1994 AUDITED ANNUAL FINANCIAL STATEMENTS FOR THE FEDERAL FINANCING BANK

OIG-95-078 MAY 17, 1994

Office of Inspector General

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United States Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

MAY 17 1995

INSPECTOR GENERAL
OIG-95-078
A-TS-95-320

MEMORANDUM FOR SECRETARY RUBIN

FROM: Valerie Lau *Valerie Lau*
Inspector General

SUBJECT: 1994 Audited Annual Financial Statements for the Federal Financing Bank (FFB)

The FFB is a Government corporation subject to the Government Corporation Control Act and is required to have an annual financial statement audit (U.S.C. 31-9106). The Chief Financial Officers (CFO) Act of 1990 (P.L. 101-576) amended the Government Corporation Control Act, but did not require Government corporations to follow specifically the audit requirements set out in Office of Management and Budget (OMB) Bulletin 93-06, Audit Reauirements for Federal Financial Statements. The Act did, however, require that a copy of the audit report be sent to the head of the FFB. Therefore, I am sending you, as Chairman of the Board of Directors of the FFB, a copy of the audit report for the Fiscal Year (FY) 1994 financial statements (Tab A).

The Act also requires that we send copies of the report to the Chairman of the Committee on Government Reform and Oversight of the House of Representatives (formerly the Government Operations Committee) and the Chairman of the Committee on Governmental Affairs of the Senate. Copies of the transmittal letters to Representative William F. Clinger and Senator William V. Roth Jr. are attached as Tab B. The management of FFB is required to send a copy of its Annual Management Report, which includes the audited financial statements, to the OMB.

FFB's financial statements for FY 1994 were audited by Price Waterhouse LLP, an independent public accountant (IPA), under contract with us. Tab A includes reports of the IPA on the FFB's financial statements as of September 30, 1994 and 1993, its internal control structure, and its compliance with laws and regulations for the year ended September 30, 1994.

The IPA issued an unqualified opinion on the financial statements. However, the IPA emphasized a matter of importance relating to prepayment of certain loans at face value, whereby the FFB is required to waive any prepayment premiums. As a result of this prepayment, FFB suffers an accumulated deficit, and its net interest income is insufficient to liquidate its liabilities as they become due. The IPA also cited two material weaknesses in its report on the internal control structure.

These weaknesses were cited in last year's report and remain largely uncorrected. The reported weaknesses are as follows:

- The FFB has not completed implementation of the Loan Management Control System as its core financial system, and

- The FFB's organizational structure is inadequate for promoting accountability and empowering managers to take action to correct weaknesses.

A draft of the audit report was provided to the FFB's management for their review. Their comments have been incorporated in this final report. Although the FFB's management did not provide written comments, they indicated concurrence with the report.

The IPA also issued a management letter which discusses various issues for management's attention that were identified during the audit, but are not required to be included in the audit reports. A copy of this letter is attached as Tab C.

ATTACHMENTS:

Tab A: Audit Report of FFB's Fiscal Year 1994 Financial Statements

Tab B: Letters to Representative William F. Clinger and Senator William V. Roth Jr.

Tab C: Report to Management

FEDERAL FINANCING BANK
1994 FINANCIAL STATEMENTS
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Price Waterhouse LLP

REPORT OF INDEPENDENT ACCOUNTANTS

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

We have audited the accompanying statements of financial position of the Federal Financing Bank ("the Bank") as of September 30, 1994 and 1993, and the related statements of operations and accumulated deficit, and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements audited by us present fairly, in all material respects, the financial position of the Bank at September 30, 1994 and 1993, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In recent years, Congress has authorized certain Rural Electrification Administration-guaranteed borrowers and Department of Defense-guaranteed foreign military sales borrowers to prepay certain loans at their face (par) value, by, in effect, waiving the contractually required prepayment premiums. Premiums are frequently paid by borrowers to lenders when, upon prepayment, market interest rates are less than those stated in the loan agreements. Because the Bank is required to simultaneously liquidate the funds it borrowed from Treasury to finance these loans, and is required to pay a prepayment premium in doing so, notwithstanding the fact the borrowers' premium was waived, the Bank has suffered losses, and has accumulated a deficit of **$2.2** billion as of September 30, 1994. It is unlikely that the Bank's net interest income at its current spread will be sufficient to liquidate the liabilities resulting from this deficiency as they become due. Therefore the Bank will likely require Congressional appropriations or an increased interest rate spread, or some combination of these, to finance its deficit.

Price Waterhouse LLP

March 31, 1995
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Price Waterhouse *LLP*

REPORT ON INTERNAL CONTROL STRUCTURE

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

We have audited the financial statements of the Federal Financing Bank (the Bank) as of and for the year ended September 30, **1994,** and have issued our report thereon dated March **31, 1995.**

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

In planning and performing our audit of the financial statements of the Bank for the year ended September 30, **1994,** we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of the Bank is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

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

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

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

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

1. The Federal Financing Bank lacks an effective core financial accounting system (Repeat Condition); and

2. The Federal Financing Bank lacks an organization structure which promotes accountability and empowers managers to take action on correcting weaknesses (Repeat Condition).

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

* * * * *

Finding 1: The Federal Financing Bank lacks an effective core financial accounting system (Repeat Condition).

In our report dated March 25, 1994, we identified that Treasury's Financial Management Service is in the process of implementing an integrated financial accounting system for the Federal Financing Bank. Once fully implemented, the Loan Management Control System (LMCS), a mainframe system, will serve as the Bank's subsidiary ledger for loans and borrowings, and will calculate and accrue interest income and expense. The LMCS also will have full general ledger capability.

As of March 25, 1994, programming for the loans and borrowing modules was complete, and the LMCS was able to calculate interest income, expense, and accruals. However, the general ledger application had not yet been fully programmed. In addition, although the subsidiary ledgers had been programmed, initial loading of information into them for all borrowers had not been completed, nor had the new information been reconciled to information contained in the Bank's spreadsheet-based system.

Because the data in LMCS did not reconcile to the data in Credit Accounting Branch's spreadsheet records, and because the general ledger application was not complete, the Credit Accounting Branch did not use LMCS as its core accounting system. Instead, the Credit Accounting Branch maintained its own subsidiary ledgers in both PC-based spreadsheet and manual form, and used manual journal vouchers to record information in the general ledger which is maintained on PC-based software.

As of September 30, 1994, the Bank's Administration had reconciled all but one loan program between the LMCS and the general ledger. In addition, during testing, we noted that LMCS was fully capable of calculating interest income, expense and accruals related to the Bank's loans receivable and borrowing, except for one loan program.

During testing, we also noted several instances where the Credit Accounting Branch continued to maintain its own subsidiary ledgers in PC-based spreadsheet rather than use LMCS as its core accounting system. In addition, management was reviewing and approving the PC-based spreadsheets, thereby permitting continued use of the PC-based spreadsheets. The Credit Accounting Branch stated that it was not completely sure if the LMCS was generating the proper data. Therefore, the Credit Accounting Branch continued to run its spreadsheets to "double check" the data generated by LMCS, in essence, run parallel with the LMCS.

We compared the data generated by LMCS to the calculation of the Credit Accounting Branch's PC-based spreadsheets for all loan programs and noted differences between the two calculations for three loan programs. Management is aware of the differences noted for the three loan programs, and is in the process of resolving these differences.

Finally, we noted that complete implementation of the integrated general ledger has not been achieved to date. Several functions are operational, however, slight programming modifications are still required for existing modules. Management has an action plan in place to make the general ledger fully operational by September 30, 1995.

Recommendations:

We recommend that the Bank terminate reliance on PC-based spreadsheet records for interest accruals. Management should adopt a policy of not accepting interest accruals provided by the accountants unless the information provided was generated from the LMCS. This procedure will eliminate the use of PC-based spreadsheets in a more timely manner. We also recommend that the Bank provide a comprehensive training course to the users of LMCS on the features available to them. This training course should provide on-hands training of all LMCS applications. In addition, a user manual should be provided to all users providing a quick reference for those features not frequently used.

Since one loan program has not been fully reconciled, we recommend that management continue its efforts in identifying the differences and then making the necessary adjustments in order to properly record the data within the LMCS. This process should be completed prior to the close of fiscal year 1995.

We also recommend that management continue its efforts in implementing the integrated general ledger. Management should run the integrated general ledger parallel with its current general ledger for a few months to ensure that all programming errors have been resolved prior to terminating the predecessor system. Additionally, management should perform a "test" close, thereby ensuring the correct data is gathered and reported in its year-end financial statements.

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

Our report dated March 25, 1994 identified that the Bank was organizationally fragmented. The Manager of the Credit Accounting Branch, who is responsible for maintaining key accounting records and preparing the Bank's financial statements, had no direct communications with the Bank's President. Any communications with the

Bank's President, Secretary, or Treasurer went through several other individuals, none of whom were assigned responsibility for the Bank. The Manager of Administration for the Bank, who is responsible for maintaining key information, reported to the Bank's President but had no other Bank personnel reporting to him. Further, communications between the Credit Accounting Branch and Administration had been extremely strained and very unproductive. Weaknesses that have manifested as a result of the situation include:

- A lack of a fully coordinated effort to complete the LMCS, and fully reconcile information between the old and new systems. The lack of an integrated system such as LMCS causes Credit Accounting Branch staff to keep separate spreadsheet and manual records for information they should be obtaining from LMCS. They also recalculate considerable amounts of information that they should be able to access LMCS to obtain. In addition, they manually record all information in a general ledger application, including all payment information, in addition to using LMCS.

- Decreased day-to-day effectiveness of all of the Bank's managers -- Administration and Credit Accounting -- because of poor relationships between the two offices, as well as the absence of a fully integrated system.

To date, the Federal Financing Bank has not fully addressed this weakness. Specifically, the Credit Accounting Branch drafted a plan to implement our recommendations, however, the draft remains under review.

Recommendations:

We recommend that the Bank continue in developing and implementing its plan to empower one individual within the Bank with the responsibility and authority to implement an integrated financial system for the Bank and streamline the roles of the offices of the Bank. As recommended in our report dated March 25, 1994, the functions of the Credit Accounting Branch should be streamlined to: 1) management and internal controls over the information in LMCS; 2) maintenance of the general ledger in accordance with generally accepted accounting principles; 3) preparing the Treasury financial reports; and 4) preparation of management and year-end financial reports. Finally, management should establish a firm deadline, such as September 30, 1995, as to the implementation of its plan.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above.

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

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

Price Waterhouse LLP

March 31, 1995
Washington, D.C.

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Price Waterhouse LLP

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

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

We have audited the financial statements of the Federal Financing Bank (the Bank) as of and for the year ended September 30, 1994, and have issued our report thereon dated March 31, 1995.

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

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

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

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

Price Waterhouse LLP

March 31, 1995
Washington, D.C.

FEDERAL FINANCING BANK
STATEMENT OF FINANCIAL POSITION
AS OF SEPTEMBER 30. 1991 and 1993
(in thousands)

	1994	1993
ASSETS		
Funds with U.S. Treasury	$338.827	$338.125
Loans receivable - net (Note 2)	109.489.211	129.430.651
Accrued interest receivable	2.370.060	2.794.094
Accounts receivable	1	8
Total assets	$112.198.099	$132.562.878
LIABILITIES AND ACCUMULATED DEFICIT		
Borrowings (Note 3)	$109,483.999	$129,426.116
Accrued interest payable	2,725,088	3,118,583
Debt prepayment premium (Note 4)	2,145,124	2,074.429
Other liabilities	367	313
Total liabilities	114.354.578	134.619.441
Accumulated deficit	(2.156.479)	(2.056.563)
Total liabilities and accumulated deficit	$112.198.099	$132.562.878

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

FEDERAL FINANCING BANK
STATEMENT OF OPERATIONS AND ACCUMULATED DEFICIT
FOR THE YEARS ENDED SEPTEMBER 30. 1991 and 1993
(in thousands)

	1991	1993
Interest on loans	$9.703.894	$11.349.539
Interest on borrowings	(9.681.802)	(11.246.969)
Net Interest Income	22.092	102.570
Administrative expenses	(2.348)	(2.3 16)
Net income before extraordinary item	19,744	100.251
Extraordinary loss on Debt prepayment premium	(119.660)	(118.153)
Net (loss)	(99.916)	(48.199)
Accumulated deficit - beginning of the year	(2,056,563)	(2.008.364)
Accumulated deficit - end of the year	($2,156.479)	($2.056.563)

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

FEDERAL FINANCING BANK
STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED
SEPTEMBER 30. 1994 AND 1993
(in thousands)

	1994	1993
CASH FLOWS FROM OPERATIONS		
Net **(loss)**	($99.916)	($48.199)
Adjustments to reconcile net (loss) to net cash provided:		
Discount amortization	(509)	**(2.129)**
Decrease in accounts receivable	7	410
Decrease in accrued interest receivable	424.034	551.126
(Decrease) in accrued interest payable	(393.495)	(512,113)
Increase in debt prepayment premium	70,695	11.650
Increase (Decrease) in other liabilities	54	(2.587)
Net cash provided by (used in) operations	870	(1.842)
CASH FLOWS FROM INVESTING ACTIVITIES		
Loan disbursements	(123,928.687)	(188,796,383)
Principal collections	143.900.161	223.891.358
Net cash provided by investing activities.	19.971.474	35.094.975
CASH FLOWS **FROM** FINANCING ACTIVITIES		
Advances	123,928.687	188,796.383
Repayments of advances	(143.900.329)	(223.889.556)
Net cash **used** in financing activities.	(19.971.642)	(35.093.173)
Net increase (decrease) in cash	$702	($40)
Cash - beginning of the year	$338.125	$338.165
Cash - end of the **year**	$338.827	$338.125

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Basis of Accounting

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

Funds with U.S. Treasury

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

Debt Prepayment Premium

The nature of the Debt Prepayment Premium is discussed in detail in Note **4.** The Debt Prepayment Premium is calculated as the difference between **1)** the face amount of the Treasury borrowing being prepaid, which is the amount the Bank receives in prepayment proceeds, and **2)** the present value of the expected future cash flows under the original terms, discounted at Treasury's rate at the prepayment date, which is the amount the Bank must pay to Treasury in order to prepay the debt.

Interest Rates on Loans

Except as discussed in Notes **2** and **4,** the Bank's policy is to charge its borrowers an interest rate that is equivalent to one-eighth of **one** percent more than the rate Treasury would pay on a security having a comparable maturity and payment schedule, as estimated by Treasury. The income resulting from the one-eighth of one percent was designed to cover the Bank's administrative expenses, and to provide equity.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Allowances for Loan Losses

The Bank does not establish an allowance for loan losses because loan principal and interest are guaranteed by federal agencies and are backed by the full faith and credit of the U.S. Government. Direct loans to the Tennessee Valley Authority (TVA) and United States Postal Service (USPS) are exceptions since they are not guaranteed by the United States. However, no allowance for loan losses was required for TVA and USPS as of September **30,** 1994.

Related Parties

The Bank is subject to the general supervision and direction of the Secretary of the Treasury. As provided by law, the Secretary of the Treasury acts as Chairman of the Board of Directors. The Bank's management functions are performed by employees of Treasury's Departmental offices; its legal counsel is Treasury's General Counsel; and, its accounting operations are conducted by Treasury's Financial Management Service **(FMS).** The Bank reimburses Treasury for facilities and services. As stated in Note **7,** the U.S. Office of Personnel Management administers and is liable for the Bank's employee benefit programs.

2. LOANS RECEIVABLE

Loans receivable include agency loans purchased, direct loans to agencies, and loans to nonfederal entities, the repayment of which is guaranteed by another Federal agency. Agency loans purchased are either notes or pools of loans sold by federal agencies in the form of certificates representing shares of ownership in the loan pool. The selling agencies guarantee the principal and interest repayments on the notes or certificates. Direct loans to agencies are debt securities issued to the Bank by agencies that are authorized by Congress to borrow to finance their activities.

2. LOANS RECEIVABLE (CONTINUED)

Loans to nonfederal entities are loans made to nonfederal borrowers whose obligation to repay the principal and interest is guaranteed by a federal agency. Loans receivable consists of the following (dollars in millions):

Agency	September 30,	
Health Maintenance Organizations, HHS	27	33
Less: Unamortized Discount	(2)	(3)
Rural Electrification Administration (REA)	4,599	4,599
Small Business Administration - Local Development Companies (SBA-LDC)	1	3
Total Agency Loans Purchased:	38,792	43,305
Direct Loans to Agencies:		
Export-Import Bank of the U.S.	3,927	5,795
Tennessee Valley Authority	3,400	6,325
Resolution Trust Corporation	26,519	31,688
U.S. Postal Service	8,973	9,731
Total Direct Loans to Agencies	42,819	53,539

2. LOANS RECEIVABLE (CONTINUED)

Agency	September 30.	
Guaranteed Loans to Nonfederal Agencies:	1994	1993
Defense Security Assistance Agency	3.785	4,083
General Services Administration	2,029	1,586
Plus: Capitalized Interest	132	102
Community Development Block Grants, Department of Housing and Urban Development (HUD)	110	131
Low Rent Public Housing, HUD	1,746	1,801
Ship Leasing, Department of Defense, Navy	1,479	1,528
Rural Utilities, REA	17,316	17,653
State/Local Development-503, SBA	523	576
Small Business Investment Corporation, SBA	56	90
Student Loan Marketing Association, Department of Education	0	4,790
Virgin Islands, Department of Interior	22	23
Washington Metro Area Transit Authority, Department of Transportation (DOT)	665	177
Railways 511, DOT	15	17
Rhode Island Depositors Economic Protection Corporation	0	30
Total Guaranteed Loans to Nonfederal Entities	27,878	32,587
Total Loans Receivable	$109,489	$129,431

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

2. LOANS RECEIVABLE (CONTINUED)

As a result of this policy the Bank incurred foregone interest of $126.2 million and $80.3 million in fiscal years 1994 and 1993, respectively. The impact of this policy reduces the value of the REA loans, however an allowance has not been recorded on the balance sheet as of September 30, 1994 because the future impact of this policy can not be predicted. Based on the shortfall in interest income in fiscal year 1994, the face value of the related loans of $21,915 million would be written down by an allowance of approximately $1,380 million, if the shortfall were to continue in the future in the same proportion as in fiscal year 1994.

3. BORROWINGS

The Bank finances its loan portfolio primarily by borrowing from the Treasury. Under the Federal Financing Bank Act of 1973, the Bank may, with the approval of the Secretary of the Treasury (SOT), borrow without limit from the U.S. Treasury. At September 30, 1994, the Bank had outstanding advances owed to Treasury of $94.4 billion, with interest rates ranging from 3.615 percent to 16.440 percent, and maturity dates from October, 1994 to January, 2028.

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

At September 30, 1994, principal installments due on borrowings are as follows (in billions):

Fiscal Year	Amount
1995	$37.8
1996	7.7
1997	6.0
1998	6.9
1999	3.8
2000-2028	47.2
Total	$109.4

3. BORROWZNGS (CONTINUED)

Payments due on borrowings are paid when principal collections on loans receivable are received. To the extent such loan proceeds are not sufficient to repay the debt. the Bank utilizes accumulated earnings received on loans. If accumulated earnings are not sufficient to repay the debt, the Bank can continue to operate using its unlimited borrowing authority with Treasury. However, borrowings to finance accumulated deficits will have to be eventually repaid either by raising the interest spread or through appropriations. The amount of interest paid in fiscal years **1994** and **1993** was **$10.1** billion and **$1 1.9** billion, respectively.

4. DEBT PREPAYMENT PREMIUM

Under the terms of its master promissory note with Treasury, the Bank must liquidate its borrowings with Treasury at the same time as loans receivable financed by those borrowings are liquidated. To avoid unusual gains or losses, the Bank's normal policy is to match the maturity and, except for a one eighth of one percent spread, the interest rate on its loans receivable with those of its borrowings. In addition, for most of its loans, premiums or discounts resulting from loan prepayments are equivalent to the premiums or discounts the Bank paid or received when it simultaneously prepaid its Treasury borrowings. Premiums or discounts arise to the extent market interest rates at the prepayment date differ from rates stated in the loan agreements. The effect of these policies is to mitigate the Bank's risk from interest rate fluctuations.

However, Congress authorized certain borrowers having loans guaranteed by the Rural Electrification Administration (REA) to prepay their loans at par (outstanding balance) rather than market value up to a specified dollar limit. Further, legislation also authorized borrowers in the foreign military sales program guaranteed by the Defense Security Assistance Agency (DSAA) to prepay at par, certain loans meeting specific criteria. The effect of these statutes was to waive payment of premiums to the Bank, which would otherwise have resulted from the fact that interest rates at the dates of prepayment were less **than** the rates in the loan agreements. Because the Bank's agreement with Treasury required it to simultaneously liquidate the funds it borrowed to finance these loans, and to pay a premium in doing so, notwithstanding the fact that the borrowers' premiums were waived, the Bank suffered losses. The Bank incurred costs of **$120** million and **$148** million in fiscal years **1994** and **1993,** respectively, as a result of prepayments under these statutes. These costs have been recorded as extraordinary **losses** in the statement of operations. The cumulative cost incurred by the Bank as a result of this legislation is **$2,552,342,427** through September **30, 1994.**

5. *COMMITMENTS AND CONTINGENCIES*

Almost all of the Bank's loans are to federal agencies or to private sector borrowers whose loans are guaranteed by a federal agency. When an agency has to honor its guarantee because a borrower defaults, that agency must obtain an appropriation or use other resources to pay the Bank. However, if an appropriation is not granted or federal agencies are not allowed to fund the losses by borrowing from the Treasury, and the Bank is legislatively required to absorb the debt the agency owes it, the Bank would incur a loss. Since the bank is unable to estimate the amounts of the probable losses which might result from default, no charge for contingencies against fiscal year 1994 income has been recorded.

As of September 30, 1994 and 1993 there were $111.5 billion and $131.4 billion, respectively, of loan commitments.

6. *ACCUMULATED DEFICIT*

The liability for the principal amount of loan prepayments, as described in Note 4 above, for fiscal years 1994 and 1993, was $2,115,441,137 and $2,069,368,220, respectively. Due to the legislation pertaining to loan prepayments by the Rural Electrification Administration (REA) and the Defense Security Assistance Agency (DSAA), the Bank has incurred losses amounting to $119,659,910 for 1994 and $148,453,170 for 1993. The recurring accumulated deficits incurred by the Bank are due to these losses. While the Bank has been able to make payments against the debt prepayment liability, it also had to pay the interest accruing on the liability. Currently, the Bank is earning interest from borrowers equivalent to one eighth of one percent more than the rate that is due Treasury on a particular security. It is unlikely that the net interest earnings at the current spread will be sufficient to liquidate the liabilities resulting from the accumulated deficit. Therefore the Bank will likely require Congressional appropriations, or an increased interest rate spread, or some combination thereof, to finance its deficit.

7. *PENSIONS AND ACCRUED ANNUAL LEAVE*

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

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

8. DISCLOSURE ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated values of each class of financial instrument for which it is practicable to estimate a fair value at September **30, 1994** and September **30, 1993** are as follows (dollars in thousands);

	Carrying Value at 1994	Fair Value at 1994	Carrying Value at 1993	Fair Value at 1993
Funds with Treasury	$338,827	$338,827	$338,125	$338,125
Loans **receivable-net**	109,489,211	116,005,329	129,430,651	154,702,436
Accrued interest receivable	2,370,060	2,370,060	2,794,094	2,794,094
Accounts receivable	1	1	8	8
Borrowings	(109,483,999)	(115,183,861)	(129,426,116)	(154,244,020)
Accrued interest payable	(2,725,088)	(2,725,088)	(3,118,583)	(3,118,583)
Debt prepayment premium	(2,145,124)	(2,145,124)	(2,074,429)	(2,074,429)
Other liabilities	(367)	(367)	(313)	(313)

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

Funds with U.S. Treasury

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

Loans Receivable and Borrowings

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

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

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

Debt Prepayment Premium

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