

GAO

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FINANCIAL AUDIT

Government National Mortgage Association's Financial Statements for 1986



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

Comptroller General
of the United States

B-114828

September 30, 1987

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

This report presents our opinion on the Government National Mortgage Association's financial statements for the year ended September 30, 1986. Reports on the association's internal accounting controls and on its compliance with laws and regulations are also provided.

The Government National Mortgage Association is a government corporation within the U.S. Department of Housing and Urban Development (HUD) and operates in the mortgage-financing market. The association administers the mortgage-backed securities program which provides secondary-market financing for most Federal Housing Administration and Veterans Administration home loans, provides special assistance in the financing of eligible types of federally underwritten mortgages, administers the provision of mortgage credit through the Emergency Home Purchase Assistance Act, directs the liquidation of the association's portfolio of mortgages, and manages three federal asset trusts.

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

Opinion on Financial Statements

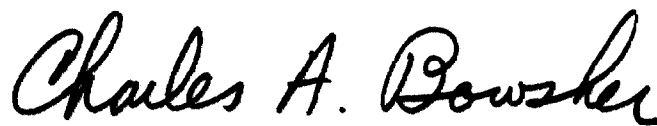
In our opinion, and consistent with the opinion of Ernst & Whinney, the Government National Mortgage Association's financial statements present fairly its financial position as of September 30, 1986, and the results of its operations and changes in financial position for the year then ended, in conformity with generally accepted accounting principles applied on a consistent basis, after revaluation of the 1985 mortgage loan portfolio. In 1985, the association announced its intent to liquidate its mortgage loan portfolio as provided for in the HUD regular Appropriation Act (Public Law 98-371). The association, however, made no adjustment in its 1985 financial statements to revalue the portfolio to be liquidated at the lower of cost or market, as required by generally

accepted accounting principles. As described in note F to the financial statements, the 1986 report enclosed herein reduces the investment of the U.S. Government as of September 30, 1985, to reflect a portfolio loss of \$460.2 million from book value (original cost) to the lower current market value.

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

During the course of the examination, Ernst & Whinney also identified several matters which, although not material to the financial statements, were communicated for the association'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, the Secretary of Housing and Urban Development, and the Board of Directors of the Government National Mortgage Association.



Charles A. Bowsher
Comptroller General
of the United States

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Abbreviation

HUD Department of Housing and Urban Development

Auditors' Opinion

Ernst & Whinney

1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

202/862-6000

Comptroller General of the United States
U.S. General Accounting Office

We have examined the balance sheet of Government National Mortgage Association as of September 30, 1986, and the related statements of revenue and expenses and investment of U.S. Government and changes in financial position for the 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.

In our opinion, the aforementioned financial statements present fairly the financial position of Government National Mortgage Association as of September 30, 1986, and the results of its operations and changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year after giving retroactive effect to the change, with which we concur, in the method of valuing the mortgage portfolio as described in Note F to the financial statements.

Ernst & Whinney

Washington, D.C.
January 13, 1987

Financial Statements

Balance Sheet

BALANCE SHEET

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

September 30, 1986

	(in thousands)
ASSETS	
Funds in U.S. Treasury	\$ 1,700
U.S. Government securities	1,778,600
Investment in mortgages (at current market value)--Note B	649,300
Advances for payments under Government obligation trust--Note C	466,600
Accrued interest and other receivables	64,100
Advances to issuers, net of allowance of \$6,800	2,000
Assets acquired through liquidations and claims against HUD/FHA and VA	800
Equipment	<u>100</u>
TOTAL ASSETS	<u>\$2,963,200</u>
LIABILITIES AND INVESTMENT OF U.S. GOVERNMENT	
LIABILITIES	
Government obligation trusts--Note C	\$ 429,000
Reserve for loss on Mortgage-Backed Securities Program--Note D	44,800
Trust and deposit liabilities	36,000
Accounts payable and accrued liabilities	<u>4,800</u>
TOTAL LIABILITIES	514,600
COMMITMENTS AND CONTINGENCIES--Note E	
INVESTMENT OF U.S. GOVERNMENT--Note F	<u>2,448,600</u>
	<u>\$2,963,200</u>

See notes to financial statements.

Statement of Revenues and Expenses and Investment of U.S. Government

STATEMENT OF REVENUES AND EXPENSES AND INVESTMENT OF U.S. GOVERNMENT

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

Year Ended September 30, 1986

	(in thousands)
REVENUES	
Interest income	\$ 312,900
Mortgage-Backed Securities Program fees	189,200
Net realized and unrealized gain on investment in mortgages--Note B	115,500
Commitment and other loan fees	3,500
Other income	<u>300</u>
TOTAL REVENUES	621,400
EXPENSES	
Provision for loss on Mortgage-Backed Securities Program--Note D	44,800
Interest expenses	26,100
Mortgage-Backed Securities Program expenses	16,400
Administrative and other expenses	9,500
Tandem plan expenses	2,400
Fees for servicing mortgages	<u>1,400</u>
TOTAL EXPENSES	<u>100,600</u>
EXCESS OF REVENUE OVER EXPENSES	<u>\$ 520,800</u>
INVESTMENT OF U.S. GOVERNMENT AT BEGINNING OF YEAR, AS PREVIOUSLY REPORTED	\$3,488,000
Adjustments--Note F	<u>(460,200)</u>
INVESTMENT OF U.S. GOVERNMENT AT BEGINNING OF YEAR, AS RESTATED	3,027,800
Excess of revenue over expenses	520,800
Returned to U.S. Treasury--Note F	<u>(1,100,000)</u>
INVESTMENT OF U.S. GOVERNMENT AT END OF YEAR	<u>\$2,448,600</u>

See notes to financial statements.

Financial Statements

Statement of Changes in Financial Position

STATEMENT OF CHANGES IN FINANCIAL POSITION

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

Year Ended September 30, 1986

	(in thousands)
RESOURCES:	
Excess of revenue over expenses	\$ 520,800
Less charges (credits) to operations not affecting cash:	
Amortization of purchase discount on mortgages	(6,900)
Provision for losses on MBS Program	<u>44,800</u>
TOTAL RESOURCES PROVIDED FROM OPERATIONS	558,700
Mortgages liquidated, net of valuation allowance	707,900
Net sales of government securities	<u>75,000</u>
	<u>1,341,600</u>
APPLICATION OF RESOURCES:	
Mortgages purchased	179,800
Repayments to U.S. Treasury	1,100,000
Increase in accrued interest and other receivables	4,500
Increase in deposits held for interest payment on participation certificates	20,500
Increase in advances to issuers	2,000
Increase in assets accrued through liquidations and claims against HUD/PHA and VA	300
Decrease in accounts payable and accrued liabilities	3,800
Decrease in trust and deposit liabilities	12,300
Net principal transferred to trust	<u>18,100</u>
	<u>1,341,300</u>
INCREASE IN FUNDS IN U.S. TREASURY	<u>\$ 300</u>

See notes to financial statements.

Notes to Financial Statements

NOTES TO FINANCIAL STATEMENTS

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

NOTE A--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Government National Mortgage Association (GNMA) is a Government corporation within the Department of Housing and Urban Development (HUD) which operates in the mortgage financing market. Its general policies are determined by the Secretary of HUD. Its mortgage activities are handled primarily through servicing agreements with the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Designated FNMA and FHLMC employees function as GNMA's agents to buy, service and sell mortgages on GNMA's behalf.

Basis of Presentation: The financial statements are presented on the accrual basis of accounting. They represent the combination of all funds associated with GNMA's activities, including GNMA's share of two Government obligation trusts.

U.S. Government Securities: U.S. Government securities are recorded at cost, net of unamortized discount or premiums. Discounts and premiums are amortized over the life of the security. Federal Housing Administration (FHA) debentures are recorded at cost and are either held until maturity or used to pay FHA insurance premiums.

Investment in Mortgages: Pursuant to the 1985 HUD regular Appropriation Act, GNMA's investment in mortgages is being liquidated and is presented at market value, as determined by recent GNMA auction results, less participation equities. Adjustments to market value are reflected in income in the period incurred. The remaining lives of the mortgages range from one to 30 years on single-family dwellings and one to 40 years on multifamily dwellings. The average holding period for the entire portfolio is estimated to be 12 years. GNMA is in the process of liquidating these mortgages, thereby affecting the average holding period.

Advances to Issuers: Advances to issuers represent advances made to issuers of GNMA mortgage-backed securities (MBS) to fulfill GNMA's guaranty of timely principal and interest payment to MBS holders. These are presented net of an allowance for advances on which repayment by the issuer is determined to be doubtful.

Recognition of Revenues and Expenses: Fees received for GNMA's guaranty of mortgage-backed securities are recognized on an accrual basis. Fees received for commitments to subsequently guarantee mortgage-backed securities and commitments to fund mortgage loans are recognized when received. Losses on assets acquired through liquidation and claims against HUD/FHA and the Veterans Administration (VA) are recognized when they occur.

Financial Statements

NOTES TO FINANCIAL STATEMENTS--CONTINUED
 GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

NOTE B--INVESTMENT IN MORTGAGES (Amounts in thousands)

Investment in mortgages at September 30, 1986 consists of the following:

Investment in mortgages--at unpaid principal balance	\$884,500
Unrealized depreciation	<u>(235,200)</u>
Investment in mortgages--at market	<u>\$649,300</u>

Net realized and unrealized gain (loss) on investments in mortgages for the year ended September 30, 1986 consists of the following:

Realized loss:		
Proceeds from sales	\$768,000	
Cost	<u>(877,500)</u>	
		\$(109,500)
Unrealized appreciation (depreciation):		
At September 30, 1985	(460,200)	
At September 30, 1986	<u>(235,200)</u>	
		<u>225,000</u>
Net realized loss and unrealized gain		<u>\$ 115,500</u>

NOTE C--GOVERNMENT OBLIGATION TRUSTS

GNMA, as trustor, along with other agencies has an interest in two Government obligation trusts (Trusts). The Trusts are comprised of mortgages and other loan obligations which serve as collateral for participation certificates issued to investors. The funds necessary to meet principal and interest requirements on these participation certificates are provided by the trustor agencies from repayment of the obligations pledged as collateral. As of September 30, 1986, the total obligation of the Trusts was \$2.165 billion as follows:

	<u>in thousands</u>
Federal Asset Liquidation Trust	
5.10% Certificates due April 6, 1987	\$ 200,000
Federal Asset Financing Trust:	
6.40% Certificates due December 11, 1987	350,000
6.05% Certificates due February 1, 1988	450,000
6.45% Certificates due April 8, 1988	335,000
6.20% Certificates due August 12, 1988	<u>830,000</u>
	<u>\$2,165,000</u>

NOTES TO FINANCIAL STATEMENTS--CONTINUED

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

NOTE C--GOVERNMENT OBLIGATION TRUSTS--CONTINUED

GNMA's portion of the obligation to the Trusts is \$429 million. GNMA has made advances to the Trusts of \$360 million and pledged mortgages with principal balances totalling \$135 million at September 30, 1986, toward the repayment of the principal balance of the obligation. Advances totaling \$106.6 million have been made toward payment of interest on the obligation. GNMA also acts as trustee for this program with the duties of receipt and distribution of collections of trust assets and investment of funds pending distribution to investors.

NOTE D--RESERVE FOR LOSSES ON MBS PROGRAM

In the operation of its MBS Programs, GNMA periodically monitors the financial condition and the operating results and statistics of issuers. As a result of these procedures, GNMA provides for any losses estimated to be incurred under GNMA's guarantee of timely payment of principal and interest to security holders.

In July 1986, one issuer of GNMA securities backed by mobile home loans was placed in a default status. Subsequent to September 30, 1986, other mobile home program issuers were placed in default status. Issuers which have defaulted and for which default is probable are responsible for approximately \$1.25 billion of the total \$3.2 billion of securities outstanding for the mobile home program.

The provision for losses on the MBS Program of \$44.8 million represents management's estimate of expected losses on the mobile home program. No significant losses are currently anticipated from the operation of the other MBS programs.

NOTE E--CONTINGENCIES AND COMMITMENTS

GNMA was contingently liable at September 30, 1986 for approximately \$241 billion under its guaranty of timely principal and interest payment to mortgage-backed securities (MBS) holders. These securities are backed by pools of FHA-insured, Farmers Home Administration-insured, and VA-guaranteed mortgage loans. Under its MBS guarantee, GNMA paid out in claims \$204 thousand in 1986. The amounts represent less than .0001 percent of mortgage-backed securities outstanding at fiscal year end.

Prior to incurring a contingent liability as guarantor of mortgage-backed securities, GNMA accepts commitment applications from securities issuers. The commitment ends when the mortgage-backed securities are issued or when the commitment period expires. Outstanding commitments, as of September 30, 1986, were \$63 billion.

NOTES TO FINANCIAL STATEMENTS--CONTINUED

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

NOTE E--CONTINGENCIES AND COMMITMENTS--CONTINUED

GNMA had outstanding commitments to purchase mortgages of \$205 million. Delivery of mortgages under these commitments is optional at the discretion of the sellers.

NOTE F--INVESTMENT OF U.S. GOVERNMENT

GNMA borrows from the U.S. Treasury, as necessary, to finance its operations instead of receiving appropriated funds. In 1985, Congress forgave all outstanding Treasury borrowings issued under the GNMA's Emergency Mortgage Purchase Assistance (EMPA) and Special Assistance Functions (SAF) amounting to \$12.65 billion. During fiscal year 1986, GNMA returned \$1.1 billion to the treasury in excess funds accumulated in its M&L (Management and Liquidation) program. Both transactions have been recorded as adjustments to Investment of the U.S. Government.

The outstanding authority to borrow from the U.S. Treasury is \$1.5 billion.

The Investment of U.S. Government at September 30, 1985 has been adjusted to reflect the change in valuation of GNMA's mortgage portfolio, from cost to current market value resulting in recognition of \$460.2 million of unrealized depreciation. This adjustment reduces net income as previously reported for the year ended September 30, 1985 by \$460.2 million.

NOTE G--RELATED PARTIES

In addition to the controls established by government corporation control laws (32 U.S.C. 9101 through 9109), GNMA is subject to management controls by the Secretary of HUD and the Director of the Office of Management and Budget. Such controls could affect GNMA's financial position or operating results in a manner that differs from those that might have been obtained if GNMA were autonomous.

HUD provides GNMA, without charge, use of space and equipment. HUD charges GNMA for data processing and other services for which GNMA recorded \$4.9 million in expense in fiscal year 1986.

Employees of GNMA participate in the Civil Service Retirement System and contribute 7% of their gross pay to the Plan. The remaining cost of the Plan is paid directly by the U.S. Government.

Auditors' Report on Internal Accounting Control

Ernst & Whinney

1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

202/862-6000

Comptroller General of the United States
U.S. General Accounting Office
Washington, D.C.

We have examined the financial statements of Government National Mortgage Association (GNMA) for the year ended September 30, 1986, and have issued our report thereon dated January 13, 1987. As part of our examination, we made a study and evaluation of the system of internal accounting control of Government National Mortgage Association to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards and the standards for financial and compliance audits contained in the U.S. General Accounting Office "Standards for Audits of Government Organizations, Programs, Activities and Functions." For the purpose of this report, we have classified the significant internal accounting controls in the following categories:

- Mortgage Backed Securities program
- Mortgage purchase and liquidation activities
- Fiduciary services
- Purchases/disbursements
- Investments

Our study included all of the control categories listed above except that we did not evaluate the accounting controls over mortgage purchase and liquidation activities because the accounting for all mortgages and related accounting is performed by the accounting systems of the Federal National Mortgage Association (FNMA) under the Combined Services Agreement between GNMA and FNMA. FNMA's external auditors have performed specific audit procedures for these accounts. Our procedures were limited to reviewing the results of the procedures performed by FNMA's external auditors. The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the entity's financial statement. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole or on any of the categories of controls identified above.

The management of Government National Mortgage Association is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control

**Auditors' Report on Internal
Accounting Control**

procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, 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.

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

Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of Government National Mortgage Association taken as a whole or on any of the categories of controls identified in the first paragraph. However, our study and evaluation disclosed no condition which we believe to be a material weakness. These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in our examination of the 1986 financial statements, and this report does not affect our report on the financial statements dated January 13, 1987.

Ernst + Whinney

Washington, D.C.
January 13, 1987

Auditors' Report on Compliance With Laws and Regulations

Ernst & Whinney

1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

202/862-6000

Comptroller General of the United States
U.S. General Accounting Office
Washington, D.C.

We have examined the financial statements of Government National Mortgage Association for the year ended September 30, 1986, and have issued our report thereon dated January 13, 1987. Our examination was made in accordance with generally accepted auditing standards and the standards for financial and compliance audits contained in the Standards for Audited of Governmental Organizations, Programs, Activities, and Functions, issued by the U.S. General Accounting Office, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The management of Government National Mortgage Association is responsible for the Association's compliance with laws and regulations. In connection with our examination referred to above, we selected and tested transactions and records and for these items determined the Association's compliance with laws and regulations noncompliance with which could have a material effect on the financial statements of the Association.

The results of our tests indicate that for the items tested, Government National Mortgage Association complied with those provisions of laws and regulations noncompliance with which could have a material effect on the financial statements. Nothing came to our attention that caused us to believe that for the items not tested Government National Mortgage Association was not in compliance with laws or regulations noncompliance with which could have a material effect on the Association's financial statements.

Ernst + Whinney

Washington, D.C.
January 13, 1987

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