FINANCIAL **STATEMENTS**

(Year ended 31 December 2002)

BANK OF CANADA

FINANCIAL REPORTING RESPONSIBILITY

The accompanying financial statements of the Bank of Canada have been prepared by management in accordance with Canadian generally accepted accounting principles and, if necessary, contain certain items that reflect best estimates and judgment of management. The integrity and objectivity of the data in these financial statements are management's responsibility. Management is responsible for ensuring that all information in the Annual Report is consistent with the financial statements.

In support of its responsibility, management has developed and maintains financial and management control systems and practices to provide reasonable assurance that transactions are properly authorized and recorded, that financial information is reliable, that the assets are safeguarded and liabilities recognized, and that the operations are carried out effectively. The Bank has an internal Audit Department, whose functions include reviewing internal controls and their application on an ongoing basis.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control and exercises this responsibility through the Audit Committee of the Board. The Audit Committee is composed of members who are neither officers nor employees of the Bank and who are financially literate, with at least one member who is a financial expert. The Audit Committee is therefore qualified to review the Bank's annual financial statements and to recommend their approval by the Board of Directors. The Audit Committee meets with management, the Internal Auditor, and the Bank's external auditors appointed by Order-in-Council. The Audit Committee has established processes to evaluate the independence of the Bank's external auditors and reviews all services provided by them. The Audit Committee has a duty to review the adoption of, and changes in, accounting principles and procedures that have material effect on the financial statements, and to review and assess key management judgment and estimates material to the reported financial information.

These financial statements have been audited by the Bank's external auditors, Raymond Chabot Grant Thornton, General Partnership and Deloitte & Touche LLP, and their report is presented herein.

D.A. Dodge, Governor

S. Vokey, CA, Chief Accountant

Ottawa, Canada

AUDITORS OF THE BANK OF CANADA
VÉRIFICATEURS DE LA BANQUE DU CANADA

AUDITORS' REPORT

To the Minister of Finance, registered shareholder of the Bank of Canada

We have audited the balance sheet of the Bank of Canada as at 31 December 2002 and the statement of revenue and expense for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance 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.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2002 and the results of its operations for the year then ended in accordance with Canadian generally accepted accounting principles.

The financial statements as at 31 December 2001 and for the year then ended were audited by Raymond Chabot Grant Thornton, General Partnership and Arthur Andersen LLP who expressed an opinion without reservation in their report dated 18 January 2002.

Raymond Chabot Grant Thornton

RAYMOND CHABOT GRANT THORNTON
General Partnership
Chartered Accountants

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
Chartered Accountants

Ottawa, Canada
17 January 2003

BANK OF CANADA

STATEMENT OF REVENUE AND EXPENSE

Year ended 31 December 2002

	2002	2001
	Millions of dollars	
REVENUE		
Revenue from investments, net of interest paid on deposits of $8.3 million ($23.2 million in 2001)	**2,016.6**	2,149.2
EXPENSE by function (notes 1 and 3)		
Monetary policy	**51.1**	43.4
Currency	**78.8**	65.6
Central banking services	**41.0**	31.1
	170.9	140.1
Retail debt services expenses	**70.3**	73.6
Retail debt services outsourcing costs	**–**	23.2
Retail debt services recoveries	**(70.3)**	(96.8)
	170.9	140.1
OTHER EXPENSE		
Restructuring and related costs (note 11)	**23.3**	28.7
	194.2	168.8
NET REVENUE PAID TO RECEIVER GENERAL FOR CANADA	**1,822.4**	1,980.4

(See accompanying notes to the financial statements.)

BANK OF CANADA

BALANCE SHEET

As at 31 December 2002

ASSETS	2002	2001
	Millions of dollars	
Deposits in foreign currencies		
U.S. dollars	**674.2**	391.9
Other currencies	**4.4**	3.8
	678.6	395.7
Advances to members of the Canadian Payments Association	**534.9**	647.5
Investments (note 4)		
Treasury bills of Canada	**13,113.1**	12,605.6
Other securities issued or guaranteed by Canada maturing within three years	**8,571.3**	8,799.8
Other securities issued or guaranteed by Canada not maturing within three years	**18,648.7**	16,976.7
Other bills	**–**	428.8
Other investments	**2.6**	2.6
	40,335.7	38,813.5
Bank premises (note 5)	**135.1**	149.2
Other assets		
Securities purchased under resale agreements	**1,904.8**	1,410.7
All other assets (note 6)	**369.7**	387.9
	2,274.5	1,798.6
	43,958.8	41,804.5

(See accompanying notes to the financial statements.)

LIABILITIES AND CAPITAL

	2002	2001
	Millions of dollars	
Bank notes in circulation	**41,146.7**	38,820.6
Deposits		
Government of Canada	**534.6**	1,005.2
Banks	**1,065.5**	1,307.1
Other members of the Canadian Payments Association	**125.8**	23.8
Other deposits	**415.0**	289.6
	2,140.9	2,625.7
Liabilities in foreign currencies		
Government of Canada	**516.2**	224.6
Other liabilities		
All other liabilities	**125.0**	103.6
	43,928.8	41,774.5
Capital		
Share capital (note 7)	**5.0**	5.0
Statutory reserve (note 8)	**25.0**	25.0
	30.0	30.0
	43,958.8	41,804.5

D.A. Dodge, Governor

S. Vokey, CA, Chief Accountant

On behalf of the Board

J.S. Lanthier, CM, FCA, Chair, Audit Committee

P. Massicotte, Lead Director

(See accompanying notes to the financial statements.)

BANK OF CANADA

NOTES TO THE FINANCIAL STATEMENTS
Year ended 31 December 2002

1. The business of the Bank

The Bank of Canada's responsibilities focus on the goals of low and stable inflation, a safe and secure currency, financial stability, and the efficient management of government funds and public debt. These responsibilities are carried out as part of the broad functions described below. Expenses in the *Statement of revenue and expense* are reported on the basis of these four corporate functions as derived through the Bank's allocation model.

Monetary policy

Contributes to solid economic performance and rising living standards for Canadians by keeping inflation low, stable, and predictable.

Currency

Designs Canada's bank notes (including anti-counterfeiting features), issues and distributes new bank notes, and replaces worn notes.

Central banking services

Promotes financial system stability and provides efficient funds-management services to the federal government.

Retail debt services

Ensures that all holders of Canada Savings Bonds and Canada Premium Bonds have their information registered and their accounts serviced through efficient operations and systems support. The Bank recovers the cost of retail debt operations on a full-cost basis.

2. Significant accounting policies

The financial statements of the Bank are in accordance with Canadian generally accepted accounting principles and conform to the disclosure and accounting requirements of the Bank of Canada Act and the Bank's bylaws. A *Statement of cash flows* has not been prepared as the liquidity and cash position of the Bank are not of primary concern to users of these financial statements. Other information regarding the Bank's activities may be derived from the *Statement of revenue and expense* and the *Balance sheet*.

The significant accounting policies of the Bank are:

a) Accounting estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts recorded in the financial statements and notes to financial statements. These estimates are based on management's best knowledge of current events and actions that the Bank may undertake in the future. Actual results may differ from those estimates.

b) Revenues and expenses

Revenues and expenses are accounted for on the accrual basis.

c) Employee benefit plans

The Bank sponsors a number of defined-benefit plans that provide pension and other post-retirement and post-employment benefits to most of its employees. The Bank accrues its obligations under these benefit plans and the related costs, net of plan assets. The costs of the plans are actuarially determined using the projected benefit method to determine the current service costs. Past service costs resulting from plan amendments, and the transitional balances are amortized on a straight-line basis over the average remaining service period of active plan members (12 years). The excess of the net actuarial gain (loss) over 10 per cent of the greater of the benefit obligation and the fair value of plan assets is amortized over the average remaining service period of active plan members (12 years). For the purpose of calculating the expected return on plan assets, assets are valued at fair value.

d) Translation of foreign currencies

Assets and liabilities in foreign currencies are translated to Canadian dollars at the rates of exchange prevailing at year-end. Investment income is translated at the rate in effect at the date of the transaction. The resulting gains and losses are included in the *Statement of revenue and expense*.

e) Advances

Advances to members of the Canadian Payments Association are liquidity loans that are fully collateralized and generally overnight in duration. The Bank charges interest on advances under the Large Value Transfer System (LVTS) at the Bank Rate. For advances under the Automated Clearing Settlement System (ACSS), the Bank charges the Bank Rate plus a margin, which was 125 basis points at 31 December 2002 (150 basis points in 2001).

f) Investments

Investments, consisting mainly of Government of Canada treasury bills and bonds, are recorded at cost and are adjusted for amortization of purchase discounts and premiums using the constant-yield method for treasury bills and bankers' acceptances and the straight-line method for bonds. The amortization, as well as gains and losses on disposition, are included in the *Statement of revenue and expense*.

g) Bank premises

Bank premises, consisting of land, buildings, computer hardware/software and other equipment, are recorded at cost less accumulated depreciation. Computer software is capitalized only when its cost exceeds $2 million. Depreciation is calculated using the straight-line method and is applied over the estimated useful lives of the assets, as shown below.

Buildings	25 to 40 years
Computer hardware/software	3 to 7 years
Other equipment	5 to 15 years

h) Special purchase and resale agreements (SPRAs)

SPRAs are repo-type transactions in which the Bank offers to purchase Government of Canada securities from designated counterparties with an agreement to sell them back at a predetermined price on the agreed resale date, generally the next business day. The Bank is prepared to enter into SPRAs at the policy target rate, defined as the midpoint of the operating band for the overnight interest rate (i.e., 25 basis points below the Bank Rate), if overnight funds are generally trading above the indicated target level. SPRAs are transacted with primary dealers, a subgroup of government securities distributors that have reached a threshold level of activity in the Government of Canada debt markets.

The balance sheet category *Securities purchased under resale agreements* represents the value receivable by the Bank. As such, this amount includes the purchase of treasury bills and bonds, the purchase of accrued interest on bonds, and the interest earned by the Bank. The treasury bills and bonds purchased under resale agreements are not recorded as investment assets.

i) Deposits

The liabilities within this category are Canadian-dollar demand deposits. For members of the Canadian Payments Association, the Bank pays interest on positive balances associated with the LVTS at the lower end of the operating band for the overnight interest rate (50 basis points below the Bank Rate), and on positive balances related to the ACSS at the lower end of the operating band for the overnight interest rate less a margin, which was 125 basis points at 31 December 2002 (150 basis points in 2001). On Special Deposit Accounts, which serve as collateral for LVTS participants, the Bank pays interest at the published overnight rate less a margin, which was 6.25 basis points at 31 December 2002 (6.25 basis points in 2001).

j) Sale and repurchase agreements (SRAs)

SRAs are reverse repo-type transactions in which the Bank offers to sell Government of Canada securities to designated counterparties with an agreement to buy them back at a predetermined price the next business day. The Bank is prepared to enter into SRAs at the policy target rate, defined as the midpoint of the operating band for the overnight interest rate (i.e., 25 basis points below the Bank Rate), if overnight funds are generally trading below the indicated target level. SRAs are transacted with primary dealers, a subgroup of government securities distributors that have reached a threshold level of activity in the Government of Canada debt markets.

k) Securities Lending Program

In 2002, the Bank implemented a Securities Lending Program to support the liquidity of Government of Canada securities by providing a secondary and temporary source of these securities to the market. These securities-lending transactions are fully collateralized and are generally overnight in duration. The securities loaned continue to be accounted for as investment assets. Lending fees charged by the Bank on these transactions are included in revenue at the date of the transaction.

l) Insurance

The Bank does not insure against direct risks of loss to the Bank, except for potential liabilities to third parties and where there are legal or contractual obligations to carry insurance. Any costs arising from these risks are recorded in the accounts at the time they can be reasonably estimated.

3. Expense by classes of expenditure

	2002	**2001**
	Millions of dollars	
Salaries	**69.9**	83.4
Benefits and other staff expenses	**15.3**	13.8
Currency costs	**31.9**	24.6
Premises maintenance	**17.9**	18.9
Services and supplies	**90.5**	54.3
Depreciation	**24.3**	26.3
	249.8	221.3
Outsourcing costs	**–**	23.2
Recoveries		
Retail debt services	**(70.3)**	(96.8)
Other	**(8.6)**	(7.6)
	170.9	140.1
Restructuring and related costs	**23.3**	28.7
Total	**194.2**	168.8

Recoveries represent the fees charged by the Bank for a variety of services. Retail debt services recoveries for 2001 include outsourcing costs.

4. Investments

Securities	2002 Millions of dollars Amortized cost	Fair market value	Average yield %	2001 Amortized cost	Fair market value	Average yield %
Treasury bills of Canada	**13,113.1**	**13,126.3**	**3.0**	12,605.6	12,655.3	3.3
Other securities issued or guaranteed by Canada maturing within 3 years	**8,571.3**	**8,883.8**	**5.6**	8,799.8	9,133.9	6.0
Other securities issued or guaranteed by Canada not maturing within 3 years	**18,648.7**	**20,407.1**	**6.0**	16,976.7	18,165.0	6.3
Other bills	**–**	**–**		428.8	428.8	2.3
	40,333.1	**42,417.2**		38,810.9	40,383.0	
Other investments	**2.6**	**2.6**		2.6	2.6	
	40,335.7	**42,419.8**		38,813.5	40,385.6	

The Bank typically holds its investments in treasury bills and bonds until maturity. The amortized book values of these investments approximate their par values.There were no securities loaned under the Securities Lending Program at 31 December 2002.

5. Bank premises

	2002 Millions of dollars Cost	Accumulated depreciation	Net book value	2001 Cost	Accumulated depreciation	Net book value
Land and buildings	**167.5**	**78.3**	**89.2**	167.5	74.9	92.6
Computer hardware/ software	**53.5**	**42.7**	**10.8**	55.2	37.4	17.8
Other equipment	**135.5**	**105.9**	**29.6**	139.4	102.4	37.0
	356.5	**226.9**	**129.6**	362.1	214.7	147.4
Project in progress	**5.5**	**–**	**5.5**	1.8	–	1.8
	362.0	**226.9**	**135.1**	363.9	214.7	149.2

The project in progress consists of the replacement of the Bank's Automated Systems that form the core of foreign reserves management. Depreciation, on a straight-line basis over 5 years, will commence in 2003 upon completion of the project.

6. All other assets

This category includes accrued interest on investments of $267.9 million ($279.0 million in 2001). It also includes the pension accrued benefit asset of $70.7 million ($55.6 million in 2001).

7. Share capital

The authorized capital of the Bank is $5.0 million divided into 100,000 shares with a par value of $50 each. The shares are fully paid and, in accordance with the Bank of Canada Act, have been issued to the Minister of Finance, who is holding them on behalf of the Government of Canada.

8. Statutory reserve

The rest fund was established in accordance with the Bank of Canada Act and represents the statutory reserve of the Bank. The statutory reserve was accumulated out of net revenue until it reached the stipulated maximum amount of $25.0 million in 1955.

9. Employee benefit plans

The Bank sponsors a number of defined-benefit plans that provide pension and other post-retirement and post-employment benefits to most of its employees. The pension plans provide benefits under a Registered Pension Plan and a Supplementary Pension Arrangement. The following table provides information about these plans.

	Pension benefit plan		Other benefit plans	
	2002	2001	2002	2001
	Millions of dollars		Millions of dollars	
For the year				
Bank contributions	**2.7**	2.0	**5.4**	5.7
Employees' contributions	**5.1**	0.4	**–**	–
Benefits paid	**22.0**	20.8	**5.4**	5.7
Benefit plan expense (revenue)	**(12.4)**	(15.1)	**13.3**	14.7
Curtailment loss	–	–	**2.7**	8.9

	Pension benefit plan		Other benefit plans	
	2002	2001	2002	2001
	Millions of dollars		Millions of dollars	
As at 31 December				
Accrued benefit obligation	**612.1**	486.4	**106.4**	87.4
Fair value of plan assets	**639.2**	690.6[a]	**–**	–
Plans' surplus (deficit)	**27.1**	204.2	**(106.4)**	(87.4)
Accrued benefit asset (liability)	**70.7**	55.6	**(51.5)**	(41.0)

a. The valuation of the plan assets disclosed in the 2001 Financial Statements was determined as of 4 October 2001. The prior year comparative numbers have been amended to reflect the valuation as at 31 December 2001.

The increase in the pension plans' accrued benefit obligation of $125.7 million ($40.2 million in 2001) from 2001 to 2002 is primarily a result of the following factors: a decrease in the discount rate used for accounting purposes $24.2 million ($26.0 million in 2001); updating of economic and demographic assumptions $30.1 million (nil in 2001); and changes to member benefits $31.0 million (nil in 2001).

The significant actuarial assumptions (weighted averages as of 31 December) used in calculating the accrued benefit obligations are as follows.

	Pension benefit plans		**Other benefit plans**	
	2002	**2001**	**2002**	**2001**
Discount rates	**5.50%**	5.75%	**5.30%**	5.99%
Expected rates of return on plan assets for the year	**6.00%**	5.70%	**N/A**	N/A
Rate of compensation increase	**4.00% + merit**	3.00% + merit	**4.00% + merit**	3.00% + merit

Interest rates for Government of Canada marketable bonds are used. These rates are lower than those used by the Bank for funding valuations of the pension benefit plans and hence show a lower surplus.

For measurement purposes, a 9.0 per cent annual rate of increase in the per capita cost of covered hospital and drug benefits was assumed. The rate was assumed to decrease gradually to 4.5 per cent over 10 years and remain at that level thereafter. The per capita cost of other health care benefits was assumed to increase at 3.0 per cent per annum.

10. Commitments

a) Operations

In 2001, the Bank entered into a long-term support agreement for retail debt services, expiring in 2011. As at 31 December 2002, fixed payments totalling $119.2 million remained, plus a variable component based on the volume of transactions. The Bank recovers the cost of retail debt services from the Canada Investment and Savings Agency.

Commitments related to other support services are $5.3 million over the next two years.

b) Foreign currency contracts

The Bank is a participant in foreign currency swap facilities with the U.S. Federal Reserve for US$2 billion, the Banco de México for Can$1 billion and with the Exchange Fund Account of the Government of Canada. There were no drawings under any of those facilities in 2002 or 2001 and, therefore, there were no commitments outstanding at 31 December 2002.

c) Investment contracts

In the ordinary course of business, the Bank enters into commitments involving the purchase and sale of securities. All commitments outstanding at 31 December are settled in the subsequent year. A summary of these outstanding commitments follows.

		2002	2001
		Millions of dollars	
Investment contracts	– sales	**1,906.1**	1,411.1

Outstanding sale investment contracts of $1,906.1 million, at an interest rate of 2.74 per cent under special purchase and resale agreements, were settled by 17 January 2003 ($1,411.1 at the end of 2001 at an interest rate of 2.25 per cent).

11. Restructuring and related costs

Outsourcing

In 2000, the Bank launched a major initiative to outsource the administration of the retail debt program to a private sector supplier, while maintaining its role as fiscal agent for retail debt. Under the terms of a contract with EDS Canada for the provision of operations and system support, Bank staff joined EDS in its Ottawa offices. This contract is for a term of 9.5 years and commenced 1 September 2001. The total one- time cost of outsourcing associated with this initiative was $23.2 million in 2001, all of which was recoverable from the Canada Investment and Savings Agency of the federal government.

Restructuring

With the outsourcing initiative completed, the Bank has undertaken to restructure its corporate services to align them with the needs of a smaller organization. This restructuring program is scheduled for completion in 2003. The following table provides information about the non-recurring costs associated with this program.

	2002	2001
	Millions of dollars	
Restructuring project costs	**14.3**	8.1
Staff redundancies	–	5.8
Curtailment loss from post-retirement benefits (note 9)	**2.7**	8.9
Unallocated corporate administration costs	**6.3**	5.9
Total	**23.3**	28.7

In 2001, a liability of $5.8 million was established to meet future obligations related to staff redundancies. During 2002, no increase to this established liability was recorded and $1.4 million of the liability was utilized. The amount outstanding as at 31 December 2002 is $4.4 million and is included in All Other Liabilities.