United States General Accounting Office

GAO

Report to the Secretary of Agriculture

December 1988

FINANCIAL AUDIT

Farmers Home Administration's Losses Have Increased Significantly

GAO/AFMD-89-20

GAO

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

Accounting and Financial
Management Division

B-226249

December 20, 1988

The Honorable Richard E. Lyng
The Secretary of Agriculture

Dear Mr. Secretary:

This report presents the results of our examination of the Farmers Home Administration's (FmHA) financial statements for the year ended September 30, 1987, and our reports on internal accounting controls and compliance with laws and regulations.

The accompanying financial statements reflect a significantly deteriorating financial condition at FmHA for several reasons: (1) FmHA lends money at interest rates far below what it must pay, (2) many of its borrowers are, by commercial standards, not creditworthy, (3) a severe decline in the agricultural economy over the past several years has led to congressional initiatives aimed at keeping farmers in business, and (4) many of the loans are delinquent and unlikely to be repaid.

Because of FmHA's operating losses, its accumulated deficit of $36 billion, and its present reliance on Treasury borrowings to continue operations, we are concerned that FmHA will require direct assistance from the Congress at levels significantly greater than the Congress has provided in the past. FmHA borrowed $12 billion from the Treasury in fiscal year 1987 to meet current obligations. The total amount due to the Treasury has steadily increased from about $60 billion in 1982 to $85 billion in 1987, of which $24 billion is due by 1989.

Our opinion on FmHA's statement of financial position reflects our concerns over the agency's inability to repay its borrowings and to meet its current operations without incurring additional debt and the magnitude of its accumulated $36 billion deficit, which includes $22 billion for losses recognized in fiscal year 1987. Furthermore, our opinion is qualified because FmHA does not record property received by voluntary conveyance at fair market value at the time of acquisition in accordance with generally accepted accounting principles for federal agencies.

The report on FmHA's system of internal accounting controls discloses material weaknesses concerning FmHA's accounting records and procedures, including (1) analysis of the collectibility of its loan portfolio, (2) implementation of its accounting system for multiple family housing loans, (3) accounting for new guaranteed loans, and (4) valuation of acquired property and reconciliation of its property accounting records. We also noted several other matters of a lesser magnitude which we will be reporting on separately.

Our report on compliance with laws and regulations discloses that FmHA complied with the provisions of laws and regulations for the transactions we tested which could have materially affected its financial statements.

This report contains recommendations to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on these recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of this letter and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this letter.

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, the Administrator of Farmers Home, interested congressional committees, and others who request them.

Sincerely yours,

Frederick D. Wolf
Director

Contents

Abbreviations

AMAS	automated multiple family housing accounting system
COORS	County Office Operating Reports
FMFIA	Federal Managers' Financial Integrity Act
FmHA	Farmers Home Administration
OIG	Office of Inspector General
OMB	Office of Management and Budget

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To the Administrator
Farmers Home Administration

We have examined the accompanying statement of financial position of the Farmers Home Administration (FmHA), an agency of the Department of Agriculture, as of September 30, 1987, and the related statements of operations and cash flows for the fiscal year then ended. Our examination was made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except as indicated in this report. In addition to this report on our examination of FmHA's 1987 financial statements, we are also reporting on our study and evaluation of FmHA's internal accounting controls and on its compliance with laws and regulations. During our audit, we also identified matters which do not affect the fair presentation of the financial statements, but nonetheless warrant management's attention. We are reporting on them separately.

Prior to fiscal year 1987, FmHA did not prepare its financial reports nor maintain its accounting records in accordance with generally accepted accounting principles. Although FmHA adopted such principles during fiscal year 1987, it was not practical to perform all the auditing procedures necessary to enable us to express an opinion on the accompanying statements of operations and cash flows for the fiscal year ended September 30, 1987, or on the consistency of application of accounting principles with the preceding year. We are, therefore, not offering an opinion on those statements.

Deteriorating Financial Condition of FmHA

FmHA operates as a credit agency, making direct loans and guaranteeing other loans through several loan revolving funds. Funding for loan programs is provided through loan repayments, Treasury borrowings (including the Federal Financing Bank) and, to a lesser degree, appropriations for loan losses. Although the revolving funds have sustained losses over the years, the losses have grown more rapidly in the 1980s due primarily to the cost of uncollectible loans and related interest.

Because of significant and continuing operating losses, and the imminent maturity of debt as described in the maturity schedule of note 9 to the financial statements, FmHA is unable to meet its outstanding debt obligations without additional borrowings or congressional appropriations.

As shown in the accompanying financial statements, FmHA incurred losses for the fiscal year ended September 30, 1987, of about $22 billion. Since its inception, as shown in note 12 of the financial statements, FmHA's cumulative losses from operations have amounted to $59 billion. To date, the Congress has provided cumulative appropriations of about $23 billion to reimburse FmHA for realized losses; consequently, FmHA's accumulated deficit stood at $36 billion as of September 30, 1987.

Collections of loan principal and corresponding interest amounted to about $7 billion in fiscal year 1987. However, payments on U.S. Treasury borrowings and related interest amounted to about $16 billion. To finance its operations and meet its current obligations, FmHA borrowed an additional $12 billion from the U.S. Treasury for fiscal year 1987. The total amount due to the U.S. Treasury has steadily increased from about $60 billion in 1982 to $85 billion in 1987, of which $24 billion is due by 1989.

Loan Losses Not Fully Recognized Prior to 1987

The magnitude of FmHA's total losses did not come to light until fiscal year 1987 because

- reasonable allowances for loan losses were not established,
- interest was being accrued on loans in default 90 days or more, and
- reasonable losses were not being recognized on guaranteed loans.

During 1987, FmHA established an adequate allowance for loan losses which resulted in an unusually high provision for losses charged to fiscal year 1987 expenses. As explained in note 6 to the financial statements, the increased provision for losses for fiscal year 1987 is not attributable to a single adverse event in 1987, but is driven by the declining trend in the agricultural economy over the past several years. Consequently, the 1987 provision for losses on loans includes both the current provision and an adjustment to prior years' provisions—prior years' effects on government equity could not be separately determined.

In fiscal year 1987, FmHA also adopted an interest recognition policy similar to that used in the banking industry and required by federal banking regulators, where interest income on loans delinquent 90 days or more is not accrued for financial statement purposes. The policy adopted by FmHA requires a 100 percent loss allowance for interest receivable on loans delinquent over 90 days.

For fiscal year 1987, adjustments to the allowance for loan losses amounted to about $9 billion, resulting in a total allowance for loan losses of approximately $15 billion as of September 30, 1987, or 24 percent of outstanding loans. Adjustments to the allowance for losses on interest receivable amounted to about $4 billion as of September 30, 1987, or 81 percent of total interest receivable.

Lastly, during 1987, FmHA revised its method of evaluating probable losses on guaranteed loans. Probable losses are now determined based on losses experienced in comparable insured lending programs, current market conditions, and historical experience. As a result of this change, and the increase in guaranteed loan program activity, the accrual for probable losses was increased $688 million to $764 million as of September 30, 1987, or 24 percent of guaranteed loans.

Value of Acquired Property May Not Be Properly Recorded

Generally accepted accounting principles require that acquired property from foreclosure or loan workout actions be recorded at estimated fair value (the amount one can reasonably expect to receive in a current sale, not a forced or liquidation sale, from a willing buyer), at the time of acquisition. Although the current FmHA accounting system records the fair value of property acquired through foreclosure, property received by voluntary conveyance is recorded at loan principal plus accrued interest. The borrower's unpaid loan balance is usually much higher than the conveyed property's fair value due to currently depressed farm property values.

Due to the depressed farm economy, FmHA's inventory of acquired property is significant. As of September 30, 1987, FmHA reported an acquired property inventory of 1.7 million acres of farmland and 14,617 single family houses with a recorded value of $1.2 billion. About 50 percent of this amount was acquired through voluntary conveyance.

Because FmHA's accounting system does not capture current property market values at the time of acquisition for voluntarily conveyed property, it was not feasible for us to determine the amount of adjustments, if any, to the allowance for losses and the related provision that would be required to record these assets at their fair values at the time of acquisition.

Significant Reporting Issues

Interest Cost Subsidy Not Recorded

Almost 56 percent of FmHA's outstanding loans have a stated interest rate of 5 percent or less, which is substantially below the Treasury borrowing rate. This results in an interest rate subsidy cost. Both budgetary and accounting principles governing the recording of below cost rate loans and the resulting interest rate subsidy cost are undergoing reexamination by the Congress and the Executive Branch at this time. Furthermore, FmHA currently does not have the system capability to accurately compute this interest cost subsidy. The interest cost subsidy is defined as the difference between the present value of the principal plus interest of individual loan receivables using their contractual interest rate and their present value using the Treasury average interest rate at the time the loan is made. Although generally accepted accounting principles require disclosure of the interest cost subsidy, FmHA cannot readily determine this cost and, therefore, has neither recorded the interest cost subsidy in the accompanying financial statements nor disclosed it in the footnotes to the financial statements. Consequently, we are unable to determine the amount of the adjustments, if any, that would be required had these subsidies been recorded.

Uncollectible Loans Not Written Off

Although FmHA established an adequate allowance for loan losses, a large amount is deemed uncollectible and, therefore, should be considered for write-off. Because of the serious financial problems of many of its borrowers, a substantial portion of FmHA debt may never be repaid. As of December 31, 1987, total outstanding principal owed by delinquent borrowers totaled almost 63 percent of FmHA's farm loan portfolio.

As a result of the Agricultural Credit Act of 1987, there has been a heightened awareness of the magnitude of the potential for loan write-offs. In March 1988, FmHA estimated that restructuring of farm loans as a result of the act would amount to approximately $9 billion in write-offs. Write-off estimates have not been established for the other programs, such as the housing program. Although the act's provisions give rise to write-offs, a consistent and adequate write-off policy should be developed for all loan programs, regardless of whether they are covered by the act's provisions. Additionally, strong internal controls should be developed and consistently applied to protect against the potential for fraud and abuse.

GAO Opinion on FmHA's Statement of Financial Position

In our opinion, except for the effects, if any, of not recording acquired property at fair value at the time of acquisition, the accompanying statement of financial position presents fairly the financial position of the Farmers Home Administration as of September 30, 1987, in conformity with generally accepted accounting principles for federal agencies.

FmHA's financial condition has seriously deteriorated. Without the resources to meet the cost of its current operations and debt payments, and considering the nature of its programs and the weakened farm economy, we believe there is little likelihood that this trend will quickly improve. Because of FmHA's operating losses, its accumulated deficit of $36 billion, and its present reliance on Treasury borrowings to continue operations, we are concerned that FmHA will require direct assistance from the Congress at levels significantly greater than the Congress has provided in the past.

Frederick D. Wolf
Director

June 1, 1988

Report on Internal Accounting Controls

We have examined the financial statements of the Farmers Home Administration (FmHA) for the fiscal year ended September 30, 1987, and have issued our report thereon. This report pertains only to our study and evaluation of the system of internal accounting controls for the fiscal year ended September 30, 1987.

As part of our examination, we made a study and evaluation of the system of internal accounting controls to the extent we considered necessary to evaluate the system as required by generally accepted government auditing standards. 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 FmHA's financial statements. For the purpose of this report, we have classified the significant internal accounting controls in the following categories:

- loans and grants,
- guaranteed loans,
- acquired property,
- treasury, and
- financial reporting.

Our study and evaluation included all of the control categories listed above except for the treasury and financial reporting categories. For those categories, we found it more efficient to rely solely on substantive audit tests. For all categories, we performed audit tests to substantiate the balances of accounts associated with the respective control category. Substantive audit tests can serve to identify weaknesses within the system of internal accounting controls that could result in errors material to the financial statements.

FmHA's management is responsible for establishing and maintaining a system of internal accounting controls in accordance with the Accounting and Auditing Act of 1950 and the Federal Managers' Financial Integrity Act of 1982. 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 of internal accounting controls are to provide management with reasonable assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and other assets are safeguarded against waste, loss, and unauthorized use or misappropriation, and (3) assets, liabilities, revenues, and expenditures applicable to agency operations are properly recorded to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over agency assets. Because of inherent limitations in any system of internal accounting controls, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

FmHA evaluated its system of internal accounting and administrative controls in accordance with the Federal Managers' Financial Integrity Act of 1982. FmHA reported to the Secretary of Agriculture in October 1987 that while its internal control system in effect during fiscal year 1987, taken as a whole, provided reasonable assurance that FmHA's internal control objectives were achieved, several material weaknesses existed, including:

- reporting, accounting data, and balancing controls are not available in all instances for the automated multiple family housing accounting system, and
- acquired property is not recorded at the property's current market value, and detailed property files are not reconciled with general ledger accounts.

We reviewed and considered FmHA's assessment in conducting our study and evaluation and determining the nature, timing, and extent of our audit tests.

Our study and evaluation, made for the limited purpose described in the second paragraph, would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on FmHA's system of internal accounting controls taken as a whole or on the categories of controls identified in the second paragraph. However, during our study and evaluation, we noted and reported to FmHA a number of internal control weaknesses which we believe could result in errors or irregularities in amounts that are material in relation to FmHA's financial statements which may not be promptly detected and corrected. These weaknesses are listed below.

- FmHA's analysis of the ultimate collectibility of its loan portfolio for establishing an adequate allowance for loss was not in accordance with Office of Management and Budget's (OMB) Circular A-129.
- FmHA's accounting system for multiple family housing loans was implemented with numerous control weaknesses.

- Controls over the entry of guaranteed loans into the accounting system were inadequate.
- Acquired property was improperly valued, and detailed property files were not reconciled with general ledger control accounts.

During fiscal year 1987, FmHA made considerable progress toward improving internal accounting controls in all of these areas. However, serious internal control weaknesses still exist in each of the areas. The results of our evaluation are described in detail in the following sections.

Procedures for Establishing a Loan Loss Reserve Are Inadequate

FmHA's analysis of the ultimate collectibility of its $27.5 billion farm loan portfolio in order to establish an allowance for losses was not performed in accordance with OMB Circular A-129. As a result, there is a relatively high risk that future years' net loan receivables will be misstated by amounts material to future FmHA financial statements.

OMB Circular A-129 states that federal agencies should perform an annual risk assessment of their loan portfolio and assign risk ratings ranging from problemless to clear losses. The circular also states that these risk ratings should be established based on payment performance, changes in borrower financial position, the degree of compliance with reporting requirements, or changes in the status of collateral or security. These risk ratings should then be used in conjunction with historical loss data, borrower characteristics, the type of credit transactions, and other relevant information to determine the estimated loan losses.

Early in our examination we began working with FmHA management to develop procedures to address loan collection risks. As a result, FmHA implemented procedures in September 1987 to perform an annual risk assessment of its loan portfolio and to produce loss estimates in accordance with these procedures. FmHA's new procedures are designed to address collateral shortfalls and project losses on a loan-by-loan basis. However, the assessment was not completed for use in preparing the fiscal year 1987 financial statements.

FmHA developed an alternative methodology to estimate the allowance for loan losses until the system under development is completed. The basic premise of this interim methodology was to use historical losses and current delinquency data to estimate future farm loan losses and use historical losses for estimating future losses on single family housing, multiple family housing, and rural development loans. Using the alternative methodology, FmHA increased its estimate for allowance for losses from $6.1 billion, for the fiscal year ended 1986, to $14.7 billion, including $12.2 billion in estimated farmer program loan losses, for the fiscal year ended 1987. Due to the impracticality of reviewing each of its 1.2 million borrowers, FmHA's interim methodology did not address all major risk factors associated with the collectibility of its loan portfolio such as current market conditions and their effect on collateral values and borrowers' financial condition. While historical loss analysis provides an adequate basis for establishing allowances for losses on single family housing, multiple family housing, and rural development loans, current market conditions and other factors must be considered in establishing the farmer program loan loss allowance.

GAO's Analysis of FmHA's Loan Loss Allowance

In evaluating FmHA's interim methodology for estimating the farm program loan loss allowance, we considered guidance provided by the American Institute of Certified Public Accountants. This guidance indicates that the auditor's evaluation of the reasonableness of a loan loss allowance should also consider a number of factors other than previous collection experience and delinquencies, such as whether the entity has made loans

(1) to borrowers with financial difficulties, such as operating losses, marginal working capital, and inadequate cash flow;

(2) in industries experiencing economic instability;

(3) secured by collateral not readily marketable or susceptible to deterioration in realizable value; or

(4) which are inadequately documented.

These factors were used in evaluating FmHA's farmer program loan loss allowance as explained in the following paragraphs.

Because of FmHA's responsibility as a "lender of last resort," it has lent money to many farmers who have marginal ability to repay. In its primary role of providing financial assistance to American farmers, in 1987 FmHA made or guaranteed over 51,000 loans totaling $3 billion to farmers who could not otherwise obtain credit from commercial lenders. Consequently, the FmHA loan portfolio can be categorized as "high risk."

Furthermore, the agricultural sector is undergoing the most significant change since the 1930s. Although American agriculture experienced a boom during the 1970s, economic forces that led to that growth reversed in the 1980s. While agricultural production has continued to increase during the 1980s, U.S. exports of these products have declined in both volume and value. Due to the depressed condition of the U.S. farm economy, there is little demand for farm land. In addition, certain legal restrictions and moratoriums on the sale of land make the collateral not readily marketable.

Data available on the current condition of borrowers is located in over 2,000 FmHA field offices around the country. In addition, our review of borrower files and discussions with FmHA officials at several field offices indicated that the current financial condition of borrowers and current value of collateral is not always available or is not reliable. As a result, it was impractical to analyze a sufficient number of loans to draw any statistically valid conclusion about the collectibility of the loans, either for the portfolio as a whole or by category. Alternatively, we developed two ranges of estimated losses. One range was based on the identification and analysis of the current market and other environmental factors that affect the collectibility of the loans. The other was based on delinquency data.

Our results showed that FmHA's allowance for loan losses fell within these two separate ranges of loss estimates. As a result, we believe that the estimates for fiscal year 1987 are reasonable, and, therefore, did not affect our opinion on the statement of financial position.

Weaknesses in the Automated Multiple Family Housing Accounting System

The FmHA Automated Multiple Family Housing Accounting System (AMAS), which accounts for $7.9 billion in rental housing loans, contains significant internal control weaknesses. Specifically,

- the AMAS borrower accounts cannot be reconciled to the general ledger due to software deficiencies,
- transactions are not properly recorded, and
- operating instructions and internal control procedures are not documented.

These weaknesses have existed since May 1985, when the system was implemented, and have been reported in Agriculture Office of Inspector General (OIG) and Federal Managers' Financial Integrity Act (FMFIA) reports. In a July 1987 audit report, the OIG noted that senior FmHA management officials decided to proceed with AMAS implementation in May

1985 even though the software for one of FmHA's most complex loan programs, representing over 10 percent of the total loan portfolio dollars, had not been fully tested and was not ready for implementation. The OIG said that failure to complete the AMAS development prior to implementation had left the system vulnerable to undetected errors and fraudulent data manipulation. Specifically, detailed files were not reconciled to the general ledger and transactions were not always input properly. For example, new loans were incorrectly identified as subsequent loans and vice versa, payments were not properly applied to loans, and incorrect payment amounts were entered. The FMFIA vulnerability assessment for 1986 further reported that there were no clear, concise, and current operating instructions nor prescribed internal control procedures. Financial Systems Division officials report that although FmHA is actively addressing the numerous AMAS problems, development will not be complete until December 1988.

In order to assure ourselves that the AMAS balances were not materially misstated, we performed substantive testing through confirmations of loan balances, reviews of interest income computations, and reconciliations. As a result of our testing, we determined that the weaknesses reported above did not affect our opinion on FmHA's statement of financial position for the year ended September 30, 1987.

All Guaranteed Loans May Not Be Recorded Properly in the Accounting System

FmHA has recorded $3.2 billion in outstanding guaranteed loans in its guaranteed loan accounting system and disclosed the same amount in its footnotes to the financial statements. FmHA did not employ adequate internal controls to ensure that all guaranteed loans were properly recorded in the system. We reviewed the Finance Office's unclosed loan report, which provides information on loan guarantees in process, and found that approximately 400 loans, obligated prior to 1986, had not been entered into the guaranteed loan accounting system or general ledger. We followed up on a sample of 16 of the approximately 400 loans and found that 11 had been approved for guarantees and that the field office had indicated that the appropriate documentation to enter the data into the guaranteed loan accounting system had been submitted to the Finance Office. However, the Finance Office had not processed the paperwork to enter the guarantees into the accounting system. Of the remaining 5 loans, 4 are still pending approval and 1 had been canceled and should have been removed from the unclosed loan report. As a result, we determined that not all approved guaranteed loans had been recorded and disclosed. In response to our concern, FmHA has also disclosed, in its footnotes to the financial statements, the total of $1.6 billion in conditional commitments reported on the unclosed loan report.

We believe that without adequate internal accounting controls over the entry of data into the guaranteed loan accounting system, there is a high risk that the total commitments for guaranteed loans and related provisions and loss accruals will be misstated.

Control Weaknesses in Accounting for Acquired Property

We found significant internal control weaknesses in accounting for acquired property. Specifically, FmHA

- did not record about $600 million of property acquired through voluntary conveyance at fair value nor was the associated gain or loss recorded in accordance with generally accepted accounting principles and
- was unable to reconcile subsidiary acquired property records with the general ledger.

During our examination, we brought these internal control weaknesses to management's attention and they began extensive system changes to resolve them. For example, FmHA designed system changes which will enable it to record the market value of acquired property at the time of acquisition, or the current market value. The new system modifications will automatically record the gain or loss on the acquisition of acquired property based on the current market value at the time of acquisition rather than at the time of sale. These changes were not completed as of our report date. Meanwhile, FmHA implemented interim procedures to adjust the value of the acquired property to fair value by using information in the County Office Operating Reports (COORS). The COORS system was designed as a management information system to report various county office operating statistics and did not incorporate internal accounting controls. For example, no reconciliations were performed between the detailed records in the COORS system and the general ledger.

In the absence of an accounting system which could generate reliable financial data on acquired property operations, it was not practical to determine whether the acquired property transactions included in the financial statements were fairly stated because it was not feasible for us to examine detailed property files at more than 2,000 FmHA field offices. As a result, our opinion on FmHA's statement of financial position as of September 30, 1987, was qualified.

Conclusions

As a result of several internal control weaknesses, the possibility exists that material errors in FmHA's financial records and reports could occur and not be promptly detected and corrected. For example, insufficient analysis of current environmental factors and their effect on collateral leaves the farm program allowance for losses vulnerable to future misstatement. Premature implementation of AMAS and the resultant inadequate internal controls have weakened the integrity of the AMAS account balances. Lack of reconciliation between field office input and finance office records has prevented reliance on the controls over the guaranteed loan accounting systems. Furthermore, the absence of a system to record acquired property in conformity with generally accepted accounting principles has led to the possible material misstatement of acquired property accounts. Although FmHA has been working to resolve these internal accounting control weaknesses, much work remains to be done.

Recommendations

We recommend that the Secretary direct the Administrator to:

- Ensure that the procedures are fully implemented for conducting an annual risk assessment of the FmHA loan portfolio and for producing loss estimates based on these assessments as required by OMB Circular A-129.
- Ensure that AMAS is thoroughly tested, that internal control procedures are in place to reconcile detailed AMAS files to the general ledger on a daily basis, and that operating instructions and internal control procedures are fully documented.
- Require that the unclosed loan report be reconciled against field office records and that all discrepancies be promptly resolved to ensure that all closed loan guarantees are entered into the guaranteed loan accounting system.
- Complete all acquired property system modifications within reasonable timeframes to ensure that all detailed files are balanced with the general ledger, that acquired property is recorded at fair value at the time of acquisition, and that gains or losses on the acquisition of property are properly recorded.

Other Opportunities for Improvement

During the course of our examination, we identified a number of other weaknesses in internal accounting controls and procedures. Although we did not consider these weaknesses to be material to the consolidated financial statements, they nonetheless merit corrective action to strengthen FmHA's internal accounting controls. Consequently, we are reporting on these separately.

Agency Comments

While we did not request official written comments on this report, we did provide a draft of the report to responsible FmHA officials. The agency generally agrees with our findings and has been working diligently to correct identified weaknesses. However, the corrective actions have not been fully implemented and, consequently, the results have not been fully evaluated. We have incorporated official comments in our report where appropriate.

Report on Compliance With Laws and Regulations

We have examined the financial statements of the Farmers Home Administration (FmHA) for the fiscal year ended September 30, 1987, and have issued our report thereon. Our examination was made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures, including tests of compliance with laws and regulations and reviews of GAO and OIG reports, as we considered necessary in the circumstances. This report pertains only to our review of compliance with laws and regulations for the year ended September 30, 1987.

Our review of compliance with laws and regulations, made for the limited purpose described in the preceding paragraph, does not necessarily cover all laws and regulations that FmHA is required to comply with. Accordingly, we are expressing an opinion only with respect to those transactions tested. In our opinion, FmHA complied with the terms and provisions of laws and regulations for the transactions tested that could have materially affected its financial statements.

In connection with our examination, nothing came to our attention that caused us to believe that FmHA was not in compliance with the terms and provisions of laws and regulations for those transactions not tested.

Statement of Financial Position

AS OF SEPTEMBER 30, 1987

ASSETS:	
Fund Balance with U.S. Treasury	$ 6,987,940,236
Accounts Receivable (Note 3) Net of Allowance for Losses ($6,593,140)	133,757,379
Interest Receivable (Note 4) Net of Allowance for Losses ($4,279,752,325) (Notes 4 & 6)	1,001,750,065
Loans Receivable (Note 5) Net of Allowance for Losses ($14,664,348,304) (Note 5 & 6)	46,228,185,609
Investments In Loan Sale Trust Assets (Note 7)	234,614,488
Acquired Property (Note 8) Net of Allowance for Losses ($599,558,930) (Note 8)	1,232,758,148
Other Assets	31,269,810
Total Assets	$ 55,850,275,735
LIABILITIES:	
Accounts Payable	$ 78,046,883
Accrued Interest Payable (Note 9)	3,820,891,500
Intragovernmental Debt (Note 9)	84,641,217,973
Notes Payable - Investors (Note 9)	1,042,224,625
Accrual for Potential Losses on Guaranteed Loans (Note 10)	764,431,364
Other Liabilities	159,516,584
Total Liabilities	$ 90,506,328,929
EQUITY: (Note 11)	
Unexpended Appropriations:	
Undelivered Orders	$ 525,035,733
Unobligated Balances	11,838,923
Invested Capital	1,142,488,651
Cumulative Results of Operations (Note 12)	(36,335,416,501)
Total Equity	$(34,656,053,194)
Total Liabilities & Equity	$ 55,850,275,735

The accompanying notes are an integral part of these financial statements.

Statement of Operations

FOR FISCAL YEAR ENDED SEPTEMBER 30, 1987

INTEREST INCOME:	
Interest on Loans (Note 4)	$ 4,148,326,172
Less Interest on Nonperforming Loans (Note 6)	1,093,355,297
Net Interest Income	3,054,970,875
INTEREST EXPENSE:	
Interest on Intragovernmental Debt (Note 9)	9,201,724,261
Other Interest Expense (Note 9)	136,136,841
Total Interest Expense	9,337,861,102
NET INTEREST EXPENSE	(6,282,890,227)
PROVISION FOR LOSSES ON:	
Insured Loans (Note 6)	9,291,127,950
Accrued Interest on Insured Loans (Note 6)	2,879,699,954
Purchased Guaranteed Loans (Note 6)	24,711,819
Accrued Interest on Purchased Guaranteed Loans (Note 6)	183,403,935
Acquired Property	607,093,358
Guaranteed Loans (Note 10)	688,425,594
Total Provision for Losses	13,674,462,610
NET INTEREST EXPENSE AND PROVISION FOR LOSSES	(19,957,352,837)
OTHER INCOME:	
Income Attributable to Housing Subsidy Granted (Note 4)	1,514,130,850
Expended Appropriations	601,588,257
Other Income	33,380,478
Total Other Income	2,149,099,585
OTHER EXPENSES:	
Interest Credit Subsidy	1,514,130,850
Grants and Contributions	348,647,055
Personnel Compensation and Fringe Benefits	298,647,000
Rents, Communications, and Utilities	45,205,000
Other Administrative Expenses	49,942,578
Other Program Expenses	132,235,852
Total Other Expenses	2,388,808,335
LOSS BEFORE SALE OF LOAN ASSETS	(20,197,061,587)
LOSS ON SALE OF LOAN ASSETS (Note 13)	(1,890,597,211)
NET LOSS FROM OPERATIONS	$(22,087,658,798)

The accompanying notes are an integral part of these financial statements.

Statement of Cash Flows

FOR FISCAL YEAR ENDED SEPTEMBER 30, 1987
INCREASE (DECREASE) IN CASH

Cash Flows from Operating Activities:	
Interest Received	$2,914,345,001
Interest Paid	(9,291,283,919)
Appropriations Received (Note 11)	556,806,000
Appropriations Disbursed	(596,238,847)
Program Expenses	(285,392,710)
Other (Net)	137,800,325
Net Cash Used in Operating Activities	(6,563,964,150)
Cash Flows from Investing Activities:	
Collections on Loans	4,536,557,922
Loans Made	(3,874,235,834)
Proceeds from Loan Principal Asset Sales	2,825,120,828
Proceeds from Sale of Acquired Property	154,836,580
Collections Received on Behalf of Investors	50,772,564
Payments Made to Investors	(51,884,160)
Acquired Property Disbursements	(91,195,265)
Purchase of Loans	(59,122,406)
Loss Settlement of Guaranteed Loans (Note 10)	(95,703,550)
Net Cash Provided by Investing Activities	3,395,146,679
Cash Flows from Financing Activities:	
Borrowings from U.S. Treasury (Note 9)	12,530,000,000
Payments on U.S. Treasury Borrowings (Note 9)	(7,100,000,000)
Reimbursements for Losses (Note 12)	4,413,671,517
Borrowings from Federal Financing Bank (Note 9)	170,000,000
Payments on Federal Financing Bank Borrowings (Note 9)	(535,000,000)
Payments on Notes Payable	(35,179,684)
Net Cash Provided by Financing Activities	9,443,491,833
Net Increase (Decrease) in Cash	6,274,674,362
Fund Balance with U.S. Treasury, Beginning of Year	713,265,874
Fund Balance with U.S. Treasury, End of Year	$6,987,940,236

The accompanying notes are an integral part of these financial statements.

Notes to Financial Statements

FOR FISCAL YEAR ENDED SEPTEMBER 30, 1987

NOTE 1: ORGANIZATION AND PROGRAMS

Entity and Basis of Consolidation

In fulfilling the mission to provide housing, credit, and agricultural assistance to people in rural areas, the Farmers Home Administration (FmHA) maintains 10 general funds, 5 revolving funds, and 2 other funds. The consolidated financial statements account for all funds for which FmHA is responsible and are presented on the accrual basis of accounting as required by the GAO Policy and Procedures Manual for Guidance of Federal Agencies (Title 2).

Lending Programs

Insured Lending Activities

During fiscal year 1987, the budgeted lending programs included insured loans. The term "insured" is defined as loans made directly from the revolving funds. These insured loans are available to be pledged as collateral for borrowings from the Federal Financing Bank. Generally, an insured loan is made only if a borrower can not secure adequate credit from other sources at reasonable rates and terms.

Federal law provides for multiple servicing actions to assist financially troubled borrowers. The most significant of these actions include:

Interest Credit Program:
An interest credit agreement is a contractual agreement between FmHA and single family and rural rental housing borrowers to reduce the borrowers' effective interest rate to as low as 1 percent. Eligibility requirements for single family housing borrowers receiving interest credit are reviewed annually. Rural rental housing borrowers receive interest credit for the life of the loan; however, amounts in excess of scheduled repayments may be due to FmHA based on tenants' income levels. Interest income on related insured loans is accrued at the contractual rate on the principal amount outstanding (note 4).

Debt Set-Aside Program:
The debt set-aside program was implemented during fiscal year 1985. This program provides for setting aside up to 25 percent of a farmer program borrower's total indebtedness to a maximum of $200,000 for 5 years. During the set-aside period, no interest is accrued nor are principal payments required (note 4).

Rental Assistance Program:
Federal law provides FmHA the authority to provide rental assistance to eligible tenants occupying eligible rural rental housing, rural cooperative housing, and certain labor housing projects financed by FmHA. Rental assistance is the portion of the approved shelter cost (consists of basic or market rent plus utility allowance) paid by FmHA to compensate for the difference between the approved shelter cost and the monthly tenant contribution. Payments made under this program are reported on the Consolidated Statement of Operations as grants and contributions.

Guaranteed Lending Activities

In addition to the insured lending activities, FmHA was authorized to guarantee loans in fiscal year 1987. The term "guarantee" means "to guarantee the payment of a loss on a loan originated, held, and serviced by a private financial agency or other lender approved by the Secretary of Agriculture." FmHA provides financial assistance to borrowers by guaranteeing loans made by a federal or state chartered bank, savings and loan association, cooperative lending agency, or approved lending institution who perform all loan servicing activities. Guaranteed loans are accounted for as contingent liabilities (note 10).

The guaranteed loan program allows FmHA to guarantee up to 90 percent of the money loaned by a financial institution (lender) to borrowers in rural areas or who employs people in rural areas.

The lender is required to inform FmHA on the loan status on December 31 and June 30 (depending on the type of loan), unless the loan is in default which requires more frequent reporting.

Most guaranteed loans may be sold in the secondary market by the lender to an institution known as a holder. Although a portion of the loan is sold to a holder, all servicing responsibility remains with the lender. Payments by the borrower are forwarded on a pro rata basis to the holder. If the holder does not receive payments on the note within 60 days of an installment due date, the holder can demand that FmHA purchase the holder's share of the loan. When the loan is purchased, FmHA assumes the rights of the holder and is entitled to the pro rata share of any payments made by the borrower to the lender. All guaranteed loans purchased by FmHA are treated as an asset (loans receivable) in its portfolio (note 5).

If the borrower defaults on the loan, the lender is responsible for liquidating the collateral. After the proceeds of the sale have been applied to the outstanding balances, FmHA is liable for losses under the terms of the guarantee (notes 5, 6, and 10).

Interest Rate Buydown Program:
The Food Security Act of 1985 (Public Law 99-198) authorized FmHA to enter into an agreement with participating guaranteed lenders to reduce the interest rate paid by guaranteed borrowers. In return, FmHA will make annual interest rate buydown payments to the lender in an amount not to exceed 50 percent of the cost of reducing the interest rate on the loan up to a maximum of two percentage points. The Act authorizes $490,000,000 for this program to be available through September 30, 1988. As of September 30, 1987, funds were obligated for this program in the amount of $31,621,221.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

Loans and Allowance for Loan Losses

Loans are carried at the principal amount outstanding less an allowance to reflect their ultimate collectibility. The allowance for loan losses is based on historical data (writeoffs, loan settlement data, and acquired property data), an analysis of borrower accounts (to include delinquent and rescheduled accounts), and an analysis of current market factors and conditions.

Acquired Property

The current procedures for valuing acquired property provide for the establishment of an allowance account to report the net realizable value of acquired property at the estimated present market value less cost of disposition based on FmHA county office operating reports. In the past the basis used to record acquired property was generally a function of the method by which the property was acquired (voluntary conveyance or foreclosure). Recognizing the recent decline in rural housing and farm property values and limitations of the current accounting system to capture current market property values, procedures for reporting the value of acquired property were revised in September 1986.

Income Recognition and Reimbursement for Losses

All significant intra-agency balances and transactions have been eliminated in the consolidation. Sources of funds for the three major revolving funds of FmHA (Agricultural Credit Insurance Fund, Rural Housing Insurance Fund, and Rural Development Insurance Fund) are provided by reimbursement for losses, borrowings from the Federal Financing Bank (FFB), borrowings from Treasury, borrower loan repayments, and loan asset sales. Sources of funds for the Rural Development Loan Fund and Self-Help Housing Land Development Fund are provided solely through Congressional appropriations and borrower loan repayments.

Interest Income

Interest income on loans is accrued at the contractual rate on the outstanding principal amount. The amount of interest income accruing to nonperforming loans (in excess of 90 days delinquent) is reported as an offset to interest income on the Consolidated Statement of Operations. This offset is not included in the provision for losses on accrued interest on insured loans as reported on the Consolidated Statement of Operations; however, the offset is included as an adjustment to the allowance for losses on interest receivable as reported on the Consolidated Statement of Financial Position.

Expended Appropriations

Appropriations are provided by Congress on both an annual and multi-year basis to fund certain general funds and other expenses such as personnel compensation and fringe benefits, rents, communications, utilities, other administrative expenses, and capital expenditures. The current budgetary process does not distinguish between capital and operating expenditures. For budgetary purposes, both are recognized as a use of budgetary resources as paid, however for financial reporting purposes under accrual accounting, operating expenses are recognized currently while expenditures for capital and other long-term assets are capitalized and are not recognized as expenses until they are consumed in FmHA's operations. Appropriations for general fund activities are recorded as a financing source when expended. Unexpended appropriations are recorded as equity of the U.S. Government (note 11).

Loss Reimbursement

Reimbursement for losses is provided by Congressional appropriations and is used to reimburse the three major revolving funds of FmHA for losses sustained in excess of reported income. The losses reimbursed include actual amounts written off and losses sustained on the sale of acquired property; however, adjustments in the allowance accounts to record estimated future losses are not included in the requests for reimbursement. Requests for reimbursement are submitted as part of the budgetary process. Appropriations to reimburse revolving fund losses are typically received 2 years after the year in which the loss was sustained (notes 11 and 12) and are recorded as an offset to cumulative results of operations.

Intragovernmental Financial Activities

The FmHA's consolidated financial statements are not intended to report the Agency's proportionate share of the Federal deficit or of public borrowings, including interest thereon. Financing for budget appropriations reported on the FmHA's Consolidated Statement of Operations and Consolidated Statement of Cash Flows could derive from tax revenues or public borrowings or both; the ultimate source of this financing, whether from tax revenues or public borrowings, has not been specifically allocated to the FmHA.

During fiscal year 1987, the majority of the FmHA's employees participated in the contributory Civil Service Retirement System (CSRS) or Federal Employees Retirement System (FERS), to which FmHA made matching contributions. The FmHA does not, however, report CSRS and FERS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees since this data is only reported in total by the Office of Personnel Management.

NOTE 3: ACCOUNTS RECEIVABLE

Accounts receivable is comprised primarily of receivables resulting from accrued rent on acquired property, accrued interest on judgments, and the investment income held by Government National Mortgage Association (GNMA). Of these, the most significant is the GNMA receivable of $104,835,716. This amount represents GNMA investment income in excess of amounts required to retire participation certificates held by GNMA. The excess amount is payable to FmHA during fiscal year 1988 when the remaining participation certificates will mature.

NOTE 4: INTEREST

The outstanding unpaid loan interest receivable and the related allowance for losses, by entity, are as follows:

	Loan Interest Receivable	Allowance For Losses (Note 6)	Net Interest Receivable
Agricultural Credit Insurance Fund	$4,757,631,388	$3,928,889,563	$ 828,741,825
Rural Housing Insurance Fund	217,662,495	139,316,309	78,346,186
Rural Development Insurance Fund	304,069,577	210,726,724	93,342,853
All Other Entities	2,138,930	819,729	1,319,201
Total	$5,281,502,390	$4,279,752,325	$1,001,750,065

Interest income on loans is accrued at the contractual rate on the outstanding principal amount. The interest income recognized, consisting primarily of accrued loan interest, by entity, as of September 30, 1987, follows:

Agricultural Credit Insurance Fund (ACIF)	$2,101,106,684
Rural Housing Insurance Fund (RHIF)	1,561,015,470
Rural Development Insurance Fund	484,091,252
All Other Entities	2,112,766
Interest on Loans	$4,148,326,172
Less Interest on Nonperforming Loans	1,093,355,297
Net Interest Income	$3,054,970,875

As of September 30, 1987, approximately 5,400 ACIF borrowers were participants in the debt set-aside program with almost $640,000,000 of principal being set aside. Interest rates on the related loans ranged from 4.5 to 13.5 percent; however, interest income is not accrued on the set-aside balances.

Interest income for RHIF does not include $1,514,130,850 of interest credit subsidy provided to single family housing and rural rental housing borrowers; however, the subsidy amount is recognized as other income and the related interest credit subsidy expense is reported in other expenses. The unpaid principal balance of loans receiving interest credit is approximately $19 billion.

The unpaid principal balance of nonperforming loans (in excess of 90 days delinquent) is approximately $14.4 billion. Although interest on these accounts continues to be accrued, this interest is not included in the net interest income reported on the Consolidated Statement of Operations.

NOTE 5: LOANS

The unpaid principal balances and the related allowance for losses by entity and major loan program are as follows:

	Unpaid Principal	Allowance for Losses on Principal (Note 6)	Net Unpaid Principal
Agricultural Credit Insurance Fund			
Farm Ownership	$ 7,549,306,495	$ 1,978,907,673	$ 5,570,398,822
Operating	6,280,073,836	2,085,087,844	4,194,985,992
Emergency	9,292,035,935	5,751,239,676	3,540,796,259
Economic Emergency	3,798,945,212	2,331,236,484	1,467,708,728
Other	587,966,142	15,360,401	572,605,741
Guaranteed loans purchased from holders	28,733,216	14,366,608	14,366,608
	$27,537,060,836	$12,176,198,686	$15,360,862,150
Rural Housing Insurance Fund			
Rural Housing	$18,368,197,321	$ 2,126,932,332	$16,241,264,989
Labor Housing	139,457,182	19,937,496	119,519,686
Rural Rental Housing	7,901,687,073	60,866,696	7,840,820,377
Rural Housing Site	703,972	613	703,359
Guaranteed loans purchased from holders	1,258,261	629,131	629,130
	$26,411,303,809	$ 2,208,366,268	$24,202,937,541
Rural Development Insurance Fund			
Water & Waste	$ 5,192,351,861	$ 28,320,406	$ 5,164,031,455
Community Facilities	1,183,506,531	683,420	1,182,823,111
Business & Industrial	37,689,102	880,041	36,809,061
Guaranteed loans purchased from holders	492,127,212	246,063,606	246,063,606
	$ 6,905,674,706	$ 275,947,473	$ 6,629,727,233
All Other Entities	$ 38,494,562	$ 3,835,877	$ 34,658,685
Total FmHA	$60,892,533,913	$14,664,348,304	$46,228,185,609

FmHA has unliquidated loan and grant obligations of $4,962,626,952 as of September 30, 1987.

The following schedule categorizes the total outstanding principal of each insured and direct loan by loan maturity date and interest rate. This schedule should not be construed as an estimate of loan principal repayments based on borrowers' repayment schedules.

Interest Rate Rounded	Loan Principal Maturing (In Years) (In Millions of Dollars)					Insured Principal Outstanding
	0 - 5	5 - 10	10 - 20	20 - 30	30 or More	
1%	$ 5	$ 16	$ 190	$ 3,201	$ 7,590	$11,002
2%	0	0	26	661	541	1,228
3%	381	121	519	776	653	2,450
4%	3	29	138	840	561	1,571
5%	1,596	1,004	3,360	5,021	6,750	17,731
6%	51	112	358	771	600	1,892
7%	882	257	1,937	691	903	4,670
8%	499	297	664	1,930	1,455	4,845
9%	277	71	500	1,356	2,830	5,034
10%	1,032	133	460	308	787	2,720
11%	326	42	396	717	1,244	2,725
12%	229	34	307	868	238	1,676
13%	655	45	367	655	191	1,913
14%	322	4	21	79	9	435
15%	228	2	10	1	0	241
16%	232	1	4	1	0	238
Totals	$6,718	$2,168	$9,257	$17,876	$24,352	$60,371
Guaranteed loans purchased from holders						522
Total loans receivable						$60,893

NOTE 6: ALLOWANCE FOR LOSSES

FmHA is currently developing a loan classification system to assist the agency in assessing the credit risk of their portfolio as required by OMB Circular A-129. However, since the system will not be operational until fiscal year 1988, FmHA implemented alternative procedures in determining the allowance for losses. The change in the method of evaluating the allowance account coupled with a significant rise in the farmer program loan delinquency rates resulted in a substantial increase in the provision charged to fiscal year 1987 expenses. The significant increase in the allowance account provided for in fiscal year 1987 is related to the declining trend in the agricultural economy over the past several years. The increase is not attributable to a single adverse event taking place during the accounting cycle. Consequently, the current year's provision for losses on insured loans includes both the current provision and adjustments to prior year provisions; prior year effects on Government Equity could not be determined.

The procedures followed in estimating losses for fiscal year 1987 included:

--The allowance for insured loan losses is based on historical data (writeoffs, loan settlement data, and acquired property data), an analysis of borrower accounts (to include delinquent and rescheduled accounts), and an analysis of current market factors and conditions.

--The allowance for losses on insured interest receivable is based on historical data (cumulative writeoffs of interest receivable) and adjusted based on an analysis of delinquent borrower accounts. The latter analysis provides for a 100 percent allowance for loss on the interest receivable on nonperforming loans (delinquent over 90 days).

--The allowance for losses on principal on guaranteed loans purchased from holders is based on a previous Office of Inspector General audit of the losses associated with purchased guaranteed loans and recent actual guaranteed loss data. The audit consisted of an analysis of repurchased loan accounts which included the following: loans paid in full, loans liquidated at a loss, loan accounts at liquidation, current loans, and delinquent loans.

--The allowance for losses on accrued interest on guaranteed loans purchased from holders provides for an allowance for interest accrued on accounts in default for more than 90 days. The allowance is estimated at 100 percent of the receivable due to the fact that these accounts, as required under the terms of the loan guarantee, are in default at the time of purchase.

The adjustments in the allowance for losses resulting from the application of the described procedures for the fiscal year ended September 30, 1987, follow:

Allowance for Loan Losses

	Beginning Balance October 1, 1986	Loans Written Off, Net	Adjustments In Allowance for Losses *	Ending Balance September 30, 1987
ACIF	$5,204,013,976	$(689,853,931)	$7,662,038,641	$12,176,198,686
RHIF	590,019,977	(31,072,539)	1,649,418,830	2,208,366,268
RDIF	307,007,462	(33,359,653)	2,299,664	275,947,473
All Others	1,861,996	(108,753)	2,082,634	3,835,877
Total	$6,102,903,411	$(754,394,876)	$9,315,839,769	$14,664,348,304

Allowance for Interest Losses

	Beginning Balance October 1, 1986	Interest Receivable Written Off, Net	Adjustments In Allowance for Losses *	Ending Balance September 30, 1987
ACIF	$ 283,153,450	$(246,005,423)	$3,891,741,536	$ 3,928,889,563
RHIF	60,448,369	(5,586,198)	84,454,138	139,316,309
RDIF	43,172,281	(12,031,930)	179,586,373	210,726,724
All Others	206,356	(63,766)	677,139	819,729
Total	$ 386,980,456	$(263,687,317)	$4,156,459,186	$ 4,279,752,325

* NOTE: The adjustments in allowance for loan losses is the respective entity's combined Provision for Losses on Insured Loans and Purchased Guaranteed Loans as reported in the Consolidated Statement of Operations.

The adjustments in allowance for interest losses is the respective entity's combined Provision for Loss on Accrued Interest on Insured Loans, Accrued Interest on Purchased Guaranteed Loans, and Interest on Nonperforming Loans as reported in the Consolidated Statement of Operations.

Considering the effect the declining agricultural economy had on rural housing and farm property values since 1984, FmHA management is of the opinion that the allowance for losses at September 30, 1987, is adequate to absorb future losses inherent in the portfolio at that date. However, significant uncertainties continue to remain over the agricultural environment. Ultimate losses which may be realized on the loan portfolio are dependent upon the impact of future commodity prices, production costs, land and housing values, and Government agricultural and economic policy.

NOTE 7: INVESTMENTS IN LOAN SALE TRUST ASSETS

In fiscal year 1987, FmHA conducted loan asset sales as required in the Omnibus Budget Reconciliation Act of 1986 (Public Law 99-509). As a result of these sales (note 13), the Rural Development Insurance Fund (RDIF) maintains an investment in the Community Program Loan Trust, 1987A. This investment, reported at its appraised value of $33,614,488, represents a Class C residual security in the Trust and entitles the holder to residual cash flows resulting from loan repayments not required to pay trust security holders or to fund required reserves.

The Rural Housing Insurance Fund (RHIF) maintains an investment in the Rural Housing Trust, 1987-1. This investment, reported at its appraised value at the time of the sale, represents Class B securities valued at $180,000,000 and Class C residual securities valued at $21,000,000.

The appraised value of the RDIF and RHIF investments was determined by the underwriters of the transactions using the following conservative assumptions:

RDIF

- o An 18 percent discount rate reflecting the expected yield requirements for an investment of this type.
- o A zero prepayment assumption.

RHIF

- o A 14.5 percent discount rate for the subordinated certificates and a 12 percent discount rate for the excess servicing.
- o A zero prepayment assumption for the sale of the subordinated certificates and a 2 percent constant prepayment rate for the sale of the excess servicing.
- o A 2 percent default scenario for the sale of the subordinated certificates.
- o A projection that the final servicing agreement uses the entire 60 basis point subservicing fee, effectively lowering the coupon on the subordinated certificates by 300 basis points.

FmHA intends to retain the RHIF Class B and C investments and the RDIF Class C investment at least until a sufficient track record has been established to allow their true value to be determined.

NOTE 8: ACQUIRED PROPERTY

Recognizing the recent decline in rural housing and farm property values and limitations of the current accounting system to capture current market property values, procedures for reporting the value of acquired property were revised in September 1986. The current procedures provided for the establishment of an allowance account to report the net realizable value of acquired property at the estimated present market value less cost of disposition based on FmHA county office operating reports. Losses on acquired property reported during fiscal year 1987 totaled $607,093,358. Of this amount, $425,688,312 related to the actual sale of acquired properties, a portion of which is attributable to prior year expenditures to maintain the property and falling property values. The remaining $181,405,046 of expense represents an increase in the estimated future losses on acquired property, bringing the total estimated allowance for loss to $599,558,930 as of September 30, 1987.

Property is acquired by the FmHA revolving funds largely through foreclosure and voluntary conveyance. The properties consist primarily of 5,382 farm properties (total acreage of approximately 1.7 million) and 14,617 rural single family dwellings which are held by the revolving funds for resale. The revolving funds are allowed to lease certain properties to eligible individuals for a period not to exceed 1 year. Fiscal year 1987 lease and rental income of $11,566,253 is reported as other income on the Consolidated Statement of Operations.

During 1984, a survey was conducted regarding declining land values of FmHA and private lender farmland inventories. Based in part on this survey and certain provisions of the Food Security Act of 1985, the Secretary of Agriculture imposed a moratorium on the sale of FmHA properties in seven states with large property inventories. This moratorium remained in effect until 1986. The 1987 Agricultural Credit Act provides additional borrower rights regarding the sale of acquired farm properties. In order to protect these rights, a moratorium on the sale of acquired farm properties has again been established except for sales to previous owner borrowers.

NOTE 9: LONG-TERM BORROWINGS

The Secretary of Agriculture is authorized by law to "make and issue notes to the Secretary of the Treasury for the purpose of obtaining funds necessary for discharging obligations and for making loans, advances, and authorized expenditures out of the Insurance Funds." This authority is exercised in the event that cash in the insurance funds is insufficient to cover Congressionally approved loan program authority or other liabilities incurred by the funds in maintaining related loan portfolios.

Borrowings from the Federal Financing Bank and private investors are in the form of Certificates of Beneficial Ownership. Certificates of Beneficial Ownership outstanding with the Federal Financing Bank are secured by unpaid loan principal balances and cash. Of the $6,987,940,236 Fund Balance as of September 30, 1987, $6,281,076,419 is held in reserve which, with pledged unpaid loan principal balances, serves as collateral for borrowings from the Federal Financing Bank. Certificates of Beneficial Ownership outstanding with private investors are secured by unpaid loan principal balances. As of September 30, 1987, long-term borrowings for FmHA consisted of the following:

Total Borrowings:

Federal Financing Bank	$65,009,000,000
U.S. Department of Treasury	19,632,217,973
Private Investors	1,042,224,625
Total Borrowings	$85,683,442,598

As of September 30, 1987, about 47 percent of the FmHA's long-term debt is due over the next 5 years as indicated below:

Fiscal Years of Maturities	Amount	Outstanding Borrowings	Weighted Average Rate
1987		$85,683,442,598	11.55%
1988	$14,510,946,393	71,172,496,205	12.19%
1989	9,166,644,229	62,005,851,976	12.16%
1990	5,765,643,691	56,240,208,285	12.26%
1991	3,398,460,932	52,841,747,353	12.12%
1992	7,813,050,860	45,028,696,493	12.08%
	40,654,746,105		
1993 - 2006	45,028,696,493	0	12.08%
	$ 85,683,442,598		

Supplemental information associated with long-term borrowings follows:

Accrued Interest Payable

		Accrued Interest Payable
Intragovernmental Debt:		
U.S. Treasury	$ 651,536,660	
Federal Financing Bank	3,081,562,161	
Total		$3,733,098,821
Private Investors		56,320,441
Other		31,472,238
TOTAL		$3,820,891,500

Interest Expense

		Interest Expense
Intragovernmental Debt:		
U.S. Treasury	$1,155,461,697	
Federal Financing Bank	8,046,262,564	
Total		$9,201,724,261
Private Investors		84,761,676
Other		51,375,165
TOTAL		$9,337,861,102

During July 1974, FmHA began selling Certificates of Beneficial Ownership (CBO) to the Federal Financing Bank (FFB) as a primary means of program financing. The CBO interest rate is based on Treasury's cost of money plus 1/8 of 1 percent to cover FFB's administrative expenses. The interest rates on FFB CBO's outstanding as of September 30, 1987, range from 7.293 percent to 16.516 percent.

NOTE 10: ACCRUAL FOR POTENTIAL LOSSES ON GUARANTEED LOANS

FmHA guaranteed loans are authorized through the Agricultural Credit Insurance Fund (ACIF), the Rural Housing Insurance Fund (RHIF), and the Rural Development Insurance Fund (RDIF). The total outstanding guaranteed loan principal on September 30, 1987, was $4,242,268,005 of which FmHA had guaranteed $3,706,453,888, which includes those guaranteed loans purchased from holders.

The guaranteed unpaid principal balance by entity net of guaranteed loans purchased from holders as of September 30, 1987, follows:

	Guaranteed Unpaid Principal Balance
ACIF	$ 2,068,909,883
RHIF	21,456,985
RDIF	1,093,968,331
Total	$ 3,184,335,199

Conditional commitments to make guaranteed loans have been established in the amount of $1,573,301,224.

Anticipated losses on guaranteed loans are estimated based on historical data, losses experienced in comparable insured programs, and current market conditions. This estimate is reported as an expense, and a corresponding accrual for potential losses on guaranteed loans is reported as a liability on the Consolidated Statement of Financial Position.

The adjustments in the accrual for potential losses (also see note 6) for the fiscal year ended September 30, 1987, follow:

	Beginning Balance October 1, 1986	Loss Settlement	Adjustments to Accrual for Potential Losses	Ending Balance September 30, 1987
ACIF	$ 38,813,529	$ (77,749,695)	$ 683,274,244	$ 644,338,078
RHIF	369,951	(166,237)	67,615	271,329
RDIF	132,525,840	(17,787,618)	5,083,735	119,821,957
TOTAL	$ 171,709,320	$ (95,703,550)	$ 688,425,594	$ 764,431,364

NOTE 11: EQUITY

Unexpended Appropriations

Unexpended Appropriations include the undelivered orders and unobligated balances of the FmHA general funds which receive Congressional appropriations through the budgetary process.

As appropriated funds incur obligations, the obligated amount is recorded as an undelivered order and shown as an equity item on the Consolidated Statement of Financial Position. Undelivered orders are relieved by either an expenditure or an obligation cancellation. Appropriated funds which are not obligated are shown as the unobligated amount of the Unexpended Appropriations on the Consolidated Statement of Financial Position. At the end of the fiscal year, certain multi-year appropriations which have unobligated balances remain available to FmHA for obligation in future periods. Unobligated appropriations returned to the U.S. Treasury may be made available for restoration to FmHA subject to administrative determination.

The following summarizes the activity for the appropriations and the Unexpended Appropriations balances of the appropriated funds for the 1987 fiscal year:

	Appropriations	Undelivered Orders	Unobligated Balances
Beginning Balances, October 1, 1986		$583,473,272	$ 8,683,694
Fiscal Year Activity:			
Appropriations Received	$556,806,000		556,806,000
Obligations Incurred		562,256,148	(562,256,148)
Obligations Cancelled		(16,037,316)	16,037,316
Accrued Expenditures		(604,656,371)	
Prior Accrued Expenditures Reimbursed			1,765,659
Balances Returned to U.S. Treasury			(9,197,598)
Ending Balances, September 30, 1987	$556,806,000	$525,035,733	$ 11,838,923

Invested Capital

Invested Capital represents: amounts appropriated by Congress to commence operations of the revolving funds; amounts appropriated to increase the working capital of revolving funds which do not receive reimbursement for losses (note 2); donations or nonreciprocal transfer of assets from other agencies; the results of operations from the transferred assets; and the Government's net investment in FmHA's property and equipment.

The following is a summary of the activity in Invested Capital for the 1987 fiscal year:

	Invested Capital
Beginning Balance, October 1, 1986	$1,140,844,031
Fiscal Year Activity:	
Capital Expenditures	3,068,114
Depreciation	(1,667,902)
Book Value of Disposed Equipment	(555,133)
Nonreciprocal Transfer of Loan Assets from Other Agencies	1,041,000
Loan Repayments Returned to U.S. Treasury	(451,897)
Results of Operations from the Transferred Loan Assets	210,438
Ending Balance, September 30, 1987	$1,142,488,651

Cumulative Results of Operations

The Cumulative Results of Operations is the net result of operations from the revolving funds since their inception and the amounts reimbursed due to realized losses (note 12). The following is a summary of the fiscal year activity for the Cumulative Results of Operations:

	Cumulative Results of Operations
Beginning Balance, October 1, 1986	$(18,662,410,935)
Fiscal Year Activity:	
Net Results from Operations	(22,086,677,083)
Reimbursement for Losses	4,413,671,517
Ending Balance, September 30, 1987	$(36,335,416,501)

NOTE 12: CUMULATIVE RESULTS OF OPERATIONS

Cumulative results of operations represent the cumulative deficit or surplus resulting from operations for all of the FmHA revolving funds. The cumulative results of operations for the Agricultural Credit Insurance Fund (ACIF) which was established in 1946, the Rural Housing Insurance Fund (RHIF) which was established in 1965, and the Rural Development Insurance Fund (RDIF) which was established in 1972 equal the net losses sustained from current and all prior years less the accumulated reimbursements for realized losses received by those funds. The cumulative results of operations, by entity, as of September 30, 1987, follow:

	Net Losses (Inception)	Reimbursement for Losses (Inception)	Cumulative Results of Operations
ACIF	$(31,555,091,705)	$ 7,375,582,000	$(24,179,509,705)
RHIF	(21,148,736,053)	12,014,851,405	(9,133,884,648)
RDIF	(6,297,036,914)	3,275,486,000	(3,021,550,914)
All Others	(471,234)	0	(471,234)
Total	$(59,001,335,906)	$22,665,919,405	$(36,335,416,501)

The reimbursement for realized losses does not include current and prior fiscal year realized losses eligible for future reimbursement. Additionally, FmHA was not fully reimbursed for the losses sustained in fiscal year 1985, which will be carried forward and requested in the next fiscal year. The potential reimbursements (based on the fiscal year of loss realization) which FmHA may receive pursuant to Congressional action follow:

	1985	1986	1987	Total
ACIF	$1,121,960,000	$2,518,193,000	$3,442,596,000	$7,082,749,000
RHIF	418,283,000	2,545,966,000	3,660,061,000	6,624,310,000
RDIF	79,992,000	762,690,000	1,592,047,000	2,434,729,000
Total	$1,620,235,000	$5,826,849,000	$8,694,704,000	$16,141,788,000

Reported cumulative results of operations in excess of the outstanding requests for reimbursement primarily represent allowance for future losses on receivables, allowance for losses on acquired property, and accrual for potential losses on guaranteed loans.

NOTE 13: LOAN ASSET SALES

In fiscal year 1987, FmHA conducted two loan asset sales as required in the Omnibus Budget Reconciliation Act of 1986 (Section 2001 of Public Law 99-509). An overview of the sales follow:

	Rural Housing Insurance Fund	Rural Development Insurance Fund	Total
Receivables Sold:	$2,985,482,414	$2,021,402,808	$5,006,885,222
Proceeds:			
Cash	$1,745,764,660	$1,125,908,863	2,871,673,523
Investments in Loan Sale Trust Assets (Note 7)	201,000,000	33,614,488	234,614,488
Protective Advance Fund	10,000,000	0	10,000,000
Total Proceeds	$1,956,764,660	$1,159,523,351	$3,116,288,011
Loss on Sale of Loans:	$1,028,717,754	$ 861,879,457	$1,890,597,211

NOTES:

- The Rural Development Insurance Fund includes $72,141,029 of receivables and $52,650,103 of cash proceeds from the sale of loans directly to borrowers at a discount of $19,490,926 prior to conducting loan sales to the Community Program Loan Trust, 1987A.

- An allowance for losses amount was not allocated to the receivables sold due to immateriality.

Rural Housing Insurance Fund

On September 29, 1987, FmHA completed the sale of loans to the Rural Housing Trust, 1987-1, backed by $2.9 billion of loans from the rural housing loan portfolio.

Securities consisted of Class A, Class B, and residual bonds. The Class A bonds are secured by subordinated bonds consisting of 20 percent of the bonds sold and a contingency servicing reserve fund. Under this structure, payments to the 20 percent junior certificate holders (which includes Class B securities and residual cash flows) are subordinated by payment to the 80 percent senior certificate holders. Additionally, credit enhancement was derived from the guarantee of timely payment of interest and principal by the American Loan Guarantee Association. The Trust sold Class A securities, backed by the loans, through an underwriting group led by Salomon Brothers Inc. Kidder, Peabody & Company served as the financial advisor to FmHA.

FmHA retained the subordinated interest and will receive all interest and principal payments due the junior certificate holder. FmHA intends to retain these certificates until a sufficient track record has been established to determine the actual value. The initial investment value was based on estimates of the fair market value by Kidder, Peabody & Company.

To effectively transfer the loan servicing function to the private sector, FmHA has agreed to act as a subservicer for up to 2 years after the sale. During this interim period, the master servicer (Manufacturers Hanover Trust Company) is responsible for selecting and training subservicers in rural housing regulations and procedures. The receivable balances and related transactions for these serviced loans are not included in the FmHA consolidated financial statements.

Rural Development Insurance Fund
On September 23, 1987, FmHA completed the sale of $1.9 billion loans from the community program loan portfolio to the Community Program Loan Trust, 1987A.

The Trust issued Class A bonds, Class B bonds, and Class C residual securities. Class A bonds were secured by subordinated bonds consisting of 7 percent of the loans sold and a liquidity reserve fund. The Trust sold Class A and B bonds, backed by the loans, through an underwriting group led by Shearson Lehman Brothers. Manufacturers Hanover Trust Company served as the financial advisor to FmHA.

FmHA retained the Class C securities representing an interest in the residual cash flows. To the extent the cash flow from the loans to the Trust exceed the amounts required to meet bond payments and maintain reserve fund requirements, FmHA will receive the cash flow surplus through its interest in the Trust. FmHA's beneficial interest in the Trust is recorded as an investment based on estimates of its fair market value made by Shearson Lehman Brothers.

NOTE 14: CONSOLIDATED SCHEDULE OF BUDGET RECONCILIATION

The following schedule provides a reconciliation of expenses to budgetary outlays as of September 30, 1987:

Expenses As Reported on Consolidated Statement of Operations:		
Nonperforming Loans Interest	$ 1,093,355,297	
Total Interest Expense	9,337,861,102	
Total Provision for Losses	13,674,462,610	
Total Other Expenses	2,388,808,335	
Loss on Sale of Loan Assets	1,890,597,211	
Total Expenses		$28,385,084,555
Deduct:		
Expenses Not Requiring Outlays:		
Provision for Losses on:		
Insured Loans (Note 6)	$ 9,291,127,950	
Accrued Interest on Insured Loans (Note 6)	2,879,699,954	
Guaranteed Loans (Note 10)	688,425,594	
Acquired Property (Note 8)	607,093,358	
Accrued Interest on Purchased Guaranteed Loans (Note 6)	183,403,935	
Purchased Guaranteed Loans (Note 6)	24,711,819	
Loss on Sale of Loan Assets (Note 13)	1,890,597,211	
Interest Credit Subsidy (Note 4)	1,514,130,850	
Interest on Nonperforming Loans (Note 6)	1,093,355,297	
Other	50,675,206	
Total Expenses Not Requiring Outlays		18,223,221,174
Expenses Requiring Outlays		10,161,863,381
Add:		
Other Outlays:		
Loans Made	3,874,235,834	
Loss Settlement of Guaranteed Loans	95,703,550	
Acquired Property Disbursements	91,195,265	
Purchase of Loans	59,122,406	
Payments Made to Investors	51,884,160	
Payments on Notes Payable	35,179,684	
Other	1,393,978	
Total Other Outlays		4,208,714,877
Change in Accounts Payable		7,990,064
Total Outlays		14,378,568,322
Less Offsetting Collections		10,633,419,587
Net Outlays		$ 3,745,148,735

NOTE 15: RECONCILIATION OF NET LOSS TO NET CASH PROVIDED BY OPERATING ACTIVITIES

The following schedule provides a reconciliation of net loss to the net cash used in operating activities as reported on the Consolidated Statement of Cash Flows for the fiscal year ended September 30, 1987:

Net Loss from Operations		$(22,087,658,798)
Adjustments:		
Expenses Not Requiring Outlays (Note 14)	18,223,221,174	
Housing Subsidy Granted	(1,514,130,850)	
Appropriations Received	556,806,000	
Expended Appropriations	(601,588,257)	
Interest Receivable Reclassified	(449,042,781)	
Change in Interest Receivable	(439,069,650)	
Interest Receivable Written-Off, Net	(263,687,317)	
Change in Accounts Receivable	(27,870,517)	
Change in Accounts Payable	(7,990,064)	
Other	47,046,910	
Total Adjustments		15,523,694,648
Net Cash Used in Operating Activities		$(6,563,964,150)

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