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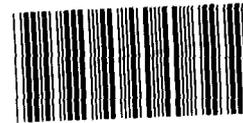
Testimony

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Financial Audit of the Rural Telephone Bank

Statement of
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Before the
Subcommittee on Government Information,
Justice and Agriculture
Committee on Government Operations
House of Representatives



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Mr. Chairman and Members of the Subcommittee, I am pleased to be here today to discuss GAO's recent audit of the 1986 financial statements of the Rural Telephone Bank (RTB) and to discuss with you the concerns which we have developed as a result of that audit.

GAO's responsibility to conduct financial statement audits of the RTB was established by the Government Corporation Control Act of 1945, which requires GAO to audit certain government corporations "consistent with principles and procedures applicable to commercial corporate transactions." The primary purpose of such audits is threefold: (1) to ascertain and report whether the information provided in an entity's financial statements is fairly presented in accordance with appropriate accounting principles, (2) to identify any significant weaknesses in internal accounting controls, and (3) to determine if the entity has complied with major laws and regulations.

Under the Government Corporation Control Act, the Rural Telephone Bank is defined as a wholly-owned government corporation subject to GAO financial statement audit at least once every three years. The Bank was established in 1971 to provide supplemental financing to rural telephone company borrowers. GAO has conducted financial audits of the Bank for the years ended 1973, 1974, 1975, 1976, 1979, and 1983. For the year ended September 30, 1986, GAO contracted with the CPA firm of Peat Marwick Main & Co., to assist in the audit of RTB.

After we finish reviewing Peat Marwick's work, it will be included as a part of our forthcoming report.

The audit of RTB disclosed that, for the fiscal year ended 1986, RTB earned, after payment of dividends on its Treasury Class A stock, net income of approximately \$25.3 million on share holders' investment of \$690 million. This investment is comprised of \$450 million in Class A stock owned by the U.S. government, and \$240 million of Class B & C stock, patronage capital, and contingency reserve. Over the past 3 years, the earnings of RTB, after payment of dividends on the Class A and C stock, were in excess of \$60 million. A schedule of net income by year and its allocation to the various accounts is attached to this testimony.

The concern which this audit raises in our mind is that, while RTB has a considerable degree of latitude in establishing interest rates and in using retained earnings to provide contingency reserves, the amount of net income and retained earnings accumulated over the past several years, and the last three years in particular, appear to be significantly higher than warranted. This has resulted from interest rate charges to the borrowers which we think were higher than necessary and which did not accurately reflect RTB's actual borrowing costs.

There has been considerable discussion as to the degree of latitude allowable to the Governor in setting individual rates and to various aspects of the interest rate calculations. We can discuss these issues with you this afternoon or pursue this with your staff should you so desire. However, the important point is that the Bank's rate setting process has allowed accumulated retained earnings in excess of the needs of the organization to carry out its operations on a self-sustaining basis.

The statute establishing RTB does not satisfactorily resolve a tension between two of its purposes. On the one hand, RTB is to set interest rates to reflect its average cost of money and to carry out operations in a self-sustaining manner. On the other hand, the statute recognizes that some earnings will remain after payment of the Bank's expenses and dividends, and the RTB is required to repay the government \$600 million as soon as practicable after 1995, without impairing the operations of RTB.

One argument for generating retained earnings is that those funds are needed for the repayment of Class A stock as provided in the statute. While that option appears to be available to the Governor under the statute, it is not explicitly required under the statute nor is it the only mechanism available to make those payments. We believe that this issue needs to be clarified and resolved in order to ensure that the intent of Congress is

appropriately carried out. Ultimately, however, it seems to us that the current level of accumulated earnings that has occurred at RTB is higher than it needs and should be dealt with.

Should the Committee or RTB decide to deal with this accumulation of earnings, there is probably a hierarchy of approaches which should be considered:

1. First, RTB needs to make changes to its rate setting procedures so that interest rates are more closely aligned with the interest rates at the time of drawdown. We understand that RTB has considered this change, received favorable public comment and will incorporate this change on new loans only. It should be noted, however, that under this change, interest rates would no longer be fixed over the construction and drawdown period and higher interest costs to the borrower can result when interest rates rise.
2. RTB currently has a number of loan commitment contracts with fixed interest rates that are higher than the currently prevailing interest rates. Relief under those contracts could be provided by making an adjustment to the interest rate to more appropriately reflect the current interest rate at the time of drawdown.

At this point then, an assessment of the impact of the above items on RTB earnings needs to be made.

3. After that assessment, to the extent that prior accumulated earnings are determined to be excessive, these could be refunded to borrowers through some form of prorated redemption of Class B stock for cash.
4. To the extent that, after the above three actions are taken, it is decided that accumulated earnings are still higher than needed for contingency purposes, the contingency reserve could be lowered.

For both items 3 and 4, we have not yet looked at the technicalities of how this would be carried out and what changes in statute would be required.

Mr. Chairman, we have completed essentially all of our audit work other than the presentation of this issue and should be in a position to issue our report shortly. However, we chose to delay issuance of the report until this hearing to get any comments you may have on this issue.

There are a number of subsidiary issues which have been raised relating to the specific details of the methods used by

RTB in calculating interest rates which we have discussed with your staff and with RTB. We would be pleased to discuss any of those issues with you or to pursue them with your staff should you so desire.

Mr. Chairman, that concludes my statement. I would be pleased to answer any questions you may have.

RURAL TELEPHONE BANK
DISPOSITION OF NET INCOME

DISTRIBUTION OF NET INCOME

PERIOD ENDING	NET INCOME	A-STOCK DIVIDEND	C-STOCK DIVIDEND	NET-INCOME AFTER CASH DIVIDENDS	B-STOCK DIVIDEND	CONTINGENCY RESERVE
6/30/72	\$ 4,351	\$ 1,040	\$ -	\$ 3,311	\$ -	\$ 3,311
6/30/73	1,292,575	368,843	21,000	902,732	114,517	788,215
6/30/74	5,225,526	1,519,959	26,650	3,678,917	545,874	3,133,043
6/30/75	7,663,778	2,318,421	27,250	5,318,107	1,293,017	4,025,090
6/30/76	9,287,537	2,914,426	34,125	6,338,986	2,147,004	4,191,982
9/30/76	2,745,763	791,228	-	1,954,535	-	1,954,535
9/30/77	12,712,600	3,647,048	32,760	9,032,792	2,947,963	6,084,829
9/30/78	15,472,486	4,259,540	32,820	11,180,126	3,677,270	7,502,856
9/30/79	17,634,387	4,873,845	35,620	12,724,922	4,572,127	8,152,795
9/30/80	18,192,656	5,501,504	38,360	12,652,792	5,680,533	6,972,259
9/30/81	16,755,674	5,950,700	96,390	10,708,584	6,937,598	3,770,986
9/30/82	16,709,904	6,447,715	101,360	10,160,829	6,402,801	3,758,028
9/30/83	18,134,890	6,857,244	113,400	11,164,246	8,805,252	2,358,994
9/30/84	22,758,288	7,440,596	138,400	15,179,292	10,627,954	4,551,338
9/30/85	27,908,507	7,965,794	147,050	19,795,663	12,336,987	7,458,676
9/30/86	33,894,764	8,581,784	147,050	25,165,930	13,091,515	12,074,415
	\$ 226,393,686	\$ 69,439,687	\$ 992,235	\$ 155,961,764	\$ 79,180,412	\$ 76,781,352

ATTACHMENT I

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