Audit Report

OIG-06-022

Audit of the Federal Financing Bank's
Fiscal Years 2005 and 2004 Financial Statements

January 4, 2006

Office of Inspector General

Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 4, 2006

OFFICE OF
INSPECTOR GENERAL

MEMORANDUM FOR SECRETARY SNOW

FROM: Harold Damelin
Inspector General

SUBJECT: Audit of the Federal Financing Bank's
Fiscal Years 2005 and 2004 Financial Statements

SUMMARY:

I am pleased to transmit the attached audited Federal Financing Bank's (FFB) financial statements for Fiscal Years (FY) 2005 and 2004, as required by the Government Corporation Control Act.

DISCUSSION:

We contracted with the independent certified public accounting firm KPMG LLP to audit FFB's financial statements as of September 30, 2005 and 2004 and for the years then ended. The contract required that the audit be performed in accordance with generally accepted government auditing standards; applicable provisions of OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*; and the *GAO/PCIE Financial Audit Manual*. The following reports, prepared by KPMG LLP, are incorporated in the attachment:

- Independent Auditors' Report on Financial Statements;
- Independent Auditors' Report on Internal Control over Financial Reporting; and
- Independent Auditors' Report on Compliance and Other Matters.

In its audit of FFB's financial statements, KPMG LLP found:

- the financial statements were fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America (GAAP);
- no matters involving internal control and its operation that are considered material weaknesses; and
- no instances of reportable noncompliance with laws and regulations tested.

In addition, KPMG LLP issued a management letter dated October 31, 2005, discussing certain matters that were identified during the audit, but which are not required to be included in the audit reports.

In connection with the contract, we reviewed KPMG LLP's reports and related documentation and inquired of its representatives. Our review, as differentiated from an audit in accordance with generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on FFB's financial statements or conclusions about the effectiveness of internal control or compliance with laws and regulations. KPMG LLP is responsible for the attached auditors' reports dated October 31, 2005 and the conclusions expressed in the reports. However, our review disclosed no instances where KPMG LLP did not comply, in all material respects, with generally accepted government auditing standards.

Should you have any questions, please contact me at (202) 622-1090, or a member of your staff may contact Marla Freedman, Assistant Inspector General for Audit, at (202) 927-5400.

Attachment

cc: Donald V. Hammond
Vice President, FFB

Roger Kodat
Vice President and Treasurer, FFB

FEDERAL FINANCING BANK

Financial Statements

September 30, 2005 and 2004

(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, 2005 and 2004, 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, 2005 and 2004, 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.

In accordance with *Government Auditing Standards*, we have also issued reports dated October 31, 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

October 31, 2005

FEDERAL FINANCING BANK

Statements of Financial Position

September 30, 2005 and 2004

(Dollars in thousands)

Assets		2005	2004
Funds with U.S. Treasury	$	361,469	449,871
Loans receivable (notes 2 and 4)		27,774,344	29,325,904
Advances to others		152	32
Accrued interest receivable		182,972	249,309
Total assets	$	28,318,937	30,025,116
Liabilities and Net Position			
Liabilities:			
Borrowings:			
Principal amount	$	26,426,618	29,323,406
Plus unamortized premium		474,640	—
Total borrowings (notes 3 and 4)		26,901,258	29,323,406
Accrued interest payable		197,036	88,720
Other liabilities		—	4
Total liabilities		27,098,294	29,412,130
Net position (note 5)		1,220,643	612,986
Total liabilities and net position	$	28,318,937	30,025,116

See accompanying notes to financial statements.

FEDERAL FINANCING BANK

Statements of Operations and Changes in Net Position

Years ended September 30, 2005 and 2004

(Dollars in thousands)

		2005	2004
Revenue and financing sources:			
Interest on loans	$	1,939,428	2,187,586
Revenue from servicing loans		3,436	3,645
Total revenue		1,942,864	2,191,231
Expenses:			
Interest on borrowings		1,139,535	1,151,688
Legislatively-mandated expense		244,420	150,134
Administrative expenses		2,945	3,139
Total expenses		1,386,900	1,304,961
Net income		555,964	886,270
Net position:			
Beginning of year		612,986	(273,284)
Net income		555,964	886,270
Gains on extinguishment of borrowings treated as capital transaction (note 6)		51,693	—
End of year (note 5)	$	1,220,643	612,986

See accompanying notes to financial statements.

FEDERAL FINANCING BANK

Statements of Cash Flows

Years ended September 30, 2005 and 2004

(Dollars in thousands)

		2005	2004
Cash flows from operations:			
Net income	$	555,964	886,270
Adjustments to reconcile net income to net cash provided by operations:			
Amortization of premium on loans		(32,973)	—
Decrease in accrued interest receivable		66,337	144,696
Increase in accrued interest payable		108,316	3,456
(Increase) decrease in advances to others		(120)	31
Decrease in other liabilities		(4)	(227)
Net cash provided by operations		697,520	1,034,226
Cash flows from investing activities:			
Loan disbursements		(4,373,603)	(46,704,799)
Loan collections		5,925,163	53,008,941
Note receivable collection		246,221	—
Net cash provided by investing activities		1,797,781	6,304,142
Cash flows from financing activities:			
Borrowings		4,373,603	47,577,451
Repayments of borrowings		(6,957,306)	(54,936,401)
Net cash used in financing activities		(2,583,703)	(7,358,950)
Net decrease in cash		(88,402)	(20,582)
Funds with U.S. Treasury – beginning of the period		449,871	470,453
Funds with U.S. Treasury – end of the period	$	361,469	449,871
Supplemental disclosures of cash flow information:			
Interest paid (net of amount capitalized)	$	1,066,269	1,153,185
Supplemental schedule of noncash investing and financing activities:			
Decrease in loans for capitalized interest receivable	$	10,837	15,926
Increase in borrowings for capitalized interest payable		4,303	7,272
Gains on early extinguishment of borrowings treated as capital transactions. (note 6)		51,693	—
The Bank issued borrowings of $14,246,221 and a related premium of $507,613 in exchange for an investment and related interest receivable totaling $14,753,834. (note 6)			
The Bank extinguished borrowings of $14,447,217 using an investment and related interest receivable totaling $14,753,834. In addition, the Bank received a note receivable for $246,221 that was due on December 31, 2004. (note 6)			

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 Secretary). 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 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 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. The 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 the respective loan balance by the Bank. The Bank correspondingly capitalizes the interest payable on its related borrowings.

(g) Premium on Borrowings

The Bank amortizes the premium on borrowings using the effective interest method. The amortization is recorded as part of interest on borrowings on the statement of operations and changes in net position.

(h) 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

(Continued)

Bank's loan servicing fee is equal to one-eighth of one percent more than the contractual interest rate with Treasury.

(i) Legislatively-mandated Expense

In prior years, the Bank purchased certificates of beneficial ownership (i.e., loans reported as loans receivable on the statement of financial position) from 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.

(j) Administrative Expenses

The Bank is subject to the general supervision and direction of the Secretary. As provided by law, the Secretary 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, 2005 and 2004, was $2,945 and $3,139 respectively, and is included as administrative expenses in the statement of operations and changes in net position.

(k) 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.

(l) Management's Use of Estimates

The preparation of financial statements in conformity with GAAP 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.

(m) 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).

(Continued)

(Dollars in thousands)

(n) 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 as of September 30, 2005 and 2004, 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, 2005, the Bank had outstanding loans receivable of $27,774,344 with interest rates ranging from 1.617% to 16.183%, and maturity dates from October 1, 2005 to January 3, 2040. At September 30, 2004, the Bank had loans receivable of $29,325,904 with interest rates ranging from 1.055% to 16.183%, and maturing dates ranging from October 1, 2004 to January 3, 2039.

Loans receivable at September 30, 2005 and 2004, consist of the following:

Agency	2005	2004
Rural Utilities Service, Department of Agriculture	$ 18,535,948	16,961,008
Rural Utilities Service, Department of Agriculture (CBO) certificates of beneficial ownership	4,270,207	4,270,207
General Services Administration	2,201,455	2,209,390
U.S. Postal Service	—	1,800,000
Foreign Military Sales, Department of Defense	1,244,459	1,464,945
Low Rent Public Housing, Department of Housing and Urban Development	971,927	1,054,777
Farmers Home Administration, Department of Agriculture	—	880,000
Ship Leasing, Department of Defense, Navy	375,712	498,583
Historically Black Colleges and Universities, Department of Education	126,500	119,485
Small Business Administration	39,705	56,575
Virgin Islands, Department of the Interior	5,523	7,641
Federal Railroad Administration, Department of Transportation	2,694	2,887
Community Development Block Grants, Department of Housing and Urban Development	214	406
Total loans receivable	$ 27,774,344	29,325,904

The loans receivable due within one year is $1,061,045 and $3,358,562 as of September 30, 2005 and 2004, respectively.

(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, 2005, the Bank had Treasury borrowings of $12,426,608 with interest rates ranging from 1.448% to 16.050%, and maturity dates from October 1, 2005, to January 3, 2040. 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.

Additionally, at September 30, 2005 the Bank had borrowings of $14,000,000 and an associated unamortized premium of $474,640 (also see note 6 for details of transaction) from the Civil Service Retirement and Disability Fund (CSR&DF), which is administered by the Office of Personnel Management (OPM). These borrowings are at stated interest rates ranging from 4.625% to 5.625%, effective interest rate of 4.125% and with maturity dates ranging from June 30, 2009 to June 30, 2019. The principal amounts, maturity dates and interest rates on the debt to OPM are the same as the obligations previously issued by Treasury's Bureau of the Public Debt to OPM as investments.

Borrowings from the public amounted to $10 at September 30, 2005 and 2004.

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, 2005, are as follows:

2006	$	1,061,045
2007		188,410
2008		650,289
2009		2,376,146
2010		1,830,371
2011 and thereafter		20,320,357
Total principal payments		26,426,618
Plus unamortized premium		474,640
Total borrowings	$	26,901,258

(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.

(Dollars in thousands)

(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, 2005 and 2004, was $31,759,870 and $34,355,330, respectively. The fair value of borrowings at September 30, 2005 and 2004, was $27,195,570 and $30,152,100, respectively.

(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, 2005 and 2004, the net position includes the following:

		2005	2004
Transfers to Treasury	$	(1,682,847)	(1,682,847)
Cumulative results of operations and gains/losses on extinguishment of borrowings treated as capital transactions		2,903,490	2,295,833
Net position	$	1,220,643	612,986

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

(6) Capital Transactions

On November 15, 2004 the Bank issued debt obligations of $14,000,000 with interest rates ranging from 4.625% to 5.625% and maturity dates ranging from June 30, 2009 to June 30, 2019, a related premium of $507,613 and a debt obligation of $246,221 with a maturity date of December 31, 2004, 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 was 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 $37,141, which represents a capital transaction with Treasury.

In June and September 2005, the Bank made early repayments to the Treasury totaling $969,240 resulting in a net gain of $14,552, which represents a capital transaction with Treasury.

(7) Capitalized Interest

Capitalized interest receivable was approximately $58,687 and $69,524, and the related capitalized interest payable was $13,860 and $18,163 as of September 30, 2005 and 2004, respectively. Capitalized interest receivable and payable are reported as part of the loans receivable and borrowing balances, respectively, on the statement of financial position.

FEDERAL FINANCING BANK

Other Supplementary Information – Schedule 1

Unaudited – See Accompanying Independent Auditor's Report

September 30, 2005 and 2004

(Dollars in thousands)

In prior years, the Federal Financing Bank (Bank) purchased certificates of beneficial ownership (i.e., loans reported as loans receivable on the statement of financial position) from 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 specified 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 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 specified 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, 2005 and 2004, the outstanding principal balance of the 19 RUS 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, 2005 is as follows:

	Interest credit
Fiscal year:	
1988–2001	$ 1,122,051
2002	98,465
2003	71,810
2004	150,134
2005	244,420
Total interest credits	1,686,880
Less appropriation	(917,699)
Total	$ 769,181

KPMG LLP
2001 M Street, NW
Washington, DC 20036

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, 2005 and 2004, 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 October 31, 2005. 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 2005 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 material weaknesses under standards issued by the American Institute of Certified Public Accountants. Material weaknesses are 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, 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. However, we noted no matters involving the internal control and its operation that we considered to be material weaknesses as defined above. Exhibit I presents the status of prior year reportable conditions.

We noted certain matters that we reported to the management of the Bank in a separate letter dated October 31, 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, the OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

October 31, 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, 2005 and 2004, 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 October 31, 2005. 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 2005 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 are not considered applicable at the Bank level. FFMIA requirements will be reviewed and reported on as part of the financial statement audit of the U.S. Department of the Treasury. 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 instances 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, the OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

October 31, 2005

Exhibit I

FEDERAL FINANCING BANK

Summary of the Status of Prior Year Findings

September 30, 2005

Prior Year Condition	Current Year Status
Accounting for non-routine transactions	This condition has been corrected.