AUDITED FISCAL YEARS 1996 AND 1995 FINANCIAL STATEMENTS OF THE FEDERAL FINANCING BANK

OIG-97-082 APRIL 23, 1997

Office of Inspector General

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United States Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

April 23, 1997

INSPECTOR GENERAL

MEMORANDUM FOR SECRETARY RUBIN

FROM: Valerie Lau
Inspector General

SUBJECT: Audited Fiscal Year 1996 Financial Statements of the Federal Financing Bank

ACTION FORCING EVENT:

Attached is the Federal Financing Bank (FFB) Financial Statement Audit Report for Fiscal Year (FY) 1996 as required by the Federal Financing Bank Act (the Act) of 1973. The Act requires you to submit a financial report of the Federal Financing Bank to Congress each year. The report is attached as Tab A. Please note the comments by the Independent Public Accountant (IPA) on financing the FFB's $2.5 billion deficit and the material weakness. These issues are summarized on the next page.

RECOMMENDATION:

Please sign the attached transmittal letters to the Chairman, House of Representatives' Committee on Government Reform and Oversight, and the Chairman, Senate Committee on Governmental Affairs, and enclose a copy of the FFB annual report for FY 1996. These letters are attached as Tab B.

_____Agree _____Disagree _____Let's Discuss

BACKGROUND/ANALYSIS:

The FFB is a Government corporation subject to the Government Corporation Control Act and is required to have an annual financial statement audit (31 U.S.C. 9106). The Chief Financial Officers (CFO) Act of 1990 amended the Government Corporation Control Act, but did not require Government corporations to follow specifically the audit requirements of Office of Management and Budget Bulletin 93-06, Audit Requirements for Federal Financial Statements.

The FFB's Annual Report includes the financial statements as of September 30, 1996 and the following reports issued by Brown & Company, the IPA:

- Independent Auditor's Report (Page 1);
- Auditor's Report on Internal Control Structure (Page 3); and
- Auditor's Report on Compliance with Laws and Regulations (Page 6).

In accordance with generally accepted Government auditing standards, the opinion on the financial statements is dated as of the last day of audit field work.

AUDITOR'S OPINION AND COMMENTS:

The IPA rendered an unqualified opinion on the financial statements. However, the IPA noted that the FFB will likely require congressional appropriations and/or an increased interest rate spread to finance its $2.5 billion deficit. The FFB has incurred losses because current legislation allows specific borrowers to prepay certain loans without the prepayment penalty (known as premiums). The FFB, however, must pay the prepayment premiums to the Treasury. In addition, legislation allows one specific borrower to pay the FFB less interest than stated in its loan agreements. The FFB absorbs the cost of foregone interest because it must pay the higher loan agreement amount of interest on the underlying borrowings to Treasury.

The Auditor's Report on Internal Control Structure cited FFB's lack of a single, integrated financial accounting system (repeat condition since FY 1993) as a material weakness. FFB's management has taken steps to correct this weakness, and anticipates that it will be resolved by FY 1998. The Auditor's Report on Compliance with Laws and Regulations contains no instances of noncompliance.

As in prior years, my staff performed a quality control review of the IPA's working papers. The audit was performed in accordance with generally accepted Government auditing standards and met the requirements of the Government Corporation Control Act as amended. Government corporations are not required to follow specifically the audit requirements of Office of Management and Budget Bulletin 93-06, Audit Requirements for Federal Financial Statements.

The IPA issued a management letter discussing various issues that were identified during the audit which are not required to be included in the audit reports.

Should you or your staff have any questions, please contact me at (202) 622-1090 or William H. Pugh, Deputy Assistant Inspector General for Audit (Financial Management), at (202) 927-5768.

ATTACHMENTS: Tab A: Audit Report of FFB's Fiscal Year 1996 Financial Statements

Tab B: Letters to the Chairman, House of Representatives Committee on Government Reform and Oversight, and the Chairman, Senate Committee on Governmental Affairs

FEDERAL FINANCING BANK

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITOR'S REPORT

FOR THE YEARS ENDED SEPTEMBER 30, 1996 AND 1995

BROWN & COMPANY

CERTIFIED PUBLIC ACCOUNTANTS
AND MANAGEMENT CONSULTANTS

BROWN & COMPANY

INDEPENDENT AUDITOR'S REPORT

The Inspector General,
U.S. Department of the Treasury
Washington, D.C.

We have audited the accompanying statements of financial position of the Federal Financing Bank (the Bank) as of September 30, 1996 and 1995, and the related statements of operations and accumulated deficit, and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the 1996 and 1995 financial statements referred to above present fairly, in all material respects, the financial position of the Federal Financing Bank as of September 30, 1996 and 1995, and the results of its operations, and accumulated deficit, and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards,* we have also issued reports dated December 31, 1996, on our consideration of the Bank's internal control structure and on its compliance with laws and regulations.

Congress has authorized certain Rural Utilities Service - RUS, (formerly known as the Rural Electrification Administration), guaranteed borrowers and Department of Defense guaranteed foreign military sales borrowers to prepay certain loans at their face (par) value by in effect waiving the contractually required prepayment premiums. In the loan industry, borrowers frequently are required to pay premiums when they prepay their loans at a time when market interest rates are lower than those stated in the loan agreements. This waiver has caused the Bank to incur losses in prior years because it is required to simultaneously liquidate the funds it borrowed from the U.S. Treasury to finance these loans and is required to pay prepayment premiums in doing so, notwithstanding the fact that the borrowers' premiums were waived. There were no debt prepayments in fiscal year 1996. In addition, Title III of the Rural Electrification Act of 1936, as amended, allows the RUS to pay less interest to the Bank than stated in its loan agreements. Because the Bank must pay the loan agreement amount of interest on its underlying borrowings to the Treasury, not the lower rate paid by the RUS, it

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incurs a loss due to foregone interest. Thus, the Bank has accumulated a deficit of $2.5 billion as of September 30, 1996. It is unlikely that the Bank's net interest income at its current spread of one-eighth of one percent will be sufficient to liquidate the liabilities resulting from this deficiency as they become due. Therefore, the Bank will likely require Congressional appropriations or an increased interest rate spread, or some combination of these, to finance its deficit.

Brown & Company

December 31, 1996
Arlington, Virginia

CERTIFIED PUBLIC ACCOUNTANTS
AND MANAGEMENT CONSULTANTS

BROWN & COMPANY

AUDITOR'S REPORT ON INTERNAL CONTROL STRUCTURE

The Inspector General,
U.S. Department of the Treasury
Washington, D.C

We have audited the financial statements of the Federal Financing Bank (the Bank) as of and for the year ended September 30, 1996 and have issued our report thereon dated December 31, 1996.

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

The management of the Bank 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.

In planning and performing our audits of the financial statements of the Bank for the year ended September 30, 1996, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of significant internal control structure policies and procedures, determined whether they have been placed in operation, assessed control risk, and performed tests of the internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted a matter involving the internal control structure and its operations that we consider to be a reportable condition under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating

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to significant deficiencies in the design or operation of the internal control structure that, in our judgement, could adversely affect the Bank's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The following reportable condition was identified:

The Federal Financing Bank lacks a single integrated financial accounting system. (Repeat Condition)

The Office of Management and Budget Circular No. A-127, *Financial Management Systems*, requires federal agencies to have an integrated financial management system that will provide an effective and efficient interrelationship between software, hardware, personnel, procedures, controls, and data contained within the systems.

The Federal Financing Bank uses the Loan Management Control System (LMCS), a mainframe system that serves as the subsidiary ledger for loans and borrowings. LMCS also calculates the accrued interest income and expense. Because LMCS does not yet have full general ledger capabilities, the Bank maintains its own general ledger and subsidiary ledgers on PC-based software applications. As a result, the Bank must prepare manual journal vouchers to enter the LMCS data in the general ledger.

Recommendation:

We recommend that the Bank's management institute appropriate policies and procedures to ensure that by the end of the 1997 fiscal year, the LMCS reports are established as the sole official financial records of the Bank and that the use of PC-based spreadsheets to report loan activities are eliminated.

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

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. We consider the reportable condition listed above to be a material weakness. This condition was considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of the Bank for the year ended September 30, 1996.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of the Federal Financing Bank in a separate letter dated December 31, 1996.

This report is intended solely for the information and use of the Inspector General of the Department of Treasury, the Board of Directors and management of the Federal Financing Bank, and the Congress. However, this report is a matter of public record and its distribution is not limited.

Brown & Company

December 31, 1996
Arlington, Virginia

CERTIFIED PUBLIC ACCOUNTANTS
AND MANAGEMENT CONSULTANTS

BROWN & COMPANY

AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

The Inspector General,
U.S. Department of the Treasury
Washington, D.C

We have audited the financial statements of the Federal Financing Bank (the Bank) as of and for the year ended September 30, 1996, and have issued our report thereon dated December 31, 1996.

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

Compliance with laws and regulations applicable to the Bank is the responsibility of the Bank's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Bank's compliance with certain provisions of applicable laws and regulations. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

This report is intended solely for the information and use of the Inspector General of the Department of Treasury, the Board of Directors and management of the Federal Financing Bank, and the Congress. However, this report is a matter of public record and its distribution is not limited.

Brown & Company

December 31, 1996
Arlington, Virginia

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FEDERAL FINANCING BANK
STATEMENTS OF FINANCIAL POSITION
SEPTEMBER 30, 1996 and 1995
(in thousands)

	1996	1995
ASSETS		
Funds with U.S. Treasury	$ 338,123	$ 337,352
Loans receivable (Note 2)	62,257,790	84,496,056
Accrued interest receivable	1,599,898	2,273,517
Total assets	$ 64,195,811	$ 87,106,925
LIABILITIES AND ACCUMULATED DEFICIT		
Borrowings (Note 3)	$ 62,250,985	$ 84,489,525
Accrued interest payable	2,330,022	2,790,136
Debt prepayment premium payable (Note 5)	2,115,441	2,115,441
Other liabilities	882	135
Total liabilities	66,697,330	89,395,237
Accumulated deficit (Note 6)	(2,501,519)	(2,288,312)
Total liabilities and accumulated deficit	$ 64,195,811	$ 87,106,925

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

FEDERAL FINANCING BANK
STATEMENTS OF OPERATIONS AND ACCUMULATED DEFICIT
FOR THE FISCAL YEARS ENDED
SEPTEMBER 30, 1996 and 1995
(in thousands)

	1996	1995
Interest Income on loans	$ 6,562,243	$ 8,576,603
Interest Expense on borrowings	6,772,088	8,705,274
Net (loss)	(209,845)	(128,671)
Less: Administrative expenses	3,362	3,162
Net (loss)	(213,207)	(131,833)
Accumulated deficit-beginning of the year	(2,288,312)	(2,156,479)
Accumulated deficit-end of the year	$ (2,501,519)	$ (2,288,312)

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

FEDERAL FINANCING BANK
STATEMENTS OF CASH FLOWS
FOR THE FISCAL YEARS ENDED
SEPTEMBER 30, 1996 and 1995
(in thousands)

	1996	1995
CASH FLOWS FROM OPERATIONS		
Net income (loss)	$ (213,207)	$ (131,833)
Adjustments to reconcile net (loss) to net cash provided (used) by operating activities:		
Decrease in accounts receivable	0	1
Decrease in accrued interest receivable	673,619	96,543
Increase (decrease) in accrued interest payable	(460,114)	35,365
(Decrease) increase in other liabilities	747	(232)
Discount amortization	5	(1,212)
Net cash provided (used) by operations	1,050	(1,368)
CASH FLOWS FROM INVESTING ACTIVITIES		
Loan disbursements	(25,326,063)	(86,444,432)
Principal collections	39,712,399	111,504,149
Net cash provided by investing activities	14,386,336	25,059,717
CASH FLOWS FROM FINANCING ACTIVITIES		
Advances	25,326,063	86,444,420
Repayments of advances	(39,712,678)	(111,504,244)
Net cash used by financing activities	(14,386,615)	(25,059,824)
Net (decrease) increase in cash	771	(1,475)
Cash -- beginning of the year	337,352	338,827
Cash -- end of the year	$ 338,123	$ 337,352

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

FEDERAL FINANCING BANK
Notes to Financial Statements
September 30, 1996 and 1995

NOTE-1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Federal Financing Bank (the Bank) was created by the Federal Financing Bank Act of 1973 (12 USC 2281) as an instrumentality of the U. S. Government. Although originally created as an off-budget entity, the Bank was subsequently placed on-budget by Public Law 99-171. The Bank was established to assist and coordinate agency borrowing and guaranteed borrowing to reduce the cost to the federal government of some of its borrowing operations. The Bank has authority to purchase agency debts and guaranteed obligations from a federal agency and to finance these transactions by borrowing from the Treasury or the public.

Basis of Accounting

The financial statements are prepared in accordance with generally accepted accounting principles and, therefore, are presented on the accrual basis of accounting.

Funds with U.S. Treasury

As a federal government corporation, the Bank maintains a fund balance with the U.S. Treasury and does not hold cash. For the purposes of the Statement of Cash Flows, the funds with the U.S. Treasury are considered cash.

Debt Prepayment Premium

The nature of the Debt Prepayment Premium payable is discussed in detail in Note 5. The Debt Prepayment Premium is calculated as the difference between 1) the face amount of the Treasury borrowing being prepaid, which is the amount the Bank receives in prepayment proceeds, and 2) the present value of the expected future cash flows under the original terms, discounted at Treasury's rate at the prepayment date, which is the amount the Bank must pay to Treasury in order to prepay the debt.

Interest Rates on Loans

Except as discussed in Notes 2 and 5, the Bank's policy is to charge its borrowers an interest rate that is equivalent to one-eighth of one percent more than the rate Treasury would pay on a security having a comparable maturity and payment schedule, as estimated by Treasury. The income resulting from the one-eighth of one percent was designed to cover the Bank's administrative expenses and to provide equity.

Loan Servicing Fee

The Bank charges the Civil Service Retirement fund (CSRF) a fee to service the loans receivable of Tennessee Valley Authority (TVA) and United States Postal Service (USPS). The CSRF acquired the assets during an exchange of Treasury securities. The nature of the exchange is discussed in detail in Note 4.

NOTE-1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Allowances for Loan Losses

The Bank does not establish an allowance for loan losses because loan principal and interest are guaranteed by federal agencies and are backed by the full faith and credit of the U.S. Government. Direct loans to the Tennessee Valley Authority (TVA) and United States Postal Service (USPS) are exceptions since they are not guaranteed by the United States. However, loans receivable from TVA and USPS as of September 30, 1996 and 1995, were fully collectible; accordingly, no allowance for loan losses was recorded.

Related Parties

The Bank is subject to the general supervision and direction of the Secretary of the Treasury. As provided by law, the Secretary of the Treasury acts as Chairman of the Board of Directors. The Bank's management and accounting functions are performed by employees of Treasury's Departmental offices; and its legal counsel is the General Counsel of the Treasury. The Bank reimburses Treasury for facilities and services.

NOTE-2. LOANS RECEIVABLE

Loans receivable include agency loans purchased, direct loans to federal agencies and loans to nonfederal entities. Agency loans purchased are either notes or pools of loans sold by federal agencies in the form of certificates representing shares of ownership in the loan pool. The selling agencies guarantee the principal and interest repayments on the notes or certificates. Direct loans to federal agencies are debt securities issued to the Bank by agencies that are authorized by Congress to borrow to finance their activities. These include loans made to the Export-Import Bank of the U.S., the Tennessee Valley Authority, the Resolution Trust Corporation, and the U.S. Postal Service. Loans to nonfederal entities are loans made to nonfederal borrowers whose obligation to repay the principal and interest is guaranteed by a federal agency. Loans receivable consists of the following (dollars in millions):

Agency	September 30,	
	1996	1995
Agency Loans Purchased:		
Farmers Home Administration, USDA	$22,375	$26,845
Medical Facilities, Department of Health and Human Services (HHS)	19	24

NOTE-2. LOANS RECEIVABLE (CONTINUED)

Agency	September 30,	
	1996	1995
Agency Loans Purchased (Continued):		
Health Maintenance Organizations, HHS	6	9
Rural Utilities Service(RUS), USDA	4,599	4,599
Total Agency Loans Purchased:	26,999	31,477
Direct Loans to Federal Agencies:		
Export-Import Bank of the U.S.	1,822	2,506
Tennessee Valley Authority	0	3,200
Resolution Trust Corporation	5,996	13,208
U.S. Postal Service	1,500	7,265
Total Direct Loans to Federal Agencies:	9,318	26,179
Guarantors of Loans to Nonfederal Entities:		
Defense Security Assistance Agency	3,247	3,493
General Services Administration	2,544	2,466
Dept. of Housing and Urban Development (HUD) - Community Development Block Grant	40	89
HUD - Low Rent Public Housing	1,627	1,689
Dept. of Defense, Navy - Ship Leasing	1,383	1,432
U. S. Department of Agriculture - Rural Utilities Service	16,750	17,275
SBA - State/Local Development-503	318	356

NOTE-2. LOANS RECEIVABLE (CONTINUED)

Agency	September 30,	
	1996	1995
Guarantors of Loans to Nonfederal Entities (Continued):		
SBA - Small Business Investment Corporation	0	6
Department of Interior - Virgin Islands	20	21
DOT - Railways 511	9	10
DOT - Federal Railroad Administration,	4	4
Total Guarantors of Loans to Nonfederal Entities	25,942	26,841
Discount and Other	(1)	(1)
Total Loans Receivable (Net)	$ 62,258	$ 84,496

Title III of the Rural Electrification Act of 1936, as amended, allows Rural Utilities Service - RUS, to pay less interest to the Bank than stated in its contractual agreements, based on RUS's receipts from its borrowers. The Bank has no recourse against RUS and incurs a loss due to foregone interest because the Bank must pay the full amount of interest on its underlying borrowings to Treasury.

As a result of this policy, the Bank incurred foregone interest of $201.6 million and $140.5 million in fiscal years 1996 and 1995, respectively. The impact of this policy reduces the value of the RUS loans. Allowances, however, have not been recorded on the balance sheet as of September 30, 1996 and 1995, because the future impact of this policy cannot be predicted.

NOTE-3. BORROWINGS

The Bank finances its loan portfolio primarily by borrowing from the Treasury. Under the Federal Financing Bank Act of 1973, the Bank may, with the approval of the Secretary of the Treasury, borrow without limit from the U.S. Treasury. At September 30, 1996, the Bank

NOTE-3. BORROWINGS (CONTINUED)

had outstanding advances owed to Treasury of $47.3 billion with interest rates ranging from 4.420 percent to 16.421 percent and maturity dates from October 1, 1996 to January 3, 2028.

Additionally, at September 30, 1996 and 1995, the Bank had outstanding borrowings of $15.0 billion from the Civil Service Trust Fund, which is administered by the Office of Personnel Management. These borrowings are at interest rates ranging from 8.75 percent to 9.25 percent with maturity dates ranging from June 30, 2003 to June 30, 2005.

Scheduled principal repayments of long term debt as of September 30, 1996, assuming no changes in terms, are as follows (dollars in billions):

Year ending September 30,	Amount
1997	$ 11.3
1998	4.8
1999	3.8
2000	2.4
2001	1.3
2002-2028	38.7
Total	$ 62.3

NOTE-4. EXCHANGE OF ASSETS

In February 1996, the Bank exchanged $7.8 billion of its loans receivable portfolio (TVA and USPS) with the Civil Service Retirement Fund (CSRF) for an equivalent amount of Treasury securities. The securities were simultaneously transferred to the Secretary of Treasury to reduce the outstanding borrowings. The exchange was initiated to allow Treasury to fulfill its financial obligations without increasing the statutory debt limit.

NOTE-5. DEBT PREPAYMENT PREMIUM PAYABLE

It is the Bank's policy to liquidate its borrowings with Treasury at the same time as loans receivable financed by those borrowings are liquidated. To avoid unusual gains or losses, the Bank's normal policy is to match the maturity and, except for a one-eighth of one percent spread, the interest rate on its loans receivable with those of its borrowings. In addition, for most of its loans, premiums or discounts resulting from loan prepayments are equivalent to

NOTE-5. DEBT PREPAYMENT PREMIUM PAYABLE (CONTINUED)

the premiums or discounts the Bank paid or received when it simultaneously prepaid its Treasury borrowings. Premiums or discounts arise to the extent market interest rates at the prepayment date differ from rates stated in the loan agreements. The effect of these policies is to mitigate the Bank's risk from interest rate fluctuations.

However, Congress authorized certain borrowers having loans guaranteed by RUS to prepay their loans at par (outstanding balance) rather than market value up to a specified dollar limit. Further, legislation also authorized borrowers in the foreign military sales program guaranteed by Defense Security Assistance Agency (DSAA) to prepay at par, certain loans meeting specific criteria. The effect of these statutes was to waive payment of premiums to the Bank, which would otherwise have resulted from the fact that interest rates at the dates of prepayment were less than the rates in the loan agreements. Because the Bank's agreement with Treasury required it to simultaneously liquidate the funds it borrowed to finance these loans, and to pay a premium in doing so, notwithstanding the fact that the borrowers' premiums were waived, the Bank suffered losses. Because these losses have exceeded the available funds, the Bank's debt prepayment premium payable for both fiscal years 1996 and 1995, was $2,115 million. While the Bank has been able to make payments against the debt prepayment premium payable, it also has to pay the interest accruing on the liability.

There were no debt prepayments in fiscal years 1996 and 1995. However, the Bank incurred interest expenses of $108 million and $114 million in fiscal years 1996 and 1995, respectively on outstanding debt prepayment premium payable. These interest expenses have been recorded as a charge against current operations in the statements of operations. The cumulative cost incurred by the Bank as a result of these legislations is $2,774 million through September 30, 1996.

NOTE-6. ACCUMULATED DEFICIT

Due to the legislations pertaining to loan prepayments by RUS and DSAA, the Bank has incurred losses amounting to $108 million for 1996 and $114 million for 1995. The recurring accumulated deficits incurred by the Bank are due to these losses and losses incurred by the Bank on foregone interest under the provisions of the Title III of the Rural Electrification Act of 1936, as described in Note 2. Currently, the Bank is earning interest from borrowers equivalent to one-eighth of one percent more than the rate that is due Treasury on a particular security. It is unlikely that the net interest earnings at the current spread will be sufficient to liquidate the liabilities resulting from the accumulated deficit. Therefore, the Bank will likely require Congressional appropriations or an increased interest rate spread, or some combination thereof, to finance its deficit.

NOTE-7. FAIR VALUE OF FINANCIAL INSTRUMENTS

Funds with U.S. Treasury

The carrying amount approximates fair value because of the liquid nature of the Funds with Treasury.

Loans Receivable and Borrowings

It is not practicable to estimate the fair value of loans receivable or borrowings because the future cash flows are susceptible to Congressional acts and certain provisions of existing laws which could result in additional prepayment premiums, or waivers of interest, or adjustments to the interest rate spread on borrowings, or Congressional appropriations, or some combination thereof. In addition, there are no quotes for loans receivable or borrowings with the same maturities or other characteristics.

Accrued Interest Receivable, Accounts Receivable, Accrued Interest Payable, Other Liabilities

These assets and liabilities are stated on the statement of financial position at the amount expected to be realized or paid.

Debt Prepayment Premium

The Debt Prepayment Premium represents a liability to Treasury under an indefinite borrowing agreement. There are no specified repayment terms and the interest rate is fixed at the prepayment date. For the purposes of estimating its fair value, it has been treated as payable on demand and is considered to be stated on the statements of financial position at its fair value.

NOTE-8. COMMITMENTS AND CONTINGENCIES

As discussed fully in Note 2, all of the Bank's loans are to federal agencies, quasi federal entities, or to private sector borrowers whose loans are guaranteed by a federal agency. When an agency has to honor its guarantee because a borrower defaults, that agency must obtain an appropriation or use other resources to pay the Bank. However, if an appropriation is not granted or federal agencies are not allowed to fund the losses by borrowing from the Treasury, and the Bank is legislatively required to write-off the debt the agency owes it, the Bank would incur a loss. Since the Bank is unable to estimate the amounts of the probable losses which might result from default, no charge for contingencies against fiscal year 1996 income has been recorded.

In the normal course of business, there are various commitments (such as commitments to purchase agency loans and commitments to extend credit to quasi federal entities and nonfederal entities) which are properly not recorded in the financial statements. In the opinion

NOTE-8. COMMITMENTS AND CONTINGENCIES (CONTINUED)

of management, these do not represent unusual risks. As of September 30, 1996 and 1995, there were $64.1 billion and $86.4 billion, respectively, of loan commitments.