

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

- 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

- 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  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

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

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)

LIABILITIES AND EQUITY

	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	
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	\$ 419,566	
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	\$ 485,735	
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	\$ <del>407</del> ,488	\$

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)*
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
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
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
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
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
(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 Columbia in 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 Dakota in 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 Rural run 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:

(in thousands)	For the six months ended November 30,		Year ended
	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:

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