USDA

U.S. Department of Agriculture
Office of Inspector General
Financial and IT Operations
Audit Report

Rural Development
Financial Statements
For Fiscal Year 2002

Report No.
85401-5-FM
January 2003

USDA

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250

DATE: JAN 10 2003

REPLY TO
ATTN OF: 85401-5-FM

SUBJECT: Rural Development Financial Statements for Fiscal Year 2002

TO: Thomas C. Dorr
Under Secretary
for Rural Development

ATTN: Sherie Hinton Henry
Director
Financial Management Division

This report presents the results of our audit of the Rural Development's financial statements for fiscal year ended September 30, 2002. It also contains the results of our assessment of Rural Development's internal control structure and compliance with laws and regulations.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective action taken or planned, including the timeframes, on the recommendation without management decision. Please note that the regulation requires a management decision be reached on all findings and recommendations within a maximum of 6 months from report issuance.

We appreciate the courtesies and cooperation extended ~~to us during the audit.~~

Richard D. Long

RICHARD D. LONG
Assistant Inspector General
for Audit

EXECUTIVE SUMMARY

U.S. DEPARTMENT OF AGRICULTURE
RURAL DEVELOPMENT
FINANCIAL STATEMENTS
FOR FISCAL YEAR 2002

AUDIT REPORT NO. 85401-5-FM

PURPOSE

Our audit objectives were to determine if (1) the financial statements present fairly, in all material respects, in accordance with generally accepted accounting principles, the assets, liabilities, and net position; net costs; changes in net position; budgetary resources; and reconciliation of net costs to budgetary obligations, (2) the internal control structure provides reasonable assurance that the internal control objectives were met, and (3) Rural Development complied with laws and regulations for those transactions and events that could have a material effect on the financial statements.

RESULTS IN BRIEF

In our opinion, Rural Development's fiscal year 2002 financial statements, including the accompanying notes, present fairly in all material respects, in conformity with generally accepted accounting principles, the assets, liabilities, and net position as of September 30, 2002; as well as net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the year then ended.

Our report on Rural Development's internal control structure discusses three material weaknesses and one reportable condition. Our report on compliance with laws and regulations also discusses one noncompliance issue. The following highlights the significant issues presented in these reports.

- Additional support was required for Rural Development's initial draft financial statements. In addition, the statements contained some errors requiring material adjustments. We attributed this to the lack of time available to perform adequate quality control reviews, given the mandated reporting timeframes.

- Due to weaknesses in information technology controls, Rural Development is highly vulnerable to intrusion; and its computer system, data, and programs are at risk for misuse.
- Financial Management Division reviews are not always being performed, in a timely manner.

In our report on compliance we noted that Rural Development's Rural Utilities Service legacy systems are not in compliance with the Office of Management and Budget's (OMB) Circular A-127, "Financial Management Systems," and all financial management systems have not been certified in accordance with OMB Circular A-130, "Management of Federal Information Resources."

KEY RECOMMENDATIONS

We recommend that Rural Development (1) improve its financial statement compilation procedures; including quality control reviews and (2) conduct timely Financial Management Division reviews.

AGENCY POSITION

Rural Development officials generally agreed with the issues and recommendations in this report.

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RURAL DEVELOPMENT'S FINANCIAL STATEMENTS
FISCAL YEAR 2002
(Prepared by Rural Development)

REPORT OF THE OFFICE OF INSPECTOR GENERAL

TO: Thomas C. Dorr
Under Secretary
for Rural Development

We have audited the accompanying Consolidated Balance Sheet of Rural Development, a mission area of the U.S. Department of Agriculture, as of September 30, 2002 and 2001; and the related Consolidated Statement of Net Cost as of September 30, 2002 and 2001; as well as the Consolidated Statements of Changes in Net Position and Financing, and Combined Statement of Budgetary Resources for fiscal year (FY) 2002 then ended. These financial statements are the responsibility of Rural Development's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with "Government Auditing Standards" issued by the Comptroller General of the United States, and the Office of Management and Budget (OMB) Bulletin 01-02, "Audit Requirements for Federal Financial Statements." 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 provided a reasonable basis for our opinion.

In our opinion, the financial statements referred to above, including the accompanying notes, present fairly in all material respects, in conformity with generally accepted accounting principles, the assets, liabilities, and net position as of September 30, 2002 and 2001; as well as its net costs for FYs 2002 and 2001; and changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the year then ended.

The information in the Management's Discussion and Analysis, and Required Supplementary Information sections is not a required part of the consolidated financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, "Form and Content of Agency Financial Statements." We applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

We have also issued a report on Rural Development's internal controls, which cites several reportable internal control weaknesses and a report on the mission area's compliance with laws and regulations.

This report is intended solely for the information and use of the management of Rural Development, OMB, and the Congress, and is not intended to be, and should not be, used by anyone other than those specified parties.

Richard D. Long

RICHARD D. LONG
Assistant Inspector General
for Audit

December 13, 2002

USDA

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

REPORT OF THE OFFICE OF INSPECTOR GENERAL ON INTERNAL CONTROL STRUCTURE

TO: Thomas C. Dorr
Under Secretary
for Rural Development

We have audited the accompanying principal financial statements of Rural Development as of and for the fiscal year ended September 30, 2002, and have issued our report thereon, dated December 13, 2002. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in "Government Auditing Standards," issued by the Comptroller General of the United States; and OMB Bulletin 01-02, "Audit Requirements for Federal Financial Statements."

In planning and performing our audit, we considered Rural Development's internal control over financial reporting by obtaining an understanding of Rural Development's internal control structure, determined whether the internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

The information presented in the Management Discussion and Analysis section is supplemental information required by OMB Bulletin 01-09, "Form and Content of Agency Financial Statements." OMB Bulletin 01-02 requires that we obtain an understanding of the internal controls designed to ensure that data supporting stated performance measures are properly recorded and accounted for to permit the preparation of reliable and complete information. Our audit work in the area of performance measures involved confirming the financial information included in the

Management Discussion and Analysis section with information contained in the principal financial statements, and ensuring that there was data to support the performance measures.

MANAGEMENT'S RESPONSIBILITY FOR INTERNAL CONTROL STRUCTURE

The management of Rural Development 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 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 the agency's prescribed basis of accounting. 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 its FY 2002 FMFIA report, Rural Development reported to the Secretary of Agriculture that it generally complied with Section 2, "Management Accountability and Control." Rural Development reported that three of the material weaknesses identified in Section 2 in prior FYs had been corrected. Two new Section 2 weaknesses were added related to Rural Development's information technology (IT) process and controls. There was also one remaining Section 2 weakness on the oversight of the Multi-Family Housing (MFH) Program.

Rural Development reported that it was not in compliance with Section 4 because its Rural Utilities Service (RUS) legacy financial management system does not comply with OMB Circular A-127, "Financial Management Systems." Besides noncompliance with OMB Circular A-127, it also discusses noncompliance with OMB Circular A-130, "Management of Federal Information Resources," as well as the need to enhance credit reform subsidy models to estimate and reestimate the cost of the Direct Single Family Housing and MFH Loan Programs.

OIG'S EVALUATION OF RURAL DEVELOPMENT'S INTERNAL CONTROL STRUCTURE

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

Direct Loans – consists of policies and procedures associated with authorizing and disbursing loans, collecting loan repayments, accruing interest and interest income and determining the allowance for subsidy.

Guaranteed Loans – consists of policies and procedures associated with authorizing and disbursing payments, authorizing guarantees, collecting repayments on defaulted guaranteed loans and determining the liability for loan guarantees.

Cash and Budgetary Resources – consists of policies and procedures associated with disbursing and collecting cash, reconciling cash balances, borrowings and repayment of debt, and budgetary resources.

Financial Reporting – consists of policies and procedures associated with processing accounting entries and preparing Rural Development's annual financial statements.

For each of the internal control structure categories listed above, we obtained an understanding of the design of significant control policies and procedures and whether they have been placed in operation. We assessed control risk and performed tests of Rural Development's internal control structure.

In making our risk assessment, we considered Rural Development's FMFIA reports, Office of Inspector General (OIG) audits, and other independent auditor reports on financial matters and internal accounting control policies and procedures. Regarding the 2002 FMFIA report, we agree with Rural Development's conclusions that it is (1) generally in compliance with Section 2 and (2) not in compliance with Section 4.

Our consideration of the internal controls over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. 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 are 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 Rural Development's ability to have reasonable assurance that the following objectives are met:

1. Transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets;

2. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition; and,

3. Transactions, including those related to obligations and costs, are executed in compliance with (a) laws and regulations that could have a direct and material affect on the Principal Statements, and (b) any other laws and regulations that OMB, Rural Development, or we have identified as being significant for which compliance can be objectively measured and evaluated.

Matters involving internal control and their operation that we consider to be reportable conditions are presented in the "Findings and Recommendations" section of this report.

FINDINGS AND RECOMMENDATIONS

I. FINANCIAL STATEMENT COMPILATION PROCESS NEEDS IMPROVEMENTS

FINDING NO. 1

Rural Development provided the financial statements, in a timely manner; however, the statements contained some errors that required adjustments and certain line-items on the Statement of Financing were not always adequately supported. We noted that some of the financial information is prepared manually which resulted in programming and processing errors. Additionally, due to the amount of time involved in preparing its financial statements, Rural Development did not have adequate lead-time to perform an effective quality control review of the statements prior to submitting them for audit. Specifically, we noted the following during our audit.

- Rural Development uses a Statistical Analysis System (SAS) program to report specific account data that feeds the lines of the statements. This data is compiled from the trial balances and other files. Rural Development relied on these reports to manually input balances into the Department templates for the financial statements. Rural Development then rounded these balances to the nearest million and prepared a word processing document to report these balances on its own financial statements. The errors on the financial statements were attributed to programming and processing errors made during this manual compilation process.

  For example, Rural Development included the correct balances on its electronic version of the Statements of Changes in Net Position and Financing that was forwarded to the Office of the Chief Financial Officer. However, the correct balances were not transferred to the hardcopy version of the financial statements provided to OIG.

- OMB Bulletin No. 01-09 requires reporting entities to ensure that information in the financial statements is presented in accordance with Federal Generally Accepted Accounting Principles and that the underlying records fully support the information. Rural Development's Statement of Financing is quite complex due to credit reform. To produce the Statement of Financing, Rural Development developed a

SAS program to account for all of the statement's nuances, which included portions of accounts going to several different lines based on minor codes, Treasury Symbols, debit/credit balances, positive/negative balances, etc. In addition, Rural Development made further reclassifications to minor codes to allow Federal Agencies' Centralized Trial-Balance System II transmissions. While the Rural Development trial balances are U.S. Standard General Ledger compliant, the Statement of Financing does not have standard crosswalks. These changes required reconciliations between minor codes listed on the Final Trial Balance and the support provided for the Statement of Financing. Therefore, OIG had to make several requests for additional supporting documentation. To provide this documentation Rural Development developed SAS queries to crosswalk balances on the Statement of Financing to the trial balance. This additional support was not readily available and was not provided to OIG within prescribed timeframes.

- Due to the time involved in manually preparing the financial statements, Rural Development did not have adequate lead-time to perform an effective quality control review prior to submitting them for audit. Had Rural Development performed an effective quality review, many of the aforementioned conditions could have been detected and corrected.

Rural Development made the appropriate changes to the financial statements and related footnotes and provided us with revised statements on December 7, 2002.

RECOMMENDATION NO. 1

In lieu of developing a system capable of automatically producing financial statements, develop controls to ensure accurate compilation of financial statements including applicable supporting documentation and quality control reviews.

II. IMPROVEMENTS STILL NEEDED IN IT CONTROLS

FINDING NO. 2

In Audit Report No. 85099-2-FM, "Security Over Rural Development's Information Technology Resources Needs Improvement," issued August 2002, OIG identified substantial weaknesses in Rural Development's ability to adequately protect its assets from the threat of fraud, misuse, and disclosure, and its critical operations from disruptions. Specifically, Rural Development has not:

- Devoted sufficient resources or empowered its Chief Information Officer (CIO) to ensure adequate management of its IT resources;
- ensured compliance with existing Federal IT security requirements;
- implemented adequate controls over eliminating vulnerabilities on its network;
- effectively controlled or monitored logical access controls to its networks or major systems; or
- effectively maintained control over licensed software and the appropriate use of systems.

Most of the issues identified in this report were reported to Rural Development management in prior contractor and OIG reports. Although OIG can provide periodic independent assessments of Rural Development operations, ultimately it is Rural Development management's responsibility for ensuring that internal controls, including information security controls, are adequate and effectively implemented on an ongoing basis. It is apparent that Rural Development has not addressed the underlying cause of its poor information security by instituting a framework for proactively managing the information security risks associated with its operations. Instead, Rural Development has reacted to individual audit findings as they were reported, with little ongoing attention to the systemic causes of control weaknesses. Rural Development relies on its IT infrastructure and individual systems to manage over $85 billion[1] in direct and guaranteed loans. The integrity of

[1] As reported in Rural Development's Fiscal Year 2001 Consolidated Financial Statements.

Rural Development's data is at significant risk if immediate actions are not taken to proactively address IT security.

To test the vulnerability of Rural Development's network to security intrusions, we assessed the security of selected network components using a commercially available software product designed to identify risk indicators associated with various operating systems. Our audit tests of 93 network devices identified 470 high and medium-risk security vulnerabilities.[2]

We also found that Rural Development's internal controls over logical access to its local area networks (LAN) and its major systems were inadequate. We identified numerous user accounts on its LAN and applications that:

- Could not be associated with a Rural Development employee or contractor;
- were associated with persons no longer employed by Rural Development;
- had never been used or had been dormant for at least 90 days; and
- allowed users access authority that was excessive as it related to the performance of their job functions.

These weaknesses make it possible for a malicious user to inappropriately modify or destroy sensitive data or computer programs, or inappropriately obtain and disclose confidential information. In today's increasingly interconnected computing environment, inadequate access controls can expose an agency's information and operations to attacks internally or from remote locations by individuals with minimal computer expertise.

Finally, we found that Rural Development needs to ensure compliance with Federal and departmental requirements. Specifically, we noted that Rural Development had not:

- Assigned the CIO and Information Systems Security Program Manager functions to a level within the organization that can independently

[2] High-risk vulnerabilities are those that provide access to the computer, and possibly the network of computers. Medium-risk vulnerabilities are those that provide access to sensitive network data that may lead to the exploitation of higher-risk vulnerabilities. Low-risk vulnerabilities are those that provide access to sensitive, but less significant network data.

report to the appropriate program and/or departmental officials and apply security across the entire agency's programs.

- Allocated sufficient resources to ensure that the Information Systems Security Program (ISSP) function is properly staffed to allow effective implementation and continuance of a comprehensive and proactive agency ISSP.

- Conducted the necessary risk assessments of its networks as required by the OMB Circular A-130, Appendix III, "Security of Federal Automated Information Resources," and Presidential Decision Directive 63, "Policy on Critical Infrastructure Protection."

- Adequately documented network security in its security plans, provided adequate security training to employees or contractors, or certified to the security for its major systems.

- Adequately tracked the security incidents that occurred on its systems, nor provided adequate corrective actions to ensure the incidents were not repeated.

- Ensured that users that have the ability to bypass significant technical and operational security controls had appropriate security clearances.

- Established adequate controls over ensuring compliance with license agreements of commercial software programs, or prohibiting its users from installing unauthorized and inappropriate software on their workstations.

- Addressed IT security in its Government Performance and Results Act performance measures.

Because OIG performed this work in a separate audit, and Rural Development and OIG are still in the process of reaching management decision on 18 of the 20 recommendations contained in that report, we are making no further recommendations herein.

III. WEAKNESSES IN RURAL DEVELOPMENT'S MANAGEMENT CONTROL SYSTEM

FINDING NO. 3

Rural Development's Financial Management Division (FMD) did not perform reviews in accordance with the 5-year cycle required in internal guidance. In FY 2002, FMD completed four of the seven reviews scheduled. Moreover, for the 5-year period covering FY 1998 through 2002, reviews were performed on only 30 States. According to a Rural Development official, the FY 2002 reviews were not completed because they could not be done within established timeframes to be included in the FY 2002 FMFIA Report. Rural Development had also responded in a prior FY that sufficient funds were not available to complete the reviews. As a result, Rural Development has reduced assurance that its management control system is operating effectively to ensure that:

- Programs achieve their intended results;
- resources are used consistent with agency mission;
- programs and resources are protected from waste, fraud, and mismanagement;
- laws and regulations are followed; and
- reliable and timely information is obtained, maintained, reported and used for decision making.

The FMFIA delegates responsibility for guidance on reviewing internal controls to the OMB. OMB developed Circular A-123 to provide guidelines on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on management controls. OMB Circular A-123 places the responsibility on each agency to identify its internal controls and establish a system to review and report on the effectiveness of those controls. Rural Development's Instruction 2006-M, Section 2006.607 states its management control system, mandated by the FMFIA, consists of four major components (1) General Accounting Office and OIG Audits and Investigations, (2) Management Control Reviews, (3) State Internal Reviews, and (4) FMD Reviews. This instruction requires FMD to complete FMD Reviews of all States within 5 years.

RECOMMENDATION NO. 2

Develop and implement a plan to complete the required FMD reviews to assure all States are reviewed within established timeframes; or perform alternative procedures, which would provide similar assurance.

IV. CREDIT REFORM IMPROVEMENTS ARE STILL NEEDED

FINDING NO. 4

OIG has previously reported material weaknesses in the procedures used by Rural Development to estimate and reestimate the costs of loan subsidies for loans made after FY 1991, as required by the Federal Credit Reform Act of 1990 (Credit Reform Act). As a result, Rural Development implemented new cash flow models for direct and guaranteed loans. Rural Development has overcome its inability to reasonably estimate the cost of its loan programs. However, enhancements of the procedures used to estimate and reestimate the costs of its loans are still needed.

For example, we noted that the initial FY 2002 Direct MFH reestimates were inaccurate. This occurred because Rural Development Budget Division used incorrect ratios and the cash flow model, as designed by the contractor, needed enhancements. As a result, Rural Development had to make material adjustments to its principal financial statements after they were provided for audit. Additionally, we noted that the estimated interest credits were not always properly calculated.

To address our concerns, Rural Development Budget and Office of the Deputy Chief Financial Officer (DCFO) personnel developed written internal control procedures for all credit reform cash flow models. In the future, all modifications will be formally coordinated in writing between Rural Development Budget and DCFO officials.

We also noted that the FY 2002 pivot tables[3] were not always accurate. The pivot tables contained errors and omissions that were attributed to manual entries made between the supporting documentation, cohort sheets and the pivot tables. These errors went undetected by Rural Development personnel because (1) there were inadequate procedures over the reconciliation of the pivot table data and (2) a second party review of the process was not performed prior to sending the information to Rural Development Budget and OIG. As a result, we identified six input errors or omissions that resulted in adjustments to the pivot tables in excess of $381 million.

[3] Pivot table is a report of raw data in an excel spreadsheet used to put data in a format consistent with the cash flow models.

RECOMMENDATION NO. 3

Rural Development should develop internal control procedures to ensure that pivot table data matches the trial balance and/or other supporting documentation. This should include documentation of the reconciliation of the pivot table data and supporting documentation. A supervisory/second party review of the data should be performed and documented prior to sending it to Rural Development Budget for inclusion in the models.

Agency Response

Rural Development agreed to prepare the supporting documentation for significant adjustments between general ledger accounts and related pivot table entries. It anticipates reconciling and documenting the significant adjustments by the second quarter of fiscal year 2003. It also agreed to document the pivot tables, general ledger crosswalks, and supporting reports for the fiscal year 2003 reestimates.

In addition, for the fiscal year 2003 reestimates it plans to improve internal controls over the pivot table reports by developing an automated reconciliation process that will compare the cohort data in the pivot tables to the associated trial balance accounts and report any differences. Differences and related adjusting entries will be fully documented. After the reconciliation is complete, it will perform a second party review of the reconciliation process, adjusting entries, and related documentation.

OIG Position

We concur with the management decision.

Material weaknesses are reportable conditions in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that misstatements 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. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected. We believe the reportable conditions described in Finding Nos. 1, 2, and 3, are material weaknesses.

This report is intended solely for the information and use of the management of Rural Development, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Richard D. Long

RICHARD D. LONG
Assistant Inspector General
For Audit

December 13, 2002

REPORT OF THE OFFICE OF INSPECTOR GENERAL ON COMPLIANCE WITH LAWS AND REGULATIONS

TO: Thomas C. Dorr
Under Secretary
for Rural Development

We have audited the principal financial statements of Rural Development as of and for the fiscal year ended September 30, 2002, and have issued our report thereon, dated December 13, 2002. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in the "Government Auditing Standards," issued by the Comptroller General of the United States, and OMB Bulletin 01-02, "Audit Requirements for Federal Financial Statements." 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 Rural Development is responsible for compliance with laws and regulations applicable to it. As part of obtaining reasonable assurance about whether Rural Development's principal financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin 01-02. We limited our tests of compliance and did not test compliance with all laws and regulations applicable to Rural Development. We tested compliance with:

- Anti-Deficiency Acts of 1906 and 1950;
- Budget and Accounting Procedures Act of 1950;
- Chief Financial Officers Act of 1990;
- Debt Collection Improvement Act of 1996;
- Federal Credit Reform Act of 1990;

- Federal Financial Management Improvement Act of 1996;
- Federal Managers' Financial Integrity Act of 1982;
- Government Management Reform Act of 1994;
- Government Performance and Results Act of 1993;
- Housing Act of 1949, Title V, as amended;
- Real Estate Settlement Procedures Act of 1974; and
- Rural Electrification Act of 1936, as amended.

As part of the audit, we reviewed management's process for evaluating and reporting on internal control and accounting systems, as required by the FMFIA, and compared the most recent FMFIA reports with the evaluation we conducted of Rural Development's internal control structure. We also reviewed and tested Rural Development's policies, procedures, and systems for documenting and supporting financial, statistical, and other information presented in the Management Discussion and Analysis section. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit, and accordingly, we do not express such an opinion.

Under the Federal Financial Management Improvement Act (FFMIA), we are required to report whether Rural Development's financial management systems substantially comply with Federal Financial Management Systems Requirements (FFMSR), applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA, Section 803(a) requirements. The results of our tests disclosed instances where Rural Development's financial management systems did not substantially comply with these requirements.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in law or regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements, or the sensitivity of the matter would cause it to be perceived as significant by others. A material instance of noncompliance noted during our audit are presented in the "Findings" section of this report.

FINDING

V. FINANCIAL MANAGEMENT SYSTEMS NEED IMPROVEMENTS

FINDING NO. 5

Rural Development reported in its most recent FFMIA Remediation Plan, dated August 30, 2002, that its financial management systems are not in compliance with FFMSR. We concur with that conclusion. The following is the basis:

- Systems for servicing the RUS electric and telecommunication direct loan portfolio do not comply with OMB Circular A-127, "Financial Management Systems," as they are inefficient, labor intensive, and lack automated controls;
- all financial management systems have not been certified in compliance with OMB Circular A-130, "Management of Federal Information Resources," and
- the Credit Reform processes and procedures need enhancements to estimate and reestimate the cost of loans and loan guarantees.

As a result, the RUS financial management systems do not provide adequate direct loan servicing and reporting. Also, since the financial management systems have not been certified, there is no assurance that systems have adequate security to prevent misuse or unauthorized access to or modification of information or to operate effectively and provide appropriate confidentiality, integrity, and availability.

Rural Development is in the process of incremental implementation of Rural Utilities Loan Servicing System to replace RUS legacy loan systems. Rural Development is also in the process of developing a milestone plan to more closely target the progress on the remediation of the certification of all financial management systems. The current planned completion date is September 2006.

Based on current corrective action plans, we are making no further recommendations in this report.

We considered the material instance of noncompliance in forming our opinion on whether the fiscal year 2002 Principal Financial Statements of the Rural Development are presented fairly, in all material aspects, and this report does not modify our opinion on Rural Development's Principal Financial Statements expressed in our report, dated December 13, 2002.

This report is intended solely for the information of the management of Rural Development, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Richard D. Long

RICHARD D. LONG
Assistant Inspector General
For Audit

December 13, 2002

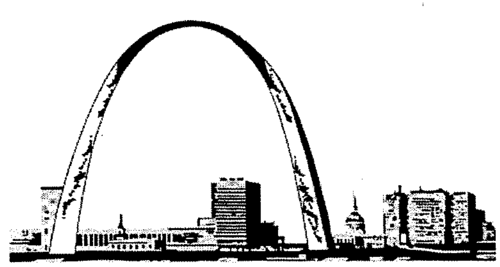
ABBREVIATIONS

CIO	Chief Information Officer
DCFO	Office of the Deputy Chief Financial Officer
FFMIA	Federal Financial Management Improvement Act
FFMSR	Federal Financial Management Systems Requirements
FMD	Financial Management Division
FMFIA	Federal Managers Financial Integrity Act
FY	Fiscal Year
ISSP	Information Systems Security Programs
IT	Information Technology
LAN	Local Area Network
MFH	Multi-Family Housing
RUS	Rural Utilities System
SAS	Statistical Analysis System
OIG	Office of the Inspector General
OMB	Office of Management and Budget

USDA
RURAL DEVELOPMENT

CONSOLIDATED FINANCIAL STATEMENTS
Fiscal Year 2002

- ***Rural Housing Service***
- ***Rural Utilities Service***
- ***Rural Business-Cooperative Service***



Prepared by
Deputy Chief
Financial Officer
St. Louis, MO.

Mission

This Management's Discussion and Analysis (MD & A), in conjunction with the accompanying consolidated financial statements, footnotes, and supplemental information, reflects the activities of the Rural Development mission area of the United States Department of Agriculture (USDA).

Rural Development's vision is to be a partner in helping the people of rural America develop sustainable communities. Its mission is to enhance the ability of rural communities to develop, grow, and improve their quality of life by targeting financial and technical resources in areas of greatest need through activities of greatest potential. This mission area was created by legislation signed into law on October 13, 1994.

Rural Development programs are designed to meet the diverse needs of rural communities, to help them obtain the financial and technical assistance needed to improve the quality of life in rural America, and to help individuals and businesses compete in the global marketplace. These programs consist of a variety of loan, loan guarantee, and grant programs, plus technical assistance, in the areas of business development; cooperative development; rural housing; community facilities; water and environment; electric power; and telecommunications, including distance learning and telemedicine.

The Rural Development Long Range Plan 2000-2005 defines the mission area's goals. The Plan was prepared in accordance with the requirements of the Government Performance and Results Act of 1993. It includes Rural Development's objectives as well as performance goals and results that provide a basis for measuring its success. The Plan consists of five goals, which support the United States Department of Agriculture's goal to "enhance the capacity of rural residents, communities and businesses to prosper." These goals are:

Goal 1. Good Jobs and Diverse Markets. Rural Development will improve the quality of life in rural America by encouraging the establishment and growth of rural business.

Goal 2. Quality Housing and Modern Community Facilities. Rural Development will improve the quality of life of rural residents by providing access to technical assistance, capital, and credit for quality housing and modern, essential community facilities.

Goal 3. Modern Affordable Utilities. Rural Development will improve the quality of life of rural residents by promoting and providing access to capital and credit for the development and delivery of modern affordable utility services.

Goal 4. Community Capacity Building. Rural Development will provide information, technical assistance, and, when appropriate, leadership to rural areas, rural communities and cooperatives to give their leaders the capacity to design and carry out their own rural development initiatives.

Goal 5. Effective, Efficient Service to the Public. Rural Development will develop the staff, systems, and infrastructure needed to ensure high quality delivery of its programs to all rural residents.

Organizational Structure

Three agencies, the Rural Housing Service (RHS), Rural Utilities Service (RUS), and Rural Business-Cooperative Service (RBS) plus the Office of Community Development (OCD), which administers the Administration's rural Enterprise Zones/Enterprise communities initiative, the National Rural Development Partnership, a nationwide network of rural development leaders and officials committed to the vitality of rural areas, and Operations and Management constitute the Rural Development mission area.

Loan Programs

Rural Development loan programs, with an outstanding portfolio of approximately $84.4 billion, are delivered through a National Office for each agency, 47 state offices, and a network of other field offices. The mission area is supported by a Finance Office in St. Louis, Missouri, which provides accounting and service support for all mission area programs, and a Centralized Servicing Center, also in St. Louis, which services the direct single-family housing portfolio. The mission area serves approximately 412,424 single family housing borrowers, 15,777 multi-family housing borrowers, 11,048 community and business borrowers, and 2,812 telecommunications, electric, cable TV, and distance learning and telemedicine borrowers.

In addition, Rural Development guarantees loans for approximately 193,356 single-family housing, 16 multi-family housing, 3,063 business & community service, and 25 electric & cable TV borrowers.

Rural Development loan programs generally require (1) providing loans to individuals and enterprises who are at a greater risk of default, since they lack the financial resources to obtain credit in the private sector, and (2) making loans bearing an interest rate at or less than the cost of funds. Rural Development has the responsibility to protect the interest of the Government by adequately securing the loans with real estate mortgages, assignments of income, personal and corporate guarantees, and liens on revenues.

The portfolio that follows reflects a total loan portfolio balance slightly higher in FY 2002 than in FY 2001. The increase in the guaranteed portfolio from $14.9 billion to $16 billion offset the decline in Single Family Housing direct portfolio from $15.9 to $15.1.

Total Loan Portfolio as September 30, 2002 Fiscal Years 2000 Through 2002 (Dollars in Billions)			
	FY 00	FY 01	FY 02
Direct Loans			
RHS			
Single Family Housing	$ 16.7	$15.9	$15.1
Multi-Family Housing	11.7	11.9	11.9
Community Facilities/Other	0.9	1.0	1.1
RUS			
Water & Environmental/Other	7.2	7.6	7.9
Electric	27.1	26.5	27.0
Telecommunications	3.6	3.5	3.6
Rural Telephone Bank	1.2	1.1	1.0
RBS			
Business and Industry	0.6	0.7	0.8
Total Direct	69.0	68.2	68.4
Guaranteed Loans			
RHS			
Single/Multi-Family Housing	10.2	11.4	12.3
Community Facilities/Other	0.2	0.2	0.2
RUS			
Water & Environmental/Other	0.1	0.1	0.1
Electric	0.4	0.5	0.5
RBS			
Business and Industry	2.5	2.7	2.9
Total Guaranteed	13.4	14.9	16.0
Total Loan Portfolio	$82.4	$83.1	$84.4

Rural Business-Cooperative Service

The mission of RBS is to enhance the quality of life for all rural Americans by providing leadership in building competitive businesses and sustainable cooperatives that can prosper in the global marketplace. RBS accomplishes this mission by investing its financial resources and technical assistance in businesses and cooperatives, and by building partnerships that leverage public, private, and cooperative resources to create jobs and stimulate rural economic activity.

This is accomplished through the delivery of a variety of loan, loan guarantee, and grant programs as well as providing direct technical advisory and education assistance for cooperatives.

Under the Business and Industry (B&I) guaranteed and direct loan programs, financial assistance is provided to finance business and industrial acquisition, construction, conversion, enlargement, repair or modernization. Eligible applicants include individuals as well as public, private or cooperative organizations, Indian tribes and corporate entities.

The Intermediary Relending Program (IRP) provides loans to intermediary borrowers, who, in turn, relend the funds to eligible recipients for economic development projects, the establishment of new businesses and/or the expansion of existing businesses, creation of employment opportunities and/or saving existing jobs in rural areas.

The Rural Business Enterprise Grant (RBEG) Program provides grants to encourage the development of small and emerging business enterprises; the creation, expansion, and operation of rural distance learning networks; and to provide adult education or job training related to potential employment or job advancement for adult students.

The Rural Economic Development Loan (REDL) and Grant (REDG) Programs provide financial assistance to borrowers to relend the funds to assist in developing rural areas, from an economic standpoint, to create new job opportunities and help retain existing employment.

The goal to create "Good Jobs and Diverse Markets" is specific to the programs administered by RBS.

One objective is to increase the availability and quality of jobs in rural areas.

Key Performance Indicators	FY 2002 Target	FY 2002 Actual
Create or save jobs		
B&I Guaranteed Loans	31,049	27,452
IRP Loans	29,206	23,868
RBEG	32,721	16,033
REDL	2,444	2,745
REDG	844	196
RBOG	0	6,007
Total	96,264	76,301

The number of B&I jobs is less than the projected target. The goal was not met due to the failure to adjust the goals to reflect a reduction in the amount of funds available. However, more jobs were created per dollar obligated than in FY 2001.

The number of IRP jobs is less than the projected target. The demand for IRP earmark funding was far less than FY 2001, upon which these projections were derived. This was compounded by RBS being unable to pool Lower Mississippi Delta and Native American earmarks to meet demands.

Under RBEG, the number of jobs created/saved is less than the target projected in the annual plan. However, a new projection of 11,112 was prepared on February 28, 2001, based on the President's Budget. The actual jobs created/saved of 16,033 surpassed these projections.

The number of REDG jobs is far less than what was projected in the annual plan. RBS prepared projections February 28, 2001, based on the President's Budget, which anticipated that no jobs would be created or saved because no funding was expected. However, $4 million in funding became available late in the year and there was insufficient time to adequately promote this program.

A second objective is to direct program resources to those rural communities and customers with the greatest need.

Key Performance Indicators	FY 2002 Target	FY 2002 Actual
Percent of funds obligated in Empowerment Zones/Enterprise Communities/REAP's		
B&I Guaranteed	2.3%	2.7%
IRP	19%	8.8%
RBEG	22%	15.8%
Percent of funds obligated for Mississippi Delta and Native American Initiatives	MD NA	MD NA
B&I Guaranteed	0% 5%	0% 1.1%
IRP	21% 10%	6.4% 9.6%
RBEG	2% 6%	2.6% 6.7%

For the IRP EZ/EC/REAP program, our 19 percent goal was not achieved due to the decreased demand for this type of funding.

The percent of EZ/EC funds obligated for RBEG was less than anticipated due to an error in projection estimates. RBS did use almost all of the appropriated funds, and every eligible request for this earmark was funded.

Under Native American for B&I, although the target was not met, we had a significant increase compared to the prior year.

Under Mississippi Delta earmark for IRP, the goal of 21 percent was not achieved due to a decrease in demand for this type of funding.

To improve use of funds, the Budget Division has recommended to Congress that all earmarks be allowed to be pooled and revert to the National Office reserve to allow full utilization of the funds appropriated for the program.

A final objective is to manage the loan portfolio in a manner that is efficient and effective.

Key Performance Indicator	FY 2002 Target	FY 2002 Actual
Delinquency rate (excluding bankruptcy cases)	3 %	10.29%

The delinquency goals for FY 2002 were not met. The impact of a slowing economy, the downward spiral of the stock market, and the terrorist attacks of September 11, 2001, have played a significant role in the upward trend of delinquent borrowers. The Service will continue to employ all tools available to lower the delinquency rate while keeping much needed jobs in rural communities. Future reviews to actively combat delinquencies using resources provided in the governing regulations; such as deferral of loan principal, workout plans, reamortizations, etc. will be carried out to the best of our abilities.

Rural Housing Service

The RHS mission is to improve the quality of life in rural America and help build competitive, vibrant rural communities through its community facilities and housing programs. The goal for the RHS as stated in its Long-Range/Strategic Plan is to improve the quality of life of rural residents by providing access to technical assistance, capital and credit for quality housing and modern, essential community facilities.

Single Family Housing Programs

RHS provides financing, with no down payment and at favorable rates and terms, either through a direct loan with RHS or a loan from a private financial institution which is guaranteed by RHS. The direct Single Family Housing (SFH) program is the largest component of the rural housing portfolio. Direct SFH loans are made to families or individuals with very low, low, and moderate incomes to buy, build, improve, repair, and/or rehabilitate rural homes. These loans are normally repayable over 33 years at an effective interest rate as low as 1 percent annually. The average interest rate for Fiscal Year (FY) 2002 was 5.21 percent with 45 percent of all SFH loans receiving interest assistance. RHS provides grants to enable very low income rural homeowners to remove health and safety hazards in their homes and to make homes accessible for people with disabilities.

The field offices handle the direct SFH loan application process and some servicing functions, and the Centralized Servicing Center handles most phases of direct loan servicing, from risk management to borrower assistance. RHS also offers escrow accounts for property taxes and insurance for its home loan borrowers.

Guaranteed loans make up the remaining portion of the SFH portfolio. Loan guarantees are made for an amount not to exceed 90 percent of the loan amount. These loans are normally repaid over 30 years with the interest rates negotiated between the borrower and the lender. The guaranteed loan program reflects the RHS commitment to achieve maximum leveraging of the federal loan funds with private sector funds.

The table which follows reflects one of the key performance indicators for the single family housing program objective of improving the quality of life for the residents of rural communities by providing access to decent, safe, affordable housing. The programs provide the 100% loan-to-value financing needed to place qualified applicants in modest single family homes. Their quality of life is improved through the advantages of homeownership, which is the American Dream.

Key Performance Indicator	FY 2002 Target	FY 2002 Actual
Number of rural households receiving financial assistance to purchase a home of their own.	53,000	42,069

The goal and most targets were met for the direct loan program, however, they were not met for the guaranteed loan program. The guaranteed loan program had a target of 39,000 which assumed use of all of the funds allocated for the program. Not all of the funds were used. The number of initial loans closed for the whole year under Section 502 Guaranteed Loan Program (28,056 loans) was 28 percent, or 10,944 less than the 39,000 target for the Section 502 Guaranteed Loan Program. The reason all funds were not used can be attributed to factors in the RHS guaranteed program such as lack of an automated underwriting capability, the prohibition on cash-out or equity withdrawal refinancing, and the increase in the guarantee fee from 1 percent to 2 percent for both money loans and refinancing loans during FY 2002.

It is anticipated that with the advent of the automated underwriting system, currently under development, which will increase the program's attractiveness and efficiency for lenders and the public, 502 Guaranteed Loan Program funds will be completely used in the future years.

Another key performance indicator for RHS is reflected below and supports the objective to manage the loan portfolio in a manner that is efficient and effective. The indicator reflects how well the accounts are monitored and supervised during the first twelve months after loan closing. By providing effective loan servicing supervision through both the local offices and the Centralized Servicing Center, borrowers who, without proper counseling and assistance, would have faced blemished credit reports and even foreclosure are able to remain in their homes thus avoiding a diminished quality of life.

Key Performance Indicator	FY 2002 Target	FY 2002 Actual
First year delinquency rate	3.8 %	2.7 %

Multi-Family Housing Programs

The Multi-Family Housing program finances farm labor housing, rural rental housing, and cooperative housing for low income and elderly people in rural communities of under 10,000 population. Farm labor housing loans and grants enable farmers, public or private nonprofit organizations, and units of state and local governments to develop or rehabilitate farm labor housing for seasonal and year round workers. These loans are generally repayable over 33 years at an interest rate of as low as 1 percent annually.

Rural rental housing loans enable developers to provide housing for the elderly, disabled individuals, and families who cannot afford the purchase price and maintenance costs of their own houses. These loans are generally repayable over 50 years at an average interest rate of 2.87 percent for FY 2002. In addition, grants are provided to public nonprofit organizations to assist rental property owners and co-ops to repair and rehabilitate their units.

The Multi-Family Housing program has established the following performance indicator to illustrate how they are meeting the objective of managing the MFH loan portfolio in a manner that is efficient and effective. When delinquency and losses are minimized, more affordable housing is available for eligible rural residents which helps to meet the RHS goal of providing more quality housing to improve the lives of rural residents.

Key Performance Indicator	FY 2002 Target	FY 2002 Actual
Number of projects with accounts more than 180 days past due	130	145

There is a 10 percent increase of accounts with 180 day or greater delinquency, however, the dollar amount has decreased $1,842,000 or 12 percent from FY 2001. This 10 percent increase reflects delinquent accounts that would have been written off previously. These accounts are now being pursued for collection through initiatives provided by the Debt Collection Improvement Act of 1996.

RHS' objective to improve the quality of life for the residents of rural communities by providing access to decent, safe, sanitary and affordable housing is reflected in the performance indicators below. By providing rental assistance, RHS is directing resources to those rural communities and customers with the greatest need.

Key Performance Indicators	FY 2002 Target	FY 2002 Actual
Total number of units funded for new construction (FY)	5,500	5,349
Total number of units funded for rehabilitation (FY)	8,400	8,685
Number of rental assistance units renewed (tenants do not lose subsidy)	42,330	39,454
Number of tenant households living in affordable, decent, safe, and sanitary housing	435,246	446,483

The number of households not displaced by loss of rental assistance (number of renewals) was slightly below target because the number of actual renewals was less than projected due to several factors: tenant income, vacancies, etc. No tenants were displaced by loss of rental assistance. The rental assistance (RA) not needed for renewals, was used for additional RA units in existing and new MFH projects.

Community Facilities Programs

Rural Development strives to improve the quality of life of rural residents by providing access to modern, essential community facilities such as fire stations, health care clinics and child care facilities. RHS continues to offer both direct and guaranteed loans which are made available to public entities such as municipalities, counties, and special purpose districts as well as nonprofit corporations and tribal governments. These loans are repayable up to 40 years. Recipients must demonstrate that they are unable to obtain capital from commercial sources.

A key performance indicator is reflected below and supports the RHS objective to manage the loan portfolio in a manner that is efficient and effective. The indicator reflects how well the accounts are monitored and supervised. When delinquency and losses are minimized the facilities are in a better position to assist the rural residents they are servicing thus improving the quality of life for their customers. This goal was achieved by RHS.

Key Performance Indicator	FY 2002 Target	FY 2002 Actual
Maintain non-delinquency (current) rate for CF customers	98%	98%

Rural Utilities Service

The RUS mission is to serve a leading role in improving the quality of life in rural America by administering its electric, telecommunications (including distance learning and telemedicine), and water and environmental programs in a service-oriented, forward-looking and financially responsible manner. The RUS programs leverage scarce federal funds with private capital for investing in rural infrastructure, technology, and the development of human resources. Financial assistance is provided to rural utilities, municipalities, commercial corporations, public utility districts, Indian Tribes, and cooperative, nonprofit, limited-dividend, or mutual associations. These entities are obligated to serve the public welfare and, in many instances, are subject to state regulatory oversight.

Electric Program

As restructuring of the electric industry advances toward a more competitive environment, Rural Development is ensuring the continued availability of reliable, high-quality electric service at a reasonable cost to rural consumers. The electric program provides financing and technical assistance to upgrade, expand, and maintain the vast rural American electric utility infrastructure. Electric borrowers have received more than $66.4 billion in loans and loan guarantees as of September 30, 2002. Another $79 million was refinanced during FY 2002.

Rural Development's goal of improving the quality of life of rural residents by promoting and providing access to capital and credit for the development and delivery of modern affordable utility services is reflected in their objectives and performance indicators.

Key Performance Indicators	FY 2002 Target	FY 2002 Actual
Number of rural electric systems upgraded	187	176
Number of consumers benefiting from system improvements (millions)	2.8	2.9
Electric loans to clients serving persistent poverty counties	89	69
Electric loans to clients serving out-migration counties	90	70

Loans are primarily used to finance the acquisition, construction, improvement, or replacement of facilities for the distribution of electric power. The guaranteed loan program is used to finance generation, transmission, and distribution facilities. Repayment of loans is secured through liens on the assets of borrowers, long-term power arrangements, and RUS oversight of borrower activities. Loan maturity dates are selected by the borrowers and generally run for the life of the facility, but no more than 35 years. The typical distribution borrower applies for a new loan about every 3 to 5 years to finance system upgrades and expansion.

Municipal rate loans are used to finance electric distribution and sub-transmission facilities. The interest rate is based on competitive rates available in the municipal bond market for similar maturities. The majority of borrowers are required to seek supplemental financing for 30 percent of their capital requirements from a private lender without a federal guarantee. Borrowers may choose from several maturities that will determine the interest rate, which changes quarterly. Certain borrowers are eligible for a capped municipal rate, which cannot exceed 7 percent. Interest rates are set when funds are actually advanced.

Hardship loans can also be used to finance electric distribution and sub-transmission facilities. These loans are made to applicants that have rates that are above state averages (rate disparity) and that serve consumers with below average per capita and household incomes. On a case by case basis, hardship loans may be offered if the RUS administrator determines that the borrower has suffered a severe, unavoidable hardship, such as a natural disaster. Hardship loans carry a statutory interest rate of 5 percent.

Treasury rate loans are used to finance electric distribution and sub-transmission facilities. RUS administers the direct Treasury rate loan program substantially the same as it administers the municipal rate loan program, with the primary distinction being one of the interest setting methodologies. Interest rates for the Treasury rate program are the prevailing cost of money to the U.S. Treasury for comparable terms.

Loan guarantees may be made for generation, transmission, or distribution facilities. The electric program approves guaranteed loans made through the FFB, National Rural Utilities Cooperative Finance Corporation (CFC), and the National Bank for Cooperatives (CoBank). The FFB interest rate is the prevailing cost of money to the U.S. Treasury for comparable terms, plus one-eighth of 1 percent. Interest rates for private lenders are the current competitive rate.

The number of rural electric system upgrades is less than the projected target due to the average size of the loans and loan guarantees made being larger than projected. With the advent of three and four year construction work plans, borrowers loans covered longer periods of time and, as a result, are for increased loan amounts. Also, the loan activity for the generation and transmission (G&T) borrower community has increased as capital is provided for much needed G&T projects to serve rural America. An increase in number and size of G&T loan guarantees reduces the availability of loan guarantees for distribution borrowers. All loan funds for the electric program were used.

The actual number of electric loans to clients serving persistent poverty and out-migration counties is less than the projected amount. The total number of loans approved in FY 2002 resulted in a less than projected number of loans to utilities providing service to persistent poverty and out-migration counties.

Telecommunications Program

The telecommunications program provides capital, establishes telecommunications standards, and provides policy guidance for rural telecommunications deployment.

The "traditional" infrastructure loan program, consisting of hardship, cost of money, rural telephone bank, and guaranteed loans provides financing for broadband and other advanced services. Since 1995, every telephone line constructed with RUS financing is capable of providing broadband service using DSL (digital subscriber loop) technology.

The Telecommunications Programs are to provide modern, affordable telecommunication services to rural communities.

Key Performance Indicators	FY 2002 Target	FY 2002 Actual
Number of new subscribers receiving services	180,000	84,739
Number of subscribers with improved service	670,000	328,425
Leveraging of telecommunications financial assistance (private investment to RUS and RTB funding)	$5:1	$4.6:1

The targets for the number of new subscribers, as well as the number of subscribers with improved service, were not met. These targets had been derived by using past experience and by developing a per subscriber relationship to the amount of loan funds available in the target year. However, the average amount of investment per subscriber increased substantially. This was a probable result of increased investment in system upgrades, as well as replacements and improvements versus actual loan funds for new subscribers.

The variance in the leveraging ratio is very slight and within the range of historical performance.

The Distance Learning and Telemedicine program continues its charge to wire our schools and improve health care delivery in rural America.

Key Performance Indicators	FY 2002 Target	FY 2002 Actual
Number of schools receiving distance learning facilities	840	794
Number of healthcare providers receiving telemedicine facilities	570	422
Leveraging of telemedicine and distance learning financial assistance (private investment to RUS funding)	$2:1	$.78:1

The targets for the number of schools and health care providers were not met, but the variances were relatively small. The targets were based on historical information from previous applications whereby a per dollar relationship was derived to set a target for the coming year. A variance from year to year is expected.

The leveraging ratio was smaller than anticipated because the required matching funds from an applicant was lowered from 30% of the total project amount to 15% of the total eligible application amount. This resulted in the reduction of leveraged funds per dollar of grant funds.

RUS has continued to administer a pilot loan program designed specifically to increase the rate of deployment of technology to small towns in rural areas. The Broadband program was truly unique, in that it enabled RUS to step beyond its traditional definition of rural (towns of 5,000 or less), and fund borrowers serving communities of up to 20,000 inhabitants.

Key Performance Indicator	FY 2002 Target	FY 2002 Actual
Number of new subscribers receiving service through the Broadband loan program	106,500	148,419

Today's information age-it can be argued-is now enabling us to repay rural America for its hard work, drive, and devotion to making this the most prosperous nation in the world.

Many challenges face rural students, residents, and businesses. Children growing up on our farms and in our rural towns are entitled to the best education our nation can provide. Our rural citizens should not have to endure inadequate health care that diminishes the quality or length of their lives. And our rural economies must be strengthened given the tools to prosper. With today's technology, we can regenerate the opportunities that were once abundant in our rural communities. We can provide the ill with life-saving treatment. And our rural students can compete on, not just a national level, but a worldwide level of high achievement. The same spirit and drive of those living in rural America that started our national odyssey will serve as the backbone of rural America's "new beginning" in today's digital odyssey.

Water and Environmental Program

Water and environmental loans and grants are provided to rural communities for the development, replacement, or upgrading of water and environmental facilities. Direct water and environmental loans are repayable up to 40 years. Water and environmental borrowers have received a total of $27 billion in direct loans, loan guarantees, and grants as of September 30, 2002. During FY 2002, $1.15 billion in direct loans, $2.3 million in guarantees, and $933 million in grants were approved.

One of the objectives of the water and environmental program is to provide rural residents with modern, affordable water and waste services. Another objective is the intent to direct program resources to those rural communities with the greatest need. This includes areas that have been consistently poor, have high unemployment rates, have out-migration, have experienced natural disasters, or experienced economic stress due to Federal actions.

Key Performance Measures	FY 2002 Target	FY 2002 Actual
Loans to develop or expand rural water systems to provide quality drinking water in compliance with the Safe Drinking Water Act	600	775
Loans to develop or expand rural waste disposal systems to provide quality waste disposal service in compliance with State and Federal environmental standards	300	415
Direct program resources to persistent poverty counties number and amount in millions)	230 $236	255 $413
Special initiatives – (number of projects and amount of funding in millions):		
EZ/EC	49 ($43)	34 ($32)
Colonias	33 ($20)	34 ($19)
Alaskan Village	28 ($24)	23 ($24)
Guaranteed Loans	6 ($5)	6 ($2)

Overall EZ/EC/REAP performance was lower than projected in terms of numbers and amounts. This is attributed to lack of submission of qualified applications meeting the requirements of those programs.

The Alaskan Villages grant program utilized the entire amount provided, however, the number of projects was lower than projected. The State of Alaska is primarily responsible for selecting the projects.

The goal of 6 guaranteed loans was met, although the dollar amount was not. This program has not grown since it cannot be used for tax-exempt issues.

Office of Community Development

Rural Development is dependent on the ability and skills of its staff for the effective delivery of its programs. The staff must be adequately trained and have the resources needed if it is to accomplish its job. Rural Development will utilize a management approach and encourage a workplace environment that ensures all customers and employees are treated fairly, equitably, and with dignity and respect.

Key Performance Indicators	FY 2002 Target	FY 2002 Actual
Ratio of non-EZ/EC grants to EZ/EC grants invested in EZ/EC communities	7:1 or greater	16.65:1
Number of jobs created in EZ/EC communities	1000	6827

Future Opportunities and Challenges

Rural Development is subject to many of the changes occurring in society as a whole and is impacted by the events of September 2001. These societal changes will potentially impact Rural Development programs and its operations. The opportunities and challenges resulting from these changes are summarized in the following areas:

Technology

Within Rural Development, initiatives such as the Data Warehouse provide employees with faster and easier access to data. Rural Development currently offers via the internet in excess of 135 forms to the public. These forms can be completed online and electronically submitted to field service centers for processing. Rural Development also promotes the capability via the internet to advertise and sell single family housing properties. This capability is being extended to the Farm Service Agency in the advertisement and sale of farm properties. Rural Development is currently developing tactical business plans for all major loan programs that will outline how current business processes will be transformed in order to electronically deliver programs directly to the public.

Rural Development is working with the Department of Agriculture, the Farm Service Agency, and the National Resource Conservation Service to deploy the secure technical infrastructure necessary to support the delivery of programs to the public including authenticating customers. We are working to provide communities with the telecommunication infrastructure to access the technologies we make available to them. Multi-Family Housing project management tenant data can now be entered via the internet. Under development is an initiative to allow guaranteed loan lenders the ability to electronically record a loan loss claim and request payment of this loss.

These initiatives will impact Rural Development's future policies and regulations, automated systems, and organizational structure.

Market Globalization

The advent of electronic commerce offers a great opportunity to rural businesses to participate in the global market, especially for the small entrepreneur or cooperative whose business is operating in a niche market. Electronic commerce eliminates factors such as geographical distance and small customer base which have historically limited the growth potential of rural businesses and communities.

Farm Bill

Passage of the Farm Security and Rural Development Act of 2002 had a broad impact on Rural Development programs and policies. The bill created a new National Board on Rural America, created new programs, provided additional funds for existing programs and provided additional authorities for other programs. This provides both an opportunity and a challenge to implement the provisions in a timely fashion to benefit the residents of rural America.

Homeland Security

The events of September 2001 had a significant impact on the citizens of the United States including Rural America. It resulted in a reevaluation of how we do business and how we would continue to do business in a time of national emergency.

Diversity

The racial and ethnic backgrounds of our rural customers and our employees will continue to become more diverse. Rural Development gives priority to ensuring all customers, including employees, are treated with dignity and respect. This priority must continue if Rural Development is to ensure its programs are delivered equitably and its workforce recognizes the value of a diverse staff.

Highlights of Rural Development's Financial Position

The accompanying financial statements include the combined financial information for rural housing, rural utilities and rural business and cooperative development programs.

Limitations on Financial Statements

These consolidated financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of the Chief Financial Officers Act of 1990. While the statements have been prepared from the books and records of the entity in accordance with the formats prescribed by the Office of Management and Budget, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization that they are a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

Entity's Systems, Controls And Legal Compliance

The purpose of the Federal Managers' Financial Integrity Act (FMFIA) is to promote the development of systematic and proactive measures to ensure management accountability for the effectiveness and efficiency of program operations.

Section 2

Section 2 of the law focuses on the assessment of the adequacy of management controls to manage the risk associated with a given program and to provide reasonable assurance that obligations/costs comply with applicable laws and regulations; that Federal assets are safeguarded against fraud, waste and mismanagement; and that transactions are properly recorded and accounted for.

A material weakness identifies an instance in which the management controls are not sufficient to provide the level of assurance required by Section 2 and requires major milestones for corrective action. Such a weakness may significantly impair the fulfillment of an agency component's mission; deprive the public of needed services; violate statutory or regulatory requirements, significantly weaken safeguards against waste, loss, unauthorized use or misappropriation of funds, property, or other assets; or result in a conflict of interest.

For FY 2002, Rural Development is reporting three open material weaknesses. The weaknesses are related to: (1) weaknesses continue to exist in Rural

Development's IT networks, (2) lack of adequate oversight and internal controls which has led to abuse by Multi-Family Housing program participants; and (3) weak access controls jeopardize the integrity and confidentiality of Rural Development's critical data.

Since the major portion of the corrective actions are in place for the above weaknesses, the impact on Rural Development operations and the public is reduced to the extent that these material weaknesses are not sufficiently serious to prevent Rural Development from providing reasonable assurance that the mission area complies with Section 2 of the FMFIA.

Section 4

Section 4 of the law relates to the review of financial accounting systems to ensure conformance with certain principles, standards, and other Federal requirements. A financial system nonconformance is an instance in which the financial system does not conform to the requirements of Section 4. A nonconformance also requires major milestones for corrective action.

For fiscal year 2002, we report that our financial management/accounting systems do not comply with Office of Management and Budget (OMB) Circular A-127, Financial Management System, requirements. The following is the basis for that conclusion: systems for servicing the RUS electric and telecommunication direct loan portfolio do not comply with OMB Circular A-127 as they are inefficient, labor intensive, and lack automated controls. All financial management systems have not been certified in compliance with OMB Circular A-130, Management of Federal Information Resources; and the Credit Reform processes and procedures need enhancements to estimate and re-estimate the cost of loans and loan guarantees.

U.S. DEPARTMENT OF AGRICULTURE
RURAL DEVELOPMENT
CONSOLIDATED BALANCE SHEET
AS OF SEPTEMBER 30, 2002 AND 2001
(In Millions)

	2002	2001
ASSETS (Note 2)		
Intragovernmental:		
Funds Balance with Treasury (Note 3)	$ 8,783	$ 8,207
Accounts Receivable (Note 5)	5	41
Total Intragovernmental	8,788	8,248
Cash and Other Monetary Assets (Note 4)	71	61
Accounts Receivable (Note 5)	2	0
Loans Receivable and Related Foreclosed Property, Net (Note 6)	57,944	59,031
General Property, Plant and Equipment, Net (Note 7)	32	16
Other (Note 8)	36	37
Total Assets	$ 66,873	$ 67,393
LIABILITIES (Note 9)		
Intragovernmental:		
Accounts Payable	$ 0	$ 64
Debt (Note 10)	49,892	50,870
Resources Payable to Treasury (Note 1Q)	8,281	9,120
Other (Note 12)	772	201
Total Intragovernmental	58,945	60,255
Accounts Payable	85	91
Loan Guarantee Liability (Note 6)	507	612
Debt Held by the Public (Note 10)	84	87
Stock Payable to RTB Borrowers (Note 11)	1,343	1,268
Other (Note 12)	180	254
Total Liabilities	61,144	62,567
Commitments and Contingencies (Note 13)		
NET POSITION		
Unexpended Appropriations	$ 5,362	$ 5,256
Cumulative Results of Operations	367	(430)
Total Net Position	$ 5,729	$ 4,826
Total Liabilities and Net Position	$ 66,873	$ 67,393

The accompanying notes are an integral part of these statements.

U.S. DEPARTMENT OF AGRICULTURE
RURAL DEVELOPMENT
CONSOLIDATED STATEMENT OF NET COST
FOR THE YEARS ENDED SEPTEMBER 30, 2002 AND 2001
(In Millions)

Costs: (Note 14)

Program Costs:	2002	2001
Intragovernmental Gross Costs	$ 3,558	$ 3,696
Less: Intragovernmental Earned Revenue (Note 15)	297	267
Intragovernmental Net Costs	3,261	3,429
Gross Costs with the Public:		
Grants and Payments	1,443	1,354
Loan Subsidy Costs	(374)	770
Other	3,077	1,030
Total Gross Costs with the Public	4,146	3,154
Less: Earned Revenues from the Public (Note 15)	4,047	4,321
Net Costs with the Public	99	(1,167)
NET COST OF OPERATIONS	$ 3,360	$ 2,262

The accompanying notes are an integral part of these statements.

U.S. DEPARTMENT OF AGRICULTURE
RURAL DEVELOPMENT
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION
FOR THE YEAR ENDED SEPTEMBER 30, 2002
(In Millions)

	2002 Cumulative Results of Operations	2002 Unexpended Appropriations
Beginning Balances	$ (430)	$ 5,256
Prior Period Adjustments (Note 16)	11	0
Beginning Balances, as Adjusted	(419)	5,256
Budgetary Financing Sources:		
Appropriations Received		2,930
Appropriations Transferred-in/out		8
Other Adjustments (rescissions, etc)		(53)
Appropriations Used	2,783	(2,779)
Transfers-in/out Without Reimbursement	1,364	
Other Budgetary Financing Sources	(104)	
Other Financing Sources:		
Imputed Financing from Costs Absorbed by Others	103	
Total Financing Sources	4,146	106
Net Cost of Operations	3,360	
Ending Balances	$ 367	$ 5,362

The accompanying notes are an integral part of these statements.

U.S. DEPARTMENT OF AGRICULTURE
RURAL DEVELOPMENT
COMBINED STATEMENT OF BUDGETARY RESOURCES
FOR THE YEAR ENDED SEPTEMBER 30, 2002

(In Millions)

	2002 Budgetary	2002 Non-Budgetary Credit Program Financing Accounts
Budgetary Resources:		
Budget Authority:		
Appropriations Received	$ 4,618	$ 0
Borrowing Authority	1	8,103
Net Transfers	588	0
Unobligated Balance:		
Beginning of Period	1,159	612
Spending Authority from Offsetting Collections:		
Earned		
Collected	5,877	3,634
Receivable from Federal Sources	(11)	(694)
Change in Unfilled Customer Orders		
Without Advance from Federal Sources	0	666
Subtotal	5,866	3,606
Recoveries of Prior Year Obligations	267	211
Permanently Not Available	(5,289)	(1,296)
Total Budgetary Resources	$ 7,210	$ 11,236

The accompanying notes are an integral part of these statements.

U.S. DEPARTMENT OF AGRICULTURE
RURAL DEVELOPMENT
COMBINED STATEMENT OF BUDGETARY RESOUCES
FOR THE YEAR ENDED SEPTEMBER 30, 2002
(In Millions)

	2002 Budgetary	2002 Non-Budgetary Credit Program Financing Accounts
Status of Budgetary Resources:		
Obligations Incurred:		
Direct	$ 5,242	$ 10,160
Reimbursable	481	0
Subtotal	5,723	10,160
Unobligated Balance:		
Apportioned	207	274
Unobligated Balance Not Available	1,280	802
Total Status of Budgetary Resources	7,210	11,236
Relationship of Obligations to Outlays:		
Obligated Balance, Net, Beginning of Period	6,729	10,232
Obligated Balance, Net, End of Period:		
Accounts Receivable	(25)	0
Unfilled Customer Orders from Federal Resources	0	(666)
Undelivered Orders	6,360	13,823
Accounts Payable	438	0
Outlays:		
Disbursements	5,422	7, 053
Collections	(5,877)	(3,635)
Subtotal	(455)	3,418
Less: Offsetting Receipts	356	0
Net Outlays	$ (811)	$ 3,418

The accompanying notes are an integral part of these statements.

U.S. DEPARTMENT OF AGRICULTURE
RURAL DEVELOPMENT
CONSOLIDATED STATEMENT OF FINANCING
AS OF SEPTEMBER 30, 2002
(In Millions)

	2002
Resources Used to Finance Activities:	
Budgetary Resources Obligated	
Obligations Incurred	$ 15,883
Less: Spending Authority from Offsetting Collections and Recoveries	9,950
Obligations Net Offsetting Collections and Recoveries	5,933
Less: Offsetting Receipts	356
Net Obligations	5,577
Other Resources	
Imputed Financing from Costs Absorbed by Others	103
Net Other Resources Used to Finance Activities	103
Total Resources Used to Finance Activities	5,680
Resources Used to Finance Items Not Part of the Net Cost of Operations:	
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered But Not Yet Provided	3,671
Resources That Fund Expenses Recognized in Prior Periods	183
Budgetary Offsetting Collections and Receipts That Do Not Affect Net Cost of Operations	
Credit Program Collections Which Increase Liabilities for Loan Guarantees or Allowances for Subsidy	(5,081)
Other	(3,939)
Resources That Finance the Acquisition of Assets	16
Other Resources or Adjustments to Net Obligated Resources That Do Not Affect Net Cost of Operations	5,260
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	110
Total Resources Used to Finance the Net Cost of Operations	5,570
Components of the Net Cost of Operations That Will Not Require or Generate Resources in the Current Period:	
Components Requiring or Generating Resources in Future Periods:	
Increase in Annual Leave Liability	0
Upward/Downward Reestimates of Credit Subsidy Expense	(368)
Increase in Exchange Revenue Receivable From the Public	(3,578)
Other	187
Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	(3,759)
Components Not Requiring or Generating Resources:	
Depreciation and Amortization	2
Other	1,547
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	1,549
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	(2,210)
Net Cost of Operations	$ 3,360

The accompanying notes are an integral part of these statements.

RURAL DEVELOPMENT
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
AS OF SEPTEMBER 30, 2002

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

These financial statements have been prepared to report the financial position and results of operations of the USDA Rural Development mission area, as required by the Chief Financial Officers Act of 1990. The financial statements have been prepared from the books and records in accordance with the Office of Management and Budget (OMB) Bulletin 01-09, *Form and Content of Agency Financial Statements*, and the accounting policies which are summarized in this note. These statements are, therefore, different from the financial reports, also prepared pursuant to OMB directives, that are used to monitor and control the use of budgetary resources.

The above mentioned Bulletin requires a Comparative Balance Sheet and Statement of Net Cost and related footnotes, as of September 30, 2002. As such only these two statements and related footnotes are prepared on a comparative basis. The Statement of Changes in Net Position, Statement of Budgetary Resources, and Statement of Financing and all related footnotes are prepared only for FY 2002.

Certain items in the prior year have been reclassified to conform to the current presentation.

B. Reporting Entity

As of September 30, 2002, the mission area provides credit for housing, rural development, and rural utilities within the U.S. Department of Agriculture (USDA). When it began in 1935, under the name of the Resettlement Administration, 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. In 1937, the Farm Security Administration (FSA) was created as successor to the Resettlement Administration. Its primary responsibilities were to make farm rehabilitation and farm ownership loans to farmers unable to borrow from usual sources of credit.

In 1946, Congress passed the Farmers Home Administration Act and the name "FHA" was adopted. The Act gave FHA the authority to administer farm ownership loans, farm operating loans, a limited water facilities loan program, and the emergency crop and feed loan program. FHA was also authorized to insure and guarantee loans made by banks, other agencies, private citizens, as well as to make direct Government loans.

During the 1960's, pursuant to the Housing Act of 1949, FHA was given the authority to administer direct and insured loans to repair or purchase new or existing housing to very low-income and low income rural residents who could not obtain credit elsewhere. These loans provided rural residents with modest, safe, and sanitary single family dwellings at affordable rates and terms. In addition, FHA was granted authority to administer rental and cooperative housing loans, farm labor housing loans, and rural housing site loans to rural areas.

The agency was commonly known as "FHA" until April 1974 when USDA formally adopted "FmHA" as the agency's abbreviation. This was done to easily distinguish Farmers Home Administration from other agencies that have the same initials, such as the Federal Housing Administration and Federal Highway Administration.

The Rural Electrification Administration (REA) was established under the Rural Electrification Act of 1936 as a credit agency within the USDA which assisted rural electric and telephone utilities in obtaining the financing required to provide electric and telephone service in rural areas.

In 1971, the Rural Telephone Bank (RTB) was established within REA to provide a supplemental source of financing for rural telephone systems. In 1987, the program was further expanded to provide zero-interest loans and grants to its borrowers for the purpose of rural development.

In 1992, the Rural Development Agency (RDA) was established by the Food, Agriculture, Conservation and Trade (FACT) Act. RDA was a separate agency within the Department of Agriculture which provided funding for loans, grants, and loan guarantees for community development in rural areas. The Health and Human Services Act of 1986 authorized further rural development lending by instituting the Intermediary Relending Program. Under this program, RDA provided loans to public or private nonprofit organizations for the purpose of relending for business or community development in rural areas.

On October 13, 1994, the President signed the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994, Public Law No. 103-354. The law permits the reorganization of the Department, including the establishment of subcabinet position, the restructuring of headquarters agencies and offices, continued reductions in the number of USDA personnel, and consolidation and closure of field office locations. This streamlining of the Department will permit USDA to deliver programs and services to the public in an efficient and cost-effective manner.

The Secretary of Agriculture abolished the position of Under Secretary of Agriculture for Small Community and Rural Development and the agencies of FmHA, RDA, and REA. At the same time, all activities related to farm loans were transferred to the Farm Service Agency. Of the subcabinet positions ordered by the Secretary, the Under Secretary of Agriculture for Rural Economic and Community Development was established. This name was later shortened to ***Rural Development*** during Fiscal Year (FY) 1996. The following is a description of the services and activities over which the mission area has jurisdiction:

<u>Rural Housing Service (RHS)</u>
RHS is responsible for housing loan programs and grants formerly performed by FmHA and rural community facility loan programs formerly performed by RDA. Other related functions include hazard waste management allocated grants and the salaries and expenses account.

<u>Rural Utilities Service (RUS)</u>
RUS is responsible for electric and telephone loan programs, Rural Telephone Bank activities, and distance learning and medical link grants formerly performed by REA. RUS is also responsible for rural water and waste disposal loans and grants and other grants which include solid waste management and emergency community water assistance formerly performed by RDA. Other related functions include the Appalachian Regional Commission and Economic Development Administration allocated grants, local television loan program, high energy cost grants, and the salaries and expenses account.

<u>Rural Business – Cooperative Service (RBS)</u>
RBS is responsible for business and industry loan programs, assistance programs for cooperatives, and activities of the Agricultural Cooperative Service, all of which were formerly performed by RDA. RBS is also responsible for rural economic development loans and grants formerly performed by REA. Other related functions include rural business enterprise and rural technology and cooperative development grants, and the salaries and expenses account.

The mission area is responsible for 103 accounting entities of various compositions and sizes which are used to make various loans and grants. As of September 30, 2002 and 2001, loan and grant obligations in the amount of $13.2 and $11.1 billion were incurred, respectively.

C. Budgets and Budgetary Accounting

The Federal Credit Reform Act of 1990 contained in the Omnibus Budget Reconciliation Act of 1990 requires substantial changes to the accounting system and in budget presentation for the loan programs previously under the ten revolving/credit funds. The ten funds are: (1) Rural Housing Insurance Fund, (2) Rural Water and Waste Disposal Loan Fund, (3) Rural Business and Industry Loan Fund, (4) Rural Community Facility Loan Fund, (5) Rural Development Insurance Fund, (6) Rural Development Loan Fund, (7) Rural Electrification and Telephone Revolving Fund, (8) Rural Communications Development Fund, (9) Rural Economic Development Subaccount, and (10) Rural Telephone Bank. The loan portfolio created in these funds prior to FY 1992 is maintained in the liquidating accounts. While no new loans or administrative expenses can be charged to the liquidating accounts, it represents the largest portion of the loan portfolio. Three additional accounts were created to cover loans made in FY 1992 and thereafter, as follows:

- The program account represents all subsidy costs and administrative expenses related to direct and guaranteed loan commitments made after FY 1991. Subsidy costs reflect the cost to the government for the credit program on and net present value basis. Administrative expenses are not included in the subsidy cost. The program account receives a current definite appropriation authority for obligations of subsidy payments and administrative expenses, and a permanent indefinite appropriation authority for reestimates of subsidy.

- The direct loan financing account records the obligations and cash flows associated with direct loan obligations made after FY 1991. Annually, Congress adopts an appropriation bill limiting the dollar amount of obligations for new loan making. New loans are also limited by a corresponding apportioned program subsidy. The direct loan financing account's loan disbursements are financed through subsidies received from the program accounts and Treasury borrowings. However, the total disbursements and cannot exceed the appropriated amount, as previously allowed under revolving accounts.

- The guaranteed loan financing account records the cash flows associated with guaranteed loan commitments made after FY 1991. Congress' annual appropriation bill limiting guaranteed loan commitments and their corresponding apportioned program subsidies serve to limit the dollar amount of obligations for new guaranteed loan commitments. Tracked cash flows include payments of default claims, receipts of fees on guaranteed loan commitments, collections on defaulted guaranteed loans and subsidy payments, and the reserve maintained to cover default payments. The disbursements for defaulted loans from the guaranteed financing account are financed through subsidies received from the program accounts, interest earned on the subsidy, and Treasury borrowings.

D. Basis of Accounting

Aided by studies and recommendations from the Financial Accounting Standards Advisory Board (FASAB), the Director of OMB and the Comptroller General published specific standards which constitute generally accepted accounting principles for the Federal Government and its component entities. This comprehensive set of accounting principles and standards must be followed by Federal entities. For those transactions deemed not addressed by FASAB pronouncements, accounting principles and standards published by authoritative standard-setting bodies and other authoritative sources shall be considered, depending upon their relevance in a particular set of circumstances.

Pre-Credit Reform and Post-Credit Reform nonfederal transactions are recorded on a cash accounting basis, except for the accrual of interest related to borrower loans; Federal transactions are recorded on an accrual accounting basis. Under the cash method, revenues are recognized when cash is received and expenses are recognized when they are paid. Budgetary accounting is also necessary to facilitate compliance with legal constraints and controls over the use of Federal funds.

All significant interfund and intrafund balances and transactions have been eliminated in the consolidation except for those Credit Reform transactions impacting the Statements of Budgetary Resources and Financing as currently required.

During FY 2002, no new Statements of Federal Financial Accounting Standards (SFFAS) were implemented, as none were applicable.

During FY 2001, two new SFFAS were implemented. First, was SFFAS #10, Accounting for Internal Use Software. See **Note 1M** for a further explanation. Second, was SFFAS #18, Amendments to Accounting Standards for Direct Loans and Loan Guarantees, as promulgated in SFFAS #2. Its purpose is threefold:

- Breakout subsidy reestimates between interest rate and technical/default.

- Provide for a reconciliation between beginning and ending balances of loan guarantee liability and subsidy cost allowance for direct loans in the footnotes.

- Provide disclosure and discussion for changes in program subsidy rates, expenses, and reestimates.

E. Revenues and Other Financing Sources

Revolving/Credit Funds:
Beginning in FY 1992, the Balanced Budget Act of 1990, Title XIII of the Omnibus Budget Reconciliation Act of 1990, provides Credit Reform procedures which affected the financing of the revolving funds. Under Credit Reform, an appropriation is received in the year of loan-making sufficient to cover the subsidy cost of providing the loan. The subsidy cost is defined as the net present value, at the time of disbursement, of the difference between the Government's estimated cash disbursements for that loan and the Government's estimated cash inflows resulting from that loan (e.g., repayments of principle and interest, and other payments adjusted for estimated defaults, prepayments, fees, penalties, and other recoveries). Consequently, the implementation of Credit Reform has resulted in authorized appropriations which provide for estimated future losses as opposed to reimbursement for losses appropriations which provided for past losses actually sustained prior to FY 1992. In addition to subsidy appropriations, the other sources of funding for the revolving funds include borrowings from Treasury and borrower loan repayments.

General Funds:
Appropriations are provided by Congress on both an annual and multi-year basis to fund certain general funds and other expenses such as personnel and 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 during normal operations. Appropriations for general fund activities are recorded as a financing source when expended. Unexpended appropriations are recorded as Net Position.

F. Fund Balance with Treasury

All receipts and disbursements are processed by the U.S. Treasury which, in effect, maintains the appropriate bank accounts.

G. Escrow Disbursement Account

With the implementation of the Centralized Serving Center on October 1, 1996, the Rural Housing Service began collecting escrow payments (i.e., insurance and taxes) from new Single Family Housing borrowers. Existing borrowers, which were delinquent and required servicing actions, must also submit these escrow payments. These payments are deposited with the Trustee, Firstar Bank, a subsidiary of U.S. Bank. As Trustee, they are required to invest these funds and disburse them as stipulated in the Trust Agreement. As of September 30, 2002 and 2001, the balance in this account was $71.1 and $61.5 million, respectively. This amount has been included in the Consolidated Balance Sheet on the Cash and Other Monetary Assets ***(Note 2)*** and Other Liabilities ***(Note 12)*** lines. It has also been included on the cash ***(Note 4)*** line

H. Direct Lending Activities

Appropriated authority is received to make direct loans. These loans represent actual cash disbursements to borrowers which require repayment. Direct loans are only made if a borrower cannot secure adequate credit from other sources at reasonable rates and terms. Federal law provides for multiple servicing actions to assist financially troubled borrowers. The maintenance of detailed loan records consistent with the terms and conditions agreed upon with the borrower is required. The most significant of these actions include:

Interest Credit Program:
The interest credit program provides for contractual agreements with single family and rural rental housing borrowers to reduce the borrowers' effective interest rate to as low as 1 percent. Single family housing borrowers currently receiving interest credit will continue to receive it for the initial loan and any subsequent loan as long as they are eligible and remain on interest credit. Borrowers' incomes will be reviewed annually to determine whether eligibility for this payment subsidy is still warranted.

Payment Assistance:
This is a type of payment subsidy for single family housing borrowers who have never received interest credit or who have ceased receiving interest credit and at a later date again qualify for a payment subsidy. Borrowers' incomes will be reviewed annually to determine whether eligibility for this payment subsidy is still warranted.

For fiscal years 2002 and 2001, interest credit and payment subsidy granted under this program is approximately $1.1 and $1.2 billion, respectively.

Moratorium:
A moratorium is a period of up to 2 years during which scheduled payments are deferred for payment at a later date. Borrowers may apply for a postponement of payments if, due to circumstances beyond their control, they are unable to continue making scheduled payments on the loan without unduly impairing their standard of living. As of September 30, 2002 and 2001, the number of borrowers with a moratorium in effect were 1,594 and 1,161, respectively.

Delinquency Workout Agreements:
Borrowers with past due accounts may be offered the opportunity to avoid liquidation by entering into an agreement with RHS that specifies a plan for bringing the account current. To receive a delinquency workout agreement, the following requirements apply:

- A borrower who is able to do so will be required to pay the past-due amount in a single payment.
- A borrower who is unable to pay the past-due amount in a single payment must pay monthly all scheduled payments plus an agreed upon additional amount that brings the account current within 2 years or the remaining term of the loan, whichever is shorter.
- If a borrower becomes more than 30 days past due under the terms of a delinquency workout agreement, RHS may cancel the agreement.

As of September 30, 2002 and 2001, the number of borrowers which had received delinquency workout agreements were 5,241 and 3,933, respectively.

I. Guaranteed Lending Activities

Other lending activities include the guaranteed loans for single family housing, multi-family housing, and community programs. The term "guarantee" means "to guarantee the repayment of loans originated, held, and serviced by a private financial agency or other lender approved by the Secretary of Agriculture". Rural Development provides financial assistance to borrowers by guaranteeing loans made by federal or state chartered banks, savings and loan associations, cooperative lending agencies, or approved lending institutions who perform all loan servicing activities. Generally, the guaranteed loan program allows Rural Development to guarantee up to 90 percent of the money loaned by a financial institution (lender) to borrowers in rural areas or to businesses who employ people in rural areas.

Some guaranteed loans may be sold in the secondary market by the lender to an institution (referred to as a holder). However, all servicing responsibilities remain 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 the Rural Development purchase the holder's share of the loan. When the loan is purchased, Rural Development 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 which are repurchased are treated as an asset (loans receivable) in the portfolio ***(Note 6)***.

Lenders are required to inform Rural Development on the loan status of community and business program borrowers as of December 31 and June 30, and single family housing borrowers on a quarterly basis unless the loan is in default which requires more frequent reporting. If a 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, Rural Development is liable for losses under the terms of the guarantee.

Rural Development also provides financial assistance in the form of loan guarantees to rural electric and telephone utilities and cooperative and commercial borrowers for community antenna television services and facilities. However, no new financing has been provided since 1981 for the above-mentioned cooperative and commercial borrowers. Guaranteed loans are accounted for as contingent liabilities ***(Note 6)***.

J. Loans Receivable and Related Foreclosed Property, Net

Loans are accounted for as receivables after funds have been disbursed. They are carried at their principal amount outstanding *(Note 6)*, and accrue interest daily based on the contractual interest rate. When a loan becomes nonperforming (in excess of 90 days delinquent or when borrowers enter into troubled debt restructuring arrangements), all interest previously accrued on the loan is reversed for financial reporting purposes, and interest income on the nonperforming loan is then recognized only to the extent of the collections received. Nonperforming loans are reclassified as performing and accrue interest when they become current or less than 90 days delinquent. In addition, interest income recognition subsequent to troubled debt restructuring arrangements is generally limited to actual cash interest received from these borrowers.

Direct loans obligated prior to October 1, 1991, are reported at the present value of future cash flows. The provision calculation is based upon these projected cash flows discounted at the weighted-average rate of outstanding Treasury and Federal Financing Bank borrowings made prior to fiscal year 1992.

The liability for loan guarantees and for guaranteed loans obligated prior to October 1, 1991, are reported at the present value of future cash flows. The provision calculation is based upon these future cash flows (i.e., expectations of loan losses and an estimate of interest assistance payments to be made on guaranteed loans) discounted at the average interest rate of U.S. Treasury interest-bearing debt. The estimates is reported as an expense, and a corresponding accrual for estimated losses on loan guarantees is reported as a liability on the Consolidated Balance Sheet.

The projected cost of direct loan and guaranteed loan defaults (for loans obligated prior to October 1, 1991) will not necessarily reflect Rural Development's future appropriation requests. To the extent that revolving fund revenues are not sufficient to fund future costs, financing will have to be obtained from future appropriations, or other congressionally approved sources. For direct loans obligated on or after October 1, 1991, Rural Development recognizes these as assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance. For guaranteed loans obligated on or after October 1, 1991, the present value of estimated net cash outflows of the loan guarantees is recognized as a liability.

K. Investments

In fiscal year 1987, a loan asset sale was conducted as required in the Omnibus Budget Reconciliation Act of 1986. As a result of these sales, residual investments were maintained in the securities. A description of these investments is included in ***Note 8***.

L. Property, Plant and Equipment (P, P&E)

The land, buildings, and equipment in the current operating environment is provided by the General Services Administration, who charges a Standard Level Users Charge that approximates the commercial rental rates for similar properties. Under Credit Reform, all equipment purchases are made through the Salaries and Expense fund. See **Note 7** for the capitalization thresholds of the various classes of P, P&E.

M. Internal Use Software

Internal Use Software is classified as "general property, plant and equipment" as defined in the Statement of Federal Financial Accounting Standard (SFFAS) #6, Accounting for Property, Plant and Equipment. See **Note 7** for further information.

Costs of internal use software are accounted for in accordance with SFFAS #10, Accounting for Internal Use Software. The effective date of SFFAS #10 is fiscal year 2001. SFFAS #10 requires the capitalization of the cost of internal use software whether it is commercial off-the-shelf, contractor-developed, or internally developed which solely meets internal or operational needs.

SFFAS #10 provides for the capitalization of costs incurred during the software development phase and the expensing of costs incurred during the preliminary design and post-implementation/operational phases for software having a useful life of at least 2-years. The capitalization threshold is $100,000.00.

Costs incurred prior to the initial application of this Standard, whether or not capitalized, should not be adjusted to the amounts that would have been capitalized, had this Standard been in effect when those costs were incurred.

N. Liabilities

Liabilities represent the amount of monies or other resources that are likely to be paid as the result of a transaction or event that has already occurred. However, no liability can be paid absent an appropriation. Where an appropriation has not been enacted, liabilities are considered not covered by budgetary resources. There is no certainty that appropriations will be enacted. Also, liabilities arising from other than contracts can be abrogated by the Government, acting in its sovereign capacity.

O. Borrowings/Interest Payable to the Treasury

Borrowings payable to the Treasury result from the Secretary of Agriculture's authority to make and issue notes to the Secretary of the Treasury for the purpose of discharging obligations for the revolving funds. These revolving funds make periodic principal and interest payments to Treasury in accordance with established agreements.

P. Federal Employee's Compensation Act (FECA)

This Act established the Federal Employees' Compensation Special Benefit Fund. This Fund pays for income lost and medical costs for federal civilian employees injured on the job, employees who have incurred a work-related occupational disease and beneficiaries of employees whose death is attributable to a job-related injury or occupational disease.

This Fund pays benefits on behalf of federal entities as costs are incurred and bills (charges back) the federal entity annually (August 15) for the costs incurred during the previous fiscal year ended June 30 (July 1 – June 30). Federal entities fund the FECA payments through appropriations or operating revenues. For appropriated funds, the payment is due at the beginning of the second fiscal year after receipt of the bill (approximately 15 months). These liabilities due to the Fund are recorded by federal entities as unfunded (if annual appropriations are used) at the time of receipt of the bill. Generally, Federal entities with no-year appropriations should recognize a funded liability and the funding availability at the time of the receipt of the chargeback from the Department of Labor (DOL).

Annually, federal entities are also allocated a portion of the long term FECA actuarial liability attributable to the entity. The liability is calculated to estimate the expected liability for death, disability, medical and miscellaneous costs for approved compensation cases. The liability amounts and the calculation methodologies are provided by DOL to the federal entities by October 31 for the previous fiscal year ended September 30.

On or before August 15 of each year, DOL submits a yearly billing (chargeback) report to federal entities. The report is entitled Notification of Workers' Compensation Cost Incurred on Your Behalf (annual chargeback report) and covers the preceding July 1 through June 30 fiscal year. Additionally, each entity receives a quarterly Detailed Chargeback Report. The quarterly report provides a detailed listing of amounts paid by the FECA fund during the previous quarter.

The current year FECA expense and total liability are calculated using information contained in these reports.

Q. Resources Payable to Treasury

Prior to FY 1999, Rural Development consolidated all unobligated net resources of loans obligated prior to fiscal year 1992 as either a Receivable from Appropriations (negative equity) or Resources Payable to Treasury (positive equity). All other capital accounts were transferred to these accounts.

Beginning in FY 1999, agencies can no longer accrue a Receivable from Appropriations, as required in Statement of Federal Financial Accounting Standard #7, Accounting for Revenue and Other Financing Sources. As a result, all unobligated net resources of loans obligated prior to fiscal year 1992 are now consolidated as a negative Resources Payable to Treasury.

The FY 2002 financial statements include formal budget reestimates for the Rural Telephone Bank direct loan program, the Section 502 Single Family Housing direct loan program, and the Section 515 Multi-Family Housing direct loan program as of September 30, 2002. The statements also include formal budgetary reestimates for all other programs as of September 30, 2001. Additionally, for financial statement reporting, reestimates were estimated as of September 30, 2002, for all other major loan programs.

The FY 2001 financial statements include formal budget reestimates for the Rural Telephone Bank direct loan program, the Section 502 Single Family Housing direct loan program, the Section 515 Multi-Family Housing direct loan program, and the Business and Industry guaranteed loan program as of September 30, 2001. The statements also include formal budgetary reestimates for all other programs as of September 30, 2000, and September 30, 1999. Additionally, for financial statement reporting reestimates were approximated as of September 30, 2001 for all other major programs.

R. Contingencies

The Rural Development mission area is a party in various legal actions and claims through the normal course of its operations. In the opinion of management and the USDA Office of the General Counsel, the ultimate resolution of these legal actions and claims will not materially affect the financial position or results of operations.

S. Capital Stock Class A

Rural Development owns all Class A stock on behalf of the United States Government and any cash dividends are paid to the U.S. Treasury. Public Laws 92-12 and 97-98 authorized Congress, in fiscal years 1971 through 1991, to appropriate no more than $30 million per year for the purchase of RTB Class A stock, a nonvoting class of stock. Class A stock has a guaranteed annual dividend of 2 percent of the total funds received. The law provides that Congress annually appropriate funds until such purchases approximate $600 million. The total amount of RTB Class A stock appropriations received is $592.1 million and no future appropriations are anticipated. Beginning in 1996, RTB is required to repurchase this stock from Rural Development; however, in accordance with Public Law 105-86, the maximum Class A stock that may be retired is 5 percent. According to enabling legislation and amendments, the Bank will be converted to independent status when 51 percent of the Class A stock issued to the United States has been fully redeemed and retired. On September 30, 2002 and 2001, in accordance with Bank Board resolutions 2002-4 and 2001-2, the seventh and sixth redemptions of Class A stock, in the amounts of $22.7 and $23.8 million occurred, leaving balances of $430.2 and $452.9 million outstanding, respectively which has been eliminated in the consolidation.

T. Unexpended Appropriations

Unexpended Appropriations include the undelivered orders and unobligated balances of the general funds and the program accounts which receive Congressional appropriations through the budgetary process. As appropriated funds incur obligations, the obligated amount is recorded as an undelivered order. Undelivered orders are reduced by either an expenditure or an obligation cancellation. Appropriated funds which are not obligated are treated as unobligated amounts. At the end of the fiscal year, certain multi-year appropriations which have unobligated balances remain available for obligation in future periods. Unobligated appropriations are returned to the U.S. Treasury when their period of availability expires.

U. Intragovernmental Financial Activities

The Rural Development mission areas is an integral part of the operations of the U.S. Department of Agriculture (USDA) and may thus be subject to financial and managerial decisions and legislative requirements which are beyond the control of the Agency's management. Consequently, day-to-day operations may not be conducted as they would if Rural Development were a separate and independent entity.

Beginning in fiscal year 1998, USDA has provided mission areas with an allocation of departmental nonreimbursed appropriated costs to include in their financial statements. These costs affect the statement of net cost, statement of changes in net position, and the statement of financing.

The consolidated financial statements are not intended to report the mission area's proportionate share of the Federal deficit or of public borrowing, including interest thereon. Financing for budget appropriations could derive from tax revenues or public borrowing or both; the ultimate source of this financing, whether from tax revenues or public borrowing, has not been specifically allocated to Rural Development.

The majority of employees participate in the Civil Service Retirement System (CSRS), to which Rural Development makes matching contributions equal to 7 percent of pay. Rural Development does not report CSRS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees. Reporting of such amounts is the responsibility of the Office of Personnel Management.

On January 1, 1987, the Federal Employees Retirement System (FERS) went into effect pursuant to Public Law 99-335. Most employees hired after December 31, 1983, are automatically covered by FERS and Social Security. Employees hired prior to January 1, 1984, can elect to either join FERS and Social Security or remain in CSRS. A primary feature of FERS is that it offers a savings plan to which the agencies automatically contribute 1 percent of pay and matches any employee contribution up to an additional 4 percent of pay.

Annual leave is accrued as it is earned and the accrual is reduced as leave is taken. Each year, the balance in the accrued annual leave account is adjusted to reflect current pay rates. To the extent current or prior year appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future financing sources. Sick leave and other types of nonvested leave are expensed as taken.

V. New Administrative Accounting System

During fiscal year 2001, Rural Development implemented a new administrative accounting system to replace the Central Accounting System (CAS). This new USDA administrative system, the Foundation Financial Information System (FFIS), is a commercial off-the-shelf fully integrated financial software package designed to meet stringent budget and funds control needs, as well as complex multi-fund accounting and reporting needs.

During fiscal year 2002, improvements continue to be made in addressing outstanding issues related to the previous implementation.

NOTE 2: NON-ENTITY ASSETS

Amounts are presented in millions.	2002	2001
With the Public		
Cash and Other Monetary Assets	$ 71	$ 61
Total Non-Entity Assets	71	61
Total Entity Assets	66,802	67,332
Total Assets	$ 66,873	$ 67,393

See *Note 1G* for a description of Cash and Other Monetary Assets.

Non-Entity Assets represent assets that are "not for use" by Rural Development.

NOTE 3: FUND BALANCE WITH TREASURY

Amounts are presented in millions.

Fund Balances:	2002	2001
Revolving Funds	$ 2,678	$ 2,844
Appropriated Funds	6,109	5,376
Other Fund Types	(4)	(13)
Total	$ 8,783	$ 8,207
Status of Fund Balance with Treasury:		
Unobligated Balance:		
Available	$ 1,801	$ 1,514
Unavailable	78	92
Obligated Balance Not Yet Disbursed	6,904	6,601
Total	$ 8,783	$ 8,207

Represents the undisbursed account balances with the U.S. Treasury as reported in the mission area's records.

Amounts in the Unavailable column are restricted to future use and are not apportioned for current use. These amounts represent the expired authority in fixed year Grant and Program accounts (fixed year's prior to fiscal year 2002) and are only available for restoration of funds. After the fifth year of expiration, all funds are returned to Treasury as required.

Note 4: CASH AND OTHER MONETARY ASSETS

Amounts are presented in millions.

	2002	2001
Cash	$ 71	$ 61
Total Cash and Other Monetary Assets	$ 71	$ 61

See *Note 1G* for a description of this Cash. As discussed in *Note 2,* this Cash is unavailable for agency use.

NOTE 5: ACCOUNTS RECEIVABLE, NET

Amounts are presented in millions.

2002

	Gross Accounts Receivable	Allowance for Uncollectible Accounts: Beginning Balance	Additions (Reductions)	Ending Balance	Net Accounts Receivable
Intragovermental					
A/R Revenue, Refund, Reimbursements.	$ 5				$ 5
Total Intragovernmental Accounts Receivable	5				5
With the Public					
A/R Revenue, Refund, Reimbursements	1				1
Audit Receivable	1				1
Total Accounts Receivable	$ 7				$ 7

2001

	Gross Accounts Receivable	Allowance for Uncollectible Accounts: Beginning Balance	Additions (Reductions)	Ending Balance	Net Accounts Receivable
Intragovermental					
A/R Revenue, Refund, Reimbursements	$ 41				$ 41
Total Intragovernmental Accounts Receivable	$ 41				$ 41

As of September 30, 2002 and 2001, the establishment of an allowance for uncollectible amounts was deemed unnecessary.

NOTE 6. LOANS RECEIVABLE AND RELATED FORECLOSED PROPERTY, NET

Balance Sheet Review

Direct Loans

Direct loan obligations or loan guarantee commitments made pre-1992 and the resulting direct loans or loan guarantees are reported at net present value.

Direct loan obligations or loan guarantee commitments made post-1991, and the resulting direct loan or loan guarantees, are governed by the Federal Credit Reform Act of 1990 as amended. The Act requires agencies to estimate the cost of direct loans and loan guarantees at present value for the Budget. Additionally, the present value of the subsidy costs (i.e. interest rate differentials, interest subsidies, delinquencies and defaults, fee offsets and other cash flows) associated with direct loans and loan guarantees are recognized as a cost in the year the loan or loan guarantee is disbursed. The net present value of loans or defaulted guaranteed loans receivable at any point in time is the amount of the gross loan or defaulted guaranteed loans receivable less the present value of the subsidy at that time.

The net present value of loans receivable is not necessarily representative of the proceeds that might be expected if these loans were sold on the open market.

Loans receivable and related foreclosed property, net balances at the end of FY 2002 were $58 billion compared to $59 billion at the end of FY 2001. Defaulted guaranteed programs were $79 million at the end of FY 2002. Table 1 below illustrates the overall composition of the Rural Development loan portfolio by mission area and loan program for FY 2002.

During the fiscal year the gross outstanding balance of the direct loans obligated post-1991 is adjusted by the value of the subsidy cost allowance held against those loans. Current year subsidy expense, modifications, and reestimates all contribute to the change of the subsidy cost allowance throughout the year. The subsidy cost allowance moved from $4.3 billion to $3.8 billion during FY 2002, a decrease of $.5 billion. During FY 2001, the allowance increased $209 million. Table 2 shows the reconciliation of subsidy cost allowance balances from FY 2001 to FY 2002.

Total direct loan subsidy expense for FY 2002 is a combination of subsidy expense for new direct loans disbursed in the current year, modifications to existing loans, and interest rate and technical reestimates to existing loans. Total direct loan subsidy expense in FY 2002 was $-68 million compared to $659 million in FY 2001. Table 3 illustrates the breakdown of total subsidy expense for FY 2002 and FY 2001 by program.

Due to the implementation of new models, new reestimate calculators, the accumulation of prior year reestimates, and other risk factors in FY 2001, it is difficult to compare the current and prior period subsidy expense or the current and prior year movement in the subsidy cost allowance.

Direct loan volume increased from $4.4 billion in FY 2001 to $4.6 billion in FY 2002. This increase was largely due to a $283 million increase in Electric and Telecommunications loans disbursed in FY 2002. Volume distribution between programs is shown in Table 4.

Table 1

Total Loans Receivable and Related Foreclosed Property, Net (in millions)

FY 2002

Direct Loans	Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Present Value Allowance	Value of Assets
Obligated Pre-1992					
Housing Loans	14,957	108	39	-5,178	9,926
Electric Loans	17,337	42	0	-1,682	15,697
Telecommunications Loans	2,076	5	0	-245	1,836
Rural Telephone Bank	680	2	0	53	735
Rural Development *	2,802	30	0	-12	2,820
Development Loan Funds	61	0	0	-20	41
Other Programs	7	0	0	-2	5
Pre-1992 Total	**37,920**	**187**	**39**	**-7,086**	**31,060**
Obligated Post-1991					
Housing Loans	12,055	51	32	-2,059	10,079
Community Facility Loans	1,135	13	3	-112	1,039
Electric Loans	9,696	4	0	-536	9,164
Telecommunications Loans	1,533	2	0	-24	1,511
Rural Telephone Bank	334	0	0	-11	323
Water and Environmental Loans	5,055	55	0	-754	4,356
Development Loan Funds	335	2	0	-150	187
Business & Industry Funds	113	2	0	-34	81
Economic Development	77	0	0	-12	65
Post-1991 Total	**30,333**	**129**	**35**	**-3,692**	**26,805**
Total Direct Loans Receivable	**68,253**	**316**	**74**	**-10,778**	**57,865**
Defaulted Guaranteed Loans					
Pre-1992					
Rural Development Insurance Fund	12	0	0	-9	3
Post-1991					
Community Facilities	4	0	0	0	4
Business & Industry	180	0	0	-108	72
Total Defaulted Guaranteed Loans	**196**	**0**	**0**	**-117**	**79**
Total Loans Receivable and Related Foreclosed Property, Net					**57,944**

* Prior to Credit Reform, Water and Environmental, Business and Industry and Community Facilities were combined under one Treasury symbol and fund.

FY 2001

Direct Loans	Loans Receivable, Gross	Interest Receivable	Foreclosed Property	Present Value Allowance	Value of Assets
Obligated Pre-1992					
Housing Loans	16,124	90	49	-2,636	13,627
Electric Loans	18,729	163	0	-1,415	17,477
Telecommunications Loans	2,278	8	0	-399	1,887
Rural Telephone Bank	794	3	0	51	848
Rural Development Insurance *	3,061	33	0	-993	2,101
Development Loan Funds	66	0	0	-17	49
Other Programs	8	0	0	1	9
Pre-1992 Total	**41,060**	**297**	**49**	**-5,408**	**35,998**
Obligated Post-1991					
Housing Loans	11,663	39	17	-2,715	9,004
Community Facility Loans	987	10	0	-116	881
Electric Loans	7,809	44	0	-437	7,416
Telecommunications Loans	1,261	2	0	-26	1,237
Rural Telephone Bank	291	0	0	-12	279
Water and Environmental Loans	4,543	49	1	-710	3,883
Development Loan Funds	312	2	0	-144	170
Business & Industry Funds	82	3	0	-31	54
Economic Development	73	0	0	-13	60
Post-1991 Total	**27,021**	**149**	**18**	**-4,204**	**22,984**
Total Direct Loans Receivable	**68,081**	**446**	**67**	**-9,612**	**58,982**
Defaulted Guaranteed Loans					
Pre-1992					
Rural Development Insurance Fund	18	0	0	-15	3
Post-1991					
Business & Industry	133	0	0	-87	46
Total Defaulted Guaranteed Loans	**151**	**0**	**0**	**-102**	**49**
Total Loans Receivable and Related Foreclosed Property, Net					**59,031**

* Prior to Credit Reform, Water and Environmental, Business and Industry and Community Facilities were combined under one Treasury symbol and fund.

Table 2

Schedule for Reconciling Subsidy Cost Allowance Balances (Post-1991 Direct Loans) ***(in millions)***

Beginning Balance, Changes, and Ending Balance	**FY 2002**	**FY 2001**
Beginning Balance of the subsidy cost allowance	**4,291**	**4,082**
Add: subsidy expense for direct loans disbursed during the year by component		
Interest rate differential costs	337	362
Default costs (net of recoveries)	25	28
Fees and other collections	-76	-77
Other subsidy costs	46	46
Total of the above subsidy expense components	332	359
Adjustments		
Loan modifications	0	0
Fees received	11	7
Loans written off	-117	-79
Subsidy allowance amortization	-407	-401
Other	90	23
Ending balance of the subsidy cost allowance before reestimates	4,200	3,991
Add or subtract subsidy reestimates by component		
Interest rate reestimate	188	719
Technical/default reestimate	-588	-419
Total of the above reestimate components	-400	300
Ending balance of the subsidy cost allowance	**3,800**	**4,291**

Table 3

Direct Loan Subsidy Expense by Program and Component (in millions)

CURRENT REPORTING YEAR	Subsidy Expense for New Direct Loans Disbursed					Mods*	Reestimates			
	Interest Differential	Defaults	Fees and Other Colls	Other	Total	Total	Interest Rate	Technical	Total	GRAND TOTAL
Direct Loan Programs										
Housing Loans	220	13	-75	51	209		-47	-422	-469	**-260**
Community Facility Loans	18	1	-1	0	18		3	-15	-12	**6**
Electric Loans	-2	2	0	-2	-2		209	-117	92	**90**
Telecommunications Loans	4	0	0	0	4		3	-5	-2	**2**
Rural Telephone Bank	1	0	0	0	1		1	-3	-2	**-1**
Water and Environmental Loans	82	1	0	-3	80		22	-27	-5	**75**
Development Loan Funds	16	0	0	0	16		0	-2	-2	**14**
Business & Industry Funds	-6	8	0	0	2		-3	4	1	**3**
Economic Development	4	0	0	0	4		0	-1	-1	**3**
Total Subsidy Expense, Direct Loans	337	25	-76	46	332		188	-588	-400	**-68**

PRIOR REPORTING YEAR	Subsidy Expense for New Direct Loans Disbursed					Mods	Reestimates			
	Interest Differential	Defaults	Fees and Other Colls	Other	Total	Total	Interest Rate	Technical	Total	GRAND TOTAL
Direct Loan Programs										
Housing Loans	227	13	-74	48	214		271	-158	113	**327**
Community Facility Loans	16	1	-2	1	16		8	11	19	**35**
Electric Loans	-3	12	0	-1	8		326	-221	105	**113**
Telecommunications Loans	4	0	0	0	4		42	-35	7	**11**
Rural Telephone Bank	0	0	0	0	0		11	-9	2	**2**
Water and Environmental Loans	96	0	0	-3	93		47	-36	11	**104**
Development Loan Funds	20	0	-1	1	20		-1	1	0	**20**
Business & Industry Loans	-2	2	0	0	0		13	28	41	**41**
Economic Development	4	0	0	0	4		2	0	2	**6**
Total Subsidy Expense, Direct Loans	362	28	-77	46	359		719	-419	300	**659**

Table 4

Total Amount of Direct Loans Disbursed (Post-1991) (in millions)

Direct Loans	Current Year	Prior Year	Current Year Over (Under) Prior Year
Housing Loans	1,207	1,222	-15
Community Facility Loans	201	163	38
Electric Loans	2,080	1,951	129
Telecommunications Loans	368	214	154
Rural Telephone Bank	60	56	4
Water and Environmental Loans	643	694	-51
Development Loan Funds	34	40	-6
Business & Industry Loans	36	27	9
Economic Development	17	16	1
Total Direct Loans Disbursed	**4,646**	**4,383**	**263**

Guaranteed Loans

Rural Development offers both direct and guaranteed loan products which are administered in coordination with conventional agricultural lenders for up to 90 percent of the principal loan amount. Under the guaranteed loan programs, the lender is responsible for servicing the borrower's account for the life of the loan. The agency, however, is responsible for ensuring borrowers meet certain qualifying criteria to be eligible and monitoring the lender's servicing activities. Borrowers interested in guaranteed loans must apply to a conventional lender, which then arranges for the guarantee with the agency. Guaranteed loans are reported on the balance sheet in two ways: estimated losses on loan credit guarantees must be valued and carried as a liability and guaranteed loans purchased from third party holders which are carried at net realizable value in loans receivable and related foreclosed property, net.

Guaranteed loans outstanding at the end of FY 2002 were $18.4 billion in outstanding principal (face value), and $16 billion in outstanding principal (guaranteed), compared to $17.1 billion and $14.9 billion at the end of FY 2001, respectively. Table 5 shows the outstanding balances by loan program.

During the fiscal year the value of the guaranteed loans is adjusted by the value of the loan guarantee liability held against those loans. Current year subsidy expense and reestimates all contribute to the change of the loan guarantee liability throughout the year. The loan guarantee liability is a combination of the liability for losses on pre-1992 guarantees and post-1991 guarantees. The total liability moved from $612 million to $507 million during FY 2002, a decrease of $105 million. The post-1991 liability moved from $587 million to $477 million, a decrease of $110 million. Table 6 shows the reconciliation of the loan guarantee liability post-1991 balances and the total loan guarantee liability.

Total guaranteed loan subsidy expense for FY 2002 is a combination of subsidy expense for new guaranteed loans disbursed in the current year and the interest rate and technical reestimates to existing loans. Total guaranteed loan subsidy expense in FY 2002 was $-28 million compared to $111 million in FY 2001. Table 7 illustrates the breakdown of total subsidy expense for FY 2002 and FY 2001 by loan program.

Due to the implementation of new models, new reestimate calculators, the accumulation of prior year reestimates, and other risk factors, it is difficult to compare the current and prior period subsidy expense or the current and prior year movement in the loan guarantee liability.

Guaranteed loan volume (face value) increased from $3.1 billion in FY 2001 to $3.4 billion in FY 2002. Volume distribution between programs is shown in Table 8.

Table 5

Loan Guarantees Outstanding (in millions)

	Pre-1992 Outstanding Principal, Face Value	Post-1991 Outstanding Principal, Face Value	Total Outstanding Principal, Face Value	Pre-1992 Outstanding Principal, Guaranteed	Post-1991 Outstanding Principal, Guaranteed	Total Outstanding Principal, Guaranteed
Guaranteed Loans (FY 2002)						
Housing Loans	16	13,602	13,618	14	12,242	12,256
Community Facility Loans	0	301	301	0	249	249
Electric Loans	317	199	516	317	199	516
Business and Industry Loans	0	3,883	3,883	0	2,863	2,863
Other Programs	84	30	114	60	24	84
Total Guarantees Disbursed	**417**	**18,015**	**18,432**	**391**	**15,577**	**15,968**
Guaranteed Loans (FY 2001)						
Housing Loans	19	12,672	12,691	17	11,405	11,422
Community Facility Loans	0	269	269	0	225	225
Electric Loans	358	147	505	358	147	505
Business and Industry Loans	0	3,504	3,504	0	2,648	2,648
Other Programs	102	23	125	70	20	90
Total Guarantees Disbursed	**479**	**16,615**	**17,094**	**445**	**14,445**	**14,890**

Table 6a

Liability for Loan Guarantees (Present value method for Pre-1992 guarantees) (in millions)

	FY 2002			FY 2001		
	Liabilities for Losses on Pre-1992 Guarantees Present Value	Liabilities for Loan Guarantees on Post-1991 Guarantees Present Value	Total Liabilities for Loan Guarantees	Liabilities for Losses on Pre-1992 Guarantees Present Value	Liabilities for Loan Guarantees on Post-1991 Guarantees Present Value	Total Liabilities for Loan Guarantees
Liability for Loan Guarantees						
Housing Loans	3	327	330	4	412	416
Community Facility Loans	0	5	5	0	1	1
Electric Loans	24	0	24	19	0	19
Business and Industry Loans	0	145	145	0	174	174
Other Programs	3	0	3	2	0	2
Total Liabilities for Loan Guarantees	**30**	**477**	**507**	**25**	**587**	**612**

Table 6b

Schedule for Reconciling Loan Guarantee Liability (in millions)

Beginning Balance, Changes, and Ending Balance	FY 2002	FY 2001
Beginning Balance of the loan guarantee liability	**587**	**572**
Add: subsidy expense for guaranteed loans disbursed during the year by component		
Interest supplement costs	18	-5
Default costs (net of recoveries)	93	81
Fees and other collections	-47	-67
Other subsidy costs	0	-1
Total of the above subsidy expense components	64	8
Adjustments		
Loan modifications	0	0
Fees received	62	48
Interest supplements paid	0	0
Claim payments to lenders	-114	-91
Interest accumulation on the liability balance	-2	18
Other	-28	-71
Ending balance of the loan guarantee liability before reestimates	569	484
Add or subtract subsidy reestimates by component		
Interest rate reestimate	-122	101
Technical/default reestimate	30	2
Total of the above reestimate components	-92	103
Ending balance of the loan guarantee liability	**477**	**587**

Table 7

Guaranteed Loan Subsidy Expense by Program and Component (in millions)

CURRENT REPORTING YEAR	Subsidy Expense for New Guaranteed Loans Disbursed					Reestimates			
	Interest Supplement	Defaults	Fees and Other Colls	Other	Total	Interest Rate	Technical	Total	GRAND TOTAL
Guaranteed Loan Programs									
Housing Loans	18	56	-38	0	36	-45	-47	-92	**-56**
Community Facility Loans	0	0	0	0	0	-2	6	4	**4**
Electric Loans	0	0	0	0	0	0	0	0	**0**
Business and Industry Loans	0	37	-9	0	28	-75	71	-4	**24**
Other Programs	0	0	0	0	0	0	0	0	**0**
Total Subsidy Expense	18	93	-47	0	64	-122	30	-92	**-28**

PRIOR REPORTING YEAR	Subsidy Expense for New Guaranteed Loans Disbursed					Reestimates			
	Interest Supplement	Defaults	Fees and Other Colls	Other	Total	Interest Rate	Technical	Total	GRAND TOTAL
Guaranteed Loan Programs									
Housing Loans	-5	60	-52	0	3	46	0	46	**49**
Community Facility Loans	0	0	-1	0	-1	-2	1	-1	**-2**
Electric Loans	0	0	0	0	0	0	0	0	**0**
Business and Industry Loans	0	21	-14	-1	6	57	1	58	**64**
Other Programs	0	0	0	0	0	0	0	0	**0**
Total Subsidy Expense	-5	81	-67	-1	8	101	2	103	**111**

Table 8

Guaranteed Loans Disbursed (in millions)	Current Year		Prior Year	
	Principal, Face Value Disbursed	Principal, Guaranteed Disbursed	Principal, Face Value Disbursed	Principal, Guaranteed Disbursed
Guaranteed Loans				
Housing Loans	2,449	2,205	2,170	1,953
Community Facility Loans	59	49	74	62
Electric Loans	54	54	92	92
Business and Industry Loans	839	658	809	635
Other Programs	9	7	4	3
Total Guaranteed Loans Disbursed	**3,410**	**2,973**	**3,149**	**2,745**

Credit Program Discussion and Descriptions

Rural Development offers direct and guaranteed loans through credit programs in the mission area through the Rural Housing Service (RHS), the Rural Business and Cooperative Service (RBS), and the Rural Utilities Service (RUS).

The Rural Development (RD) mission area

Each year, Rural Development (RD) programs create or preserve tens of thousands of rural jobs and provide or improve the quality of rural housing. To leverage the impact of its programs, RD is working with state, local and Indian tribal governments, as well as private and nonprofit organizations and user-owned cooperatives. RD programs are administered through the three services.

Through its loan and grant programs, RHS provides affordable housing and essential community facilities to rural communities. Programs also help finance new or improved housing for moderate, low, and very low-income families each year. RHS programs also help rural communities to finance, construct, enlarge or improve fire stations, libraries, hospitals and medical clinics, industrial parks, and other community facilities.

RBS's goal is to promote a dynamic business environment in rural America. RBS works in partnership with the private sector and community based organizations to provide financial assistance and business planning. It also provides technical assistance to rural businesses and cooperatives, conducts research into rural economic issues, and provides cooperative educational materials to the public.

The RUS helps to improve the quality of life in rural America through a variety of loan programs for electric energy, telecommunications, and water and environmental projects. RUS programs leverage scarce Federal funds with private capital for investing in rural infrastructure, technology and development of human resources.

RD agencies are able to provide certain loan servicing options to borrowers whose accounts are distressed or delinquent. These options include reamortization, restructuring, loan deferral, lowering interest rates, acceptance of easements, and debt write-downs. The choice of servicing options depends on the loan program and the individual borrower.

<u>Rural Development List of Programs</u>

Rural Housing Service

Home Ownership Direct Loans
Home Ownership Guaranteed Loans
Home Improvement and Repair Direct Loans
Home Ownership and Home Improvement and Repair Nonprogram Loans

Rural Business Service

Business and Industry Direct Loans
Business and Industry Guaranteed Loans
Intermediary Relending Program Direct Loans
Rural Economic Development Direct Loans

Rural Housing Service (contd.)
Rural Housing Site Direct Loans
Farm Labor Housing Direct Loans
Rural Rental and Rural Cooperative Housing Loans
Rental Housing Guaranteed Loans
Multi-family Housing – Nonprogram – Credit Sales
Community Facilities Direct Loans
Community Facilities Guaranteed Loans

Rural Utilities Service

Water and Environmental Direct Loans
Water and Environmental Guaranteed Loans
Electric Direct Loans
Electric Guaranteed Loans
Telecommunications Direct Loans
Rural Telephone Bank
Federal Financing Bank – Telecommunications Guaranteed
Distance Learning and Telemedicine Direct
Broadband Telecommunications Services

Table 9a

Program Characteristics – Direct

Major Programs (Direct)	Repayment Period	Interest Rate	Unique Servicing Option
Housing Single-Family	Maximum 30-38 years/program	Current	Payment assistance - payment moratoriums – loan reamortization
Rural Rental/Rural Cooperative	1997 and prior – 50 years Subsequent – 50 year amortization with 30 year repayment and balloon	Current	Payment assistance - rental assistance to tenants
Community Facility	Maximum 40 years	4.5% to current	Workout agreements – loan reamortization
Water & Environmental	Useful life not to exceed 40 years	< or equal 5% to current	Principal payment deferments – loan reamortization –loan transfers
Electric	Maximum 35 years	Current	Payment deferments- loan reamortization – discounted loan prepayments Loans prior to 11/93 received interest rates from 2-5%.
Telecommunications	Expected composite life (depreciated life plus 3 years	5-7%	Payment extension
Rural Telephone Bank	Expected useful life not to exceed 35 years	Current or 5%	Payment extension
Development Loans Intermediary Relending	Maximum 30 years	1%	Payment moratoriums
Business and Industry	Maximum 40 years	Current	Loan reamortization –loan transfer

Table 9b

Program Characteristics – Guaranteed			
Major Programs (Guaranteed)	**Repayment Period**	**Interest Rate**	**Unique Servicing Option**
Housing Single-Family	Maximum 30 years	Lender	Maximum 90% guarantee –Lender pays 2% fee - Loans may be sold to third party
Community Facilities	Maximum 40 years	Lender	Maximum 90% guarantee – Lender pays 1% fee – Loans may be sold to third party
Electric	Maximum 35 years	Lender	100% guarantee
Business & Industry	Maximum 7- 30 years per program	Lender	Guarantee maximum 60-80% - Lender pays 2% fee-

Discussion of Administrative Expenses, Subsidy Costs, and Subsidy Rates

Administrative Expenses

Consistent with the Federal Credit Reform Act of 1990 as amended, subsidy cash flows exclude direct Federal administrative expenses. Administrative expenses for FY 2002 are shown in Table 10.

Table 10

Administrative Expenses ***(in millions)***

Direct Loan Programs	Amount	Guaranteed Loan Programs	Amount
Total	178	**Total**	131

Reestimates, Default Analysis, and Subsidy Rates

The Federal Credit Reform Act of 1990 as amended governs the proprietary and budgetary accounting treatment of direct and guaranteed loans. The long-term cost to the government for direct loans or loan guarantees is referred to as "subsidy cost". Under the Act, subsidy costs for loans obligated beginning in FY 1992 are recognized at the net present value of projected lifetime costs in the year the loan is disbursed. Subsidy costs are revalued annually. Components of subsidy include interest subsidies, defaults, fee offsets, and other cash flows.

Based on a sensitivity analysis conducted for each cohort or segment of a loan portfolio, the difference between the budgeted and actual interest for both borrower and Treasury remain the key components for the subsidy formulation and reestimate rates of many USDA direct programs. USDA uses the government-wide interest rate projections provided by the Office of Management and Budget in order to do its calculations and analysis.

New cash flow models for direct Rural Development housing were used initially in FY 2001. For direct housing programs, the FY 1999 and 2000 activity year reestimates were prepared using the pre-existing model while the FY 2001 activity was reestimated and verified using the new direct housing models. All these direct housing reestimates were recorded in FY 2001. FY 2002 reestimates were prepared for major direct programs in the current fiscal year.

Rural Development community and utility program reestimates related to FY 1999 and 2000 activity were prepared utilizing the new model and recorded in the prior period. For FY 2001 activity, due to the predictability of the programs, an approximator method was used to prepare subsidy reestimates for material programs. Reestimates for three years' activity are recorded in the prior reporting period. In FY 2002, all programs reestimates were prepared for FY 2001 activity and FY 2002 major program activity reestimates were recorded using an estimated procedure. The Rural Telephone Bank which uses this model has booked reestimates annually and current year reestimates were calculated using the model.

In FY 2001, Rural Development loan guarantee programs recorded prior year activity and material FY 2001 activity reestimates executed using the guaranteed model. For the current period, all guaranteed reestimates were recorded for prior year activity and material FY 2002 activity reestimates executed using the model. Key sensitivity elements in the guaranteed programs are fee collections and defaults. During FY 2001, the Single-Family Housing program increased the upfront fee from 1% to 2% during the year, which resulted in a lower subsidy rate. Both material programs, Single-Family Housing and Business and Industry, experienced losses in excess of the budgeted projections.

Subsidy rates are used to compute each year's subsidy expenses as disclosed above. The subsidy rates disclosed pertain only to the current year FY 2002 cohorts. These rates cannot be applied to the direct and guaranteed loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new loans reported in the current year could result from disbursements of loans from both current year cohorts and prior year cohorts. The subsidy expense reported in the current year also include reestimates.

Table 11

Subsidy Rates for Direct Loans (percentage)

FY 2002

Direct Loan Programs	Interest Differential	Defaults	Fees and Other Collection	Other	Total
Section 502 Single-Family Housing	13.20	1.31	-7.15	5.80	13.16
Section 504 Housing Repair	29.96	2.30	-5.98	5.85	32.13
Credit Sales Section 203 (SFH)	-20.20	4.55	-10.51	21.34	-4.82
Section 514 Farm Labor Housing	46.94	0.08	-2.51	2.80	47.31
Section 515 Rural Rental Housing	50.56	-0.03	-30.91	22.70	42.32
Section 523 Self-Help Housing Land Development	3.54	1.03	-9.14	9.65	5.08
Section 524 Housing Site Development	-1.75	1.77	-9.64	10.17	0.55
Credit Sales Section 209 (MFH)	50.52	-0.02	-1.96	-6.37	42.17
Modular Housing Loans	17.94	0.03	-1.64	1.35	17.68
Community Facilites	4.53	1.18	0.00	-0.28	5.43
Distance Learning and Telemedicine	0.00	0.01	0.00	-0.08	-0.07
Water and Environmental Disposal	6.96	0.12	0.00	-0.20	6.88
Electric Hardship	2.92	0.03	0.00	0.03	2.98
Electric Municipal	-0.15	0.03	0.00	0.03	-0.09
FFB Electric	-1.12	0.03	0.00	-0.04	-1.13
Electric Treasury	-0.06	0.03	0.00	-0.01	-0.04
Telephone Hardship	2.27	0.03	0.00	0.02	2.32
Telephone Treasury	0.00	0.04	0.00	0.06	0.10
FFB Telephone	-0.92	0.11	0.00	-0.04	-0.85
Rural Telephone Bank	2.29	0.02	0.00	-0.17	2.14
Intermediary Relending Program	43.22	0.00	0.00	-0.01	43.21
Rural Economic Development	24.91	0.05	0.00	-0.80	24.16
Business and Industry	-30.79	58.98	0.00	0.28	28.47

FY 2001

Direct Loan Programs	Interest Differential	Defaults	Fees and Other Collect.	Other	Total
Section 502 Single-Family Housing	17.33	1.01	-6.70	4.42	16.06
Section 504 Housing Repair	33.66	1.96	0.00	-.018	35.44
Credit Sales Section 203 (SFH)	-13.89	3.89	-10.05	16.82	-3.23
Section 514 Farm Labor Housing	52.23	0.06	-2.24	2.54	52.59
Section 515 Rural Rental Housing	56.24	-0.04	-1.10	-5.83	49.27
Section 523 Self-Help Housing Land Development	4.00	1.02	-9.05	9.60	5.57
Section 524 Housing Site Development	-2.53	1.82	-9.66	10.25	-0.12
Credit Sales Section 209 (MFH)	56.26	-0.04	-1.73	-5.46	49.03
Modular Housing Loans	23.17	-0.05	-1.51	-1.54	20.07
Community Facilites	12.03	0.36	0.00	-0.70	11.69
Distance Learning and Telemedicine	-0.43	0.03	0.00	-0.21	-0.61
Water and Environmental Disposal	14.04	0.09	0.00	-0.54	13.59
Electric Hardship	12.85	0.01	0.00	-2.90	9.96
Electric Municipal	7.56	0.05	0.00	-0.66	6.95
FFB Electric	-3.30	0.21	0.00	0.00	-3.09
Electric Treasury	-0.06	0.03	0.00	-0.01	-0.04
Telephone Hardship	11.32	0.01	0.00	-0.97	10.36
Telephone Treasury	-1.42	0.02	0.00	0.40	-1.00
FFB Telephone	-2.04	0.00	0.00	0.00	-2.04
Rural Telephone Bank	1.60	0.03	0.00	-0.15	1.48
Intermediary Relending Program	51.00	0.03	0.00	-0.12	50.91
Rural Economic Development	27.32	0.17	0.00	-1.42	26.07
Business and Industry	-18.04	23.86	0.00	-0.00	5.82

Table 12

Subsidy Rates for Loan Guarantees (percentage)

FY 2002

Guaranteed Loan Programs	Interest Supplement	Defaults	Fees and Other Collect	Other	Total
Section 502 Single-Family Housing	0.00	3.28	-2.00	0.00	1.28
Section 538 Multi-Family Housing	8.82	2.24	-7.13	0.00	3.93
Community Facilities	0.00	0.12	-0.80	0.00	-0.68
Electric	0.00	0.08	0.00	0.00	0.08
Business and Industry	0.00	5.22	-1.48	0.00	3.74
NAD Bank	0.00	5.28	-1.60	0.00	3.68

FY 2001

Guaranteed Loan Programs	Interest Supplement	Defaults	Fees and Other Collect	Other	Total
Section 502 Single-Family Housing	0.00	2.20	-2.00	0.00	0.20
Section 538 Multi-Family Housing	5.39	2.02	-5.89	0.00	1.52
Community Facilities	0.00	0.29	-0.80	-0.03	-0.54
Electric	0.00	0.01	0.00	0.00	0.01
Business and Industry	0.00	2.46	-1.49	0.11	0.86
NAD Bank	0.00	2.64	-1.70	-0.12	0.82

Foreclosed Property

Property is acquired largely through foreclosure and voluntary conveyance. Acquired properties associated with loans are reported at their market value at the time of acquisition. The projected future cash flows associated with acquired properties are used in determining the related allowance (at present value).

For the years 2002 and 2001, Rural Housing Service properties consist primarily of 1,114 and 1,249 rural single-family dwellings, respectively. The average holding period for single family housing properties in inventory for the years 2002 and 2001 was 20 and 21.5 months, respectively. The approximate number of borrowers for which foreclosure proceedings were in process at the end of the fiscal year 2002 and 2001 was 22,000 and 18,600, respectively. Certain properties can be leased to eligible individuals.

Commitments to Guarantee

Rural Development has approximately $2.0 billion in commitments to extend loan guarantees.

Non-performing Loans

Rural Development's loan interest income on non-performing receivables is calculated but the recognition of revenue is deferred. Non-performing receivables are defined as receivables that are in arrears by 90 or more days.

Interest Credit

Approximately $19.1 and $19.6 billion of the Rural Housing Service unpaid loan principal as of September 30, 2002 and 2001, respectively, was receiving interest credit. If those loans receiving interest credit had interest accrued at the full-unreduced rate, interest income would have been approximately $1.1 billion and $1.2 billion higher for fiscal years 2002 and 2001, respectively. At the end of FY 2002 and 2001, the Rural Development portfolio contained approximately 104 and 114 thousand restructured loans with an outstanding unpaid principal balance of $6.2 and $6.7 billion, respectively.

NOTE 7: GENERAL PROPERTY, PLANT AND EQUIPMENT, NET

Amounts are presented in millions.

This equipment generally represents computer hardware, software, and other office equipment used in the Rural Development mission area's network of offices. Refer to **Notes 1L and 1M** for further information. There were no changes in the Capitalization Thresholds during the reporting periods.

2002

Classes	Cost	Accumulated Depreciation	Book Value	Estimated Useful Life **	Method of Depreciation *	Capitalization Threshold
Personal Property						
Equipment	$ 11	$ (4)	S 7	1-5	SL	$ 5,000
Internal Use Software	17	(2)	15	2-15	SL	$100,000
Internal Use Software in Development	10	0	10	2-15	SL	$100,000
Total	$ 38	$ (6)	$ 32			

2001

Classes	Cost	Accumulated Depreciation	Book Value	Estimated Useful Life**	Method of Depreciation *	Capitalization Threshold
Personal Property						
Equipment	$ 8	$ (3)	$ 5	1-5	SL	$ 5,000
Internal Use Software	11	0	11	2-15	SL	$100,000
Total	$ 19	$ (3)	$ 16			

*** SL – Straight Line** **** Range of Service Life**

NOTE 8: OTHER ASSETS

Amounts are presented in millions.

	2002	2001
With the Public		
Investment in Loan Asset Sale Trust*	$ 35	$ 35
Other	1	2
Total Other Assets	$ 36	$ 37

* In fiscal year 1987, a loan asset sale was conducted 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) and the Rural Housing Insurance Fund (RHIF) maintain investments in the Class C securities of the Community Program, Loan Trust, 1987A, and the Rural Housing Trust, 1987-1, respectively. These investments represent a residual security in the respective Trust and entitles Rural Development to residual cash flows resulting from loan repayments not required to pay trust security holders or to fund required reserves. Rural Development intends to retain the RDIF and RHIF Class C investments into the foreseeable future.

NOTE 9: LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

Amounts are presented in millions.

	2002	2001
Intragovernmental		
Unfunded FECA Liability	$ 5	$ 0
Total Intragovernmental	5	0
With the Public		
Federal Employee and Veterans' Benefits	31	5
Annual Leave	34	69
Total Liabilities Not Covered by Budgetary Resources	70	74
Total Liabilities Covered by Budgetary Resources	61,074	62,493
Total Liabilities	$ 61,144	$ 62,567

See *Note 1P* for a discussion of FECA.
See *Note 1U* for a discussion of Annual Leave.

Liabilities not covered by budgetary resources represent liabilities for which Congressional action is required before budgetary resources could be provided.

NOTE 10: DEBT

Amounts are presented in millions.

	2001 Beginning Balance	Net Borrowing	2001 Ending Balance	Net Borrowing	2002 Ending Balance
Agency Debt					
Held by the Public	$ 2	$ 0	$ 2	$ 0	$ 2
Notes Payable	88	(3)	85	(3)	82
Total Agency Debt	90	(3)	87	(3)	84
Other Debt					
Debt to the Treasury	24,463	1,187	25,650	1,863	27,513
Debt to the Federal Financing Bank (FFB)	26,960	(1,740)	25,220	(2,841)	22,379
Total Other Debt	51,423	(553)	50,870	(978)	49,892
Total Debt	$ 51,513	$ (556)	$ 50,957	$ (981)	$ 49,976

	2002	2001
Classification of Debt		
Intragovernmental Debt	$ 49,892	$ 50,870
Debt Held by the Public	84	87
Total Debt	$ 49,976	$ 50,957

Borrowings from the FFB are either in the form of Certificates of Beneficial Ownership (CBO) or loans executed directly between the borrower and FFB with Rural Development unconditionally guaranteeing repayment. Borrowings from private investors are in the form of CBO's. CBO's outstanding with the FFB and private investors are generally secured by unpaid loan principal balances. CBO's outstanding are related to Pre-Credit Reform loans and are no longer used for program financing.

FFB CBO's are repaid as they mature and are not related to any particular group of loans. Borrowings made to finance loans directly between the borrower and FFB mature and are repaid as the related group of loans becomes due. Interest rates on the related group of loans are equal to interest rates on FFB borrowings, except in those situations in which an FFB-funded loan is restructured and the terms of the loan are modified. For fiscal year 2002 and 2001, there were approximately $79 and $68 million of FFB loans repriced or refinanced, respectively.

In conjunction with certain RUS troubled debt restructurings, Rural Development has assumed notes payable to non-federal entities for FY 2002 and 2001, approximating $82 and $85 million, respectively for debt previously guaranteed. A substantial portion of these balances are owed to the National Rural Utilities Cooperative Finance Corporation, a private lender to rural electric borrowers. The notes bear interest at rates ranging from 7.13 to 10.70 percent, and mature through the year 2026.

Supplemental information associated with debt follows:

Amounts are presented in millions.

	2002	2001
Interest Payable, Federal		
Federal Financing Bank	$ 196	$ 546
U.S. Treasury	3	17
Total	$ 199	$ 563

These interest payable amounts associated with borrowings from the Treasury and the FFB are included in the table at the beginning of this note.

	2002	2001
Interest Expense, Federal		
Federal Financing Bank	$ 1,829	$ 2,155
U.S. Treasury	1,494	1,377
Total	$ 3,323	$ 3,532

NOTE 11: STOCK PAYABLE TO RTB BORROWERS

Amounts are presented in millions.

	2002	2001
With the Public		
B Stock Payable	$ 792	$ 820
C Stock Payable	551	448
Total	$ 1,343	$ 1,268

These liabilities are long-term in nature.

Capital Stock Class B:
Class B stock, a voting class of stock, is issued only to borrowers of RTB, in proportion to actual loan advances. RTB requires borrowers to purchase Class B stock in the amount of 5 percent of advanced loans amounts. Class B stock is nontransferable, except in connection with a transfer of ownership, approved by RTB, of all or part of a RTB loan. A borrower may exchange Class B stock for Class C stock either upon retiring the debt with RTB or effective November 8, 1999, prior to retiring all debt on a proportionate basis equal to the percentage of each note repaid. Otherwise, the borrower retains possession of the stock.

Capital Stock Class C:
Class C stock, a voting class of stock, is issued only to RTB borrowers, or to corporations and public entities eligible to borrow from RTB under Section 408 of the Rural Electrification Act of 1936, as amended, or by organizations controlled by such borrowers, corporations, and public entities.

For further details regarding Class B & C Stock, see **Note 7, Capital Stock**, in the Rural Telephone Bank Financial Statements which is issued under separate cover.

NOTE 12: OTHER LIABILITIES

Amounts are presented in millions.

2002

	Non-Current	Current	Total
Intragovernmental			
Employer Contributions &			
Payroll Taxes Payable	$ 0	$ 2	$ 2
Unfunded FECA Liability	0	5	5
Liability for Deposit Funds & Suspense			
Accounts	0	(4)	(4)
Other	0	17	17
Payable to Treasury General Fund	0	752	752
Total Intragovernmental	0	772	772
Accrued Funded Payroll and Benefits	0	(1)	(1)
Dividends Payable	0	22	22
Liability for Deposit Funds &			
Suspense Accounts	0	72	72
Annual Leave	0	34	34
Other	17	36	53
Total Other Liabilities	$ 17	$ 935	$ 952

2001

	Non-Current	Current	Total
Intragovernmental			
Employer Contributions &			
Payroll Taxes Payable	$ 0	$ 3	$ 3
Other	0	11	11
Payable to Treasury General Fund	0	187	187
Total Intragovernmental	0	201	201
Accrued Funded Payroll and Benefits	0	5	5
Unfunded Leave	0	69	69
Dividends Payable	0	21	21
Liability for Deposit Funds &			
Suspense Accounts	0	62	62
Other	16	81	97
Total Other Liabilities	$ 16	$ 439	$ 455

These liabilities are covered by Budgetary Resources.

NOTE 13: COMMITMENTS AND CONTINGENCIES

COMMITMENTS

Rural Development has commitments under cancelable leases for office space. The majority of buildings in which Rural Development operates are leased by the General Services Administration (GSA). GSA charges rent which is intended to approximate commercial rental rates.

As of September 30, 2002 and 2001, there were approximately $2.0 and $2.3 billion in commitments to extend loan guarantees, respectively.

As of September 30, 2002 and 2001, there were no obligations due to cancelled appropriations for which there is a contractual commitment for payment.

CONTINGENCIES

A class action complaint alleging race and gender discrimination under various civil rights and program statutes, known as, Chiang v. Veneman, Civil Action #2000/004 (D.C.V.I.) is in the early stages of litigation. The Government has filed a Motion to Dismiss and to Strike the Class Allegations. A determination has been made by the Office of General Counsel that it is "Reasonably Possible" that an unfavorable outcome is likely to occur. Opposing counsel has requested relief in the amount of $2.8 billion.

On January 25, 2002, the District Court denied the Government's Motion to Dismiss and to Strike the Class Allegations. On May 31, 2002, the District Court heard oral arguments on class certification. The Government is vigorously opposing class certification in this case, but will continue to evaluate the merits and litigation risks as the case moves forward.

A threatened lawsuit from PAPRI (Productos Agricolas de Puerto Rico, Inc.) to possibly void a Business and Industry loan note guarantee (60% guaranteed by Rural Development) is pending. A determination has been made by the Office of General Counsel that it is "Reasonably Possible" that an unfavorable outcome is likely to occur should the lawsuit proceed. The estimated range of potential loss is $7.2 million to $12 million.

Although overall the existing multiple family housing portfolio is in fair to good condition, Rural Development National Office officials, during a fiscal year 2000 Management Control Review determined that adequate funds had not been accrued to address future maintenance costs. A conservative estimate is that in the next 5 years, approximately 4,250 properties and 85,000 apartment units, will physically deteriorate to the point where safety and sanitation will necessitate a general modernization program to maintain their marketability and ultimately compete for tenants. The cost is expected to reach into the hundreds of millions of dollars.

NOTE 14: SUPPORTING SCHEDULE FOR THE STATEMENT OF NET COST

Amounts are presented in millions.

2002

	Mortgage Credit	Housing Assistance	Area & Regional Development	Energy Supply & Conservation	Agricultural Research & Services	Consolidated Total
Costs:						
Program Costs:						
Intragovernmental Gross Costs	$ 1,172	$ 13	$ 730	$ 1,643	$ 0	$ 3,558
Less: Intragovernmental Earned Revenue (Note 15)	118	0	114	65	0	297
Intragovernmental Net Costs	1,054	13	616	1,578	0	3,261
Gross Costs with the Public						
Grants and Payments	2	728	710	0	3	1,443
Loan Subsidy Costs	(486)	2	51	59	0	(374)
Other	3,458	23	(669)	265	0	3,077
Total Gross Costs with the Public	2,974	753	92	324	3	4,146
Less: Earned Revenues from the Public (Note 15)	1,634	0	683	1,730	0	4,047
Net Costs with the Public	1,340	753	(591)	(1,406)	3	99
NET COST OF OPERATIONS	$ 2,394	$ 766	$ 25	$ 172	$ 3	$ 3,360

NOTE 14: SUPPORTING SCHEDULE FOR THE STATEMENT OF NET COST

Amounts are presented in millions.

2001

	Mortgage Credit	Housing Assistance	Area & Regional Development	Energy Supply & Conservation	Agricultural Research & Services	Intra-Agency Eliminations	Consolidated Total
Costs:							
Program Costs:							
Intragovernmental Gross Costs	$ 1,447	$ 37	$ 1,005	$ 1,656	$ 1	$ (450)	$ 3,696
Less: Intragovernmental Earned Revenue (Note 15)	370	27	237	83	0	450	267
Intragovernmental Net Costs	1,077	10	768	1,573	1	0	3,429
Gross Costs with the Public							
Grants and Payments	1	721	631	0	1	0	1,354
Loan Subsidy Costs	375	1	271	123	0	0	770
Other	(1,677)	31	323	2,353	0	0	1,030
Total Gross Costs with the Public	(1,301)	753	1,225	2,476	1	0	3,154
Less: Earned Revenues from the Public (Note 15)	1,580	0	898	1,843	0	0	4,321
Net Costs with the Public	(2,881)	753	327	633	1	0	(1,167)
NET COST OF OPERATIONS	$ (1,804)	$ 763	$ 1,095	$ 2,206	$ 2	$ 0	$ 2,262

OTHER DISCLOSURES

FUNCTION LEVEL TITLE	SUB FUNCTION LEVEL TITLE	BUDGET SUB FUNCTION CODE	ACTIVITY INCLUDED IN FINANCIAL STATEMENTS PROGRAMS (where applicable)	LOAN/GRANT PROGRAMS INCLUDED IN BUDGET SUB FUNCTION CODE
National Defense	Department of Defense – Military	051	Other	Armament Retooling and Support
Energy	Energy Supply & Conservation	271, 272	Rural Utilities Service	Rural Electric and Telecommunication
National Resources	Water Resources Conservation & Land Management Pollution Control & Abatement	301 302 304	Other	Hazardous Waste Disposal
Agriculture	Agricultural Research and Services	352	Rural Business and Cooperative Services	Conservation loans
Commerce & Housing	Mortgage Credit	371	Rural Housing Service	Single Family Housing (direct & guaranteed) Multi-Family Housing (direct & guaranteed)
Community & Regional Development	Area & Regional Development	452	Rural Housing Service	Rural Community Facility (direct and guarant
			Rural Business and Cooperative Service	Rural Business and Industry (direct and Guaranteed) Rural Economic Development (loans and grants) Rural Development Loan funds
			Rural Utilities Service	Rural Water and Waste (direct and Guaranteed) Rural Telephone Bank Distance Learning and Telemedicine
Income Security	Housing Assistance	604	Rural Housing Service	Domestic Farm Labor Grants Very low-income housing repair grants Construction Defects Rental Assistance Program Other Housing Grants

USDA and the individual agencies preparing their own financial statements are required to prepare the Statement of Net Cost at the subfunction level. The Statement of Net Cost, as prepared by the Department of Treasury for the U.S. Government, shows these activities at the function level.

NOTE 15: EARNED REVENUES

Amounts are presented in millions.

2002

	Mortgage Credit	Housing Assistance	Area & Regional Development	Energy Supply & Conservation	Total
With the Public					
Interest Revenue	$ 1,634	$ 0	$ 683	$ 1,730	$ 4,047
Other	0	0	0	0	0
Total	1,634	0	683	1,730	4,047
Intragovernmental					
Interest Revenue from Treasury	114	0	112	65	291
Other	4	0	2	0	6
Total	118	0	114	65	297
Total Earned Revenues	$ 1,752	$ 0	$ 797	$ 1,795	$ 4,344

NOTE 15: EARNED REVENUES

Amounts are presented in millions.

2001

	Mortgage Credit	Housing Assistance	Area & Regional Development	Energy Supply & Conservation	Intra-Agency Eliminations	Total
With the Public						
Interest Revenue	$ 1,538	$ 0	$ 891	$ 1,843	$ 0	$ 4,272
Other	42	0	7	0	0	49
Total	1,580	0	898	1,843	0	4,321
Intragovernmental						
Interest Revenue from Treasury	94	0	115	50	0	259
Other	276	27	122	33	(450)	8
Total	370	27	237	83	(450)	267
Total Earned Revenues	$ 1,950	$ 27	$ 1,135	$ 1,926	$ (450)	$ 4,588

Other Disclosures

Credit Reform
The amount of subsidy expense on post-1991 direct loans equals the present value of estimated cash outflows over the life of the loan less the present value of cash inflows, discounted at the interest rate of marketable Treasury securities within a similar maturity term. A major component of subsidy expense is the interest subsidy cost/interest differential. This is defined as the excess of the amount of direct loans disbursed over the present value of the interest and principal payments required by the loan contracts, discounted as the applicable Treasury rate. One of the components of interest subsidy cost/interest differential is interest revenue. This interest revenue is earned from both federal and non-federal sources. For a further discussion of present value refer to **Note 1J**.

Exchange Transactions With Non-Federal Sources
When a new direct loan program becomes a reality, the applicable public law normally addresses interest rates to be charged to borrowers in some fashion. Public laws can be specific, state a minimum and/or maximum rate, or in general terms. The following general discussion about borrower interest rates is in relation to loan programs within each of our mission areas.

Rural Housing Service: The two largest loan programs (single-family housing and rural rental & cooperative housing) have a statutory basis for rates that is not less than the current average market yield on outstanding U.S. marketable obligations of comparable maturities. This rate has been determined to be the 25-year Treasury rate.

Rural Business-Cooperative Service: The main loan program (business and industry) has a statutory basis for a rate which is not less than the Treasury rate determined by considering 1) current average market yield on outstanding U.S. marketable obligations of comparable maturities, 2) comparable private market rates, 3) Secretary's insurance plus an additional charge to cover losses.

Rural Utilities Services: Water and Waste loans have a statutory basis for a rate which has a range between less than or equal to 5% to not greater than the current market yield for outstanding municipal obligations of comparable maturities adjusted to the nearest 1/8 of 1%. Telephone cost-of-money loans have a statutory basis for a rate equal to the current cost-of-money to the Federal Government for loans of a similar maturity, but not to exceed 7 percent. Electric municipal rate loans have a statutory basis for a rate equal to the current market yield on outstanding municipal obligations, subject to a 7 percent maximum, with remaining periods to maturity similar to the term selected by the applicant. Telephone and Electric hardship rate loans have a statutory basis for a rate of 5 percent. The rate on telephone and electric loans purchased by the Federal Financing Bank, shall be the rate applicable to similar loans being made or purchased by the Federal Financing Bank.

Exchange Transactions With Federal Sources
As the discussion in **Note 1B** attests, the history of Rural Development is one of financial and technical assistance to rural America. Rural Development serves as a temporary source of supervised credit until borrowers are able to qualify for private sector resources. As the lender of last resort, Rural Development is unable to recoup all the costs associated with its loan making and loan servicing activities. The main reason is that the costs associated with borrowings from Treasury to make loans exceeds the interest income received from borrowers plus any interest income earned from Treasury.

NOTE 16: PRIOR PERIOD ADJUSTMENTS

Amounts are presented in millions.

	2002
Property	$ (1)
FECA Actuarial	12
Total	$ 11

NOTE 17: APPORTIONMENT CATEGORIES OF OBLIGATIONS INCURRED

Amounts are presented in millions

		2002	
	Direct	Reimbursable	Total
Category A	$ 11,498	$ 0	$ 11,498
Category B	3,904	481	4,385
Total Obligations Incurred	$ 15,402	$ 481	$ 15,883

NOTE 18: AVAILABLE BORROWING AUTHORITY, END OF PERIOD

The amount of available borrowing authority as of September 30, 2002 is $13.2 billion.

NOTE 19: TERMS OF BORROWING AUTHORITY USED

- *Requirements for repayments of borrowings:* Borrowings are repaid on SF 1151, Nonexpenditure Transfer Authorization, as maturity dates become due. For liquidating accounts, maturity dates are one working day prior to the anniversary date of the note. For financing accounts, maturity dates are based on the period of time used in the subsidy calculation, not the contractual term of the agency's loans to borrowers. This period of time used in the subsidy calculation will normally be longer than the contractual term of the agency's loans to borrowers.

- *Financing sources for repayments of borrowings:* Included are reestimates and cash flows (i.e., borrower loan principal repayments), appropriations received in liquidating accounts for "cash needs", residual unobligated balances, where applicable, and other Treasury borrowings.

- *Other terms of borrowing authority used:* In general, borrowings are for periods of between one year and approximately fifty years depending upon the loan program/cohort. Interest rates on borrowings in the liquidating accounts were assigned on the basis of the Treasury rate in effect at the time of the borrowing. Interest rates on borrowings in the financing accounts are assigned on the basis of the Treasury rate in effect during the period of loan disbursements. Some individual loans are disbursed over several quarters or years. Consequently, several interest rates can be applicable to an individual loan. Thus, a single weighted average interest rate is maintained for each cohort and is adjusted each year until the disbursements for the cohort have been made. Each year, the current average annual interest rate is weighted by current year disbursements and merged with the prior years weighted average to calculate a new weighted average.

  Prepayments can be made on Treasury borrowings in the liquidating and financing accounts without penalty; however, they cannot be made on Federal Financing Bank Certificates of Beneficial Ownership in the liquidating accounts without penalty.

NOTE 20: ADJUSTMENTS TO BEGINNING BALANCE OF BUDGETARY RESOURCES

Amounts are presented in millions.

	2002
Actual Recoveries of Prior Year Obligations	$ 478
Cancellations of Expired Accounts	(43)
Enacted Rescissions of Current Year Balances	(4)
Capital Transfers and Redemption of Debt	(5,346)
Other Authority Withdrawn	(1,192)
Total Adjustments	$ (6,107)

Actual recoveries of prior year obligations represent cancellations or downward adjustments of obligations incurred in prior fiscal years that did not result in an outlay. For expired accounts, these recoveries are available for upward adjustments of valid obligations incurred during the unexpired period but not recorded.

Cancellations of expired accounts represent the amount of appropriation authority which is cancelled five years after the expiration of an annual or a multi-year appropriation.

Enacted rescissions of current year balances represent legislation canceling budget authority previously provided by law and prior to the time when the authority would otherwise expire.

Capital Transfers represent amounts deposited to Treasury receipt accounts for "Earnings of Government-Owned Enterprises" or "Repayment of Capital investment, Government-Owned Enterprises."

Redemption of debt represents the amount of principal repayments paid to the Treasury or the Federal Financing Bank on outstanding borrowings. It does **not** include interest payments, which are shown as an obligation and an outlay.

Other authority withdrawn represents the withdrawal of borrowing authority from no-year accounts through downward adjustments of prior year obligations.

In FY 2002, the beginning unobligated balance differed from the ending unobligated balance for FY 2001 in the amount of $62 million. A timing discrepancy for $67 million occurred when obligations were accrued for financial statement purposes in FY 2001, but were not recorded in the budgetary accounts until FY 2002. The accounting treatment for parent/child relationships was changed from FY 2001 to FY 2002 resulting in a $5 million difference having the opposite effect of the aforementioned adjustment.

NOTE 21: PERMANENT INDEFINITE APPROPRIATIONS

Existence, purpose, and availability of permanent indefinite appropriations: Permanent indefinite appropriations are mainly applicable to liquidating accounts which have the ability to apportion them and for reestimates related to upward adjustments of subsidy in the program accounts. These appropriations become available pursuant to standing provisions of law without further action by Congress after transmittal of the Budget for the year involved. They are treated as permanent the first year they become available, as well as in succeeding years. However, they are not stated as specific amounts but are determined by specified variable factors, such as "cash needs" for the liquidating accounts and information about the actual performance of a cohort or estimated changes in future cash flows of the cohort in the program accounts.

The period of availability for these appropriations are as follows: Annual authority is available for obligation only during a specified year and expires at the end of that time. Multi-year authority is available for obligation for a specified period of time in excess of one fiscal year. No-year authority remains available for obligation for an indefinite period of time, usually until the objectives for which the authority was made available are achieved.

Annual and multi-year authority expire for the purpose of incurring new obligations. However, the authority is available for adjustments to obligations and for disbursements that were incurred or made during the period prior to expiration, but not recorded. Unless specifically authorized in law, the period that the expired authority is available for adjustments to obligations or for disbursements is five fiscal years (beginning with the first expired year). At the end of the fifth expired year, the authority is "cancelled". Thereafter, the authority is not available for any purpose.

NOTE 22: LEGAL ARRANGEMENTS AFFECTING USE OF UNOBLIGATED BALANCES

The availability/use of budget authority (i.e., unobligated balances) for obligation and expenditure are limited by purpose, amount, and time.

--**Purpose** – Funds may be obligated and expended only for the purpose authorized in appropriation acts or other laws.

--**Amount** – Obligations and expenditures may not exceed the amounts established in law. Amounts available are classified as either definite (i.e., not to exceed a specified amount) or indefinite (i.e., amount is determined by specified variable factors).

--**Time** – The period of time during which budgetary resources may incur new obligations is different from the period of time during which the budgetary resources may be used to disburse funds.

The time limitations on the use of unobligated balances are the same as those previously discussed in the last two paragraphs of the permanent indefinite appropriations footnote disclosure.

Any information about legal arrangements affecting the use of unobligated balances of budget authority will be specifically stated by program and fiscal year in the appropriation language or in the alternative provisions section at the end of the appropriations act.

NOTE 23: EXPLANATION OF DIFFERENCES BETWEEN THE STATEMENT OF BUDGETARY RESOURCES AND THE BUDGET OF THE UNITED STATES GOVERNMENT

The 2004 Budget of the United States Government, with the Actual Column completed for fiscal year 2002, has not yet been published as of the date of these financial statements. The Budget is currently expected to be published and delivered to Congress in early February 2003. The Budget will be available from the Government Printing Office.

NOTE 24: EXPLANATION OF RELATIONSHIP BETWEEN LIABILITIES NOT COVERED BY BUDGETARY RESOURCES ON THE BALANCE SHEET AND THE CHANGE IN COMPONENTS REQUIRING OR GENERATING RESOURCES IN FUTURE PERIODS ON THE STATEMENT OF FINANCING

Liabilities not covered by budgetary resources represent select ending liability account balances of a specific reporting period. Components requiring or generating resources in future periods represent the year over year increase in these select liability accounts or the specific expenses recognized during the reporting period except for upward/downward reestimates of credit subsidy expense. These subsidy reestimates are recognized expenses even though budgetary resources will be provided in a subsequent period. These credit subsidy reestimates are reported as liabilities covered by budgetary resources since the budget authority to fund the reestimates is permanent and indefinite and no further congressional action is required to provide the resources.

Examples of liabilities which are included are:

- Accrued unfunded annual leave liability
- Unfunded FECA liability
- FECA actuarial liability
- Upward/Downward reestimates of credit subsidy expense

NOTE 25: DESCRIPTION OF TRANSFERS THAT APPEAR AS A RECONCILING ITEM ON THE STATEMENT OF FINANCING

- The Appalachian Regional Commission (ARC) invests in the basic building blocks of sustainable economic development in the 406 counties (13-State Region) which comprise the Appalachian Region. ARC has allocated funds to Rural Development to provide accounting services. As of September 30, 2002, the amount of this reconciling item is $17.1 million.
- The Economic Development Administration's (EDA) Assistance Program provides grants for public works facilities, other financial assistance, and planning and coordination assistance needed to alleviate conditions of substantial and persistent unemployment and underemployment in economically distressed areas and regions. EDA has allocated funds to Rural Development to provide accounting services. As of September 30, 2002, the amount of this reconciling item is $1.1 million.

NOTE 26: INCIDENTAL CUSTODIAL COLLECTIONS

Amounts are presented in millions.

	Custodial Activity	
	2002	**2001**
Sources of Collections		
Soil Conservation Service Loan Collections	$ 1	$ 1
Total Revenue Collected	$ 1	$ 1
Disposition of Collections		
Amount Transferred to Treasury Receipt Accounts	$ 1	$ 1
Total Disposition of Revenue	$ 1	$ 1
Net Custodial Activity	$ 0	$ 0

REQUIRED SUPPLEMENTARY INFORMATION

Amounts are presented in millions.

	2002 Budgetary				
	Rural Community Advancement Program	Rural Electrification/ Telecommunication Funds	Rural Telephone Bank Funds	Rural Housing Funds	Rental Assistance Programs
Budgetary Resources:					
Budget Authority					
Appropriations Received	$ 2,582	$ 86	$ 11	$ 837	$ 763
Borrowing Authority	0	1	0	0	0
Net Transfers	460	103	(23)	(4)	0
Unobligated Balance:					
Beginning of Period	98	3	772	156	9
Net Transfers, Actual	0	0	0	0	0
Spending Authority from Offsetting Collections:					
Earned					
Collected	428	2,858	220	1,866	0
Receivable from Federal Sources	0	0	0	0	0
Change in Unfilled Customer Orders Without Advance from Federal Sources	0	0	0	0	0
Subtotal	428	2,858	220	1,866	0
Recoveries of Prior Year Obligations	32	20	8	24	0
Permanently Not Available	(1,853)	(1,839)	(10)	(1,491)	(63)
Total Budgetary Resources	$ 1,747	$ 1,232	$ 978	$ 1,388	$ 709

REQUIRED SUPPLEMENTARY INFORMATION

Amounts are presented in millions.

2002 Budgetary

	Rural Community Advancement Program	Rural Electrification/ Telecommunicatio n Funds	Rural Telephone Bank Funds	Rural Housing Funds	Rental Assistance Programs
Status of Budgetary Resources:					
Obligations Incurred:					
Direct	$ 1,567	$ 1,143	$ 33	$ 1,324	$ 705
Reimbursable	0	0	0	0	0
Subtotal	1,567	1,143	33	1,324	705
Unobligated Balance:					
Apportioned	71	0	0	21	3
Unobligated Balance Not Available	109	89	945	43	1
Total Status of Budgetary Resources	1,747	1,232	978	1,388	709
Relationship of Obligations to Outlays:					
Obligated Balance, Net, Beginning of Period	2,377	572	123	539	2,738
Obligated Balance Transferred, Net	0	0	0	0	0
Obligated Balance, Net, End of Period:					
Accounts Receivable	0	0	0	0	0
Unfilled Customer Orders from Federal Resources	0	0	0	0	0
Undelivered Orders	2,599	278	95	270	2,741
Accounts Payable	84	103	21	142	48
Outlays:					
Disbursements	1,229	1,314	31	1,427	654
Collections	(428)	(2,858)	(220)	(1,866)	0
Subtotal	801	(1,544)	(189)	(439)	654
Less: Offsetting Receipts	54	26	3	269	0
Net Outlay:	$ 747	$ (1,570)	$ (192)	$ (708)	$ 654

REQUIRED SUPPLEMENTARY INFORMATION

Amounts are presented in millions.

2002 Budgetary

	Rural Housing Grants	Salaries & Expense	Other	Total
Budgetary Resources:				
Budget Authority				
Appropriations Received	$ 105	$ 150	$ 84	$ 4,618
Borrowing Authority	0	0	0	1
Net Transfers	0	0	52	588
Unobligated Balance:				
Beginning of Period	39	53	29	1,159
Net Transfers, Actual	0	0	0	0
Spending Authority from Offsetting Collections:				
Earned				
Collected	0	497	8	5,877
Receivable from Federal Sources	0	(23)	12	(11)
Change in Unfilled Customer Orders				
Without Advance from Federal Sources	0	0	0	0
Subtotal	0	474	20	5,866
Recoveries of Prior Year Obligations	5	174	4	267
Permanently Not Available	0	(28)	(5)	(5,289)
Total Budgetary Resources	$ 149	$ 823	$ 184	$ 7,210

REQUIRED SUPPLEMENTARY INFORMATION

Amounts are presented in millions.

	2002 Budgetary			
	Rural Housing Grants	**Salaries & Expense**	**Other**	**Total**
Status of Budgetary Resources:				
Obligations Incurred:				
Direct	$ 107	$ 296	$ 67	$ 5,242
Reimbursable	0	481	0	481
Subtotal	107	777	67	5,723
Unobligated Balance:				
Apportioned	42	3	67	207
Unobligated Balance Not Available	0	43	50	1,280
Total Status of Budgetary Resources	149	823	184	7,210
Relationship of Obligations to Outlays:				
Obligated Balance, Net, Beginning of Period	107	123	150	6,729
Obligated Balance Transferred, Net	0	0	0	0
Obligated Balance, Net, End of Period:				
Accounts Receivable	0	(6)	(19)	(25)
Unfilled Customer Orders from Federal Resources	0	0	0	0
Undelivered Orders	132	96	149	6,360
Accounts Payable	2	35	3	438
Outlays:				
Disbursements	75	624	68	5,422
Collections	0	(497)	(8)	(5,877)
Subtotal	75	127	60	(455)
Less: Offsetting Receipts	0	0	4	356
Net Outlay	$ 75	$ 127	$ 56	$ (811)

REQUIRED SUPPLEMENTARY INFORMATION

Amounts are presented in millions.

	2002 Non-Budgetary Credit Program Financing Accounts				
	Rural Community Advancement Program	Rural Electrification/ Telecommunication Funds	Rural Telephone Bank Funds	Rural Housing Funds	Rental Assistance Programs
Budgetary Resources:					
Budget Authority:					
Appropriations Received					
Borrowing Authority	$ 1,531	$ 4,969	$ 174	$ 1,302	$ 0
Net Transfers					
Unobligated Balance:					
Beginning of Period	113	6	5	478	0
Spending Authority from Offsetting Collections:					
Earned					
Collected	738	976	49	1,804	0
Receivable from Federal Sources	(319)	(90)	(16)	(213)	0
Change in Unfilled Customer Orders					
Without Advance from Federal Sources	311	68	19	217	0
Subtotal	730	954	52	1,808	0
Recoveries of Prior Year Obligations	80	34	22	69	0
Permanently Not Available	(123)	(278)	(35)	(844)	0
Total Budgetary Resources	$ 2,331	$ 5,685	$ 218	$ 2,813	$ 0

REQUIRED SUPPLEMENTARY INFORMATION

Amounts are presented in millions.

	2002 Non-Budgetary Credit Program Financing Accounts				
	Rural Community Advancement Program	**Rural Electrification/ Telecommunicatio n Funds**	**Rural Telephone Bank Funds**	**Rural Housing Funds**	**Rental Assistance Programs**
Status of Budgetary Resources:					
Obligations Incurred:					
Direct	$ 2,088	$ 5,323	$ 201	$ 2,381	$ 0
Reimbursable					
Subtotal	2,088	5,323	201	2,381	0
Unobligated Balance:					
Apportioned	140	0	0	113	0
Unobligated Balance Not Available	103	362	17	319	0
Total Status of Budgetary Resources	2,331	5,685	218	2,813	0
Relationship of Obligations to Outlays:					
Obligated Balance, Net, Beginning of Period	2,319	6,208	1,001	487	0
Obligated Balance Transferred, Net					
Obligated Balance, Net, End of Period:					
Accounts Receivable					
Unfilled Customer Orders from Federal Resources	(311)	(68)	(19)	(217)	0
Undelivered Orders	3,244	8,382	1,110	768	0
Accounts Payable					
Outlays:					
Disbursements	1,402	3,205	86	2,244	0
Collections	(738)	(976)	(49)	(1,804)	0
Subtotal	664	2,229	37	440	0
Less: Offsetting Receipts	0	0	0	0	0
Net Outlay:	$ 664	$ 2,229	$ 37	$ 440	$ 0

REQUIRED SUPPLEMENTARY INFORMATION

Amounts are presented in millions.

2002 Non-Budgetary Credit Program Financing Accounts

	Rural Housing Grants	Salaries & Expense	Other	Total
Budgetary Resources:				
Budget Authority	$	$	$	$
Appropriations Received				
Borrowing Authority	0	0	127	8,103
Net Transfers				
Unobligated Balance:				
Beginning of Period	0	0	10	612
Spending Authority from Offsetting Collections:				
Earned				
Collected	0	0	67	3,634
Receivable from Federal Sources	0	0	(56)	(694)
Change in Unfilled Customer Orders				
Without Advance from Federal Sources	0	0	51	666
Subtotal	0	0	62	3,606
Recoveries of Prior Year Obligations	0	0	6	211
Permanently Not Available	0	0	(16)	(1,296)
Total Budgetary Resources	$ 0	$ 0	$ 189	$ 11,236

REQUIRED SUPPLEMENTARY INFORMATION

Amounts are presented in millions.

	2002 Non-Budgetary Credit Program Financing Accounts			
	Rural Housing Grants	**Salaries & Expense**	**Other**	**Total**
Status of Budgetary Resources:				
Obligations Incurred:				
Direct	$ 0	$ 0	$ 167	$ 10,160
Reimbursable	0	0		
Subtotal	0	0	167	10,160
Unobligated Balance:				
Apportioned	0	0	21	274
Unobligated Balance Not Available	0	0	1	802
Total Status of Budgetary Resources	0	0	189	11,236
Relationship of Obligations to Outlays:				
Obligated Balance, Net, Beginning of Period	0	0	217	10,232
Obligated Balance Transferred, Net				
Obligated Balance, Net, End of Period:				
Accounts Receivable				
Unfilled Customer Orders from Federal Resources	0	0	(51)	(666)
Undelivered Orders	0	0	319	13,823
Accounts Payable				0
Outlays:				
Disbursements	0	0	116	7,053
Collections	0	0	(68)	(3,635)
Subtotal	0	0	48	3,418
Less: Offsetting Receipts	0	0	0	0
Net Outlays	$ 0	$ 0	$ 48	$ 3,418