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REPORT TO THE CONGRESS

Audit Of The Rural Telephone
Bank, Department of Agriculture,
For The Initial Period October 1,
1971, To June 30, 1972

B-159292

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

092637

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JAN. 8, 1973



COMPTROLLER GENERAL OF THE UNITED STATES

WASHINGTON D C 20548

B-159292

To the President of the Senate and the
Speaker of the House of Representatives

This is our report on the audit of the Rural Telephone Bank,
Department of Agriculture, for the initial period October 1, 1971, to
June 30, 1972

Our audit was made pursuant to the Government Corporation
Control Act, (31 U S C 841)

Copies of this report are being sent to the Director, Office of
Management and Budget, the Secretary of Agriculture, and the
Governor, Rural Telephone Bank

A handwritten signature in black ink, reading "James B. Stacks".

Comptroller General
of the United States

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ABBREVIATIONS

GAO	General Accounting Office
REA	Rural Electrification Administration

D I G E S T

WHY THE AUDIT WAS MADE

The Government Corporation Control Act requires the General Accounting Office (GAO) to audit annually the Rural Telephone Bank and to report such audit to the Congress

MATTERS OF INTEREST

This is the report on GAO's initial audit of the Rural Telephone Bank. The Bank was established as a body corporate and an instrumentality of the United States by Public Law 92-12, approved May 7, 1971, to meet the growing capital needs of rural telephone systems.

The Bank is an agency of the United States and is subject to the supervision and direction of the Secretary of Agriculture. The Administrator of the Rural Electrification Administration (REA), Department of Agriculture, serves as the Governor of the Bank, the Bank's chief executive officer. Since 1949 REA has been authorized to make loans for furnishing and improving rural telephone service.

The Bank's general purposes are to

- Obtain an adequate supply of funds from the sale of stock and debentures, to supplement REA's telephone loan program
- Use its funds to make loans to providers of telephone service in

rural areas which have received REA loans or loan commitments

- Conduct its operations, to the extent practicable, on a self-sustaining basis. The Congress' objective is that the Bank eventually become an entirely privately owned, operated, and financed corporation. (See p 3)

The Bank's board of directors, called the Telephone Bank Board, was appointed on September 15, 1971. The Board held its first meeting, elected its officers, and adopted its bylaws in October 1971. Therefore the Bank's statement of income and patronage capital (retained earnings) (schedule 2) is for the 9-month period from October 1, 1971, to June 30, 1972.

The Bank made its first loan commitments in January 1972. Through June 30, 1972, it made loan commitments of about \$91 million to 89 borrowers. Advances totaling about \$590,000 were made to two borrowers. Net income for the period was \$4,351. (See p 12)

The computation of net income did not include the cost of personnel and facilities of the Department of Agriculture, mainly REA and the Office of the General Counsel, used by the Bank in carrying out its operations. REA had not estimated the amount of such expenses attributable to the Bank's operations. The Bank's authorizing legislation

authorizes the use of Department personnel and facilities at no cost

Also in accordance with the authorizing legislation, the Bank obtains funds from the U S Treasury in exchange for stock in the Bank. The stock is entitled to a return of 2 percent, which is less than the rate paid by the Treasury on borrowed funds. The return to the Treasury of \$1,040 during the period on funds provided to the Bank was about \$1,960 less than the cost to the Treasury of borrowing a similar amount of funds.

Had the foregoing costs been required by the law to be absorbed by the Bank, the Bank's net income for the period and its patronage capital (retained earnings)--reported as \$3,311--would have been correspondingly reduced. (See p 14)

OPINION ON FINANCIAL STATEMENTS

In GAO's opinion the Bank's finan-

cial statements present fairly its financial position at June 30, 1972, and the results of its operations and the changes in its financial position for the 9 months then ended, in conformity with generally accepted accounting principles and with applicable Federal laws. (See p 14)

RECOMMENDATIONS OR SUGGESTIONS

This report contains no recommendations or suggestions.

MATTERS FOR CONSIDERATION
BY THE CONGRESS

This report discloses the results of GAO's initial audit of the Bank and other information necessary to keep the Congress informed of the operations and financial condition of the Bank.

CHAPTER 1

INTRODUCTION

The Rural Telephone Bank was established as a body corporate and an instrumentality of the United States by Public Law 92-12, approved May 7, 1971, to meet the growing capital needs of rural telephone systems. The law amended the Rural Electrification Act of 1936 (7 U.S.C. 901), under which the Rural Electrification Administration (REA), Department of Agriculture, has been authorized since October 1949 to make loans for furnishing and improving rural telephone service.

The general purposes of the Bank are to obtain an adequate supply of funds, to the extent feasible from non-Federal sources, to supplement the REA telephone loan program; to use such funds to make loans to providers of telephone service in rural areas which have received REA loans or loan commitments; and to conduct its operations, to the extent practicable, on a self-sustaining basis. In the act the Congress declared that its objective was that the Bank eventually become an entirely privately owned, operated, and financed banking corporation.

To enhance the Bank's ability to obtain funds on favorable terms and conditions, Public Law 92-324, approved June 30, 1972, further amended the Rural Electrification Act of 1936 to permit the Bank to issue debentures to the Secretary of the Treasury and to authorize the Secretary of the Treasury to purchase such debentures.

MANAGEMENT AND ADMINISTRATION

The Bank is an agency of the United States and is subject to the supervision and direction of the Secretary of Agriculture. Its chief executive officer, called the Governor of the Bank, is the Administrator of REA.

The management of the Bank is vested in a board of directors, called the Telephone Bank Board, consisting of 13 members. The initial Board, consisting of ex officio members and members appointed by the President as provided by the act, during the period ended June 30, 1972, was as follows:

Ex officio members

David A. Hamil, Administrator, REA.
E. A. Jaenke, Governor, Farm Credit Administration

Members appointed by the President
to serve at his pleasure

Representing the Department of Agriculture

Dr. Thomas K. Cowden, Assistant Secretary of Agriculture.

Clarence D. Palmby, Assistant Secretary of Agriculture.¹

Dr. Eric Thor, Administrator, Farmer Cooperative Service.

Representing the public

Charles H. Pillard, president, International Brotherhood of Electrical Workers.

Willis F. Ward, chairman, Michigan Public Service Commission.

Members appointed by the President
to serve until election of
their successors

Glenn W. Bergland, manager, Winnebago Cooperative Telephone Association, Thompson, Iowa.

Mrs. Jean S. Brandli, president, Coosa Valley Telephone Company, Pell City, Alabama.

¹Mr. Palmby resigned on June 7, 1972, as a director of the Bank and as an assistant secretary of agriculture. On the same date the President appointed Carroll G. Brunthaver as a director of the Bank and nominated him as an assistant secretary of agriculture.

LeRoy T. Carlson, president, Telephone and Data Systems, Inc., Chicago, Illinois, and director, National R.E A Telephone Association

B Maynard Christenson, president, Dakota Cooperative Telephone Company, Inc., Irene, South Dakota

David J. McKay, manager, the Golden Belt Telephone Association, Inc., LaCrosse, Kansas.

Harold G. Payne, president, Telephone Utilities of Pennsylvania, Inc., and manager, Brookville Telephone Company, Export, Pennsylvania.

The act provides that, within 12 months of these initial appointments, the Governor call a meeting of all entities eligible to borrow from the Bank and organizations controlled by such entities to elect the above six members' successors for 2-year terms. Three of these members are to be elected from eligible cooperative-type entities and organizations controlled by them and three from commercial-type entities and organizations controlled by them. Subsequently these members are to be elected in the same proportion from similar organizations which hold class B and class C stock of the Bank by majority vote of the holders of such stock. (See following section for discussion of classes of stock)

The required election was held on September 14, 1972. The directors reelected were:

Glenn W. Bergland
Mrs Jean S. Brandl
B. Maynard Christenson
Harold G. Payne

New directors elected were:

Roy C Boecher, Pioneer Telephone Cooperative, Inc.,
Kingfisher, Oklahoma.

Arndon O. Haynes, Mashell Telephone Company, Eatonville, Washington.

As permitted by the act, the Bank uses, at no cost to the Bank, the facilities and the services of employees of the Department of Agriculture, mainly those of REA and the Office of the General Counsel, in carrying out its operations

CAPITALIZATION

The Bank's capital consists of capital stock subscribed by the U.S. Government, by borrowers from the Bank, by corporations and public bodies eligible to become borrowers from the Bank, and by organizations controlled by such entities. There are three classes of capital stock of the Bank

Class A stock is issuable, at a par value of \$1 a share, only to the Administrator of REA on behalf of the United States. The act authorizes appropriations, not to exceed \$30 million annually, for purchase of class A stock until such class A stock equals \$300 million. On August 10, 1971, the Congress appropriated \$30 million for the purchase of class A stock.

The act provides that class A stock be redeemed and retired by the Bank as soon as practicable after June 30, 1985, and after the amount of class A and class B stock issued totals \$400 million but not to the extent that the Telephone Bank Board determines that such retirement will impair the operations of the Bank. The minimum amount of class A stock that shall be retired under these conditions shall equal the amount of class B stock sold by the Bank during such year.

Class A stock is entitled to a return, payable from income, at the rate of 2 percent a year on the amounts of class A stock actually paid into the Bank. Such a return is cumulative and is payable annually into miscellaneous receipts of the Treasury.

Class B stock is issuable, at a par value of \$1 a share, only to the Bank's borrowers. Such borrowers are required by the act to invest in class B stock an amount equal to 5 percent of the amount of loans obtained from the Bank for purposes other than the purchase of class B stock. No dividends are payable on class B stock, but its holders are entitled to patronage refunds in class B stock from net income after provisions for a contingency reserve, the return on class A stock, and dividends on class C stock. Class B stock may be converted into class C stock under certain conditions specified in the Bank's bylaws.

Class C stock is issuable, at a par value of \$1,000 a share, to borrowers or to corporations and public bodies eligible to borrow, or to organizations controlled by such borrowers, corporations, and public bodies. Dividends may be paid on class C stock at a rate determined by the Telephone Bank Board. No dividends may be declared on class C stock, however, until arrearages, if any, on payments to the holder of the cumulative class A stock have been paid. Until all class A stock is retired, the Board may not declare any dividends on class C stock at an annual rate in excess of the then-current average rate payable on the Bank's telephone debentures, which are described in the following section.

BORROWING POWER

The Bank is authorized to obtain funds through the public or private sale of its bonds, debentures, notes, and other evidences of indebtedness (collectively called telephone debentures). Telephone debentures may be issued at such times, bear interest at such rates, and contain such terms and conditions as the Telephone Bank Board shall determine. The amount of telephone debentures which may be outstanding at any one time may not exceed eight times the paid-in capital and retained earnings of the Bank.

Public Law 92-324 authorizes the Bank to issue telephone debentures to the Secretary of the Treasury and authorizes the Secretary of the Treasury to purchase such debentures at his discretion. Each purchase of the debentures by the Secretary shall be upon such terms and conditions as to yield a return at a rate not less than the current average yield on outstanding marketable U S obligations of comparable maturity.

During the 9-month period ended June 30, 1972, the Bank had not issued telephone debentures.

LENDING POWER

The Bank is authorized by section 408(a) of the Rural Electrification Act of 1936 to make loans, in conformance with policies approved by the Telephone Bank Board, to corporations and public bodies which have received telephone loans or loan commitments from REA under its authority-- section 201 of the act. The Bank's loans may be made:

1. For the same purposes and under the same limitations as loans made by REA under section 201 of the act Section 201 provides that the Administrator, REA, make loans to finance the improvement, expansion, construction, acquisition, and operation of telephone lines, facilities, and systems to furnish and improve telephone service in rural areas. Section 201 provides further that preference be given to persons (natural persons, firms, corporations, or associations) and public bodies providing telephone service in rural areas and to cooperative, nonprofit, limited-dividend, or mutual associations.

Insofar as possible, assurance must be obtained that the telephone service to be furnished or improved by a loan will be made available to the widest practical number of rural users. A loan may be made to refinance the outstanding indebtedness of a person furnishing telephone service in rural areas, provided that such refinancing does not constitute more than 40 percent of the loan.

2. To finance or refinance the construction, improvement, expansion, acquisition, and operation of telephone lines, facilities, or systems to improve the efficiency, effectiveness, or financial stability of REA's or the Bank's telephone loan borrowers With respect to loans for the acquisition of existing telephone lines, facilities, or systems, the acquisition must be approved by the Secretary of Agriculture and must meet other specified conditions.

To make optimum use of the Bank's loan funds, the Telephone Bank Board adopted the policy that a loan for the acquisition of telephone exchange facilities under this section not be recommended for approval by the Secretary of Agriculture unless the Governor of the Bank determined that the acquisition was reasonably necessary to improve the efficiency, effectiveness, or financial stability of the borrower's telephone system, that the location and character of the proposed acquisition were such that the acquisition was reasonably necessary to accomplish such improvement, and that the amount of the requested loan

for such acquisition was reasonably justified by the nature and scope of the improvement which the acquisition would effect

- 3 To pay for the class B stock required to be purchased by borrowers.

The act provides that a telephone loan be made by the Bank, in preference to a loan by REA, if the borrower is eligible for a loan from the Bank and if the Bank has funds available. However, if the loan is for facilities for a telephone system which will have an average of three or fewer subscribers for each mile of telephone line, the loan is to be made by REA, unless the borrower elects to obtain the loan from the Bank.

The act provides that the loans be fully amortized over a period not to exceed 50 years. All loan commitments made during the period ended June 30, 1972 (see p. 12), required amortization over a period of 35 years.

A loan may not be made unless the Governor of the Bank certifies that in his judgment (1) the security for the loan is reasonably adequate and such loan will be repaid within the time agreed and (2) the borrower has the capability of producing net income or margins before interest at least equal to 150 percent of the interest requirements on all of its outstanding and proposed loans or such higher percentage as may be fixed from time to time by the Telephone Bank Board. The second requirement may be waived by the Governor under certain specified conditions

A loan made by the Bank is required, to the extent practicable, to bear interest at the highest rate which meets the requirements set forth in the paragraph above, consistent with the borrower's ability to pay such interest rate and with achievement of the objectives of the act, but not less than 4 percent a year. The maximum interest rate as determined by the Telephone Bank Board was 8 percent a year.

CONVERSION OF OWNERSHIP, OPERATION,
AND CONTROL OF THE BANK

Whenever 51 percent of the maximum amount of class A stock issued to the United States and outstanding at any time after June 30, 1985, has been fully redeemed and retired:

1. The Governor of the Bank shall be selected by the Telephone Bank Board.
2. The five members of the Board designated by the President shall cease to be members
3. The Bank shall cease to be an agency of the United States but shall continue in existence, in perpetuity, as an instrumentality of the United States and as a banking corporation.

When all class A stock has been fully redeemed and retired, loans made by the Bank shall no longer be subject to certain restrictions prescribed by the act. The Congress reserved the right, however, to review the continued operations of the Bank after all class A stock has been fully redeemed and retired.

CHAPTER 2

OPERATIONS

The law creating the Bank was approved on May 7, 1971, and the Telephone Bank Board was appointed September 15, 1971. The Board held its first meeting, elected its officers, and adopted its bylaws in October 1971. Therefore the Bank's statement of income and patronage capital (retained earnings) (schedule 2) is for the 9 months from October 1, 1971, to June 30, 1972.

The Bank, which made its first loan commitments on January 21, 1972, made the following loan commitments through June 30, 1972.

<u>Number of borrowers</u>	<u>Interest rate</u>	<u>Amount of loan commitments</u>
21	4 0%	\$17,814,400
6	4 5	4,284,000
5	4 0	7,345,800
4	5.5	4,725,000
8	6 0	5,882,650
10	6.5	10,225,950
3	7 0	1,890,000
6	7.5	9,439,500
<u>26</u>	8.0	<u>29,347,500</u>
<u>89</u>		<u>\$90,954,800</u>

During that period the Bank also made advances totaling \$587,923 to two borrowers against commitments to them of \$2,783,550.

Net income for the period was \$4,351. The 2-percent return on class A stock payable to the Treasury from net income was \$1,040. The balance of \$3,311, representing patronage capital (retained earnings) at June 30, 1972, was reserved for contingencies. The Telephone Bank Board did not declare patronage refunds on class B stock or dividends on class C stock.

CHAPTER 3

SCOPE OF EXAMINATION

Our audit of the Rural Telephone Bank consisted principally of an examination of its statement of financial condition at June 30, 1972, and the related statements of income and patronage capital (retained earnings) and of changes in financial position for the 9 months ended June 30, 1972. Also we reviewed the system of internal control and the basic laws, rules, and regulations applicable to the Bank, to ascertain the policies and restrictions under which it was required to operate. The examination was conducted at the Rural Telephone Bank, Washington, D C

Our audit was made in accordance with generally accepted auditing standards and included such tests of the Bank's accounting records and financial transactions and such other auditing procedures as we considered necessary in the circumstances.

CHAPTER 4

OPINION ON FINANCIAL STATEMENTS

The financial statements, schedules 1 through 3, and the notes to the financial statements were prepared by the Rural Telephone Bank.

The operating expenses reported by the Bank did not include the cost of personnel and facilities of the Department of Agriculture, mainly REA and the Office of the General Counsel, used by the Bank in carrying out its operations. Also the Bank obtained funds from the U.S. Treasury in exchange for stock in the Bank. The stock is entitled to a return of 2 percent, which is less than the rate paid by the Treasury on borrowed funds.

Public Law 92-12 authorizes the Bank to use the personnel and facilities of the Department at no cost, and REA had made no estimate of the amount of such expenses attributable to the Bank's operations.¹ Public Law 92-12 also provides that the Bank pay to the Treasury from income a return at the rate of 2 percent a year on the amounts of class A stock actually paid into the Bank by the Treasury. The return to the Treasury on such funds actually paid into the Bank during the period was \$1,040. The cost of such funds to the Treasury, computed on the basis of the average yield on long-term, outstanding marketable Treasury obligations for the applicable period, was about \$3,000.

Had the foregoing costs been required by law to be absorbed by the Bank, the Bank's net income for the period and its patronage capital (retained earnings) would have been correspondingly reduced.

In our opinion, the financial statements (schedules 1, 2, and 3) present fairly the financial position of the Rural Telephone Bank at June 30, 1972, and the results of its operations and the changes in its financial position for the

¹ REA officials told us that consideration would be given to estimating such expenses for future years.

9 months then ended, in conformity with generally accepted accounting principles and with applicable Federal laws.

RURAL TELEPHONE BANKBALANCE SHEETJUNE 30, 1972ASSETS

CASH		
With U S Treasury (note 1)	\$29,456,697	
On hand	<u>9,000</u>	\$29,465,697
INVESTMENTS		
In U S Government securities at amortized cost which approximates market	524,731	
Accrued interest on securities	<u>8,641</u>	533,372
LOANS RECEIVABLE (note 2)		
Loans receivable	587,923	
Accrued interest on loans	<u>316</u>	
	588,239	
Less Allowances for possible losses	<u>200</u>	588,039
UNAMORTIZED PREOPERATING COSTS (note 3)		
		<u>11,328</u>
		<u>\$30,598,436</u>

LIABILITIES AND INVESTMENT

LIABILITIES:		
Accounts payable and accrued liabilities	\$ 1,535	
Return payable to the U S Treasury on Class A stock	<u>1,040</u>	\$ 2,575
INVESTMENT OF THE UNITED STATES GOVERNMENT		
Class A stock		30,000,000
INVESTMENT OF THE PUBLIC		
Class B stock		
Total subscriptions	4,332,055	
Less unissued	<u>4,199,505</u>	
Issued	132,550	
Class C stock	<u>460,000</u>	
		592,550
PATRONAGE CAPITAL (RETAINED EARNINGS)		
(note 4)		<u>3,311</u>
		<u>\$30,598,436</u>

The notes following schedule 3 are an integral part of this statement.

SCHEDULE 2

RURAL TELEPHONE BANK

STATEMENT OF INCOME AND

PATRONAGE CAPITAL (RETAINED EARNINGS)

FOR THE 9 MONTHS ENDED JUNE 30, 1972 (note 5)

INCOME:

Interest earned on loans	\$ 3,704	
Interest earned on investments	<u>6,511</u>	\$10,215

EXPENSES:

Operating costs incurred:

Directors' fees	8,000
Directors' travel expenses	6,039
Printing and reproduction	1,639
Fidelity insurance	502
Supplies, postage, and miscellaneous	812
Provision for possible losses on loans	<u>200</u>

Total	17,192
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Less: Unamortized preoperating costs (note 3)	<u>11,328</u>
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Operating expenses for the period	<u>5,864</u>
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NET INCOME FOR THE PERIOD	4,351
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Less: Return to U S Government on Class A stock	<u>1,040</u>
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PATRONAGE CAPITAL (RETAINED EARNINGS), JUNE 30, 1972 (note 4)	<u>\$ 3,311</u>
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The notes following schedule 3 are an integral part of this statement.

RURAL TELEPHONE BANKSTATEMENT OF CHANGES IN FINANCIAL POSITIONFOR THE 9 MONTHS ENDED JUNE 30, 1972 (note 5)

RESOURCES WERE PROVIDED BY:

Investment in Class A stock by the U.S. Government	\$30,000,000
Investment in Class B stock by borrowers	132,550
Investment in Class C stock by borrowers and others	460,000
Interest earned on loans and U.S. Gov- ernment securities	10,215
Increases in accounts payable and other liabilities	<u>2,575</u>
	<u>\$30,605,340</u>

RESOURCES WERE USED FOR:

Increase in cash	\$29,465,697
Investments in U S. Government securities	524,731
Advances on loan commitments to borrowers (net of provision for possible losses, \$200)	587,723
Increase in accrued interest on loans and securities	8,957
Increase in preoperating costs	11,328
Return to U.S. Government on Class A stock investment	1,040
Current period's operating expenses	<u>5,864</u>
	<u>\$30,605,340</u>

The notes following schedule 3 are an integral part of this statement.

RURAL TELEPHONE BANK

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 1972

- 1/ Includes \$29,409,000, representing proceeds from the sale of Class A stock to U S. Government In accordance with the RE Act, this amount is to remain on deposit in the Treasury of the United States until disbursed to meet loan commitments or operating expenses.
- 2/ The notes evidencing indebtedness on the Bank's loans are generally for 35 years and are secured by a first mortgage, which also secures equally and ratably notes evidencing indebtedness on REA loans.

Commitments as of June 30, 1972, were \$90,366,877 as follows

Cumulative loan commitments to 6/30/72	\$90,954,800
Unadvanced on commitments	<u>90,366,877</u>
Advances on commitments - Cumulative	587,923
Principal repayments - Cumulative	<u>-</u>
Loans receivable	<u>\$ 587,923</u>

- 3/ From inception to June 30, 1972, the principal costs incurred by the Bank were primarily related to activities of defining operating and funding policies. The major portion of these costs were for fees and travel expenses of the Bank Board of Directors, which met four times during fiscal year 1972. At these meetings the Board elected officers; adopted the bylaws, operating procedures, and Accounting Principles, Standards and Policies; established a Finance Committee to study the short- and long-term credit requirements of the Bank, appointed an election committee to recommend to the Governor and Board procedures and rules for calling and conducting an election of directors as prescribed by law; and adopted a policy on sharing of a first lien with other lenders. These activities during the first year are of a preoperating nature; and the applicable

unamortized costs totaling \$11,328 will be amortized ratably over fiscal years 1973 and 1974.

4/ By action of the Board on August 10, 1972 (Article VIII of the Bank's bylaws) this amount was reserved for contingencies.

5/ The Bank's Board of Directors was appointed on September 15, 1971, and the first Board meeting was held on October 14, 1971. The initial costs of the Bank were incurred in October 1971. Therefore, the Statement of Income and Patronage Capital (Retained Earnings) and the Statement of Changes in Financial Position cover only the period from October 1, 1971, through June 30, 1972.

Copies of this report are available from the
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