
NON-GAAP FINANCIAL MEASURES

In addition to financial measures determined in accordance with GAAP, management evaluates performance based on certain non-GAAP measures, which we refer to as “adjusted” measures. Below we provide a discussion of each of these non-GAAP measures and provide a reconciliation of our adjusted measures to the most comparable GAAP measures in this section. We believe our non-GAAP adjusted metrics, which are not a substitute for GAAP and may not be consistent with similarly titled non-GAAP measures used by other companies, provide meaningful information and are useful to investors because management uses these metrics to compare operating results across financial reporting periods, for internal budgeting and forecasting purposes, for compensation decisions and for short- and long-term strategic planning decisions. In addition, certain of the financial covenants in our committed bank revolving line of credit agreements and debt indentures are based on our adjusted measures.

Statements of Operations Non-GAAP Adjustments

Our primary performance measure is TIER. TIER is calculated by adding the interest expense to net income prior to the cumulative effect of change in accounting principle and dividing that total by the interest expense. TIER is a measure of our ability to cover interest expense requirements on our debt. We adjust the TIER calculation to add the derivative cash settlements to the interest expense and to remove the derivative forward value gains (losses) and foreign currency adjustments from total net income. Adding cash settlements back to interest expense also has a corresponding effect on our adjusted net interest income.

We use derivatives to manage interest rate risk on our funding of the loan portfolio. The derivative cash settlements represent the amount that we receive from or pay to our counterparties based on the interest rate indexes in our derivatives that do not qualify for hedge accounting. We adjust the reported interest expense to include the derivative cash settlements. We use the adjusted cost of funding to set interest rates on loans to our members and believe that the interest expense adjusted to include derivative cash settlements represents our total cost of funding for the period. TIER calculated by adding the derivative cash settlements to the interest expense reflects management’s perspective on our operations and, therefore, we believe that it represents a useful financial measure for investors.

The derivative forward value gains (losses) and foreign currency adjustments do not represent our cash inflows or outflows during the current period and, therefore, do not affect our current ability to cover our debt service obligations. The derivative forward value gains (losses) included in the derivative gains (losses) line of the statement of operations represents a present value estimate of the future cash inflows or outflows that will be recognized as net cash settlements for all periods through the maturity of our derivatives that do not qualify for hedge accounting. We have not issued foreign-denominated debt since 2007, and as of May 31, 2018 and 2017, there were no foreign currency derivative instruments outstanding.

For operational management and decision-making purposes, we subtract derivative forward value gains (losses) and foreign currency adjustments from our net income when calculating TIER and for other net income presentation purposes. In addition, since the derivative forward value gains (losses) and foreign currency adjustments do not represent current period cash flows, we do not allocate such funds to our members and, therefore, exclude the derivative forward value gains (losses) and foreign currency adjustments from net income in calculating the amount of net income to be allocated to our members. TIER calculated by excluding the derivative forward value gains (losses) and foreign currency adjustments from net income reflects management’s perspective on our operations and, therefore, we believe that it represents a useful financial measure for investors.

Total equity includes the noncash impact of derivative forward value gains (losses) and foreign currency adjustments recorded in net income. It also includes as a component of accumulated other comprehensive income the impact of changes in the fair value of derivatives designated as cash flow hedges as well as the remaining transition adjustment recorded when we adopted the accounting guidance that required all derivatives be recorded on the balance sheet at fair value. In evaluating our debt-to-equity ratio discussed further below, we make adjustments to equity similar to the adjustments made in calculating TIER. We exclude from total equity the cumulative impact of changes in derivative forward value gains (losses) and foreign currency adjustments and amounts included in accumulated other comprehensive income related to derivatives designated for cash flow hedge accounting and the remaining derivative transition adjustment to derive non-GAAP adjusted equity.

Table 40 provides a reconciliation of adjusted interest expense, adjusted net interest income and adjusted net income to the comparable GAAP measures. The adjusted amounts are used in the calculation of our adjusted net interest yield and adjusted TIER for fiscal years 2018, 2017, 2016, 2015 and 2014.

Table 40: Adjusted Financial Measures — Income Statement

(Dollars in thousands)	Year Ended May 31,				
	2018	2017	2016	2015	2014
Interest expense.....	\$ (792,735)	\$ (741,738)	\$ (681,850)	\$ (635,684)	\$ (654,655)
Include: Derivative cash settlements	(74,281)	(84,478)	(88,758)	(82,906)	(73,962)
Adjusted interest expense	<u>\$ (867,016)</u>	<u>\$ (826,216)</u>	<u>\$ (770,608)</u>	<u>\$ (718,590)</u>	<u>\$ (728,617)</u>
Net interest income	\$ 284,622	\$ 294,896	\$ 330,786	\$ 317,292	\$ 302,885
Include: Derivative cash settlements	(74,281)	(84,478)	(88,758)	(82,906)	(73,962)
Adjusted net interest income.....	<u>\$ 210,341</u>	<u>\$ 210,418</u>	<u>\$ 242,028</u>	<u>\$ 234,386</u>	<u>\$ 228,923</u>
Net income (loss)	\$ 457,364	\$ 312,099	\$ (51,516)	\$ (18,927)	\$ 192,926
Exclude: Derivative forward value gains (losses) ...	306,002	179,381	(221,083)	(114,093)	39,541
Adjusted net income	<u>\$ 151,362</u>	<u>\$ 132,718</u>	<u>\$ 169,567</u>	<u>\$ 95,166</u>	<u>\$ 153,385</u>

We consider the cost of derivatives to be an inherent cost of funding and hedging our loan portfolio and, therefore, economically similar to the interest expense that we recognize on debt issued for funding. We therefore include derivative cash settlements in our adjusted interest expense and exclude the unrealized forward value of derivatives from our adjusted net income.

TIER and Adjusted TIER

Table 41 presents our TIER and adjusted TIER for the years ended May 2018, 2017, 2016, 2015 and 2014.

Table 41: TIER and Adjusted TIER

	Year Ended May 31,				
	2018	2017	2016	2015	2014
TIER ⁽¹⁾	<u>1.58</u>	<u>1.42</u>	<u>0.92</u>	<u>0.97</u>	<u>1.29</u>
Adjusted TIER ⁽²⁾	<u>1.17</u>	<u>1.16</u>	<u>1.22</u>	<u>1.13</u>	<u>1.21</u>

⁽¹⁾ TIER is calculated based on net income plus interest expense for the period divided by interest expense for the period.

⁽²⁾ Adjusted TIER is calculated based on adjusted net income plus adjusted interest expense for the period divided by adjusted interest expense for the period.

Debt-to-Equity and Adjusted Debt-to-Equity

Management relies on the adjusted debt-to-equity ratio as a key measure in managing our business. We therefore believe that this adjusted measure, in combination with the comparable GAAP measure, is useful to investors in evaluating performance. We adjust the comparable GAAP measure to:

- exclude debt used to fund loans that are guaranteed by RUS from total liabilities;
- exclude from total liabilities, and add to total equity, debt with equity characteristics issued to our members and in the capital markets; and
- exclude the noncash impact of derivative financial instruments and foreign currency adjustments from total liabilities and total equity.

We are an eligible lender under a RUS loan guarantee program. Loans issued under this program carry the U.S. government's guarantee of all interest and principal payments. We have little or no risk associated with the collection of principal and interest payments on these loans. Therefore, we believe there is little or no risk related to the repayment of the liabilities used to fund RUS-guaranteed loans and we subtract such liabilities from total liabilities to calculate our adjusted debt-to-equity ratio.

Members may be required to purchase subordinated certificates as a condition of membership and as a condition to obtaining a loan or guarantee. The subordinated certificates are accounted for as debt under GAAP. The subordinated certificates have long-dated maturities and pay no interest or pay interest that is below market, and under certain conditions we are prohibited from making interest payments to members on the subordinated certificates. For computing our adjusted debt-to-equity ratio we subtract members' subordinated certificates from total liabilities and add members' subordinated certificates to total equity.

We also sell subordinated deferrable debt in the capital markets with maturities of up to 30 years and the option to defer interest payments. The characteristics of subordination, deferrable interest and long-dated maturity are all equity characteristics. For computing our adjusted debt-to-equity ratio we subtract subordinated deferrable debt from total liabilities and add it to total equity.

We record derivative instruments at fair value on our consolidated balance sheets. For computing our adjusted debt-to-equity ratio we exclude the noncash impact of our derivative accounting from liabilities and equity. Also, for computing our adjusted debt-to-equity ratio we exclude the impact of foreign currency valuation adjustments from liabilities and equity. The debt-to-equity ratio adjusted to exclude the effect of foreign currency translation reflect management's perspective on our operations and, therefore, we believe is a useful financial measure for investors.

Table 42 provides a reconciliation between the liabilities and equity used to calculate the debt-to-equity ratio and the adjusted debt-to-equity ratio as of May 31, 2018, 2017, 2016, 2015 and 2014. As indicated in the table below, subordinated debt is treated in the same manner as equity in calculating our adjusted-debt-to-equity ratio.

Table 42: Adjusted Financial Measures — Balance Sheet

(Dollars in thousands)	May 31,				
	2018	2017	2016	2015	2014
Total liabilities	\$ 25,184,351	\$ 24,106,887	\$23,452,822	\$21,934,273	\$21,220,311
Exclude:					
Derivative liabilities	275,932	385,337	594,820	408,382	388,208
Debt used to fund loans guaranteed by RUS	160,865	167,395	173,514	179,241	201,863
Subordinated deferrable debt	742,410	742,274	742,212	395,699	395,627
Subordinated certificates	1,379,982	1,419,025	1,443,810	1,505,420	1,612,191
Adjusted total liabilities	<u>\$ 22,625,162</u>	<u>\$ 21,392,856</u>	<u>\$ 20,498,466</u>	<u>\$ 19,445,531</u>	<u>\$ 18,622,422</u>
Total equity	\$ 1,505,853	\$ 1,098,805	\$ 817,378	\$ 911,786	\$ 970,374
Exclude:					
Prior-year cumulative derivative forward value losses	(340,976)	(520,357)	(299,274)	(185,181)	(224,722)
Current-year cumulative derivative forward value (gains) losses	306,002	179,381	(221,083)	(114,093)	39,541
Accumulated other comprehensive income ⁽¹⁾	1,980	3,702	4,487	5,371	6,320
Include:					
Subordinated certificates	1,379,982	1,419,025	1,443,810	1,505,420	1,612,191
Subordinated deferrable debt	742,410	742,274	742,212	395,699	395,627
Adjusted total equity	<u>\$ 3,661,239</u>	<u>\$ 3,597,378</u>	<u>\$ 3,519,270</u>	<u>\$ 3,106,808</u>	<u>\$ 3,157,053</u>

⁽¹⁾ Represents AOCI related to derivatives. See "Note 10—Equity" for a breakout of our AOCI components.

Table 43 displays the calculations of our debt-to-equity and adjusted debt-to-equity ratios as of the years ended May 31, 2018, 2017, 2016, 2015 and 2014.

Table 43: Debt-to-Equity Ratio

	May 31,				
	2018	2017	2016	2015	2014
Debt-to-equity ratio ⁽¹⁾	16.72	21.94	28.69	24.06	21.87
Adjusted debt-to-equity ratio ⁽²⁾	6.18	5.95	5.82	6.26	5.90

⁽¹⁾ Calculated based on total liabilities as of the end of the period divided by total equity as of the end of the period.

⁽²⁾ Calculated based on adjusted total liabilities at period end divided by adjusted total equity at period end.

Members' Equity

Total CFC equity includes the noncash impact of derivative forward value gains (losses) and foreign currency adjustments recorded in net income. It also includes amounts recorded in accumulated other comprehensive income. We provide the components of accumulated other comprehensive income in "Note 10—Equity." Because these amounts generally have not been realized, they are not available to members and are excluded by CFC's Board of Directors in determining the annual allocation of adjusted net income to patronage capital, members' capital reserve and other member funds. We therefore exclude from total CFC equity the cumulative impact of changes in derivative forward value gains (losses) and foreign currency adjustments and accumulated other comprehensive income because these amounts have not been realized to reflect what management considers to be equity available to members.

Table 44 provides a reconciliation of members' equity to total CFC equity as of May 31, 2018 and 2017.

Table 44: Members' Equity

(Dollars in thousands)	May 31,	
	2018	2017
Members' equity:		
Total CFC equity	\$ 1,474,333	\$ 1,069,953
Excludes:		
Accumulated other comprehensive income.....	8,544	13,175
Current year-end cumulative derivative forward value losses....	(30,831)	(332,525)
Subtotal.....	(22,287)	(319,350)
Members' equity	\$ 1,496,620	\$ 1,389,303