

**OFFICE OF FEDERAL HOUSING
ENTERPRISE OVERSIGHT**

FINANCIAL REPORT

September 30, 2004

Office of Federal Housing Enterprise Oversight

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OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

FISCAL YEAR 2004 MANAGEMENT'S DISCUSSION AND ANALYSIS

MISSION STATEMENT

OFHEO promotes housing and a strong economy by ensuring the safety and soundness of Fannie Mae and Freddie Mac and fostering the strength and vitality of the nation's housing finance system.

OVERVIEW

The Office of Federal Housing Enterprise Oversight (OFHEO) was established by Title XIII of the Housing and Community Development Act of 1992, Public Law Number 102-550, known as the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (1992 Act). OFHEO is an independent office within the Department of Housing and Urban Development (HUD) with responsibility for examining and regulating the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) (collectively, the Enterprises) and ensuring that they are adequately capitalized. The two Enterprises were created by Government Charter to provide an adequate flow of money into the housing markets and to make home ownership possible for many Americans that might otherwise not be able to finance a home.

A Director appointed by the President and confirmed by the Senate for a five-year term heads OFHEO. In October 1999, Armando Falcon, Jr. was sworn in as the second Director. Under Director Falcon's continued leadership, OFHEO effectively regulated the Enterprises in FY 2004, determining quarterly that the Enterprises were adequately capitalized and met significant supervisory challenges at Freddie Mac and Fannie Mae.

Supervision of a Dynamic, Growing and Complex Environment

Since OFHEO began operations in 1993, Fannie Mae and Freddie Mac have more than tripled in size and shifted their business strategy from primarily guaranteeing mortgage-backed securities to principally managing asset portfolios of mortgages and mortgage securities. To fund the growth of their mortgage asset portfolios, the Enterprises have rapidly increased their outstanding debt, developed innovative debt instruments—including instruments denominated in foreign currencies—and established a program of regular issuances that frequently are viewed by market participants as alternatives to investing in U.S. Treasury securities. To minimize their funding costs and manage the interest rate risk inherent in financing fixed-rate mortgages with debt, the Enterprises have become among the most important end users of interest rate derivatives. The notional amount of the derivatives contracts of the Enterprises increased from \$72 billion at year-end 1993 to \$1.6 trillion on September 30, 2004, down 9 percent from September 30, 2003. The Enterprises have also expanded the range of mortgages they purchase, buying loans with higher loan-to-value ratios, subprime mortgages, loans to low-risk borrowers who choose to provide limited documentation, and more mortgages secured by multifamily properties. Those changes have required increasingly complex and sophisticated risk management and accounting by Fannie Mae and Freddie Mac and corresponding changes in supervision by OFHEO.



Dramatic advances in information technology have made possible the expansion and the increasing complexity of the business operations and risk management of Fannie Mae and Freddie Mac. The Enterprises use cutting-edge technology, employing massive databases and complex quantitative models, to measure and manage their risks in an ever changing business and economic environment. These technologies not only permit the Enterprises to leverage their resources but also pose operational risks that Fannie Mae and Freddie Mac must actively manage. OFHEO must also understand and monitor Enterprise operational risks and ensure the adequacy of their strategies for managing those risks.

Meeting the Supervisory Challenges of FY 2004

OFHEO continued to perform its role as an effective regulatory agency by examining both Enterprises, and by evaluating capital management and compliance with capital standards at each Enterprise. In addition, OFHEO had two on-going special examinations in FY 2004 - one at Freddie Mac and a second one at Fannie Mae.

OFHEO made public the results the special examination of Freddie Mac and took appropriate enforcement actions against the Enterprise and responsible corporate officials. The report on the special examination of Freddie Mac detailed a pattern of inappropriate conduct and improper management of earnings that led to the restatement and management restructuring of the company. As a result of the findings of the special examination, Freddie Mac paid a large civil penalty in FY 2004 of \$125 million as part of a consent order with OFHEO. OFHEO also reviewed and approved a plan of remediation for Freddie Mac and subsequently monitored the progress made by Freddie Mac to implement the approved corrective actions. To date, Freddie Mac has made satisfactory progress in complying with the remediation agreement, and roughly half of the agreement has been implemented. The Enterprise is cooperating with OFHEO in accomplishing our mutual goal of remediation. As a result of the increased operational risk at Freddie Mac, OFHEO directed Freddie Mac to maintain a targeted capital surplus of 30% over their minimum capital requirement. To date, Freddie Mac has maintained a surplus in compliance with this directive.

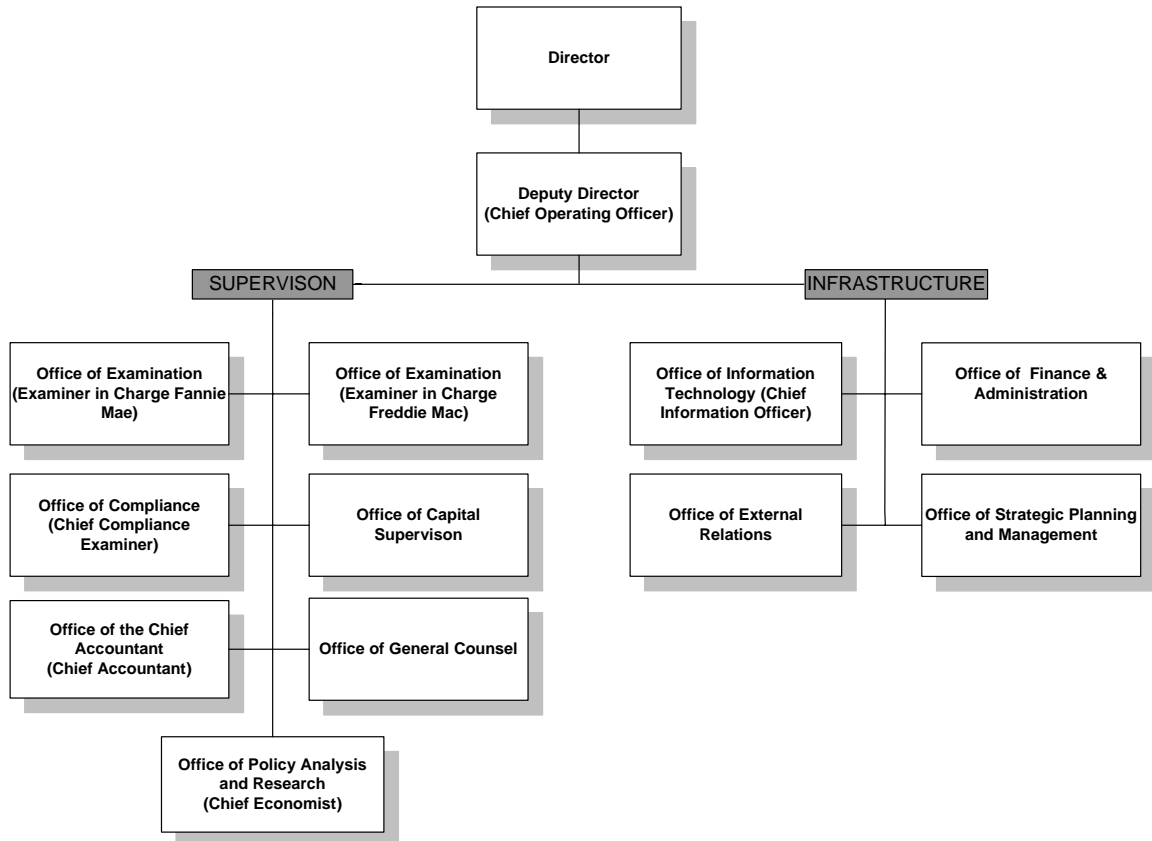
In addition, OFHEO began a special examination of accounting policies and practices at Fannie Mae. The scope of this review includes accounting policies and controls at the Enterprise, with an emphasis on identification of any control weaknesses or unusual accounting transactions. In September 2004, OFHEO reported serious safety and soundness issues to the Fannie Mae Board of Directors. OFHEO found pervasive and willful misapplication of Generally Accepted Accounting Principles (GAAP) as well as critical operational deficiencies. The Board reached an agreement with OFHEO on a plan of remediation to correct the many serious problems identified by OFHEO. This agreement is an important first step toward resolving the concerns of OFHEO and ensuring financial safety and soundness at Fannie Mae. As part of the remediation plan, Fannie Mae is required to build their capital surplus to 30% over their minimum capital requirement by June 2005 based on the increased risks evident at Fannie Mae. The special examination at Fannie Mae continues, and if OFHEO discovers more problems, the Office may take further action.

ORGANIZATIONAL STRUCTURE IS FOCUSED ON SUPERVISION

In FY 2003, the Director added two new offices to the management structure - the Office of Compliance and the Chief Accountant's Office - to augment the activities performed by the Offices of Examination and strengthen internal capability to examine compliance and accounting treatment issues at the Enterprises. During FY 2004, OFHEO staffed the two new offices and added strength to other key supervisory programs in the Offices of Examination – Fannie Mae, Examination – Freddie Mac, Capital Supervision, and General Counsel.



OFHEO continues to be located at a single site at 1700 G Street NW in the District of Columbia. The Director and Deputy Director carry out the mission through the coordinated efforts of 11 offices. These offices are: (1) Examination – Fannie Mae, (2) Examination – Freddie Mac, (3) Compliance, (4) Capital Supervision, (5) Chief Accountant, (6) General Counsel, (7) Policy Analysis and Research, (8) Information Technology, (9) Finance and Administration, (10) External Relations, and (11) Strategic Planning and Management.



BUDGET UNCERTAINTY CONTINUES TO WEAKEN REGULATOR

Unlike any other financial regulator, OFHEO is required by law to seek its budgetary resources through the appropriations process, though OFHEO is not funded by taxpayer dollars. OFHEO has encountered two problems in using the Appropriations process to fund operations. First, the appropriations process is a lengthy process with budget requests developed two years in advance of implementation. The process is inflexible and does not allow necessary flexibility in changes to the budget request to respond to current developments at the Enterprises. Second, when the appropriations bill, in which the budget of OFHEO is incorporated, is not completed prior to the start of the fiscal year, the lack of adequate available funding impacts key initiatives and effectively stop momentum on achieving goals because of funding constraints.

As demonstrated in FY 2003, it took nearly seven months to complete the appropriations process to get additional funds for the Freddie Mac examination. As a consequence, the OFHEO Director was forced to divert



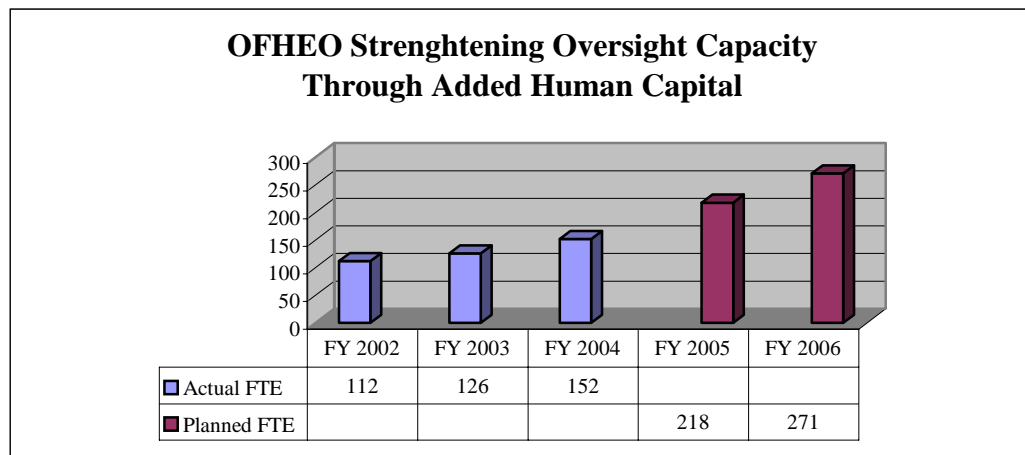
existing staff from other work and reallocate financial resources in order to continue the investigative work at Freddie Mac. OFHEO had no authority to make a special assessment to cover the increased costs of regulation.

During FY 2004, OFHEO operated under a Continuing Resolution (CR) for the first six months. This meant that OFHEO did not have access to the funds necessary to support the planned initiatives to strengthen supervisory activities. Additionally, larger purchases had to be postponed to ensure that the reduced funding would be adequate to cover operational expenses. The uncertainty about when and if resources would be available to OFHEO impeded the hiring of needed additional staff and delayed other initiatives.

During the second half of FY 2004, OFHEO moved forward with its staffing initiative. However, uncertainty began to impact decisions as FY 2005 loomed closer and a budget had not been enacted. October 1 passed and OFHEO was again operating under a CR, which provided funding through November 20, 2004. The base for FY 2005 operations was set at 88 percent of FY 2004 funding. This is significant in that the FY 2005 budget requirements are \$19.3 million greater than the full FY 2004 funding. This is an effective reduction of funding needed in the amount of \$23.8 million. The reduction from the full funding level for FY 2004 attributed by the Office of Management and Budget (OMB) to “one-time” expenses contained in the FY 2004 budget that could not be used in calculating the CR funding.

Director Falcon has repeatedly voiced concern about the potential impacts of the current funding strategy and has asked both OMB and Congress to remove OFHEO from the appropriations process. He is concerned that the appropriations process constrains the ability of OFHEO to respond appropriately to new unanticipated developments that could impair the financial safety and soundness of the Enterprises and prohibit the Enterprises from performing their important public missions.

Since Director Falcon’s tenure began, he has strengthened the oversight capability of the office by adding staff and has refocused its examinations to target key risk areas at the Enterprises. OFHEO has grown in FTE nearly 36 percent from FY 2002 to FY 2004 year end. OFHEO utilized 152 full-time equivalent (FTE) work years during FY 2004 up from 126 FTE in FY 2003, and up from 112 FTE in FY 2002. OFHEO had planned to more aggressively add staff in FY 2004, but had to delay hiring in the early part of the year due to the constraints of CRs. The agency faces similar restrictions in attaining hiring goals under the current funding strategy for FY 2005.



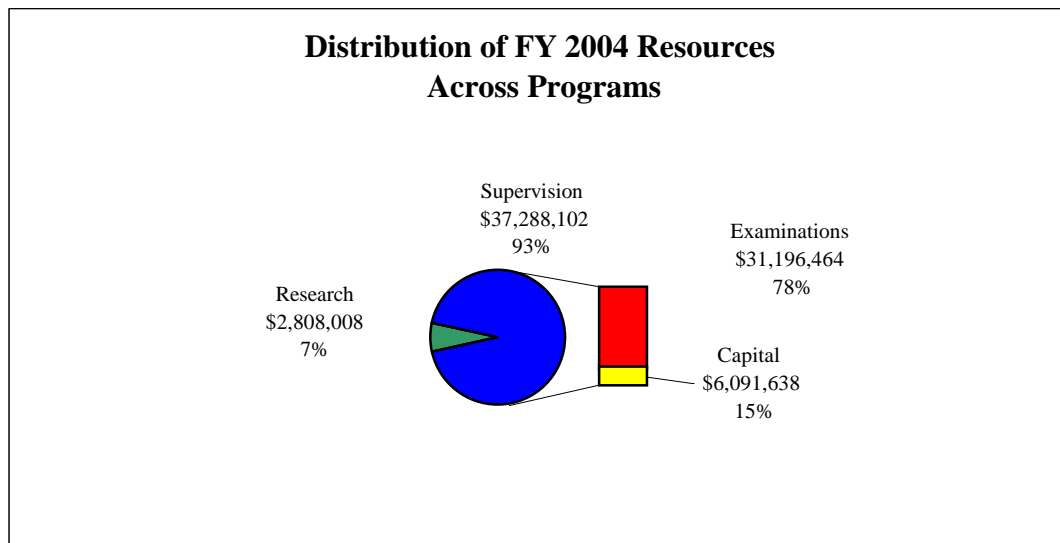
OFHEO IS NOT FINANCED BY TAXES

While the budget is currently subject to the annual congressional appropriations process, OFHEO is not funded by tax dollars. Fannie Mae and Freddie Mac bear the full cost of OFHEO operations through an annual assessment based on the annual operating budget as appropriated. Each Enterprise pays a pro rata share of the annual assessment. The combined assets and off-balance sheet obligations of each Enterprise determine the pro rata shares. Pursuant to law, OFHEO makes an annual assessment to the extent appropriated. The annual assessment is paid in semi-annual payments, October 1 and April 1. In the event that OFHEO is operating under a CR, the Enterprises are assessed for operating funds based on the provisions of the CR.

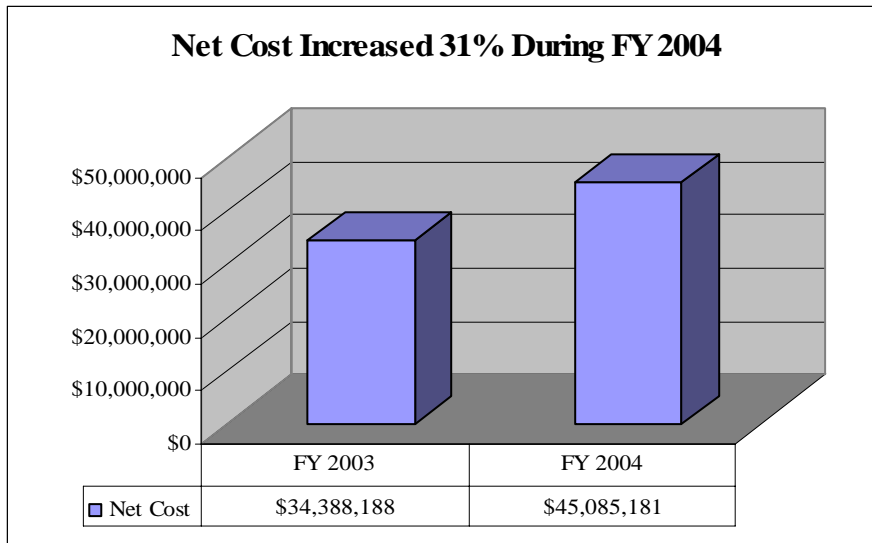
KEY FINANCIAL INFORMATION

In FY 2004, Congress appropriated OFHEO \$39.9 million for salaries and operating expenses. Due to a recovery of the prior years' unspent obligations, OFHEO had \$40.1 million available for obligations during FY 2004. Obligations represent monies awarded to specific contractors, payroll costs, and other expenses such as equipment purchases and employee travel costs for the fiscal year. All funds were obligated for the year ended September 30, 2004.

Of the \$40.1 million obligated during FY 2004, 93% or \$37.2 million was obligated for supervisory programs. Supervisory programs include all examination activities, capital management and supervision. The graph below reflects nearly \$30.9 million for examination, including annual examination activities, compliance examination, and accounting policy examination. The balance of funds was obligated for activities supporting economic research related to housing finance activities and for information disseminated to the public, such as the quarterly House Price Index. Administrative and support services costs are distributed to the mission programs on a prorate basis.



The net cost of operations of OFHEO rose during FY 2004 by 31% or \$10.7 million. Net cost includes payments made during FY 2004 regardless of obligating fiscal year. The increase represents an increase in human capital (compensation, benefits and expenses to support higher staffing levels) and contract services for the Fannie Mae special examination.



FINANCIAL MANAGEMENT ACHIEVEMENTS AND IMPROVEMENTS

Financial Statement Audit

OFHEO continues to receive *unqualified audit opinions* on its financial statements, internal controls and compliance with laws and regulations. The external auditors of OFHEO found that the financial statements prepared by OFHEO represented materially correct financial information, and the auditors did not identify any major control weaknesses or noncompliance with laws and regulations.

Federal Managers' Financial Integrity Act (FMFIA)

During FY 2004, OFHEO's managers continued to monitor internal controls and reported on the effectiveness of controls to the Director. In the internal control compliance letters received by Director Falcon from senior management, no reportable material weaknesses were identified. In subsequently issued letters, Director Falcon will advise the President and the Congress that OFHEO complied with FMFIA as of the end of FY 2004 (September 30, 2004)

Compliance with Prompt Payment Act

The Prompt Payment Act requires Federal agencies to make timely payments to vendors and improve the cash management practices of the government by taking discounts when they are justified. This means that OFHEO must pay its bills within a narrow window of time – not too early and not late.



In FY 2004, OFHEO continued its good performance for prompt payment of bills. During FY 2004, the dollar amount subject to prompt payment, increased by 9% over FY 2003, from \$8.2 million to \$8.9 million. The amount of interest penalty paid increased from \$479 in FY 2003 to \$875 in FY 2004.

Federal Financial Management Information Act (FFMIA) of 1996

The FFMIA codified in law certain financial management system requirements that were already in place for Executive Branch agencies but added one new requirement: new guidelines for auditors to report on agency compliance with system requirements and for agency heads and agency management to correct deficiencies within a reasonable time.

In FY 2004, OFHEO began the conversion process to a new core accounting system. OFHEO had selected off-the-shelf software certified by the Joint Financial Management Improvement Program (JFMIP) as meeting the minimum requirements established for Federal Government financial systems. Throughout FY 2004, OFHEO was engaged in executing the varied tasks associated with system conversion: custom coding, data conversion, process development, user training, systems interfacing and parallel testing. OFHEO's new system, named the Financial Information and Management System (FIMS), was implemented and began service in October 2004. FIMS provides the agency with greater functionality and flexibility, allowing the agency to streamline administrative and accounting processes.

OFHEO will continue to use service agreements with other Federal agencies when appropriate and cost effective. The National Finance Center (NFC), operated by the Department of Agriculture, will continue to provide payroll systems and services. OFHEO will be working toward interfacing the payroll system with its new accounting system during FY 2005.

LIMITATIONS OF THE FINANCIAL STATEMENTS

While OFHEO is not specifically covered by the requirements in the Chief Financial Officers (CFO) Act, the Office has prepared financial statements to report the financial position and results of operations of OFHEO, pursuant to the requirements of 31 U.S.C. 3515(b). The statements have been prepared from the books and records of OFHEO in the format prescribed by OMB. These statements supplement the periodic financial reports used to monitor and control budgetary resources that were prepared from the same books and records. The statements should be read with the understanding that they are for a component of the U.S. Government and an entity of the Department of Housing and Urban Development in its consolidated financial statements.

The following principal statements present the financial position of OFHEO, an independent office within HUD, as of September 30, 2004, and September 30, 2003. The statements are in conformity with the instructions provided for federal entities by the OMB and comply with Statements of Federal Financial Accounting Standards effective as of September 30, 2004.

OFHEO DELIVERS RESULTS

Despite the challenges of FY 2004, OFHEO achieved its goals. When reports from the still-ongoing OFHEO Special Examinations of both Freddie Mac and Fannie Mae identified significant accounting and internal control weaknesses in each Enterprise that raised safety and soundness concerns, OFHEO sought corrective action by each Enterprise and effected change. While continuing to monitor their compliance with their respective



directives—Freddie Mac with the December 9, 2003 consent order and Fannie Mae with the September 27, 2004 agreement— both enterprises continued to meet the OFHEO capital standards during FY 2004. The special examination noted problems that raised safety and soundness concerns at Fannie Mae, and OFHEO will formally reassess the safety and soundness ratings at both Enterprises when the regular examination work is completed. While focused on these priority goals and activities, OFHEO also achieved all of the annual goals set out in the FY 2004 Performance Plan (note that data for the last quarter for one performance goal are not yet available).

OFHEO ACHIEVES FY 2004 PERFORMANCE GOALS

OFHEO uses strategic planning and performance planning to set long term objectives and annual goals, and monitors progress throughout the year to produce results.

OFHEO has three Strategic Objectives:

1. Ensure the Enterprises comply with safety and soundness standards, are adequately capitalized, and comply with other legal requirements.
2. Enhance public understanding of the nation’s housing finance system.
3. Contribute to Federal efforts to promote efficient and effective financial markets and home ownership.

OFHEO set eight performance goals to reach its strategic objectives and three performance goals to support its resource management strategy. The FY 2004 Performance Plan outlines the means and strategies to achieve these annual performance goals. As for all regulators, the outcomes or results of the work of OFHEO are achieved through the actions of others. The Office provides regulation, supervision, guidance, review and a variety of products that influence the Enterprises and the financial markets. Highlights of the goals and accomplishments for each strategic objective are described below. The FY 2004 Annual Performance Report, with a more detailed description of OFHEO performance, will be issued by February 27, 2005 in accordance with the Government Performance and Results Act and subsequent amendments.

Before FY 2004 began, OFHEO requested additional funds to undertake the special examination of Fannie Mae and to continue the litigation arising from the continuing Freddie Mac examination. Although the requested level was enacted in appropriations, the expenses related to the special examination of Fannie Mae and the ongoing litigation related to the special examination of Freddie Mac exceeded expectations, and the Director was required to redirect contract and staff resources away from some planned activities. Still, OFHEO kept most of its activities on track and was able to achieve its planned performance goals.

Strategic Objective 1: Ensure the Enterprises comply with safety and soundness standards, are adequately capitalized, and comply with other legal requirements.

During FY 2004, OFHEO completed the Calendar Year (CY) 2003 annual risk-based examinations and initiated CY 2004 annual examinations. OFHEO found both Enterprises financially sound in CY 2003, but raised concerns through the targeted special examinations of both Enterprises. In December 2003, OFHEO issued a “Report of the Special Examination of Freddie Mac”, identified unsafe and unsound practices, and required remedial action. OFHEO also initiated a special examination of Fannie Mae and completed a “Report of



Findings to Date: Special Examination of Fannie Mae” in September 2004 that found safety and soundness concerns.

The “Report of the Special Examination of Freddie Mac” detailed a pattern of inappropriate conduct and improper management of earnings that lead to the company’s restatement of financial results for several years. Freddie Mac agreed to implement corrective measures as part of a consent order with OFHEO addressing Board oversight, internal controls, internal audit, accounting, risk management, and disclosure, and to pay a civil money penalty of \$125 million. Freddie Mac continues to make progress on its remediation plan, and OFHEO will verify safety and soundness controls related to the remediation plan as part of its ongoing examinations.

The “Report of Findings to Date: Special Examination of Fannie Mae” identified improper accounting and inadequate controls in several areas. The improper accounting of deferred price adjustments and of derivatives and hedging activities had the effect of minimizing earnings volatility and providing opportunities for improper earnings management. The Fannie Mae Board of Directors agreed to employ corrective accounting and management measures to (1) implement correct accounting treatments that will bring the Enterprise into compliance with Financial Accounting Standards for recognizing amortization of purchase premiums and discounts on securities and loans (FAS 91) and for derivatives and certain hedging activities (FAS 133), (2) undertake a top-to-bottom review of staff structure responsibilities, independence of functions, compensation and incentives, (3) appoint an independent chief risk officer and separate other key business functions currently performed jointly by certain individuals and departments, and (4) put in place policies to assure adherence to accounting rules and new internal controls. Fannie Mae has already implemented the OFHEO directive of May 2004 to change its accounting treatments of asset impairments for manufactured housing and aircraft lease securities.

The agreements that OFHEO reached with each Enterprise also affect their capital levels. Each Enterprise is required to retain a targeted capital surplus of 30 percent above the regulatory minimum capital levels. For Freddie Mac, this became effective as of January 29, 2004. Fannie Mae is required to submit a capital plan to OFHEO by November 12, 2004 detailing (1) how the Enterprise will grow its minimum capital surplus level to 30 percent by June 30, 2005 and (2) how the Enterprise will maintain a minimum capital surplus no lower than its August 30, 2004 levels. For FY 2004, both Enterprises met the regulatory capital standards for minimum and risk-based capital and were classified adequately capitalized for each quarter of the fiscal year, through June 30, 2004. For Freddie Mac, this included a surplus above minimum capital that exceeded the 30 percent surplus target. The capital classifications for both Enterprises are subject to revision based on the ongoing regulatory reviews by OFHEO. Adequate information to determine the capital classification of the Enterprises as of September 30, 2004, the last quarter of FY 2004, is not yet available.

After the Freddie Mac restatement of its 2003 financial information, OFHEO reaffirmed the capital adequacy of Freddie Mac for all four quarters in 2003. OFHEO published the restated minimum capital results for each quarter in 2003 (which included the first quarter of FY 2004). OFHEO will reassess the capital adequacy conclusions for the quarters in 2004 at the time Freddie Mac publishes these financials. The outcome of the OFHEO examination of Fannie Mae may also require the Enterprise to restate financial information and provide OFHEO with revised capital positions, which will be reevaluated to determine whether there would be changes in the capital classifications.

During FY 2004, OFHEO reorganized its supervisory function. In addition to establishing new Offices of Compliance and of the Chief Accountant, OFHEO strengthened and restructured the annual risk-based examinations program into two units with separate staffs, one for Freddie Mac and one for Fannie Mae. The dedication of staff to each Enterprise will result in the development of greater expertise in the operations,



structure, and regulatory issues of each company. OFHEO is also hiring additional experienced examiners, increasing its on-site presence at the Enterprises, and providing a more in-depth analysis of Enterprise performance, risks, processes, and controls. As in prior years, before conducting the annual examinations, the Office established and shared with the Enterprises safety and soundness standards that reflected various components of risk and risk management. Each quarter OFHEO updated the risk profile for each Enterprise and revised the examination strategies as necessary. The examination process and results are described in more detail in the OFHEO 2004 Report to Congress, June 15, 2004. Both CY 2003 examinations were completed on schedule and both Enterprises responded appropriately to examination issues.

OFHEO also strengthened its capital supervision of the Enterprises in 2004. OFHEO conducted additional analyses of trends and relationships between movements in market interest rates, changes in the Enterprises' portfolios and capital requirements, as well as more and less severe interest rate scenarios than employed in the risk-based capital stress test. These analyses supported the regulatory classifications. OFHEO continued research and analysis of issues related to risk and capital, and realigned resources in FY 2004 to direct more of its research and analysis to these areas. In future years, OFHEO will continue to review possible changes to the risk-based and minimum capital standards and will seek public comments on any proposed amendments.

During FY 2004, OFHEO continued to monitor Enterprise compliance with applicable laws, including laws related to disclosure. After reviewing the methodology used by the Enterprises to set the conforming loan limits, which govern Enterprise penetration in the market for home loans, OFHEO found the informal procedure inadequate and in February 2004 instituted a formal supervisory procedure to ensure a fair and accurate calculation. Strengthening its regulatory infrastructure, in April 2004, OFHEO proposed for public comment a regulation outlining new standards for corporate governance at the Enterprises to address current weaknesses and reduce the potential for future corporate misconduct. OFHEO posted on its web site comments received from the public and expects to issue a final corporate governance regulation in FY 2005.

Strategic Objective 2: Enhance public understanding of the nation's housing finance system.

OFHEO continued to provide information and analysis to the public, including the housing finance and investor analyst communities throughout the year. OFHEO does most of its analysis for internal use, and shares appropriate information with the public whenever possible. For example, OFHEO developed the House Price Index (HPI) for the risk-based capital stress test, and releases the quarterly HPI calculations to the public, sharing information about changes in house prices for the nation, regions, and metropolitan areas. Early in FY 2004, OFHEO posted several staff working papers on its web site, continuing to share staff research with the public to stimulate discussion and comment. In January 2004, OFHEO issued a report, "The Single-Family Mortgage industry in the Internet Era: Technology Developments and Market Structure". In April 2004, OFHEO posted on its web site an updated public version of the OFHEO risk-based capital stress test model and accompanying stylized data set. By running this "hypothetical firm" through the stress test model, a member of the public can better understand the sensitivities and implications of the stress test. In June 2004, OFHEO issued its Annual Report to Congress, describing the findings of the CY 2003 examinations of both Enterprises. OFHEO is unique among regulators, as it is required by law to make public its examination findings.

OFHEO also shared its reports of the special examinations of Freddie Mac and Fannie Mae with the public. After the Freddie Mac Board of Directors agreed to the consent order in December 2003, OFHEO posted on its web site the "Report of the Special Examination of Freddie Mac". In May 2004, OFHEO posted on its web site its letter to Fannie Mae recommending changes in accounting treatments of asset impairments for manufactured housing and aircraft lease securities, which Fannie Mae agreed to adopt. In September 2004, OFHEO shared its "Report of Findings to Date: Special Examination of Fannie Mae" with the Fannie Mae Board of Directors.



The OFHEO Director consulted with the Fannie Mae Board and posted the Report on the OFHEO web site. These reports, related Congressional hearings, and their wide coverage by the media continued to educate the public about the complexity of the business of the Enterprises, corporate governance principles, accounting standards, and corporate disclosure.

OFHEO also continued to make its own analysis and operations more transparent. OFHEO focused research and analysis on priority projects for internal use that will improve the understanding of safety and soundness and capital adequacy. As future agency products reflect this internal research, their dissemination through speeches, testimony, regulation, or reports can enlighten the public. OFHEO continued to enhance the analysis accompanying its quarterly announcements of the Enterprises' capital levels, to provide analytical information about interest rates, risk management strategies, portfolio composition and other components of the Enterprises' holdings that affected the risk-based capital calculations and the changes from quarter to quarter. In February 2004, OFHEO shared with the public its directive to the Enterprises to follow a formal procedure in calculating the conforming loan limit, describing the methodology used to calculate this limit that governs the Enterprises' market for purchasing loans.

During FY 2004, the OFHEO Director testified before Congress on issues related to the Freddie Mac restatement, the OFHEO special examination and the alternative legislative proposals designed to strengthen the regulation of the Enterprises. Challenged by an increase in inquiries, OFHEO continued to provide timely responses to Congress and the public. OFHEO staff made presentations at industry and professional forums on Enterprise regulation, the relationship between the OFHEO HPI and other indices, borrower costs and credit rationing in the subprime mortgage market, delinquency of subprime mortgages, and estimating and testing default and prepayment equations.

Strategic Objective 3: Contribute to Federal efforts to promote efficient and effective financial markets and homeownership.

OFHEO continued work with the other Federal financial regulators, the Office of Management and Budget, the Treasury Department, the Securities and Exchange Commission, the Federal Reserve, the Council of Economic Advisors, the Justice Department, the Government Accountability Office, and the Department of Housing and Urban Development on a variety of issues. These include the Freddie Mac restatement, issues related to the special examinations of Freddie Mac and Fannie Mae, risk-based capital requirements, fair-value accounting for mortgages held in portfolio, corporate and mortgage-backed securities disclosure, fair lending and credit scoring, supervision and examination practices, standards for Internet banking, risk management techniques and other issues related to non-mortgage investments, and planning, performance management and performance measurement. OFHEO continues to lead an interagency working group on Communications and Coordination for the Financial and Banking Information Infrastructure Committee, a standing committee of the President's Critical Infrastructure Protection Board, and is a member of the interagency Corporate Fraud Task Force.

Resource Management Strategy: Manage OFHEO resources effectively to enable the Office to fulfill its mission.

The OFHEO workforce, information systems, and internal controls form the critical foundation for achieving its strategic objectives. OFHEO identified three crosscutting performance goals as indicative of an effective support infrastructure. To maintain a high-caliber workforce, OFHEO staff and their managers updated the individual development plans. OFHEO also accomplished all projects planned for FY 2004 in the IT 5-year Strategic Plan. OFHEO received an unqualified audit opinion on its FY 2003 financial statements, and its FY



2004 independent review of information security found no material weaknesses. The HUD Inspector General found that OFHEO exceeded the requirement in the FY 2004 Appropriations Act to use no less than 60 percent of its fiscal year 2004 funds for examination, supervision and capital oversight of Fannie Mae and Freddie Mac. OFHEO agreed to implement the IG recommendation to design and conduct an employee time usage study to validate OFHEO managers' estimates of the cost of achieving each strategic goal.

FY 2005 and the Future

The OFHEO FY 2003-2008 Strategic Plan provides a framework for the Annual Performance Plans, budgets, and operations of OFHEO. The Strategic Plan continues to reflect the Congressional mandate that OFHEO ensure the safety and soundness of Fannie Mae and Freddie Mac, and emphasizes the need to foster the strength and vitality of the nation's housing finance system.

OFHEO will continue the special examinations of Freddie Mac and Fannie Mae and monitor their implementation of the requirements in the directives. These include improvements in corporate governance, compensation incentives, internal controls and accounting treatments. For Freddie Mac, this includes monitoring monthly the minimum capital level of the Enterprise, to ensure that it maintains targeted capital surpluses at least 30 percent above the regulatory minimum capital standard, and classifying it against that standard and the risk-based standard quarterly. During FY 2005, OFHEO expects to revisit the FY 2004 quarterly capital classifications after Freddie Mac releases its CY 2004 financial information. For Fannie Mae, OFHEO expects to issue a monthly classification of the capital adequacy of the Enterprise according to the minimum capital standard, including the requirement that Fannie Mae increase its surplus to 30 percent by the end of June 2005. OFHEO will continue to classify Fannie Mae quarterly based upon both minimum and risk-based capital positions. OFHEO will also monitor financial revisions necessary to correct hedge accounting of derivatives and amortization of premiums and discounts.





Dembo, Jones, Healy, Pennington & Marshall, P.C.

Certified Public Accountants and Consultants

Independent Auditors' Opinion on the Financial Statements

Mr. Armando Falcon
Director
Office of Federal Housing Enterprise Oversight

We have audited the accompanying balance sheets of the Office of Federal Housing Enterprise Oversight (OFHEO) as of September 30, 2004 and 2003, and the related statements of net cost, changes in net position, budgetary resources, and financing for the fiscal years then ended. These financial statements are the responsibility of OFHEO's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements." These standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Office of Federal Housing Enterprise Oversight as of September 30, 2004 and 2003, and its net costs; changes in net position; budgetary resources; and financing activities for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management Discussion and Analysis (MD&A) and the Required Supplemental Information (RSI) sections are not required parts of the basic financial statements of the Office of Federal Housing Enterprise Oversight but are supplementary information required by the Federal Accounting Standards Advisory Board and OMB Bulletin No. 01-09, "Form and Content of Agency Financial Statements". We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the MD&A and the RSI. However, we did not audit the information and, accordingly, express no opinion on it.

In accordance with *Governmental Auditing Standards*, we have also issued a report dated November 12, 2004, on our consideration of the Office of Federal Housing Enterprise Oversight's internal control over financial reporting and a report dated November 12, 2004 on its compliance with certain provisions of laws and regulations. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards*, and, in considering the results of the audits, these reports should be read in conjunction with this report.

While this report is intended solely for the information and use of the management of the Office of Federal Housing Enterprise Oversight, OMB and Congress, it is also a matter of public record, and its distribution is, therefore, not restricted.

Dembo, Jones, Healy, Pennington & Marshall, P.C.

November 12, 2004



Dembo, Jones, Healy, Pennington & Marshall, P.C.

Certified Public Accountants and Consultants

Report of Independent Auditors on Internal Control

Mr. Armando Falcon
Director
Office of Federal Housing Enterprise Oversight

We have audited the accompanying balance sheets of the Office of Federal Housing Enterprise Oversight (OFHEO) as of September 30, 2004 and 2003, and the related statements of net cost, changes in net position, budgetary resources, and financing for the fiscal years then ended, and have issued our report thereon dated November 12, 2004. We conducted our audits in accordance with: auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements."

In planning and performing our audits, we considered the Office of Federal Housing Enterprise Oversight's internal control over financial reporting by obtaining an understanding of OFHEO's internal control, determined whether 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 No. 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, such as those controls relevant to ensuring efficient operations. The objective of our audits was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued 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 that, in our judgment, could adversely affect the OFHEO's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the 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. However, we noted no matters involving the internal control and its operation that we considered to be material weaknesses as defined above. However, we noted other matters involving the internal control over financial reporting, which we will be reporting to management of the Office of Federal Housing Enterprise Oversight in a separate letter by November 30, 2004.

Finally, with respect to internal control related to performance measures reported in the annual performance plan, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

While this report is intended solely for the information and use of the management of the Office of Federal Housing Enterprise Oversight, OMB and Congress, it is also a matter of public record, and its distribution is, therefore, not restricted.

Dembo, Jones, Healy, Pennington & Marshall, P.C.

November 12, 2004



Dembo, Jones, Healy, Pennington & Marshall, P.C.

Certified Public Accountants and Consultants

Report of Independent Auditors on Compliance with Laws and Regulations

Mr. Armando Falcon
Director
Office of Federal Housing Enterprise Oversight

We have audited the accompanying balance sheets of the Office of Federal Housing Enterprise Oversight (OFHEO) as of September 30, 2004 and 2003, and the related statements of net cost, changes in net position, budgetary resources, and financing for the fiscal years then ended, and have issued our report thereon dated November 12, 2004. We conducted our audits in accordance with: auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements."

The management of the Office of Federal Housing Enterprise Oversight is responsible for complying with laws and regulations applicable to OFHEO. As part of obtaining reasonable assurance about whether OFHEO's 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 No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to the Office of Federal Housing Enterprise Oversight.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02. OMB Bulletin No. 01-09, "Form and Content of Agency Financial Statements", defines the form and content of financial statements of the executive departments and agencies listed in the attachment to the Bulletin. The Office of Federal Housing Enterprise Oversight is not required to follow OMB Bulletin No. 01-09 but has voluntarily adopted the Bulletin's requirements.

Under FFMIA, we are required to report whether OFHEO's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States 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 no instances in which OFHEO's financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audits and, accordingly, we do not express such an opinion.

While this report is intended solely for the information and use of the management of the Office of Federal Housing Enterprise Oversight, OMB and Congress, it is also a matter of public record, and its distribution is, therefore, not restricted.

Dembo, Jones, Healy, Pennington & Marshall, P.C.

November 12, 2004

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
BALANCE SHEETS
As of September 30, 2004 and 2003

	2004	2003
ASSETS		
Intragovernmental Assets		
Fund Balance with Treasury - Note 2	\$ 8,340,510	\$ 7,269,362
Accounts Receivable	24,714	12,412
Total Intragovernmental Assets	8,365,224	7,281,774
Accounts Receivable	443	-
Property, Plant and Equipment, Net - Note 3	11,215,567	14,991,959
TOTAL ASSETS	\$ 19,581,234	\$ 22,273,733
LIABILITIES		
Liabilities Covered by Budgetary Resources:		
Intragovernmental Liabilities		
Other	\$ 17,296	\$ 75,460
Total Intragovernmental Liabilities	17,296	75,460
Other Payables and Liabilities		
Accounts Payable	2,834,506	1,682,720
Other Liabilities	922,680	649,662
Total Other Payables and Liabilities	3,757,186	2,332,382
Total Liabilities Covered by Budgetary Resources - Note 4	3,774,482	2,407,842
Liabilities Not Covered by Budgetary Resources:		
Governmental		
Accrued Annual Leave	1,327,603	1,089,807
Accrued FECA	467	-
Total Liabilities Not Covered by Budgetary Resources - Note 5	1,328,070	1,089,807
TOTAL LIABILITIES	\$ 5,102,552	\$ 3,497,649
NET POSITION		
Unexpended Appropriations	\$ 4,414,972	\$ 4,710,466
Cumulative Results of Operations	10,063,710	14,065,618
Total Net Position	14,478,682	18,776,084
TOTAL LIABILITIES AND NET POSITION	\$ 19,581,234	\$ 22,273,733

The accompanying notes are an integral part of these statements.



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
STATEMENTS OF NET COST
For the Years Ended September 30, 2004 and 2003

	2004	2003
Program Costs		
Program Costs		
Intragovernmental Costs	\$ 6,691,778	\$ 6,361,230
Less: Earned Revenues	-	(29,353)
Total Intragovernmental Costs	6,691,778	6,331,877
Public Costs	38,393,403	28,056,311
Total Net Program Costs - Note 7	\$ 45,085,181	\$ 34,388,188
Net Cost of Operations	\$ 45,085,181	\$ 34,388,188

The accompanying notes are an integral part of these statements.



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30, 2004 and 2003

	2004 Cumulative Results of Operations	2004 Unexpended Appropriations	2003 Cumulative Results of Operations	2003 Unexpended Appropriations
Beginning Balance	\$ 14,065,618	\$ 4,710,466	\$ 19,144,187	\$ 3,228,855
Budgetary Financing Sources:				
Appropriations Received	\$ -	\$ 39,915,000	\$ -	\$ 30,000,000
Other Adjustments	-	(1,815)	-	(1,142)
Appropriations Used	40,208,679	(40,208,679)	28,517,247	(28,517,247)
Other Financing Sources:				
Imputed Financing	874,594	-	792,372	-
Total Financing Sources	\$ 41,083,273	\$ (295,494)	\$ 29,309,619	\$ 1,481,611
Net Cost of Operation	(45,085,181)	-	(34,388,188)	-
Ending Balance - Net Position	\$ 10,063,710	\$ 4,414,972	\$ 14,065,618	\$ 4,710,466

The accompanying notes are an integral part of these statements.



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30, 2004 and 2003

	2004	2003
Budgetary Resources		
Appropriations	\$ 39,915,000	\$ 30,000,000
Unobligated Balance, Beginning of Period	1,815	1,142
Spending Authority from Offsetting Collections:		
Collected	-	29,353
Recoveries of Prior Year Obligations - Note 9	181,110	67,884
Permanently not available Pursuant to Public Law 102-550	(1,815)	(1,142)
Total Budgetary Resources	\$ 40,096,110	\$ 30,097,237
Status of Budgetary Resources		
Obligations Incurred - Note 8	\$ 40,096,110	\$ 30,095,422
Unobligated Balance Not Available	-	1,815
Total Status of Budgetary Resources	\$ 40,096,110	\$ 30,097,237
Relationship of Obligations to Outlays:		
Obligated Balance, Net - Beginning of Period	7,267,548	4,982,438
Obligated Balance, Net - End of Period		
Undelivered Orders	(4,566,028)	(4,859,706)
Accounts Payable	(3,774,482)	(2,407,842)
Total Obligated Balance, Net - End of Period	(8,340,510)	(7,267,548)
Outlays		
Disbursements	\$ 38,842,537	\$ 27,742,428
Less: Collections	-	(29,353)
Net Outlays	\$ 38,842,537	\$ 27,713,075

The accompanying notes are an integral part of these statements.



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
STATEMENTS OF FINANCING
For the Years Ended September 30, 2004 and 2003

	2004	2003
Budgetary Resources Obligated		
Obligations Incurred	\$ 40,096,110	\$ 30,095,422
Less: Spending Authority from Offsetting Collections/Adjustments		
Collections	-	(29,353)
Recoveries of Prior Year Obligations - Note 9	(181,110)	(67,884)
Obligations Net of Offsetting Collections and Recoveries	\$ 39,915,000	\$ 29,998,185
Exchange Revenue not in Entity's Budget	-	-
Net Obligations	\$ 39,915,000	\$ 29,998,185
Other Resources		
Imputed Financing from Costs Absorbed by Others	874,594	792,372
Net Other Resources Used to Finance Activities	874,594	792,372
Total Resources Used to Finance Activities	\$ 40,789,594	\$ 30,790,557
Resources Used to Finance Items not Part of the Net Cost of Operations		
(Increase) Decrease in Goods/Services/Benefits Ordered but not Provided	293,678	(1,391,666)
Resources That Fund Expenses Recognized in Prior Periods	(12,746)	-
Net Resources That Finance the Acquisition of Assets	(3,180,737)	(2,331,285)
Total Resources Used to Finance Items not Part of the Net Cost of Operations	(2,899,805)	(3,722,951)
Total Resources Used to Finance the Net Cost of Operations	\$ 37,889,789	\$ 27,067,606
Components of the Net Cost of Operations that will Require or Generate Resources in Future Periods		
Increase in Annual Leave Liability	237,796	154,689
Other	467	-
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	238,263	154,689
Components Not Requiring or Generating Resources:		
Depreciation and Amortization	6,957,129	7,002,427
Total Components Not Requiring or Generating Resources	6,957,129	7,002,427
Revaluation of Assets and/or Liabilities		
Loss on Disposition of Assets	-	163,466
Total Revaluation of Assets and/or Liabilities	-	163,466
Total Components of Net Cost of Operations that will not Require or Generate Resources in the current Period	7,195,392	7,320,582
Net Cost of Operations	\$ 45,085,181	\$ 34,388,188

The accompanying notes are an integral part of these statements.



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
STATEMENTS OF CUSTODIAL ACTIVITY
For the Years Ended September 30, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Revenue Activity:		
Sources of Cash Collections:		
Fines Assessed - Note 10	\$ 125,125,000	\$ -
Total Cash Collections	125,125,000	-
Accrual Adjustments	-	-
Total Custodial Revenue	\$ 125,125,000	\$ -
Disposition of Collections:		
Transferred to Others:		
US Treasury	125,125,000	-
Net Custodial Activity	\$ -	\$ -

OFHEO had no custodial activity in FY 2003.

The accompanying notes are an integral part of these statements.



NOTES TO FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The Office of Federal Housing Enterprise Oversight (OFHEO) was established as an independent office within the Department of Housing and Urban Development (HUD) by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (title XIII of P.L. 102-550). OFHEO is responsible for examination of Fannie Mae and Freddie Mac, and determining whether the Enterprises are operating in a financially safe and sound manner and are adequately capitalized.

The accompanying financial statements reflect the activities of OFHEO. OFHEO has only entity activities and the financial statements reflect those activities, which include the appropriation received to conduct operations. OFHEO does not perform custodial activities on behalf of other federal agencies.

Basis of Presentation

OFHEO is not covered by the requirements of the Chief Financial Officer's (CFO) Act nor the Accountability of Tax Dollars of 2002 to prepare audited financial statements. The principal statements were prepared from the official financial records and general ledger of OFHEO in accordance with Generally Accepted Accounting Principles (GAAP) as established through the Federal Accounting Standards Advisory Board (FASAB) standards and follow the presentation guidance established by the Office of Management and Budget (OMB) Bulletin 01-09.

Basis of Accounting

Transactions are recorded on both an accrual accounting basis and on a budgetary basis. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal requirements and controls over the use of Federal funds. OFHEO complies with the U.S. Standard General Ledger and conforms to the hierarchy of the American Institute of Certified Public Accountants (AICPA) through Statement on Auditing Standards (SAS) No. 69, as amended by SAS No. 91, *Federal GAAP Hierarchy*, of accounting principles for the Federal Government:

Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations plus AICPA and Financial Accounting Standards Board (FASB) pronouncements if made applicable to the Federal governmental entities by a FASAB Statement or Interpretation;

FASAB Technical Bulletins and the following pronouncements if specifically made applicable to Federal governmental entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position;

AICPA Accounting Standards Executive Committee (ACSEC) Practice Bulletins if specifically made applicable to Federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB;

Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the Federal government (OMB Circular A-134); and



NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Accounting policy and procedures established by OFHEO to enhance consistency or to provide guidance in the absence of government-wide standards.

Funds with the U.S. Treasury

Each year Congress enacts a “no-year” appropriation to fund OFHEO’s operating costs. The appropriation is paid by an annual assessment from Fannie Mae and Freddie Mac and not with taxpayer funds. OFHEO receives an appropriation warrant from the U.S. Treasury General Fund each year, and fully offsets the General Fund warrant with money collected from the Enterprises.

Law requires that OFHEO return to the Enterprises unobligated funds as of the end of the fiscal year by crediting the next year’s assessment. It is important to understand how the crediting provision functions with the “no year” fund designation. “No year” funds are available for obligation without fiscal year limitation. Rules for “no year” funds essentially remove all statutory limits as to when the funds may be obligated and expensed, and funds remain available for their original purpose until expended. When OFHEO closes its books each fiscal year, it accounts for funds not obligated as of the end of that fiscal year (September 30). OFHEO reduces the current year’s (October 1) assessment by the amount of the unobligated balance from the previous year. Consequently, the amount of the annual assessment from the Enterprises is reduced by the credit awarded to the Enterprises for unobligated funds from the prior year.

OFHEO cash receipts and disbursements are processed by the United States Department of the Treasury (Treasury). The funds with Treasury are primarily assessment funds that are available to pay current liabilities and to finance authorized purchase commitments. OFHEO does not have monetary assets held outside OFHEO’s fund balance at Treasury. OFHEO does not maintain an Imprest Fund and does not hold any marketable or non-marketable securities. OFHEO does not operate a direct loan or loan guarantee program.

Property and Equipment

OFHEO’s property and equipment is recorded at cost and is depreciated using the straight-line method over the estimated service lives of the assets. Service lives have been established as three years for most computer related systems and up to 20 years for other equipment. Leasehold improvements are depreciated over the remaining term of the lease agreement. OFHEO has an established capitalization threshold of \$5,000 to conform to the materiality approach for the accounting that supports OFHEO’s independent financial statements. Other property items, normal repairs, and maintenance are charged to expense as incurred.

OFHEO has no capitalized leases, no real property holdings, and no heritage assets.

Accounts Receivable

OFHEO’s Accounts Receivable consists of receivables and reimbursements due from others. No account is estimated as uncollectible.



NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Liabilities

Liabilities represent the amount of funds that are likely to be paid by OFHEO as the result of a transaction or event that has already occurred.

OFHEO reports its liabilities under two categories: Liabilities covered by budgetary resources and liabilities not covered by budgetary resources.

Liabilities covered by budgetary resources are liabilities that are funded by a current appropriation or other funding source. Both intragovernmental (payable to other federal entities) and governmental liabilities consist of accounts payable and accrued liabilities. Accounts payable reflect invoices processed for payment during the fiscal year which are yet unpaid as of the end of the fiscal year due to scheduling of payments to reflect prompt payment guidelines. Accrued liabilities consist of both estimates of accounts payable for the value of services received during the fiscal year for which OFHEO had not been billed as of the end of the fiscal year and payroll accruals reflecting payroll costs earned by employees during the fiscal year which are not paid until the next fiscal year.

Liabilities not covered by budgetary resources are liabilities that are not funded by any current appropriation or other funding source. These liabilities consist of accrued annual leave and compensatory time, and accrued FECA. Annual leave and compensatory time are earned throughout the fiscal year and are paid when leave is taken; the accrued liability for annual leave and compensatory time represent the balance earned, but not yet taken. The Department of Labor (DOL) is the central paying agent for all worker's compensation claims filed under the Federal Employees Compensation Act. The accrued FECA liability represents the amount OFHEO is to reimburse DOL for claims paid to OFHEO employees. No liability is recorded for future worker's compensation for fiscal years 2004 and 2003 as OFHEO's methodology for estimating this future worker's compensation as prescribed by DOL determined that the liability would be negligible.

Retirement Plans

OFHEO participates in the retirement plans offered by the Office of Personnel Management (OPM) and does not maintain any private retirement plans. The majority of employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS).

OFHEO expenses its contributions to the retirement plans of covered employees as the expenses are incurred. OFHEO is reporting imputed financing with respect to retirement plans, health benefits and life insurance pursuant to guidance received from OPM. These costs are paid by OPM and not by OFHEO. Disclosure is intended to provide information regarding the full cost of OFHEO's program in accordance with GAAP.

Net Position

OFHEO's net position is comprised of the following components:

- 1) Unexpended Appropriations, consisting of undelivered orders and unobligated balances of OFHEO's funds.



NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

2) Cumulative Results of Operations, consisting of:

- a. Invested capital, which represents OFHEO’s investment in property and equipment, net of accumulated depreciation. Increases to invested capital are recorded when assets are acquired with direct appropriations, and decreases are recorded as a result of depreciation and disposition of capital assets.
- b. Future funding requirements, which represent funds required to pay for accrued annual leave and compensatory time and accrued FECA. The expense for these accruals is not funded from current assessments, but will be funded from future assessments as the expenses are incurred.
- c. Equity in accounts receivable.

NOTE 2 - FUND BALANCE WITH TREASURY

Fund Balance with Treasury consists of the following as of September 30, 2004 and 2003:

	<u>Obligated</u>	<u>Available</u>	<u>Unobligated</u> <u>Unavailable</u>	<u>2004</u>	<u>2003</u>
General Funds	\$8,340,510	-	-	\$8,340,510	\$7,269,362

NOTE 3 - PROPERTY, PLANT AND EQUIPMENT

OFHEO’s major asset is the Risk-Based Capital software and associated equipment. The Risk-Based Capital software is used to decide on a quarterly basis the amount of risk-based capital determined by the Director to be required for each Enterprise’s adequate capitalization. The final Risk-Based Capital rule, which includes a description of the stress test software, was published in September 2001 and became enforceable in September 2002. The software was put into use for its intended purpose effective October 1, 2002. Therefore, depreciation began as of that date of implementation.

Property, Plant and Equipment balances as of September 30, 2004 and 2003 are as follows:

<u>Asset Type</u>	<u>Acquisition</u> <u>Cost</u>	<u>Accumulated</u> <u>Depreciation</u>	<u>2004</u> <u>Net</u> <u>Book Value</u>	<u>2003</u> <u>Net</u> <u>Book Value</u>
Equipment	\$ 5,343,964	\$ 4,158,996	\$ 1,184,968	\$ 2,162,925
Leasehold Improvements	3,998,553	1,290,445	2,708,108	2,787,514
Internal Use Software	15,062,280	10,041,520	5,020,760	10,041,520
Internal Software in Development	2,301,731	-	2,301,731	-
Total	\$26,706,528	\$ 15,490,961	\$11,215,567	\$14,991,959



NOTE 4 – LIABILITIES COVERED BY BUDGETARY RESOURCES

	<u>2004</u>	<u>2003</u>
Intragovernmental Accrued Accounts Payable	\$ 17,296	\$ 75,460
Other Liabilities	<u>2,834,506</u>	<u>1,682,720</u>
Sub-Total Intragovernmental/Other Liabilities	\$ 2,851,802	\$ 1,758,180
Accrued Payroll and Benefits	<u>922,680</u>	<u>649,662</u>
Liabilities Covered By Budgetary Resources	\$ 3,774,482	\$ 2,407,842

NOTE 5 – LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

Liabilities not covered by budgetary resources consist of accrued annual leave, compensatory time earned but not used and accrued FECA as of September 30, 2004 and 2003. The accrued leave and compensatory time liability is adjusted as they are earned and used through out the year. The accrued FECA liability represents claims paid on behalf of OFHEO by the Department of Labor (DOL) for which OFHEO will reimburse DOL in future periods. The expense for these accruals will be funded from future assessments as the expenses are incurred. The net change of the accrued leave, compensatory time and accrued FECA is reflected in the Statement of Financing.

NOTE 6 – OPERATING LEASE

OFHEO has an occupancy lease with the Office of Thrift Supervision (OTS) that covers office space and building services which include utilities, security guards, janitorial services, mail delivery, use of the loading dock, garage parking and building operation and maintenance. The initial term of the lease was for five years beginning in 1993, with the option to renew for three 5-year terms. OFHEO has exercised the second of the three option terms. Total rent expense for the years ended September 30, 2004 and 2003 was approximately \$3.4 million and \$3.0 million, respectively.

OFHEO may terminate the lease agreement in whole or in part. In the event of a termination at OFHEO's discretion, OFHEO would be required to pay two months rent. If either party ceases to exist or merge with another entity by operation of law, either party may terminate the rental agreement. In the event of termination under this provision, neither party is liable for further costs, fees, damages or other monies due to the termination, except for payments through the date of termination.

NOTE 7 – PROGRAM COSTS

OFHEO does not have stewardship responsibilities for federal lands. Program Costs represent assessment collections, from Fannie Mae and Freddie Mac, that have been expensed for salaries and operating expenses to support OFHEO during the fiscal years ended September 30, 2004 and 2003. Program Costs are distributed into two categories: Public and Federal. Public costs result from contracts with the private sector for goods or



NOTE 7 – PROGRAM COSTS (continued)

services. Federal costs are a result of OFHEO contracting with other federal agencies for goods and/or services (e.g. purchase of supplies from the General Services Administration).

	<u>2004</u>	<u>2003</u>
Intragovernmental Program Costs Paid	\$ 6,674,482	\$ 6,285,770
Less: Earned Revenue	-	(29,353)
Accrued Accounts Payable Federal	<u>17,296</u>	<u>75,460</u>
Total Federal Program Costs	<u>\$ 6,691,778</u>	<u>\$ 6,331,877</u>
Public Program Costs Paid	\$28,601,768	\$19,207,718
Accrued Accounts Payable Public	2,834,506	1,682,720
Loss on Disposition of Assets	-	163,446
Depreciation Expense	<u>6,957,129</u>	<u>7,002,427</u>
Total Public Program Costs	<u>\$38,393,403</u>	<u>\$28,056,311</u>
Total Program Costs	\$45,085,181	\$34,388,188

NOTE 8 – APPORTIONMENT CATEGORIES OF OBLIGATIONS INCURRED

All obligations incurred are characterized as OMB Category B obligations (i.e., not apportioned by fiscal quarter) as reported on the Statements of Budgetary Resources for the years ended September 30, 2004 and 2003 and consisted of the following:

	<u>2004</u>	<u>2003</u>
Direct Obligations (Category B)	\$40,096,110	\$30,066,069
Reimbursable Obligations (Category B)	<u>-</u>	<u>29,353</u>
Total Obligations Incurred	\$40,096,110	\$30,095,422

NOTE 9 – RECOVERIES OF PRIOR YEAR OBLIGATIONS

Recoveries of prior year obligations consist of the reapportionment of prior year funds by OMB. OFHEO requested and received the authority to re-obligate these prior year funds in fiscal years 2004 and 2003.

NOTE 10 – CUSTODIAL ACTIVITIES

During fiscal year 2004, OFHEO collected \$125,000,000 for payment of a penalty assessed against Freddie Mac as a result of a special investigation conducted into Freddie Mac's accounting and internal controls. OFHEO also collected \$125,000 for payment of a penalty assessed against a former employee of Freddie Mac as a result of the same special investigation.



NOTE 10 – CUSTODIAL ACTIVITIES (continued)

These funds were deposited directly to the General Fund of the Treasury and were not available for use by OFHEO.

NOTE 11 – EXPLANATION OF DIFFERENCES BETWEEN THE STATEMENT OF BUDGETARY RESOURCES AND THE BUDGET OF THE UNITED STATES GOVERNMENT

The Budget of the United States Government with actual amounts for the year ended September 30, 2004 has not been published as of the issue date of these financial statements.



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
Required Supplementary Information
Intra-governmental Trading Partners
For The Fiscal Periods Ended
September 30, 2004 And 2003

Trading Partner Agency	Intra-governmental Assets	
	2004	2003
Department of Treasury ¹	\$ 8,340,510	\$ 7,269,362
Department of Housing and Urban Development ²	24,714	-
National Finance Center ³	-	12,412
	\$ 8,365,224	\$ 7,281,774

¹ Fund balance with Treasury consists of assessment funds that are available to pay current liabilities and to finance authorized purchase commitments.

² This receivable represents funds owed by HUD for HUD employees incorrectly coded for payroll processing and charged against OFHEO funds.

³ During FY 2001, duplicate awards were processed. Employees have issued checks for repayment to the National Finance Center, OFHEO is awaiting the refund from the National Finance Center. This is reflected as a reflected as an accounts receivable from the National Finance Center.

Trading Partner Agency	Intra-governmental Liabilities	
	2004	2003
Department of Housing and Urban Development	\$ -	\$ 71,884
Department of Commerce	-	2,300
Department of Treasury	-	705
Department of Veteran's Affairs	-	571
Federal Deposit Insurance Corporation	17,296	-
	\$ 17,296	\$ 75,460

OFHEO's intra-governmental liabilities consist of accounts payable for the value of services received for which OFHEO had not been billed as of the end of the fiscal year.

The accompanying notes are an integral part of these statements.

