FEDERAL FINANCING BANK

Financial Statements

September 30, 2004 and 2003

(With Independent Auditors' Report Thereon)

FEDERAL FINANCING BANK

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KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Financial Statements

Inspector General, U.S. Department of the Treasury and the
Fiscal Assistant Secretary of the U.S. Department of the Treasury:

We have audited the accompanying statements of financial position of the Federal Financing Bank (the Bank) as of September 30, 2004 and 2003, and the related statements of operations and changes in net position and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and applicable provisions of Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Federal Financing Bank, as of September 30, 2004 and 2003, and the results of its operations, changes in net position, and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 8 to the financial statements, the Bank restated its fiscal year 2003 financial statements.

In accordance with *Government Auditing Standards*, we have also issued reports dated June 10, 2005, on our consideration of the Bank's internal control over financial reporting and its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on its compliance with laws, regulations, contracts, and other matters. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. The other supplementary information included in Schedule 1 is presented for purposes of additional analyses and is not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements and, accordingly, we express no opinion on it.

KPMG LLP

June 10, 2005

FEDERAL FINANCING BANK

Statements of Financial Position

September 30, 2004 and 2003

(Dollars in thousands)

Assets		**2004**	**As restated 2003**
Funds with U.S. Treasury	$	449,871	470,453
Loans receivable (notes 2 and 4)		29,325,904	35,630,046
Advances to others		32	63
Accrued interest receivable		249,309	394,005
Total assets	$	30,025,116	36,494,567
Liabilities and Net Position			
Liabilities:			
Borrowings (notes 3 and 4)	$	29,323,406	36,682,356
Accrued interest payable		88,720	85,264
Other liabilities		4	231
Total liabilities		29,412,130	36,767,851
Net position (notes 5 and 8)		612,986	(273,284)
Total liabilities and net position	$	30,025,116	36,494,567

See accompanying notes to financial statements.

FEDERAL FINANCING BANK

Statements of Operations and Changes in Net Position

Years ended September 30, 2004 and 2003

(Dollars in thousands)

		2004	As restated 2003
Revenue and financing sources:			
Interest on loans	$	2,187,586	3,042,262
Revenue from servicing loans		3,645	3,770
Total revenue		2,191,231	3,046,032
Expenses:			
Interest on borrowings		1,151,688	2,534,524
Legislatively-mandated expense (note 8)		150,134	71,810
Administrative expenses		3,139	4,251
Total expenses		1,304,961	2,610,585
Net income (note 8)		886,270	435,447
Net position:			
Beginning of year (note 8)		(273,284)	(75,336)
Net income (note 8)		886,270	435,447
Loss on extinguishment of borrowings treated as capital transaction (notes 6 and 8)		—	(633,395)
End of year (notes 5 and 8)	$	612,986	(273,284)

See accompanying notes to financial statements.

FEDERAL FINANCING BANK

Statements of Cash Flows

Years ended September 30, 2004 and 2003

(Dollars in thousands)

		2004	As restated 2003
Cash flows from operations:			
Net income (note 8)	$	886,270	435,447
Adjustments to reconcile net income to net cash provided by (used in) operations:			
Decrease in accrued interest receivable		144,696	134,668
Increase (decrease) in accrued interest payable		3,456	(772,382)
Decrease (increase) in advances to others		31	(34)
Increase (decrease) in other liabilities		(227)	231
Net cash provided by (used in) operations		1,034,226	(202,070)
Cash flows from investing activities:			
Loan disbursements		(46,704,799)	(29,348,780)
Loan collections		53,008,941	33,426,364
Net cash provided by investing activities		6,304,142	4,077,584
Cash flows from financing activities:			
Borrowings		47,577,451	60,437,068
Repayments of borrowings (note 8)		(54,936,401)	(63,858,469)
Loss on extinguishment of borrowings treated as capital transaction (notes 6 and 8)		—	(321,712)
Net cash used in financing activities		(7,358,950)	(3,743,113)
Net (decrease) increase in cash		(20,582)	132,401
Funds with U.S. Treasury – beginning of the period		470,453	338,052
Funds with U.S. Treasury – end of the period	$	449,871	470,453
Supplemental disclosures of cash flow information:			
Interest paid (net of amount capitalized)	$	1,153,185	3,380,857
Supplemental schedule of noncash investing and financing activities:			
Decrease in loans for capitalized interest receivable	$	15,926	17,839
Increase (decrease) in borrowings for capitalized interest payable		7,272	(73,951)
Loss on extinguishment of borrowings treated as capital transaction (notes 6 and 8)		—	(311,683)

See accompanying notes to financial statements.

(1) Summary of Significant Accounting Policies

The Federal Financing Bank (the Bank) was created by the Federal Financing Bank Act of 1973 (12 USC 2281, the Act) as an instrumentality of the U. S. Government and a body corporate under the general supervision of the Secretary of the Treasury. The budget and audit provisions of the Government Corporation Control Act are applicable to the Bank in the same manner as they are applied to other wholly owned government corporations.

The Bank was established by Congress at the request of the U.S. Department of the Treasury (Treasury), in order "to assure coordination of federal and federally assisted borrowing programs with the overall economic and fiscal policies of the U. S. Government, to reduce the cost of federal and federally assisted borrowing from the public, and to assure that such borrowings are financed in a manner least disruptive of private financial markets and institutions." The Bank was given broad statutory authority to finance obligations issued, sold, or guaranteed by federal agencies so that the Bank could meet these debt management objectives.

The Bank is authorized, with the approval of the Secretary of the Treasury, to issue obligations to the public in amounts not to exceed $15,000,000. Additionally, the Bank is authorized to issue obligations in unlimited amounts to the Secretary of the Treasury and, at the discretion of the Secretary, may agree to purchase any such obligations.

(a) Basis of Presentation

The Bank has historically prepared its financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP), based on standards issued by the Financial Accounting Standards Board (FASB), the private-sector standards-setting body. In October 1999, the American Institute of Certified Public Accountants (AICPA) designated the Federal Accounting Standards Advisory Board (FASAB) as the standards-setting body for the financial statements of federal government entities, with respect to the establishment of accounting principles generally accepted in the United States of America. FASAB has indicated that financial statements prepared based upon standards promulgated by the FASB may also be regarded as in accordance with GAAP for those federal entities, such as the Bank, that have issued financial statements based upon FASB standards in the past. Accordingly, consistent with historical reporting, the Bank's financial statements are presented in accordance with accounting and financial reporting standards promulgated by the FASB.

(b) Basis of Accounting

The financial statements are presented on the accrual basis of accounting. The Bank recognizes loans when they are issued and related repayments when they are received. The Bank recognizes borrowings when they are received and repayments when they are made. In addition, the Bank recognizes interest on loans and revenue from servicing loans when they are earned and recognizes interest on borrowings and expenses when they are incurred.

(c) Funds with U.S. Treasury

As a government corporation, the Bank maintains a Fund Balance with Treasury (fund account 20X4521) and does not hold cash. For the purposes of the statement of cash flows, the funds with Treasury are considered cash.

(d) Loans Receivable

The Bank issues loans to federal agencies for their own use or to issue loans to private sector borrowers, whose loans are guaranteed by the federal agencies. When a federal agency has to honor its guarantee because a private sector borrower defaults, the federal agency must obtain an appropriation or use other resources to pay the Bank. Loan principal and interest are backed by the full faith and credit of the U.S. Government, except for loans to the U.S. Postal Service. The Bank has not incurred and does not expect to incur any credit-related losses on its loans.

(e) Interest on Loans

The Bank’s general policy is to capture the liquidity premium between Treasury Securities and the private sector lending rates, and to charge a rate that reflects the risk inherent in a borrower or transaction, when such a rate will accomplish a broader goal. The income resulting from the interest spread covers the administrative expenses of the Bank and any surplus is transferred to the Treasury’s General Fund. Under amendments to the Federal Credit Reform Act, effective October 1, 1998, while the Bank is permitted to charge a spread on new lending arrangements with government-guaranteed borrowers, the margin is not retained by the Bank, but rather is maintained by the loan guarantor. In the event that this results in the Bank being unable to fund its administrative expenses related to these loans, the Federal Credit Reform Act, as amended, states that the Bank may require reimbursements from loan guarantors.

(f) Capitalized Interest

In accordance with loan agreements with the Bank, the General Services Administration (GSA) and Historically Black Colleges and Universities (HBCU) have the option of deferring payments of interest on their loans until future periods. When GSA or HBCU elect, in advance, to defer interest payments, the accrued interest is recorded as capitalized interest receivable and added to their respective loan balance by the Bank. The Bank correspondingly capitalizes the interest payable on its related borrowings.

(g) Revenue from Servicing Loans

The Bank charges certain Rural Utilities Services (RUS) borrowers a loan service fee that is reported as revenue from servicing loans on the statements of operations and changes in net position. The Bank’s loan servicing fee is equal to one-eighth of one percent more than the contractual interest rate with Treasury.

(h) Legislatively Mandated Expense

In prior years, the Bank issued certificates of beneficial ownership (i.e., loans reported as loans receivable on the statement of financial position) to the Rural Utilities Service (RUS), a component of the U.S. Department of Agriculture. RUS used the funds received from the Bank to issue loans to non-federal entities, specifically private utility companies. In 1987, Congress passed legislation (i.e., 7 USC Sec. 940c - Cushion of Credit Payments Program) that required RUS to develop and promote a program to encourage private utility companies to voluntarily make deposits into cushion of credit accounts established within RUS. The legislation also indicated that private utility companies may reduce the balance of its cushion of credit account only if the reduction is used to make scheduled payments on loans received from RUS. In accordance with the legislation, the private utility companies accrue interest at the higher of 5% or the weighted average rate of the certificates of beneficial ownership on cash deposited into the cushion of credit accounts with RUS. The legislation also indicated that RUS shall receive an interest credit from the Bank equal to the amount of interest RUS pays to the private utility companies. The Bank records the interest credit in the period the cost is incurred as a legislatively-mandated expense in the statement of operations and changes in net position.

(i) Administrative Expenses

The Bank is subject to the general supervision and direction of the Secretary of the Treasury. As provided by law, the Secretary of the Treasury acts as Chairman of the board of directors. Employees of Treasury's Departmental Offices perform the Bank's management and accounting functions; its legal counsel is the General Counsel of the Treasury. The Bank reimburses Treasury for the facilities and services it provides. The amount of such reimbursements for the years ended September 30, 2004 and 2003, was $3,139 and $4,251 respectively, and is included as administrative expenses in the statement of operations and changes in net position.

(j) Net Position

The Bank can borrow from Treasury to meet its immediate cash needs and can also seek appropriations from Congress to make up for accumulated losses that will not be met by income.

(k) Management's Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

(l) Tax-Exempt Status

The Bank is exempt from tax in accordance with Section 11(a) of the Federal Financing Bank Act of 1973 (12 USC 2281).

(Dollars in thousands)

(m) Related Parties

The Bank conducts most of its financial transactions with other federal entities and therefore the financial statement balances that represent transactions with other federal entities include all assets, liabilities—except borrowings from the public of $10,000 as of September 30, 2004 and 2003, revenues, and expenses.

(2) Loans Receivable

Loans receivable represent the outstanding balances for loans to agencies. The Bank has the ability and intends to hold loans receivable until maturity or payoff. At September 30, 2004, the Bank had outstanding loans receivable of $29,325,904 with interest rates ranging from 1.055% to 16.183%, and maturity dates from October 1, 2004 to January 3, 2039. At September 30, 2003, the Bank had loans receivable of $35,630,046 with interest rates ranging from 0.942% to 16.183%, and maturing dates ranging from October 1, 2003 to December 31, 2037.

Loans receivable at September 30, 2004 and 2003, consist of the following:

Agency	2004	2003
Rural Utilities Service, Department of Agriculture	$ 16,961,008	15,618,233
Rural Utilities Service, Department of Agriculture (CBO) certificates of beneficial ownership	4,270,207	4,270,207
General Services Administration	2,209,390	2,230,528
U.S. Postal Service	1,800,000	7,273,437
Foreign Military Sales, Department of Defense	1,464,945	1,688,440
Low Rent Public Housing, Department of Housing and Urban Development	1,054,777	1,133,232
Farmers Home Administration, Department of Agriculture	880,000	2,635,000
Ship Leasing, Department of Defense, Navy	498,583	607,494
Historically Black Colleges and Universities, Department of Education	119,485	81,340
Small Business Administration	56,575	77,313
Virgin Islands, Department of the Interior	7,641	9,605
Federal Railroad Administration, Department of Transportation	2,887	3,069
Community Development Block Grants, Department of Housing and Urban Development	406	2,148
Total loans receivable	$ 29,325,904	35,630,046

The loans receivable due within one year is $3,358,562 and $8,479,290 as of September 30, 2004 and 2003, respectively.

(Continued)

(Dollars in thousands)

(3) Borrowings

Under the FFB Act the Bank may, with the approval of the Secretary of the Treasury, borrow without limit from the Treasury. Repayments on Treasury borrowings match the terms and conditions of corresponding loans made by the Bank and bear interest at the respective rate as determined by the Secretary of the Treasury. The Bank's borrowings are repayable on demand. At September 30, 2004, the Bank had Treasury borrowings of $29,323,396 with interest rates ranging from 1.055% to 16.050%, and maturity dates from October 1, 2004, to January 3, 2039. At September 30, 2003, the Bank had Treasury borrowings of $36,682,346, with interest rates ranging from 0.875% to 16.050%, and maturity dates from October 1, 2003 to December 31, 2037.

Borrowings from the public amounted to $10 at September 30, 2004 and 2003.

The scheduled principal repayments below reflect maturities of the Bank's borrowings and do not necessarily match the maturities of assets in the Bank's loan portfolio. Scheduled principal repayments of borrowings as of September 30, 2004, are as follows:

2005	$	3,358,437
2006		899,820
2007		268,731
2008		1,551,186
2009		815,027
2010 and thereafter		22,430,205
Total	$	29,323,406

(4) Fair Value of Financial Instruments

(a) Funds with U.S. Treasury

The carrying amount approximates fair value because of the liquid nature of the funds with Treasury.

(b) Loans Receivable and Borrowings

The fair value of loans receivable and borrowings is calculated using discounted cash flow analyses based on contractual repayment terms. The discount rates used in the loans receivable analysis are based on interest rates currently being offered by the Bank on loans of similar maturity and other characteristics. The discount rates used in the borrowings analysis are based on interest rates of current borrowings from Treasury using similar maturity and other characteristics. The fair value of loans receivable at September 30, 2004 and 2003, was $34,355,330 and $41,706,900, respectively. The fair value of borrowings at September 30, 2004 and 2003, was $30,152,100 and $36,433,750, respectively.

(Continued)

(Dollars in thousands)

(c) Advances to Others, Accrued Interest Receivable, Accrued Interest Payable, and Other Liabilities

The carrying amount of advances to others, accrued interest receivable, accrued interest payable, and other liabilities approximate fair value as they represent the amounts expected to be realized or paid and are current assets and liabilities.

(5) Net Position

At September 30, 2004 and 2003, the net position includes the following:

		2004	As restated 2003
Transfers to Treasury	$	(1,682,847)	(1,682,847)
Cumulative results of operations and gains/losses on extinguishment of borrowings treated as capital transactions		2,295,833	1,409,563
Net position	$	612,986	(273,284)

Included in the net position activity is income the Bank earned prior to fiscal year 2000 that the Bank transferred to Treasury.

(6) Loss on Extinguishment of Borrowings Treated as Capital Transaction

In fiscal year 2003, the Bank incurred losses on extinguishment of borrowings that were treated as capital transactions. The following summarizes these transactions:

1. October 18, 2002 Borrowings and Extinguishment

   On October 18, 2002, the Bank borrowed $15,065,949 from the Department of the Treasury (Treasury) with interest rates ranging from 1.669% to 5.141% and maturity dates ranging from January 2, 2003 through December 31, 2026. The Bank borrowed these funds to exercise its call option for $14,999,990 of debt and interest payable amounting to $65,959 to the Civil Service Retirement and Disability Trust Fund (CSR&DF), administered by the Office of Personnel Management, with interest rates ranging from 8.75% to 9.25% and maturity dates ranging from June 30, 2003 to June 30, 2005. The call option was exercised at par and without penalty.

2. March 5, 2003 Borrowings and Extinguishment

   The Bank issued 9(a) Debt Obligations of $14,999,990 with related premium and interest of $1,014,800 to the CSR&DF with an interest rate of 5.25% and maturity dates ranging from October 1, 2003 through December 31, 2035. In exchange, the Bank received $15,045,358 of investments at par value issued by the Treasury "Specified Treasury Specials" with a coupon rate of 5.25% and maturity dates ranging from June 30, 2004 through June 30, 2011, and related purchased premium and interest amounting to $969,432.

The Bank used the investments "Specified Treasury Specials" received from CSR&DF of $15,045,358 along with the related premium and interest of $969,432 to extinguish $15,411,791 of borrowings from Treasury at an interest rate of 5.25% and maturity dates ranging from October 1, 2003 through December 31, 2035, and related capitalized interest of $60,768, and interest payable of $230,546. The Bank realized a net loss on these transactions amounting to $311,683, which represents a capital transaction with Treasury.

3. June 30, 2003 Borrowings and Extinguishment

On June 30, 2003, the Bank borrowed $16,573,941 from the Department of the Treasury with interest rates ranging from 0.872% to 4.480% and maturity dates ranging from October 1, 2003 to December 31, 2035, to exercise its call option and repurchase 9(a) Obligations from the CSR&DF with a par value of $14,999,990 and related premium, capitalized interest, and interest payable of $1,252,239. The Bank realized a net loss on this transaction amounting to $321,712, which represents a capital transaction with CSR&DF.

(7) Capitalized Interest

Capitalized interest receivable was approximately $69,524 and $85,450, and the related capitalized interest payable was $18,163 and $25,435 as of September 30, 2004 and 2003, respectively. Capitalized interest receivable and payable are reported as part of the loans receivable and borrowing balances, respectively, on the statement of financial position.

(8) Restatement

(a) The Bank restated net income for the year ended September 30, 2003 to correct for $633,395 in losses on the extinguishment of borrowings with Treasury that should be presented as capital transactions because the transactions are with related parties (i.e., entities under common control). Accordingly, the Bank reclassified $633,395 in losses from the expense to the net position section of the Statement of Operations and Changes in Net Position for the fiscal year ended September 30, 2003. In addition, this resulted in a reclassification of $633,395 from the operations section to the financing activities ($321,712) and non-cash financing ($311,683) sections of the fiscal year 2003 statement of cash flows. The Bank's net position did not change as a result of the restatement.

(b) The Bank restated the fiscal year 2003 financial statements to eliminate an allowance for loan losses that was established for interest credits to be paid in future years to RUS in accordance with legislation (i.e., 7 USC Sec. 940c - Cushion of Credit Payments Program) and instead to record interest credits as a legislatively-mandated expense in the period incurred. Accordingly, the Bank eliminated the allowance for loan losses of $477,584 as of October 1, 2002, eliminated the related bad debt expense of $177,560, and reported a legislatively-mandated expense of $71,810 on the Statement of Operations and Changes in Net Position for the fiscal year ended September 30, 2003. This resulted in an increase in net income of $105,750. In addition, the Bank reclassified $105,750 from the increase in allowance for losses line to the net (loss) income line within the operations section of the fiscal year 2003 statement of cash flows.

(Dollars in thousands)

The adjustments and related impact on the Fiscal Year 2003 Statement of Financial Position are as follows:

Description		Amounts as previously reported	Restatement adjustments (a)	Restatement adjustments (b)	As restated
Assets:					
Allowance for losses	$	(583,334)	—	583,334	—
Total assets		35,911,233	—	583,334	36,494,567
Liabilities and net position:					
Net position		(856,618)	—	583,334	(273,284)

The adjustments and related impact on the Fiscal Year 2003 Statement of Operations and Changes in Net Position are as follows:

Description		Amounts as previously reported	Restatement adjustments (a)	Restatement adjustments (b)	As restated
Expenses:					
Bad debt expense	$	177,560	—	(177,560)	—
Legislatively-mandated expense		—	—	71,810	71,810
Loss on extinguishment of borrowings, net		633,395	(633,395)	—	—
Total expenses		3,349,730	(633,395)	(105,750)	2,610,585
Net (loss) income		(303,698)	633,395	105,750	435,447
Net position:					
Net position, beginning of the year		(552,920)	—	477,584	(75,336)
Loss on extinguishment of borrowings treated as capital transaction		—	(633,395)	—	(633,395)
Net (loss)/income		(303,698)	633,395	105,750	435,447
Net position, end of the year		(856,618)	—	583,334	(273,284)

(Continued)

(Dollars in thousands)

The adjustments and related impact on the Fiscal Year 2003 Statement of Cash Flows are as follows:

Description		Amounts as previously reported	Restatement adjustments (a)	Restatement adjustments (b)	As restated
Cash flows from operations:					
Net (loss) income	$	(303,698)	633,395	105,750	435,447
Increase in allowance for losses		105,750	—	(105,750)	—
Loss on extinguishment of borrowings, net		633,395	(633,395)	—	—
Cash flows from financing activities:					
Repayment of borrowings		(64,180,181)	321,712	—	(63,858,469)
Loss on extinguishment of borrowings treated as capital transaction		—	(321,712)	—	(321,712)
Supplemental schedule of noncash investing and financing activities:					
Loss on extinguishment of borrowings treated as capital transaction		—	(311,683)	—	(311,683)

(9) Subsequent Event

On November 15, 2004 the Bank issued a debt obligation of $14,246,221 with interest rates ranging from 4.625% to 5.625% and maturity dates ranging from June 30, 2009 to June 30, 2019; and related premium of $507,613 to CSR&DF and received in exchange $14,000,000 of investments at par value “Specified Treasury Specials” issued by Treasury with interest rates ranging from 4.625% to 5.625% and maturity dates ranging from June 30, 2009 to June 30, 2019; related purchased accrued interest receivable of $246,221; and related purchased premium of $507,613.

On November 15, 2004, the Bank used the “Specified Treasury Specials” received from the CSR&DF of $14,000,000; related premium of $507,613; and related interest receivable of $246,221 to extinguish $14,447,217 of borrowings from the Treasury, related capitalized interest of $15,064; and related interest payable of $82,473. In addition, the Bank received a note receivable from the Treasury of approximately $246,221 that is due on December 31, 2004.

These transactions resulted in the Bank owing debt to the CSR&DF instead of owing debt to the Treasury and resulted in a gain of $37,142, which represents a capital transaction with Treasury.

FEDERAL FINANCING BANK

Other Supplementary Information – Schedule 1

Unaudited – See Accompanying Independent Auditors' Report

September 30, 2004 and 2003

(Dollars in thousands)

In prior years, the Federal Financing Bank (Bank) issued certificates of beneficial ownership (i.e., loans reported as loans receivable on the statement of financial position) to the Rural Utility Service (RUS), a component of the U.S. Department of Agriculture. RUS used the funds received from the Bank to issue loans to non-federal entities, specifically private utility companies. In 1987, Congress passed legislation (i.e., 7 USC Sec. 940c - Cushion of Credit Payments Program) that required RUS to develop and promote a program to encourage private utility companies to voluntarily make deposits into cushion of credit accounts established within RUS. The legislation also indicated that private utility companies may reduce the balance of its cushion of credit account only if the reduction is used to make scheduled payments on loans received from RUS. In accordance with the legislation, the private utility companies accrue interest at a rate of 5 percent per annum on cash deposited into the cushion of credit accounts with RUS. The legislation also indicated that RUS shall receive an interest credit from the Bank equal to the amount of interest RUS pays to the private utility companies. The Bank records the interest credit in the period the cost is incurred as a legislatively mandated expense. As of September 30, 2004, the outstanding principal balance of the 19 loans totaled $4,270,207, with interest rates ranging from 7.755% to 15.325%, and maturity dates ranging from 2006 to 2021. In October 1998, the Bank received an appropriation that off-set the RUS-CBO interest credits by $917,699.

The interest credits that the Bank has provided RUS-CBO through September 30, 2004 is as follows:

		Interest credit
Fiscal year:		
1988-1999	$	951,966
2000		87,720
2001		82,365
2002		98,465
2003		71,810
2004		150,134
Total interest credits		1,442,460
Less appropriation		(917,699)
Total	$	524,761

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Independent Auditors' Report on Internal Control over Financial Reporting

Inspector General, U.S. Department of the Treasury, and the
Fiscal Assistant Secretary of the U.S. Department of the Treasury:

We have audited the statements of financial position of the Federal Financing Bank (the Bank) as of September 30, 2004 and 2003, and the related statements of operations and changes in net position and cash flows for the years then ended, and have issued our report thereon dated June 10, 2005. As discussed in Note 8 to the financial statements, the Bank restated its fiscal year 2003 financial statements. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and applicable provisions of Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our fiscal year 2004 audit, we considered the Bank's internal control over financial reporting by obtaining an understanding of the Bank's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02, as applicable to the Bank, and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on the Bank's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control over financial reporting that, in our judgment, could adversely affect the Bank's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, caused by error or fraud in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected.

In our fiscal year 2004 audit, we noted the following matters involving the internal control over financial reporting and its operation that we consider to be a material weakness.

Accounting for Non-Routine Transactions

OMB Circular No. A-123, states, "Transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports." The Bank did not did not have effective internal controls over the selection, monitoring, and application of generally accepted accounting principles related to non-routine transactions as follows:

1. On November 15, 2004, after the fiscal year ended September 30, 2004, the Bank executed a Financing Transaction with the U.S. Department of the Treasury and the Civil Service Retirement and Disability Trust Fund (Financing Transactions). During the accounting for this transaction the Bank followed certain procedures it had implemented to assess the recording and reporting of borrowing and related extinguishment transactions conducted with the U.S. Department of the Treasury and the Civil Service Retirement and Disability Trust Fund (Financing Transactions) and it was determined that the accounting principles used to record and report similar borrowing and extinguishment transactions in fiscal year 2003 were incorrect. The net income for the year ended September 30, 2003 included $633 million of losses resulting from the fiscal year 2003 borrowing and extinguishment transactions that should have been presented as capital transactions.

2. Also subsequent to September 30, 2004, it was determined that the accounting principles that the Bank used to record and report interest credits paid to the Rural Utilities Service were incorrect. In 1987, when legislation passed requiring the Bank to provide interest credits to Rural Utilities Service, the Bank concluded that it did not need to record an allowance for interest credits to be paid in future years to the Rural Utilities Service; however, in 1998 the Bank restated the 1997 financial statements to record an allowance for these interest credits. The Bank continued to report an allowance, which was $583 million as of September 30, 2003, that should not have been recorded and the Bank recorded a related expense of $178 million that should have been $72 million for the fiscal year ended 2003.

As a result, the Bank's assets and net position were understated by $583 million as of September 30, 2003 and the Bank's net income was understated by $739 million for the year ended September 30, 2003. The Bank has restated its fiscal year 2003 financial statements in conjunction with issuing the fiscal year 2004 financial statements, to correct for these misstatements.

Recommendation

We recommend that the Bank establish internal controls to select, monitor, and apply the generally accepted accounting principles to account for non-routine transactions, such as the Financing Transactions and interest credits paid to the Rural Utilities Service. This should include requiring Bank personnel to participate in periodic training on accounting standards, effectively research the accounting standards, and to review and approve the Bank's selection of accounting policies at least annually.

Management Response

Management has prepared an official response presented as a separate attachment to this report. In summary, management does not believe that the facts and circumstances related to the finding give rise to a reportable condition in internal control.

Auditors' Response to Management's Response

We understand that FFB management considered and implemented comments provided by its auditors in preparing the financial statements; however, FFB management is responsible for selecting and applying the appropriate accounting principles. Therefore, we believe that the condition identified constitutes a material weakness.

We noted certain matters that we reported to management of the Bank in a separate letter dated June 10, 2005.

This report is intended solely for the information and use of the Bank's management, the U.S. Department of the Treasury's Office of Inspector General, OMB, the U.S. Government Accountability Office, and Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

June 10, 2005

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Compliance and Other Matters

Inspector General, U.S. Department of the Treasury, and the
Fiscal Assistant Secretary of the U.S. Department of the Treasury:

We have audited the statements of financial position of the Federal Financing Bank (the Bank) as of September 30, 2004 and 2003, and the related statements of operations and changes in net position and cash flows for the years then ended, and have issued our report thereon dated June 10, 2005. As discussed in Note 8 to the financial statements, the Bank restated its fiscal year 2003 financial statements. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and applicable provisions of Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements.*

The management of the Bank is responsible for complying with laws, regulations, and contracts applicable to the Bank. As part of obtaining reasonable assurance about whether the Bank's fiscal year 2004 financial statements are free of material misstatement, we performed tests of the Bank's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts, and certain provisions of other laws and regulations, specified in OMB Bulletin No. 01-02. Our audit procedures were not designed to test the requirements of OMB Bulletin No. 01-02 relating to the *Federal Financial Management Improvement Act* (FFMIA) of 1996, which were not considered applicable at the Bank level. FFMIA requirements will be reviewed and reported at the U.S. Department of the Treasury consolidated level. We limited our tests of compliance to the provisions described in the preceding sentence and we did not test compliance with all laws, regulations, and contracts applicable to the Bank. However, providing an opinion on compliance with laws, regulations, and contracts was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph disclosed no instance of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

This report is intended solely for the information and use of the Bank's management, the U.S. Department of the Treasury's Office of Inspector General, OMB, the U.S. Government Accountability Office, and Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

June 10, 2005

FEDERAL FINANCING BANK
WASHINGTON, D.C. 20220

August 4, 2005

KPMG LLP
2001 M Street, N. W.
Washington, DC 20036-3389
Attention: Jeff Norris

Dear Mr. Norris:

This letter is in response to the *Independent Auditors' Report on Internal Control Over Financial Reporting* in connection with the audit of the financial statements of the Federal Financing Bank for fiscal year ended September 30, 2004.

Management's Response: Management acknowledges that, in previous years, no formal policies and procedures existed by which the Bank would structure and account for non-routine transactions such as those executed with the Civil Service Retirement and Disability Trust Fund (Financing Transactions). As pointed out in the finding, we believe that this short-coming was addressed during the execution of the Financing Transaction of November 15, 2004, at which time the Bank implemented procedures which resulted in the determination that such transactions should be presented as capital transactions. It is the Bank's intention to use these procedures as guidelines for the execution of similar Financing Transactions in the future.

As stated in the finding, when legislation was passed in 1987 requiring the Bank to provide interest credits to the Rural Utilities Service, management concluded that there was not a need to record an estimated allowance for future interest credits. This treatment received favorable audit reviews for the following 10 years, until the bank's auditors for fiscal 1998 concluded that an allowance account should be recorded. The financial statements for fiscal 1997 were then restated to include this allowance. The current restatement of fiscal 2003 financial statements is a return to management's conclusion of 1987 not to record an allowance for future credits. The current restatement is a reaffirmation of management's original accounting treatment and not indicative of an internal controls issue.

Sincerely,

Brian D. Jackson
Chief Financial Officer