

Office of Inspector General

Audit of FCA's Financial Statements
Fiscal Year 2006



November 2006

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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
1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000



November 9, 2006

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 or Agency) financial statements for the fiscal year ended September 30, 2006. The Office of Inspector General (OIG) contracted with Harper, Rains, Knight, & Company, P.A. (HRK), an independent accounting firm, to perform the audit. This letter also incorporates a summary of what I believe are significant management and performance challenges facing the Agency. I also described these challenges in the OIG Semiannual Report to the Congress for the period ended September 30, 2006 (Semiannual Report).

HRK issued an unqualified opinion. HRK opined that FCA's principal financial statements present fairly, in all material respects, the financial position of the Agency as of September 30, 2006 and 2005, in conformity with generally accepted accounting principles. HRK issued two other reports. Its report on internal control noted no matters considered to be material weaknesses. The HRK report on compliance with laws and regulations does not note any instances of noncompliance. In the OIG's opinion, HRK's work provides a reasonable basis on which to render its opinion and we concur with their reports.

The contract with HRK required they perform the audit in accordance with "Government Auditing Standards" issued by the Comptroller General of the United States and 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 work papers; and
- reviewed the audit reports.

As part of the Agency's annual 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 Semiannual Report, I outlined substantive challenges confronting the Agency. These challenges fall into two general categories. First are the challenges related to the FCA's mission of ensuring a safe, sound, and dependable Farm Credit System (FCS or System) as a source of credit and related services to agriculture. Some of these challenges may be influenced by events that are outside the control of the Agency. Second, but no less important, are the challenges related to the Agency's operations.

Management and Performance Challenges

FCS - The System is a lender to a single industry, agriculture, and is therefore vulnerable to economic swings in that industry. Nevertheless, the FCS remains sound in all material respects. Earnings and capital levels have continued to strengthen and asset quality remains high. However, there are many aspects of agriculture and rural America today that raise the question of whether there should be modifications to the Farm Credit Act of 1971, as amended (Act), in order to enable the System to better serve agricultural and rural economies of the future.

The FCA and the System have a responsibility to inform Congress when there is a need to update the Act in order to ensure the FCS is able to provide constructive and sufficient credit and related services to agriculture into the future. Ensuring that Congress is so informed will require a consistency in approach and strategic thinking on the part of the Agency and the System to assist Congress in maintaining the Act as a dynamic and empowering vehicle for the ultimate benefit of America's farmers, ranchers, and other rural citizens.

FCA - The FCA must balance the often competing demands of ensuring the FCS fulfills its public policy purpose, proactively examining risk in the regulated institutions both individually and systemically, and controlling the cost of the regulator. FCA's challenge is complex because it has become increasingly difficult to reconcile significant provisions of the Act with the realities of the agricultural industry, the economic environment, and financial markets in the 21ST Century.

The Agency should anticipate that the System will seek broader powers through regulatory interpretations of the Act. At the same time, FCA should expect that the System's competitors will press for the Agency to be a strict interpreter of the Act. As a financial regulator, FCA must maintain a flexible and responsive, yet independent and objective, regulatory environment for the System.

Strategic Planning - The FCA Board adopted its 2004-2009 Strategic Plans in December 2003. Since adoption, the Agency has a new Chairman and a new Board member. The changes in top leadership provide an opportunity to revise the plan to ensure the Board's vision is accomplished. The challenge is to establish a strategic plan that is ongoing in nature and in pace with the Agency's environment. In 2005, the Board established a Strategic Planning Committee, one of three committees established to facilitate the Board's oversight responsibilities and communication between the Board and Agency staff. This committee has the potential to catalyze the strategic planning function and address this challenge.

The Board refined Agency performance measures in January 2005. FCA should evaluate its performance measures on an ongoing basis to ensure 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.

Agency Governance - The Act provides for a full-time three-member Board. Board members are appointed by the President and confirmed by the Senate. This small full-time Board presents a challenge in terms of defining the roles and responsibilities of Board members relative to the governance of the Agency. The Board must be able to engage in professional policy debate and set a sound course for 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 creating an environment at the Board level that promotes a constructive working relationship between Board members. Board members have made significant and obvious strides to remain current and knowledgeable in the dynamic agriculture, financial, and regulatory environments.

Human Capital - In March 2001, the OIG recommended FCA develop a human capital plan and FCA management agreed. Under Chairman Pellett's leadership, senior managers have focused on the challenge of marshalling, managing, and maintaining human capital to assure accountability and maximize FCA

performance. The Agency also made a significant investment in strategic studies in 2004 and 2005. The objective of the strategic studies was to create a picture of the System and the credit needs of rural America in 5 to 7 years and identify organizational and human capital opportunities to help FCA adapt.

Chairman Pellett's leadership in initiating the strategic studies, in reorganizing the Agency, and in emphasizing the importance of human capital has resulted in the completion of a comprehensive 5-year strategic human capital plan. The plan identifies five human capital goals and six human capital initiatives, including leadership continuity of which succession planning is an integral part.

A critical component in implementing the human capital plan is providing for management succession. Individuals with the potential to become managers should be identified, provided developmental opportunities, and, when appropriate, promoted to higher positions. This, as part of a human capital plan, should be linked to the Agency's Strategic Plan for long-term achievement of the Agency's mission.

FCA's challenge will be to implement the human capital plan to ensure organizational approaches that enable FCA to adapt to evolving technology, a changing workforce, and other environmental forces. In addition to achieving full transformation of the Agency's organization and processes, the way in which FCA meets its mission will be heavily dependent on quality of its human capital, having the appropriate skill sets, and how it organizes to meet its mission. A significant step in this direction was the completion of the 5-year strategic human capital plan.

Financial Management - Timely, accurate, and useful financial information is essential for:

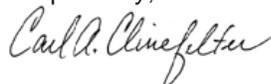
- making day-to-day decisions;
- managing the Agency's operations more effectively;
- supporting results-oriented management approaches; and
- ensuring accountability on an ongoing basis.

In April 2006, FCA outsourced accounting, financial reporting, contracting and procurement, and e-Travel functions to the Bureau of the Public Debt, Department of the Treasury. While the transition is still underway, its ultimate success will still need to be measured by whether the Agency and its managers are receiving timely service, useful financial reporting, and improved efficiencies. To measure this, the Agency will need to develop performance measures to assess the achievement of goals related to this outsourcing.

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. Internally, there is an opportunity to further strengthen how IT complements human capital initiatives to reformulate the work processes of FCA. There is also an opportunity to capture knowledge of employees who are approaching retirement. In this regard, the Office of Management Services has undertaken an initiative entitled Electronic Recordkeeping-Knowledge Management. The objective of this project is to develop an electronic system to manage the Agency's official records and to retain its critical institutional, technical, and operational knowledge.

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. FCA's ongoing challenge is to establish effective mechanisms to ensure that current and future members of staff have the skills to use technology to operate in an efficient, effective, and secure manner.

Respectfully,



Carl A. Clinefelter
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, 2006 and 2005, and the related statements of net cost, changes in net position, budgetary resources, and financing for the fiscal 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 statement audits 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." 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 assets, liabilities, and net position of the FCA as of September 30, 2006 and 2005, 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 fiscal year 2006 and 2005 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 2-25 and the Required Supplemental Information on pages 73-76 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.

Harper, Rains, Knight & Company, P.A.
November 3, 2006



HARPER, RAINS, KNIGHT
& COMPANY
*Certified Public Accountants
A Professional Association*

**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 the Farm Credit Administration (FCA) as of and for the fiscal years ended September 30, 2006 and 2005, and have issued our report thereon dated November 3, 2006. 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.

Harper, Rains, Knight & Company, P.A.
November 3, 2006



**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 fiscal years ended September 30, 2006 and 2005, and have issued our report thereon dated November 3, 2006. 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 three requirements discussed in the preceding paragraph. 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.

Harper, Rains, Knight & Company, P.A.
November 3, 2006

R E P O R T

Fraud | Waste | Abuse | Mismanagement



FARM CREDIT ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

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