audit report

Issue Date November 12, 2004	
Audit Case Number 2005-FO-0001	

TO: Ronald A. Rosenfeld, President, Government National Mortgage Association, T

Randy W. McGinnis

FROM: Randy W. McGinnis, Director, Financial Audits Division, GAF

SUBJECT: **Audit of the Government National Mortgage Association's (Ginnie Mae) Financial Statements for Fiscal Year 2004**

HIGHLIGHTS

What We Audited and Why

In accordance with the Government Corporation Control Act as amended (31 U.S.C. 9105), we audited the Government National Mortgage Association's (Ginnie Mae) Financial Statements. This report presents the results of our audit of Ginnie Mae's principal financial statements for the year ended September 30, 2004. Also provided are assessments of Ginnie Mae's internal controls and compliance with laws, regulations and provisions of contracts that could have a direct and material effect on its financial statements. We did not audit the financial statements of Ginnie Mae for the year ended September 30, 2003. Those statements were audited by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, as it relates to amounts included for Ginnie Mae is based solely on the report of the other auditors. Our report includes a copy of Ginnie Mae's principal financial statements for the years ended September 30, 2004 and 2003. However, the objective of our audit was to express an opinion on the fair presentation of these financial statements.

What We Found

Ginnie Mae's financial statements are presented fairly, in all material respects, in conformity with the United States generally accepted accounting principles. Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses under standards issued by the American Institute of Certified Public Accountants. However, we noted no matters involving the internal control and its operation that we considered to be material weaknesses. The results of our tests of compliance with certain laws, regulations, and provisions of contracts disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* and OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, as applicable to government corporations.

What We Recommend

We noted no matters material to the financial statements that require recommendations in this report. However, we noted other matters involving internal control over financial reporting and its operation that we have reported to the management of Ginnie Mae in a separate letter.

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INDEPENDENT AUDITOR'S REPORT

To the President,
Government National Mortgage Association

We have audited the accompanying balance sheet of Ginnie Mae as of September 30, 2004 and the related statements of revenues and expenses and changes in investments of U.S. government and of cash flows for the year then ended. The objective of our audit was to express an opinion on the fair presentation of these financial statements. The financial statements of Ginnie Mae as of September 30, 2003, were audited by other auditors whose report dated December 3, 2003, expressed an unqualified opinion on those statements. Our opinion expressed herein, as it relates to amounts included for Ginnie Mae as of September 30, 2003, is based solely on the report of the other auditors.

Opinion Statement

In our opinion, based upon our audit and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of Ginnie Mae as of September 30, 2004and 2003, and the results of its operations and the cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Internal Control

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses under standards issued by the American Institute of Certified Public Accountants. Material weaknesses are 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. However, we noted no matters involving the internal control and its operation that we considered to be material weaknesses as defined above.

We noted other matters involving internal control over financial reporting and its operation that we have reported to the management of Ginnie Mae in a separate letter.

Compliance With Laws and Regulations

The results of our tests of compliance with certain provisions of laws, regulations, and provisions of contracts disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 01-02, as applicable to government corporations.

Management's Responsibilities

The *Government Management Reform Act of 1994* (GMRA) requires each federal agency to report annually to Congress on its financial status and any other information needed to fairly present its financial position and results of operations. To meet the GMRA reporting requirements, Ginnie Mae prepares annual financial statements. Ginnie Mae is a wholly owned government corporation within the U.S. Department of Housing and Urban Development (HUD).

Management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;

- Establishing and maintaining internal controls over financial reporting, and preparation of the Management's Discussion and Analysis; and

- Complying with laws, regulations, and provisions of contracts.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud may nevertheless occur and not be detected.

Auditor's Responsibilities

Our responsibility is to express an opinion on the fiscal year 2004 financial statements of Ginnie Mae based on our audit. We conducted our audit in accordance with Auditing Standards Generally Accepted in the United States of America, the standards applicable to audits contained in

Government Auditing Standards and OMB Bulletin No. 01-02, as applicable to government corporations. Those standards and OMB Bulletin No. 01-02 require that we plan and perform audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Our audit was not designed to test the requirements of OMB Bulletin No. 01-02 relating to the *Federal Financial Management Improvement Act of 1996* (FFMIA); they are not considered applicable at the Ginnie Mae level. Our audit was also not designed to test the requirements of the *Federal Credit Reform Act of 1990*, because Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees*, has not been considered in preparing these financial statements.

An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall financial statement presentation.

We believe that our audit provides a reasonable basis for our opinion.

Distribution

This report is intended for the information and use of the management of HUD and Ginnie Mae, OMB, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specific parties. However, this report is a matter of public record and its distribution is not limited.

James A. Heist

James A. Heist
Assistant Inspector General
For Audit

November 12, 2004

PRINCIPAL FINANCIAL STATEMENTS

BALANCE SHEETS

September 30	2004	2003
(Dollars in thousands)		
Assets:		
Funds with U.S. Treasury	$ 3,355,100	$ 2,931,800
U.S. Government securities - Note B	7,539,800	7,215,800
Mortgages held for sale, net - Note C	37,200	39,200
Properties held for sale, net - Note D	4,500	1,400
Accrued interest on U.S. Government securities	59,200	62,500
Accrued fees and other receivables	24,600	26,100
Advances against defaulted Mortgage-Backed Security pools, net - Note E	1,600	-
Fixed assets - software, net of accumulated amortization	4,100	8,000
Other assets - Note A	385,200	69,100
Total Assets	**$ 11,411,300**	**$ 10,353,900**
Liabilities and Investment of U.S. Government		
Liabilities:		
Reserve for loss on Mortgage-Backed Securities Program - Note F	$ 518,700	$ 519,300
Deferred revenue	75,100	80,600
Deferred liabilities and deposits	4,900	1,600
Accounts payable and accrued liabilities	39,700	33,300
Other liabilities - Note A	385,200	69,100
Total Liabilities	**$ 1,023,600**	**$ 703,900**
Commitments and Contingencies - Notes G, H, and I		
Investment of U.S. Government	10,387,700	9,650,000
Total Liabilities and Investment of U.S. Government	**$ 11,411,300**	**$ 10,353,900**

See accompanying notes to financial statements.

STATEMENTS OF REVENUES AND EXPENSES AND CHANGES IN INVESTMENT OF U.S. GOVERNMENT

For the years ended September 30	**2004**	**2003**
(Dollars in thousands)		
Revenues:		
Mortgage-Backed Securities Program income	$ 372,800	$ 406,100
Interest income	442,700	389,300
Other income, net	-	4,200
Total Revenues	**815,500**	**799,600**
Expenses:		
Mortgage-Backed Securities Program expenses	63,300	55,400
Administrative expenses	10,600	10,300
Fixed asset amortization	3,900	2,400
Total Expenses	**77,800**	**68,100**
Provision for loss on Mortgage-Backed Securities Program - Note F	-	-
Excess of Revenues Over Expenses	**737,700**	**731,500**
Investment of U.S. Government at Beginning of Year	9,650,000	8,918,500
Excess of revenues over expenses	737,700	731,500
Investment of U.S. Government at End of Year	**$ 10,387,700**	**$ 9,650,000**

See accompanying notes to financial statements.

STATEMENTS OF CASH FLOWS

For the years ended September 30	2004	2003
(Dollars in thousands)		
Cash flows from operating activities:		
Interest received	$ 446,000	$ 387,200
Mortgage-Backed Securities Program fees	374,300	411,000
Advances against defaulted Mortgage-Backed Security pools	(6,200)	(6,500)
Mortgage-Backed Securities losses and expenses	(54,600)	(50,600)
Other income received	(5,500)	19,600
Administrative expenses	(10,600)	(10,300)
Purchases of mortgages/properties, net of disposal	3,900	(45,500)
Net cash provided by operating activities	**747,300**	**704,900**
Cash flows from investing activities:		
Purchase of U.S. Treasury Securities, net	(324,000)	(280,600)
Purchase of software	-	(1,600)
Net cash used by investing activities	**(324,000)**	**(282,200)**
Net increase in cash	423,300	422,700
Funds with U.S. Treasury at Beginning of Year	2,931,800	2,509,100
Funds with U.S. Treasury at End of Year	**$ 3,355,100**	**$ 2,931,800**

STATEMENTS OF CASH FLOWS, Continued

For the years ended September 30		2004		2003
(Dollars in thousands)				
Net excess of revenues over expenses	$	737,700	$	731,500
Adjustments to reconcile net excess of revenues over expenses to net cash provided by operating activities:				
Provision for loss on Mortgage-Backed Securities Program		-		-
Decrease (increase) in accrued interest Federal Investments		3,300		(2,100)
(Increase) decrease in advances against defaulted Mortgage-Backed Security pools		(1,600)		4,400
Increase (decrease) in deferred liabilities and deposits		3,300		(200)
Increase in accounts payable and accrued liabilities		6,400		2,900
(Decrease) increase in deferred revenue		(5,500)		15,400
Decrease in Mortgage-Backed Securities Reserve, net of other assets, relating to operating activities		(200)		(49,400)
Fixed asset amortization		3,900		2,400
Total adjustments		**9,600**		**(26,600)**
Net cash provided by operating activities	**$**	**747,300**	**$**	**704,900**

See accompanying notes to financial statements.

Notes to the Financial Statements
September 30, 2004 and 2003

Note A – Organization and Summary of Significant Accounting Policies

The Government National Mortgage Association (Ginnie Mae) was created in 1968 through amendment of Title III of the National Housing Act as a Government corporation within the Department of Housing and Urban Development (HUD). The Mortgage-Backed Securities (MBS) program is Ginnie Mae's primary ongoing activity. The purpose of the program is to increase liquidity in the secondary mortgage market and attract new sources of capital for residential mortgage loans. Through the program, Ginnie Mae guarantees the timely payment of principal and interest on securities backed by pools of mortgages issued by private mortgage institutions. The guaranty is backed by the full faith and credit of the United States Government. Ginnie Mae requires that the mortgages be insured or guaranteed by the Federal Housing Administration (FHA), the Rural Housing Service (RHS) (formerly Farmer's Home Administration), the Department of Veterans Affairs (VA), or the HUD Office of Public and Indian Housing (PIH).

These MBS are not assets of Ginnie Mae, nor are the related outstanding securities liabilities; accordingly, neither is reflected on the accompanying balance sheets.

Funds with U.S. Treasury: All of Ginnie Mae's receipts and disbursements are processed by the U.S. Treasury, which in effect, maintains Ginnie Mae's bank accounts. For purposes of the Statements of Cash Flows, Funds with U.S. Treasury are considered cash.

U.S. Government Securities: Ginnie Mae classifies its investments in U.S. Government Securities based on its ability and positive intent to hold them to maturity. Therefore, Ginnie Mae's investment in U.S. Government Securities is recorded at amortized cost. Discounts and premiums are amortized, on a level yield basis, over the life of the related security.

Mortgages Held for Sale: Mortgages held for sale, which are purchased out of MBS pools, are carried at the lower of cost or fair value, with any unrealized losses included in current period earnings. The related allowance for loss is established to reduce the carrying value of mortgages held for sale to their estimated fair value, which is based on the amount Ginnie Mae expects to realize in cash upon sale of the mortgages.

Properties Held for Sale: Foreclosed assets are recorded at the lower of cost or fair value, less estimated costs to sell. The related allowance for loss is established to reduce the property carrying value to fair value, less costs to sell. Property related expenses incurred during the holding period are included in MBS program expenses.

Advances Against Defaulted MBS Pools: Advances against defaulted MBS pools represent payments made to fulfill Ginnie Mae's guaranty of timely principal and interest payments to the MBS security holders. Such advances are reported net of an allowance for doubtful recoveries to the extent management believes they will not be recovered. The allowance for doubtful recoveries is estimated based on actual and expected recovery experience, and is adjusted for FHA, VA, and RHS claims that have been filed.

Fixed Assets: Ginnie Mae's fixed assets represent systems (software) that are used to accomplish its mission. Ginnie Mae defers significant software development project costs, and amortizes them over a three- to five-year period beginning with the project's completion.

Reserve for Loss on MBS Program: In the operation of its MBS programs, Ginnie Mae estimates the cost of liquidating its existing portfolio of mortgage servicing rights acquired from defaulted issuers and expected issuer defaults. Reserves are established to the extent management believes issuer defaults are probable and FHA, VA, and RHS insurance or guaranty are insufficient to recoup Ginnie Mae expenditures. The reserves are increased by provisions charged as an expense in the Statements of Revenue and Expenses, and reduced by charge-offs, net of recoveries.

Recognition of Revenues and Expenses: Ginnie Mae receives monthly guaranty fees for each MBS mortgage pool, based on a percentage of the pool's outstanding balance. Fees received for Ginnie Mae's guaranty of MBS are recognized as earned. Ginnie Mae receives commitment fees as issuers request Commitment Authority, and recognizes the commitment fees as income as issuers use their Commitment Authority, with the balance deferred until earned or expired, whichever occurs first. Fees from expired Commitment Authority are not returned to issuers. Ginnie Mae recognizes as income the major portion of fees related to the issuance of multiclass securities in the period the fees are received, with the balance deferred and amortized over the weighted average life of the underlying mortgages to match the recognition of related administrative expenses. Losses on assets acquired through liquidation and claims against HUD/FHA and VA are recognized when they occur.

FIN 45: The Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 45 (FIN 45), *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, an interpretation of FASB Statements No. 5, 57, and 107, and Rescission of FASB Interpretation No. 34, in November 2002. FIN 45 clarifies the requirements of FASB Statement No. 5, *Accounting for Contingencies*, relating to the guarantor's accounting for, and disclosure of, the issuance of certain types of guarantees. FIN 45 requires that upon issuance of a guarantee, the entity (i.e., the guarantor) must recognize a liability for the fair value of the obligation it assumes under that guarantee. The disclosure provisions of FIN 45 are effective for financial statements that end after December 15, 2002. FIN 45's provisions for initial recognition and measurement are to be applied on a prospective basis only to guarantees issued or modified after December 31, 2002. The guarantor's previous accounting for guarantees that were issued before the date of FIN 45's initial application may not be revised or restated to reflect the effect of the recognition and measurement provisions of FIN 45. We have completed an evaluation of our guarantees for disclosures required by FIN 45, and have disclosed an asset and liability of $385.2 million. There is no impact of adopting FIN 45 on the net financial position.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets, and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note B – U.S. Government Securities

The U.S. Government Securities portfolio is held in special market-based U.S. Treasury Securities that are bought and sold at composite prices received from the Federal Reserve Bank of New York. These securities are maintained in book-entry form at the Bureau of Public Debt, and are made up of Overnight Certificates, U.S. Treasury Notes, and U.S. Treasury Inflation-Indexed Securities (reflects inflation compensation). The coupon rates of Ginnie Mae's holdings as of September 30, 2004, range from 1.72 percent to 7.88 percent, and as of September 30, 2003, the range was from 0.95 percent to 7.88 percent.

The amortized cost and fair values as of September 30, 2004 were as follows:

Dollars in Thousands	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. Treasury Overnight Certificates	$ 1,293,100	$ -	$ -	$ 1,293,100
U.S. Treasury Notes	1,998,700	99,800	-	2,098,500
U.S. Treasury Inflation-Indexed Securities	4,248,000	314,200	-	4,562,200
	$ 7,539,800	**$ 414,000**	**$ -**	**$ 7,953,800**

The amortized cost and fair values as of September 30, 2003 were as follows:

Dollars in Thousands	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. Treasury Overnight Certificates	$ 1,411,700	$ -	$ -	$ 1,411,700
U.S. Treasury Notes	2,765,500	240,900	-	3,006,400
U.S. Treasury Inflation-Indexed Securities	3,038,600	176,800	-	3,215,400
	$ 7,215,800	**$ 417,700**	**$ -**	**$ 7,633,500**

The amortized cost, fair value, and annual weighted average interest rates of U.S. Government securities at September 30, 2004, by contractual maturity date, were as follows:

Dollars in Thousands	**Amortized Cost**	**Fair Value**	**Weighted Average Interest Rate**
Due within one year	$ 2,102,700	$ 2,118,200	1.50%
Due after one year through five years	1,189,100	1,273,400	2.51%
Due after five years through ten years	4,248,000	4,562,200	1.59%
	$ 7,539,800	**$ 7,953,800**	**1.72%**

The amortized cost, fair value, and annual weighted average interest rates of U.S. Government securities at September 30, 2003, by contractual maturity date, were as follows:

Dollars in Thousands	**Amortized Cost**	**Fair Value**	**Weighted Average Interest Rate**
Due within one year	$ 2,181,700	$ 2,208,300	0.97%
Due after one year through five years	1,995,500	2,209,900	1.60%
Due after five years through ten years	3,038,600	3,215,300	1.83%
	$ 7,215,800	**$ 7,633,500**	**1.51%**

Note C – Mortgages Held for Sale, Net

Ginnie Mae acquires certain mortgages from defaulted issuers' portfolios to bring the pools into conformity with MBS program requirements. Ginnie Mae acquires mortgages ineligible to remain in pools when servicing rights are sold. Mortgages held for sale were as follows:

	September 30,	
Dollars in Thousands	**2004**	**2003**
Unpaid principal balance	$ 44,700	$ 52,400
Allowance for losses	(7,500)	(13,200)
Mortgages held for sale, net	**$ 37,200**	**$ 39,200**

Note D – Properties Held for Sale, Net

Ginnie Mae acquires residential properties by foreclosure out of the defaulted issuer portfolios in order to comply with MBS program requirements. Balances and activity in properties held for sale were as follows:

	September 30,	
Dollars in Thousands	**2004**	**2003**
Cost of properties, beginning of year	$ 3,900	$ 2,100
Additions	7,700	5,800
Dispositions and losses	(3,900)	(4,000)
Cost of properties, end of year	7,700	3,900
Allowances for losses and costs to sell	(3,200)	(2,500)
Properties held for sale, net	**$ 4,500**	**$ 1,400**

Note E – Advances Against Defaulted Mortgage-Backed Security Pools, Net

Under its MBS guaranty, Ginnie Mae advanced $34.4 million in Fiscal Year 2004, and $39.8 million in Fiscal Year 2003 against defaulted MBS pools to ensure timely pass-through payments. Recoveries of advances, either from late payment remittances or through FHA insurance or VA guaranty proceeds were $28.2 million in Fiscal Year 2004, and $40.3 million in Fiscal Year 2003. Advances of $101.6 million were written off in Fiscal Year 2004 and no advances were written off in Fiscal Year 2003.

	September 30,	
Dollars in Thousands	**2004**	**2003**
Advances against defaulted pools	$ 7,400	$ 102,784
Allowance for losses	(5,800)	(102,784)
Advances against defaulted pools	**$ 1,600**	**$ -**

Note F – Reserve for Loss on MBS Program

Ginnie Mae establishes a reserve for losses through a provision charged to operations, when in management's judgment, defaults of issuers of MBS become probable. The reserve for losses is based on an analysis of the MBS portfolio outstanding. In estimating losses, management utilizes a statistically based model that evaluates numerous factors, including, but not limited to, general and regional economic conditions, mortgage characteristics, and actual and expected future default and loan loss experience.

Management also considers uncertainties related to estimations in the reserve setting process. The reserve is relieved as losses are realized from the disposal of the defaulted issuers' portfolios. Ginnie Mae recovers part of its losses through servicing fees on the performing portion of the portfolios and the sale of servicing rights. As Ginnie Mae's defaulted issuer portfolio decreases, original estimates are compared with actual results over time, and the adequacy of the reserve is assessed, and if necessary, the reserve is adjusted. Management believes that its reserve is adequate to cover probable losses from defaults by issuers of Ginnie Mae guaranteed MBS. Changes in the reserve for the years ended September 30, 2004 and 2003, were as follows:

Dollars in Thousands	**Single Family**	**Multifamily**	**Manufactured Housing**	**Total**
September 30, 2002	$ 229,600	$ 57,700	$ 251,400	$ 538,700
Recoveries	5,500	400	2,500	8,400
Realized losses	(17,100)	(700)	(10,000)	(27,800)
Provision	-	-	-	-
September 30, 2003	$ 218,000	$ 57,400	$ 243,900	$ 519,300
Recoveries	10,000	800	3,300	14,100
Realized losses	(6,900)	(100)	(7,700)	(14,700)
Provision	-	-	-	-
September 30, 2004	**$ 221,100**	**$ 58,100**	**$ 239,500**	**$ 518,700**

Ginnie Mae incurs loss when FHA and VA insurance and guarantees do not cover expenses that result from issuer defaults. Such expenses include: (1) unrecoverable losses on individual mortgage defaults because of coverage limitations on mortgage insurance or guarantees; (2) ineligible mortgages included in defaulted Ginnie Mae pools; (3) improper use of proceeds by an issuer; and (4) non-reimbursable administrative expenses and costs incurred to service and liquidate portfolios of defaulted issuers.

Subsequent to September 30, 2004, Ginnie Mae defaulted a single-family issuer. At this time, Ginnie Mae believes that the estimated reserve for loss is more than adequate to cover any non-insured loss sustained for this issuer and from unknown future losses from the occurrence of any normal periodic defaults.

Note G – Financial Instruments with Off – Balance Sheet Risk

Ginnie Mae is subject to credit risk for financial instruments not reflected in its balance sheet in the normal course of operations. These financial instruments include guarantees of MBS and commitments to guaranty MBS. The Ginnie Mae guaranteed security is a pass-through security, whereby mortgage principal and interest payments, except for servicing and guaranty fees, are passed through to the security holders, monthly. Mortgage prepayments are also passed through to security holders. As a result of the structure of the security, Ginnie Mae bears no interest rate or liquidity risk. Ginnie Mae's exposure to credit loss is contingent on the event of non-performance by other parties to the financial instruments. Other than those issuers considered in the reserve for loss on the MBS program (see Note F), Ginnie Mae does not anticipate non-performance by the counter parties.

Ginnie Mae guarantees the timely payment of principal and interest to MBS holders should the issuers fail to do so. The securities are backed by pools of insured or guaranteed FHA, RHS, or VA mortgage loans. On September 30, 2004, the amount of securities outstanding, which are guaranteed by Ginnie Mae was $453.4 billion, and it includes $96.1 million of Ginnie Mae Guaranteed Bonds. However, Ginnie Mae's potential loss is considerably less because the underlying mortgages serve as primary collateral, and the FHA, RHS, and VA insurance or guaranty indemnifies Ginnie Mae for most losses.

During the mortgage closing period and prior to granting its guaranty, Ginnie Mae enters into commitments to guaranty MBS. The commitment ends when the securities are issued, or the commitment period expires. Ginnie Mae's risk related to outstanding commitments is much less than for outstanding securities, due in part, to Ginnie Mae's ability to limit Commitment Authority granted to individual issuers of MBS.

Outstanding MBS securities and commitments were as follows:

Dollars in Billions	September 30, 2004	September 30, 2003
Outstanding MBS securities	$ 453.4	$ 473.9
Outstanding MBS commitments	$ 42.9	$ 46.4

Note H – Concentrations of Credit Risk

Concentrations of credit risk exist when a significant number of counter parties (e.g., issuers and borrowers) engage in similar activities, or are susceptible to similar change in economic conditions that could affect their ability to meet contractual obligations. Generally, Ginnie Mae's MBS pools are diversified among issuers and geographic areas. No significant geographic concentrations of credit risk exist; however, to a limited extent, securities are concentrated among issuers as noted below, as of September 30, 2004:

	Single Family		Multifamily		Manufactured Housing	
Dollars in Billions	Number of Issuers	Remaining Principal Balance	Number of Issuers	Remaining Principal Balance	Number of Issuers	Remaining Principal Balance
Largest performing issuers	20	$ 380.2	9	$ 20.3	1	$ 0.1
Other performing issuers	146	40.0	65	12.4	3	0.1
Defaulted issuers	6	0.2	2	0.1	8	0.0

During Fiscal Year 2004, single family, multifamily, and manufactured housing defaulted issuers had remaining principal balances of $236 million, $55.7 million, and $36.4 million, respectively, as of September 30, 2004.

In Fiscal Year 2004, Ginnie Mae issued a total of $81.4 billion in its multiclass securities program. The estimated outstanding balance of multiclass securities included in the total MBS securities balance in Note G as of September 30, 2004, was $189.1 billion. These guaranteed securities do not subject Ginnie Mae to additional credit risk beyond that assumed under the MBS program.

Note I – Commitments and Contingencies

As of September 30, 2004, Ginnie Mae was named in several legal actions, virtually all of which involved claims under the guaranty program. It is not possible to predict the eventual outcome of the various actions; however, in the opinion of management and counsel, the resolution of these claims will not result in adverse judgments to such an extent they would materially affect the financial position or results of operations of Ginnie Mae.

Note J – Related Parties

Ginnie Mae is subject to controls established by government corporation control laws (31 U.S.C. Chapter 91), and management controls by the Secretary of HUD and the Director of the Office of Management and Budget (OMB). Such controls could affect Ginnie Mae's financial position or operating results in a manner that differs from those that might have been obtained if Ginnie Mae were autonomous.

HUD provides Ginnie Mae, without charge, use of office space and equipment. Ginnie Mae reimbursed HUD $10.6 million in Fiscal Year 2004, and $10.3 million in Fiscal Year 2003, for administrative expenses allocated to Ginnie Mae, including payroll and payroll-related costs.

Payroll-related costs for which Ginnie Mae reimbursed HUD included matching contributions to the Civil Service Retirement System (CSRS), and the Federal Employees' Retirement System (FERS). Although Ginnie Mae funds a portion of pension benefits under these programs, it has no liability for future payments to employees under these programs and does not account for the assets of CSRS or FERS, 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), and are allocated to HUD. OPM also accounts for the health and life insurance programs for Federal employees and retirees, and funds the non-employee portion of the costs of such programs.

Cash receipts, disbursements, and investment activities are processed by the U.S. Treasury. Funds with U.S. Treasury represent cash currently available to finance purchase commitments and pay current liabilities. Ginnie Mae has authority to borrow from the U.S. Treasury to finance operations in lieu of appropriations, if necessary.

Note K – Fair Value of Financial Instruments

The following table shows the fair value of financial instruments to which Ginnie Mae has a contractual obligation to deliver, or a contractual right to receive cash from another entity as of September 30, 2004 and 2003:

	September 30, 2004		September 30, 2003	
Dollars in Thousands	**Cost**	**Fair Value**	**Cost**	**Fair Value**
Funds with U.S. Treasury	$ 3,355,100	$ 3,355,100	$ 2,931,800	$ 2,931,800
U.S. Government securities	7,539,800	7,953,800	7,215,800	7,633,500
Advance against MBS pools	1,600	1,600	-	-
Other assets	125,500	125,500	129,200	129,200
Unrecognized financial instruments	-	1,248,000	-	1,194,000
Other liabilities	119,700	119,700	115,500	115,500

The fair value of Ginnie Mae's largest asset, U.S. Government Securities, is estimated based on quoted market prices for securities of similar maturity. The fair values of Funds with U.S. Treasury, advances against MBS pools, other assets, and other liabilities are not materially different from their carrying values.

Unrecognized financial instruments comprise the net fair value of the fee Ginnie Mae receives for the guaranty of timely payment of principal and interest. The value was derived by discounting the estimated future net cash flows relating to Ginnie Mae guaranteed MBS outstanding. The assumptions and estimates used in calculating the fair values of unrecognized financial instruments are based on management's evaluation of economic conditions, and therefore, are not subject to precise quantification.

These discounted cash flows consist of estimated future guaranty fees, taking into account estimated prepayments, in excess of: (1) projected losses relating to the MBS program, including projected losses on defaulted pools of MBS; and (2) projected administrative expenses. The discount rate approximates an interest rate for risk-free instruments of a type and duration similar to the Ginnie Mae guaranty. The fair value of Ginnie Mae's guaranty recognizes the present value of future fees, which are not recognized under accounting principles generally accepted in the United States of America, since to do so would record revenue prior to realization. The fair value of unrecognized financial instruments increased from Fiscal Year 2003 to Fiscal Year 2004, and is primarily attributable to the impact of interest rate volatility.

Ginnie Mae's standing as a Federal Government corporation whose guaranty carries the full faith and credit of the U.S. Government makes it difficult to determine what the fair value of its financial instruments would be in the private market. Accordingly, the amount Ginnie Mae would realize upon sale of its financial instruments could differ, perhaps materially, from the amounts shown above.

Note L – Credit Reform

The primary purpose of the Federal Credit Reform Act of 1990, which became effective on October 1, 1991, is to more accurately measure the cost of Federal credit programs, and to place the cost of such credit programs on a basis equivalent with other Federal spending. Credit reform focuses on those credit programs that operate at a loss by providing for appropriated funding, within budgetary limitations, to subsidize the loss element of the credit program. Negative subsidies, calculated for credit programs operating at a profit, normally result in the return of funds to the U.S. Treasury. OMB specifies the methodology an agency is to follow in accounting for the cash flows of its credit programs.

Ginnie Mae's credit activities have historically operated at a profit. Ginnie Mae has not incurred borrowings or received appropriations to finance its credit operations. As of September 30, 2004, Ginnie Mae had reserves of $10.4 billion held in the U.S. Treasury. Pursuant to the statutory provisions under which Ginnie Mae operates, its net earnings are used to build sound reserves. In the opinion of management, and HUD's General Counsel, Ginnie Mae is in compliance with OMB implementation requirements for the Federal Credit Reform Act, as applicable to government corporations.

APPENDIX

Appendix A

Scope and Methodology

To accomplish our audit objectives, we:

- Considered Ginnie Mae's internal control over financial reporting by obtaining an understanding of Ginnie Mae's internal control, determining whether internal controls had been placed into operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements.

- Limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon.

- Obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions with respect to internal controls related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis section.

- Performed tests of Ginnie Mae's compliance with certain laws, regulations and provisions of contracts, with which noncompliance could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws, regulations, and contracts specified in OMB Bulletin No. 01-02. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations and provisions of contracts applicable to Ginnie Mae. Providing an opinion on compliance with all laws, regulations and provisions of contracts was not an objective of our audit and accordingly, we do not express such an opinion.