

INDEPENDENT AUDITORS' REPORT

**Board of Directors
National Endowment for Democracy
Washington, D.C.**

We have audited the accompanying statements of financial position of National Endowment for Democracy (the "Endowment") as of September 30, 2005 and 2004, and the related statements of activities and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Endowment'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 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 Endowment's internal control over financial reporting. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the basic 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, such financial statements present fairly, in all material respects, the financial position of the Endowment as of September 30, 2005 and 2004, and the changes in its net assets and the cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

December 2, 2005

STATEMENTS OF FINANCIAL POSITION SEPTEMBER 30, 2005 AND 2004

ASSETS	2005	2004
CURRENT ASSETS:		
Cash and cash equivalents	\$ 2,630,845	\$ 2,337,909
Grants receivable—federal appropriation and special funding	117,420,119	77,525,464
Accounts receivable	2,323	6,871
Prepaid expenses and other assets	125,880	16,446
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Total current assets	120,179,167	79,886,690
FURNITURE AND EQUIPMENT	215,461	207,432
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TOTAL ASSETS	<u>\$ 120,394,628</u>	<u>\$80,094,122</u>
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	\$ 894,077	\$ 608,256
Grants payable	73,447,561	47,249,536
Deferred grant revenue—		
federal appropriation and special funding	44,342,348	30,800,108
Current obligations under capital leases	39,880	35,675
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Total current liabilities	118,723,866	78,693,575
CAPITAL LEASES OBLIGATIONS—Long-term portion	77,434	121,706
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Total liabilities	118,801,300	78,815,281
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NET ASSETS:		
Unrestricted	220,867	9,262
Temporarily restricted	1,372,461	1,269,579
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Total net assets	1,593,328	1,278,841
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TOTAL LIABILITIES AND NET ASSETS	<u>\$ 120,394,628</u>	<u>\$80,094,122</u>

See notes to financial statements.

**STATEMENTS OF ACTIVITIES AND CHANGES IN NET ASSETS
YEARS ENDED SEPTEMBER 30, 2005 AND 2004**

	2005			2004		
	Unrestricted	Temporarily Restricted	Total	Unrestricted	Temporarily Restricted	Total
SUPPORT AND REVENUE:						
Grant revenue—government agencies	\$113,026,546	\$	\$113,026,546	\$79,253,788	\$	\$79,253,788
Other grants and contributions		263,150	263,150		610,748	610,748
Other revenue, interest, and miscellaneous income	168,594	26,907	195,501	158,733	79,839	238,572
Total support and revenue	113,195,140	290,057	113,485,197	79,412,521	690,587	80,103,108
NET ASSETS RELEASED FROM RESTRICTIONS— Satisfaction of program restrictions						
	187,175	(187,175)		838,934	(838,934)	
Total revenues	113,382,315	102,882	113,485,197	80,251,455	(148,347)	80,103,108
EXPENSES:						
Program services—Grants programs—						
Federal—USDOS	101,971,387		101,971,387	68,769,453		68,769,453
Other	27,800		27,800			
Total grant programs	101,999,187		101,999,187	68,769,453	–	68,769,453
Other activities—Non-Federal:						
International Forum:						
Management and support	5,087		5,087	1,567		1,567
<i>Journal of Democracy</i>	78,829		78,829	85,618		85,618
Research and conferences	22,287		22,287			
World Movement for Democracy	(3,266)		(3,266)	1,027,314		1,027,314
NED Events and Development	61,525		61,525	91,504		91,504
Total other activities—Non-Federal	164,462		164,462	1,206,003	–	1,206,003
Other activities—Federal-USDOS:						
Federal—USDOS						
International Forum:						
<i>Journal of Democracy</i>	298,634		298,634	272,428		272,428
Democracy Resource Center	278,719		278,719	244,699		244,699
Research and conferences	129,094		129,094	98,782		98,782
Management and support	400,841		400,841	337,241		337,241
Reagan/Fascell Fellowship Program	964,432		964,432	1,172,585		1,172,585
World Movement for Democracy	377,998		377,998	799,030		799,030
World Movement for Democracy	111,037		111,037			
World Movement for Democracy	23,977		23,977			
Total other activities—Federal-USDOS	2,584,732		2,584,732	2,924,765	–	2,924,765
Supporting services:						
Federal—USDOS	8,422,329		8,422,329	7,574,271		7,574,271
Total other activities and support services	\$11,171,523		\$11,171,523	\$11,705,039	\$	\$11,705,039
Total expenses	113,170,710		113,170,710	80,474,492	–	80,474,492
CHANGES IN NET ASSETS	211,605	102,882	314,487	(223,037)	(148,347)	(371,384)
NET ASSETS—Beginning of year	9,262	1,269,579	1,278,841	232,299	1,417,926	1,650,225
NET ASSETS—End of year	\$ 220,867	\$ 1,372,461	\$ 1,593,328	\$ 9,262	\$1,269,579	\$ 1,278,841

See notes to financial statements.

STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2005 AND 2004

	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Changes in net assets	\$ 314,487	\$ (371,384)
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Depreciation and amortization	102,085	96,304
Changes in assets and liabilities:		
Grants receivable—federal appropriation and special funding	(39,894,655)	(33,391,950)
Accounts receivable	4,548	(6,871)
Prepaid expenses and other assets	(109,434)	347,211
Pledges receivable		
Accounts payable and accrued liabilities	285,821	(278,966)
Grants payable	26,198,025	14,176,304
Deferred grant revenue—federal appropriation and special funding	<u>13,542,240</u>	<u>18,942,260</u>
Net cash provided by (used in) operating activities	<u>443,117</u>	<u>(487,092)</u>
CASH FLOWS USED IN INVESTING ACTIVITIES—		
Purchase of furniture and equipment	<u>(110,114)</u>	<u>(43,189)</u>
Net cash used in investing activities	<u>(110,114)</u>	<u>(43,189)</u>
CASH FLOWS USED IN FINANCING ACTIVITIES—		
Principal payments under capital lease obligations	<u>(40,067)</u>	<u>(38,415)</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	292,936	(568,696)
CASH AND CASH EQUIVALENTS—Beginning of year	<u>2,337,909</u>	<u>2,906,605</u>
CASH AND CASH EQUIVALENTS—End of year	<u><u>\$2,630,845</u></u>	<u><u>\$2,337,909</u></u>

See notes to financial statements.

NOTES TO FINANCIAL STATEMENTS YEARS ENDED SEPTEMBER 30, 2005 AND 2004

1. ORGANIZATION AND ACCOUNTING POLICIES

Organization—The National Endowment for Democracy (the “Endowment”) is a private, not-for-profit organization headquartered in Washington, D.C. The Endowment was established coincident to a grant awarded by the United States Information Agency (“USIA”) as mandated by the National Endowment for Democracy Act (the “Act”) of the United States Congress. The purpose of the Endowment is to encourage free and democratic institutions throughout the world through activities that promote individual rights and freedoms. The Endowment awards grants to organizations with programs consistent with its objectives. On October 1, 1999, USIA and the U.S. Department of State (“USDOS”) consolidated. Accordingly, the Endowment receives funding for its annual Congressional Appropriation and other special federal funding from the USDOS.

Basis of Presentation—The accounts of the Endowment are maintained and the financial statements have been prepared on the accrual basis of accounting. The Endowment reports to the U.S. Government on the basis of obligations incurred and cash expenditures made.

Use of Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Furniture and Equipment—Furniture and equipment which are not part of direct program costs are recorded at cost and are depreciated or amortized on the straight-line method over their estimated service lives or the terms of the lease, as applicable, ranging from three to ten years.

Grants Receivable—Federal Appropriation and Special Funding—At the time a grant agreement is signed and awarded to the Endowment, a receivable and deferred revenue are recorded. When payments are received from the awarding agency, the receivable is reduced. The deferred revenue is recognized as revenue in accordance with the Endowment’s revenue recognition policy.

Revenue Recognition—Grants received from government agencies specify the periods in which monies are to be expended. Additionally, certain government grants restrict the use of funds for programs in specific countries. Revenues from government grants are recognized as earned in the year in which the Endowment obligates the funds for the intended purpose which is set forth in the grant agreement.

Agreements with the former USIA and USDOS provide for the subsequent audit of costs funded under the grant agreements. It is the policy of the Endowment to provide for cost disallowances based upon its experience in previous contract audits.

Deferred Grant Revenue—Federal Appropriation and Special Funding—Resources awarded in the form of federal grant agreements made to the Endowment in excess of obligations incurred are recorded as deferred grant revenue – federal appropriation and special funding.

Contributions—The Endowment reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified in the statement of activities as net assets released from restrictions. Income on these net assets is classified as temporarily restricted or unrestricted in accordance with the donor’s stipulation.

Cash and Cash Equivalents—Cash and cash equivalents include cash on deposit, overnight repurchase agreements, and investments in money market accounts and mutual funds. For the years ended September 30, 2005 and 2004, the Endowment recorded an unrealized gain of \$26,907 and \$79,839 on mutual funds, respectively.

2. FURNITURE AND EQUIPMENT

Furniture and equipment less accumulated depreciation and amortization as of September 30, 2005 and 2004 is as follows:

	2005	2004
Furniture and equipment	\$253,957	\$186,581
Equipment under capital lease	<u>213,963</u>	<u>213,963</u>
Total	467,920	400,544
Less accumulated depreciation and amortization	<u>(252,459)</u>	<u>(193,112)</u>
Furniture and equipment—net	<u>\$215,461</u>	<u>\$207,432</u>

3. GRANTS RECEIVABLE—FEDERAL APPROPRIATION AND SPECIAL FUNDING

Grants receivable are from the U.S. Government and represent balances of Federal Reserve Letters of Credit and direct funding established by the former USIA and USDOS grant agreements. The Endowment collects U.S. Government funds by filing requests for direct funding and by presenting payment vouchers against letters of credit when it disburses cash for program grants and administrative costs.

4. PREPAID EXPENSES AND OTHER ASSETS

During fiscal year 2005, the Endowment incurred conference costs for its world democracy conference which is scheduled to be held in April 2006 in Istanbul, Turkey. Accordingly, these costs totaling \$102,329 will be expensed during fiscal 2006.

5. GRANTS PAYABLE

Grants payable represent the undisbursed balances of funds obligated to the Endowment's grantees. Grantee organizations are entitled to collect grant funds as needed by presenting requests for funds to the Endowment. Such grants payable are generally disbursed within a 12-month period after the funds have been obligated to the Endowment's grantees.

6. DEFERRED REVENUE— FEDERAL APPROPRIATION AND SPECIAL FUNDING

The following schedule summarizes the changes in deferred grant revenue from agencies of the U.S. Government for the years ended September 30, 2005 and 2004:

	Deferred Grant Revenue, Beginning of Year	Add: Grants Awarded/ Amended	Less: Grants Obligated	Deferred Grant Revenue, End of Year
USDOS Grants:				
Grants Program:				
Primary Funding	\$1,628,750	\$59,198,592	\$54,113,517	\$6,713,825
Special Funding—Africa 2004	2,404,390	4,464,000	3,563,583	3,304,807
Special Funding—Balkans	63,967			63,967
Special Funding—Balkans (2001)	454,504		503,001	(48,497)
Special Funding—Balkans (2003)	250,359		97,463	152,896
Special Funding—Balkans (2004)	2,625,000	2,625,000	1,516,764	3,733,236
Special Funding—Burma	5,588	204		5,792
Special Funding—Burma (2001)	327,375		219,957	107,418
Special Funding—Burma (2003)	434,388	3,959,994	2,999,308	1,395,074
Special Funding—China/Tibet	32,315			32,315
Special Funding—China/IRI	2,567			2,567
Special Funding—China 2003	89,750			89,750
Special Funding—China 2004	265,815		74,581	191,234
Special Funding—Cuba		3,000,000	2,427,993	572,007
Special Funding—Greater China	2,982,300	3,968,000	2,771,736	4,178,564
Special Funding—Iraq (2002)	29,950		35,742	(5,792)
Special Funding—Iraq (2004)	9,086,015	37,783,596	35,450,981	11,418,630
Special Funding—M.E. Southeast Asia	3,479,350		2,479,375	999,975
Special Funding—Muslim (2002)	232,791		52,864	179,927
Special Funding—Muslim (2004)	1,039,055	3,968,000	743,775	4,263,280
Special Funding—NIS (2002)	41,802		99,286	(57,484)
Special Funding—NIS (2003)	360,345		131,328	229,017
Special Funding—NIS (2004)	3,129,643	5,665,000	4,305,432	4,489,211
Special Funding—North Korea (2003)	221,830	496,000	206,130	511,700
Special Funding—Tibet (2002)	2,624			2,624
Special Funding—Tibet (2003)	120,920		37,909	83,011
Special Funding—Venezuela	33,316			33,316
International Forum and World Movement for Democracy:				
World Movement for Democracy—NDRI	180,914		135,287	45,627
World Movement for Democracy—Durban Conference	105			105
World Movement for Democracy—Networks/SC	245,780		96,102	149,678
World Movement for Democracy—Istanbul Conference		250,000		250,000
Reagan/Fascell Fellowship Program Year 1				
Reagan/Fascell Fellowship Program Year 2				
Reagan/Fascell Fellowship Program Year 3 & 4	1,028,600	1,190,400	964,432	1,254,568
USAID Grant:				
Special Funding—World Movement for Democracy				
Total 2005	<u>\$30,800,108</u>	<u>\$126,568,786</u>	<u>\$113,026,546</u>	<u>\$ 44,342,348</u>
Total 2004	<u>\$11,857,849</u>	<u>\$ 98,196,047</u>	<u>\$ 79,253,788</u>	<u>\$ 30,800,108</u>

7. TEMPORARILY RESTRICTED NET ASSETS

Net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes specified by donors during the years ended September 30, 2005 and 2004, as follows:

	2005	2004
International Forum:		
<i>Journal of Democracy</i>	\$ 78,829	\$ 85,618
Research and Conference	22,287	
World Movement for Democracy	24,534	661,812
NED Events and Development and Hewlett	61,525	91,504
Total net assets released from restrictions	<u>\$187,175</u>	<u>\$838,934</u>

Temporarily restricted net assets are available for the following purposes at September 30:

	2005	2004
International Forum:		
<i>Journal of Democracy</i>	\$ 553	\$ 46,882
Visiting Fellows Program	551	551
World Movement for Democracy	149,373	
Research and Conferences	2,713	
NED Events and Development	1,219,271	1,222,146
Total temporarily restricted net assets	<u>\$1,372,461</u>	<u>\$1,269,579</u>

8. RELATED PARTIES

The Endowment awards grants to various organizations to be used for programs which the Board of Directors determines are consistent with the purposes of the Act. Some of the organizations which submit proposals and are awarded funds have members of their Board of Directors represented on the Board of Directors of the Endowment. There were no awards to related parties during the years ended September 30, 2005 and 2004.

Article VI, Section V, of the Endowment's bylaws provides that any Board member who is an officer or director of an organization seeking to receive grants from the Endowment must abstain from considering and voting on such grant. The provision does not prevent any director from supplying factual information that the Board requests.

9. COMMITMENTS

The Endowment has noncancelable operating leases for office space that expire in August 2006. The lease for office space includes a provision for rent escalations to compensate for increases in operating costs. In addition, the Endowment leases equipment under capital leases that expire on various dates through 2008.

Accumulated amortization for property under capital leases was \$156,882 and \$90,486 as of September 30, 2005 and 2004, respectively. The Endowment executed a new lease for their new headquarters in August 2005. The lease commences July 1, 2006 and expires June 30, 2016. Future minimum lease payments expire as follows for the years ending September 30, 2005 and 2004:

	Capital Leases	Operating Leases
2006	\$ 50,736	\$ 1,126,414
2007	40,968	2,278,083
2008	36,250	2,335,038
2009		2,393,412
2010		2,453,252
Thereafter		<u>15,526,328</u>
Total minimum payments	<u>127,954</u>	<u>26,112,527</u>
Less: Interest	10,640	
Present value of minimum payments	<u>\$117,314</u>	<u>\$26,112,527</u>

Rent expense was \$1,008,648 and \$871,133 for the years ended September 30, 2005 and 2004, respectively.

10. BANK LETTER OF CREDIT

During fiscal year 2005, the Endowment obtained a standby letter of credit in the amount of \$377,323 from a commercial bank. The letter of credit represents the security deposit for the Endowment's noncancelable operating lease for office space that was executed in August 2005. The lease commences July 1, 2006 and expires June 30, 2016.

11. INCOME TAXES

The Endowment is exempt from income taxes, except for unrelated business income activities, under Section 501(c)(3) of the U.S. Internal Revenue Code and has been classified as an organization that is not a private foundation under Section 509(a).

12. RETIREMENT PLAN

The Endowment has a defined contribution annuity plan for all of its employees, under which the Endowment contributes a percentage of eligible employees' annual earnings to individually owned tax-deferred annuity contracts. The Endowment's contribution to the plan is based on 10% of an eligible employee's annual earnings. The employer contributions to the plan for the years ended September 30, 2005 and 2004, were \$444,048 and \$419,039, respectively.

13. TRANSFERS TO GOVERNMENT AGENCIES

Commencing in fiscal year 1987, the U.S. Government established a policy whereby recipients of federal funds are required to deposit grant funds in interest-bearing accounts. Interest earned in excess of \$250 per fiscal year must be remitted back to the U.S. Government. Total interest earned on federal funds in fiscal year 2005 and 2004 was approximately \$2,793 and \$1,733, respectively.

