

FEDERAL FINANCING BANK
1993 FINANCIAL STATEMENTS
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Price Waterhouse



REPORT OF INDEPENDENT ACCOUNTANTS

To the Inspector General of the Department of Treasury
and Board of Directors of the Federal Financing Bank

We have audited the accompanying statement of financial position of the Federal Financing Bank (the Bank) as of September 30, 1993 and the related statements of operations and accumulated deficit, and of cash flows for the year 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 audit. The financial statements of the Bank for the year ended September 30, 1992 were audited by another independent accountant whose report dated March 31, 1993, expressed an unqualified opinion on those financial statements.

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

In our opinion, the financial statements audited by us present fairly, in all material respects, the financial position of the Bank at September 30, 1993, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

In recent years, Congress has authorized certain 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. Premiums are frequently paid by borrowers to lenders when, upon prepayment, market interest rates are less than those stated in the loan agreements. Because the Bank is required to simultaneously liquidate the funds it borrowed from Treasury to finance these loans, and is required to pay a prepayment premium in doing so, notwithstanding the fact the borrowers'



premium was waived, the Bank has suffered losses, and has accumulated a deficit of \$2.1 billion as of September 30, 1993. It is unlikely that the Bank's net interest income at its current spread 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 thereof, to finance its deficit.

Price Waterhouse

March 25, 1994
Washington, D.C.

Price Waterhouse



REPORT ON INTERNAL CONTROL STRUCTURE

March 25, 1994

To the Inspector General of the Department of Treasury
and the Board of Directors of the Federal Financing Bank

We have audited the financial statements of the Federal Financing Bank (the Bank) as of and for the year ended September 30, 1993, and have issued our report thereon dated March 25, 1994.

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

In planning and performing our audit of the financial statements of the Bank for the year ended September 30, 1993, we considered its 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 reasonable assurance on the internal control structure.

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.



For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories:

- General ledger and financial reporting
- Loans, interest income, and interest receivable
- Borrowings, interest expense, and interest payable
- Debt Prepayment Premium
- Administrative expenses

For all of the internal control structure categories listed above, we obtained an understanding of the design of the relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

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

1. The Federal Financing Bank lacks an effective core financial accounting system, and;
2. The Federal Financing Bank lacks an organization structure which promotes accountability and empowers managers to take action on correcting weaknesses.

A material weakness is a 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. We consider the two reportable conditions above to be material weaknesses. Our discussion of these material weaknesses forms the remainder of this report.

* * * * *



Finding 1: The Federal Financing Bank lacks an effective core financial accounting system.

Treasury's Financial Management Service is currently implementing an integrated financial accounting system for the Federal Financing Bank. Once fully implemented, the Loan Management Control System (LMCS), a mainframe system, will serve as the Bank's subsidiary ledger for loans and borrowings, and will calculate and accrue interest income and expense. The LMCS also will have full general ledger capability. At present, programming for the loans and borrowing modules is complete, and they can now calculate interest income, expense, and accruals. The general ledger application has not yet been fully programmed.

Although the subsidiary ledgers have been programmed, initial loading of information into them for all borrowers has not been completed, nor has the new information been reconciled to information contained in the Bank's spreadsheet-based system. Such a reconciliation is important because several agencies' loan balances show material differences between the previous, non-integrated records and LMCS; and for two agencies, loans are reported in summary only, and the detailed loan records have never been maintained by the Bank.

Because the data in LMCS does not reconcile to the data in the Credit Accounting Branch's spreadsheet records, and because the general ledger application is not complete, the Credit Accounting Branch does not use LMCS as its core accounting system. Instead, the Credit Accounting Branch maintains its own subsidiary ledgers in both PC-based spreadsheet and manual form, and uses manual journal vouchers to record information in the general ledger which is maintained on PC-based software. In effect, the Credit Accounting Branch duplicates every existing accounting function that LMCS does, including processing all payment information, not only in manual form but also, in some cases, automated spreadsheet format.

In June, 1993, the Bank's Administration branch made an effort to reconcile loan information in the general ledger to LMCS, and identified some differences. However, the remaining differences have not yet been fully resolved. For example, there is no effort underway to capture, in LMCS, the underlying detail regarding the loans for which the Bank maintains only agency totals instead of information for individual loans. Progress on completing the new general ledger system has been slow.



The problems in fully implementing the new system have several effects:

- Resources are being expended unnecessarily in maintaining duplicate sets of records, especially when each receipt is being recorded in a manual ledger, in addition to posting in LMCS.
- The control and management function is diminished because the spreadsheet environment takes substantially more effort to control and manually reconcile to cash records than the integrated system which automatically reconciles subsidiary ledgers to the general ledger.
- Relations between the Administration department and the Credit Accounting Branch are strained because of unclear direction for corrective action.

Clearly, the implementation of LMCS needs to be placed back on track. The recommendation which follows addresses the need to energize this effort. In a related second material weakness below, we address the related organizational and communication weaknesses that compound the system's weaknesses.

Recommendation:

We recommend that the President of the Bank take the following steps:

1. Task the management of the Bank with implementing LMCS as its core financial system, and terminating reliance on spreadsheet records, by an established deadline. We suggest September, 1994 for the implementation of LMCS as the subsidiary ledger for loans, borrowings, interest receivable, income, payable and expense; and September, 1995 for implementation of an integrated general ledger. It may be possible to implement the subsidiary ledger functions gradually before September 1994, one borrower at a time, once the balances have been reconciled for each borrower.
2. Ensure that the Bank's task force for implementation completes the following steps:
 - **Reconciliation of LMCS to non-integrated spreadsheets.** The reconciliation effort should identify at the specific loan level, the items which are different between LMCS and the spreadsheets. A hurdle to entering some loans to LMCS is the lack of supporting documentation. However, documented or not, cash flows relating to those loans are



being received, and the system will never integrate with Treasury's receipts records if those loans are not captured in LMCS. They may be flagged as undocumented loans in the system if necessary. The objective is to reflect all loans and related liabilities in the system. Once the differences have been identified at the loan level, they should be promptly resolved by the following steps 1) Research original documentation; 2) Compare actual interest/principal receipts to expected receipts; and 3) Confirm all loan balances with the related agency.

Secondly, loans where only agency totals exist must be addressed. Solutions include:

- Coordination with the related agency to download information from their systems into LMCS. The data should be "scrubbed" first, to format it for LMCS, and to identify problems with the data such as no-name accounts, missing fields, "plug" accounts or negative accounts.
- If for some reason downloading is not an option, for example if the borrowing agency only maintains manual records, then consider obtaining the manual records and entering the data in the LMCS, once again "scrubbing" the data as you go.
- If the data does not exist at the agency level either, the only option is to enter the loan balance in total at a weighted average interest rate, and account for differences in expected interest receipts on a monthly basis via journal vouchers.

The reconciliation effort will not yield a perfect result. There will be no-name accounts, accounts with fields missing such as termination or origination date, and other remaining unidentified differences with the borrowing agencies. These should not be allowed to hamper the reconciliation and integration effort and should not be permitted to absorb significant amounts of effort either in the implementation process or on a regular ongoing basis. The task force should define its plan of action for remaining unknowns:

- Agree on "guesses" for missing data such as dates, borrower name, etc. Document the decision and enter the guess in the system.



- Determine how much time will be spent further tracking an item, based on its materiality. At the end of the allotted time, the reconciler reports the efforts undertaken to the reconciliation task force. The task force makes a decision to make the change to LMCS and documents that decision.

At the end of the reconciliation effort, all of the Bank's outstanding loans will be in the system. This will be evidenced by the fact that pre-calculated interest receipts are in fact collected.

- **Switch-over to using the LMCS for revenue, expense, and accrual entries.** Once the LMCS is reconciled to non-integrated systems for each borrower, the switch to using it for revenue, expense and accrual entries should be simple. Credit Accounting Branch should run parallel to LMCS for one or two months using its spreadsheet application to ensure confidence in the LMCS data, then switch off the spreadsheet applications for calculating data.
- **Determine all the reasons why the Credit Accounting Branch believes it needs to maintain spreadsheet records.** It is certainly easy to work with data and perform analyses when the accountant has all the data needed in a simple spreadsheet, rather than having to rely on inquiry-only access to a mainframe system. The users of LMCS should identify all the reasons they may need a spreadsheet, and ensure that this functionality is readily available by on-line inquiry to LMCS, through a menu driven screen. The alternative approach of having convenient downloading access to LMCS, whereby accountants can easily obtain current information in spreadsheet software, should be explored -- but with a warning not to duplicate effort again. Ideally, LMCS should automatically produce all the information needed by the Bank to perform adequate accounting and control.
- **Complete development -- or acquisition -- of the general ledger application and integrate it with all other aspects of LMCS.** It is important that Credit Accounting Branch review all the journal entries to the general ledger for the past two or three years and ensure that the entries can easily be accomplished by the LMCS general ledger application. Once management is confident that the general ledger application is functioning properly, switch off the PC-based application.



- **Ensure that relevant management and control reports are produced by the system.** Examples of management and control reports needed include the following:
 - Expected versus actual receipts by loan
 - New loans issued, loans terminated each month
 - Prepayment of loans
 - Monthly financial statements showing comparison to last year/month and to budget

The strategic plan should give an estimate of the resources expected to be spent on the effort, and be broken down into small, interim steps so that the tasks become manageable. The task force should meet as necessary and at least monthly.

3. The President should make a clear statement of commitment and expectation that LMCS will be implemented. The Bank's loan records should be reconciled to LMCS and LMCS implemented as the Bank's subsidiary ledger by September, 1994, and the subsidiary ledger should be fully integrated with a general ledger by September, 1995.

* * * * *



Finding 2: The Federal Financing Bank lacks an organization structure which promotes accountability and empowers managers to take action on correcting weaknesses.

At present, the Bank is organizationally fragmented. The Manager of the Credit Accounting Branch, who is responsible for maintaining key accounting records and preparing the Bank's financial statements, has no direct communications with the Bank's President. Any communications with the Bank's President, Secretary, or Treasurer must go through several other individuals, none of whom are assigned responsibility for the Bank. The Manager of Administration for the Bank, who is responsible for maintaining key information, does report to the Bank's President but has no other Bank personnel reporting to him. Further, communications between the Credit Accounting Branch and Administration is extremely strained and unproductive.

The weaknesses that have manifested as a result of this situation include:

- A lack of a fully coordinated effort to complete the LMCS, and fully reconcile information between the old and new systems. The lack of an integrated system such as LMCS causes Credit Accounting Branch staff to keep separate spreadsheet and manual records for information they should be obtaining from LMCS. They also recalculate considerable amounts of information that they should be able to access LMCS to obtain. In addition, they manually record all information in a general ledger application, including all payment information, in addition to using LMCS.
- Administration staff and Credit Accounting Branch having differing opinions about the accuracy of the financial information. For example, Administration's personnel place reliance on LMCS and not the PC-based general ledger, while Credit Accounting Branch personnel continue to rely on the PC-based general ledger application until the LMCS subsidiary ledger is fully integrated to the LMCS general ledger.
- Decreased day-to-day effectiveness of all of the Bank's managers -- Administration and Credit Accounting -- because of poor relationships between the two offices, as well as the absence of a fully integrated system.



Recommendation:

We recommend that the President of the Bank, along with the Secretary and the Treasurer, empower one individual within the Bank with the responsibility and authority to implement an integrated financial system for the Bank. This will require that both Administration and the Credit Accounting Branch report *directly* to this individual. We also recommend that the roles of the offices of the Bank be streamlined.

A good benchmark for an efficient organization structure is the one used by many commercial banks. The credit administration function -- daily, routine processing of information to LMCS -- should be performed by Administration. This would include:

- verifying adequate documentation and inputting new loans and corresponding borrowings
- accessing current applicable interest rates on the effective dates
- ensuring that accrual routines are functioning
- the calculation of Debt Prepayment Premium and processing to LMCS

The function of the Credit Accounting Branch should be streamlined to: 1) management and internal controls over the information in LMCS; 2) maintenance of the general ledger in accordance with generally accepted accounting principles; 3) preparing the standard Treasury financial reports; and 4) preparation of management and year-end financial reports. Credit Accounting Branch's functions would include the following:

- Ensuring appropriate cut-off of accrual and income transactions
- Ensuring proper posting of non-standard entries which would include recording debt prepayment premium and interest credit entries
- Reconciling cash transactions in the Treasury account
- Following up on a timely basis any interest not received or overdue principal
- Approving and processing any adjusting journal vouchers to the general ledger



- Preparing the standard Treasury financial reports
- Initiating and coordinating the research of issues affecting disclosures necessary for the financial statements. In most cases, these require merely an information request from LMCS programmers, and in other cases, such as determining the future possible impact of new policies such as the debt prepayment premium or the interest credit program, they are multi-faceted tasks requiring the input of Legal Counsel, Treasury management, and others.
- Preparing monthly management reports for executive management meetings.
- Preparing the year-end financial statements
- Management and resolution of any other weaknesses as they arise.

* * * * *



Status of prior year's material weaknesses

The following material weaknesses were reported to the Federal Financing Bank by another independent auditor in a report dated March 31, 1993:

| MATERIAL WEAKNESS | | CURRENT STATUS |
|-------------------|---|---|
| 1 | Cash transactions were recorded in the general ledger more than 30 days after the transaction had occurred. | This condition still exists. The reason cited for the delay is that cash transactions are posted to Credit Accounting Branch's spreadsheet records in batch mode once a month. We consider this condition to be an example of inefficiencies caused by not having an efficient accounting system. Once the integrated system is fully implemented, as noted in recommendation 1 above, accounts can be updated daily. |
| 2 | A subsidiary is not maintained for Small Business Administration/Local Development Corporation (SBA/LDC) loans. | This weakness still exists. This is one of the reasons why LMCS is not ready to be utilized as a core accounting system. Our recommendations regarding this weakness are addressed in recommendation 1 above. |
| 3 | A subsidiary ledger in an acceptable format is not maintained for debt owed to Treasury. | The borrowings subsidiary ledger and the loans subsidiary ledger are one and the same thing. It would be redundant to duplicate the loans system to create a borrowings system. This weakness exists, however, because the loans system is not yet operational, as we discussed in recommendation 1 above. |
| 4 | Subsidiary ledgers and commitment ledgers are not adequately maintained. | This weakness relates to the lack of reconciliation of data in the spreadsheet applications to the general ledger. This condition still exists and must be resolved by implementing LMCS as the Bank's core accounting system, as recommended in 1 above. |

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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.

In addition to the material weaknesses we identified, we noted certain matters involving the internal control structure and its operation that we have reported to the management of the Bank in a separate letter.

This report is intended for the information of the Office of Inspector General and 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.

Price Waterhouse

March 25, 1994
Washington, D.C.

Price Waterhouse



REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

To the Inspector General of the Department of Treasury
and the Board of Directors of the Federal Financing Bank

We have audited the financial statements of the Federal Financing Bank (the Bank) as of and for the year ended September 30, 1993, and have issued our report thereon dated March 25, 1994.

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

Compliance with laws and regulations applicable to 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 examination of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires that the head of each agency reports annually to the President of the United States and the Congress that the agency's systems of internal accounting and administrative control fully comply with internal control standards established by the U.S. Office of Management and Budget. Alternatively, the agency must report any material weaknesses in the agency's systems of internal accounting and administrative control, along with plans and a schedule for correcting such weaknesses. The passage of the Chief Financial Officers Act of 1990 made these requirements applicable to the Bank. In our report on the Bank's internal control structure dated March 25, 1994, we identified two material weaknesses. These material weaknesses were not reported in the Bank's most recent FMFIA report dated December 22, 1992.



Except for the condition stated in the fourth paragraph above, the results of our tests indicate that, with respect to the items tested, the Bank complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the Bank had not complied, in all material respects, with those provisions.

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

Price Waterhouse

March 25, 1994
Washington, D.C.

FEDERAL FINANCING BANK
 STATEMENT OF FINANCIAL POSITION
 AS OF SEPTEMBER 30, 1993 and 1992
 (in thousands)

| | 1993 | 1992 |
|--|----------------------|----------------------|
| ASSETS | | |
| Funds with U.S. Treasury | \$338,125 | \$338,165 |
| Loans receivable - net (Note 2) | 129,430,651 | 164,503,561 |
| Accrued interest receivable | 2,794,094 | 3,345,220 |
| Accounts receivable | 8 | 418 |
| Total assets | \$132,562,878 | \$168,187,364 |
| LIABILITIES AND ACCUMULATED DEFICIT | | |
| Borrowings (Note 3) | \$129,426,116 | \$164,499,353 |
| Accrued interest payable | 3,118,583 | 3,630,696 |
| Debt prepayment premium (Note 4) | 2,074,429 | 2,062,779 |
| Other liabilities | 313 | 2,900 |
| Total liabilities | 134,619,441 | 170,195,728 |
| Accumulated deficit | (2,056,563) | (2,008,364) |
| Total liabilities and accumulated deficit | \$132,562,878 | \$168,187,364 |

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

FEDERAL FINANCING BANK
 STATEMENT OF OPERATIONS AND ACCUMULATED DEFICIT
 FOR THE YEARS ENDED SEPTEMBER 30, 1993 and 1992
 (in thousands)

| | 1993 | 1992 |
|--|---------------|---------------|
| Interest on loans | \$11,349,539 | \$14,696,128 |
| Interest on borrowings | (11,246,969) | (14,503,760) |
| Net interest income | 102,570 | 192,368 |
| Administrative expenses | (2,316) | (2,496) |
| Net income before extraordinary item | 100,254 | 189,872 |
| Extraordinary loss on Debt prepayment premium | (148,453) | (86,717) |
| Net (loss) income | (48,199) | 103,155 |
| Accumulated deficit - beginning of the year | (2,008,364) | (2,111,583) |
| Prior period adjustment | 0 | 64 |
| Accumulated deficit - end of the year | (\$2,056,563) | (\$2,008,364) |

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

FEDERAL FINANCING BANK
STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED
SEPTEMBER 30, 1993 AND 1992
(in thousands)

| | 1993 | 1992 |
|--|---------------|---------------|
| CASH FLOWS FROM OPERATIONS | | |
| Net (loss) income | (\$48,199) | \$103,155 |
| Adjustments to reconcile net (loss) income to net cash provided: | | |
| Prior period adjustment | | 64 |
| Discount amortization | (2,129) | (634) |
| Decrease in accounts receivable | 410 | 0 |
| Decrease in accrued interest receivable | 551,126 | 1,027,848 |
| (Decrease) in accrued interest payable | (512,113) | (1,017,626) |
| Increase (decrease) in debt prepayment premium | 11,650 | (42,955) |
| (Decrease) increase in other liabilities | (2,587) | 2,151 |
| Net cash (used in) provided by operations | (1,842) | 72,003 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Loan disbursements | (188,796,383) | (358,280,103) |
| Principal collections | 223,891,358 | 388,080,666 |
| Net cash provided by investing activities | 35,094,975 | 29,800,563 |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Advances | 188,796,383 | 358,277,887 |
| Repayments of advances | (223,889,556) | (388,152,180) |
| Net cash used in financing activities | (35,093,173) | (29,874,293) |
| Net decrease in cash | (\$40) | (\$1,727) |
| Cash - beginning of the year | \$338,165 | \$339,892 |
| Cash - end of the year | \$338,125 | \$338,165 |

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

FEDERAL FINANCING BANK
Notes to the Financial Statements
September 30, 1993 and 1992

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 is discussed in detail in Note 4. 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 4, 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.

FEDERAL FINANCING BANK
Notes to the Financial Statements
September 30, 1993 and 1992

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, no allowance for loan losses was required for TVA and USPS as of September 30, 1993.

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 functions are performed by employees of Treasury's Departmental offices; its legal counsel is Treasury's General Counsel; and, its accounting operations are conducted by Treasury's Financial Management Service (FMS). The Bank reimburses Treasury for facilities and services. As stated in Note 8, the U.S. Office of Personnel Management administers and is liable for the Bank's employee benefit programs.

2. LOANS RECEIVABLE

Loans receivable include agency loans purchased, direct loans to agencies, and loans to nonfederal entities, the repayment of which is guaranteed by another federal agency. 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 agencies are debt securities issued to the Bank by agencies that are authorized by Congress to borrow to finance their activities.

FEDERAL FINANCING BANK
Notes to the Financial Statements
September 30, 1993 and 1992

2. LOANS RECEIVABLE (CONTINUED)

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, | |
|---|---------------|---------------|
| | <u>1993</u> | <u>1992</u> |
| <u>Agency Loans Purchased:</u> | | |
| Farmers Home Administration | \$38,619 | \$42,979 |
| Medical Facilities, Department of Health and Human Services (HHS) | 54 | 69 |
| Less: Unamortized Discount | (3) | (5) |
| Health Maintenance Organizations, HHS | 33 | 60 |
| Rural Electrification Administration (REA) | 4,599 | 4,599 |
| Small Business Administration - Local Development Companies (SBA-LDC) | 3 | 5 |
| Total Agency Loans Purchased: | 43,305 | 47,707 |
| <u>Direct Loans to Agencies:</u> | | |
| Export-Import Bank of the U.S. | 5,795 | 7,692 |
| Tennessee Valley Authority | 6,325 | 7,175 |
| Resolution Trust Corporation | 31,688 | 46,535 |
| Federal Deposit Insurance Corporation | 0 | 10,160 |
| U.S. Postal Service | 9,731 | 9,903 |
| Total Direct Loans to Agencies | 53,539 | 81,465 |

FEDERAL FINANCING BANK
Notes to the Financial Statements
September 30, 1993 and 1992

2. LOANS RECEIVABLE (CONTINUED)

| Agency | September 30, | |
|---|------------------|------------------|
| <u>Guaranteed Loans to Nonfederal Entities:</u> | <u>1993</u> | <u>1992</u> |
| Foreign Governments, Defense Security Assistance Agency | 4,083 | 4,344 |
| General Services Administration | 1,586 | 774 |
| Plus: Capitalized Interest | 102 | 82 |
| Guam Power Authority, Department of Interior | 0 | 27 |
| Community Development Block Grants, Department of Housing and Urban Development (HUD) | 131 | 174 |
| Low Rent Public Housing, HUD | 1,801 | 1,853 |
| Ship Leasing, Department of Defense, Navy | 1,528 | 1,576 |
| Rural Utilities, REA | 17,653 | 18,142 |
| State/Local Development-503, SBA | 576 | 634 |
| Small Business Investment Corporation, SBA | 90 | 143 |
| Seven States Energy Corporation, Tennessee Valley Authority | 0 | 2,417 |
| Student Loan Marketing Association, Department of Education | 4,790 | 4,820 |
| Virgin Islands, Department of Interior | 23 | 24 |
| Washington Metro Area Transit Authority, Department of Transportation (DOT) | 177 | 177 |
| Railways 511, DOT | 17 | 19 |
| Rhode Island Depositors Economic Protection Corporation, Department of Treasury | 30 | 125 |
| Total Guaranteed Loans to Nonfederal Entities | 32,587 | 35,331 |
| Total Loans Receivable | \$129,431 | \$164,503 |

Congress enacted laws allowing the Rural Electrification Administration (REA) to pay less interest to the Bank than stated in its contractual agreements, based on REA's receipts from its borrowers. The Bank has no recourse against REA and must absorb the cost of this foregone interest, because the Bank must pay the full amount of interest on its underlying borrowings to Treasury.

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2. LOANS RECEIVABLE (CONTINUED)

As a result of this policy, the Bank incurred foregone interest of \$80.3 million in fiscal year 1993, which was the first year of this policy. The impact of this policy reduces the value of the REA loans; however, an allowance has not been recorded on the balance sheet as of September 30, 1993 because the future impact of this policy can not be predicted. Based on the shortfall in interest income in fiscal year 1993, the face value of the related loans of \$22,252 million would be written down by an allowance of approximately \$830 million, if the shortfall were to continue in the future in the same proportion as in fiscal year 1993.

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, 1993, the Bank had outstanding advances owed to Treasury of \$114.3 billion, with interest rates ranging from 2.881 percent to 16.305 percent, and maturity dates from October 1, 1993 to September 30, 2026.

Additionally, 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, and with maturity dates ranging from June 30, 2003 to June 30, 2005.

At September 30, 1993, principal installments due on borrowings are as follows (in billions):

| Fiscal Year | Amount |
|-------------|---------|
| 1994 | \$38.7 |
| 1995 | 9.7 |
| 1996 | 11.8 |
| 1997 | 6.6 |
| 1998 | 6.9 |
| 1999-2026 | 55.7 |
| Total | \$129.4 |

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3. BORROWINGS (CONTINUED)

Payments due on borrowings are paid when principal collections on loans receivable are received. To the extent such loan proceeds are not sufficient to repay the debt, the Bank utilizes accumulated earnings received on loans. If accumulated earnings are not sufficient to repay the debt, the Bank can continue to operate using its unlimited borrowing authority with Treasury. However, borrowings to finance accumulated deficits will have to be eventually repaid either by raising the interest spread or through appropriations. The amount of interest paid in fiscal years 1993 and 1992 was \$11.9 billion and \$15.5 billion, respectively.

4. DEBT PREPAYMENT PREMIUM

Under the terms of its master promissory note with Treasury, the Bank must 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 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 the Rural Electrification Administration (REA) 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 the 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. The Bank incurred costs of \$148 million and \$87 million in fiscal years 1993 and 1992, respectively, as a result of prepayments under these statutes. These costs have been recorded as extraordinary losses in the Statement of Operations. The cumulative cost incurred by the Bank as a result of this legislation is \$2,506,269,509 through September 30, 1993.

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5. COMMITMENTS AND CONTINGENCIES

Almost all of the Bank's loans are to federal agencies 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 absorb 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 1993 income has been recorded.

As of September 30, 1993 and 1992 there were \$131.4 billion and \$166.5 billion, respectively, of loan commitments.

6. ACCUMULATED DEFICIT

The liability for the principal amount of loan prepayments as described in Note 4 above was \$2,069,368,220 and \$2,057,195,943 respectively for fiscal years 1993 and 1992. Due to the legislation pertaining to loan prepayments by the Rural Electrification Administration (REA) and the Defense Security Assistance Agency (DSAA), the Bank has incurred losses amounting to \$148,453,170 for 1993 and \$86,717,628 for 1992. The recurring accumulated deficits incurred by the Bank are due to these losses. While the Bank has been able to make payments against the debt prepayment liability, it also had to pay the interest accruing on the liability. 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.

7. PRIOR PERIOD ADJUSTMENTS

Prior period adjustments of \$64,000 were made for the year ended September 30, 1992, for previously unrecorded capitalized interest on GSA loan programs, Foley Court, Foley Square, and Foley Office Building.

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8. PENSIONS AND ACCRUED ANNUAL LEAVE

Virtually all of the employees whose salary cost is allocated to the Bank by Treasury are covered by either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). For CSRS employees, Treasury withholds a portion of their base earnings. The employees' contributions are then matched by Treasury and the sum is transferred to the Civil Service Retirement Fund, from which the CSRS employees will receive retirement benefits. For FERS employees, Treasury withholds, in addition to social security withholdings, a portion of their base earnings. Treasury contributes an amount proportional to the employees' base earnings towards retirement, and in addition a scaled amount towards each individual FERS employee's Thrift Savings Plan, depending upon his/her level of savings. The FERS employees will receive retirement benefits from the Federal Employees Retirement System, Social Security System and the Thrift Savings Plan deposits that have accumulated in their accounts.

Although Treasury funds a portion of pension benefits under the Civil Service and Federal Employees Retirement Systems relating to its employees and makes the necessary payroll withholdings from them, it has no liability for future payments to employees under these programs and does not account for the assets of the Civil Service and Federal Employees Retirement Systems nor does it have actuarial data with respect to accumulated plan benefits or the unfunded pension liability relative to its employees. These amounts are reported by the Office of Personnel Management (OPM) for the Retirement Systems and are not allocated to the individual employers. OPM also accounts for health and life insurance programs for retired civilian federal employees. Similar to the accounting treatment afforded the retirement programs, the actuarial data related to the health and life insurance programs is maintained by OPM and is not available on an individual employer basis.

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9. FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated values of each class of financial instrument for which it is practicable to estimate a fair value at September 30, 1993 are as follows (dollars in thousands);

| As of September 30, 1993 | Carrying Value | Fair Value |
|-----------------------------|----------------|---------------|
| Funds with U.S. Treasury | \$338,125 | \$338,125 |
| Loans receivable-net | 129,430,651 | 154,702,436 |
| Accrued interest receivable | 2,794,094 | 2,794,094 |
| Accounts receivable | 8 | 8 |
| Borrowings | (129,426,116) | (154,244,020) |
| Accrued interest payable | (3,118,583) | (3,118,583) |
| Debt prepayment premium | (2,074,429) | (2,074,429) |
| Other liabilities | (313) | (313) |

The methods and assumptions used to estimate the fair value of each class of financial instrument are described below.

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

The fair value of Loans Receivable is estimated by discounting the future cash flows using the September 30, 1993 rates at which similar loans would be made to borrowers for the same remaining maturities. The fair value of borrowings is estimated using the same calculation as the fair value of loans using the borrowing rate which is one eighth of one percent lower than the lending rate. The effects of any future policy changes to permit additional prepayment premiums or waivers of interest have not been considered in estimating fair value.

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

These assets and liabilities are stated on the balance sheet at the amount expected to be realized or paid.

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9. FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

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 balance sheet at its fair value.