United States General Accounting Office

GAO

Report to the Congress

May 1990

FINANCIAL AUDIT

Rural Telephone Bank's 1988 Financial Statements

141433

GAO

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

Comptroller General
of the United States

B-159292

May 23, 1990

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 (RTB) financial statements for the fiscal year ended September 30, 1988. Reports on RTB's internal accounting controls and on its compliance with laws and regulations are also provided.

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 RTB at least once every 3 years under the provisions of the Government Corporation Control Act (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 RTB for the year ended September 30, 1988. We determined the scope of the audit work; monitored its progress at all key points; reviewed the working papers of the certified public accountants, KPMG Peat Marwick; and performed other procedures as we deemed necessary. Our examinations were conducted in accordance with generally accepted government auditing standards.

In our opinion, and consistent with the opinion of KPMG Peat Marwick, RTB's financial statements present fairly, in all material respects, its financial position as of September 30, 1988, and the results of its operations, changes in stockholders' equity, and cash flows for the year then ended, in conformity with generally accepted accounting principles. The September 30, 1987, financial statements, which are presented for comparative purposes, were not audited and, thus, no opinion has been expressed on them.

The report by KPMG Peat Marwick on internal accounting controls, with which we concur, discloses a reportable condition concerning RTB's methodology for estimating its provision for losses on loans. RTB's method did not consider prevailing economic conditions, the quality and quantity of loans, and other relevant factors which could adversely affect the accuracy of RTB's financial information. RTB has responded that it will analyze its reserve balances and evaluate necessary changes to the methodology for estimating its provision for losses on loans.

KPMG Peat Marwick's report on compliance with laws and regulations, with which we also concur, disclosed nothing to indicate that RTB had not complied with applicable laws and regulations that could have materially affected its financial statements. However, KPMG Peat Marwick did report a compliance item that should be highlighted. Specifically, RTB did not obligate at least $177,045,000, the minimum amount of direct loans authorized for fiscal year 1988, pursuant to Public Law 100-202. RTB committed to lend $80,139,000, which was the total amount of loans applied for during the year.

During the course of its audit, KPMG Peat Marwick also identified several matters which, although not material to the financial statements, were communicated to RTB in a separate management letter.

Distribution of Excess RTB Reserve

As discussed in section d of note 6 and presented in RTB's Statement of Changes in Stockholders' Equity, Public Law 100-203, the Omnibus Budget Reconciliation Act of 1987, requires that RTB transfer the balance in its reserve for contingencies to a reserve for losses due to interest rate fluctuations. At September 30, 1988, the balance in the reserve was $98,267,903. In our March 1989 report, Reserve Accounting: Rural Telephone Bank's Reserve for Losses Due to Interest Rate Fluctuations (GAO/AFMD-89-15), we concluded that a $10 million reserve for losses due to interest rate fluctuations appeared to be more than reasonable. We recommended that remaining amounts in the reserve in excess of $10 million plus 1988 profits not yet designated for a specific use be distributed as stock dividends to RTB's borrowers who hold RTB Class B stock. Subsequently, as disclosed in note 9, RTB's Board of Directors amended the bylaws to provide for a stock distribution of the excess. To comply with the recommendation and the change in the bylaws, RTB distributed approximately $125 million in patronage refunds on its Class B stock during fiscal year 1989.

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, the Administrator of the Rural Electrification Administration, and the Board of Directors of the Rural Telephone Bank.

Charles A. Bowsher for
Comptroller General
of the United States

Contents

Abbreviation

RTB Rural Telephone Bank

Auditors' Opinion

Peat Marwick

Certified Public Accountants

2001 M. Street, N.W.
Washington, DC 20036

The Comptroller General
U.S. General Accounting Office

The Board of Directors
Rural Telephone Bank:

We have audited the accompanying statement of financial position of the Rural Telephone Bank as of September 30, 1988, and the related statements of operations, changes in stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Rural Telephone Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Rural Telephone Bank as of September 30, 1988, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles. The statement of financial position of the Rural Telephone Bank as of September 30, 1987, and the related statements of operations, changes in stockholders' equity, and cash flows for the year then ended were not audited and, accordingly, we do not express an opinion on them.

In addition to this report on our audit of the Rural Telephone Bank's September 30, 1988 financial statements, we are also reporting on our study and evaluation of internal accounting controls and compliance with laws and regulations. During our audit, we identified matters that do not affect the fair presentation of the financial statements, but nonetheless warrant management's attention. We are reporting them separately to the General Accounting Office and the Rural Telephone Bank.

KPMG Peat Marwick

June 30, 1989

Auditors' Report on Internal Accounting Controls

Peat Marwick

Certified Public Accountants

2001 M. Street, N.W.
Washington, DC 20036

The Comptroller General
U.S. General Accounting Office

The Board of Directors
Rural Telephone Bank:

We have audited the financial statements of the Rural Telephone Bank (RTB) as of and for the year ended September 30, 1988, and have issued our report thereon dated June 30, 1989.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of RTB for the year ended September 30, 1988, we performed a study of the internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of RTB is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure 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 internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

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For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories: loan receipts, loan disbursements, treasury, and financial reporting. Our study included all of the control categories listed above and it was more limited than would be necessary to express an opinion on the internal control structure taken as a whole or on any of the control categories.

We noted one matter involving the internal control structure and its operation that we consider to be a reportable condition under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. We noted one reportable condition as follows:

- RTB has not updated its methodology for estimating the provision for loss on loans since the early 1970's. The method presently used does not consider prevailing economic conditions, the quality and quantity of loans in the portfolio, or other relevant factors. In addition, RTB relies on limited financial analysis and unaudited financial information for annual evaluations of borrowers' financial status. We understand that historically there have been few RTB borrowers who have experienced difficulty meeting debt service requirements, yet the current method incrementally increases the provision for loss on loans each year. Based on the history of the telephone program, we recommend RTB consider revising its method to discontinue the incremental provision for loss increases, establish procedures for reviewing the financial condition of all borrowers on an annual basis and annually determine the adequacy of the provision for loss on loans.

A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we do not believe the reportable condition described above is a material weakness.

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We also noted other matters involving the internal control structure and its operation that we have reported to the management of RTB in a separate letter dated June 30, 1989.

This report is intended for the information of RTB and the General Accounting Office. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

KPMG Peat Marwick

June 30, 1989

Auditors' Report on Compliance With Laws and Regulations

Peat Marwick

Certified Public Accountants

2001 M. Street, N.W.
Washington, DC 20036

The Comptroller General
U.S. General Accounting Office

The Board of Directors
Rural Telephone Bank:

We have audited the financial statements of the Rural Telephone Bank (RTB) as of and for the year ended September 30, 1988, and have issued our report thereon dated June 30, 1989.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws and regulations applicable to RTB is the responsibility of RTB's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of RTB's compliance with certain provisions of the Rural Electrification Act of 1936, as amended (7 U.S.C. 901-950b); the Anti-Deficiency Act (31 U.S.C 1341, 1342, 1511 - 1517) and the Continuing Appropriation Act for fiscal year 1988 (Public Law 100-202). However, our objective was not to provide an opinion on overall compliance with such laws.

The results of our tests indicate that, with respect to the items tested, RTB complied, in all material respects, with certain provisions of the laws referred to in the preceding paragraph of this report, and with respect to items not tested, nothing came to our attention that caused us to believe that RTB had not complied, in all material respects, with those laws. However, we noted the following item we believe should be highlighted.

The continuing resolution for fiscal year 1988 (Public Law 100-202) provided that the principal amount of direct RTB loans shall not be less than $177,045,000 nor more than $210,540,000 during fiscal year 1988. However, RTB committed to lending only $80,139,000 during fiscal year 1988. Our audit tests determined that of the amount of RTB telephone-insured loans applied for during fiscal year 1988, no amounts were denied. Thus, RTB was not able to obligate the minimum amount available to it for direct RTB loans because the demand for such loans fell short of the minimum requirement.

This report is intended for the information of RTB and the General Accounting Office. The restriction is not intended to limit the distribution of this report, which is a matter of public record.

KPMG Peat Marwick

June 30, 1989

Financial Statements

Statement of Financial Position

September 30, 1988
(with comparative balances for 1987)

Assets		1988	1987 (unaudited)
Funds with U.S. Treasury	$	188,376,434	81,224,991
Investment securities (note 3)		805,151	805,155
Loans, net of allowance for loan losses of $5,512,000 in 1988 and $5,295,000 in 1987 (note 4)		1,407,898,557	1,441,307,857
Accrued interest receivable		10,709,251	9,867,701
Other assets		402	450
	$	1,607,789,795	1,533,206,154
Liabilities and Stockholders' Equity			
Liabilities:			
Accounts payable		683,947	8,015
Loans payable to the U.S. Treasury (note 5)		758,762,000	758,762,000
Accrued interest payable		19,125,591	19,125,591
Total liabilities		778,571,538	777,895,606
Stockholders' equity (note 6):			
Investment of U.S. government - Class A stock, $1 par value; 600,000,000 shares authorized		505,950,000	477,240,000
Investment of others:			
Class B stock, $1 par value		181,402,657	165,320,340
Class C stock, $1,000 par value		6,787,000	2,949,000
Patronage capital:			
Designated for contingencies		-	76,781,352
Reserve for interest rate fluctuations (note 9)		98,267,903	-
Patronage capital earned		36,810,697	33,019,856
Total stockholders' equity		829,218,257	755,310,548
Commitments (note 8)			
	$	1,607,789,795	1,533,206,154

See accompanying notes to financial statements.

Statement of Operations

For the year ended September 30, 1988
(with comparative balances for 1987)

	1988	1987 (unaudited)
Interest income:		
Interest on loans	$ 114,363,003	112,199,642
Interest on U.S. Treasury securities	57,075	58,058
Interest on funds with U.S. Treasury	9,617,864	5,722,934
Total interest income	124,037,942	117,980,634
Interest expense	76,502,367	76,502,367
Net interest income	47,535,575	41,478,267
Provision for loan losses (note 4)	217,000	391,000
Net interest income after provision for loan losses	47,318,575	41,087,267
Other operating income	2,528	1,442,352
Other operating expenses:		
Directors' fees	12,600	17,600
Directors' travel	39,890	48,532
Other	8,174	44,890
Total other operating expenses	60,664	111,022
Net income	$ 47,260,439	42,418,597

See accompanying notes to financial statements.

Statement of Changes in Stockholders' Equity

For the year ended September 30, 1988
(with comparative balances for 1987)

	Class A stock	Class B stock	Class C stock
Fiscal year 1987 balances and transactions, (unaudited):			
Balance, September 30, 1986	$ 448,530,000	149,451,815	1,730,000
Net income for the year ended September 30, 1987		-	-
Issuance of Class A stock	28,710,000	-	-
Cash dividends on Class A stock ($.02 per share)	-	-	-
Issuance of Class B stock (net of rescissions)	-	2,777,010	-
Stock dividends on Class B stock	-	13,091,515	-
Cash dividends on Class C stock ($85 per share)	-	-	-
Issuance of Class C stock	-	-	1,219,000
Amount designated for contingencies	-	-	-
Balance, September 30, 1987	477,240,000	165,320,340	2,949,000
Fiscal year 1988 balances and transactions:			
Amount designated for contingencies	-	-	-
Transfer to reserve for interest rate fluctuations, January 1, 1988	-	-	-
Net income for the year ended September 30, 1988	-	-	-
Issuance of Class A stock	28,710,000	-	-
Cash dividends on Class A stock ($.02 per share)	-	-	-
Issuance of Class B stock (net of rescissions)	-	4,799,677	-
Stock dividends on Class B stock	-	11,295,117	-
Issuance of Class C stock	-	-	3,838,000
Cash dividends on Class C stock ($85 per share)	-	-	-
Class C stock cash dividends declared but not paid ($85 per share)	-	-	-
Adjustment to Class B stock dividends	-	(12,477)	-
Balance, September 30, 1988	$ 505,950,000	181,402,657	6,787,000

See accompanying notes to financial statements.

Designated for contingencies	Reserve for interest rate fluctuations (note 9)	Patronage capital	Total
64,706,937	-	25,312,980	689,731,732
-	-	42,418,597	42,418,597
-	-	-	28,710,000
-	-	(9,398,741)	(9,398,741)
-	-	-	2,777,010
-	-	(13,091,515)	-
-	-	(147,050)	(147,050)
-	-	-	1,219,000
12,074,415	-	(12,074,415)	-
76,781,352	-	33,019,856	755,310,548
21,474,074	-	(21,474,074)	-
(98,255,426)	98,255,426	-	-
-	-	47,260,439	47,260,439
-	-	-	28,710,000
-	-	(9,872,847)	(9,872,847)
-	-	-	4,799,677
-	-	(11,295,117)	-
-	-	-	3,838,000
-	-	(250,665)	(250,665)
-	-	(576,895)	(576,895)
-	12,477	-	-
-	98,267,903	36,810,697	829,218,257

Statement of Cash Flows

For the year ended September 30, 1988
(with comparative balances for 1987)

	1988	1987 (unaudited)
Funds from operating activities:		
Interest received	$ 123,196,392	117,018,565
Interest paid	(76,502,367)	(76,502,367)
Administrative expenses paid and other, net	40,953	1,412,235
Net funds provided from operating activities	46,734,978	41,928,433
Funds from investing activities:		
Collections on loans	152,680,668	39,307,039
Advances on loans - including Class B stock issued	(119,488,368)	(51,974,938)
Net funds provided from investing activities	33,192,300	(12,667,899)
Funds from financing activities:		
Proceeds from issuance of stock	37,347,677	32,706,010
Cash dividends paid	(10,123,512)	(9,545,791)
Net funds provided from financing activities	27,224,165	23,160,219
Net increase in funds with U.S. Treasury	107,151,443	52,420,753
Funds with U.S. Treasury, beginning of year	81,224,991	28,804,238
Funds with U.S. Treasury, end of year	$ 188,376,434	81,224,991

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	1988	1987 (unaudited)
Reconciliation of net income to net funds provided from operating activities:		
Net income	$ 47,260,439	42,418,597
Adjustments to reconcile net income to net funds provided from operating activities:		
Provision for losses on insured loans	217,000	391,000
Changes in assets and liabilities:		
Increase (decrease) in accrued interest receivable	(841,550)	(962,069)
Decrease in other assets	52	127,980
Increase (decrease) in accounts payable	675,932	(47,075)
Dividends declared but not paid	(576,895)	-
Net funds provided from operating activities	$ 46,734,978	41,928,433

See accompanying notes to financial statements.

Notes to Financial Statements

September 30, 1988

(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 51 percent of the Class A stock issued to the U.S. government and outstanding at any time since September 30, 1985 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

Section 403(b) of the Rural Electrification Act of 1936, as amended, (the Act), the Bank's enabling legislation, authorizes the Bank to partially or jointly use the facilities and services of employees of REA, or of 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. Origination fees are not charged on loans issued.

(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 charge-offs net of recoveries.

(d) Income Taxes

The Bank is an instrumentality of the United States and 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 approximately $6,000,000 per year.

(3) Investment Securities

The Bank's investment securities at September 30, 1988 and 1987 are as follows:

	1988		1987 (unaudited)	
	Book value	Market value	Book value	Market value
U.S. government bonds due in 1993 (rates ranging from 6.75% to 7.50%)	$ 805,151	760,388	805,155	727,573

(Continued)

(4) Loans

The composition of loans outstanding at September 30, 1988 and 1987 is as follows:

	1988	1987 (unaudited)
Loans	$ 1,322,423,814	1,360,403,314
Class B stock (note 6)	90,986,743	86,199,543
Less - allowance for loan losses	(5,512,000)	(5,295,000)
Total	$ 1,407,898,557	1,441,307,857

Interest rates, all of which are fixed, on loans range from 4 percent to 12 1/4 percent.

Transactions in the allowance for loan losses for the years ended September 30, 1988 and 1987 are shown below:

	1988	1987 (unaudited)
Balance at beginning of year	$ 5,295,000	4,904,000
Provision charged to operations	217,000	391,000
Loans charged off/recoveries	-	-
Balance at end of year	$ 5,512,000	5,295,000

(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 408 of the Rural Electrification Act of 1936, as amended (7 U.S.C. 948). Each year's advances are to be repaid in a lump sum on or before 50 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. The first principal payment to the U.S. Treasury will be due in 2023. As of September 30, 1988 and 1987, the Bank's cumulative debenture borrowings from the Treasury amounted to $758,762,000, at interest rates ranging from 7.25 to 14.625 percent.

Total outstanding borrowings from the U.S. Treasury may not exceed twenty times the Bank's equity. As of September 30, 1988 and 1987, the Bank's cumulative borrowing authority totaled $16.6 billion and $15.1 billion, respectively.

(Continued)

(6) 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. As of September 30, 1988 and 1987, 505,950,000 and 477,240,000 shares, respectively, of Class A stock were issued and outstanding.

(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 5 percent of the approved loan for construction purposes. 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 calculated at a specified percentage of interest income on loans to Class B stockholders, approved each year by the Board (10 percent in 1988 and 12 percent in 1987).

Class B stock is nontransferable, except in connection with the assumption by the transferee with the approval of the Bank governor of all or part of the transferor's loan from the Bank. A borrower, upon retiring debt with the Bank, may exchange Class B stock for Class C stock. Otherwise, the borrower retains possession. Class B stock can be redeemed only after all shares of Class A stock have been redeemed or retired.

Subscriptions receivable for Class B stock 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 for full amount of the Class B stock. 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, 1988 and 1987 is as follows:

	1988	1987 (unaudited)
Class B stock issued and committed for issuance	$ 109,022,940	112,655,168
Less - subscriptions not recognized	18,036,197	26,455,625
Stock issued based on loans originated	90,986,743	86,199,543
Cumulative patronage refunds (stock dividends) issued and outstanding	90,415,914	79,120,797
Total Class B stock issued and outstanding	$ 181,402,657	165,320,340

(c) Class C Stock

Class C stock is issued only to borrowers, or to corporations and public entities eligible to borrow from the Bank under Section 408 of the Act, or by organizations controlled by such borrowers, corporations and public entities, and is voting stock. The Bank may pay dividends on Class C stock (8.5 percent in 1988 and 1987). The number of shares of Class C stock issued and outstanding at September 30, 1988 and 1987 was 6,787 and 2,949, respectively.

(d) Patronage Capital

Patronage capital is distributed as follows:

Designated for Contingencies and Reserve for Interest Rate Fluctuations - Prior to the passage of the Ominibus Reconciliation Act of 1987, passed on December 22, 1987, an amount determined by the Board of Directors (not less than 10 percent of patronage capital) for each fiscal year was designated for contingencies. The amount so designated at September 30, 1987 did not include the amount designated from 1987 operations. The new law required that the reserve for contingencies be transferred to the reserve for losses due to interest rate fluctuations (see note 9).

(Continued)

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

(7) Waived Penalty Revenue on Loan Prepayments

Public Law 100-203, enacted December 22, 1987, allowed borrowers of the Bank to prepay loans (or any part thereof) until September 30, 1988, by paying the loan face amount without prepayment penalties. Total waived penalties approximated $9,700,000 during 1988.

(8) Commitments

A reconciliation of the Bank's unadvanced loan commitments from September 30, 1987 to September 30, 1988 follows:

Unadvanced loan commitments September 30, 1987	$ 792,257,249
Loan approvals during fiscal year 1988	80,139,150
Loan advances including Class B stock during fiscal year 1988	(119,488,367)
Recission of loan commitments during fiscal year 1988	(64,734,190)
Unadvanced loan commitments September 30, 1988	$ 688,173,842

Interest rates on unadvanced loan commitments made prior to October 1, 1987 range from 6.5 percent to 11.5 percent. Interest rates on unadvanced loan commitments made on or after October 31, 1987 will be the "cost of money rate" as defined in Section 408 of the Act, determined at the end of the fiscal year in which the initial advance is made, but not less than 5 percent. Loan commitments are generally extended for 6 years. Unadvanced loan commitments at September 30, 1988 will expire through 1994.

(9) Subsequent Event

On March 30, 1989, the Board of Directors amended the Bylaws of the Bank regarding the allocation of patronage capital for fiscal years after 1987. Any amounts in the reserve for interest rate fluctuations in excess of $10,000,000 shall be allocated as Class B stock dividends to those borrowers holding Class B stock during the fiscal year the amounts were earned.

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