United States General Accounting Office

GAO

Report to the Secretary of Agriculture

June 1990

FINANCIAL AUDIT

Rural Electrification Administration's Financial Statements for 1988 and 1987

141569

GAO/AFMD-90-73

GAO

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

Accounting and Financial
Management Division

B-231262

June 13, 1990

The Honorable Clayton K. Yeutter
The Secretary of Agriculture

Dear Mr. Secretary:

This report presents our opinion on the Rural Electrification Administration's (REA) financial statements for the fiscal year ended September 30, 1988. Reports on REA's internal accounting controls and on its compliance with laws and regulations are also provided.

Under authority of the Rural Electrification Act of 1936, as amended, REA makes direct loans and guarantees loans made by other qualified lenders to suppliers of electric and telephone service in rural areas. REA also makes grants and loans for the purpose of promoting rural economic development and job-creation projects.

We contracted with an independent certified public accounting firm to conduct a financial and compliance audit of REA 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 work also included a review of the loan loss exposure for approximately $3 billion of REA loans and $2 billion of loan guarantees because of the sensitive nature of ongoing negotiations between REA and the borrowers. Our examinations were conducted in accordance with generally accepted government auditing standards.

In our opinion, and consistent with the opinion of KPMG Peat Marwick, REA's financial statements present fairly, in all material respects, its financial position as of September 30, 1988, and the results of its operations and cash flows for the year then ended, in conformity with generally accepted accounting principles.

Several of REA's major electric program borrowers are experiencing severe financial difficulties due to their participation in the financing of large power plants, some of which are nuclear. REA is involved in litigation with certain of these borrowers. Although REA's financial statements include an estimate of probable future losses associated with these loans, REA is unable to predict their ultimate impact on its financial position.

We audited the September 30, 1987, financial statements, which are presented for comparative purposes. Our opinion on REA's fiscal year 1987 statement of financial position was unqualified. However, because 1987 was the first year that REA's financial statements had been audited, scope limitations with respect to opening balances for net loans receivable precluded us from expressing an opinion on the statements of operations and cash flows.

The report by KPMG Peat Marwick on internal accounting controls, with which we concur, discloses four reportable conditions which 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. The reportable conditions were that (1) REA's methodology for estimating its provision for losses on loans and guarantees had not been updated, (2) adequate procedures were lacking for transferring borrower monitoring responsibility from the "workout team," which resolves loan collection problems with financially troubled borrowers, to operations personnel, (3) REA was inappropriately continuing to recognize interest revenue on delinquent loans, and (4) REA's controls to monitor expenditures made through the U.S. Department of Agriculture's National Finance Center did not provide conclusive assurance that purchase orders and invoices were properly processed. KPMG Peat Marwick reported, and we concur, that the first two conditions are material weaknesses.

KPMG Peat Marwick presented recommendations, with which we concur, to correct the weaknesses discussed in its report on internal accounting controls. REA has stated that it agrees with the findings and that (1) it has revised the procedures used to estimate its provision for losses on loans and guarantees it has made, (2) documented procedures will be developed to ensure the proper transition of borrowers from the "workout team" to operations personnel, (3) it now fully reserves interest accrued on delinquent loans, and (4) steps have been taken to improve controls over expenditures made through the National Finance Center.

KPMG Peat Marwick's report on compliance with laws and regulations, with which we also concur, disclosed nothing to indicate that REA had not complied with such applicable laws and regulations which could have a material effect on the financial statements. However, KPMG Peat Marwick noted two compliance items which should be highlighted. Specifically, REA did not meet the $933,075,000 minimum amount of rural electric loan guarantee commitments authorized for fiscal year 1988 by

Public Law 100-202. REA guaranteed loans totalling $774,672,000, which was the total amount of loans applied for during the year. In addition, because the loan application and grant award process had not been finalized as of September 30, 1988, REA did not make loans or grants from the rural economic development subaccount during fiscal year 1988, as required by Public Law 100-203.

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

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, and interested congressional committees.

Sincerely yours,

Donald H. Chapin

Donald H. Chapin
Assistant Comptroller General

Contents

Abbreviation

REA Rural Electrification Administration

Auditors' Opinion

Peat Marwick

Certified Public Accountants

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

The Comptroller General
U.S. General Accounting Office

The Administrator
Rural Electrification Administration:

We have audited the accompanying statement of financial position of Rural Electrification Administration as of September 30, 1988, and the related statements of operations, changes in equity, and cash flows for the year then ended. These financial statements are the responsibility of Rural Electrification Administration's management. Our responsibility is to express an opinion on these financial statements based on our audit. We did not audit the loan loss exposure of loans totaling $3,139,004,928 (9 percent of total assets) which are included in loans receivable in the accompanying financial statements. Additionally, we did not audit the loss exposure for guaranteed loans totaling $2,349,681,006 (82 percent of total guarantees) that are included in the guaranteed loans which are not reflected on the statement of financial position in the accompanying financial statements, but are disclosed in note 1(d). Accordingly, the statement of financial position includes $1,125,158,000 of loan loss allowances and $346,842,000 of accrual for probable losses on guaranteed loans that were audited by other auditors. In addition, the statement of operations includes $492,809,460 of provision for losses on loans and $66,817,181 of provision for losses on guaranteed loans that were audited by other auditors. The other auditors' report has been furnished to us, and our opinion, insofar as it relates to the amounts included for allowance for loan loss and accrual for probable losses on guaranteed loans for the aforementioned lending arrangements, is based solely on the report of other auditors. The statement of financial position of Rural Electrification Administration as of September 30, 1987, prior to restatement as described in note 10, was audited by other auditors whose report dated June 1, 1988 expressed an unqualified opinion. The other auditors' report dated June 1, 1988 did not express an opinion on the statements of operations and cash flows for the fiscal year ended September 30, 1987 since certain information with respect to valuation of net loans receivable at October 1, 1986 was not readily available. We also reviewed the adjustments described in note 10 that were applied to restate the September 30, 1987 financial statements. In our opinion, such adjustments were appropriate and have been properly applied.

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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 and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Rural Electrification Administration at 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 as defined in Title 2 of the General Accounting Office's Policy and Procedures Manual for Guidance of Federal Agencies.

As discussed in note 1(c), several of REA's major electric program borrowers are experiencing severe financial difficulties relating to their participation in the financing of large power plants, some of which are nuclear. REA is involved in substantial litigation with certain of these borrowers. The financial statements include an estimate of probable future losses associated with these loans. However, REA is unable to predict their ultimate impact on REA's financial position.

In addition to this report on our audit of the Rural Electrification Administration'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 Electrification Administration.

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 Administrator
Rural Electrification Administration:

We have audited the financial statements of Rural Electrification Administration (REA) 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 REA 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 REA 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 certain matters involving the internal control structure and its operation that we consider to be reportable conditions 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. The reportable conditions we noted are as follows:

- REA has not updated its methodology for estimating the provision for loss on loans and guaranteed 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, REA relies on limited financial analysis and unaudited financial information for annual evaluations of borrowers' financial status. Furthermore, REA has not developed specific procedures to monitor and evaluate electric borrowers involved in significant long-term construction; electric borrowers who cannot, by law, pledge their assets as loan security; or cable television borrowers. We recommend that REA revise its method for evaluating the financial condition of its borrowers and the adequacy of the provision for losses on loans and guaranteed loans.

- Formal procedures do not exist for the transition of borrower monitoring responsibility from the workout team, that resolves loan collection problems with financially troubled borrowers, to the operations personnel, once a settlement has been reached on a troubled loan. We recommend that important information concerning events that occurred during the workout phase be formally documented and communicated to the operations personnel who are responsible for monitoring the loan.

- REA continues to accrue interest on delinquent loans receivable. Accrued interest over which collectibility is questionable should be reserved. We recommend that REA establish a policy to fully reserve interest on loans delinquent for more than 90 days.

- REA maintains a log of purchase orders sent to NFC but does not receive reports from NFC indicating that such purchase orders have been processed. Furthermore, copies of invoices sent to the National Finance Center (NFC) for payment are not maintained by REA. Finally, REA does not reconcile reports of invoices paid by NFC to REA's purchase order log to enable REA to monitor outstanding purchase orders. We recommend that REA maintain copies of all documentation sent to NFC for processing and that monthly reports concerning processing activity be requested from NFC and be reconciled to REA's records. In addition, the report of invoices paid by NFC should be used to update REA's purchase order log.

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. We believe the first two conditions reported in the sixth paragraph are material weaknesses as defined in the immediately previous paragraph.

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

This report is intended for the information of REA 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 Administrator
Rural Electrification Administration:

We have audited the financial statements of the Rural Electrification Administration (REA) 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 REA is the responsibility of REA's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of REA's compliance with certain provisions of the Rural Electrification Act of 1936, as amended (7 U.S.C. 901-950b), as amended; the Anti-Deficiency Act (31 U.S.C. 1341, 1342, 1511-1517), and the Continuing Appropriations 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, REA 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 REA had not complied, in all material respects, with those laws. However, we noted two items we believe should be highlighted.

- The continuing resolution for fiscal year 1988 (Public Law 100-202) provided REA commit to guarantee not less than $933,075,000 nor more than $2,100,615,000 in rural electric guarantee commitments during fiscal year 1988. However, REA granted guarantees of only $774,672,000 during fiscal year 1988. Our audit tests determined that of the amount of electric

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guaranteed loans applied for during fiscal year 1988, no amounts were denied. Thus, REA was not able to obligate the minimum amount available to it for electric guarantee commitments because demand for such guarantees fell short of the minimum requirement.

- Public Law 100-203 requires that zero interest loans and grants shall be made during each fiscal year to the full extent of the amounts held by the rural economic development subaccount. REA made no loans or grants from the rural economic development subaccount during fiscal year 1988 because the grant award process had not been finalized as of September 30, 1988.

This report is intended for the information of REA 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

Statements of Financial Position

September 30, 1988 and 1987

(Dollars in Thousands)

Assets	1988	1987 (as restated)
Loans receivable, net of allowance for loan losses of $1,791,972,000 and $990,400,000 at September 30, 1988 and 1987, respectively (notes 2, 3 and 4)	$ 34,497,412	36,390,302
Accrued interest receivable	62,299	130,299
Funds with U.S. Treasury	198,731	83,677
Accounts receivable	25	6,351
Other assets	2,896	2,365
	$ 34,761,363	36,612,994
Liabilities and Equity		
Liabilities:		
Intragovernmental debt (notes 3 and 4)	31,992,200	34,085,806
Notes payable (note 5)	568,778	-
Accrual for probable losses on guaranteed loans	367,756	291,841
Accrued interest payable	26,918	20,918
Other liabilities (note 6)	4,049	2,922
Total liabilities	32,959,701	34,401,487
Equity:		
Investment of others:		
Class B stock, $1 par value (note 7)	181,403	165,320
Class C stock, $1,000 par value (note 7)	6,787	2,949
Restricted capital (note 9)	98,268	76,781
Patronage capital earned	36,810	33,020
Total investment of others	323,268	278,070
Equity of the U.S. government:		
Unexpended appropriations - undelivered orders	2,758	1,038
Invested capital	1,565	1,559
Donated capital (note 8)	505,950	477,240
Cumulative results of operations (note 10)	968,121	1,453,600
Total equity of the U.S. government	1,478,394	1,933,437
Total equity	1,801,662	2,211,507
Commitments and contingencies (notes 1c and 2)		
	$ 34,761,363	36,612,994

See accompanying notes to financial statements.

Statements of Operations

Years ended September 30, 1988 and 1987

(Dollars in Thousands)

	1988	1987 (unaudited - as restated)
Interest income:		
Interest on loans	$ 2,320,264	2,673,089
Interest earned on Funds with U.S. Treasury	27,475	7,467
Total interest income	2,347,739	2,680,556
Interest expense - interest on borrowings	(2,236,414)	(2,524,728)
Net interest income	111,325	155,828
Provision for losses on:		
Insured loans (note 2)	(801,572)	(563,070)
Guaranteed loans	(75,915)	(291,841)
Total provision for losses	(877,487)	(854,911)
Net interest income after provision for losses	(766,162)	(699,083)
Other income (expenses):		
Appropriations realized	27,555	25,983
Prepayment penalty income	268	1,442
Other income	2	58
Other expenses	(28,866)	(26,174)
Loss on discounted loan prepayments (note 11)	-	(299,015)
Net other income (expenses)	(1,041)	(297,706)
Net loss	$ (767,203)	(996,789)

See accompanying notes to financial statements.

Statements of Changes in Equity

Years ended September 30, 1988 and 1987

(Dollars in Thousands)

	Class B stock	Class C stock	Restricted capital - designated for contingencies (note 9)	Restricted capital - reserve for interest rate fluctuations (note 9)
Fiscal year 1987 balances and transactions (unaudited):				
Balance, September 30, 1986	$ 149,452	1,730	64,707	-
Net income for the year ended September 30, 1987 (as restated - note 10)	-	-	-	-
1987 appropriations for RTB Stock	-	-	-	-
1987 appropriations for interest subsidies and losses	-	-	-	-
Cash dividends on Class A stock	-	-	-	-
Issuance of Class B stock (net of rescissions)	2,777	-	-	-
Stock dividends on Class B stock	13,091	-	-	-
Cash dividends on Class C stock ($85 per share)	-	-	-	-
Issuance of Class C stock	-	1,219	-	-
Amount designated for contingencies	-	-	12,074	-
Change in unliquidated obligations	-	-	-	-
Other	-	-	-	-
Balance, September 30, 1987 (as restated)	165,320	2,949	76,781	-
Fiscal year 1988 balances and transactions:				
Net income for the year ended September 30, 1988	-	-	-	-
1988 appropriations for RTB stock	-	-	-	-
1988 appropriations for interest subsidies and losses	-	-	-	-
Transfer to reserve for interest rate fluctuations, January 1, 1988	-	-	(98,256)	98,256
Cash dividends paid on Class A stock	-	-	-	-
Issuance of Class B stock (net of rescissions)	4,800	-	-	-
Stock dividends on Class B stock	11,295	-	-	-
Issuance of Class C stock	-	3,838	-	-
Cash dividends on Class C stock ($85 per share)	-	-	-	-
Class C stock cash dividends declared but not paid ($85 per share)	-	-	-	-
Amount designated for contingencies	-	-	21,475	-
Adjustment to Class B stock dividends	(12)	-	-	12
Change in unliquidated appropriations	-	-	-	-
Other	-	-	-	-
Balance, September 30, 1988	$ 181,403	6,787	-	98,268

See accompanying notes to financial statements.

Patronage capital earned	Unexpended appropriations	Invested capital	Donated capital	Cumulative results of operations	Total
25,313	298	1,409	448,530	2,471,216	3,162,655
42,418	-	-	-	(1,039,207)	(996,789)
-	-	-	28,710	-	28,710
-	-	-	-	21,591	21,591
(9,399)	-	-	-	-	(9,399)
-	-	-	-	-	2,777
(13,091)	-	-	-	-	-
(147)	-	-	-	-	(147)
-	-	-	-	-	1,219
(12,074)	-	-	-	-	-
-	740	-	-	-	740
-	-	150	-	-	150
33,020	1,038	1,559	477,240	1,453,600	2,211,507
47,260	-	-	-	(814,463)	(767,203)
-	-	-	28,710	-	28,710
-	-	-	-	328,984	328,984
-	-	-	-	-	-
(9,873)	-	-	-	-	(9,873)
-	-	-	-	-	4,800
(11,295)	-	-	-	-	-
-	-	-	-	-	3,838
(251)	-	-	-	-	(251)
(576)	-	-	-	-	(576)
(21,475)	-	-	-	-	-
-	-	-	-	-	-
-	1,720	-	-	-	1,720
-	-	6	-	-	6
36,810	2,758	1,565	505,950	968,121	1,801,662

Statements of Cash Flows

Years ended September 30, 1988 and 1987

(Dollars in Thousands)

	1988	1987 (unaudited - as restated)
Funds from operating activities:		
Interest received	$ 2,415,739	2,368,479
Interest paid	(2,230,414)	(2,518,322)
Appropriations received for operations	29,275	26,723
Appropriations expended for operations	(27,555)	(25,983)
Administrative expenses paid and other, net	3,585	1,676
Net funds provided from (used by) operating activities	190,630	(147,427)
Funds from investing activities:		
Collections on loans	2,805,850	1,798,503
Advances on loans	(1,712,896)	(1,390,438)
Overpayments by borrowers, net of refunds	96	85
Purchase of property and equipment, net	(6)	407
Proceeds from maturing investments	-	128
Net funds provided from investing activities	1,093,044	408,685
Funds from financing activities:		
Appropriations for RTB stock	28,710	28,710
Repayments on Federal Financing Bank borrowings	(2,363,320)	(1,502,582)
Borrowings from Federal Financing Bank	269,714	1,225,041
Proceeds from issuance of notes payable	568,778	-
Payments on U.S. treasury borrowings	-	(325,773)
Borrowings from U.S. treasury	-	319,774
Proceeds from issuance of stock	8,638	28,808
Appropriations for interest subsidies and losses	328,984	21,591
Dividends paid	(10,124)	(9,546)
Net funds provided from (used by) financing activities	(1,168,620)	(213,977)
Net increase in Funds with U.S. Treasury	115,054	47,281
Funds with U.S. Treasury, beginning of year	83,677	36,396
Funds with U.S. Treasury, end of year	$ 198,731	83,677

(Continued)

(Dollars in Thousands)

	1988	1987 (unaudited - as restated)
Reconciliation of net loss to net funds provided from (used by) operating activities:		
Net loss	$ (767,203)	(996,789)
Adjustments to reconcile net loss to net funds provided from (used by) operating activities:		
Provision for losses on insured loans	801,572	563,070
Provision for losses on guaranteed loans	75,915	291,841
Loss on discounted loan prepayments	-	299,015
Changes in assets and liabilities:		
Decrease (increase) in accrued interest receivable	68,000	(306,220)
(Increase) decrease in accounts receivable	6,326	(325)
(Increase) decrease in other assets	(530)	2,609
Increase (decrease) in other liabilities	1,127	(1,119)
Increase in accrued interest payable	6,000	491
Dividends declared but not paid	(577)	-
Total adjustments	957,833	849,362
Net funds provided from (used by) operating activities	$ 190,630	(147,427)

See accompanying notes to financial statements.

Notes to Financial Statements

(1) Summary of Significant Accounting Policies

(a) Entity

The Rural Electrification Administration (REA) is a credit agency of the U.S. Department of Agriculture established by the Rural Electrification Act of 1936 to assist in financing electric and telephone organizations serving rural areas. The Rural Electrification Administration maintains one general fund and three revolving funds, including a revolving fund known as the Rural Telephone Bank, a government corporation, which is combined in these financial statements. The financial statements include all funds for which REA is responsible and are presented on the accrual basis of accounting as required by Title 2 of the U.S. General Accounting Office's (GAO) Policy and Procedures Manual for Guidance of Federal Agencies. All significant intra-agency balances and transactions have been eliminated.

(b) Recognition of Financing Sources and Interest Income

REA finances its loan programs through available receipts and, when necessary, by long-term and interim borrowings from the U.S. Department of the Treasury and Federal Financing Bank (FFB). (See also note 4.) Revolving funds were established in the early 1970s to maintain the rural electric and telephone programs with the intention of making them self-sustaining. However, REA receives annual appropriations for administrative expenditures as described below; cable television program losses; and interest subsidies and losses, which, by law, are not considered incurred for the rural electric and telephone programs.

Appropriations are provided by the Congress on an annual basis to fund capital expenditures, loan losses and such administrative expenditures as personnel compensation and fringe benefits, rents, communications and utilities. The budgetary process does not distinguish between operating and capital expenditures. For budgetary purposes, both are recognized as a use of budgetary resources; however, for financial reporting purposes, under accrual accounting, operating expenditures are recognized currently while expenditures for capital assets are capitalized and recognized as expenses when they are consumed in REA's operations. Financing sources for these expenses, which derive from both current- and prior- year appropriations, are recognized on this same basis.

(Continued)

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Interest income on loans is accrued at the contractual rate on the outstanding principal amount.

(c) Loans Receivable and Allowance for Losses

REA makes insured and guaranteed loans from the Rural Electrification and Telephone Revolving Fund (RETRF), the Rural Telephone Bank (RTB), and the Rural Communications Development Fund (RCDF). The RETRF insured loan program authorizes the Administrator of REA to grant loans to rural electric and telephone utilities. These loans are repaid over 35 years with principal amortization generally beginning 3 years after the date of the note. Origination fees are not charged.

The interest rate on loans made prior to May 11, 1973, was 2 percent. However, since 1973, the interest rate has been 5 percent, although some loans may still be made at 2 percent in cases involving extreme financial hardship.

REA makes certain loans through financing provided by FFB. Although loans are executed between the borrower and FFB with REA unconditionally guaranteeing repayment, REA makes all decisions concerning loan origination and bears ultimate risk for loan collection. Therefore, loans made through FFB financing are considered to be assets of REA. Interest rates on these loans are determined at the time funds are advanced and are based upon the average U.S. Treasury rate, plus 0.125 percent. FFB loans mature at varying periods between 2 and 7 years, or at 35 years. Loans which mature in 2 to 7 years generally may be extended for a maximum of 35 years. Loans made through FFB financing are reflected as loans receivable in the accompanying financial statements with a corresponding intergovernmental debt liability.

RTB's insured loan program was established as a supplemental source of financing for the growing capital needs of rural telephone utilities. RTB lends at rates approximately equal to its cost of money.

RCDF insured or guaranteed loans to both cooperative and commercial borrowers for community antenna television services and facilities. RCDF has not made any new loans since 1981.

Loans are carried at the principal amount outstanding less an allowance to reflect their ultimate collectibility. REA bases its loan loss estimates on delinquency rates, current economic conditions, borrowers' credit histories, and borrowers' financial conditions.

(Continued)

Since 1984, several of REA's major electric program borrowers are experiencing severe financial difficulties due to their participation in the financing of large power plants, some of which are nuclear. During construction of a number of projects, cost overruns and delays in operation have occurred. In addition, load growth and economic conditions have substantially changed since REA's initial loan review. Where states do not allow construction work-in-progress costs to be considered for the determination of electric rates, the owners cannot obtain rate increases to meet revenue requirements and debt service payments until the plants become operational. Furthermore, nuclear power has created unrest among consumers, causing substantial difficulty for owners in obtaining a license for the operation of nuclear plants. In some cases, nuclear plants sit idle or are abandoned. Until the plants become operational, no revenue can be generated and, therefore, some borrowers have not met their debt service requirements. A few borrowers have filed for bankruptcy due to their severe financial distress. REA is also involved in substantial litigation with a few borrowers who are experiencing severe financial difficulties.

REA's practice of restructuring the debt of its troubled borrowers was considered in developing allowances for loan losses. REA restructuring agreements often incorporate the issuance of additional guarantees as well as the issuance of contingent notes, for which repayment is contingent upon future events, such as sustained load growth. Because of the troubled borrower situations, significant uncertainties exist relating to the ultimate recovery of REA's outstanding exposure in these lending arrangements. The ultimate financial effect of the resolution of these matters cannot presently be determined.

In fiscal years 1988 and 1987, REA increased the allowance for loan losses to more adequately reflect the downward trend in market conditions. In 1987, the increase pertaining to fiscal year 1987 could not be distinguished from amounts pertaining to prior years. Therefore, the full amount of the adjustment was recognized in fiscal year 1987. As of September 30, 1988 and 1987, the allowance for losses account amounted to $1,791,972,000 and $990,400,000, respectively.

Additionally, accrued interest on potential problem loans is excluded from income with an offsetting increase in a specific allowance account when management determines such exclusion is warranted.

(Continued)

(d) Guaranteed Loans

As of September 30, 1988 and 1987, REA is contingently liable for $2,868,266,000 and $1,478,357,000 in guaranteed loans, respectively. These guaranteed loans are not included in loans receivable on the accompanying statement of financial position.

Estimated losses on anticipated defaults of guaranteed loans are recognized as expenses and a corresponding accrual for probable losses is established. This liability represents the estimated cost of defaults for those guaranteed loans which will not be repaid based on (1) prior delinquency experience and (2) management's assessment of the borrower's financial condition. REA provided an accrual for probable losses on guaranteed loans in fiscal years 1988 and 1987 due to the downward trend in market conditions. (See note 1(c) above.) In 1987, the amount of the increase in the accrual pertaining to fiscal year 1987 could not be distinguished from amounts pertaining to prior years, and the full amount of the adjustment was recognized in fiscal year 1987. As of September 30, 1988 and 1987, the accrual for probable losses on guaranteed loans amounted to $367,756,000 and $291,841,000, respectively. The change in the accrual for probable losses during fiscal year 1988 represents a $75,915,000 provision for losses as reflected in the accompanying statement of operations.

(e) Certificates of Beneficial Ownership

Certificates of Beneficial Ownership (CBOs) are REA-backed securities which represent FFB's participation in a pool of REA's insured loans receivable. The issuance of a CBO is recorded as a borrowing and the corresponding interest is expensed.

(f) Interest Earned on Interest-Bearing Balances with the U.S. Treasury

Each of the revolving funds earns interest on its cash held in the U.S. Treasury if the fund has outstanding borrowings with the U.S. Treasury and owes interest on those borrowings. The amount of interest earned per month is limited to the interest owed on U.S. Treasury borrowings.

(g) Intragovernmental Financial Activities

REA's financial activities interact with and are dependent upon those of the federal government as a whole. Thus, REA's financial statements do not reflect the results of all financial decisions and activities applicable to REA's operations, as if it were a stand-alone entity.

(Continued)

REA's financial statements are not intended to report the agency's proportionate share of the federal deficit or of public borrowing, including interest thereon. Financing for budget appropriations reported on REA's statements of operations and changes in cash flows could derive from tax revenues or public borrowing or both; the ultimate source of this financing, whether it be tax revenues or public borrowing, has not been specifically allocated to REA.

During fiscal year 1988 and 1987, the majority of REA's employees participated in the contributory Civil Service Retirement System (CSRS) or Federal Employees Retirement System (FERS), to which REA made matching contributions. Such contributions are recognized as expenses in the statements of operations. However, REA does not 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.

(h) Income Taxes

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

(i) Reclassification

Certain amounts for 1987 have been reclassified to conform to the current year presentation.

(2) Loans Receivable and Allowance for Loan Losses

As of September 30, 1988 and 1987, loans receivable and the allowance for loan losses amounted to (dollars in thousands):

	1988			1987		
	Loan amount	Allowance	Net receivable	Loan amount	Allowance	Net receivable
RETRF:						
Insured	$ 15,638,295	572,117	15,066,178	14,741,580	109,246	14,632,334
FFB	19,219,423	1,209,619	18,009,804	21,173,537	874,359	20,299,178
RTB	1,413,411	5,512	1,407,899	1,446,603	5,295	1,441,308
RCDF	18,255	4,724	13,531	18,982	1,500	17,482
Total	$ 36,289,384	1,791,972	34,497,412	37,380,702	990,400	36,390,302

Because REA does not maintain amortization tables on loans receivable, the amount of loans receivable scheduled for collection in each of the next 5 years is not available.

(Continued)

The activity in the allowance for loan losses for the fiscal years ended September 30, 1988 and 1987, is as follows (dollars in thousands):

	RETRF				
	Insured	FFB	RTB	RCDF	Total
Beginning balance October 1, 1986	$ 35,926	385,000	4,904	2,205	428,035
Loans written off, net	-	-	-	(694)	(694)
Provisions for loan losses	73,320	489,359	391	-	563,070
Recoveries	-	-	-	(11)	(11)
Ending balance September 30, 1987	109,246	874,359	5,295	1,500	990,400
Loans written off, net	-	-	-	-	-
Provisions for loan losses	462,871	335,260	217	3,224	801,572
Recoveries	-	-	-	-	-
Ending balance September 30, 1988	$ 572,117	1,209,619	5,512	4,724	1,791,972

As of September 30, 1988, loans that have been authorized but not yet disbursed consist of (dollars in thousands):

RETRF	$ 7,205,861
RTB	688,174
RCDF	1,359
	$ 7,895,394

The following presents a summary of loans receivable on which the accrual of interest has been discontinued because circumstances indicate collection is doubtful (dollars in thousands):

	1988	1987
Aggregate nonaccruing loans	$ 2,564,642	-
Gross interest income that would have been recorded during the year on nonaccrual loans	$ 213,080	-

(Continued)

The following presents a summary of loans receivable on which the loan terms have been restructured to provide a reduction or deferral of interest and/or principal because of a deterioration in the financial position of the borrower (dollars in thousands):

	1988	1987
Outstanding balance of restructured loans	$ 2,440,568	2,303,476
Gross interest income that would have been recorded during the year if the restructured loans had been current in accordance with their original terms	$ 223,795	154,370
Interest actually recorded on restructured loans during the year	$ 112,207	123,913

Commitments for additional funds to borrowers with restructured loans at September 30, 1988 amounted to approximately $3,489,000.

(3) Effect of Below Market Interest Rates

REA originates certain electric and telephone loans at 2 percent and 5 percent. These stated rates were below the U.S. Treasury rates, the rates at which REA could borrow money when the loans were originated (market interest rates). In addition, several loans receivable have undergone troubled debt restructurings which resulted in restructured loans with interest rates below the market interest rates. To offset the costs of lending at below-market interest rates, REA has certain noninterest-bearing borrowings from the U.S. Treasury.

Federal accounting principles governing the recording of interest rate subsidies and discounts on below market interest rate receivables and liabilities are undergoing reexamination by the Congress, the Executive Branch, and the GAO. The present interpretation of these matters by GAO is that disclosure of the effects of interest rate subsidies and discounts on below market interest rate receivables and liabilities is required but need not be recorded in the financial statements. Accordingly, REA has not recognized the cost of interest rate subsidies or discounts on loans receivable originated at below-market interest rates or noninterest-bearing borrowings in the accompanying financial statements.

(Continued)

The estimated effect of recognizing the interest rate subsidies and discounts on below-market interest rate loans receivable and noninterest-bearing borrowings on REA's financial statements as of September 30, 1988, assuming borrower repayment according to the terms of the loan, would be as follows (dollars in thousands):

Effect on Statement of Financial Position

Assets

Loans, issued at market rates	$ 18,709,254
Loans, issued at 2%, 5%, or which have been restructured	15,788,158
Loans receivable, as presently recorded, net of allowance for loan losses	34,497,412
Interest rate subsidy discount	(4,519,109)
Loans receivable, net of allowance for loan losses, as adjusted for interest rate subsidy	29,978,303
Accrued interest receivable, Funds with U.S. Treasury, accounts receivable and other assets	263,951
Total assets, as adjusted for interest rate subsidy	$ 30,242,254

(Continued)

9

Effect on Statement of Financial Position, Continued

Liabilities and Equity

Liabilities:	
Intragovernmental debt:	
FFB	$ 23,344,091
RETRF Treasury borrowings	7,864,743
Other Treasury borrowings	783,366
Intragovernmental debt	31,992,200
Discount on U.S. Treasury borrowings	(3,648,187)
Intragovernmental debt, net of discount	28,344,013
Notes payable, accrual for probable losses on guaranteed loans, accrued interest payable and other liabilities	967,501
Total liabilities, net of discount	29,311,514
Equity:	
Investment of others	323,268
Equity of the U.S. government, as presently recorded	1,478,394
Prior period effect of recording interest rate subsidy discount and discount on U.S. Treasury borrowings	(885,172)
Current year impact of recording interest rate subsidy discount and discount on U.S. Treasury borrowings	14,250
Equity of the U.S. government, net of discounts	607,472
Total equity, net of discount	930,740
Total liabilities and equity, net of discount	$ 30,242,254

(Continued)

Effect on Statement of Operations

Net loss, as presently recorded	$ (767,203)
Interest income - amortization of interest rate subsidy discount	194,078
Interest expense - amortization of discount on U.S. Treasury borrowings	(143,657)
Interest rate subsidy to borrowers - issuance of new loans in 1988	(36,171)
Net increase in income due to imputed interest	14,250
Net loss, as adjusted for imputed interest	$ (752,953)

If the $4,519,109,000 unamortized interest rate subsidy on loans receivable were reported on the statement of financial position, then the allowance for losses on loans would be established based on the discounted loans receivable. It is estimated that the allowance for losses would be reduced by an immaterial amount, and, therefore, has not been reflected in the effects on the financial statements shown above.

(Continued)

(4) Intragovernmental Debt

As of September 30, 1988 and 1987, REA borrowings consist of the following (dollars in thousands):

	1988	1987
FFB Borrowings:		
Direct loans made through FFB financing	$ 19,204,884	21,196,490
Certificates of Beneficial Ownership (CBOs)	4,139,207	4,241,207
	23,344,091	25,437,697
Treasury borrowings:		
RETRF, due 6/30/1993 - 12/31/2016, noninterest bearing	7,864,743	7,864,743
RTB, due 6/30/2024 - 6/30/2036, interest accrues at 7.25 percent - 14.625 percent	758,762	758,762
RCDF, due 9/30/2016 - 9/30/2021, interest accrues at 10.5 percent - 15.14 percent	24,604	24,604
	8,648,109	8,648,109
	$ 31,992,200	34,085,806

REA borrows funds from FFB to finance certain loans. These loans serve as collateral for the FFB borrowings. FFB borrowings bear interest at rates ranging from 6.197 percent to 15.128 percent and mature as the related loans receivable become due, through 2023. Interest rates on the related loans receivable are equal to the interest rates on FFB borrowings.

Because FFB borrowings mature as the related loans receivable become due, and amortization tables on loans receivable are not maintained, the amount of intergovernmental debt payable in each of the next 5 years is not available.

In 1987, the method of recording CBOs was changed to conform with generally accepted accounting principles for federal agencies, which requires the issuance of CBOs to be recorded as a borrowing and corresponding interest to be expensed. REA has CBOs with maturity dates ranging from December 31, 1988 to March 31, 2016. Interest rates on CBOs vary from 7.664 percent to 15.325 percent.

(Continued)

(5) Notes Payable

In conjunction with the restructuring of several loans receivable during fiscal year 1988, REA assumed notes payable totaling $568,778,000 with interest rates which range from 8.1775 percent to 10.7825 percent, maturing through the year 2017.

Principal payments on notes payable are due as follows (in thousands):

Year ending September 30:	
1989	$ 2,451
1990	3,819
1991	4,553
1992	5,061
1993	5,643
Thereafter	547,251
Total	$ 568,778

(6) Rural Economic Development Subaccount

Included in other liabilities at September 30, 1988 is $403,991 relating to the rural economic development subaccount. This subaccount was established by REA under the authority of Public Law 100-203 Section 1403 (December 22, 1987) and is credited on a monthly basis with a portion of the interest REA earns on cushion of credit payments made to REA after October 1, 1987. REA is authorized to provide grants or zero interest loans to borrowers under this Act for the purpose of promoting rural economic development and job creation projects, including funding for project feasibility studies, start-up costs, incubator projects, and other reasonable expenses for the purpose of fostering rural development. The law further requires that such loans and grants shall be made during each fiscal year to the full extent of the amounts held by the rural economic development subaccount, subject only to limitations as may be from time-to-time imposed by law. As of September 30, 1988, REA has not extended any loans or grants under this program because the grant-awarding process has not been finalized.

(7) Investment of Others - Capital Stock - Rural Telephone Bank

Class B stock is issued only to loan customers of RTB and is voting stock. Each customer is required to purchase such stock in the amount of 5 percent of the approved loan amount for construction purposes. RTB 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 RTB Board (10 percent in 1988 and 12 percent in 1987).

(Continued)

Class B stock is nontransferable, except in connection with the assumption by the transferee with the approval of the Rural Telephone Bank Governor of all or part of the transferor's loan from RTB. A borrower, upon retiring debt with RTB, 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, which is nonvoting RTB stock owned by the government, have been redeemed and retired. Class A stock is to be redeemed and retired by RTB as soon as practicable after September 30, 1995, but not to the extent that RTB's Board determines that such retirement will impair operations of RTB. (See note 8 for further details on Class A stock.)

Subscriptions receivable for Class B stock are not reflected in the accompanying financial statements. When RTB makes the first advance under each loan, it issues the stock applicable to the total loan and charges loans receivable for the full amount of the Class B stock. In the event of rescission of part of the loan commitment subsequent to issuance of the stock, RTB rescinds the applicable portion of Class B stock and reduces loans receivable. Subscriptions receivable amounted to $18,036,000 and $26,456,000 for the fiscal years ended September 30, 1988 and 1987. The number of shares of Class B stock issued and outstanding at September 30, 1988 and 1987 was 181,403,000 and 165,320,000, respectively.

Class C stock is issued only to RTB borrowers, or to corporations and public entities eligible to borrow from RTB under Section 408 of the Act, or by organizations controlled by such borrowers, corporations, and public entities, and is voting stock. RTB 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 as of September 30, 1988 and 1987 was 6,787 and 2,949, respectively.

(8) Donated Capital

Public Laws 92-12 and 97-98 authorize the Congress, beginning in fiscal year 1971 through 1991, to appropriate no more than $30 million per year to REA for the purchase of RTB Class A stock. The laws contemplate that the Congress will continue to annually appropriate funds until such purchases equal $600,000,000. During each of fiscal years 1988 and 1987, REA received $28,710,000 in donated capital. As of September 30, 1988 and 1987 donated capital amounted to $505,950,000 and $477,240,000. RTB Class A stock has been eliminated in combination.

(Continued)

(9) Restricted Capital - Rural Telephone Bank

Prior to the passage of the Omnibus Reconciliation Act of 1987, passed on December 22, 1987, not less than 10 percent of the patronage capital of RTB for each fiscal year, as determined by the RTB Board of Directors, was designated to be placed in a contingency reserve. The new law required that the contingency reserve be transferred to a reserve for interest rate fluctuations. At September 30, 1988 and 1987, restricted capital was $98,268,000 and $76,781,000, respectively.

(10) Prior Period Adjustment

REA restructured several loans with effective restructuring dates prior to September 30, 1987. Certain activity relating to these restructured loans was improperly recorded in the prior period. REA has recorded adjustments to reflect the proper loan receivable balances for these loans as of September 30, 1987. The net result of these adjustments on the accompanying financial statements was a $40,488,000 decrease of loans receivable and a corresponding decrease of cumulative results of operations as of September 30, 1987.

(11) Loss on Discounted Loan Prepayments

Public Law 99-509 allowed borrowers of RETRF insured loans to prepay such loans during fiscal year 1987 at the lesser of the outstanding principal balance due on the loan or the loan's present value discounted from the face value at maturity at the rate set by the Administrator. REA sustained losses on the prepayments of these loans during fiscal year 1987 of $299,015,000.

(12) Waived Prepayment Penalties

Section 1401 of the Omnibus Reconciliation Act of 1987 (Public Law 100-203) and Section 1011 of the Omnibus Reconciliation Act of 1986 (7 U.S.C 936(a)) required REA to accept certain FFB-financed loan prepayments at book value without prepayment penalties during fiscal years 1988 and 1987. Likewise, REA was allowed to prepay FFB borrowings, used to finance these loans, without prepayment penalty. Total waived prepayment penalties amounted to approximately $450,000,000 and $161,000,000 in fiscal years 1988 and 1987, respectively. The amount of prepaid FFB loans approximated $2,000,000,000 and $580,000,000 in 1988 and 1987, respectively.

(Continued)

(13) Subsequent Event

On March 30, 1989, the RTB Board of Directors amended the Bylaws of the RTB regarding the allocation of patronage capital for fiscal years after 1987. Any amounts in the reserve for interest rate fluctuations classified as restricted capital on the accompanying statement of financial position (see note 9), 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.

(14) Reconciliation to Budget Report

The following schedule reconciles total expense as reported in the accompanying Combined Statements of Operations, with negative outlays as reported in the Office of Management and Budget Report, SF-133, "Report on Budget Execution," for the year ended September 30, 1988 (dollars in thousands):

Reconciliation to Budget Report

Total expenses:		
Interest expense	$ 2,236,414	
Provision for losses	877,487	
Other expenses	28,866	$ 3,142,767
Budgetary outlays not included as expenses:		
Loans made	1,712,896	
Dividends paid	10,124	
Other	530	1,723,550
Items not requiring outlays:		
Provision for losses	(877,487)	
Decrease in accounts receivable	(6,326)	
Increase in accounts payable and other liabilities	(1,127)	
Excess of interest accrued on borrowings over interest paid	(6,000)	
Other	(1,509)	(892,449)
Offsetting collections credited:		
Interest received	(2,415,739)	
Loan collections	(2,805,850)	
Proceeds from issuance of stock	(8,638)	
Appropriations for interest subsidies and losses	(328,984)	
Proceeds from note payable	(568,778)	
Prepayment premiums received	(268)	
Other income	(2)	
Overpayments by borrowers, net of refunds	(96)	(6,128,355)
Net receipts (negative outlays)		$ (2,154,487)

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