United States General Accounting Office 134303

GAO

Report to the Congress

September 1987

FINANCIAL AUDIT

Rural Telephone Bank's Financial Statements for 1986

134303

040414

GAO/AFMD-87-54

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-159292

September 30, 1987

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

This report presents our opinion on the Rural Telephone Bank's financial statements for the year ended September 30, 1986. Reports on the bank's internal accounting controls and on its compliance with laws and regulations are also provided. We are including a matter for your consideration regarding interest rates charged by the bank and its buildup of contingency reserves.

The Rural Telephone Bank was established in 1971 to provide supplemental financing for the Rural Electrification Administration's telephone program borrowers. The Rural Telephone Bank and the Rural Electrification Administration are agencies of the U.S. Department of Agriculture.

We are required to conduct an audit of the bank at least once every 3 years under the provisions of 31 U.S.C. 9105. To fulfill our responsibility, we contracted with an independent certified public accounting firm to conduct a financial and compliance audit of the bank for the year ended September 30, 1986. We reviewed the working papers of the certified public accountants, Peat Marwick Main & Co., and performed other procedures as we deemed necessary. Our examinations were performed in accordance with generally accepted government auditing standards.

Opinion on Financial Statements

In our opinion, and consistent with the opinion of Peat Marwick Main & Co., the Rural Telephone Bank's financial statements present fairly its financial position as of September 30, 1986, and the results of its operations, changes in stockholders' equity, and changes in financial position for the year then ended, in conformity with generally accepted accounting principles applied on a consistent basis. The 1985 financial statements, which are presented for comparative purposes, have not been audited and thus an opinion was not expressed on them.

The report by Peat Marwick Main & Co. on internal accounting controls disclosed no condition believed to be a material weakness. The auditors' report on compliance with laws and regulations disclosed nothing to indicate that the bank had not complied with such applicable laws and regulations which could have a material effect on the financial statements. We concur with these reports.

During the course of the examination, Peat Marwick Main & Co. also identified several matters which, although not material to the financial statements, were communicated for the bank's consideration in a separate management letter.

Policy Issues Noted During Our Review

From 1972 through September 30, 1986, the Rural Telephone Bank earned $156 million after payment of dividends on class A and C stock. These earnings were generated primarily from an excess of interest charged on loans made to rural telephone company borrowers, after payments of interest on the bank's borrowings from the U.S. Treasury. While the bank's authorizing legislation provides considerable latitude in establishing interest rates, the amount of net income and retained earnings accumulated appears to be higher than necessary. For the 3-year period ending September 30, 1986, the bank had net income exceeding $60 million after payment of cash dividends. Its reserve balance as of September 30, 1986, was almost $77 million.

In July 1987, we testified[1] that the bank is in the process of changing its rate-setting procedures for new loans. It plans to charge borrowers the interest rate in effect at the time the bank disburses the loan rather than the one in effect at the time the bank makes the loan commitment. This will more closely align interest rates charged to borrowers to the bank's cost of funds and reduce the risk to both the bank and its borrowers.

We also noted that the bank has a number of outstanding loan commitments with fixed interest rates that are higher than currently prevailing market interest rates. Adjusting those interest rate commitments to more appropriately reflect interest rates at the time of drawdown would provide relief to borrowers, thus ensuring the availability of funds at reasonable costs.

We also testified that if the bank or the Congress decides to deal with the existing accumulated reserves, several options are available. One of these would include making cash refunds to borrowers through some form of prorated redemption of class B stock dividends. Steps to reduce the contingency reserve may require legislative change.

[1]Statement of Frederick D. Wolf, Director, Accounting and Financial Management Division, before the Subcommittee on Government Information, Justice and Agriculture, Committee on Government Operations, House of Representatives, on the financial audit of the Rural Telephone Bank (GAO/T-AFMD-87-19).

Matter for Consideration

As we testified, the Congress may wish to amend the Rural Electrification Act to provide more specificity regarding acceptable levels of net income and accumulated reserves. The legislative process would permit the Congress to reevaluate the bank's method for calculating interest rates on loans if the Congress wishes to limit net income and reduce the existing level of accumulated reserves.

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, the Secretary of Agriculture, and the Board of Directors of the Rural Telephone Bank.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

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Auditors' Opinion

KPMG Peat Marwick

Certified Public Accountants

Peat Marwick Main & Co.
1990 K Street, N.W.
Washington, DC 20006

Comptroller General
U.S. General Accounting Office:

We have examined the balance sheet of the Rural Telephone Bank as of September 30, 1986, and the related statements of income, changes in stockholders' equity and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and the standards for financial and compliance audits contained in the Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, issued by the U.S. General Accounting Office, and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of the Rural Telephone Bank at September 30, 1986, and the results of its operations, changes in stockholders' equity, and changes in financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. The balance sheet of the Rural Telephone Bank as of September 30, 1985, and the related statements of income, changes in stockholders' equity and changes in financial position for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

Peat Marwick Main & Co.

November 28, 1986

Financial Statements

Balance Sheet

September 30, 1986
(with comparative figures for 1985)

Assets	1986	1985 (unaudited)
Interest-bearing balances with the U.S. Treasury	$ 28,804,238	22,990,345
Investment securities (note 3)	933,154	933,115
Loans, net of allowance for loan losses of $4,904,000 in 1986 and $4,397,000 in 1985 (note 4)	1,429,030,958	1,378,258,111
Accrued interest receivable	8,905,632	8,143,887
Other assets	431	595
	$ 1,467,674,413	1,410,326,053
Liabilities and Stockholders' Equity		
Liabilities:		
Accounts payable	55,090	203,766
Loans payable to the U.S. Treasury (note 5)	758,762,000	758,709,000
Accrued interest payable	19,125,591	18,543,134
Total liabilities	777,942,681	777,455,900
Stockholders' equity (note 7):		
Investment of U.S. Government - Class A stock, $1 par value; 600,000,000 shares authorized	448,530,000	420,000,000
Investment of others:		
Class B stock, $1 par value	149,451,815	133,949,179
Class C stock, $1,000 par value	1,730,000	1,730,000
Patronage capital:		
Designated for contingencies	64,706,937	57,248,261
Patronage capital earned	25,312,980	19,942,713
Total stockholders' equity	689,731,732	632,870,153
Commitments (note 8)		
	$ 1,467,674,413	1,410,326,053

See accompanying notes to financial statements.

Statement of Income

For the year ended September 30, 1986
(with comparative figures for 1985)

	1986	1985 (unaudited)
Interest revenue:		
Interest on loans	$ 109,095,993	102,808,170
Interest on U.S. Treasury securities	64,954	73,651
Interest on deposits with U.S. Treasury	1,806,492	1,835,925
Total interest revenue	110,967,439	104,717,746
Interest expense	76,495,495	76,287,756
Net interest income	34,471,944	28,429,990
Other expenses:		
Provision for loan losses (note 4)	507,000	494,000
Directors' fees	10,600	11,900
Directors' travel	23,591	28,292
Postage and printing	5,825	1,980
Miscellaneous	164	535
Audit fees (note 6)	30,000	(15,224)
Total other expenses	577,180	521,483
Net income	$ 33,894,764	27,908,507

See accompanying notes to financial statements.

Statement of Changes in Stockholders' Equity

For the year ended September 30, 1986
(with comparative figures for 1985)

	Class A stock	Class B stock	Class C stock	Patronage capital	Designated for contingencies	Total
Fiscal year 1985 balances and transactions (unaudited):						
Balance, September 30, 1984	$ 390,000,000	120,828,719	1,730,000	15,317,692	52,696,923	580,573,334
Net income for the year ended September 30, 1985	-	-	-	27,908,507	-	27,908,507
Issuance of Class A stock	30,000,000	-	-	-	-	30,000,000
Cash dividends on Class A stock ($.02 per share)	-	-	-	(7,965,794)	-	(7,965,794)
Issuance of Class B stock (net of rescissions)	-	2,492,506	-	-	-	2,492,506
Stock dividends on Class B stock	-	10,627,954	-	(10,627,954)	-	-
Cash dividends on Class C stock ($80 per share)	-	-	-	(138,400)	-	(138,400)
Amount designated for contingencies	-	-	-	(4,551,338)	4,551,338	-
Balance, September 30, 1985	420,000,000	133,949,179	1,730,000	19,942,713	57,248,261	632,870,153
Fiscal year 1986 balances and transactions:						
Net income for the year ended September 30, 1986	-	-	-	33,894,764	-	33,894,764
Issuance of Class A stock	28,530,000	-	-	-	-	28,530,000
Cash dividends on Class A stock ($.02 per share)	-	-	-	(8,581,784)	-	(8,581,784)
Issuance of Class B stock (net of rescissions)	-	3,165,649	-	-	-	3,165,649
Stock dividends on Class B stock	-	12,336,987	-	(12,336,987)	-	-
Cash dividends on Class C stock ($85 per share)	-	-	-	(147,050)	-	(147,050)
Amount designated for contingencies	-	-	-	(7,458,676)	7,458,676	-
Balance, September 30, 1986	$ 448,530,000	149,451,815	1,730,000	25,312,980	64,706,937	689,731,732

See accompanying notes to financial statements.

Statement of Changes in Financial Position

For the year ended September 30, 1986
(with comparative figures for 1985)

	1986	1985 (unaudited)
Sources of cash:		
Operations:		
Net income	$ 33,894,764	27,908,507
Add (deduct) items not affecting cash:		
Provision for loan losses	507,000	494,000
Amortization of discounts on investments	(39)	(2,085)
Total cash provided by operations	34,401,725	28,400,422
Increase (decrease) in:		
Accrued interest payable	582,457	(24,344)
Other assets	163	(396)
Loans payable to the U.S. Treasury	53,000	7,285,000
Investments matured	-	250,000
Loan principal collected	20,572,536	17,360,050
Class A stock issued	28,530,000	30,000,000
Total sources of cash	84,139,881	83,270,732
Uses of cash:		
Advances on loan commitments	68,686,734	70,090,890
Cash dividends	8,728,834	8,104,194
Increase (decrease) in:		
Accounts payable	148,674	(126,841)
Accrued interest receivable	761,746	(1,953,170)
Total uses of cash	78,325,988	76,115,073
Increase in cash	5,813,893	7,155,659
Cash, beginning of year	22,990,345	15,834,686
Cash, end of year	$ 28,804,238	22,990,345

See accompanying notes to financial statements.

Notes to Financial Statements

September 30, 1986 and 1985

(1) Background Information

(a) Mission

The Rural Telephone Bank (the Bank) was established on May 7, 1971, to provide a supplemental source of financing for the Rural Electrification Administration's (REA) telephone program. The REA is a credit agency of the U.S. Department of Agriculture which assists organizations with financing of electric or telephone service in rural areas.

(b) Conversion

According to authorizing legislation and amendments, the Bank will be converted to independent status when fifty-one percent of the Class A stock originally issued to the U.S. Government has been fully redeemed and retired. When such conversion occurs, the Bank will no longer be an agency of the U.S. Department of Agriculture and the President will cease to appoint board members. However, Congress may continue its oversight responsibilities for the Bank's operations.

(c) Operations

The Bank's enabling legislation, Section 403(b) of the Rural Electrification Act, authorizes the Bank to partially or jointly use the facilities and services of REA, or any other agency of the U.S. Department of Agriculture, without cost.

The Bank's operations are conducted by REA employees who carry out similar responsibilities under REA's Rural Telephone program. REA and the U.S. Department of Agriculture's Office of General Counsel provide administrative and facilities support to the Bank without reimbursement.

(2) Summary of Significant Accounting Policies

The following is a summary of the significant accounting and reporting policies followed by the Bank.

(a) Investment Securities

Investment securities are stated at cost, adjusted for amortization of premium and accretion of discount to maturity. Securities are written down to market only when there has been a permanent impairment of value.

(Continued)

(b) Loans

Loans are stated at unpaid principal amount net of the allowance for loan losses. Interest on loans is accrued at a level rate of return over the term of the loan.

(c) Allowance for Loan Losses

The allowance for loan losses is management's current estimate of the anticipated losses in the present loan portfolio. The allowance is increased by provisions charged to operating expenses and decreased by loan chargeoffs net of recoveries.

(d) Income Taxes

The Bank is an instrumentality of the United States and, as such, is not subject to income taxes.

(e) Donated Services

As previously stated, the REA and the Department of Agriculture's Office of General Counsel provide administrative and facilities support to the Bank without charge. Because there is no clearly measurable and objective basis for determining the value of such services, donated services are not reflected in the accompanying financial statements. However, management estimates the value of these services at $5,300,000 per year.

(3) Investment Securities

The Bank's investment securities at September 30, 1986 and 1985 are as follows:

	1986		1985	
	Book value	Market value	Book value	Market value
U.S. government bonds due:				
Within 1 year	$ 127,995	128,040	-	-
In 1993	805,159	797,571	933,115	801,427
	$ 933,154	925,611	933,115	801,427

(Continued)

(4) Loans

The composition of loans outstanding at September 30, 1986 and 1985 is as follows:

	1986	1985 (unaudited)
Construction	$ 1,350,512,425	1,302,398,227
Class B stock (note 7)	83,422,533	80,256,884
Less - allowance for loan losses	(4,904,000)	(4,397,000)
Total	$ 1,429,030,958	1,378,258,111

Interest rates on construction loans range from 4% to 12%.

Transactions in the allowance for loan losses for the years ended September 30, 1986 and 1985 are shown below:

	1986	1985 (unaudited)
Balance at beginning of year	$ 4,397,000	3,903,000
Provision charged to operations	507,000	494,000
Loans charged off	-	-
Less - recoveries	-	-
Balance at end of year	$ 4,904,000	4,397,000

(5) Loans Payable to the U.S. Treasury

On July 26, 1973, the Bank executed an open end note payable to the Secretary of the Treasury to fund loans to be obtained under Section 407 of the Rural Electrification Act, as amended (7 U.S.C. 947). Each year's advances are to be repaid in a lump sum on or before fifty years from the year-end following the date of advance at a rate of interest established by the Secretary of the Treasury for the calendar month in which each advance is made. As of September 30, 1986 and 1985, the Bank's cumulative debenture borrowings from the Treasury amounted to $759 million, at interest rates ranging from 7.25 to 14.625 percent.

Total outstanding debenture borrowings may not exceed twenty times the Bank's equity. As of September 30, 1986 and 1985, the Bank's cumulative borrowing authority totaled $13.8 billion and $12.7 billion, respectively.

(Continued)

(6) Audit Fees

The U.S. General Accounting Office (GAO) conducted an audit of the Bank beginning in 1983 and estimated that the audit fee would be $60,000. The Bank paid GAO $30,000 in 1983 and 1984 for such services. The audit was completed in 1985 at a cost $15,224 less than originally anticipated. Accordingly, the GAO reimbursed the Bank for the balance.

The 1986 audit fee represents management's accrual of audit expense.

(7) Stockholders' Equity

(a) Class A Stock

Class A stock is owned by the REA on behalf of the United States and is nonvoting stock. The Bank is authorized to issue up to $30,000,000 par value of this stock annually, until such stock issued and outstanding equals $600,000,000. Class A stock is to be redeemed and retired by the Bank as soon as practicable after September 30, 1995, but not to the extent that the Bank's Board determines that such retirement will impair the operations of the Bank. Class A stockholders receive cash dividends, payable from income, at a rate of 2 percent per annum.

(b) Class B Stock

Class B stock is issued only to loan customers of the Bank and is voting stock. Each customer is required to purchase such stock in the amount of five percent of the approved loan. The Bank may not pay cash dividends on Class B stock, but holders are entitled to patronage refunds in the form of Class B stock dividends at a specified percentage rate approved each year by the Board (twelve percent in 1985 and 1986). Class B stock can be redeemed and retired only after all shares of Class A stock have been redeemed and retired.

Subscriptions receivable are not reflected in the accompanying financial statements. When the Bank makes the first advance under each loan, it issues the stock applicable to the total loan and charges loans receivable. In the event of rescission of part of the loan commitment subsequent to issuance of the stock, the Bank rescinds the applicable portion of Class B stock and reduces loans receivable.

(Continued)

Class B stock at September 30, 1986 and 1985 is as follows:

	1986	1985 (unaudited)
Class B stock issued and committed for issuance	$ 105,744,708	101,876,884
Less - subscriptions not recognized	22,322,175	21,620,000
Stock issued based on loans originated	83,422,533	80,256,884
Cumulative patronage refunds issued and outstanding	66,029,282	53,692,295
Total Class B stock issued and outstanding	$ 149,451,815	133,949,179

(c) Class C Stock

Class C stock is issued only to borrowers, corporations, and public entities eligible to borrow and is voting stock. The Bank may pay dividends on Class C stock.

(d) Patronage Capital

Patronage capital is distributed as follows:

Designated for Contingencies - After the close of each fiscal year, an amount determined by the Board of Directors (not less than ten percent of patronage capital) is designated for contingencies. The amount so designated at September 30, 1986 does not include the amount designated from 1986 operations.

Patronage Capital Earned - Net income after dividends on Class A stock is reflected as patronage capital earned. This balance will be partially designated for contingencies with the remainder distributed to Class B and C shareholders.

(Continued)

(8) Commitments

A reconciliation of the Bank's unadvanced loan commitments from September 30, 1985 to September 30, 1986 follows:

Unadvanced loan commitments September 30, 1985	$ 665,345,573
Loan approvals during the fiscal year 1986	127,896,825
Loan advances including Class B Stock during fiscal year 1986	(71,852,383)
Recission of loan commitments during fiscal year 1986	(46,765,507)
Unadvanced loan commitments September 30, 1986	$ 674,624,508

Interest rates on unadvanced loan commitments range from 6.5% to 11.5%. Loan commitments are generally extended for 6 years. Unadvanced loan commitments at September 30, 1986 will expire through 1992.

Auditors' Report on Internal Accounting Control

KPMG Peat Marwick

Certified Public Accountants

Peat Marwick Main & Co.
1990 K Street, N.W.
Washington DC 20006

AUDITORS' REPORT ON INTERNAL CONTROL

Comptroller General
U.S. General Accounting Office:

We have examined the financial statements of Rural Telephone Bank (the Bank) for the year ended September 30, 1986 and have issued our report thereon dated November 28, 1986. As part of our examination, we made a study and evaluation of the Bank's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards and the standards for financial and compliance audits contained in the Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, issued by the U.S. General Accounting Office. For the purpose of this report, we have classified the significant internal accounting controls into the following categories: loans, interest revenue, and financial reporting. Our study and evaluation included all of the control categories listed above. The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the Bank's financial statements. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole or on any of the control categories identified above.

The Bank's management is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projections of any evaluation of the system to future periods is subject to the risks that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

The Bank evaluated its system of internal accounting and administrative controls in accordance with the Federal Manager's Financial Integrity Act of 1982 (Public Law 97-255). The Bank reported in September 1986 that its internal control system in effect during fiscal year 1986, taken as a whole, provided reasonable assurance that the Bank's objectives were achieved within the limits described above. The Bank's evaluation was reviewed and considered in conducting our study and evaluation and determining the nature, timing, and extent of audit tests.

Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of the Bank taken as a whole, or on any of the control categories identified in the first paragraph. However, our study and evaluation and our examination disclosed no condition that we believe to be a material weakness. In our letter to management dated November 28, 1986, we have separately communicated our observations and recommendations regarding other matters.

Peat Marwick Main & Co.

November 28, 1986

Auditors' Report on Compliance With Laws and Regulations

KPMG Peat Marwick

Certified Public Accountants

Peat Marwick Main & Co.
1990 K Street, N.W.
Washington DC 20006

AUDITORS' REPORT ON COMPLIANCE

Comptroller General
U.S. General Accounting Office:

We have examined the financial statements of the Rural Telephone Bank (the Bank) for the year ended September 30, 1986 and have issued our report thereon dated November 28, 1986. Our examination was made in accordance with generally accepted auditing standards and the standards for financial and compliance audits contained in the Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, issued by the U.S. General Accounting Office and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The management of the Bank is responsible for the Bank's compliance with laws and regulations. In connection with the examination referred to above, we selected and tested transactions and records to determine the Bank's compliance with those laws and regulations for which noncompliance could have a material effect on the financial statements.

The results of our tests indicate that, for the transactions and records tested, the Bank complied with those laws and regulations for which noncompliance could have a material effect on the Bank's financial statements. With respect to the transactions and records that were not tested by us, nothing came to our attention to indicate that the Bank had not complied with such laws and regulations.

Peat Marwick Main & Co.

November 28, 1986

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