

Office of Inspector General

Audit of FCA's Financial Statements
Fiscal Year 2004



November 2004

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For the financial statements and related notes to each fiscal year's financial audit report, refer to FCA's Performance and Accountability Report (PAR) for that year. The PARs can be found at www.fca.gov/reports/performance_reports.html.

Farm Credit Administration

Office of Inspector General
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November 3, 2004

The Honorable Nancy C. Pellett
Chairman of the Board
Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090

Dear Chairman Pellett:

This letter transmits the report on the audit of the Farm Credit Administration's (FCA) financial statements for the fiscal year ended September 30, 2004. The Office of Inspector General (OIG) tasked Harper, Rains, Knight, and Company, P.A. (HRK), an independent accounting firm, to perform the audit. This letter also incorporates a summary of what I believe are the most significant management and performance challenges facing the agency as described in the OIG Semiannual Report to the Congress dated September 30, 2004.

HRK issued an unqualified opinion. HRK opined FCA's principal financial statements present fairly, in all material respects, the financial position of FCA as of September 30, 2004 and 2003, in conformity with generally accepted accounting principles. HRK issued two other reports. The report on the internal control noted no matters involving the internal control and its operation that HRK considered to be material weaknesses. The HRK report on compliance with laws and regulations does not note any instances of noncompliance. In our opinion, HRK's work provides a reasonable basis on which to render its opinion and we concur with the reports.

The task order required HRK to perform the audit in accordance with *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*. To ensure the quality of the work performed, the OIG:

- reviewed HRK's approach and planning of the audit;
- evaluated the qualifications and independence of the auditors;
- monitored progress of the audit;
- examined working papers; and
- reviewed the audit report.

As part of the Performance and Accountability Report, the Inspector General is required to provide an opinion on the most serious management and performance challenges facing the Agency. In the most recent Semiannual Report to Congress, I outlined major challenges confronting the Farm Credit Administration. These challenges fall into two general categories. First are the challenges related to the FCA's core mission of ensuring a dependable supply of credit to agriculture through the institutions it has chartered. These challenges are often shaped and influenced by events that are outside the control of the Agency. Second, but no less important, are those challenges related to the Agency's operations.

The Farm Credit System (FCS or System) is a single industry lender and is vulnerable to economic swings. While the System is presently sound, there are many challenges facing agriculture and rural America today that raise the question of whether there should be modifications to the Farm Credit Act (Act) in order to enhance agricultural and rural economies of the future.

As a financial regulator, FCA must maintain a flexible and responsive regulatory environment. FCA is pressed to test the limits of its flexibility within the bounds of the Act. The constraints of the Act may be part of the reason that one of the largest institutions recently announced it would be applying to terminate its charter. The FCA Board has faced pressures to consider loan syndications to be “participations” instead of “loans” to avoid certain provisions in the Act. The Board has faced similar issues related to preferred stock.

The FCA is challenged to balance the often competing demands of ensuring the FCS fulfills its public purpose, proactively examining risk in the regulated institutions both individually and systemically, and controlling the cost of the regulator. FCA’s challenge is more complex because it has become increasingly difficult to reconcile significant provisions of the Act with the realities of the agricultural industry, the business environment, and financial markets in the 21st Century. FCA management fully understands this challenge and the Chairman recently provided testimony to Congress that clearly identifies the challenge.

“What we learned is that we must maintain a flexible and responsive regulatory environment. And where appropriate, we should eliminate or revise regulations that unnecessarily impair the System’s activities.

However, the limits of that flexibility are currently being tested as the changes in agriculture and rural America have eclipsed the legislative parameters initially granted to the System. The mission-driven desire and sometime financially-driven need of the System to expand its operations, not only within agriculture but also to rural America presents some challenges within existing authorities.”

Human Capital—The OIG recommended FCA develop a human capital plan in March 2001. FCA management agreed to this recommendation, yet FCA still does not have a plan. The problem had been the lack of a consistent strategic approach to marshalling, managing, and maintaining human capital to maximize FCA performance and assure its accountability.

FCA has the opportunity to consider organizational approaches that recognize the reality of evolving technology, a changing workforce, and other environmental forces. For example, as competitive sourcing, electronic government (E-Government), financial management, and other initiatives lead to changes—how FCA meets its mission may need to change, including the skill sets it needs and how it organizes those skills to meet its mission.

FCA can also improve its performance by building commitment and accountability through involving and empowering employees. FCA staff and its leaders must understand the rationale for making organizational and cultural changes. Everyone has a stake in helping to shape and implement initiatives as part of the Agency’s efforts to meet current and future challenges. The cooperation of leaders and employees throughout the organization can lead to effective and sustained changes.

Agency management has made a renewed commitment to develop a human capital plan. Part of that commitment is evidenced by a study that the Chairman announced to FCA staff to evaluate the Agency’s needs over a five to seven year planning horizon. The Chairman plans to evaluate the examination function, the regulatory development function and then the functions that support these operations. This approach is promising because it is a methodical and cohesive strategy designed to produce measurable results addressing the human capital needs of the Agency. It is also promising because the Chairman has communicated her plans to all staff—building understanding of and commitment to the organization’s needs.

Agency Governance—The Act provides for a full time three-member Board. The Board members are appointed by the President and confirmed by the Senate. A small full-time Board presents a challenge in terms of defining the roles and responsibilities of the Board members relative to the governance of the Agency. The Board's rules of operation are a foundation for trust and shared expectations among Board members. A collegial Board founded on mutual trust and respect is essential to FCA's ultimate effectiveness.

The Chairman has taken action to address this challenge by sharing authority and tasking a Board member with the responsibility to lead the Board in its efforts on governance issues. This represents a positive and concrete commitment with accompanying resources to address this longstanding management challenge.

Strategic Planning—The FCA Board adopted a Strategic Plan a year ago. A change in chairmanship is an opportunity for management to refine strategies and alignment to ensure the Board's vision is accomplished.

The Board and Agency staff will face the significant challenge of refining performance measures to enhance a results oriented culture at FCA. The Agency will need to achieve a balance among results, public expectations, and employee issues. FCA should evaluate its performance measures to ensure that they challenge and stretch the organization. Performance measures can be a powerful tool to continue the push into a results-oriented organization. An effective performance management system fosters performance and accountability at the individual, organizational, and ultimately overall Agency levels.

Financial Management—Timely, accurate, and useful financial information is essential for making day-to-day decisions; managing the Agency's operations more efficiently, effectively, and economically; supporting results-oriented management approaches; and ensuring accountability on an ongoing basis. During September 2003, the Agency decided to reprogram funds and purchase a new financial system. Management originally scheduled implementation of the new system during FY 2004. However, implementation has been delayed until June 2005. OIG has noted significant improvements are needed in project management to successfully complete implementation.

Management's challenge is to bring yet another system on line at a reasonable cost to the FCA and concurrently leverage the system to deliver timely financial information critical for making well-informed management decisions. The challenge forces the Agency to develop new measures of financial management success. Financial management success goes far beyond an unqualified financial statement audit opinion. Measures such as delivering financial information that managers can use for day-to-day operations, and developing reports that capture the full cost of programs and projects can help bring about improvements.

Financial management represents a challenge that goes to the fiber of FCA's business operations and management culture. FCA needs to ensure that underlying financial management processes, procedures, and information are in place for effective program management. FCA already has information that is readily available. However, the Chief Financial Officer (CFO) seems to be stuck in controlling the distribution of the information. This type of information control serves as a roadblock to improved management. FCA needs to take steps to get information into the hands of managers. FCA will also need to improve managers' ability to use the information to measure, control, and manage costs, to manage for results, and to make timely and fully informed decisions about allocating limited resources.

Security and Disaster Preparedness—Recently, management has made significant strides towards improving its preparedness by acting on OIG suggestions for an expedited effort to prepare for an emergency. Management completed a Continuity of Operations Plan, conducted drills and revised procedures based upon those drills. The Agency's level of preparedness is improving but it remains a management challenge to continue to refine procedures to ensure that the Agency reduces its vulnerability to significant disruption in operations in the event of an emergency. The speed of change in the security environment will be a challenge for all government organizations. This is especially true and a

challenge for smaller organizations like FCA where an increased emphasis on physical and information security competes with program areas for limited budget funding.

Leveraging Technology—Information technology (IT) is a key element of management reform efforts that can help dramatically reshape government to improve performance and reduce costs. The Agency has recognized that in order to meet the constraints of its budget, it must be able to maximize its return on investment in technology. FCA's challenge is to establish effective mechanisms to ensure that current and future staff has the skills to use technology to operate in an efficient and effective manner.

Internally, there is an opportunity for IT to complement human capital initiatives to reformulate the work processes of FCA. In order for this to come about, FCA will need to invest in training and reward employees who are able to develop innovative approaches to accomplish Agency goals using technology.

Externally, E-Government offers many opportunities to better serve the public, make FCA more efficient and effective, and reduce costs. FCA has begun to implement some E-Government applications, including the use of the Internet to collect and disseminate information and forms. Here, FCA's challenge is to identify opportunities to develop partnerships with other agencies to develop joint E-Government strategies.

Respectfully,

/s/ Stephen G. Smith

Stephen G. Smith
Inspector General



INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

FARM CREDIT ADMINISTRATION
The Board and Office of Inspector General

We have audited the balance sheets of the Farm Credit Administration (FCA) as of September 30, 2004 and 2003, and the 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 FCA'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 statements contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 01-02, "Audit Requirements for Federal Financial Statements". These standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatements. 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 assets, liabilities, and net position of the Farm Credit Administration as of September 30, 2004 and 2003, and the net cost, changes in net position, budgetary resources, and reconciliation of net cost to budgetary resources for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the FY 2004 and 2003 principal financial statements of the FCA. The accompanying financial information, discussed below, is not a required part of the principal financial statements.

The Management Discussion and Analysis on pages 2-23; and the Required Supplemental Information on pages 70-71 is supplementary information required by the Federal Accounting Standards Advisory Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the information. However, we did not audit the information and express no opinion on it.

Harper, Rains, Knight & Company, P.A.

November 1, 2004



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**INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL**

FARM CREDIT ADMINISTRATION

The Board and Office of Inspector General

We have audited the Principal Statements (hereinafter referred to as "financial statements") of Farm Credit Administration (FCA) as of and for the year ended September 30, 2004 and 2003, and have issued our report thereon dated November 1, 2004. 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, Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements."

In planning and performing our audits, we considered FCA's internal control over financial reporting by obtaining an understanding of the agency'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, such as those controls relevant to ensuring efficient operations. The objective of our audits 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 agency'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 no matters involving the internal control and its operation that we considered to be material weaknesses as defined above.

With respect to internal control related to performance measures reported in the Performance report, 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 FCA, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Harper, Rains, Knight & Company, P.A.

November 1, 2004



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**INDEPENDENT AUDITOR'S REPORT
ON COMPLIANCE WITH LAWS AND REGULATIONS**

FARM CREDIT ADMINISTRATION
The Board and Office of Inspector General

We have audited the Principal Statements (hereinafter referred to as "financial statements") of the Farm Credit Administration (FCA) as of and for the year ended September 30, 2004 and 2003, and have issued our report thereon dated November 1, 2004. 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, Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements."

The management of FCA is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the agency's financial statements are free of material misstatement, we performed tests of its 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 FCA.

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

Under FFMIA, we are required to report whether the agency'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 no instances in which the agency's financial management systems did not substantially comply with the Federal financial management systems requirements, United States Government Standard General Ledger at the transaction level and applicable Federal accounting standards.

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

This report is intended solely for the information and use of the management of FCA, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Harper, Rains, Knight & Company, P.A.

November 1, 2004

R E P O R T

Fraud | Waste | Abuse | Mismanagement



FARM CREDIT ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

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