treatment resulted in Fannie Mae recognizing two years' worth of credits at year end 1998, which had the net after-tax effect of recognizing $108 million in additional income. As late as November 1998, Fannie Mae planned to change its method of accounting for the tax credit in 1999. However, the change was accelerated to 1998, which substantially offset the recorded SFAS 91 catch-up adjustment.

21. The second adjustment was made after year-end and just prior to Fannie Mae closing its books for 1998. The Company recognized in income the reversal of aged credit items totaling $3.9 million, describing them as "miscellaneous income." These items came from a suspense account that had a credit balance of over $26 million before the $3.9 million reversal. For the most part, the credit balance in this account related to net interest income. This amount existed in a suspense account from at least as early as 1994, yet there was no reversal of the credit balances in this suspense account until the $3.9 million reversal for 1998.

22. Management's decisions to book an amount significantly less than the total calculated catch-up amount and to institute the two accounting adjustments in the fourth quarter of 1998 resulted in the Company not only exceeding Wall Street expectations, but also hitting the earnings per share ("EPS") target necessary to trigger maximum bonuses.

23. Under the Company's Annual Incentive Pool ("AIP") for 1998, an EPS figure of $3.13 would trigger minimum bonuses, an EPS figure of $3.18 would trigger the target bonus, and an EPS figure of $3.23 would trigger maximum bonuses.

24. Without these improper accounting adjustments, Fannie Mae's management could have received substantially smaller bonuses (based on either a pool of

## SFAS 91 Accounting Policy

27. Prior to 2000, the Company had an unwritten policy of only booking SFAS 91 catch-up when it exceeded a "threshold" of +/- $100 million of net interest income ("NII") for the year. Following Fannie Mae's failure to record the full amount of calculated catch-up at year-end 1998, the Company developed a written SFAS 91 policy (the "Policy"). The concept of a threshold remained in the written Policy, and the threshold was calculated as a percentage of either NII or Guaranty Fees ("G-fees") under the rubric of accounting for estimation error. The Policy, which violated GAAP in several respects, allowed the Company to continue to decrease the likelihood of large SFAS 91 adjustments.

28. The Policy used a "precision threshold" to determine the amount of catch-up Fannie Mae would record at the end of the year. This precision threshold was an amount equal to +/- 1% of NII or +/- 2% of G-fees for the period. Under this Policy, Fannie Mae was able to reduce the amount of catch-up recorded in any given period, as no adjustment would be recorded if the catch-up calculation fell within the threshold, and the Company would only record catch-up that exceeded the precision threshold.

29. There is no support for the use of a threshold in SFAS 91 or in the Financial Accounting Standards Board ("FASB") implementation guide for SFAS 91 developed to assist companies in complying with the standard. SFAS 91 specifically requires that an adjustment be made when there is a difference between actual and expected prepayments, or a change in expected prepayments, of the loans resulting in a difference from the previous amortization calculation. Under SFAS 91, the amount of catch-up is to be determined based on the company's best estimate of the calculated

on its debt costs. It quickly became apparent to the Company's management that SFAS 133 could cause an undesirable amount of earnings volatility. Minimizing, or to the extent possible eliminating, this earnings volatility became a focus of members of senior management.

37. Because financial instruments react differently to interest rate movements, it is often difficult to perfectly hedge a debt issuance with an offsetting derivative. To the extent instruments do not perfectly offset each other, SFAS 133 generally requires companies to measure and record this "ineffectiveness" in their income statements.[5] This process is commonly referred to as the "long-haul" method. Thus, consistent with the standard, earnings volatility associated with the use of derivatives is minimized to the extent hedge relationships are "effective." Significantly, SFAS 133 allows for special exceptions, known colloquially as the "short-cut" and "matched terms" methods (or the "perfect effectiveness" method) of hedge accounting. These narrow exceptions allow qualifying companies to avoid the burdensome requirement of measuring and recording hedge ineffectiveness, and to avoid income statement volatility that can otherwise result from SFAS 133.

38. Given the size of its portfolio, Fannie Mae did not have the systems or personnel necessary to perform long-haul accounting. Moreover, the long-haul method would result in the income statement volatility that senior management wanted to avoid.

39. The Company disregarded the requirements of SFAS 133 and qualified transactions for the "short-cut" method based on erroneous interpretations and an unjustified reliance on materiality. By failing to comply with the requirements of SFAS

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[5] Ineffectiveness is essentially the differential between the change in value of the derivative and the change in value of the hedged item.

(e) Grant such other and further relief as this Court deems necessary and appropriate under the circumstances.

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Respectfully submitted,

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