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Report to the Secretary of Agriculture

May 1991

FINANCIAL AUDIT

Farmers Home Administration's Financial Statements for 1989 and 1988

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GAO

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

Accounting and Financial
Management Division

B-226249

May 6, 1991

The Honorable Edward R. Madigan
The Secretary of Agriculture

Dear Mr. Secretary:

This report presents the results of our audit of the Farmers Home Administration's (FmHA) consolidated financial statements for the fiscal years ended September 30, 1989 and 1988. Reports on FmHA's internal control structure and on its compliance with laws and regulations are also provided, as well as a discussion and analysis of FmHA's operating results for fiscal years 1987 through 1989.

Results in Brief

Our opinion on FmHA's consolidated financial statements is qualified for both fiscal years 1989 and 1988 because we were unable to satisfy ourselves that the acquired farm and rural housing property accounts were presented fairly. (See appendix II.) Specifically, our opinion discloses that (1) accounting records used to support the reported amount of FmHA's acquired property were not accurate and (2) reports produced by the Acquired Property Tracking System (APTS) were not properly reconciled with the detailed acquired property files at FmHA field offices.

Our report on FmHA's internal control structure (see appendix III) discusses the problem with the acquired property tracking system and an additional internal control weakness related to the new farm loan classification system's inability to project loan losses on FmHA's $22 billion direct farm loan portfolio. The Department of Agriculture's 1989 Federal Managers' Financial Integrity Act (FMFIA) report has cited the acquired property system as the departmental financial system most in need of improvement.

We and the Office of Management and Budget (OMB) have identified FmHA as a high-risk area within the federal government. We are currently conducting detailed reviews to determine the nature and extent of problems associated with FmHA systems and programs. Some of the issues identified include

- the recovery of guarantee claim costs from the remaining assets of defaulting borrowers;

- the need for more on-site visits or financial audits of lenders to verify pledged assets backing FmHA direct and guaranteed loans, especially in the farm program and business and industry program; and
- the oversight of the disposal of properties acquired by the government as a result of defaults, especially in the farm and rural housing programs.

Our 1989 report on compliance with laws and regulations discloses that FmHA complied with the provisions of laws and regulations for the transactions we tested which could have materially affected its consolidated financial statements. (See appendix IV.)

This report also contains a discussion and analysis of FmHA's operations for the 3 fiscal years, 1987 through 1989, that we have audited FmHA's financial statements. (See appendix I.) Our analysis focuses on FmHA operations and presents trends in FmHA's operations, including the status of its loan portfolio. This analysis provides additional information for the diverse users of FmHA's financial statements, including the Congress in its oversight role. We encourage FmHA to develop and include such analyses in its future annual reports.

Our discussion and analysis of FmHA's financial operations shows the following:

- FmHA has consistently operated at a loss because it pays higher interest than it receives from borrowers and because many of its loans are not repaid. However, FmHA's overall net loss from operations declined from $13.8 billion in fiscal year 1988 to $6.9 billion in fiscal year 1989, primarily due to lower provisions for loan losses and lower losses on loan sales. Of the $6.9 billion loss, $5.8 billion represented net interest expense.
- The book value of FmHA's total loan portfolio decreased from $60.9 billion in fiscal year 1987 to $54.5 billion in fiscal year 1989. However, this decline was due principally to loan write-offs, loan asset sales, and a shift from direct loans to guarantees. The decline in the allowance for loan losses to 28 percent of the total loan portfolio as of September 30, 1989, was not significant.
- Emergency farm loans represent a high risk that they will not be repaid. New emergency loans have been significantly reduced in the past 4 years due to legislative changes and tighter borrower qualifications. FmHA reserved 82 percent of its $10 billion in outstanding emergency loans as of September 30, 1989, as uncollectible.

- Nonfarm loans totaled $32 billion as of September 30, 1989, and continue to represent a high percentage (59 percent) of total outstanding FmHA loans.
- Beginning in fiscal year 1992, the new Federal Credit Reform Act of 1990 requires that all subsidies be recognized in FmHA's budget. FmHA will be required to develop its budget and accounting systems capability to comply with this legislation.
- FmHA loan guarantees are growing, similar to the trend in other federal agencies. FmHA is now contingently liable for $4.5 billion of loan guarantees and has reserved $1.3 billion for losses on these guarantees.

FmHA's cumulative deficit from operations amounted to $40.6 billion at the end of fiscal year 1989. Of this amount, the potential reimbursement from the Congress for realized losses is $18.6 billion. The $22 billion difference represents primarily allowances for losses on loans receivable and acquired property and accrual for estimated losses on guaranteed loans. These losses, when they occur, will require reimbursement from the Congress.

The extent of FmHA losses in the future will depend on the health of the agricultural economy because its portfolio tends to expand during periods of economic stress and contract when the farm economy improves. Being a lender of last resort, FmHA will consistently operate at a loss because (1) many loans are not repaid and (2) it loans money at a lower rate than what it pays the U.S. Treasury for borrowing money. When more loans are provided, the interest rate subsidy costs rise and more loans are not repaid. The extent of losses will also depend on FmHA efforts to improve its processes for making and servicing loans and its oversight of the disposal of acquired properties.

Scope and Methodology

We are authorized to conduct an audit of FmHA as an executive agency under the Accounting and Auditing Act of 1950. We conducted prior financial audits of FmHA for fiscal years 1987 and 1988 (GAO/AFMD-89-20 and GAO/AFMD-90-37). The current and prior audits were conducted in accordance with generally accepted government auditing standards.

In our discussion and analysis, we used data from the consolidated financial statements for fiscal years 1987 through 1989, which were audited. To support our analysis, we also used supplementary FmHA data and explanations, which were not subject to an audit and independent verification. Our analysis also draws from other GAO reports where applicable.

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

We discussed the contents of our report with FmHA officials and their comments have been incorporated where appropriate.

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

Sincerely yours,

Donald H. Chapin

Donald H. Chapin
Assistant Comptroller General

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Abbreviations

APTS	Acquired Property Tracking System
FMFIA	Federal Managers' Financial Integrity Act
FmHA	Farmers Home Administration
GAAP	generally accepted accounting principles
OIG	Office of Inspector General
OMB	Office of Management and Budget
USDA	U.S. Department of Agriculture

Discussion and Analysis of FmHA's Operating Results

This discussion and analysis presents information on FmHA's operating costs and major assets for fiscal years 1987 through 1989. It is a narrative presentation of the results of an analytical review of financial data on FmHA's farm and nonfarm programs. Important aspects of FmHA's financial operations are discussed and relevant trends are pointed out.

Background

The Farmers Home Administration is a credit agency for agriculture and rural development within the U.S. Department of Agriculture (USDA). FmHA is a lender of last resort that provides loans and guarantees to those in rural America who are unable to obtain credit from other sources at reasonable rates and terms. FmHA held 7 percent of the outstanding U.S. farm debt in 1978. It increased to 15.6 percent at year-end 1989. When the agency began in 1935, its original function was to make loans and grants to depression-stricken families that would help them regain self-sufficiency on family farms. In more recent years, the Congress has created additional programs to benefit families and communities in rural areas.

Most credit activity is conducted through 3 revolving funds, which, when consolidated with 15 other smaller funds, form FmHA's consolidated financial statements. The Agricultural Credit Insurance Fund provides loans for farm ownership, operations, and emergencies. The Rural Housing Insurance Fund provides loans to low-income families to own, repair, or rent housing in rural areas. The Rural Development Insurance Fund provides loans for water, waste disposal, or other community facilities, as well as rural businesses.

FmHA's programs are administered in all 50 states and U.S. territories through 46 state offices, 264 district offices, and 1,904 county offices, plus the national office in Washington, D.C., and the finance center in St. Louis, Missouri. Loans and guarantees are financed through borrowings from the U.S. Treasury and the Federal Financing Bank; from interest received and repayments of loans; and from congressional appropriations for reimbursement of interest subsidies, program administration, and loan losses.

FmHA's Losses Continued in Fiscal Year 1989

FmHA will consistently operate at a loss. The majority of losses occur from two sources. First, as a lender of last resort, FmHA makes many loans which are not repaid. Second, FmHA lends money to farmers and rural residents and enterprises at a lower rate than its cost of funds from the Treasury, resulting in a net interest expense to FmHA. Consequently, even if FmHA borrowers repaid their loans on a timely basis, FmHA would still lose money because of the low interest rates it provides to borrowers. For example, in fiscal year 1989 FmHA interest expenses exceeded interest income by about $5.8 billion.

As shown in table I.1, FmHA's fiscal year 1989 operations suffered a net loss of $6.9 billion, a decrease from its fiscal year 1988 net loss of $13.8 billion. The lower loss was due mainly to a $5.7 billion lower provision for loan losses and fewer losses on loan sales. Most of the fiscal year 1989 loss is attributable to net interest expense. Approximately $18.6 billion of FmHA's $75.6 billion debt to Treasury was used to cover FmHA's losses for fiscal years 1987 through 1989. The interest on this amount was as much as 31 percent, or $1.8 billion of FmHA's net interest expense of $5.8 billion, based on the average interest rate of 12.15 percent paid to Treasury. Interest will be paid on the $18.6 billion until FmHA receives appropriations to reimburse it for the losses. These appropriations are typically received 2 years after the year in which the loss was sustained.

Table I.1: FmHA's Net Loss on Operations for Fiscal Years 1987 Through 1989

Dollars in billions

	Fiscal year		
Operating component	**1987**	**1988**	**1989**
Net interest expense	$6.3	$6.4	$5.8
Provision for credit losses	13.7	6.0	0.3
Loan asset sales losses	1.9	1.1	0.1
Net administrative costs	0.2	0.3	0.7
Total net loss on operations	**$22.1**	**$13.8**	**$6.9**

Note: Because 1987 was the first fiscal year that FmHA's financial statements were audited, the provision for loan losses included a substantial adjustment for prior years. Hence, the 1987 reported losses are not representative.

FmHA's Loan Portfolio Is Declining

As table I.2 shows, FmHA's loan portfolio declined from $60.9 billion in 1987 to $54.5 billion in fiscal year 1989. The decline was primarily due to write-offs of uncollectible loans, loan asset sales, and a shift from direct FmHA loans to guarantees. In fiscal year 1989, FmHA wrote off $2.8 billion of loans, $1.3 billion of which were attributable to the loan restructuring permitted by the Agricultural Credit Act of 1987. Primarily as a result of these loan write-offs, FmHA's total loan portfolio decreased from $58.2 billion in fiscal year 1988 to $54.5 billion in fiscal year 1989. Similarly, FmHA's allowance for loan losses declined from $18.5 billion in fiscal year 1988 to $15.3 billion in fiscal year 1989 due primarily to write-offs.

Table I.2: FmHA's Loan Portfolio for Fiscal Years 1987 Through 1989

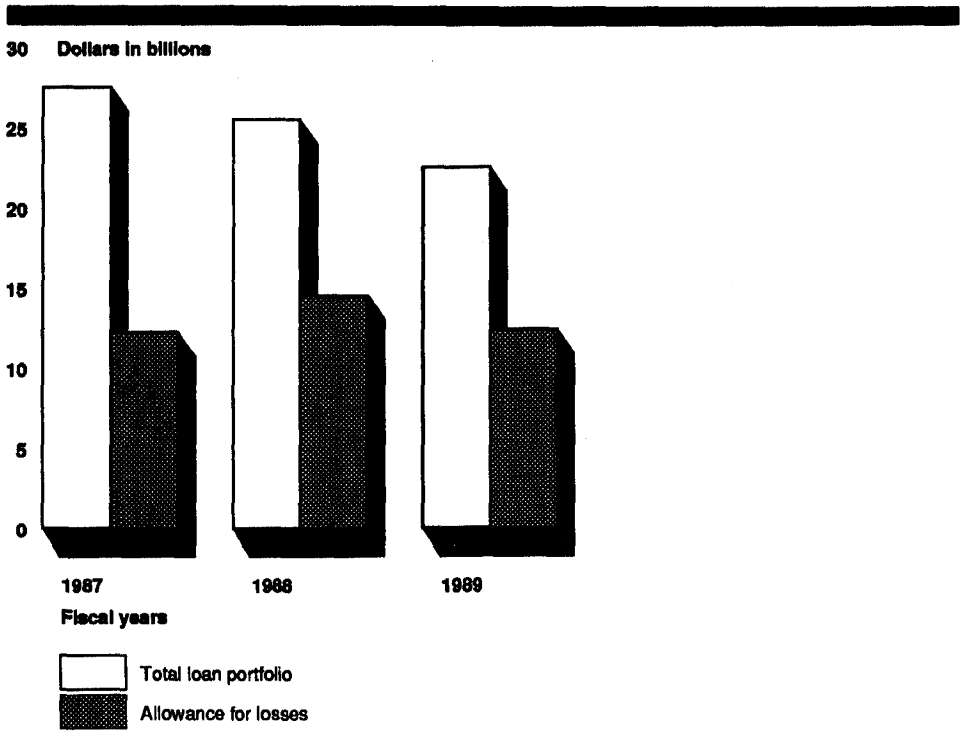
Dollars in billions

	Fiscal year		
Loan type	**1987**	**1988**	**1989**
Farm			
Emergency	$13.1	$11.8	$10.1
Ownership	7.5	7.3	7.0
Operations	6.3	5.7	4.9
Other	0.6	0.7	0.5
Subtotal farm loans	**27.5**	**25.5**	**22.5**
Nonfarm			
Rural housing	26.4	27.0	27.8
Rural development	7.0	5.7	4.2
Subtotal nonfarm loans	**33.4**	**32.7**	**32.0**
Total	**$60.9**	**$58.2**	**$54.5**

Farm Loans Have Declined

As figure I.1 shows, farm loans amounted to $22.5 billion, 41 percent of FmHA's total loan portfolio, as of September 30, 1989, down from $27.5 billion, 45 percent, in fiscal year 1987. The decline in the farm loan portfolio was primarily due to write-offs and loan restructurings and a shift from direct FmHA loans to guarantees. As of September 30, 1989, farm loan losses constituted 81 percent of FmHA's total allowance for loan losses.

Figure I.1: Farm Loans and Allowance for Losses for Fiscal Years 1987 Through 1989



Emergency Farm Loans Present High Risk

As of September 30, 1989, emergency loans constituted 45 percent of FmHA's total farm loan portfolio and represent a high risk that they will not be repaid. FmHA has reserved 82 percent of the $10 billion of emergency loans outstanding at September 30, 1989, as uncollectible. Emergency loans include disaster loans for losses of crops, livestock, supplies, or equipment and economic loans for hardships created by credit scarcity or cost price squeezes beyond the farmers' control. Emergency loans are riskier than other FmHA farm loans because (1) they are made to help farmers recover from losses rather that generate new income and (2) they typically have insufficient collateral to recover the debt. In another report,[1] we discussed the evolution of the emergency loan program, why its delinquency rate is so high, what alternatives are available to reduce uncollectible debt, and what changes are needed to make the program function more effectively.

[1] Farmers Home Administration: Problems and Issues Facing the Emergency Loan Program (GAO/RCED-88-4, November 30, 1987).

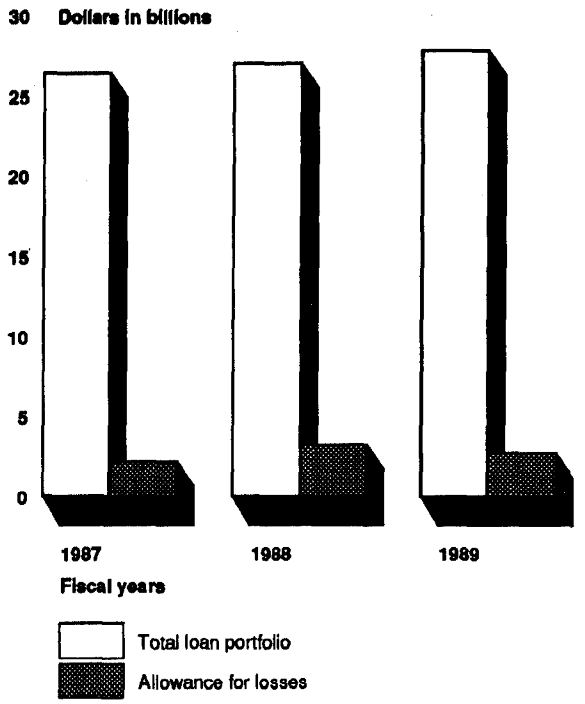
The amount of new emergency loans has been significantly reduced in the past 4 years as a result of legislative changes and FmHA actions which limited both the number of farmers who qualify for emergency loan assistance and the size of the loans provided. From fiscal years 1986 through 1989, only $435 million in new emergency loans were added to the FmHA loan portfolio.

Nonfarm Loans Comprise Over Half of the FmHA Portfolio

Rural housing and rural development loans totaled about $32 billion as of September 30, 1989, and accounted for 59 percent of the total FmHA loan portfolio. This represents a modest decrease of $1.3 billion from 1987 even though about $8.4 billion in loan assets were sold in fiscal years 1987 through 1989. These sales were necessary to achieve sales proceeds goals established by the Agricultural Credit Act of 1987, the Omnibus Budget Reconciliation Act of 1986, and the Continuing Appropriations Act of 1987.

As shown in figure I.2, rural housing loans grew from $26.4 billion in fiscal year 1987 to $27.8 billion in fiscal year 1989, even though $3 billion in housing loans were sold in fiscal year 1987. The allowance for housing loan losses has remained between 8 and 12 percent of the portfolio over the 3 years.

Figure I.2: Rural Housing Loans and Allowance for Losses for Fiscal Years 1987 Through 1989

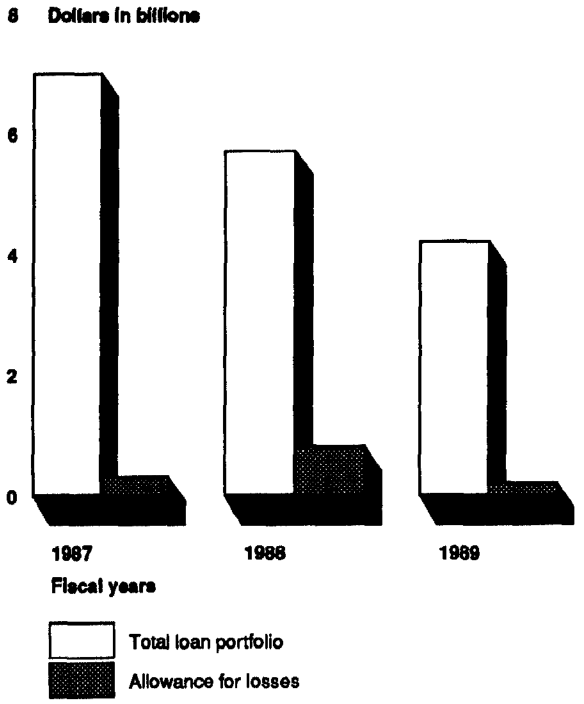


The largest component of the rural housing loan portfolio is the single-family housing program, which has remained at approximately $19 billion since fiscal year 1987. These loans are provided to low-income rural residents who cannot obtain credit elsewhere to repair or purchase affordable housing. They are generally repayable over 33 years at an interest rate which could be as low as 1 percent annually; however, the average interest rate of the rural housing portfolio as of September 30, 1989, was 5.73 percent.

The remaining rural housing loan portfolio consists primarily of the multi-family housing program, which amounted to $8.9 billion in outstanding loans as of September 30, 1989, and accounted for the overall modest growth in the rural housing portfolio since fiscal year 1987. These loans finance rental units, cooperative housing, or related facilities to low-income and elderly people in rural communities of under 10,000 population. They are generally repayable over 50 years and had an average annual interest rate of 2.15 percent as of September 30, 1989.

As figure I.3 shows, rural development loans decreased from $6.9 billion in fiscal year 1987 to $4.2 billion in fiscal year 1989. The decline was primarily due to borrowers buying back $3.4 billion of their debt in fiscal years 1988 and 1989 as part of the loan asset sales program. The loan loss allowance constituted only 1.5 percent of FmHA's total allowance for loan losses as of September 30, 1989.

Figure I.3: Rural Development Loans and Allowance for Losses for Fiscal Years 1987 Through 1989



Rural development loans primarily consist of water and waste facility loans provided to rural associations for the development, replacement, or upgrading of water and waste facilities. Loans are also provided for community facilities and essential services in rural communities under 20,000 population. Rural development loans are repayable in not more than 40 years and bear annual interest rates of 5 to 7 percent.

Interest Subsidy

FmHA makes loans at interest rates below Treasury market rates and provides interest credits to single-family home borrowers, giving rise to interest subsidies. The subsidies are provided for through annual appropriations over the life of the loans. Currently, FmHA does not recognize the present value of the future interest subsidy for these loans and its accounting system is unable to calculate loan discounts or to automatically compute related entries needed to account for the cost subsidy over the life of the loans. A loan-by-loan analysis would be required for such a determination. Consequently, the analyses included in this appendix do not show the effect of the interest subsidy.

Using aggregate numbers, however, we estimate that the present value of the future interest subsidy, or unamortized discount, on FmHA's loan portfolio amounted to about $14.2 billion as of September 30, 1989. FmHA disclosed about $8.7 billion of the interest subsidy in note 16. This amount is the interest differential between the below-cost interest rates granted to FmHA borrowers and the average Treasury market rate of interest at the time the loans are made, an estimate of FmHA's net cost of borrowing funds over the life of the loans. The remaining $5.5 billion interest subsidy represents the estimated present value of interest credits provided annually to low-income, single-family home borrowers over the life of the mortgage. The annual interest credit on those mortgages (about $0.8 billion in 1989) is considered an entitlement and, in accordance with Title 2, is reported as an annual expense in the financial statements.

The effect of disclosing the full amount of the interest subsidy in the financial statements would be to reduce FmHA's loan portfolio and allowance for losses accounts as shown in table I.3.

Table I.3: Disclosure of Full Interest Subsidy in FmHA's Fiscal Year 1989 Financial Statements

Dollars in billions

	Loans receivable	Less allowance for losses	Net loans receivable
FmHA portfolio	$54.5	$15.3	$39.2
Less interest subsidy	14.2	6.1	8.1
Portfolio net of subsidy	$40.3	$9.2	$31.1

The Federal Credit Reform Act of 1990 is intended to more accurately measure the costs of federal credit programs and to place these programs on an equivalent budgetary basis with other federal spending. For credit granted in 1992 and beyond, the act requires that budget authority be available and outlays be recorded for the expected subsidy costs of all direct loans and loan guarantees when they are made. The budget is to reflect the combined effect of the interest subsidies and defaults for all of FmHA's credit programs, including those which FmHA currently treats as entitlements but which can be considered interest credit subsidies. FmHA will be required to develop its budget and accounting systems capability to comply with this legislation.

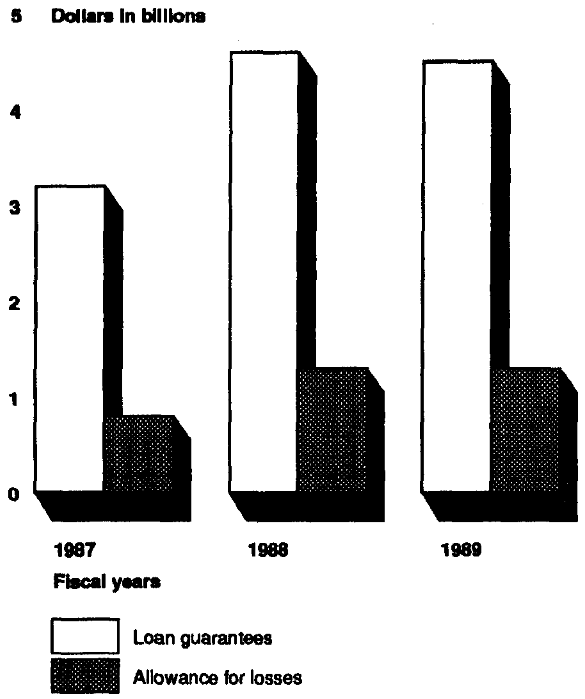
FmHA Loan Guarantees Are Growing

FmHA guarantees of loans made by private lenders have increased to $4.5 billion as of September 30, 1989. Under the business and industry program legislated in 1972, commercial loans to individuals and corporations are guaranteed up to 90 percent of the total loan. These loans are used to (1) finance development and improvements and (2) enhance employment in rural communities with a population of less than 50,000. In addition, FmHA began emphasizing guaranteed farm loans in fiscal year 1984 to help keep lending in the private sector, reduce budget outlays, and better service a deteriorating direct loan portfolio. The Food Security Act of 1985 and subsequent appropriations supported FmHA's shift to guaranteed farm loans.

FmHA is contingently liable, as of September 30, 1989, for $4.5 billion of loan guarantees. As shown in figure I.4, loan guarantees were $3.2 billion as of September 30, 1987, and the subsequent growth is partly related to the overall decline in the direct loan portfolio. Based on its past experience with defaults and losses, FmHA reserved $1.3 billion for losses on loan guarantees as of September 30, 1989.

Farm loan guarantees constituted 82 percent of total guarantees as of September 30, 1989, up from 65 percent as of September 30, 1987. Business and industrial loan guarantees accounted for the remaining 18 percent of the total guarantees as of September 30, 1989, down from 34 percent in 1987.

Figure I.4: FmHA Loan Guarantees and Allowance for Losses for Fiscal Years 1987 Through 1989



Opinion Letter

GAO

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

Accounting and Financial
Management Division

B-226249

To the Administrator
Farmers Home Administration

We have audited the accompanying consolidated statements of financial position of the Farmers Home Administration (FmHA), as of September 30, 1989 and 1988, and the related statements of operations and cash flows for the fiscal years then ended. These financial statements are the responsibility of FmHA's management. Our responsibility is to express an opinion on these financial statements based on our audits. In addition to this report on our audit of FmHA's fiscal year 1989 and 1988 financial statements, we are also reporting on FmHA's internal control structure and compliance with laws and regulations.

We conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. As described in the following paragraphs, however, the scope of our work was limited with respect to FmHA's valuation of acquired property and its associated loss provision.

Audits include examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Audits also include assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Our opinion on FmHA's fiscal year 1988 financial statements (GAO/AFMD-90-37) was qualified because significant internal accounting control weaknesses in the acquired property accounting system resulted in the reporting of inaccurate data. As a result, it was not feasible for us to determine the amount of adjustments, if any, to establish the correct net realizable value of FmHA's acquired property accounts and the associated provision for losses for fiscal year 1988.

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Our audit of the fiscal year 1989 financial statements disclosed that significant control weaknesses continued to exist in the Acquired Property Tracking System, allowing the reporting of inaccurate data. These inaccuracies remained uncorrected because reports produced by the system were not properly reconciled with detailed acquired property files at FmHA's field offices. FmHA has acknowledged the severity of problems in its acquired property accounting system. In its December 1989 Federal Managers' Financial Integrity Act letter to the President, USDA cited FmHA's acquired property accounting system as the financial system most in need of improvement in USDA. The letter specifically cited the need for FmHA to reconcile detailed property files with general ledger control accounts in order to provide accurate financial information.

Accordingly, in the absence of an accounting system generating reliable financial data on acquired property operations, we determined that it was not practicable to perform, nor did we perform, sufficient alternative audit procedures to satisfy ourselves as to the net realizable value of FmHA's acquired property and the associated provision for losses for fiscal year 1989.

In our opinion, except for the effects of such adjustments, if any, that might have been necessary had we been able to perform the necessary auditing procedures to satisfy ourselves as to the value of acquired property and the associated provision for losses, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of the Farmers Home Administration as of September 30, 1989 and 1988, the results of its operations, and its cash flows for the fiscal years then ended, in conformity with generally accepted accounting principles.

BELOW MARKET INTEREST LOANS

As discussed in note 16, FmHA makes loans at interest rates which are below Treasury market rates. Currently, FmHA does not recognize the full interest rate cost subsidy for these loans, as required by title 2, and FmHA's accounting system is unable to calculate loan discounts or to automatically compute related entries needed to account for the cost subsidy over the life of these loans. The effect on the financial statements of not recognizing these subsidies is estimated to be immaterial in relation to the statements taken as a whole.

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The recently enacted Federal Credit Reform Act of 1990 (Public Law 101-508, section 13201) requires that funding for loan subsidy costs applicable to fiscal year 1992 and beyond be appropriated up front in the year in which such loans are authorized. Previously, any such subsidy was provided for through appropriations made annually over the life of the subsidized loans. FmHA will be required to develop its accounting system capability to comply with this legislation.

Donald H. Chapin
Assistant Comptroller General

November 30, 1990

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Report on Internal Control Structure

We have audited the consolidated financial statements of the Farmers Home Administration for the years ended September 30, 1989 and 1988, and have issued our opinion thereon. This report pertains only to our consideration of FmHA's internal control structure for the year ended September 30, 1989. Our report on the study and evaluation of the FmHA's system of internal accounting controls for the year ended September 30, 1988, is presented in GAO/AFMD-90-37, dated January 25, 1990.

We conducted our audit in accordance with generally accepted government auditing standards. 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 consolidated financial statements of the Farmers Home Administration for the fiscal year ended September 30, 1989, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control structure.

For purposes of this report, we have classified FmHA's significant internal control structure policies and procedures into the following categories:

- loans and grants (authorizing and disbursing loans, accruing interest on loans, and collecting loan repayments);
- guaranteed loans (authorizing and disbursing payments, authorizing guarantees, and accruing interest and collecting repayments on defaulted guaranteed loans);
- acquired property (acquiring properties through foreclosure, valuing the property, managing property inventories, and disposing of property through sales);
- treasury (disbursing and collecting cash, reconciling cash balances, and managing debt); and
- financial reporting (processing accounting entries and preparing FmHA's annual financial statements).

For all of the internal control structure categories listed above, we obtained an understanding of the design of the relevant policies and procedures, determined whether they had been placed in operation, and assessed the associated control risk. We performed limited tests of control procedures for all the categories. In addition, we performed audit tests to substantiate account balances associated with each control category. Such tests can serve to identify weaknesses in the internal control structure.

Management's Responsibility for Internal Controls

FmHA's management 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.

FmHA's Evaluation of Its Internal Controls

FmHA annually evaluates its system of internal accounting and administrative controls and issues a report to the Secretary of Agriculture for inclusion in the Department of Agriculture's annual report to the Congress required by the Federal Managers' Financial Integrity Act (FMFIA). In its November 1989 FMFIA report covering fiscal year 1989, FmHA reported that its internal control system, taken as a whole, complied with the requirement to provide reasonable assurance that internal control objectives were achieved. However, FmHA also reported that several material weaknesses existed. These weaknesses involved items such as inadequate control over management of acquired farm properties and incomplete implementation of OMB Circular A-129 requirements on credit management and debt collection (including salary offset, reporting to credit bureaus, and prescreening of all borrowers).

The 1989 FMFIA report also contained FmHA's annual assessment of its financial management system's compliance with accounting principles, standards, and related requirements for federal agencies. FmHA has one overall accounting system comprised of 13 subsystems. In those subsystems, the assessment identified six areas which materially failed to conform with accounting principles and standards. The six areas were scheduled for correction in 1990 and 1991. FmHA reported that, except for the six areas noted, the accounting system taken as a whole generally complied with accounting principles and standards.

The scope of our audit did not include a review of FmHA's FMFIA report. Accordingly, we are not attesting to the accuracy of FmHA's conclusions with regard to its internal control structure or whether all significant internal control weaknesses were reported. However, in planning for our audit, we considered FmHA's FMFIA reports, USDA's Office of Inspector General (OIG) reports on financial matters and internal accounting controls, and other GAO reports in determining the nature, timing, and extent of our audit procedures. We also considered the OMB report of federal high-risk areas, which included FmHA, issued in December 1989.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more 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.

Prior Corrective Actions Not Complete

In our fiscal year 1988 report on internal accounting controls, we reported three conditions which adversely affected FmHA's ability to record, process, and report financial data. Specifically, we found that

- acquired property was improperly valued, and detailed property files were not reconciled with general ledger accounts;
- instructions for estimating realistic collateral values and computing estimated losses in the loan classification system were not applied consistently and accurately by FmHA personnel, and detailed files at the field offices were not reconciled with the automated farm loan classification system detailed records; and
- a sound methodology for determining property holding and disposition costs had not been developed.

In its May 1990 response to our fiscal year 1988 report, FmHA agreed to initiate action to address these weaknesses. However, corrective actions had not yet been completed on any of the conditions discussed above by the end of our field work on November 30, 1990. As a result, we could not assess the effectiveness of the corrective actions.

The results of our fiscal year 1989 examination disclosed that FmHA experienced additional problems related to two of the conditions above. FmHA was unable to reconcile reports produced by the acquired property system with detailed files at the field offices. In addition, a significant internal control weakness existed in the new farm loan classification system, because software did not contain edit checks to detect input errors.

Control Weaknesses Persist in the Acquired Property Accounting System

In our fiscal year 1988 report on internal accounting controls, we noted serious internal control weaknesses in the new Acquired Property Tracking System. Specifically, inaccuracies and data entry errors were not detected and corrected because of software design problems and because reports produced by the APTS were not reconciled with detailed acquired property records at FmHA's field offices as required by GAO's Policy and Procedures Manual for Guidance of Federal Agencies, Title 2. FmHA agreed with our recommendation to design software parameter checks to detect the input of unreasonable property values and implemented appropriate system modifications in September 1989. To reconcile the information in APTS with source documents maintained at the county offices, FmHA required all county offices to review and correct their records and to certify the accuracy of the inventory recorded in APTS as of July 21, 1989.

The results of our tests of the APTS records disclosed that the agency's reconciliation efforts had not been successful. Our examination of a statistical sample of acquired properties located at 119 county offices revealed that property values were incorrectly reported in 43 percent of the cases reviewed. We provided a list of the properties to FmHA officials for corrective action. Examples included the following:

- The APTS report for a Mississippi county office contained a farm appraised in 1983 at $7.3 million. Our review showed that the property was reappraised in May 1989 for $971,000. However, in the February 1990 APTS report, this property was still recorded at $7.3 million.
- Three different county offices in Puerto Rico reported the same farm, valued at $540,000, as belonging to each of them.
- The value of a farm in Florida was reported at $411,500 based on a June 1987 appraisal. Our review showed that this value was reduced in February 1989 to $175,000 when the property was reappraised; however, APTS still reported the earlier value on September 30, 1989.
- A farm in Oklahoma was reported at $154,000 based on a 1985 appraisal. Our review showed that an updated appraisal conducted in

April 1989 reduced the market value to $43,000. However, APTS records at the FmHA Finance Office showed the property still being reported in APTS at $154,000 as of June 1990.

In its December 1989 FMFIA letter to the President, USDA cited FmHA's acquired property accounting system as the financial system most in need of improvement in USDA. In July 1990, FmHA issued a letter to its county offices citing weaknesses noted during our fiscal year 1989 review and requested every county supervisor to reconcile the acquired property files with the APTS report and take corrective action to bring the acquired property accounting system into agreement with the detailed property files. Accordingly, we qualified our opinion on FmHA's fiscal year 1989 consolidated financial statements due to the lack of reliable financial data on acquired property operations.

Poor Software Design Prohibits the Use of the New Farm Loan Classification System

In fiscal year 1988, FmHA implemented a loan classification system for its farm loan portfolio to comply with generally accepted accounting principles (GAAP) and OMB requirements. This system is designed to classify loans according to degree of risk and to estimate losses based on collateral shortfalls. The estimated loss information from the system is used as the primary basis for calculating the allowance for farm loan losses on the $22 billion farm loan portfolio reported in FmHA's financial statements.

Our audit tests disclosed that poor software design allowed inaccurate loan loss estimates to be entered in the farm loan classification system and rendered the system unreliable for calculating the allowance for farm loan losses presented in the fiscal year 1989 financial statements. Overall, the system reported that estimated farm loan losses totaled over $68 billion—even though the loan portfolio was only about $22 billion. The loan classification system did not include edit checks and input controls to ensure the acceptance of only valid and reasonable data. Errors in estimated loan losses reported by the system included the following:

- A $60,002,000 loss on a borrower in Louisiana, even though the actual estimated loss was $600,020;
- A $55,214,100, loss on a borrower in Minnesota, even though the actual estimated loss was $552,141; and
- A $20,000,000 loss on a borrower in Utah, even though the actual estimated loss was $177,600.

GAAP require that automated or manual agency accounting systems contain sufficient internal controls to prevent, detect, and correct errors and irregularities which may occur. It also states that input controls should detect unauthorized, incomplete, duplicate, or otherwise erroneous transactions and ensure they are controlled until corrected. As shown, the loan classification system lacked the input controls necessary to detect and correct input errors. Because transactions are currently processed at FmHA's 2,000 field offices, it is especially critical that adequate internal controls be incorporated into all FmHA software.

In June 1990, FmHA began implementing system design changes to improve internal controls in the loan classification system. Design changes included edit checks to compare the amount of estimated loss with the borrower's total unpaid principal and interest outstanding and to reject the transaction as a discrepancy to be corrected and re-entered if the estimated loss was greater than the borrower's total unpaid balance. The target date for completion is June 1991.

FmHA developed an alternative methodology to calculate the allowance for farm loan losses in the fiscal year 1989 financial statements. This alternative methodology was to apply loss ratios to the fiscal year 1989 farm loan portfolio based on data from the fiscal year 1988 loan classification system. Historical loss data and an analysis of current market factors were also considered in the alternative methodology. Using this methodology, FmHA determined that its estimated allowance for losses on the farm loan portfolio should be decreased from $14.5 billion, for fiscal year 1988, to $12.4 billion for fiscal year 1989. This paralleled a decrease in the farm loan portfolio from $25.5 billion in 1988 to $22.5 billion in 1989.

Our evaluation of FmHA's alternative methodology disclosed that it was reasonably accurate for establishing the 1989 allowance for farm loan losses because the farm loan portfolio did not change significantly between fiscal years 1988 and 1989. Accordingly, we did not qualify our opinion on FmHA's fiscal year 1989 consolidated financial statements for this item.

Conclusions

Although FmHA implemented system modifications to detect unreasonable acquired property values, the agency is still unable to reconcile the individual property files with the general ledger. As a result, we cannot be certain that data generated by APTS are reliable or that the acquired property accounts are fairly stated. Until APTS reports are reconciled regularly, the acquired property accounting system is vulnerable to errors and fraudulent data manipulation.

In fiscal year 1988, FmHA initiated the loan classification system in order to perform an annual risk assessment of its loan portfolio and to estimate loan losses based on collateral shortfalls. While the system is a major step toward meeting GAAP and OMB requirements, sufficient internal controls have not been built into the software design. As a result, the system reported estimated farm loan losses that were overstated and could not be used for establishing the fiscal year 1989 allowance for losses on farm loans or for financial management purposes.

Recommendations

We recommend that the Secretary of Agriculture direct the Administrator of the Farmers Home Administration to

- require accurate and timely reconciliation of the acquired property general ledger accounts with detailed acquired property files each fiscal year;
- implement internal controls to detect and correct data entry errors in the farm loan classification system; and
- reconcile estimated loss information from the loan classification system to the hardcopy files at the field offices to ensure that all previous data entry errors are corrected.

Report on Compliance With Laws and Regulations

We have audited the consolidated financial statements of the Farmers Home Administration (FmHA) for the fiscal years ended September 30, 1989 and 1988, and have issued our opinion thereon. This report pertains only to our review of FmHA's compliance with laws and regulations for the year ended September 30, 1989. Our report on FmHA's compliance with laws and regulations for the year ended September 30, 1988, is presented in GAO/AFMD-90-37, dated January 25, 1990.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of FmHA is responsible for compliance with laws and regulations applicable to FmHA. As part of obtaining reasonable assurance as to whether the consolidated financial statements are free of material misstatement, we selected and tested transactions and records to determine FmHA's compliance with certain provisions of the following laws and regulations which, if not complied with, could have a material effect on FmHA's consolidated financial statements. However, it should be noted that our objective was not to provide an opinion on the overall compliance with such provisions.

We tested compliance with the

- Agricultural Credit Act of 1987 (Public Law 100-233);
- Anti-Deficiency Act (31 U.S.C. 1341, 1342, and 1512-1519);
- Debt Collection Act of 1982 (31 U.S.C. 3711-3719) and related regulations;
- Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512);
- Prompt Payment Act (31 U.S.C. 3901-3906);
- Omnibus Budget Reconciliation Act of 1986 (Public Law 99-509); and
- other legislation and regulations concerning FmHA's farm, housing, and community and business loans and grants.

Because of the limited purpose for which our tests of compliance were made, the laws and regulations tested did not cover all legal requirements with which FmHA has to comply.

The results of our tests for fiscal year 1989 indicate that, with respect to the items tested, FmHA complied in all material respects with those provisions of laws and regulations. With respect to transactions not tested, nothing came to our attention that caused us to believe that FmHA had not complied, in all material respects, with those provisions.

Financial Statements

Consolidated Statements of Financial Position

	As of September 30 1989	1988
	(Dollars in Thousands)	
ASSETS:		
Fund Balance with U.S. Treasury	$ 650,055	$ 3,343,405
Accounts Receivable (Note 3) Net of Allowance for Losses of $10,278 in 1989 and $8,237 in 1988	46,463	36,852
Interest Receivable (Notes 4 & 6) Net of Allowance for Losses of $4,746,881 in 1989 and $4,871,014 in 1988	817,920	739,546
Loans Receivable (Notes 5 & 6) Net of Allowance for Losses of $15,291,202 in 1989 and $18,473,501 in 1988	39,209,316	39,697,111
Investments In Loan Sale Trust Assets (Note 7)	223,782	233,275
Acquired Property (Note 8)	694,681	867,941
Other Assets	36,599	33,089
Total Assets	$ 41,678,816	$ 44,951,219
LIABILITIES:		
Accounts Payable	$ 104,092	$ 90,539
Accrued Interest Payable (Note 9)	3,368,057	3,580,859
Intragovernmental Debt (Note 9)	75,592,718	80,154,218
Notes Payable - Investors (Note 9)	136,519	670,278
Accrual for Estimated Losses on Guaranteed Loans (Note 10)	1,297,568	1,278,587
Other Liabilities	88,033	109,855
Total Liabilities	80,586,987	85,884,336
EQUITY: (Note 11)		
Unexpended Appropriations:		
Undelivered Orders	471,737	493,916
Unobligated Balances	12,477	11,617
Invested Capital	1,159,290	1,148,812
Cumulative Results of Operations (Note 12)	(40,551,675)	(42,587,462)
Total Equity	(38,908,171)	(40,933,117)
Total Liabilities & Equity	$ 41,678,816	$ 44,951,219

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

Consolidated Statements of Operations

	For Fiscal Years Ended September 30 1989	1988
	(Dollars in Thousands)	
INTEREST INCOME:		
Interest on Loans (Note 4)	$ 3,388,143	$ 3,578,579
Less Interest on Nonperforming Loans (Note 6)	537,421	997,267
Interest Income	2,850,722	2,581,312
INTEREST EXPENSE:		
Interest on Intragovernmental Debt (Note 9)	8,539,205	8,890,353
Other Interest Expense (Note 9)	70,254	96,935
Interest Expense	8,609,459	8,987,288
NET INTEREST EXPENSE	(5,758,737)	(6,405,976)
PROVISION FOR LOSSES ON:		
Loans (Note 6)	122,913	5,090,231
Accrued Interest on Loans (Note 6)	7,616	85,318
Acquired Property (Note 8)	103,081	205,392
Guaranteed Loans (Note 10)	98,796	627,642
Total Provision for Losses	332,406	6,008,583
NET INTEREST EXPENSE AND PROVISION FOR LOSSES	(6,091,143)	(12,414,559)
OTHER INCOME:		
Income Attributable to Interest Credit Program (Note 4)	1,425,277	1,427,314
Expended Appropriations	600,274	589,225
Other Income	82,101	86,108
Total Other Income	2,107,652	2,102,647
OTHER EXPENSES:		
Loss on Sale of Loan Assets (Note 13)	83,341	1,074,893
Interest Credit Program Expense	1,425,277	1,427,314
Grants and Contributions	380,236	351,532
Personnel Compensation and Fringe Benefits	310,949	303,905
Rents, Communications, and Utilities	40,931	42,451
Other Administrative Expenses	56,043	51,650
Other Program Expenses	246,382	163,063
Prepayment Penalty on Intragovernmental Debt (Note 9)	341,549	79,508
Total Other Expenses	2,884,708	3,494,316
NET LOSS FROM OPERATIONS	$ (6,868,199)	$(13,806,228)

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

Consolidated Statements of Cash Flows

INCREASE (DECREASE) IN CASH

	For Fiscal Years Ended September 30	
	1989	1988
	(Dollars in Thousands)	
Cash Flows from Operating Activities:		
Interest Received	$ 2,423,718	$ 2,432,661
Interest Paid	(8,818,512)	(9,203,252)
Appropriations Received (Note 11)	588,565	574,098
Appropriations Disbursed	(601,933)	(596,433)
Program Expenses	(752,464)	(383,658)
Other (Net)	93,489	224,433
Net Cash Used in Operating Activities	(7,067,137)	(6,952,151)
Cash Flows from Investing Activities:		
Collections on Loans	3,070,204	3,380,200
Loans Made	(3,529,118)	(3,493,511)
Proceeds from Loan Principal Asset Sales	1,082,470	1,053,975
Proceeds from Sale of Acquired Property	95,159	155,344
Collections Received on Behalf of Investors	17,299	30,838
Payments Made to Investors	(18,868)	(74,550)
Acquired Property Disbursements	(55,612)	(73,698)
Purchase of Loans	(37,680)	(262,015)
Loss Settlement of Guaranteed Loans (Note 10)	(79,815)	(113,486)
Return of Investment - Loan Asset Sale Trust	9,946	1,795
Net Cash Provided by Investing Activities	553,985	604,892
Cash Flows from Financing Activities:		
Borrowings from U.S. Treasury (Note 9)	16,930,000	17,705,000
Payments on U.S. Treasury Borrowings (Note 9)	(16,306,500)	(15,679,000)
Reimbursements for Losses (Notes 11 and 12)	8,904,061	7,554,171
Borrowings from Federal Financing Bank (Note 9)	1,000,000	0
Payments on Federal Financing Bank Borrowings (Note 9)	(6,185,000)	(6,513,000)
Payments on Notes Payable (Note 9)	(533,759)	(371,947)
Revolving Fund Appropriations	11,000	7,500
Net Cash Provided by Financing Activities	3,819,802	2,702,724
Net Increase (Decrease) in Cash	(2,693,350)	(3,644,535)
Fund Balance with U.S. Treasury, Beginning of Year	3,343,405	6,987,940
Fund Balance with U.S. Treasury, End of Year	$ 650,055	$ 3,343,405

See Note 15 for Reconciliation of Net Loss to Net Cash Used in Operating Activities.

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

Notes to Consolidated Financial Statements

NOTE 1: ORGANIZATION AND PROGRAMS

Entity and Basis of Consolidation

Farmers Home Administration (FmHA) is the credit agency for agriculture and rural development in the U.S. Department of Agriculture (USDA). In 1989, the Agency marked 54 years of financial and technical assistance to rural America. This service has been performed under the successive names of Resettlement Administration, Farm Security Administration, and Farmers Home Administration.

When it began in 1935, the Agency's original function was to make loans and grants to Depression-stricken families and help them regain self-sufficiency in making their living on family farms. For 54 years, FmHA has been concerned primarily with credit and counseling services that have supplemented resources of the private sector for building strong family farms. In 1989, farm credit still accounted for a significant portion of all resources administered by FmHA. Of the $5.1 billion of loan and grant obligations incurred by FmHA in fiscal year 1989, $2.2 billion were for farmer programs.

During the last 2 decades, Congress created additional nonfarm programs to benefit families and communities in rural areas. These programs have helped to provide safe, modest housing; modern, sanitary water and sewer systems; essential community facilities; and job- and economy-boosting business and industry in rural areas. These are reflected in the current mission statement which directs FmHA to "serve as a temporary source of supervised credit and technical support for rural Americans for improving their farming enterprises, housing conditions, community facilities, and other business endeavors until they are able to qualify for private sector resources."

Over the years, FmHA has developed a credit system that reaches the county level. The Agency has approximately 11,600 permanent full-time employees who serve rural America from 46 State Offices, 264 District Offices, and 1,904 County Offices, plus the National Office in Washington, D.C., and the Finance Office in St. Louis, Missouri. Service is provided in every rural county or parish in the 50 states, plus the Pacific Trust Territory, American Samoa, Guam, Puerto Rico, and the Virgin Islands.

In fulfilling its mission as a "lender of last resort" in providing housing, credit, and agricultural assistance to people in rural areas, the Farmers Home Administration (FmHA) maintains 11 general funds, 5 revolving funds, and 2 other funds. The majority of FmHA loans are made from three revolving loan funds. The oldest is the Agricultural Credit Insurance Fund (ACIF), established when FmHA began to make insured loans in the 1940's, and now the fund from which all farmer program loans are made. The Rural Housing Insurance Fund (RHIF) was established with inauguration of insured rural housing loans in 1965. The Rural Development Insurance Fund (RDIF), established under the Rural Development Act of 1972, took over from ACIF the Agency's lending for water, sewer, and other community facilities, and for business and industrial development.

The consolidated financial statements account for all funds for which FmHA is responsible and are presented on the accrual basis of accounting as required by the GAO Policy and Procedures Manual for Guidance of Federal Agencies (Title 2).

Lending Programs

Insured Lending Activities

Farmers Home Administration budgeted lending programs include insured loans. The term "insured" is defined as loans made directly from the revolving funds. These insured loans are available as security for borrowings from the Federal Financing Bank. Generally, an insured loan is made only if a borrower can not secure adequate credit from other sources at reasonable rates and terms.

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

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

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

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

Loan Deferral Program:
The loan deferral program allows a delinquent borrower to postpone the payment of principal and interest for up to 5 years. To qualify, a borrower must be unable to pay essential living expenses or maintain the farm property and pay the debts, but must demonstrate the potential to begin debt payments when the deferral period ends. The borrower is not required to pay interest on the deferred interest. Instead, the deferred interest will be repaid in equal installments over the remaining term of the loan. The interest rate at the end of the deferral will be the lesser of the current rate on a similar type new loan or the original rate on the loan.

Debt Write-Down Program:
The Agricultural Credit Act of 1987 permits FmHA to write-down farmer program loans to the recovery value of the collateral if the borrower has a feasible plan to continue the farming operation. Loans can be written-down only if the restructured loan would result in recovery to the Government that would be equal to or greater than the amount recovered if the collateral was involuntarily liquidated. Borrowers who participate in the debt write-down program must sign a shared appreciation agreement entitling FmHA to share in the appreciation of the real estate securing the loan, thereby recapturing a portion of the debt write-down amount. The agreement allows FmHA to receive from 50 to 75 percent of the appreciation during the life of the 10-year agreement if, during the 10 years, the borrower sells or conveys the property, ceases farming operations, or pays the debt in full. At the end of the tenth year, the borrower must pay

50 percent of the appreciation on the property. The amount the borrower must repay cannot exceed the amount of write-down received.

Net Recovery Buyout Program:
If the borrower is unable to show repayment ability using the available servicing options including debt write-down, the borrower will be offered the option to satisfy his loan at the net recovery value of collateral. The recovery value, since it reflects liquidation costs, will be less than the market value of the collateral. Borrowers qualifying for the option will be required to sign an equity recapture agreement. The agreement provides that, if the borrower sells the property which secured the loan within 2 years of the agreement, FmHA will receive the difference between the net recovery value and the current market value. FmHA cannot recapture more than the debt written off.

Guaranteed Lending Activities

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

Generally, the guaranteed loan program allows FmHA to guarantee up to 90 percent of the money loaned by a financial institution (lender) to borrowers in rural areas or who employs people in rural areas. However, if a borrower participates in the interest rate buydown program, purchases property from the acquired property inventory of the Farm Credit System, and receives a 5 percent interest rate reduction from the lender, FmHA is allowed to guarantee the loan up to 95 percent.

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

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

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

Interest Rate Buydown Program:
The Food Security Act of 1985 (Public Law 99-198) authorized FmHA to enter into an agreement with participating guaranteed lenders to reduce the interest rate paid by guaranteed borrowers. In return, FmHA will make annual interest rate buydown payments to the lender in an amount not to exceed 50 percent of the cost of reducing the interest rate on the loan up to a maximum of two percentage points or, as provided in the Agricultural Credit Act of 1987, 2.5 percent points if the borrower purchases property from the acquired property of the Farm Credit System and the lender provides a 5 percent interest rate reduction. The Food Security Act authorized $490,000,000 for this program to be available through September 30, 1988; however, the Agricultural Credit Act of 1987 extended this authority through fiscal year 1993. For the fiscal years 1989 and 1988, $14,179,629 and $16,515,488, respectively, were obligated for this program.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

Loans and Allowance for Loan Losses

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

Accrual for Estimated Losses on Guaranteed Loans

Anticipated losses on guaranteed loans are estimated based on historical data, current market conditions, and field office expectations of loan losses. This estimate is reported as an expense, and a corresponding accrual for estimated losses on guaranteed loans is reported as a liability on the Consolidated Statement of Financial Position.

Interest Income

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

Income Recognition and Reimbursement for Losses

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

Loss Reimbursement

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

Expended Appropriations

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

Debt Restructuring Under the Agricultural Credit Act of 1987

Under the provisions of the Agricultural Credit Act of 1987, FmHA troubled debt restructuring options were expanded to include debt write-down as well as prior options to reschedule and/or reamortize borrower loan accounts. After restructuring, interest accrues on the principal amount, and the restructured balances (interest and principal) are included in the FmHA financial statements.

Title 2 of the GAO's Policies and Procedures Manual for Guidance of Federal Agencies provides that, for financial reporting purposes, a restructured loan be reduced to the estimated future cash receipts (including both interest and principal) if the future receipts are expected to be less than the originally recorded receivable. The resulting restructured amount would be noninterest bearing for financial reporting purposes. If the future cash receipts are greater than the recorded receivable, the receivable is not adjusted and cash receipts in excess of the recorded receivable should be recognized as interest income.

However, FmHA is required to maintain detailed loan accounting records consistent with the terms and conditions agreed upon with the borrower. In order to comply with the financial reporting requirements discussed in the above paragraph, a separate loan accounting system would be required. Because developing such a system would be cost prohibitive, FmHA management is of the opinion that committing Agency resources is not justifiable considering the limited benefits which could be realized and that the reporting of the troubled debt, as presented, does not have a material effect on the Agency's financial statements. Consequently, the Agency did not adopt the Title 2 standards for financial reporting of troubled debt restructuring.

Intragovernmental Financial Activities

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

During fiscal years 1989 and 1988, the majority of the FmHA's employees participated in the contributory Civil Service Retirement System (CSRS) or Federal Employees Retirement System (FERS), to which FmHA made matching contributions. The FmHA does not, however, report CSRS and FERS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees since this data is only reported in total by the Office of Personnel Management.

NOTE 3: ACCOUNTS RECEIVABLE

Accounts receivable is comprised primarily of receivables resulting from accrued rent on acquired property, accrued interest on judgments, and the recapture of interest credit. Of these, the most significant is the $24,160,303 recapture of interest credit receivable. This amount represents the amount of interest credit to be repaid to the Government and is determined after giving consideration to the amount of interest credit provided, the appreciation in property value, the method used to satisfy the loan, the period of time the loan was outstanding, and the amount of equity the borrower has in the property when the loan is satisfied.

NOTE 4: INTEREST

The outstanding unpaid loan interest receivable and the related allowance for losses, by entity, as of September 30, 1989 and 1988, follow:

	September 30, 1989 (Dollars in Thousands)			September 30, 1988 (Dollars in Thousands)		
	Loan Interest Receivable	Allowance For Losses (Note 6)	Net Interest Receivable	Loan Interest Receivable	Allowance For Losses (Note 6)	Net Interest Receivable
ACIF	$5,071,323	$4,336,656	$ 734,667	$5,071,905	$4,470,154	$ 601,751
RHIF	225,251	186,892	38,359	235,524	181,328	54,196
RDIF	266,999	222,372	44,627	301,185	218,559	82,626
Other	1,228	961	267	1,946	973	973
Total	$5,564,801	$4,746,881	$ 817,920	$5,610,560	$4,871,014	$ 739,546

Interest income on loans is accrued at the contractual rate on the outstanding principal amount. The interest income recognized, consisting primarily of accrued loan interest, by entity, for the fiscal years 1989 and 1988 follows:

	1989 (Dollars in Thousands)	1988
Agricultural Credit Insurance Fund (ACIF)	$1,751,318	$1,906,753
Rural Housing Insurance Fund (RHIF)	1,352,938	1,305,785
Rural Development Insurance Fund (RDIF)	283,689	365,321
All Other Entities	198	720
Interest on Loans	3,388,143	3,578,579
Less Interest on Nonperforming Loans	537,421	997,267
Net Interest Income	$2,850,722	$2,581,312

As of September 30, 1989, approximately 12,900 borrowers were participants in the debt set-aside program with almost $540,000,000 of principal being set aside. Interest rates on the majority of the related loans ranged from 4.5 to 13.5 percent; however, interest income is not accrued on the set-aside balances.

Interest income for RHIF does not include $1,425,277,242 of interest credit provided to single family housing and rural rental housing borrowers; however, the amount is recognized as other income and the related interest credit program expense is reported in other expenses. The unpaid principal balance of loans receiving interest credit is approximately $19.7 billion.

The unpaid principal balance of nonperforming loans (in excess of 90 days delinquent) is approximately $13 billion. Although interest on these accounts continues to be accrued, this interest is not included in the net interest income reported on the Consolidated Statement of Operations.

NOTE 5: LOANS

The unpaid principal balances and the related allowance for losses by entity and major loan program as of September 30, 1989 and 1988, follow:

	September 30, 1989 (Dollars in Thousands)			September 30, 1988 (Dollars in Thousands)		
	Unpaid Principal	Allowance for Losses on Principal (Note 6)	Net Unpaid Principal	Unpaid Principal	Allowance for Losses on Principal (Note 6)	Net Unpaid Principal
Agricultural Credit Insurance Fund						
Farm Ownership	$ 6,981,601	$ 2,347,031	$ 4,634,570	$ 7,304,333	$ 2,629,309	$ 4,675,024
Operating	4,878,640	1,749,395	3,129,245	5,729,855	2,409,106	3,320,749
Emergency	7,084,431	5,717,796	1,366,635	8,419,073	6,585,509	1,833,564
Economic Emergency	2,955,771	2,530,249	425,522	3,419,262	2,842,750	576,512
Other	523,744	15,190	508,554	564,036	28,095	535,941
Guaranteed loans purchased from holders	28,271	14,135	14,136	29,742	14,871	14,871
	22,452,458	12,373,796	10,078,662	25,466,301	14,509,640	10,956,661
Rural Housing Insurance Fund						
Rural Housing	18,751,858	2,324,457	16,427,401	18,560,191	3,118,259	15,441,932
Labor Housing	140,778	20,126	120,652	137,566	19,667	117,899
Rural Rental Housing	8,914,216	336,093	8,578,123	8,347,437	64,300	8,283,137
Rural Housing Site	959	1	958	566	1	565
Guaranteed loans purchased from holders	1,396	698	698	1,641	821	820
	27,809,207	2,681,375	25,127,832	27,047,401	3,203,048	23,844,353
Rural Development Insurance Fund						
Water & Waste	2,890,673	21,267	2,869,406	4,072,137	465,434	3,606,703
Community Facilities	879,081	1,262	877,819	1,025,371	47,310	978,061
Business & Industrial	20,216	1,336	18,880	36,914	862	36,052
Guaranteed loans purchased from holders	408,861	206,367	202,494	484,997	242,499	242,498
	4,198,831	230,232	3,968,599	5,619,419	756,105	4,863,314
All Other Entities	40,022	5,799	34,223	37,491	4,708	32,783
Total FmHA	$54,500,518	$15,291,202	$39,209,316	$58,170,612	$18,473,501	$39,697,111

FmHA had unliquidated loan and grant obligations of $4,668,962,778 and $4,845,631,423 as of September 30, 1989 and 1988, respectively.

The following schedule provides the loan principal repayments based on borrowers' repayment schedules.

Loan Principal Repayments By Fiscal Year
(Dollars in Thousands)

Fiscal Years	Principal Repayments
1990	$4,994,543
1991	1,774,204
1992	1,650,384
1993	1,543,076
1994	1,494,807
1995-1999	7,504,853
2000-2004	7,221,359
2005-2009	7,031,435
2010-2014	7,393,773
Over 2014	13,453,556
Subtotal	$54,061,990
Guaranteed loans purchased from holders	438,528
Total loans receivable	$54,500,518

* NOTE: The FY 1990 principal repayments include approximately $2.3 billion of fully matured loans which are due and payable.

NOTE 6: ALLOWANCE FOR LOSSES

In fiscal year 1988 FmHA began the implementation of a loan classification system. As of September 30, 1989, approximately 83 percent of the portfolio including farmer, single family housing, and community program loans was classified. The loan classification system, required by OMB Circular A-129, provides the Agency additional data to assist in assessing the credit risk of the portfolio. OMB Circular A-129 provides that Federal agencies annually perform a risk assessment of their portfolio and assign risk ratings. The risk ratings are based on the borrower's financial position, payment history, collateral or security value, as well as other relevant information.

The procedures followed in estimating losses for fiscal year 1989 included:

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

--The allowance for losses on accrued interest receivable is based on historical data (cumulative writeoffs of interest receivable), an analysis of the loan classification of borrower accounts, and an analysis of recent delinquency data. The latter analysis provides for a 100 percent allowance for loss on the interest receivable on loans delinquent over 90 days.

The other adjustments in allowance for loan losses for 1988 include an estimated $498 million loss on the anticipated fiscal year 1989 sale of community program loan assets. The $498 million estimated loss was not reported in the Provision for Losses on Loans but was included in the Loss on Sale of Loan Assets in the Consolidated Statement of Operations. The fiscal year 1989 adjustment represents $498 million of discount (relating to the accrued 1988 estimated loss) provided to community program borrowers who participated in the asset sale. Additional information regarding the 1989 and 1988 loan asset sales is provided in Note 13.

The other adjustments in allowance for interest losses represent Interest on Nonperforming Loans as reported in the Consolidated Statement of Operations.

The provision and other adjustments in the allowance for losses for the fiscal years 1989 and 1988 follow:

	Allowance for Loan Losses		Allowance for Interest Losses	
	1989	1988	1989	1988
	(Dollars in Thousands)		(Dollars in Thousands)	
Beginning Balance	$ 18,473,501	$ 14,664,348	$ 4,871,014	$ 4,279,752
Receivables Written Off, Net	(2,807,212)	(1,779,078)	(669,170)	(491,323)
Provision for Losses	122,913	5,090,231	7,616	85,318
Other Adjustments in Allowance for Losses	(498,000)	498,000	537,421	997,267
Ending Balance	$ 15,291,202	$ 18,473,501	$ 4,746,881	$ 4,871,014

FmHA experienced a significant increase in loan writeoffs during fiscal year 1989 compared to fiscal year 1988 ($2.8 and $1.8 billion, respectively). Of the $2.8 billion fiscal year 1989 writeoffs, $1.3 billion is attributable to the loan restructuring permitted with the passage of the Agricultural Credit Act of 1987 (note 1, Debt Write-Down and Net Recovery Buyout Programs). Approximately 3,800 borrowers with unpaid principal balances of nearly $1.1 billion received debt write-down of almost $611 million. Additionally, almost 4,000 borrowers were eligible for the Net Recovery Buyout Program. Writeoffs of nearly $710 million were recorded for these borrowers.

In recognition of the diversity of the FmHA portfolio, the following schedules provide the provision and other adjustments made to the allowance for losses by entity for fiscal year 1989:

Allowance for Loan Losses
(Dollars in Thousands)

	Beginning Balance October 1, 1988	Loans Written Off, Net	Provision and Other Adjustments In Allowance for Losses	Ending Balance September 30, 1989
ACIF	$14,509,640	$(2,559,625)	$ 423,781	$12,373,796
RHIF	3,203,048	(162,853)	(358,820)	2,681,375
RDIF	756,105	(84,397)	(441,476)	230,232
All Others	4,708	(337)	1,428	5,799
Total	$18,473,501	$(2,807,212)	$ (375,087)	$15,291,202

Allowance for Interest Losses
(Dollars in Thousands)

	Beginning Balance October 1, 1988	Interest Receivable Written Off, Net	Provision and Other Adjustments In Allowance for Losses	Ending Balance September 30, 1989
ACIF	$ 4,470,153	$ (614,416)	$ 480,919	$ 4,336,656
RHIF	181,328	(10,019)	15,583	186,892
RDIF	218,559	(44,635)	48,448	222,372
All Others	974	(100)	87	961
Total	$ 4,871,014	$ (669,170)	$ 545,037	$ 4,746,881

With consideration to the state of the agricultural economy and its effect on rural housing and farm property values, FmHA management is of the opinion that the allowance for losses at September 30, 1989, is adequate to absorb future losses inherent in the portfolio at that date. However, considerable uncertainties continue to remain over the agricultural environment. The losses which will ultimately be realized on the loan portfolio are dependent upon the impact of future commodity prices, production costs, land and housing values, and Government agricultural and economic policy.

NOTE 7: INVESTMENTS IN LOAN SALE TRUST ASSETS

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

The Rural Housing Insurance Fund (RHIF) maintains an investment in the Rural Housing Trust, 1987-1. This investment represents Class B securities valued at $169,167,344 (1987 appraised value of $180,000,000 less return of investment received during fiscal years 1989 and 1988 of $9,493,193 and $1,339,463, respectively) and Class C residual securities valued at $21,000,000.

FmHA intends to retain the RDIF and RHIF Class C investments at least until a sufficient track record has been established to allow their true value to be determined. FmHA intends to sell the RHIF Class B investment during fiscal year 1990. Based on estimates of the Class B investment's future value, it is anticipated that FmHA will receive sale proceeds in excess of its recorded value.

NOTE 8: ACQUIRED PROPERTY

Acquired property is reported at net realizable value (estimated market value less cost of disposition). Property is acquired by the FmHA revolving funds largely through foreclosure and voluntary conveyance. The properties consist primarily of 4,261 farm properties (total acreage of approximately 1.4 million) and 9,111 rural single family dwellings which are held by the revolving funds for resale. The revolving funds are allowed to lease certain properties to eligible individuals for a period not to exceed 1 year. Fiscal years 1989 and 1988 lease and rental income of $12,272,826 and $10,769,632, respectively, is reported as other income on the Consolidated Statement of Operations.

The 1987 Agricultural Credit Act provides borrower rights regarding the sale of acquired farm properties. In order to protect these rights, restrictions were imposed on the sale of acquired farm properties.

The financial audits conducted by GAO for the fiscal years 1988 and 1987 cited internal control weaknesses concerning the valuation of acquired property and the reconciliation of the property accounting records. Due to accounting system limitations in recording gains or losses realized at the time property is acquired through voluntary conveyance, FmHA developed procedures to properly report these losses as loan losses. These procedures estimated the losses incurred from property acquired through voluntary conveyance and included these losses in the loan receivable writeoffs. These weaknesses will continue to exist and related corrective procedures will remain in effect until revisions are fully implemented to the acquired property system. These revisions are included in a major systems alteration currently in process.

NOTE 9: LONG-TERM BORROWINGS

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

Borrowings from the Federal Financing Bank and private investors are in the form of Certificates of Beneficial Ownership. Certificates of Beneficial Ownership outstanding with the Federal Financing Bank are secured by unpaid loan principal balances, cash, and the Agency's authority to borrow. Certificates of Beneficial Ownership outstanding with private investors are secured by unpaid loan principal balances. The long-term borrowings of FmHA as of September 30, 1989 and 1988, follow:

Long-Term Borrowings
(Dollars in Thousands)

	1989	1988
Federal Financing Bank	$ 53,311,000	$ 58,496,000
U.S. Department of Treasury	22,281,718	21,658,218
Private Investors	136,519	670,278
Total Borrowings	$ 75,729,237	$ 80,824,496

As of September 30, 1989, about 58 percent of the FmHA's long-term debt is payable over the next 5 years as indicated below:

Fiscal Years of Maturities	Amount Due	Outstanding Borrowings	Weighted Average Rate
	(Dollars in Thousands)		
1989		$ 75,729,237	11.54%
1990	$ 14,767,029	60,962,208	11.93%
1991	11,793,461	49,168,747	12.26%
1992	5,793,051	43,375,696	12.04%
1993	4,421,708	38,953,988	12.15%
1994	7,000,203	31,953,785	12.22%
	43,775,452		
1995 - 2006	31,953,785	0	12.22%
	$ 75,729,237		

Supplemental information associated with fiscal years 1989 and 1988 long-term borrowings follows:

Accrued Interest Payable
(Dollars in Thousands)

	1989	1988
Intragovernmental Debt:		
U.S. Treasury	$ 786,100	$ 706,981
Federal Financing Bank	2,547,292	2,829,543
Subtotal	3,333,392	3,536,524
Private Investors	8,027	37,783
Other	26,638	6,552
TOTAL	$ 3,368,057	$ 3,580,859

Interest Expense
(Dollars in Thousands)

	1989	1988
Intragovernmental Debt:		
U.S. Treasury	$ 1,310,655	$ 1,211,362
Federal Financing Bank	7,228,550	7,678,991
Subtotal	8,539,205	8,890,353
Private Investors	31,164	68,851
Other	39,090	28,084
TOTAL	$ 8,609,459	$ 8,987,288

During July 1974, FmHA began selling Certificates of Beneficial Ownership (CBO) to the Federal Financing Bank (FFB) as a primary means of program financing. The CBO interest rate is based on Treasury's cost of money plus 1/8 of 1 percent to cover FFB's administrative expenses. The interest rates on FFB CBO's outstanding as of September 30, 1989, range from 7.324 percent to 16.516 percent.

During fiscal years 1989 and 1988, FmHA was required to pay a prepayment penalty on the early retirement of FFB CBO's. The agreement between FmHA and FFB provides that redemption of CBO's may occur at any time; however, the payment made shall be of an amount "which will result in a yield for the period from the date of repurchase to the maturity date of such CBO equal to the U.S. Treasury new issue rate for a security with a maturity and payment schedule comparable to the remaining maturity and payment schedule of such CBO." The application of this provision of the agreement resulted in a penalty for fiscal year 1989 and 1988 of $341,548,818 and $79,507,592, respectively.

NOTE 10: ACCRUAL FOR ESTIMATED LOSSES ON GUARANTEED LOANS

FmHA guaranteed loans are authorized through the Agricultural Credit Insurance Fund (ACIF), the Rural Housing Insurance Fund (RHIF), and the Rural Development Insurance Fund (RDIF). The total outstanding guaranteed loan principal on September 30, 1989, was $5,297,314,422 of which FmHA had guaranteed $4,529,039,519. The period of guarantee provided by FmHA may extend 40 years depending on loan purpose.

The guaranteed unpaid principal balance by entity as of September 30, 1989 and 1988, follows:

	Guaranteed Unpaid Principal Balance 1989	1988
	(Dollars in Thousands)	
ACIF	$ 3,691,778	$ 3,618,477
RHIF	15,413	17,306
RDIF	821,849	965,062
Total	$ 4,529,040	$ 4,600,845

Conditional commitments to make guaranteed loans have been established in the amount of $345,646,658.

Anticipated losses on guaranteed loans are estimated based on historical data, current market conditions, and field office expectations of loan losses. In fiscal year 1988, FmHA used comparable insured program allowance for losses methodology to determine the accrual for estimated losses in the guaranteed farmer program portfolio of ACIF because adequate historical loss data was unavailable. However, in fiscal year 1989, FmHA implemented procedures to assess the potential loss based upon historical ACIF guaranteed loan loss experience. Consequently, the 1989 provision for losses on guaranteed loans includes both the current provision and an adjustment to prior years' provisions. Additionally, the prior years' effects on Government equity could not be separately determined. This estimate is reported as an expense, and a corresponding accrual for estimated losses on guaranteed loans is reported as a liability on the Consolidated Statement of Financial Position.

The adjustments in the accrual for estimated losses (also see Note 6) as of September 30, 1989 and 1988, in thousands of dollars, follow:

	Beginning Balance October 1, 1988	Loss Settlement	Adjustments to Accrual for Estimated Losses	Ending Balance September 30, 1989
ACIF	$1,168,444	$ (56,467)	$ 92,727	$1,204,704
RHIF	233	(124)	195	304
RDIF	109,910	(23,224)	5,874	92,560
TOTAL	$1,278,587	$ (79,815)	$ 98,796	$1,297,568

	Beginning Balance October 1, 1987	Loss Settlement	Adjustments to Accrual for Estimated Losses	Ending Balance September 30, 1988
ACIF	$ 644,338	$ (82,057)	$ 606,163	$1,168,444
RHIF	271	(404)	366	233
RDIF	119,822	(31,025)	21,113	109,910
TOTAL	$ 764,431	$ (113,486)	$ 627,642	$1,278,587

NOTE 11: EQUITY

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

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

The following summarizes the activity for the appropriations and the Unexpended Appropriations balances of the appropriated funds for the 1989 and 1988 fiscal years in thousands of dollars:

	Appropriations	Undelivered Orders	Unobligated Balances
Beginning Balances, October 1, 1988		$493,916	$ 11,617
Fiscal Year Activity:			
Appropriations Received	588,565		588,565
Obligations Incurred		591,733	(591,733)
Obligations Cancelled		(10,725)	10,725
Accrued Expenditures		(601,654)	
Reimbursements		(1,533)	1,533
Balances Returned to U.S. Treasury			(8,230)
Ending Balances, September 30, 1989	$588,565	$471,737	$ 12,477
Beginning Balances, October 1, 1987		$525,036	$ 11,839
Fiscal Year Activity:			
Appropriations Received	$574,098		574,098
Obligations Incurred		577,653	(577,653)
Obligations Cancelled		(14,570)	14,570
Accrued Expenditures		(592,730)	
Reimbursements		(1,473)	1,473
Balances Returned to U.S. Treasury			(12,710)
Ending Balances, September 30, 1988	$574,098	$493,916	$ 11,617

Invested Capital

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

The following is a summary of the activity in Invested Capital for the 1989 and 1988 fiscal years:

	Invested Capital 1989	Invested Capital 1988
	(Dollars in Thousands)	
Beginning Balance	$ 1,148,812	$ 1,142,489
Fiscal Year Activity:		
Appropriated Increase to Working Capital	11,000	7,500
Capital Expenditures	2,913	3,505
Depreciation	(1,976)	(3,776)
Book Value of Disposed Equipment	(1,956)	(1,082)
Nonreciprocal Transfer of Loan Assets from Other Agencies	1,190	573
Loan Repayments Returned to U.S. Treasury	(768)	(385)
Results of Operations from the Transferred Loan Assets	75	(12)
Ending Balance	$ 1,159,290	$ 1,148,812

Cumulative Results of Operations

The Cumulative Results of Operations is the net result of operations from the revolving funds since their inception and the amounts reimbursed due to realized losses (Note 12). The following is a summary of the 1989 and 1988 fiscal years' activity for the Cumulative Results of Operations:

	Cumulative Results of Operations 1989	Cumulative Results of Operations 1988
	(Dollars in Thousands)	
Beginning Balance	$(42,587,462)	$(36,335,417)
Fiscal Year Activity:		
Net Results from Operations	(6,868,274)	(13,806,216)
Reimbursement for Losses	8,904,061	7,554,171
Ending Balance	$(40,551,675)	$(42,587,462)

NOTE 12: CUMULATIVE RESULTS OF OPERATIONS

Cumulative results of operations represent the cumulative deficit or surplus resulting from operations for all of the FmHA revolving funds. The cumulative results of operations for the Agricultural Credit Insurance Fund (ACIF) which was established in 1946, the Rural Housing Insurance Fund (RHIF) which was established in 1965, and the Rural Development Insurance Fund (RDIF) which was established in 1972 equal the net losses sustained from current and all prior years less the accumulated reimbursements for realized losses received by those funds. The cumulative results of operations, by entity, as of September 30, 1989, follow:

	Net Losses (Inception)	Reimbursement for Losses (Inception)	Cumulative Results of Operations
ACIF	$(42,961,858,199)	$14,451,331,000	$(28,510,527,199)
RHIF	(27,334,455,791)	18,966,105,561	(8,368,350,230)
RDIF	(9,372,213,311)	5,706,715,000	(3,665,498,311)
All Others	(7,298,877)	0	(7,298,877)
Total	$(79,675,826,178)	$39,124,151,561	$(40,551,674,617)

The reimbursement for realized losses does not include current and prior fiscal year realized losses eligible for future reimbursement. Additionally, FmHA was not fully reimbursed for the losses sustained in fiscal year 1987, which will be carried forward and requested in the next fiscal year. The potential reimbursements (based on the fiscal year of loss realization) which FmHA may receive pursuant to Congressional action follow:

	1987	1988	1989	Total
ACIF	$ 10,000,000	$4,452,159,000	$5,672,356,000	$10,134,515,000
RHIF	0	2,677,897,000	2,667,186,000	5,345,083,000
RDIF	3,500,000	1,470,999,000	1,666,160,000	3,140,659,000
Total	$ 13,500,000	$8,601,055,000	$10,005,702,000	$18,620,257,000

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

NOTE 13: LOAN ASSET SALES

As in the previous fiscal year, FmHA was required to sell loan assets in fiscal year 1989. An overview of the 1989 and 1988 sales follows:

	1989	1988
	(Dollars in Thousands)	
Receivables Sold:	$1,690,951	$1,663,735
Cash Proceeds:	1,109,610	1,086,842
Discount on Loans Sold:	$ 581,341	$ 576,893
Loss Estimated in 1988 for 1989 Asset Sale:	(498,000)	498,000
Total Loss on Sale of Loans:	$ 83,341	$1,074,893

NOTE: An allowance for losses amount was not allocated to the 1989 or 1988 receivables sold due to immateriality.

1988 Loan Asset Sales:
During fiscal year 1988, FmHA sold community program loan assets through a borrower buyback offer (Discount Purchase Program) whereby eligible borrowers were provided the opportunity to purchase their loans at a discount under the provisions of the Agricultural Credit Act of 1987. The Act extended to eligible community program borrowers the right to buy back their loans at a price comparable to that paid by the Community Program Loan Trust, 1987A (the community program trust asset sale FmHA conducted in fiscal year 1987), but updated for current market conditions.

During fiscal year 1988, approximately 2100 borrowers purchased nearly 3700 loans with an unpaid balance, including accrued interest, of $1,663,734,368. Proceeds from the Discount Purchase Program amounted to $1,086,841,795. The discount associated with the program was $576,892,573. Additionally, based on existing legislation regarding a loan asset sale for fiscal year 1989, FmHA provided for in 1988 an estimated $498 million loss related to the anticipated 1989 loan asset sale. Consequently, the total loss on sale of loans recognized in fiscal year 1988 was $1,074,892,573.

1989 Loan Asset Sales:
Farmers Home Administration was required by the Omnibus Budget Reconciliation Act of 1986 and the Continuing Appropriations Act of 1987 to raise net proceeds of $584 million in fiscal year 1989 through the sale of community program loans. The Rural Development, Agriculture, and Related Agencies Appropriations Act of 1989 included a provision which required that borrowers be given the opportunity of prepayment before a sale of loan assets was conducted. Based on these statutory requirements, FmHA offered another Discount Purchase Program to eligible community program borrowers.

During fiscal year 1989, approximately 1,700 borrowers purchased over 3,400 loans with an unpaid balance, including accrued interest, of $1,690,951,291. Proceeds from the Discount Purchase Program amounted to $1,109,610,009 resulting in a discount of $581,341,282. However, because of the $498,000,000 loss accrued in 1988 relating to 1989 loan asset sale, the total loss on sale of loans recognized in fiscal year 1989 was $83,341,282.

NOTE 14: CONSOLIDATED SCHEDULE OF BUDGET RECONCILIATION

The following schedule provides a reconciliation of expenses to budgetary outlays as of September 30, 1989 and 1988:

	1989	1988
	(Dollars in Thousands)	
Expenses As Reported on Consolidated Statement of Operations:		
Nonperforming Loans Interest	$ 537,421	$ 997,267
Total Interest Expense	8,609,459	8,987,288
Total Provision for Losses	332,406	6,008,583
Total Other Expenses	2,884,708	3,494,316
Total Expenses	12,363,994	19,487,454
Deduct:		
Expenses Not Requiring Outlays:		
Provision for Losses on:		
Loans (Note 6)	122,913	5,090,231
Accrued Interest on Loans (Note 6)	7,616	85,318
Guaranteed Loans (Note 10)	98,796	627,642
Acquired Property (Note 8)	103,081	205,392
Loss on Sale of Loan Assets (Note 13)	83,341	1,074,893
Interest Credit Program Expense (Note 4)	1,425,277	1,427,314
Interest on Nonperforming Loans (Note 6)	537,421	997,267
Other	16,070	27,004
Total Expenses Not Requiring Outlays	2,394,515	9,535,061
Expenses Requiring Outlays	9,969,479	9,952,393
Add:		
Other Outlays:		
Loans Made	3,529,118	3,493,511
Loss Settlement of Guaranteed Loans	79,815	113,486
Acquired Property Disbursements	55,612	73,698
Purchase of Loans	37,680	262,015
Payments Made to Investors	18,868	74,550
Payments on Notes Payable	533,759	371,947
Other	2,228	6,854
Total Other Outlays	4,257,080	4,396,061
Change in Accounts and Accrued Interest Payables	199,249	227,540
Total Outlays	14,425,808	14,575,994
Less Offsetting Collections	6,820,581	7,301,875
Net Outlays	$ 7,605,227	$ 7,274,119

NOTE 15: RECONCILIATION OF NET LOSS TO NET CASH USED IN OPERATING ACTIVITIES

The following schedule provides a reconciliation of net loss to the net cash used in operating activities as reported on the Consolidated Statement of Cash Flows for the fiscal years ended September 30, 1989 and 1988:

	1989	1988
	(Dollars in Thousands)	
Net Loss from Operations	$ (6,868,199)	$(13,806,228)
Adjustments:		
Expenses Not Requiring Outlays (Note 14)	2,394,515	9,535,061
Income Attributable to Interest Credit Program	(1,425,277)	(1,427,314)
Appropriations Received	588,565	574,098
Expended Appropriations	(600,274)	(589,225)
Interest Receivable Reclassified	(288,342)	(255,770)
Change in Interest Receivable	45,759	(329,058)
Interest Receivable Written-Off, Net	(669,170)	(491,323)
Change in Accounts Receivable	(11,652)	95,261
Change in Accounts and Accrued Interest Payables	(199,249)	(227,540)
Other	(33,813)	(30,113)
Total Adjustments	(198,938)	6,854,077
Net Cash Used in Operating Activities	$ (7,067,137)	$ (6,952,151)

NOTE 16: INTEREST RATE COST SUBSIDY

FmHA loan making activities provide for stated loan interest rates which are below Treasury market rates. Because the revolving funds typically borrow money to fund these lending programs at the U.S. Treasury rate, costs associated with making loans at a lower interest rate have historically been recognized through the difference between the interest expense on intragovernmental debt and accrued loan interest income on an annual basis.

Federal accounting principles governing the recording of interest rate cost subsidy on below market rate receivables are undergoing reexamination by the Congress, the Executive Branch, and the General Accounting Office. The final interpretation of federal accounting principles, as they relate to interest rate cost subsidy, cannot presently be determined. Accordingly, the FmHA accounting system currently does not provide for loan discounting or provide the automated capability for the related accounting entries over the life of the loan.

Within ACIF, loans are available at limited resource rates significantly below the Treasury average interest rate. Based on an analysis of loans outstanding as of September 30, 1989 and 1988, if a discount had been recognized at the time of loan closing, the unamortized discount would approximate $2.5 and $2.8 billion, respectively. Similarly, within RDIF, community facility and water and waste loans are typically made at interest rates substantially below the U.S. Treasury average interest rate. In analyzing RDIF loans outstanding as of September 30, 1989 and 1988, if a discount had been recognized at the time of loan closing, the unamortized discount would approximate $1 and $1.6 billion, respectively.

Within RHIF, the portfolio is comprised of single family housing (SFH) and multiple family housing (MFH) loans. Regarding the SFH loan programs, the stated rate on the majority of loans approximates the U.S. Treasury average interest rate. Although SFH borrowers may participate in the interest credit program (thereby receiving an effective rate below the market rate), the interest credit is subject to an annual review/adjustment. Additionally, FmHA is authorized to recapture partial or full repayment of the interest credit when the property is sold, transferred, or vacated by the borrower and appreciation in the property has occurred. Because an unknown portion of the interest credit may be recovered and the fact that few SFH loans are held to the full term of the note, the extent of the interest rate cost subsidy over the life of SFH loans cannot be reasonably estimated. The stated interest rate on MFH loans also approximates the average Treasury rate; however, MFH loans are eligible for interest credit for the entire life of the loan and are not subject to recapture. FmHA estimates the unamortized discount on MFH loans would approximate $5.2 billion for both September 30, 1989 and 1988. The expense of providing the interest credit program to SFH and MFH borrowers is currently recognized as an operating expense during the year and reported in the Consolidated Statement of Operations. (See Note 4 for additional information regarding the RHIF interest credit program expense.)

These estimates assume borrower repayments under the terms of the note. Also, if the $8.7 billion unamortized loan discount was reported on the Statement of Financial Position, then the related allowance for losses would be established based on the discounted loans receivable. It is estimated that the allowance for losses would be reduced by approximately $5.4 billion and the net cumulative effect of reporting the unamortized discount would cause an approximate $3.3 billion reduction in net loans receivable.

Since unamortized discount and allowance for loss data are not maintained on a loan-by-loan basis, the reduction in the allowance for losses was based upon an analysis of each of the largest funds in aggregate. A loan-by-loan analysis would be required to determine the actual effect of the unamortized discount on the allowance for losses computation.

Following are the estimated adjustments which would be necessary to recognize the interest rate cost subsidy on the below market rate loans receivable as of September 30, 1989 and 1988, respectively. These estimated adjustments represent the cumulative effect (prior and current years) on each year shown.

Consolidated Statement of Financial Position

	1989	1988
	(Dollars in Thousands)	
ASSETS:		
Loans Receivable, as presently recorded, net of allowance for losses	$39,209,316	$39,697,111
Cumulative effect on current and prior years of recording interest rate cost subsidy	(8,668,615)	(9,646,835)
Cumulative effect on current and prior years of recording interest rate cost subsidy on allowance for losses	5,413,879	6,784,102
Loans Receivable, net	$35,954,580	$36,834,378
EQUITY:		
Cumulative Results of Operations, as presently recorded	$(40,551,675)	$(42,587,462)
Cumulative effect on current and prior years of recording interest rate cost subsidy	(3,254,736)	(2,862,733)
Cumulative Results of Operations	$(43,806,411)	$(45,450,195)

Consolidated Statement of Operations

	1989	1988
Net Loss from Operations, as presently recorded	$(6,868,199)	$(13,806,228)
Cumulative effect on current and prior years of recording interest rate cost subsidy	(3,254,736)	(2,862,733)
Net Loss from Operations	$(10,122,935)	$(16,668,961)

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