NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP /DC/
Form 10-Q
January 11, 2008

FORM 10-Q

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended November 30, 2007

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period From To

Commission File Number 1-7102

NATIONAL RURAL UTILITIES COOPERATIVE
FINANCE CORPORATION

(Exact name of registrant as specified in its charter)

DISTRICT OF COLUMBIA
(State or other jurisdiction of incorporation or organization)

52-0891669
(I.R.S. Employer Identification Number)

2201 COOPERATIVE WAY, HERNDON, VA 20171
(Address of principal executive offices)

Registrant's telephone number, including area code, is 703-709-6700.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x.

The Registrant is a cooperative and consequently, does not issue any equity capital stock.

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

A S S E T S

	November 30, 2007	May 31, 2007
Cash and cash equivalents	$ 188,655	$ 304,107
Loans to members	18,261,923	18,131,873
Less: Allowance for loan losses	(530,802)	(561,663)
Loans to members, net	17,731,121	17,570,210
Accrued interest and other receivables	286,009	291,637
Fixed assets, net	5,692	4,555
Debt service reserve funds	54,993	54,993
Bond issuance costs, net	36,409	45,611
Foreclosed assets	70,145	66,329
Derivative assets	211,507	222,774
Other assets	22,364	14,965
	$18,606,895	$18,575,181

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands)

L I A B I L I T I E S A N D E Q U I T Y

	November 30, 2007	May 31, 2007
Short-term debt	$ 6,492,588	$ 4,427,123
Accrued interest payable	281,556	281,458
Long-term debt	9,275,267	11,295,219
Deferred income	25,044	27,990
Guarantee liability	14,681	18,929
Other liabilities	29,860	27,611
Derivative liabilities	169,928	71,934
Subordinated deferrable debt	311,440	311,440
Members' subordinated certificates:		
Membership subordinated certificates	649,424	649,424
Loan and guarantee subordinated certificates	759,053	732,023
Total members' subordinated certificates	1,408,477	1,381,447
Commitments and contingencies		
Minority interest	15,933	21,989
Equity:		
Retained equity	570,248	697,837
Accumulated other comprehensive income	11,873	12,204
Total equity	582,121	710,041
	$18,606,895	$18,575,181

See accompanying notes.

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(in thousands)

For the Three and Six Months Ended November 30, 2007 and 2006

	Three months ended November 30,		Six months ended November 30,	
	2007	2006 (As restated)*	2007	2006 (As restated)*
Interest income	$ 263,287	$ 260,244	$ 531,241	$ 524,933
Interest expense	(240,017)	(248,591)	(487,342)	(504,595)
Net interest income	23,270	11,653	43,899	20,338
Recovery of loan losses	14,301	-	14,301	-
Net interest income after recovery of loan losses	37,571	11,653	58,200	20,338
Non-interest income:				
Rental and other income	352	308	703	625
Derivative cash settlements	11,507	16,493	19,836	31,748
Results of operations of foreclosed assets	1,856	2,989	3,816	5,991
Total non-interest income	13,715	19,790	24,355	38,364
Non-interest expense:				
Salaries and employee benefits	(8,828)	(8,209)	(17,651)	(16,761)
Other general and administrative expenses	(5,929)	(4,568)	(10,416)	(8,744)
Recovery of (provision for) guarantee liability	1,200	(1,800)	3,300	(400)
Derivative forward value	(75,412)	(53,239)	(109,012)	(116,590)
Foreign currency adjustments	-	(20,620)	-	(17,299)
Loss on sale of loans	-	-	(518)	-
Total non-interest expense	(88,969)	(88,436)	(134,297)	(159,794)
Loss prior to income taxes and minority interest	(37,683)	(56,993)	(51,742)	(101,092)
Income taxes	2,912	486	4,011	1,200

Loss prior to minority interest	(34,771)	(56,507)	(47,731)	(99,892)
Minority interest	4,545	312	6,123	678
Net loss	$ (30,226)	$ (56,195)	$ (41,608)	$ (99,214)

See accompanying notes.
*See Note 1(i)

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY
(UNAUDITED)
(in thousands)

For the Six Months Ended November 30, 2007 and 2006

	Total	Accumulated Other Comprehensive Income (Loss)	Subtotal Retained Equity	Membership Fees	Unallocated Net Income	Education Fund	Members' Capital Reserve	Patronage Capital Allocated General Reserve Fund	Other
Six months ended November 30, 2007:									
Balance as of May 31, 2007	$ 710,041	$ 12,204	$ 697,837	$ 997	$ 131,528	$ 1,406	$ 158,308	$ 405,100	$ 498
Patronage capital retirement	(85,494)	-	(85,494)	-	-	-	-	(85,494)	-
Loss prior to income taxes and minority interest	(51,742)	-	(51,742)	-	(51,742)	-	-	-	-
Other comprehensive loss	(331)	(331)	-	-	-	-	-	-	-
Income taxes	4,011	-	4,011	-	4,011	-	-	-	-
Minority interest	6,123	-	6,123	-	6,123	-	-	-	-
Other	(487)	-	(487)	(1)	1	(487)	40	-	(40)
Balance as of November 30, 2007	$ 582,121	$ 11,873	$ 570,248	$ 996	$ 89,921	$ 919	$ 158,348	$ 319,566	$ 498
Six months ended November 30, 2006:									
Balance as of May 31, 2006	$ 784,408	$ 13,208	$ 771,200	$ 994	$ 225,849	$ 1,281	$ 156,844	$ 385,735	$ 497
Patronage capital retirement	(84,247)	-	(84,247)	-	-	-	-	(84,247)	
Loss prior to income taxes and minority interest (As restated)*	(101,092)	-	(101,092)	-	(101,092)	-	-	-	-

Other comprehensive loss	(502)	(502)	-	-	-	-	-	-	-
Income taxes	1,200	-	1,200	-	1,200	-	-	-	-
Minority interest	678	-	678	-	678	-	-	-	-
Other	(481)	-	(481)	(1)	-	(480)	-	-	-
Balance as of November 30, 2006 (As restated)*	$ 599,964	$ 12,706	$ 587,258	$ 993	$ 126,635	$ 801	$ 156,844	$ 497	$ 301,488

See accompanying notes.
*See Note 1(i)

5

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(in thousands)

For the Six Months Ended November 30, 2007 and 2006

	2007	2006 (As restated)*
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (41,608)	$ (99,214)
Add (deduct):		
Amortization of deferred income	(4,240)	(7,840)
Amortization of bond issuance costs and deferred charges	11,463	9,510
Depreciation	1,118	1,105
Recovery of loan losses	(14,301)	-
(Recovery of) provision for guarantee liability	(3,300)	400
Results of operations of foreclosed assets	(3,816)	(5,991)
Derivative forward value	109,012	116,590
Foreign currency adjustments	-	17,299
Loss on sale of loans	518	-
Changes in operating assets and liabilities:		
Accrued interest and other receivables	(9,068)	(18,141)
Accrued interest payable	98	27,765
Other	(5,264)	(6,271)
Net cash provided by operating activities	40,612	35,212
CASH FLOWS FROM INVESTING ACTIVITIES:		
Advances made on loans	(3,595,700)	(3,347,118)
Principal collected on loans	3,403,193	3,550,432
Net investment in fixed assets	(744)	(333)
Net cash provided by foreclosed assets	-	56,831
Net proceeds from sale of foreclosed assets	-	487
Net proceeds from sale of loans	39,580	-
Net cash (used in) provided by investing activities	(153,671)	260,299
CASH FLOWS FROM FINANCING ACTIVITIES:		
(Repayments of) proceeds from issuances of short-term debt, net	(103,653)	136,133
Proceeds from issuance of long-term debt, net	668,890	111,154
Payments for retirement of long-term debt	(346,590)	(478,913)

Payments for retirement of subordinated deferrable debt	(175,000)	(150,000)
Proceeds from issuance of members' subordinated certificates	43,189	18,710
Payments for retirement of members' subordinated certificates	(11,851)	(17,322)
Payments for retirement of National Rural patronage capital	(77,378)	(74,094)
Net cash used in financing activities	(2,393)	(454,332)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(115,452)	(158,821)
BEGINNING CASH AND CASH EQUIVALENTS	304,107	260,338
ENDING CASH AND CASH EQUIVALENTS	$ 188,655	$ 101,517

See accompanying notes.
*See Note 1(i)

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(in thousands)

For the Six Months Ended November 30, 2007 and 2006

	2007	2006 (As restated)*
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 475,781	$ 467,321
Cash paid for income taxes	767	982

See accompanying notes.
*See Note 1(i)

NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(1) General Information and Accounting Policies

(a) General Information

National Rural Utilities Cooperative Finance Corporation ("National Rural" or "the Company") is a private, not-for-profit cooperative association incorporated under the laws of the District of Columbiain April 1969. The principal purpose of National Rural is to provide its members with a source of financing to supplement the loan programs of the Rural Utilities Service ("RUS") of the United States Department of Agriculture. National Rural makes loans to its rural utility system members ("utility members") to enable them to acquire, construct and operate electric distribution, generation, transmission and related facilities. National Rural also provides its members with credit enhancements in the form of letters of credit and guarantees of debt obligations. National Rural is exempt from payment of federal income taxes under the provisions of Section 501(c)(4) of the Internal Revenue Code. National Rural is a not-for-profit member-owned finance cooperative, thus its objective is not to maximize its net income, but to offer its members low cost financial products and services consistent with sound financial management.

Rural Telephone Finance Cooperative ("RTFC") was incorporated as a private not-for-profit cooperative association in the state of South Dakotain September 1987. In February 2005, RTFC reincorporated as a not-for-profit cooperative association in the District of Columbia. The principal purpose of RTFC is to provide and arrange financing for its rural telecommunications members and their affiliates. RTFC's results of operations and financial condition are consolidated with those of National Rural in the accompanying financial statements. RTFC is headquartered with National Rural in Herndon, Virginia. RTFC is a taxable cooperative that pays income tax based on its net income, excluding net income allocated to its members, as allowed by law under Subchapter T of the Internal Revenue Code.

National Cooperative Services Corporation ("NCSC") was incorporated in 1981 in the District of Columbia as a private non-profit cooperative association. The principal purpose of NCSC is to provide financing to the for-profit or non-profit entities that are owned, operated or controlled by or provide substantial benefit to, members of National Rural. NCSC also markets, through its cooperative members, a consumer loan program for home improvements and an affinity credit card program. NCSC's membership consists of National Rural and distribution systems that are members of National Rural or are eligible for such membership. NCSC's results of operations and financial condition are consolidated with those of National Rural in the accompanying financial statements. NCSC is headquartered with National Rural in Herndon, Virginia. NCSC is a taxable corporation.

The Company's consolidated membership was 1,543 as of November 30, 2007 including 899 utility members, the majority of which are consumer-owned electric cooperatives, 513 telecommunications members, 66 service members and 65 associates in 49 states, the District of Columbia and two U.S.territories. The utility members included 830 distribution systems and 69 generation and transmission ("power supply") systems. Memberships among National Rural, RTFC and NCSC have been eliminated in consolidation. All references to members within this document include members and associates.

In the opinion of management, the accompanying consolidated financial statements contain all adjustments (which consist only of normal recurring accruals) necessary for a fair statement of the Company's results for the interim periods presented.

These interim unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 2007.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect the assets, liabilities, revenues and expenses reported in the financial statements, as well as amounts included in the notes thereto, including discussion and disclosure of contingent liabilities. While the Company uses its best estimates and judgments based on the known facts at the date of the financial statements, actual results could differ from these estimates as future events occur.

The Company does not believe it is vulnerable to the risk of a near term severe impact as a result of any concentrations of its activities.

(b) Principles of Consolidation

The accompanying financial statements include the consolidated accounts of National Rural, RTFC and NCSC and certain entities controlled by National Rural and created to hold foreclosed assets and effect loan securitization transactions, after elimination of all material intercompany accounts and transactions. Financial Accounting Standards Board ("FASB") Interpretation No. ("FIN") 46(R), Consolidation of Variable Interest Entities, an interpretation of Accounting Research Bulletin No. 51, requires National Rural to consolidate the financial results of RTFC and NCSC. National Rural is the primary beneficiary of variable interests in RTFC and NCSC due to its exposure to absorbing the majority of expected losses.

National Rural is the sole lender to and manages the lending and financial affairs of RTFC through a management agreement in effect through December 1, 2016. Under a guarantee agreement, RTFC pays National Rural a fee in exchange for which National Rural reimburses RTFC for loan losses. All loans that require RTFC board approval also require National Rural approval. National Rural is not a member of RTFC and does not elect directors to the RTFC board. RTFC is an associate member of National Rural.

National Rural is the primary source of funding to and manages the lending and financial affairs of NCSC through a management agreement which is automatically renewable on an annual basis unless terminated by either party. NCSC funds its programs either through loans from National Rural or commercial paper and long-term notes issued by NCSC and guaranteed by National Rural. In connection with these guarantees, NCSC must pay a guarantee fee and purchase from National Rural interest-bearing subordinated term certificates in proportion to the related guarantee. Under a guarantee agreement, NCSC pays National Rural a fee in exchange for which National Rural reimburses NCSC for loan losses, excluding losses in the consumer loan program. All loans that require NCSC board approval also require National Rural approval. National Rural controls the nomination process for one out of 11 NCSC directors. The full membership of NCSC elects directors on the basis of one vote for each member. NCSC is a service organization member of National Rural.

RTFC and NCSC creditors have no recourse against National Rural in the event of default by RTFC and NCSC, unless there is a guarantee agreement under which National Rural has guaranteed NCSC or RTFC debt obligations to a third party. At November 30, 2007, National Rural had guaranteed $287 million of NCSC debt and derivative instruments with third parties. The maturities for NCSC debt guaranteed by National Ruralrun through 2031. As of November 30, 2007, National Rural's maximum potential exposure totaled $305 million related to guarantees of NCSC debt and derivatives. Guarantees related to NCSC debt and derivative instruments are not included in Note 12 at November 30, 2007 as the debt and derivatives are reported on the consolidated balance sheet. At November 30, 2007, National Rural had no guarantees of RTFC debt to third party creditors. All National Rural loans to RTFC and NCSC are secured by all assets and revenues of RTFC and NCSC. At November 30, 2007, RTFC had total assets of $1,986 million including loans outstanding to members of $1,792 million and NCSC had total assets of $518 million including loans outstanding of $464 million. At November 30, 2007 and May 31, 2007, National Rural had committed to lend RTFC up to $4 billion of which $2 billion was outstanding at November 30, 2007. At November 30, 2007 and May 31, 2007, National Rural had committed to provide credit to NCSC of up to $1 billion. At November 30, 2007, National Rural had provided a total of $510 million of credit to NCSC, representing $223 million of outstanding loans and $287 million of credit enhancements.

National Rural established limited liability corporations and partnerships to hold foreclosed assets and effect loan securitization transactions. National Rural has full ownership and control of all such companies and thus consolidates their financial results. National Rural presents the companies formed to hold foreclosed assets in one line on the consolidated balance sheets and the consolidated statements of operations. A full consolidation is presented for the company formed to effect loan securitization transactions.

Unless stated otherwise, references to the Company relate to the consolidation of National Rural, RTFC, NCSC and certain entities controlled by National Rural and created to hold foreclosed assets and effect loan securitization transactions.

(c) Allowance for Loan Losses

The Company maintains an allowance for loan losses at a level estimated by management to adequately provide for probable losses inherent in the loan portfolio, which are estimated based upon a review of the loan portfolio, past loss experience, specific problem loans, economic conditions and other pertinent factors which, in management's judgment, deserve current recognition in estimating loan losses. On a quarterly basis, the Company prepares an analysis of the adequacy of the loan loss allowance and makes adjustments to the allowance as necessary. The allowance is based on estimates and, accordingly, actual loan losses may differ from the allowance amount.

Management makes recommendations of loans to be written off to the board of directors of National Rural. In making its recommendation to write off all or a portion of a loan balance, management considers various factors including cash flow analysis and collateral securing the borrower's loans.

Activity in the loan loss allowance account is summarized below:

	For the six months ended November 30,		Year ended
(in thousands)	2007	2006	May 31, 2007
Balance at beginning of period	$ 561,663	$ 611,443	$611,443
Recovery of loan losses	(14,301)	-	(6,922)
Write-offs	(16,755)	(304)	(44,668)
Recoveries of prior write-offs	195	219	1,810
Balance at end of period	$ 530,802	$ 611,358	$561,663

(d) Interest Income

Interest income includes the following:

	For the three months ended November 30,		For the six months ended November 30,	
(in thousands)	2007	2006	2007	2006
Interest on long-term fixed rate loans (1)	$215,183	$206,054	$429,743	$411,627
Interest on long-term variable rate loans (1)	22,690	30,546	47,239	62,171
Interest on short-term loans (1)	19,244	17,877	39,592	35,930
Interest on investments (2)	1,900	1,421	4,836	3,449
Conversion fees (3)	1,735	2,442	3,509	4,954
Make-whole and prepayment fees (4)	65	382	1,754	825
Commitment and guarantee fees (5)	1,385	1,260	2,920	5,469
Other fees	1,085	262	1,648	508
Total interest income	$263,287	$260,244	$531,241	$524,933

(1) Represents interest income on loans to members.
(2) Represents interest income on the investment of cash.
(3) Conversion fees are deferred and recognized using the interest method over the remaining original loan interest rate pricing term, except for a small portion of the total fee charged to cover administrative costs related to the conversion which is recognized immediately.
(4) Make-whole and prepayment fees are charged for the early repayment of principal and recognized when collected.
(5) Commitment fees for RTFC loan commitments are, in most cases, refundable on a prorata basis according to the amount of the loan commitment that is advanced. Such refundable fees are deferred and then recognized on a prorata basis based on the portion of the loan that is not advanced prior to the expiration of the commitment. Commitment fees on National Rural loan commitments are not refundable and are billed and recognized based on the unused portion of committed lines of credit. Guarantee fees are charged based on the amount, type and term of the guarantee. Guarantee fees are deferred and amortized using the straight-line method into interest income over the life of the guarantee.

Deferred income on the consolidated balance sheets is comprised primarily of deferred conversion fees totaling $22 million and $25 million at November 30, 2007 and May 31, 2007, respectively.

(e) Interest Expense

Interest expense includes the following:

	For the three months ended November 30,		For the six months ended November 30,	
(in thousands)	2007	2006	2007	2006

Interest expense - commercial paper and bid notes (1)	$ 33,192	$ 49,068	$ 71,478	$ 96,002
Interest expense - medium-term notes (1)	83,681	93,307	166,867	188,174
Interest expense - collateral trust bonds (1)	63,405	49,488	128,755	100,560
Interest expense - subordinated deferrable debt (1)	4,916	8,153	9,831	16,783
Interest expense - subordinated certificates (1)	12,030	11,876	24,154	23,916
Interest expense - long-term private debt (1)	34,960	30,022	65,743	60,304
Debt issuance costs (2)	2,767	2,067	5,297	4,102
Commitment and guarantee fees (3)	4,605	4,000	8,675	8,014
Loss on extinguishment of debt (4)	-	-	5,509	4,806
Other fees	461	610	1,033	1,934
Total interest expense	$240,017	$248,591	$487,342	$504,595

(1) Represents interest expense and the amortization of discounts on debt.
(2) Includes amortization of all deferred charges related to debt issuance, principally underwriter's fees, legal fees, printing costs and comfort letter fees. Amortization is calculated on the effective interest method. Also includes issuance costs related to dealer commercial paper.
(3) Includes various fees related to funding activities, including fees paid to banks participating in the Company's revolving credit agreements and fees paid under bond guarantee agreements with RUS as part of the Rural Economic Development Loan and Grant ("REDLG") program. Fees are recognized as incurred or amortized on a straight-line basis over the life of the respective agreement.
(4) Represents the loss on the early retirement of debt including the write-off of unamortized discount, premium and issuance costs.

The Company does not include indirect costs, if any, related to funding activities in interest expense.

(f) Comprehensive Income

Comprehensive income includes the Company's net income, as well as other comprehensive income related to derivatives. Comprehensive income is calculated as follows:

	For the three months ended November 30,		For the six months ended November 30,	
(in thousands)	2007	2006	2007	2006
Net loss	$ (30,226)	$ (56,195)	$ (41,608)	$ (99,214)
Other comprehensive income:				
Reclassification adjustment for realized gain on derivatives	(256)	(251)	(331)	(502)
Comprehensive loss	$ (30,482)	$ (56,446)	$ (41,939)	$ (99,716)

(g) Reclassifications

Certain reclassifications of prior period amounts have been made to conform to the current reporting format.

The May 31, 2007 balance of deferred loan origination costs totaling $4 million was reclassified from other assets to loans to members on the consolidated balance sheet to conform with the November 30, 2007 presentation.

(h) New Accounting Pronouncements

On June 1, 2007, the Company adopted Statement of Financial Accounting Standard (“SFAS”) 155, Accounting for Certain Hybrid Financial Instruments – an amendment of SFAS 133 and 140. SFAS 155 permits fair value measurement of any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. SFAS 155 also clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, Accounting for Derivative Instruments and Hedging Activities, as amended. It establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS 155 also clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity’s first fiscal year that begins after September 15, 2006. The Company’s adoption of SFAS 155 did not have a material impact on the Company's financial position or results of operations.

On June 1, 2007, the Company adopted SFAS 156, Accounting for Servicing of Financial Assets. SFAS 156 requires the initial measurement of all separately recognized servicing assets and liabilities at fair value and permits, but does not require, the subsequent measurement of servicing assets and liabilities at fair value. SFAS 156 is effective as of the beginning of the first fiscal year that begins after September 15, 2006. The Company’s adoption of SFAS 156 did not have a material impact on the Company's financial position or results of operations.

On June 1, 2007, the Company adopted FIN No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of SFAS 109. FIN 48 clarifies the accounting for income taxes by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company’s adoption of FIN 48 did not have a material impact on the Company's financial position or results of operations. The Company classifies interest and penalties assessed as tax expense.

In September 2006, the FASB issued SFAS 157, Fair Value Measurements. SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. The Company's adoption of SFAS 157 as of June 1, 2008 is not expected to have a material impact on the Company's financial position or results of operations.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities. The fair value option established by SFAS 159 permits entities to choose to measure eligible financial instruments at fair value. The unrealized gains and losses on items for which the fair value option has been elected should be reported in earnings. The decision to elect the fair value option is determined on an instrument by instrument basis and is irrevocable. Assets and liabilities measured at fair value pursuant to the fair value option should be reported separately in the balance sheet from those instruments measured using other measurement attributes. SFAS 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. As part of the Company's adoption of SFAS 159 as of June 1, 2008, it does not plan to choose the option to measure eligible financial instruments at fair value and therefore the adoption of SFAS 159 is not expected to have a material impact on the Company's financial position or results of operations.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51. This statement amends ARB 51, Consolidated Financial Statements, to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain of ARB 51's consolidation procedures for consistency with the requirements of SFAS 141, Business Combinations. Noncontrolling interests shall be reclassified to equity, consolidated net income shall be adjusted to include net income attributable to noncontrolling interests and consolidated comprehensive income shall be adjusted to include comprehensive income attributable to the noncontrolling interests. This statement is effective for fiscal years beginning on or after December 15, 2008. The Company's adoption of SFAS 160 on June 1, 2009 is not expected to have a material impact on the Company's financial position or results of operations.

(i) Restatement

Subsequent to the issuance of the May 31, 2006 consolidated financial statements, the Company's management identified an error in the recording of interest expense on foreign denominated debt and the cash settlement income from foreign currency exchange agreements, as well as the related accrued interest payable and accrued interest receivable. The Company was using the agreed upon foreign exchange rate from the foreign currency exchange agreement rather than the average spot foreign currency exchange rate during the income statement period to convert the interest expense on the foreign denominated debt and foreign exchange agreement income to U.S. dollars. The Company was also using the agreed upon foreign exchange rate from the foreign currency exchange agreement rather than the spot foreign currency exchange rate at the end of the balance sheet period to convert the accrued interest payable and accrued interest receivable to U.S. dollars. The interest expense on the foreign denominated debt and the cash settlement income from the foreign currency exchange agreement are equal and offsetting amounts, as the Company uses the amount received under the exchange agreement to pay the interest expense on the foreign denominated debt. The amounts for the accrued interest payable and accrued interest receivable are also offsetting. As a result of this error, interest expense and cash settlement income were understated by $3 million and $7 million for the three and six months ended November 30, 2006, respectively. The Company subtracts the net accrual from the last settlement date on its derivatives at each period end in the calculation of the related fair value, so the error in the calculation of the income receivable on the foreign exchange agreements also impacted the fair value of the derivatives recorded as a derivative asset. Thus this correction also impacts the change in the fair value of the derivatives reported in the derivative forward value line on the consolidated statement of operations. The derivative forward value loss and net loss lines were understated by $4 million and $7 million for the three and six months ended November 30, 2006, respectively. There is no impact on cash flows from operating activities or the total change in cash in the consolidated statements of cash flows.

A summary of the significant effects of the restatement on the consolidated statements of operations for the three and six months ended November 30, 2006 is as follows:

	For the three months ended November 30, 2006		
(in thousands)	As previously reported	Adjustment	As restated
Interest expense	$ (245,261)	$ (3,330)	$(248,591)
Net interest income	14,983	(3,330)	11,653
Net interest income after provision for loan losses	14,983	(3,330)	11,653
Derivative cash settlements	13,163	3,330	16,493

Total non-interest income	16,460	3,330	19,790
Derivative forward value	(49,080)	(4,159)	(53,239)
Total non-interest expense	(84,277)	(4,159)	(88,436)
Loss prior to income taxes and minority interest	(52,834)	(4,159)	(56,993)
Loss prior to minority interest	(52,348)	(4,159)	(56,507)
Net loss	(52,036)	(4,159)	(56,195)

	For the six months ended November 30, 2006		
(in thousands)	As previously reported	Adjustment	As restated
Interest expense	$ (497,716)	$ (6,879)	$(504,595)
Net interest income	27,217	(6,879)	20,338
Net interest income after provision for loan losses	27,217	(6,879)	20,338
Derivative cash settlements	24,869	6,879	31,748
Total non-interest income	31,485	6,879	38,364
Derivative forward value	(109,534)	(7,056)	(116,590)
Total non-interest expense	(152,738)	(7,056)	(159,794)
Loss prior to income taxes and minority interest	(94,036)	(7,056)	(101,092)
Loss prior to minority interest	(92,836)	(7,056)	(99,892)
Net loss	(92,158)	(7,056)	(99,214)

(2) Loans and Commitments

Loans outstanding to members and unadvanced commitments by loan type and by segment are summarized as follows:

	November 30, 2007		May 31, 2007	
(in thousands)	Loans Outstanding	Unadvanced Commitments (1)	Loans Outstanding	Unadvanced Commitments (1)
Total by loan type (2):				
Long-term fixed rate loans	$14,806,429	$ -	$ 14,663,340	$ -
Long-term variable rate loans	1,918,327	5,646,720	1,993,534	5,703,313
Loans guaranteed by RUS	252,087	491	255,903	491
Short-term loans	1,281,060	7,462,247	1,215,430	7,200,156
Total loans outstanding	18,257,903	13,109,458	18,128,207	12,903,960
Deferred origination fees	4,020	-	3,666	-
Less: Allowance for loan losses	(530,802)	-	(561,663)	-
Net loans	$17,731,121	$13,109,458	$ 17,570,210	$12,903,960
Total by segment:				
National Rural:				
Distribution	$12,881,373	$ 9,191,590	$ 12,827,772	$ 9,176,686
Power supply	3,007,262	2,998,166	2,858,040	2,798,124
Statewide and associate	114,081	120,737	119,478	139,156
National Rural total	16,002,716	12,310,493	15,805,290	12,113,966
RTFC	1,791,504	508,336	1,860,379	473,762
NCSC	463,683	290,629	462,538	316,232
Total loans outstanding	$18,257,903	$13,109,458	$ 18,128,207	$12,903,960

	November 30, 2007		May 31, 2007	
(in thousands)	Loans Outstanding	Unadvanced Commitments (1)	Loans Outstanding	Unadvanced Commitments (1)

Non-performing and restructured loans (3):				
Non-performing loans (2):				
RTFC:				
Long-term fixed rate loans	$ 219,734	$ -	$ 212,984	$ -
Long-term variable rate loans	253,480	2,160	261,081	-
Short-term loans	29,984	-	27,799	418
Total non-performing loans	$ 503,198	$ 2,160	$ 501,864	$ 418
Restructured loans (2):				
National Rural:				
Long-term fixed rate loans	$ 52,420	$ -	$ 52,420	$ -
Long-term variable rate loans	532,476	186,673	544,697	186,673
Short-term loans	-	12,500	-	12,500