55,232,490	$ 55,875,301

NOTE 4 – SPECIAL DRAWING RIGHTS (Continued)

The table above reflects the actual dollar equivalent amount of SDRs received or transferred by ESF. Amounts within the financial statements computed on accrual basis will thus differ since actual SDR movements occur shortly after the balance sheet date.

NOTE 5 – INVESTMENT SECURITIES AND OTHER FOREIGN CURRENCY DENOMINATED ASSETS

The amortized cost, gross unrealized holding gains and losses, and fair value of available-for-sale and held-to-maturity debt securities by major security type and class of security at September 30, 2012 and 2011 were as follows:

September 30, 2012 (In Thousands)	Amortized Cost	Gross Unrealized Holdings Gains	Gross Unrealized Holding (Losses)	Fair Value
Available for sale:				
Other FCDAs	$ 2,698,677	$ 61,002	$ (20,427)	$ 2,739,252
German Bonds	1,984,889	15,999	(65,565)	1,935,323
French Bonds	1,360,852	26,318	(48,359)	1,338,811
French Notes	1,311,809	30,452	(34,658)	1,307,603
Japanese Bonds	7,614,891	409,959	(19,824)	8,005,026
Total	$ 14,971,118	$ 543,730	$ (188,833)	$ 15,326,015

September 30, 2011 (In Thousands)	Amortized Cost	Gross Unrealized Holdings Gains	Gross Unrealized Holding (Losses)	Fair Value
Available for sale:				
Other FCDAs	$ 3,028,305	$ –	$ (173,342)	$ 2,854,963
German Bonds	2,010,188	37,692	(29,249)	2,018,631
French Bonds	1,310,036	30,006	(17,459)	1,322,583
French Notes	1,372,644	36,998	(18,604)	1,391,038
Japanese Bonds	7,183,099	905,856	(4,914)	8,084,041
Total	$ 14,904,272	$ 1,010,552	$ (243,568)	$ 15,671,256

Other FCDAs represent Euro denominated instruments issued by the Bank of International Settlements, and typically mature within one year.

NOTE 5 – INVESTMENT SECURITIES AND OTHER FOREIGN CURRENCY DENOMINATED ASSETS (Continued)

Debt securities held as unrealized losses were as follows September 30, 2012:

September 30, 2012 (In Thousands)	Unrealized Losses Greater Than 1 Year		Fair Value	
Available-for-sale				
Other FCDAs	$	-	$	-
German Bonds		48,990		730,038
French Bonds		34,046		427,215
French Notes		27,534		385,672
Japan Bonds		11,424		766,096
Total	$	121,994	$	2,309,021

September 30, 2012 (In Thousands)	Unrealized Losses Less Than 1 Year		Fair Value	
Available-for-sale				
Other FCDAs	$	20,427	$	847,236
German Bonds		16,575		430,421
French Bonds		14,313		270,292
French Notes		7,124		217,721
Japan Bonds		8,400		629,100
Total	$	66,839	$	2,394,770

Maturities of debt securities classified as available for sale were as follows at September 30, 2012:

September 30, 2012 (In Thousands)	Amortized Cost		Fair Value	
Available-for-sale:				
Due within one year	$	6,971,311	$	7,146,851
Due after one year but before five years		7,999,807		8,179,164
Total	$	14,971,118	$	15,326,015

NOTE 5 – INVESTMENT SECURITIES AND OTHER FOREIGN CURRENCY DENOMINATED ASSETS (Continued)

Impairment Assessment

The ESF evaluates whether unrealized losses on investment securities indicate other-than-temporary impairment. Based on this evaluation, ESF recognized no other-than-temporary impairment losses on any securities in fiscal years 2012 and 2011.

Fair Value

The fair value of securities available for sale are measured using the hierarchy or lowest level input that is significant to the fair value measurement of the investment in its entirety. The following table presents assets that are measured at fair value on a recurring basis at September 30, 2012 and 2011.

		Fair Value Measurements at Reporting Date Using		
September 30, 2012 (In Thousands)	**Fair Value At 9/30/2012**	**Quoted Prices In Active Markets For Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Available for sale:				
Other FCDAs	$ 2,739,252	$ 2,739,252	$ -	$ -
German Bonds	1,935,323	1,935,323	-	-
French Bonds	1,338,811	1,338,811	-	-
French Notes	1,307,603	1,307,603	-	-
Japanese Bonds	8,005,026	8,005,026	-	-
Total	$ 15,326,015	$ 15,326,015	$ -	$ -

NOTE 5 – INVESTMENT SECURITIES AND OTHER FOREIGN CURRENCY DENOMINATED ASSETS (Continued)

		Fair Value Measurements at Reporting Date Using		
September 30, 2011 (In Thousands)	**Fair Value At 9/30/2011**	**Quoted Prices In Active Markets For Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Available for sale:				
Other FCDAs	$ 2,854,963	$ 2,854,963	$ -	$ -
German Bonds	2,018,631	2,018,631	-	-
French Bonds	1,322,583	1,322,583	-	-
French Notes	1,391,038	1,391,038	-	-
Japanese Bonds	8,084,041	8,084,041	-	-
Total	$ 15,671,256	$ 15,671,256	$ -	$ -

NOTE 6 – ACCUMULATED OTHER COMPREHENSIVE INCOME

The accumulated balances for other comprehensive income are as follows:

September 30, 2012 (In Thousands)	**Accumulated Other Comprehensive Income**	
Balance at September 30, 2011		$ 766,984
Unrealized holding gains/(losses) arising during the period	$ (99,727)	
Less: reclassification of gains recognized in net income	(312,360)	
Other comprehensive loss		(412,087)
Balance at September 30, 2012		$ 354,897

NOTE 6 – ACCUMULATED OTHER COMPREHENSIVE INCOME (Continued)

September 30, 2011 (In Thousands)	Accumulated Other Comprehensive Income	
Balance at September 30, 2010		$ 1,172,593
Unrealized holding gains/(losses) arising during the period	$ 239,221	
Less: reclassification of gains recognized in net income	(644,830)	
Other comprehensive loss		(405,609)
Balance at September 30, 2011		$ 766,984

NOTE 7 – SDR CERTIFICATES ISSUED TO FEDERAL RESERVE BANKS

The Special Drawing Right Act of 1968 authorized the Secretary of the Treasury to issue Special Drawing Right certificates (SDRCs), not to exceed the value of SDR holdings, to the Federal Reserve System in return for interest-free dollar amounts equal to the face value of certificates issued (SDR monetization). The certificates may be issued for the purpose of financing the acquisition of SDRs from other countries or to provide resources for financing other operations of the ESF. Certificates issued have no set maturity and are to be redeemed by the ESF at such times and in such amounts as the Secretary of the Treasury may determine (SDR demonetization). As of September 30, 2012 and 2011, the amount of certificates issued to Federal Reserve Banks was $5.2 billion.

NOTE 8 - FAIR VALUES OF FINANCIAL INSTRUMENTS

Financial Instruments (FASB ASC 825-10) requires all entities to disclose the fair value of financial instruments, where feasible, in an effort to provide financial statement users with information in making rational investment and credit decisions.

To estimate the fair value of each class of financial instrument, the ESF applied the following methods using the indicated assumptions:

Cash and Cash Equivalents

Cash and Cash Equivalents consist of U.S. government securities and FCDAs, and are reported in the Statements of Financial Position at amounts that approximate their fair values.

Securities Purchased Under Agreement to Resell

The fair value is based upon quoted market interest rates for similar securities.

NOTE 8 - FAIR VALUES OF FINANCIAL INSTRUMENTS (Continued)

SDR Certificates Issued to Federal Reserve Banks

The fair value of these certificates is based on the face value of the certificate as they are not subject to market or interest rate risk nor are they subject to fluctuations in exchange rates.

Special Drawing Right (SDR) Holdings and SDR Allocations

The fair values are based on quoted prices published weekly by the IMF.

Investment Securities and Other FCDAs

The fair value of Investment Securities and Other FCDAs are based upon quoted market and current exchange rates.

The estimated fair values of the ESF's financial instruments at September 30 are as follows:

September 30 (In Thousands)	2012		2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets:				
Cash and Cash Equivalents	$ 32,433,191	$ 32,433,191	$ 30,974,114	$ 30,974,114
Securities Purchased-Under Agreement to Resell	771,360	771,360	2,505,269	2,505,269
Investment Securities and Other Foreign Currency Denominated Assets	15,326,015	15,326,015	15,671,256	15,671,256
SDR Holdings	55,232,490	55,232,490	55,875,301	55,875,301
Liabilities:				
Certificates Issued to Federal Reserve Banks	5,200,000	5,200,000	5,200,000	5,200,000
SDR Allocations	54,463,490	54,463,490	55,149,673	55,149,673

NOTE 9 – COMMITMENTS AND CONTINGENCIES

Foreign Currency Denominated Agreements

Foreign currency denominated agreements that exist between the Treasury and foreign entities or governments provide for drawings of dollars by those entities or governments and drawings of foreign currencies by the Treasury. The Treasury enters into these agreements through the ESF. Under these agreements, the ESF receives repayment of an agreed-upon amount in dollars regardless of currency fluctuations. With the exception of the Mexico agreement noted below, there were no foreign currency denominated agreements as of September 30, 2012 and 2011.

Exchange Stabilization Agreements

The ESF has an Exchange Stabilization Agreement (ESA) with Mexico. In April 1994, the Treasury signed the North American Framework Agreement, which includes the ESA with Mexico. The ESA provides for a $3 billion standing swap line between the Bank of Mexico and the ESF.

The amounts and terms (including the assured source of repayment) of any new borrowings under the North American Framework Agreement are subject to certain requirements of the agreement that specify the transactions are exchange rate neutral for the ESF and would bear interest referenced to U.S. Treasury bills. Drawings are contingent on certain other conditions being met.

There were no drawings outstanding on the ESF swap line as of September 30, 2012 and 2011. On November 29, 2011, the Treasury renewed its participation in the agreement until December 14, 2012.

NOTE 10 – SUBSEQUENT EVENTS

We evaluated and have had no subsequent events through December 3, 2012, the date that these financial statements were available to be issued.