



U.S. Department of Agriculture



Office of Inspector General
Financial & IT Operations

Audit Report

Rural Telephone Bank's Financial Statements for Fiscal Years 2004 and 2003

Report No. 15401-5-FM
November 2004



UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
Washington D.C. 20250



DATE: November 5, 2004

REPLY TO

ATTN OF: 15401-5-FM

SUBJECT: Rural Telephone Bank's Financial Statements for
Fiscal Years 2004 and 2003

TO: Board of Directors
Rural Telephone Bank

ATTN: John M. Purcell
Director
Financial Management Division
Rural Development

This report represents the auditors' opinion on the Rural Telephone Bank's (RTB) principal financial statements for the fiscal years ended September 30, 2004, and 2003. Reports on RTB's internal control and on its compliance with laws and regulations are also provided.

Gardiner, Kamya & Associates, P.C. (GKA) an independent certified public accounting firm, conducted the audits. We monitored the progress of the audits at all key points, reviewed the workpapers, and performed other procedures, as we deemed necessary. We determined the audits were conducted in accordance with generally accepted auditing standards, Government Auditing Standards (issued by the Comptroller General of the United States), and the Office of Management and Budget's Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements."

It is the opinion of GKA that the financial statements present fairly, in all material respects, RTB's financial position as of September 30, 2004, and 2003; and its net costs, changes in net position, budgetary resources and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with generally accepted accounting principles. GKA's report on RTB's internal control contains three reportable conditions relating to:

- application of OMB Circular A-130 standards to the legacy loan system;
- information security weaknesses in the new loan system; and
- information technology security weaknesses.

GKA identified the first cited reportable condition as a material weakness. GKA's report on RTB's compliance with laws and regulations addresses noncompliance with the Federal Financial Management Improvement Act.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective actions taken or planned, including the timeframes to address the report's recommendations. Please note that the regulation requires a management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance.

/s/

ROBERT W. YOUNG
Assistant Inspector General
for Audit



GARDINER KAMYA
& ASSOCIATES, PC

CERTIFIED PUBLIC ACCOUNTANTS | MANAGEMENT CONSULTANTS

**U.S. DEPARTMENT OF AGRICULTURE
RURAL TELEPHONE BANK (RTB)**

**FINANCIAL STATEMENTS
SEPTEMBER 30, 2004 and 2003**

and

INDEPENDENT AUDITOR'S REPORT THEREON

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**U.S. DEPARTMENT OF AGRICULTURE
RURAL TELEPHONE BANK (RTB)**

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Independent Auditor's Report on Financial Statements

To the Inspector General and the
Rural Telephone Bank Board of Directors

We have audited the accompanying Balance Sheets of the Rural Telephone Bank (RTB), an agency of the United States Department of Agriculture, as of September 30, 2004 and 2003, and the related Statements of Net Cost, Changes in Net Position, Budgetary Resources and Financing for the years then ended. These financial statements are the responsibility of the management of the RTB. 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 the Office of Management and Budget Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 RTB as of September 30, 2004 and 2003, and its net costs, changes in net position, budgetary resources, and the reconciliation of budgetary obligations to net costs for the years then ended in conformity with generally accepted accounting principles.

The information in the Management's Discussion & Analysis (MD&A) is not a required part of the financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the MD&A information.

In accordance with *Government Auditing Standards*, we have also issued reports dated October 22, 2004, on our consideration of the RTB's internal control over financial reporting, and on our tests of its compliance with certain provisions of applicable laws and regulations. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards*, and, in considering the results of the audit, these reports should be read in conjunction with this report.

Gardner, Kanya & Associates P.C.
October 22, 2004



Independent Auditor's Report on Internal Control over Financial Reporting

To the Inspector General and the
Rural Telephone Bank Board of Directors

We have audited the financial statements of the Rural Telephone Bank (RTB), an agency of the United States Department of Agriculture, as of, and for the year ended September 30, 2004, and have issued our report thereon dated October 22, 2004. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audit, we considered the RTB's internal control over financial reporting by obtaining an understanding of the RTB's internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed 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. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of the 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 the internal control that, in our judgment, could adversely affect the RTB'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 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 internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected.

However, we noted certain matters discussed on the following pages (A Material Weakness and Reportable Conditions) involving the internal control and its operation that we consider to be reportable conditions. We consider Reportable Condition 1 to be a Material Weakness.

In addition, with respect to internal controls related to performance measures reported in the Management's Discussion and Analysis (MD&A), we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

This report is intended solely for the information and use of the management of the RTB, Rural Development (RD), United States Department of Agriculture (USDA), Office of the Inspector General (OIG), OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Gardner, Kamya & Associates, P.C.
October 22, 2004

REPORTABLE CONDITIONS
(A MATERIAL WEAKNESS AND REPORTABLE CONDITIONS)

1. Rural Utilities Service (RUS) Legacy System Compliance - Material Weakness and Reportable Condition

During our audit, we noted that the RUS Legacy system was issued a waiver from Certification and Accreditation (C&A) reviews, and management has not applied OMB standards (Circular A-130, Appendix III) to evaluate material deficiencies previously reported for RD systems that would apply to the RUS Legacy system operated in fiscal year (FY) 2004. Management reported this condition in its amended FMFIA report as a material weakness, and management has called for performing a C&A review for the RUS Legacy system in FY 2005. We agree with management that this condition is a material weakness, and it should be considered in determining FFMI compliance for financial systems for FY 2004.

RD reported in its most recent FFMI Remediation Plan dated October 29, 2004, that its financial management systems are not in compliance with Federal Financial Management System Requirements (FFMSR). We concur with that conclusion. RD reported that the RUS legacy system has not been certified and accredited in compliance with OMB Circular A-130, "Management of Federal Information Resources." As a result, there is no assurance that the RUS legacy system has adequate security to prevent misuse or unauthorized access to or modification of information or to operate effectively and provide appropriate confidentiality, integrity, and availability.

The remediation plan also included corrective actions concerning the implementation of RULSS to address RUS legacy systems noncompliance with OMB Circular A-127, "Financial Management Systems." RD has modified that plan and completed a Joint Financial Management Improvement Program (JFMIP) Direct Loan System Requirements review of the RUS legacy systems and determined that the existing systems, procedures, and operations substantially comply with the JFMIP functionality. Additionally, RD has determined that many of the problems and weaknesses that originally contributed to RUS legacy systems being substantially noncompliant have been largely resolved through compensating enhancements to operational procedures and controls.

RD provided OIG (which in turn provided to GKA) a copy of this review on September 30, 2004, and the support for the review on October 6, 2004. Consequently, we have not had ample time to review this information and will defer comment until we have completed our review.

2. RULSS Compliance- Reportable Condition

As noted above, management's amended FMFIA filing cites a corrective action for RUS Legacy system. We noted that management's corrective action did not cite plans to decommission RUS Legacy system once additional modules of the RULSS become operational, and that management did not address RULSS information security weaknesses in the FMFIA filing. We have reviewed those weaknesses and related notes on mitigation status as reported in the Rural

Development Mitigation Plan for RULSS, July 2004. We have concluded that the unresolved weaknesses, including but not limited to those identified for mitigation in phase III of the C&A process, are a reportable condition for Federal Financial Management Improvement Act (FFMIA) and FMFIA compliance of this major application.

3. Information Technology Security – Reportable Condition

Based on our review of recent USDA OIG evaluations of information technology security and controls, RTB is also not in compliance with OMB Circular A-130 with respect to the information security access controls in the National Information Technology Center (NITC), Kansas City, Missouri, and the Finance Office's Local Area Network, St. Louis, Missouri. During our audit, as well as based on information from the prior year audit, we noted that the following conditions, which were identified by the OIG (contained in USDA audit report number 85099-4-FM, related issue update 04-02, and Report Number 88501-1-FM, see the mentioned reports for details of the findings), are still outstanding:

From USDA Audit Report Number 85099-4-FM and Other Information

- A-130 Compliance - C&As completed for General Support Systems, but the RUS Legacy system was waived anticipating its decommissioning upon full implementation of RULSS.
- Access Controls - RD has begun to implement new controls in this area but until they are fully implemented data is at risk for disclosure, modification, or deletion, including risks for user identification, authorization, remote access, and password settings.
- Timely correction of Vulnerabilities - The Information Systems Security Program Manager has started to implement routine scanning and mitigation processes, but RD systems remain unnecessarily vulnerable to exploitation until this is implemented agency-wide.
- Application Change Controls - RD is not following its own policies for identifying, selecting, installing and modifying software.

From USDA Audit Report Number 88501-1-FM and Other Information

- Security Plan - NITC has not updated its security plan to include software monitoring policies and procedures for midrange environment.
- Contingency Plan - Needs to be finalized to meet OMB requirements, and business resumption plans for network and midrange environment.
- System Certification - As of September 30, 2004, NITC has completed its system certification.
- Logical Access Controls - New procedures for password, security logs, global system settings, and Internet user controls need to be implemented.
- Change Controls for System Software - NITC had not documented the system software changes that had been approved or establish procedures to ensure change controls were being properly carried out.
- Midrange Servers - Inventory is incomplete and servers should be configured in accordance with USDA and National Institute of Standards and Technology (NIST) guidelines.

RECOMMENDATIONS

The OIG has revised prior year recommendations to reflect progress management has made. Based on the current implementation status for replacing RUS Legacy applications with modules from RULSS, and management assurances that corrective actions will be taken in FY 2005 and full disclosure will be made to the auditors, we have no additional recommendations at this time.



Independent Auditor's Report on Compliance with Laws and Regulations

To the Inspector General and the
Rural Telephone Bank Board of Directors

We have audited the financial statements of the Rural Telephone Bank (RTB), an agency of the United States Department of Agriculture, as of, and for the year ended September 30, 2004, and have issued our report thereon dated October 22, 2004. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The management of the RTB is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the RTB's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to the RTB.

The results of our tests of compliance with laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02.

Under FFMIA, we are required to report on whether the RTB's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA section 803 (a) requirements.

The results of our tests disclosed instances where RTB's financial management systems did not substantially comply with these requirements. Management reported in its most recent FFMTA Remediation Plan dated October 29, 2004, that its financial management systems are not in compliance with Federal Financial Management System Requirements (FFMSR). We concur with that conclusion. Management reported that the RUS legacy system has not been certified and accredited in compliance with OMB Circular A-130, "Management of Federal Information Resources." As a result, there is no assurance that the RUS legacy system has adequate security to prevent misuse or unauthorized access to or modification of information or to operate effectively and provide appropriate confidentiality, integrity, and availability.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the management of the RTB, Rural Development (RD), United States Department of Agriculture (USDA) Office of the Inspector General (OIG), OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Hardiner, Kenya & Associates, P.C.

October 22, 2004



United States
Department of
Agriculture

Rural Development
Washington, D.C.

Ms. Alexis M. Stowe
Principal
Gardiner, Kamya & Associates, P.C.
1717 K Street, N.W., Suite 601
Washington, D.C. 20036

NOV - 3 2004

Ms. Wanda Philippi
Regional Inspector General
Financial and IT Operations Division
Office of the Inspector General
8930 Ward Parkway
Suite 3016
Kansas City, MO 64114

Dear Ms. Stowe and Ms. Philippi:

We have reviewed the Office of Inspector General Draft Report on Rural Telephone Bank's fiscal year 2004 financial statements, Report on Internal Control, and the Report on Compliance with Laws and Regulations and agree on its contents.

Rural Development will develop a plan of action to address the findings and recommendations identified during the audit. The plan will include the specific actions to be taken on the recommendations and their estimated completion date.

I would like to thank your office for its continuing professionalism in conducting the audit.

Sincerely,

HILDA GAY LEGG OCT 21 2004
Governor, Rural Telephone Bank

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
THE RURAL TELEPHONE BANK'S FINANCIAL STATEMENTS

***Mission and
Organizational Structure***

The Rural Telephone Bank (RTB) was designed to assure rural telephone systems access to private sources of capital by establishing a supplemental credit mechanism to which borrower systems may turn for all or part of their future capital requirements. Since its inception in 1971, RTB has approved approximately \$4.48 billion in loans to rural telecommunications infrastructure.

Ownership of RTB, in addition to the U.S. Government, consists of borrowers, former borrowers and other related organizations authorized to invest. RTB operates on a cooperative basis and earnings, in excess of the annual return of two percent required on the Government's investment, are returned to the non-government owners.

The Rural Utilities Administrator serves as the Governor of RTB. In this capacity, the Governor may exercise and perform all of RTB's functions, powers, and duties except for matters specifically reserved for the Board of Directors. Overall policy decisions and management vest in a 13-member board composed of seven members appointed by the President and six members elected by RTB stockholders. RTB operations are conducted by Rural Development employees that have similar duties and responsibilities under rural telecommunications programs. In addition, Rural Development and the U.S. Department of Agriculture's Office of General Counsel provide facilities and administrative support to RTB without reimbursement.

***Performance Goals
And Results***

In fiscal year (FY) 2004, a total of \$170 million in loans were approved. RTB financing represented approximately 25 percent of the total loans approved by Rural Development under the telecommunications loan program. The following performance indicators are calculated based on the percentage of RTB funding provided as a supplement to other Rural Utilities funding:

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
THE RURAL TELEPHONE BANK'S FINANCIAL STATEMENTS

Performance Indicators	FY 2004 Target	FY 2004 Actual
Number of rural residents and businesses to receive new or improved service as a result of new loan investment	100,874	40,924
Leveraging of private funds	1.3 : 1	.94:1

Number of improved and new subscribers. The target for new and/or improved subscribers was not met. One reason for this, was new authority under the 2002 Farm Bill to utilize loan funds to refinance existing debt. The target was derived using prior year experience and expecting all funds to be utilized for new subscribers, not considering refinancing existing subscribers.

Leveraging. The target was not met. This performance indicator measures the extent to which borrowers are investing with funds other than RTB funds. During the past year, a higher proportion of funding was invested from RTB funds and other government funds instead of private funding sources. Several factors contributed to this, including favorable terms associated with government loans (i.e., lower interest rates, and longer maturities) and a desire to increase cash reserves through a conservative cash management approach(resulting in fewer dollars invested from general funds).

***Entity's Financial
Statements***

Assets increased during the fiscal year from \$2.1 billion to \$2.2 billion. This \$0.1 million increase resulted from loan repayments and additional interest earned on funds with the U. S. Treasury. Liabilities increased due to an increase in debt to Treasury and an increase in the declared dividend.

***Entity's Systems, Controls
And Legal Compliance***

The purpose of the Federal Managers' Financial Integrity Act (FMFIA) is to promote the development of management structures that ensure management accountability for results and include appropriate, cost effective controls. The FMFIA requires annual assurance statements on both management controls and compliance with financial management system requirements.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
THE RURAL TELEPHONE BANK'S FINANCIAL STATEMENTS

For fiscal year 2004, Rural Development is reporting that our internal controls and financial management and accounting systems are substantially compliant with Section 2 and not compliant with Section 4 of the Federal Managers' Financial Integrity Act (FMFIA).

Rural Development has exhibited a new commitment to addressing flaws in its Information Systems Security Program. Certification and accreditation has been completed for major applications and general support systems, except for the RUS Legacy Systems; audit findings and required corrective actions have been discussed with audit agencies; and a master plan was developed to identify tasks, timeframes, resources, interdependencies, and responsibilities.

Rural Development has initiated corrective actions to enhance network security and to strengthen logical access controls. Key actions include summarizing the corrected vulnerabilities and rescanning to verify the network security corrections by 2nd quarter FY 2005; developing a strategy regarding Rural Development's and the CIO's responsibilities by 2nd quarter FY 2005, developing a project plan outlining Rural Development's responsibilities by 3rd quarter FY 2005, and certification and accreditation of the RUS Legacy Systems by 3rd quarter FY 2005.

***Future Opportunities
And Challenges***

The RTB is required, by law, to privatize its operations through the redemption and retirement of Class A stock "as soon as practicable after September 30, 1995, but not to the extent that, the Telephone Bank Board determines that such retirement will impair the operations of the telephone bank..." (Rural Electrification Act of 1936, Section 406(c)). The President's fiscal year 2002, 2003, and 2004 budgets emphasized privatization by eliminating lending authorization in those years. It is important to note that the appropriations bills for fiscal years 1996 through 2004 have stipulated, however, that no more than five percent of the amount of Class A stock outstanding could be retired for each of those years, thereby preventing an expedited privatization of the RTB. To date, the board has voted to

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
THE RURAL TELEPHONE BANK'S FINANCIAL STATEMENTS

retire \$203.8 million of Class A stock, voting to retire the maximum amount allowable under the appropriations laws in every year since 1997, leaving a balance of \$388.3 million.

With a strong focus on privatization, and the recognition that, to continue as a viable private lender that helps meet the growing capital requirements of the rural telecommunications industry, the RTB must formulate and implement a sound business plan for operations as a privatized entity. As such, during the year, the board formed a working group to further analyze the RTB's viability as a private entity. The working group consists of four elected members of the board as well as representatives from Treasury and the Office of Management and Budget. At a meeting held in June 2004, the working group directed staff to work with the Office of the Chief Financial Officer to assemble a history of the RTB's cash flow from its inception. The analysis was completed in September 2004 and is currently being studied. The working group will assess this information in the early part of fiscal year 2005 to determine which next steps are appropriate in view of the results of the analysis and report their finding to the board at the November meeting.

***Limitation on
Financial Statements***

These financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b). While the statements have been prepared from the books and records of the entity in accordance with the formats prescribed by the Office of Management and Budget, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization that they are a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

U.S. Department of Agriculture
Rural Telephone Bank
BALANCE SHEET
As of September 30, 2004 and 2003
(in dollars)

	<u>2004</u>	<u>2003</u>
ASSETS		
Assets for Use by Entity:		
Federal		
Fund Balance with Treasury (Note 2)	\$ 1,410,526,048	\$ 1,267,349,461
Interest Receivable (Note 3)	5,800,817	56,457,531
Non-Federal		
Credit Program Receivables, Net (Note 4)	788,206,343	798,786,981
Total Assets	<u>\$ 2,204,533,208</u>	<u>\$ 2,122,593,973</u>
LIABILITIES		
Liabilities Covered by Budgetary Resources:		
Federal		
Accounts Payable	\$ 10,954,015	\$ 18,440,437
Debt (Note 5)	343,114,808	300,996,852
Non-Federal		
Other Liabilities (Note 6)	48,779,630	28,184,069
Total Liabilities	<u>402,848,453</u>	<u>347,621,358</u>
COMMITMENTS AND CONTINGENCIES (Note 7)		
NET POSITION		
Unexpended Appropriations (Note 8)	<u>17,959,620</u>	<u>21,282,263</u>
Capital Stock (Note 9)		
Federal		
Equity of the U.S. Government		
Capital Stock Class A	388,275,537	408,711,091
Subsidy Re-estimates	(72,455)	(5,274,229)
Total Equity of the U.S. Government	388,203,082	403,436,862
Non-Federal		
Investment of Others		
Capital Stock Class B	521,621,555	540,839,299
Capital Stock Class C	821,487,000	736,888,000
Restricted Capital	10,000,000	10,000,000
Patronage Capital Earned	42,413,498	62,526,191
Total Investment of Others	<u>1,395,522,053</u>	<u>1,350,253,490</u>
Cumulative Results of Operations	<u>1,783,725,135</u>	<u>1,753,690,352</u>
Total Net Position	<u>1,801,684,755</u>	<u>1,774,972,615</u>
Total Liabilities and Net Position	<u>\$ 2,204,533,208</u>	<u>\$ 2,122,593,973</u>

The accompanying notes are an integral part of these statements.

U.S. Department of Agriculture
Rural Telephone Bank
STATEMENT OF NET COST
For the Year Ended September 30, 2004 and 2003
(in dollars)

	<u>2004</u>	<u>2003</u>
Program Costs		
Intragovernmental Gross Costs		
Borrowing Interest Expense	\$ 24,263,120	\$ 23,843,334
Operating Expense	<u>3,152,291</u>	<u>3,061,967</u>
Total Intragovernmental Gross Costs	27,415,411	26,905,301
Less: Intragovernmental Earned Revenue (Note 10)	<u>72,828,481</u>	<u>62,598,854</u>
Intragovernmental Net Costs	(45,413,070)	(35,693,553)
Gross Costs with the Public	(6,854,510)	3,918,811
Less: Earned Revenues from the Public (Note 10)	<u>50,995,392</u>	<u>69,762,007</u>
Net Costs with the Public	(57,849,902)	(65,843,196)
Net Cost of Operations	\$ <u><u>(103,262,972)</u></u>	\$ <u><u>(101,536,749)</u></u>

The accompanying notes are an integral part of these statements.

U.S. Department of Agriculture
Rural Telephone Bank
STATEMENT OF CHANGES IN NET POSITION
For the Year Ended September 30, 2004 and 2003
(in dollars)

	<u>2004</u>		<u>2003</u>	
	<u>Cumulative Results of Operations</u>	<u>Unexpended Appropriations</u>	<u>Cumulative Results of Operations</u>	<u>Unexpended Appropriations</u>
Beginning Balance	\$ 1,753,690,352	\$ 21,282,263	\$ 1,714,008,081	\$ 20,868,302
Budgetary Financing Sources:				
Appropriations Received		3,508,716		6,785,691
Appropriations Transferred In/Out				(23,112)
Other Adjustments		(2,185,796)		(925,939)
Appropriations Used	4,645,563	(4,645,563)	5,422,679	(5,422,679)
Transfers In/Out w/o Reimbursement	(3,339,410)		(11,630,362)	
Other Budgetary Financing Sources:				
Redemption of Class A Stock	(20,435,554)		(21,511,110)	
A Stock Dividends	(8,174,222)		(8,604,444)	
C Stock Dividends	(48,779,630)		(28,184,069)	
Investment of Others	2,855,064		2,652,828	
Total Budgetary Financing Sources	(73,228,189)	(3,322,643)	(61,854,478)	413,961
Net Costs of Operations	103,262,972		101,536,749	
Ending Balances	<u>1,783,725,135</u>	<u>17,959,620</u>	<u>1,753,690,352</u>	<u>21,282,263</u>

The accompanying notes are an integral part of these statements.

U.S. Department of Agriculture
Rural Telephone Bank
STATEMENT OF BUDGETARY RESOURCES
For the Year Ended September 30, 2004 and 2003
(in dollars)

	2004		2003	
	<u>Budgetary</u>	<u>NonBudgetary Credit Program Financing Accounts</u>	<u>Budgetary</u>	<u>NonBudgetary Credit Program Financing Accounts</u>
Budgetary Resources				
Appropriations Received (Note 14)	3,508,716		6,785,691	
Borrowing Authority (Note 12/13)		216,476,539		169,683,148
Net Transfers	(20,435,554)		(21,534,222)	
Subtotal	<u>(16,926,838)</u>	<u>216,476,539</u>	<u>(14,748,531)</u>	<u>169,683,148</u>
Unobligated Balances (Note 15)				
Beginning of Period (Brought Forward)	1,202,530,590	1,626,149	944,525,777	17,158,087
Spending Authority from Offsetting Collections				
Earned				
Collected	202,823,634	61,452,350	246,629,294	94,174,043
Receivables from Federal Sources	(50,656,712)		56,457,531	
Change in Unfilled Customer Orders				
Without Advance from Federal Sources		(2,247,273)		979,895
Subtotal	<u>152,166,922</u>	<u>59,205,077</u>	<u>303,086,825</u>	<u>95,153,938</u>
Recoveries of Prior Yr Obligations	15,739,704	76,361,157	14,052,543	32,470,200
Permanently Not Available	<u>(10,360,018)</u>	<u>(110,543,040)</u>	<u>(9,530,383)</u>	<u>(116,996,827)</u>
Total Budgetary Resources	<u><u>1,343,150,360</u></u>	<u><u>243,125,882</u></u>	<u><u>1,237,386,231</u></u>	<u><u>197,468,546</u></u>
Status of Budgetary Resources:				
Obligations Incurred (Note 11)				
Direct	52,269,637	212,703,525	34,855,641	195,842,397

The accompanying notes are an integral part of these statements.

U.S. Department of Agriculture
Rural Telephone Bank
STATEMENT OF BUDGETARY RESOURCES
For the Year Ended September 30, 2004 and 2003
(in dollars)

	2004		2003	
	<u>Budgetary</u>	<u>NonBudgetary Credit Program Financing Accounts</u>	<u>Budgetary</u>	<u>NonBudgetary Credit Program Financing Accounts</u>
Unobligated Balances:				
Apportioned			55,308	
Unobligated Balances Not Yet Available	<u>1,290,880,723</u>	<u>30,422,358</u>	<u>1,202,475,282</u>	<u>1,626,149</u>
Total Status of Budgetary Resources	<u>1,343,150,360</u>	<u>243,125,882</u>	<u>1,237,386,231</u>	<u>197,468,546</u>
Relationship of Obligations to Outlays				
Obligated Balance, Net - Beginning of Period	53,498,911	1,169,348,641	117,418,532	1,090,814,527
Obligated Balance, Net - End of Period				
Accounts Receivable	(5,800,819)		(56,457,530)	
Undelivered Orders	64,268,714	1,205,445,814	81,772,373	1,169,348,641
Accounts Payable	<u>48,779,630</u>		<u>28,184,068</u>	
Subtotal	<u>107,247,525</u>	<u>1,205,445,814</u>	<u>53,498,911</u>	<u>1,169,348,641</u>
Outlays				
Disbursements	33,438,031	102,492,467	28,265,188	83,858,188
Collections	<u>(202,823,634)</u>	<u>(61,452,350)</u>	<u>(246,629,294)</u>	<u>(94,174,043)</u>
Subtotal	<u>(169,385,603)</u>	<u>41,040,117</u>	<u>(218,364,106)</u>	<u>(10,315,855)</u>
Less: Offsetting Receipts	<u>11,155,042</u>		<u>4,179,159</u>	
Net Outlays	<u>(180,540,645)</u>	<u>(41,040,117)</u>	<u>(222,543,265)</u>	<u>(10,315,855)</u>

The accompanying notes are an integral part of these statements.

U.S. Department of Agriculture
Rural Telephone Bank
STATEMENT OF FINANCING
For the Year Ended September 30, 2004 and 2003
(in dollars)

	<u>2004</u>	<u>2003</u>
Resources Used To Finance Activities:		
Budgetary Resources Obligated		
Obligations Incurred	\$264,973,162	\$230,698,038
Less: Spending Authority From Offsetting Collections and Recoveries	<u>303,472,860</u>	<u>444,763,507</u>
Obligations Net of Offsetting Collections and Recoveries	(38,499,698)	(214,065,469)
Less: Offsetting Receipts	<u>11,155,042</u>	<u>4,179,159</u>
Total Resources Used To Finance Activities	<u>(49,654,740)</u>	<u>(218,244,628)</u>
Resources Used To Finance Items Not Part Of The Net Costs Of Operations:		
Change in Budgetary Resources Obligated For Goods, Services, and		
Benefits Ordered But Not Yet Provided	18,593,516	65,164,178
Resources That Fund Expenses Recognized in Prior Periods	320,953	1,288,591
Budgetary Offsetting Collections and Receipts That Do Affect		
Net Costs of Operations		
Credit Program Collections Which Increase Liabilities for Loan Guarantees		
or Allowance for Subsidy	(213,619,273)	(397,260,868)
Other	(11,155,042)	(4,179,160)
Resources That Finance the Acquisition of Assets	151,880,497	112,608,543
Other Resources or Adjustments to Net Obligated Resources That Do		
Not Affect Net Cost of Operations	<u>(53,979,349)</u>	<u>(222,378,716)</u>
Total Resources Used to Finance Items Not Part of The Net Cost of Operations	<u>(53,979,349)</u>	<u>(222,378,716)</u>
Total Resources Used to Finance the Net Cost of Operations	<u>4,324,609</u>	<u>4,134,088</u>
Components of the Net Cost of Operations That Will Not Require or		
Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Periods:		
Upward/Downward Reestimates of Credit Subsidy Expense (Note 16)	(8,220,231)	(6,356,133)
Other	(99,127,798)	(98,008,250)
Total Components of Net Cost of Operations That Will Require or		
Generate Resources in Future Periods	(107,348,029)	(104,364,383)
Components Not Requiring or Generating Resources		
Depreciation and Amortization		
Other	<u>(239,552)</u>	<u>(1,306,454)</u>
Total Components of Net Cost of Operations That Will Not Require or		
Generate Resources in the Current Period	<u>(107,587,581)</u>	<u>(105,670,837)</u>
Net Costs of Operations	<u>(\$103,262,972)</u>	<u>(\$101,536,749)</u>

The accompanying notes are an integral part of these statements.

RURAL TELEPHONE BANK

NOTES TO THE FINANCIAL STATEMENTS

NOTE 1: SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The Rural Telephone Bank (RTB), established in May 1971, provides a supplemental source of financing under the Rural Utilities Service (RUS) telephone loan program. RUS is a credit agency within the U.S. Department of Agriculture (USDA) which assists rural electric and telephone organizations in obtaining the financing required to provide electric and telephone service in rural areas. RTB lends principally to rural telephone organizations.

RTB is a government corporation that functions as an agency of USDA, subject to the supervision and direction of the Secretary of Agriculture. As provided by law, the Administrator of RUS serves as the Governor of RTB. In this capacity, the Governor may exercise and perform all of RTB's functions, powers, and duties, except for matters specifically reserved for its Board of Directors. As discussed below, upon retirement of the Class A stock held by the U.S. Government, the RTB would no longer operate as an integral agency of the Government.

Adverse changes in the telephone industries could have a direct and material impact on the financial capacity of RTB borrowers to provide for the repayment of loans.

B. Basis of Presentation

The accompanying financial statements have been prepared to report the financial position, net costs, and changes in net position of RTB as required by the Government Management Reform Act of 1994, and in conformity with generally accepted accounting principles (GAAP). GAAP for Federal financial reporting entities recognize the Federal Accounting Standards Advisory Board (FASAB) as the standards-setting body designated to establish these principles for these entities. The financial statements have also been prepared from the books and records of RTB in accordance with the form and content for entity financial statements specified by the Office of Management and Budget (OMB) Bulletin 01-09, *Form and Content of Agency Financial Statements*, except that credit subsidy reestimates are presented as a separate line item within total equity of the U.S. Government. The financial statements also follow USDA accounting policy guidelines.

C. Basis of Accounting

RTB's transactions are recorded on the accrual basis of accounting and with respect to certain information regarding budgetary resources and financing, a budgetary accounting basis. Under the accrual method, revenues are recognized when earned, and expenses are recognized when a liability is incurred. Budgetary accounting is also necessary to facilitate compliance with legal constraints and controls over the use of Federal funds. Any significant interfund and intrafund balances and transactions have been eliminated in the consolidation of the pre- and post-credit reform lending programs.

RURAL TELEPHONE BANK
NOTES TO THE FINANCIAL STATEMENTS

During FY's 2004 and 2003, no new Statements of Federal Financial Accounting Standards (SFFAS) were implemented, due to the fact that either none were applicable or no changes were required.

D. Fund Balance with United States Treasury

RTB maintains all cash accounts with the United States Treasury. It is the policy of RTB not to maintain cash in commercial bank accounts, except in the normal course of processing cash receipts through third-party commercial banking institutions. Fund Balance with Treasury represents appropriated and revolving funds that are available to pay current liabilities and finance authorized loan commitments. RTB earns interest on all cash balances maintained at the Treasury in accordance with the terms of the 1973 note executed by RTB and U.S. Treasury, Section 505(c) of the Federal Credit Reform Act of 1990 and recent legislation (Public Law 106-78).

E. Credit Program Receivables, Net

Loans are accounted for as receivables after funds are disbursed. Loans receivable are carried at the principal amount outstanding, net of an allowance for estimated uncollectible amounts for pre-fiscal year (FY) 1992 loans. For direct loans obligated on or after October 1, 1991, RTB recognizes these assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance (Note 4). All loan receivables are due from non-Federal borrowers and accrue interest daily based on the contractual interest rate.

RTB's allowance is estimated based on delinquency rates, current economic conditions, borrowers' credit histories, borrowers' outstanding balances, and an analysis of each borrower's financial condition.

Due to accelerated reporting requirements, a reestimate approximator method was implemented in FY 2003. Actual budgetary reestimates, as of September 30, 2004, will be completed during FY 2005.

The projected cost of direct loan defaults (for loans obligated prior to October 1, 1991) will not necessarily reflect RTB's future appropriation requests. To the extent that fund revenues are not sufficient to fund future costs, financing will have to be obtained from future appropriations, or other Congressionally-approved sources.

RURAL TELEPHONE BANK NOTES TO THE FINANCIAL STATEMENTS

F. Liabilities

Liabilities are recognized for amounts of probable future outflows or other sacrifices of resources as a result of past transactions or events. Since RTB is a component of the United States Government, a sovereign entity, its liabilities cannot be liquidated without legislation that provides resources to do so. Payments of all liabilities other than contracts can be abrogated by the sovereign entity.

Liabilities Covered by Budgetary Resources are those liabilities funded by available budgetary resources including: (1) new budget authority, (2) spending authority from offsetting collections, (3) recoveries of unexpired budget authority, (4) unobligated balances of budgetary resources at the beginning of the year, and (5) permanent indefinite appropriation or borrowing authority. All of RTB's liabilities are covered by budgetary resources.

- **Accounts Payable**

Accounts payable consist solely of amounts payable to the United States Treasury based on credit reform subsidy reestimates.

- **Debt - United States Treasury**

As required under Credit Reform legislation, a note was executed by RTB with the United States Treasury that provides funds for direct loans approved after September 30, 1991 (Post-1991). The interest rate charged to RTB is the average annual Treasury rate, as provided by OMB. For loans approved prior to October 1, 1991 (Pre-1992), Treasury funding is provided, when needed, in accordance with the terms of a note executed by RTB and Treasury in July 1973. RTB has not borrowed against the note for several years since the pre-1992 fund balance is sufficient to advance new loans.

G. Stock Conversion

In accordance with its authorizing legislation and amendments, RTB will be converted to independent status at such time when 51 percent of the Class A stock issued to the U.S. Government (and outstanding at any time since September 30, 1985) has been fully redeemed and retired. When such conversion occurs, RTB will no longer be an agency of the USDA and the President will cease to appoint Board members. However, after the conversion, Congress may still continue its oversight responsibilities for RTB's operations.

H. Operations

The Rural Electrification Act of 1936, as amended, and RTB's enabling legislation, authorize RTB to partially or jointly use the facilities and services of employees of RUS, or of any other agency of the USDA, without cost. Under the Federal Credit Reform Act, \$3,152,291 of appropriated funds provided to RTB to cover administrative costs were transferred to RUS for

RURAL TELEPHONE BANK
NOTES TO THE FINANCIAL STATEMENTS

FY 2004. This amount represents the additional cost to RUS for managing RTB. In this regard, RTB's operations are conducted by RUS administrative and program employees who have similar responsibilities under RUS's rural telephone loan program.

I. Intra-Governmental Relationships and Transactions

In the course of its operations, RTB has relationships and financial transactions with other Federal agencies. The more prominent of these are with RUS and the United States Treasury. RUS determines the annual cost allocations associated with the administration of RTB by RUS employees and the Treasury receives the collections of proceeds from direct loans issued on behalf of RTB.

NOTE 2: FUND BALANCE WITH TREASURY

Amounts presented in dollars.

	<u>2004</u>	<u>2003</u>
Fund Balances:		
Revolving Funds	\$1,392,566,428	\$1,246,067,198
Appropriated Funds	17,959,620	21,282,263
Total	<u>\$1,410,526,048</u>	<u>\$1,267,349,461</u>
	<u>2004</u>	<u>2003</u>
Unobligated Balance		
Unavailable, end of year *	\$1,333,482,500	\$ 1,144,620,655
Unavailable, restricted	299,934	1,397,096
Available	77,101	55,309
Obligated Balance		
Not Yet Disbursed	<u>76,666,513</u>	<u>121,276,401</u>
Total	<u>1,410,526,048</u>	<u>\$1,267,349,461</u>

*Amount becomes available through the SF 132 process.

**RURAL TELEPHONE BANK
NOTES TO THE FINANCIAL STATEMENTS**

NOTE 3: INTEREST RECEIVABLE

Amounts presented in dollars.

	<u>2004</u>	<u>2003</u>
Intragovernmental Due from Treasury	\$ 5,800,817	\$ 56,457,531

In FY 2004, Treasury interest was based on the average fund balance on deposit with the Treasury as of August 31, 2004, and received in current fiscal year business. A receivable was calculated for the month of September and included in this year's balance sheet and will be received in FY 2005. In FY 2003, Treasury interest was based on the average fund balance on deposit with the Treasury as of September 30, 2003, but not received until FY 2004.

NOTE 4: DIRECT LOANS, NON FEDERAL BORROWERS

Purpose

The Rural Telephone Bank (RTB) was created by Public Law 92-12 on May 7, 1971. The RTB was designed to assure rural telephone systems access to private sources of capital. It did this by establishing a supplemental credit mechanism to which borrower systems may turn for all or part of their future capital requirements. The RTB is owned by the U.S. Government, its borrowers, former borrowers, and other related organizations authorized to invest. The RTB operates on a cooperative basis and earnings, in excess of the annual return of 2 percent required on the Government's investment, are returned to the non-Government owners as patronage refunds.

RTB makes telecommunications loans to public bodies, cooperative, nonprofit, limited association or mutual associations. RTB loans are made concurrently with RUS cost-of-money loans to finance the improvement, expansion, construction, and acquisition of systems or facilities that improve telephone service in rural areas. However, RTB does not finance station apparatus owned by the borrower, headquarters facilities, and vehicles not used primarily in construction.

Eligibility

To be eligible, a borrower must be incorporated and must provide or propose to provide the basic local exchange telephone service needs of rural areas. A borrower must demonstrate that the average number of proposed subscribers per mile of line in the service area of the borrower is less than or equal to 15, or the borrower has a projected Times Interest Earned Ratio (borrowers net income after taxes plus interest expense, all divided by interest expense) of at least 1.0 but not greater than 5.0. Additionally, the borrower must participate in an approved telecommunications modernization plan for the state.

RURAL TELEPHONE BANK NOTES TO THE FINANCIAL STATEMENTS

Repayment Period and Interest Rates

Loans must be repaid within a period that approximates the expected useful life of the facilities to be financed, not to exceed 35 years. Generally, interest is payable each month as it accrues. Principal payments on each note generally are scheduled to begin 2 years after the date of the note. After this deferral period, interest and principal payments on all funds advanced during this 2-year period are scheduled in equal monthly installments. RTB loans will bear interest at a rate equal to the cost of funds to RTB. However, the rate will not be less than 5 percent.

Servicing Options

RTB may extend the time of payment of principal or interest on a loan. This extension may be up to 5 years after such payment is due. Payment may be deferred as long as necessary in disaster situations so long as the final maturity date is not later than 40 years after the date of the loan.

Accounting Policy

Direct loan obligations made prior to FY 1992 are reported on a net realizable value basis. Direct loan obligations made after FY 1991 are governed by the Federal Credit Reform Act. The Act provides that the present value of the subsidy costs (i.e., interest rate differentials, interest subsidies, delinquencies and defaults, fee offsets and other cash flows) associated with direct loans be recognized as a cost in the year the loan is made. The net present value of loans receivable at any point in time is the amount of the gross loan receivable less the present value of the subsidy at that time.

Economic Factors and Outlook Affecting Subsidy Reestimates

The RTB subsidy rate is supported by three components to include interest rate, defaults, and prepayments. The interest rate component is the only sensitive component and there have been no defaults in this program.

The reestimate amounts have been minimal with the FY 2003 actual budgetary reestimates resulting in a \$5 million downward reestimate decreasing program funding requested at time of formulation. With the borrower rate being approximated by the Treasury rate at the time of advancing funds, interest subsidy rate increases have been significant. Currently, there are no foreseeable events that may require significant additional subsidy.

RURAL TELEPHONE BANK
NOTES TO THE FINANCIAL STATEMENTS

Direct Loans Obligated Prior to FY 1992
(Allowance for Loss Method):

Amounts presented in dollars.

	<u>2004</u>	<u>2003</u>
Loans Receivable, Gross	\$ 423,503,887	\$ 476,005,260
Interest Receivable	\$ 1,008,091	\$ 1,276,411
Allowance for Loan Losses	\$ (3,921,333)	\$ (4,160,886)
Value of Assets Related to Direct Loans	<u>\$ 420,590,645</u>	<u>\$ 473,120,785</u>

Direct Loans Obligated After FY 1991
(Present Value Method)

Amounts presented in dollars.

	<u>2004</u>	<u>2003</u>
Loans Receivable, Gross	\$ 363,676,369	\$ 327,814,491
Interest Receivable	\$ 245,037	\$ 116,160
Allowance for Subsidy Cost (Present Value)	<u>\$ 3,694,292</u>	<u>\$ (2,264,455)</u>
Value of Assets Related to Direct Loans	<u>\$ 367,615,698</u>	<u>\$ 325,666,196</u>
Total Portfolio Value of Assets Related To Direct Loans	<u>\$ 788,206,343</u>	<u>\$ 798,786,981</u>

Total Amount of Direct Loans Disbursed:

Amounts presented in dollars.

	<u>2004</u>	<u>2003</u>
Direct Loans Obligated Prior to FY 1992	<u>\$ 854,337</u>	<u>\$ 576,000</u>
Direct Loans Obligated After FY 1991	<u>\$ 63,881,123</u>	<u>\$ 53,176,849</u>

RURAL TELEPHONE BANK
NOTES TO THE FINANCIAL STATEMENTS

Subsidy Expense for Direct Loans by Program and Component:

Amounts presented in dollars.

Subsidy Expense for New Direct Loans Disbursed

	<u>2004</u>	<u>2003</u>
Interest Differential	\$ 970,454	\$ 1,050,915
Defaults	\$ 19,407	\$ 11,949
Other	\$ 153,020	\$ 4,157
Total	<u>\$ 1,142,881</u>	<u>\$ 1,067,021</u>

Reestimates

	<u>2004</u>	<u>2003</u>
Interest Rate Reestimates	\$ (10,884,876)	
Technical Reestimates	\$ 2,677,319	\$ (6,356,133)
Total	<u>\$ (8,207,557)</u>	<u>\$ (6,356,133)</u>
Total Direct Loan Subsidy Expense:	<u><u>\$ (7,064,676)</u></u>	<u><u>\$ (5,289,112)</u></u>

RURAL TELEPHONE BANK
NOTES TO THE FINANCIAL STATEMENTS

Subsidy Rates for Direct Loans by Program and Component:

Budget Subsidy Rates for Direct Loans by Program and Component

	<u>2004</u>	<u>2003</u>
Interest Differential	(4.29)%	2.21%
Defaults	0.02%	0.02%
Other Collections	(0.05)%	(0.85)%
Total	<u>(4.32)%</u>	<u>1.38%</u>

Schedule for Reconciling Subsidy Cost Allowance Balances:
(Post- FY 1991 Direct Loans)

Amounts presented in dollars.

	<u>FY 2004</u>	<u>FY 2003</u>
Beginning Balances, Changes, and Ending Balances		
Beginning balance of the subsidy cost allowance:	<u>\$ 2,264,455</u>	<u>\$ 11,050,542</u>
Add: subsidy expense for direct loans disbursed during the reporting years by component:		
(a) Interest rate differential costs	970,454	1,050,915
(b) Default costs (net of recoveries)	19,407	11,949
(c) Fees and other collections	153,020	4,157
Total of the above subsidy expense and components	<u>\$ 1,142,881</u>	<u>\$ 1,067,021</u>
Adjustment:		
(a) Subsidy allowance amortization	1,105,929	(3,496,975)
Ending balance of the subsidy cost allowance before reestimates	<u>\$ 4,513,265</u>	<u>\$ 8,620,588</u>
Add or subtract subsidy reestimates by component:		
(a) Interest rate reestimate	(10,884,876)	
(b) Technical/default reestimate	2,677,319	(6,356,133)
Total of the above reestimate components	<u>\$ (8,207,557)</u>	<u>\$ (6,356,133)</u>
Ending balance of the subsidy cost allowance	<u>\$ (3,694,292)</u>	<u>\$ 2,264,455</u>
	<u>FY 2004</u>	<u>FY 2003</u>
Administrative Expense	<u>\$ 3,152,291</u>	<u>\$ 3,061,967</u>

RURAL TELEPHONE BANK
NOTES TO THE FINANCIAL STATEMENTS

NOTE 5: DEBT

Amounts presented in dollars.

	2004		
	<u>Beginning Balance</u>	<u>Net Borrowings</u>	<u>Ending Balance</u>
Federal Debt			
Interest Bearing:			
Debt to the Treasury	<u>\$ 300,996,852</u>	<u>42,117,956</u>	<u>\$ 343,114,808</u>

	2003		
	<u>Beginning Balance</u>	<u>Net Borrowings</u>	<u>Ending Balance</u>
Federal Debt			
Interest Bearing:			
Debt to the Treasury	<u>\$ 323,133,633</u>	<u>(22,136,781)</u>	<u>\$ 300,996,852</u>

Legislation limits outstanding borrowings from the U.S. Treasury to an amount, which shall not exceed twenty times RTB's equity. As of September 30, 2004 and 2003, RTB's maximum borrowing authority approximated \$36 billion, and \$35 billion, respectively. All Federal debt is covered by budgetary resources.

NOTE 6: OTHER LIABILITIES

Dividends declared and unpaid on Class C Stock to non-federal recipients in the amount of \$48.8 million and \$28.2 million as of September 30, 2004 and 2003, respectively, and are payable on December 15, 2004. This liability is covered by budgetary resources.

NOTE 7: COMMITMENTS AND CONTINGENCIES

The RTB has in the course of its loan making activities, unliquidated loan obligations that, in the absence of contractual violations or cancellations, will require disbursements. Unliquidated loan obligations at September 30, 2004 and 2003, total approximately \$1,270 million, and \$1,251 million, respectively.

As of September 30, 2004 and 2003, there were no obligations due to canceled appropriations for which there is a contractual commitment for payment.

RURAL TELEPHONE BANK
NOTES TO THE FINANCIAL STATEMENTS

NOTE 8: UNEXPENDED APPROPRIATION

Amounts presented in dollars.

	<u>2004</u>	<u>2003</u>
<u>Unexpended appropriations</u>		
Unobligated	\$ 377,035	\$ 1,452,404
Undelivered orders	17,582,585	19,829,859
Total Unexpended Appropriations	<u>\$ 17,959,620</u>	<u>\$ 21,282,263</u>

Unexpended appropriations include the undelivered orders and unobligated balances of the program accounts, which receive Congressional appropriations through the budgetary process.

As appropriated funds incur obligations, the obligated amount is recorded as an undelivered order. Undelivered orders are reduced by either an expenditure or an obligation cancellation. Appropriated funds, which are not obligated, are treated as unobligated amounts. Unobligated appropriations are returned to the U.S. Treasury when their period of availability expires.

NOTE 9: CAPITAL STOCK

Amounts presented in dollars.

A summary of the RTB capital stock structure follows:

	<u>2004</u>	<u>2003</u>
CAPITAL STOCK CLASS A (\$1 par value)		
Shares authorized	600,000,000	600,000,000
Shares issued and outstanding	388,275,537	408,711,091
Cash dividends	\$ 8,174,222	\$ 8,604,444
CAPITAL STOCK CLASS B (\$1 par value)		
Shares authorized	Unlimited	Unlimited
Shares issued and outstanding	521,621,555	540,839,299
Stock dividends (distributed 12/03)	62,504,042	71,989,406
CAPITAL STOCK CLASS C (\$1,000 par value)		
Shares authorized	Unlimited	Unlimited
Par Value, shares issued and outstanding	821,487,000	\$ 736,888,000
Cash dividends (accrued 09/04)	\$ 48,779,630	\$ 28,184,069

Capital Stock Class A

Public Laws 92-12 and 97-98 authorized Congress, in FY's 1971 through 1991, to appropriate no more than \$30 million per year for the purchase of RTB Class A stock. The law provides that Congress annually appropriate funds until such purchases approximate \$600 million. As of September 30, 2004, RTB Class A stock appropriations amounted to approximately \$591.1 million,

RURAL TELEPHONE BANK NOTES TO THE FINANCIAL STATEMENTS

the total funding USDA Rural Development will receive from Congress. Beginning in 1996, RTB was required to repurchase this stock; however, in accordance with Public Law 106-78, Section 718, the maximum Class A stock that may be retired is 5 percent. According to enabling legislation and amendments, the Bank will be converted to independent status when 51 percent of the Class A stock issued to the United States has been fully redeemed and retired.

On September 30, 2004 and 2003, in accordance with Bank Board resolution 2004-1 and 2003-2, the ninth and eighth redemption's of Class A stock, in the amounts of \$20.4 million and \$21.5 million occurred, leaving balances of \$388.3 and \$408.7 million outstanding, respectively.

Class A stock has a guaranteed annual dividend of 2 percent of the total funds received. Although Rural Development owns all Class A stock on behalf of the United States Government, the cash dividends are paid to the U.S. Treasury.

Capital Stock Class B

Class B stock, a voting class of stock, is issued only to borrowers of RTB, in proportion to actual loan advances. RTB requires borrowers to purchase Class B stock in the amount of 5 percent of advanced loan amounts. RTB may not pay cash dividends on Class B stock. Rather, holders of Class B stock are entitled to patronage refunds (paid in the form of Class B stock dividends) equal to the amount of patronage capital in excess of \$10 million. Patronage refunds are allocated on liquidating account loans, based on the ratio of interest revenue to RTB from each holder to RTB's total interest revenue from all liquidating account Class B stockholders. Stock subscriptions relating to unadvanced loans approximated \$60 million for both September 30, 2004, and 2003, and are not reflected in the accompanying principal financial statements.

Class B stock is nontransferable, except in connection with a transfer of ownership approved by RTB, of all or part of a RTB loan. Class B stock can be redeemed only after all shares of Class A stock, a nonvoting class of stock owned by the U.S. Government, have been redeemed and retired. A borrower may exchange Class B stock for Class C stock: 1) upon retiring all debt with RTB; or 2) effective November 9, 1999, prior to retiring all debt on a proportionate basis equal to the percentage of each note repaid. As of September 30, 2004, and 2003, B stock exchanges of \$239.9 million and \$198.6 million under the latter method have occurred, respectively.

Capital Stock Class C

Class C stock, a voting class of stock, is issued only to RTB borrowers, or to corporations and public entities eligible to borrow from RTB under Section 408 of the RE Act as amended, or by organizations controlled by such borrowers, corporations, and public entities. RTB may pay cash dividends on Class C stock.

Restricted Capital

The Omnibus Budget Reconciliation Act of 1987 required the RTB to establish a contingency reserve for interest rate fluctuations. As a result, the RTB Board of Directors amended the bylaws of RTB regarding the allocation of patronage capital and established a reserve of \$10 million. Any amounts

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NOTES TO THE FINANCIAL STATEMENTS

in the reserve for interest rate fluctuations, classified as Restricted Capital on the Balance Sheet, in excess of \$10 million will be allocated as Class B stock dividends to those borrowers holding Class B stock during the fiscal year the amounts were earned. At September 30, 2004 and 2003, Restricted Capital was \$10 million for both years.

Patronage Capital Earned

Patronage Capital Earned consists of all revenues of the RTB for any fiscal year in excess of the amount thereof necessary to:

- Pay expenses of the RTB, including without limitation, payments in lieu of property taxes.
- Pay interest on telephone debentures accruing during the fiscal year.
- Provide reasonable allowances for depreciation, obsolescence, and losses on loans and interest receivable.
- Pay to the holders of Class A stock an amount equal to 2 percent per annum of the capital furnished to the RTB for such stock.
- Pay to the holders of Class C stock dividends at the rate determined by the Board, provided the following criteria is met:
 - No dividends shall be declared on Class C stock until arrearages, if any, on payments to holders of the cumulative Class A stock have been paid.
 - Until all Class A stock has been retired, the Board shall not declare any dividends on Class C stock at an annual rate in excess of the then current average rate payable on the RTB's telephone debentures.

Cumulative Results of Operations

Cumulative Results of Operations are allocated to the various components of Net Position based on the requirements of the RE Act. Specifically, current year results of operations are recorded as Patronage Capital Earned and redistributed to the Class B stock and Restricted Capital accounts. Cash dividends are paid out of Cumulative Results of Operations.

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NOTES TO THE FINANCIAL STATEMENTS

NOTE 10: EARNED REVENUES

Amounts presented in dollars.

	<u>2004</u>	<u>2003</u>
<u>Intragovernmental Earned Revenue</u>		
Interest Revenue from Treasury	\$ 72,828,481	\$ 62,598,854
<u>Earned Revenue from the Public</u>		
Interest and Penalties Revenue	<u>50,995,392</u>	<u>69,762,007</u>
Total Earned Revenues	<u>\$ 123,823,873</u>	<u>\$ 132,360,861</u>

NOTE 11: APPORTIONMENTS CATEGORIES OF OBLIGATIONS INCURRED

Direct obligations incurred as of September 30, 2004 and 2003, is approximately \$213 million and \$231 million, respectively. For FY 2004, \$170 million was apportioned for direct loans and \$43 million was apportioned for Treasury interest expense and reestimates; and for FY 2003, \$203 million was apportioned for direct loans and \$28 million was apportioned for Treasury interest expense and reestimates.

NOTE 12: AVAILABLE BORROWING/CONTRACT AUTHORITY, END OF PERIOD

The amount of Federal borrowing authority available as of September 30, 2004 and 2003, is approximately \$1,302 million and \$1,160 million, respectively.

NOTE 13: TERMS OF BORROWING AUTHORITY USED

Requirements for repayments of borrowings: Borrowings are repaid on Form SF 1151, Nonexpenditure Transfers, as maturity dates become due. For liquidating accounts, maturity dates are fifty years from the close of the fiscal year the funds were advanced by Treasury to the Bank. For financing accounts, maturity is based on the period of time used in the subsidy calculation, not the contractual term of the agency's loans to borrowers. This period of time used in the subsidy calculation will normally be longer than the contractual term of the agency's loans to borrowers.

Terms of borrowings used: In general, borrowings are for periods of up to fifty years depending upon the cohort. Interest rates on borrowings in the liquidating accounts were assigned on the basis of the Treasury rate in effect at the time of the borrowing. Interest rates on borrowings in the financing accounts are assigned on the basis of the Treasury rate in effect at the end of the year of loan

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disbursements. Since individual loans are typically disbursed over several years, several interest rates may be applicable to an individual loan. A single weighted average interest rate, which is adjusted each year until all the disbursements for the cohort have been made, is maintained. Prepayments can be made on Treasury borrowings in the liquidating and financing accounts without penalty.

Financing sources for repayments of borrowings: Included are reestimates and cash flows (i.e. borrower loan principal repayments), appropriations received in liquidating accounts for "cash needs", residual unobligated balances, where applicable, and other Treasury borrowings.

NOTE 14: PERMANENT INDEFINITE APPROPRIATIONS

Permanent indefinite appropriations are mainly applicable to liquidating accounts which have the ability to apportion them and for reestimates related to upward adjustments of subsidy in the program accounts. These appropriations become available pursuant to standing provisions of law without further action by Congress after transmittal of the Budget for the year involved. They are treated as permanent the first year they become available, as well as succeeding years. However, they are not stated as specific amounts but are determined by specific variable factors, such as "cash needs" for the liquidating accounts and information about the actual performance of a cohort or estimated changes in future cash flows of the cohort in the program accounts.

The period of availability for these appropriations is as follows: Annual authority is available for obligations only during a specific year and expires at the end of that time; Multi-year authority is available for obligations for a specified period of time in excess of one fiscal year; No-year authority remains available for obligation for an indefinite period of time, usually until the objectives for which the authority was made available are achieved.

Annual and multi-year authority expires for the purpose of incurring new obligations. However, the authority is available for adjustments to obligations and for disbursements that were incurred or made during the period prior to expiration, but not recorded. Unless specifically authorized in law, the period that the expired authority is available for adjustments to obligations or for disbursements is five fiscal years (beginning with the first expired year). At the end of the fifth expired year, the authority is "canceled". Therefore, the authority is not available for any purpose.

NOTE 15: LEGAL ARRANGEMENTS AFFECTING USE OF UNOBLIGATED BALANCES

- *Legal arrangements affecting the use of unobligated balances of budget authority:* The availability/use of budgetary resources (i.e., unobligated balances) for obligation and expenditure are limited by purpose, amount, and time.
- *Purpose:* Funds may be obligated and expended only for the purposes authorized in appropriations acts or other laws.

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- *Amount:* Obligations and expenditures may not exceed the amounts established in law. Amounts available are classified as either definite (i.e., not to exceed a specified amount) or indefinite (i.e. amount is determined by specified variable factors).
- *Time:* The period of time during which budgetary resources may incur new obligations is different from the period of time during which the budgetary resources may be used to disburse funds.

The time limitations on the use of unobligated balances are the same as those previously discussed in the last two paragraphs of the permanent indefinite appropriations footnote disclosure (Note 14).

Any information about legal arrangements affecting the use of unobligated balances of budget authority will be specifically stated by programs and fiscal year in the appropriation language or in the alternative provisions section at the end of the appropriations act.

**NOTE 16: EXPLANATION OF DIFFERENCES BETWEEN THE STATEMENT OF
BUDGETARY RESOURCES (SBR) AND THE BUDGET OF THE UNITED STATES
GOVERNMENT**

The 2006 Budget of the United States Government, with the Actual Column completed for FY 2004, has not yet been published as of the date of these financial statements. The Budget is currently expected to be published and delivered to Congress in early February 2005.

The 2005 Budget of the United States Government, with the Actual Column completed for FY 2003, was published in February 2004 and reconciled to the SBR. No reporting errors were found. However, legitimate differences did occur as described in the table below. The legitimate differences represent:

- Expired budgetary authority available for upward adjustments of obligations, which is excluded from the President's Budget Actual Column per OMB Circular No. A-11 but is included in the SBR.
- Amounts due to rounding.

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Reconciliation Between FY 2003 Statement of Budgetary Resources and the President's Budget

Amounts are presented in millions.

Applicable Line From SBR	Amount from SBR	Applicable Line From President's Budget	Amount from President's Budget	Legitimate Differences	Reporting Errors
Total Budgetary Resources (line 7)	\$1,435	Total budgetary resources available for obligation	\$1,433	\$2 expired	None
Total Status of Budgetary Resources (line 11)	\$1,435	Total new obligations, Unobligated balance expiring/withdrawn, Unobligated balance carried forward, end of year, and Unobligated balance available, end of year	\$1,433	\$2 expired	None
Outlays (line 15)	(\$229)	Outlays	(\$229)	None	None

NOTE 17: EXPLANATION OF RELATIONSHIP BETWEEN LIABILITIES NOT COVERED BY BUDGETARY RESOURCES ON THE BALANCE SHEET AND THE CHANGE IN COMPONENTS REQUIRING OR GENERATING RESOURCES IN FUTURE PERIODS ON THE STATEMENT OF FINANCING

Components requiring or generating resources in future periods represent upward/downward reestimates of credit subsidy expense. These subsidy reestimates are recognized expenses even though budgetary resources will be provided in a subsequent period. These credit subsidy reestimates are reported as liabilities covered by budgetary resources since the budget authority to fund the reestimates is permanent and indefinite and no further congressional action is required to provide the resources.