Farm Credit Administration

1996

Annual Report

Contents

Message From the Chairman

This annual report covers the performance of the Farm Credit Administration (FCA) for the fiscal year (FY) October 1, 1995, through September 30, 1996. During the year, the Agency continued its progress in reducing costs, streamlining operations, and reducing regulatory burden. I am especially gratified that FCA was able to accomplish these improvements without compromising FCA's ability to oversee the safety and soundness of Farm Credit System (FCS or System) institutions. We also continued to place a high priority on creating innovative examination and supervisory programs that meet our needs as well as those of our customers, improving efficiency, and strengthening communications with all our constituencies.

In April 1996, the Board adopted a policy statement on association structure to provide greater flexibility to associations seeking to merge and to those associations affected by the mergers. In June 1996, the Board adopted a policy statement on disaster relief efforts, encouraging System institutions operating in disaster-affected areas to work to alleviate pressures on borrowers under stress. Also in June 1996, the Board reproposed regulations concerning customer eligibility and capital standards for FCS institutions. These regulations engendered much interest both from System institutions and their competitors. I personally believe that the mission of the Farm Credit System to finance the needs of American agriculture is as vital and important today as it was when the System was first established. Final passage of these regulations will help ensure the continuation of this important source of credit.

A major development in 1996 was the implementation of a Five-Year Staffing and Structure Plan. This effort was completed in response to my request for a comprehensive study of FCA's organizational, functional and staffing requirements. It has positioned the Agency to move smoothly into the next century with the right mix of positions and talent to accomplish the Agency's mission and strategic plan.

We were pleased to see the enactment in February of the Farm Credit System Reform Act of 1996 (Reform Act) which provided some statutory relief to System institutions. Among other measures, it moved the mandatory examination cycle from 12 to 18 months and repealed a provision requiring a separate Board of Directors for the Farm Credit System Insurance Corporation. Both of these measures translate directly into cost savings for the System. The Reform Act also amended certain provisions relating to the Federal Agricultural Mortgage Corporation by removing hindrances to its operational flexibility and competitiveness.

This report demonstrates once again that FCA has had a successful year. I want to express my appreciation to the dedicated FCA employees who professionally and effectively handled their responsibilities during a stressful time. There will be more changes in the coming year as several senior managers and other key staff take on the challenges of retirement. We wish all of them well and we look forward with much enthusiasm to working with our new management team. I also want to thank my fellow Board Member Doyle Cook for his contibutions throughout this year. We remain committed to the mission of the FCA—promoting a safe and sound, competitive Farm Credit System.

Chairman
Farm Credit
Administration Board

Farm Credit Administration Organization

Farm Credit Administration

The Farm Credit Administration (FCA or Agency) is an independent agency in the executive branch of the U.S. Government responsible for regulating and examining the banks, associations, and related entities that constitute the Farm Credit System (FCS or System). Initially created by an Executive order of President Franklin D. Roosevelt in 1933, the Agency now derives its powers and authorities from the Farm Credit Act of 1971, as amended (Act). FCA promulgates regulations to implement the Act and examines FCS institutions for compliance with applicable statutes, regulations, and safe and sound banking practices. If an institution is found to be in violation of these statutes or regulations or is operating in an unsafe or unsound manner, the Agency has several enforcement options at its disposal to bring about corrective action. In addition, FCA annually examines the National Consumer Cooperative Bank and its affiliate, the NCB Development Corporation, and presents the reports of examination to the U.S. Senate Committee on Banking, Housing, and Urban Affairs and the U.S. House of Representatives Committee on Banking and Financial Services.

The Agency has its headquarters in McLean, Virginia. It has two regional offices and field offices at its headquarters and in Marietta, Georgia; Denver, Colorado; Dallas, Texas; Sacramento, California; St. Louis, Missouri; and Bloomington, Minnesota.[1]

Marsha Pyle Martin, Chairman and CEO; Doyle L. Cook, Board Member.

Farm Credit Administration Board

FCA is managed by a full-time, three-person board appointed by the President with the advice and consent of the U.S. Senate. FCA Board members serve a 6-year term and may not be reappointed after serving a full term or more than 3 years of a previous member's term. The President designates one of the members as Chairman of the Board. The Chairman also serves as the Agency's chief executive officer. One position on the FCA Board is currently vacant.

Marsha Pyle Martin was appointed to the FCA Board and designated Chairman and Chief Executive Officer by President Bill Clinton on October 17, 1994; her term expires October 13, 2000. She brings to her position 34 years of experience in agriculture and agricultural finance. A Texas native, she joined the Federal Intermediate Credit Bank (FICB) of Texas in 1970 and in 1979 earned the distinction of being the first woman appointed to a senior officer position. During her career with the FICB of Texas and the Farm Credit Bank (FCB) of Texas, she gained broad management experience, providing leadership and direction for the bank's corporate relations, legal, operations and supervision, management information, human resources, marketing, and public and legislative affairs departments. She has held leadership positions with various agricultural councils and advisory committees in Texas, including the Texas Agricultural Loan Mediation Program Advisory Board, the Texas Department of Commerce Credit Advisory Committee, the

1. On April 2, 1996, FCA announced plans to close the regional offices in Denver, Colorado, and McLean, Virginia, and the field offices in Marietta, Georgia, and St. Louis, Missouri during fiscal year 1997.

Texas Agricultural Lifetime Leadership Board of Directors, and the Texas Agricultural Cooperative Council. In 1990, she received the Cooperative Communicators Association's highest honor, the H.E. Klinefelter Award, in recognition of her distinguished contributions to cooperative communications. In 1995, she was honored by the Board of Directors of the FCB of Texas as the individual who had made the greatest contribution to agriculture and farm credit in Texas and was named to the Academy of Honor in Agriculture. In 1996, she was presented the Distinguished Alumni Award by Texas Woman's University. She holds a B.A. from Texas Woman's University and an M.S. from Texas A&M University.

Doyle L. Cook was appointed to the FCA Board by the President on October 5, 1994, to a term that expires May 21, 1998. Mr. Cook also serves as Chairman of the Farm Credit System Insurance Corporation's (FCSIC) Board of Directors. He brings to this position 33 years of experience in agricultural lending, 19 of which were with various FCS institutions. Preceding his appointment to the FCA Board, Mr. Cook served as president and chief executive officer of the FCB of Spokane, an active participant on various committees of the banks of the FCS, a director of the Federal Agricultural Mortgage Corporation (Farmer Mac), and a member of the Chicago Mercantile Exchange Lender Advisory Committee. Previously, he served as president and chief executive officer of the Farm Credit Services of Mid-America, ACA; senior vice president for credit for the FICB of Texas; and senior vice president of the FICB of Louisville. He began his career with Ralston Purina, where he worked in credit, marketing, finance, and general management for 13 years before joining the FCS. Mr. Cook, a native of Star City, Arkansas, holds a B.S. in agricultural business and an M.S. in agricultural economics from the University of Arkansas.

Office Functions

The **FCA Board** is responsible for Agency policy, promulgation of regulations to implement the Act, and enforcement activities. It also provides for the examination and supervision of the FCS, including Farmer Mac, and oversees the FCS Building Association (FCSBA).

The **Office of Chief Operating Officer** manages the day-to-day operations of the Agency, supervises development and controls implementation of the Agency budget and operating plan, and serves as liaison to the FCA Board for development of regulations and Board policies.

The **Office of Examination** provides regulation and oversight of FCS institutions through examination, supervisory programs, and regulatory standards that promote safe and sound operations and ensure compliance with applicable laws and regulations; directs a program of examination policy formulation; and supports key headquarters and field operations.

The **Office of General Counsel** provides the FCA Board and staff with legal services. It supports the Agency in its supervision and examination of FCS institutions; development and promulgation of regulations; review of legislative proposals; prosecution and defense of civil litigation; enforcement of applicable laws and regulations; implementation and administration of conservatorships and receiverships; and oversight of Farmer Mac. It also fulfills the Agency's responsibilities under the Freedom of Information and Privacy Acts and provides guidance on general corporate, personnel, ethics, and administrative matters.

The **Office of Resources Management** provides administrative management and services to the Agency in the areas of fiscal, human, and information resources, and contracting and procurement. It also serves as liaison to the FCSBA.

The **Office of Policy Development and Risk Control** has primary responsibility for developing regulations and policy positions to implement applicable statutes and promote the safety and soundness of the FCS. It also processes regulatory approvals and manages the Agency's chartering and enforcement activities, provides economic and financial analyses to identify risks facing the FCS, and facilitates and guides FCA's strategic planning function.[2]

The **Office of Congressional and Public Affairs** coordinates and disseminates Agency information to Congress, FCS institutions, employees, Federal agencies, and others. It also develops and monitors legislation pertinent to FCA and FCS, serves as the Agency's congressional liaison, and prepares testimony for the Chairman and other Agency officials.

The **Office of Inspector General** provides independent and objective oversight of Agency programs and operations through audits, investigations, and the review of proposed legislation and regulations.

The **Office of Secondary Market Oversight** uses examinations, general rulemaking, and enforcement authority to provide for the general supervision of the safe and sound performance of Farmer Mac.

The **Secretary to the Board** processes all matters that go to FCA Board members, ensures compliance with public disclosure laws, and manages the day-to-day operations of the Office of the Board.

The **Equal Employment Opportunity** program provides leadership in an effort to achieve and manage a diverse workforce in FCA, encourages awareness of and respect for diversity in the workplace, and focuses on preventing employment discrimination and processing employee discrimination complaints.

Figure 1 on page 6 depicts FCA's organizational structure as of October 1, 1996.

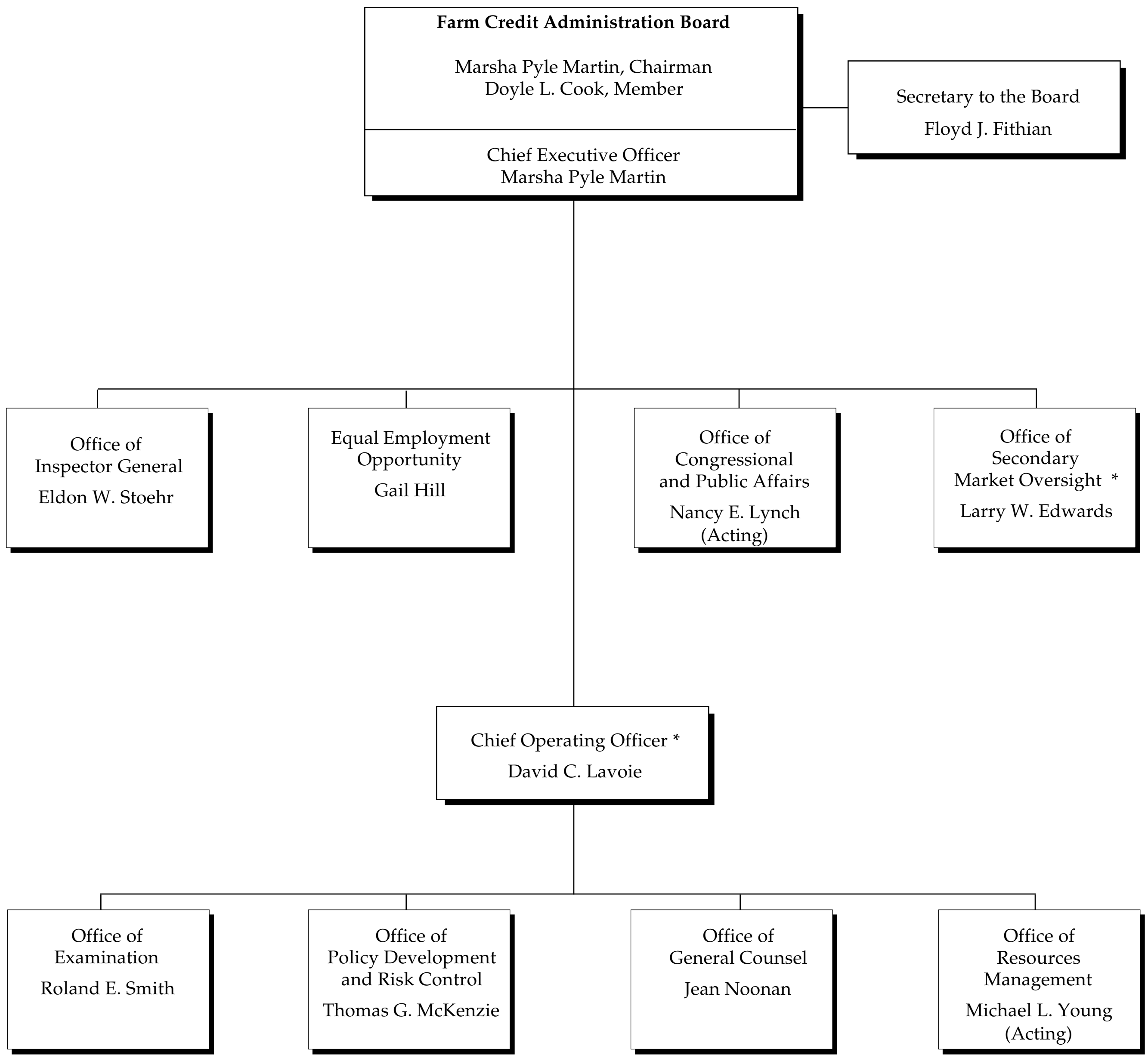
Officials[3]

David C. Lavoie	Chief Operating Officer
Roland E. Smith	Chief Examiner and Director, Office of Examination
Jean Noonan	General Counsel
Michael L. Young	Acting Director, Office of Resources Management
Thomas G. McKenzie	Director, Office of Policy Development and Risk Control
Nancy E. Lynch	Acting Director, Office of Congressional and Public Affairs
Eldon W. Stoehr	Inspector General
Larry W. Edwards	Director, Office of Secondary Market Oversight
Floyd J. Fithian	Secretary to the FCA Board
Gail Hill	Manager, Equal Employment Opportunity

2. The Office of Policy Development and Risk Control was formed on October 1, 1996, as a result of merging the Office of Special Supervision and Corporate Affairs with the Regulation Development unit, formerly part of the Office of Examination.

3. These officials and their positions are as of October 1, 1996, when the Agency implemented a new organizational structure that resulted in changes in several senior management positions.

Figure 1
Farm Credit Administration Organizational Structure
(As of October 1, 1996)



*** Reports to the Board for policy and to the Chief Executive Officer for administration.**

Overview of Organizations

Farm Credit System

The FCS is a network of borrower-owned cooperative financial institutions and related service organizations that serve all 50 States and the Commonwealth of Puerto Rico. These institutions specialize in providing credit and related services to farmers, ranchers, and producers or harvesters of aquatic products. Loans may be made to finance certain processing and marketing activities of these borrowers. Loans may also be made to rural homeowners (for housing); certain farm-related businesses; and agricultural, aquatic, and public utility cooperatives.

On September 30, 1996, there were 235 System banks and associations, consisting of the following:

- Six FCBs, which make direct long-term real estate loans through 69 Federal Land Bank Associations (FLBAs) and provide loan funds to 66 Production Credit Associations (PCAs), 55 Agricultural Credit Associations (ACAs), and 32 Federal Land Credit Associations (FLCAs). PCAs make short- and intermediate-term loans; ACAs make short-, intermediate-, and long-term loans; and FLCAs make long-term loans

- One Bank for Cooperatives (BC), which makes loans to agricultural, aquatic, and public utility cooperatives, and other persons or organizations owned by or having transactions with such cooperatives

- One Agricultural Credit Bank (ACB), which has the combined authorities of an FCB and a BC and provides loan funds to five ACAs. In addition, both the BC and the ACB are authorized to finance U.S. agricultural exports and provide international banking services for farmer-owned cooperatives.

The following FCS entities are also examined and regulated by FCA:

- The Federal Farm Credit Banks Funding Corporation (Funding Corporation) is an entity owned by FCS banks that markets debt securities the banks sell to raise loan funds

- The Farm Credit System Financial Assistance Corporation was chartered in 1988 to provide needed capital to the System through the purchase of preferred stock issued by System institutions that received financial assistance authorized by the FCS Assistance Board

- Farmer Mac guarantees the timely payment of principal and interest on securities representing interests in, or obligations backed by, pools of agricultural real estate loans

- Service corporations organized under Section 4.25 of the Act include the following:

  - The Farm Credit Finance Corporation of Puerto Rico uses tax incentives offered to investors to provide low-interest funding (other than that from the Funding Corporation) to the Puerto Rico Farm Credit, ACA

  - The Farm Credit Leasing Services Corporation provides equipment leasing services to eligible borrowers, including agricultural producers, cooperatives, and rural utilities

  - Farm Credit Financial Partners, Inc., provides support services to the associations affiliated with CoBank, ACB

  - AgCo Services Corporation is chartered to provide management information systems and electronic data processing services to CoBank, ACB, and AgAmerica, FCB, and its affiliated associations

- The FCSBA acquires, manages, and maintains facilities to house the headquarters and field offices of FCA. The FCSBA was formed in 1981 and is owned by FCS banks. However, oversight of its activities is vested in the FCA Board.

Farm Credit System Insurance Corporation

The FCSIC was established by the Agricultural Credit Act of 1987 to ensure the timely payment of principal and interest on insured notes, bonds, and other obligations issued on behalf of FCS banks and to act as conservator or receiver of FCS institutions. By ensuring the repayment of FCS securities to investors, FCSIC helps to maintain a dependable source of funds for farmers, ranchers, and other FCS borrowers. FCA Board members serve ex officio as the Board of Directors for FCSIC; however, the FCA Board Chairman may not serve as the Chairman of the FCSIC Board.

Farm Credit Administration Performance Report

Highlights of Operations

A key Agency objective in recent years has been to make continuous improvement in the strategic planning and implementation process. In fiscal year (FY) 1996, the FCA Board and senior management performed a comprehensive review of the Agency's Strategic Plan. As a result, the Agency's mission statement was modified to sharpen the focus on its regulatory role. In addition, the goals in the Strategic Plan were revised to reflect accomplishments that the Agency achieved in the past year as well as new developments in the operating environment.

The Agency's revised mission statement is as follows:

The Farm Credit Administration promotes a safe and sound, competitive Farm Credit System.

The FCA Board's vision for the Agency is that the FCA will continue to be a recognized leader in effective and efficient financial regulation. In keeping with this vision and to help guide operations, the Board adopted the following goals for the Agency to pursue during the period FY 1997–2001:

1. Minimize risk to the System's customer/shareholders, investors, and the Farm Credit Insurance Fund

2. Implement effective regulations and policies that impose minimal burden

3. Enhance FCA's effectiveness and cost efficiency

In addition to these goals, the Strategic Plan contains a number of strategies and specific action initiatives designed to ensure that the goals are met over the planning period.

During FY 1996, FCA management was successful in reducing Agency costs, streamlining operations, reducing regulatory burden, continuing the transition to a client/server computing architecture, and creating innovative examination and supervisory programs. While some of these initiatives were rooted in legislative developments, they also reflect the Agency's commitment to improve efficiency, strengthen communications with its constituencies, and become more customer focused. Meeting the needs of customers without compromising the safety and soundness of FCS institutions continues to be a high priority of the FCA Board.

A significant development in FY 1996 was the announcement of a Five-Year Staffing and Structure Plan (Staffing Plan). Among the actions implemented were the consolidation of the former Office of Special Supervision and Corporate Affairs and the Regulation Development unit of the Office of Examination (OE) into the new Office of Policy Development and Risk Control (OPDRC), a reduction in staff, and the announced closings of the OE regional offices and two field offices in FY 1997. The overall effect of the Staffing Plan was to reduce Agency staff by 10.5 percent in FY 1996.

During the year, regulatory burden was reduced by eliminating several policy statements, developing new guidelines for the issuance of bookletters, and identifying regulations that can be revised by incorporating them into new or existing regulation projects. Also, to promote more participation in the rulemaking process, the Agency published an Advance Notice on Proposed Rulemaking (ANPRM) on two occasions seeking comments on prospective regulations.

Studies were conducted during FY 1996 to evaluate risks from the drought in the Southwest, the sharp decline in cattle prices, and hedge-to-arrive contracts.[4] Although these developments elevated the risk profile of certain institutions in affected areas, safety and soundness concerns appeared to be manageable. However, the FCA will continue to monitor these situations closely to determine the likelihood of increased risk in these institutions.

In FY 1996, the FCA continued its implementation of a client/server computing architecture as the foundation for applying technology to improve Agency operations. This technology permits easier access to and use of information needed to accomplish FCA's mission. This improved technology will enable

4. Hedge-to-arrive contracts are a hybrid advance marketing tool, used by grain farmers and grain marketers, that may contribute to losses caused by an atypical supply-and-demand price reaction in 1996.

FCA to streamline the examination process, enhance efficiency and effectiveness, and share information among all headquarters and field staff.

In a continuing effort to improve communication, FCA Board members visited OE field offices as well as many FCS institutions, often as guest speakers. FCA also continued to sponsor meetings with board chairmen and presidents of FCS institutions. These meetings provided an opportunity for two-way communication on topics ranging from the Agency's internal operations to current regulatory issues. Furthermore, the Agency had opportunities to work closely with Congress by providing testimony and staff briefings on several issues. Much of the congressional communication related to H.R. 2029, the Farm Credit System Reform Act of 1996, which was signed into law by President Clinton on February 10, 1996. This legislation significantly reduced regulatory burdens on FCS institutions and provided Farmer Mac with new operational authorities. The Agency also worked with other Federal agencies on the joint issuance of a rule regarding flood insurance requirements. FCA responded to a large number of requests for information about its programs and operations and conducted a number of reviews based on borrowers' inquiries concerning possible violations of their borrower rights.

Agency management was successful in responding to findings and recommendations contained in audit reports issued by the Agency's Office of Inspector General (OIG). Excluding one report that was issued at the end of the fiscal year, the Agency resolved 98 percent of the OIG's outstanding recommendations during the fiscal year.

The Agency's financial statements for the year ended September 30, 1996, received an unqualified opinion. The auditors noted no material weaknesses in their report on the internal control structure of the Agency, which was reviewed for the purpose of expressing an opinion on the financial statements. However, the auditor's report on the Agency's compliance with laws and regulations disclosed two instances of noncompliance which are described on page 31. Management's response to the auditor's report begins on page 44.

Among the Agency's financial accomplishments in FY 1996 were the following:

- Refunded $3.1 million to FCS institutions, which includes a portion of prior years' assessments and the Agency's earned interest and miscellaneous income

- Continued to exercise effective controls over spending: the Agency's overall obligations were $2.3 million less than budgeted, even with additional obligations relating to the implementation of the Staffing Plan. The benefits and cost savings of implementing the Staffing Plan will be achieved in future years

- Continued to implement financial controls and procedures and respond to audit recommendations relating to the financial management system.

Performance Measures

In FY 1996, the FCA continued a project to develop performance measures for Agency operations. According to the Government Performance and Results Act (GPRA), a measurement system should focus on results or desired outcomes rather than traditional efficiency and financial measures to determine overall effectiveness. However, the latter are also important components of any measurement system.

During the year, the Agency researched performance measures concepts; benchmarked other Government agencies, as well as a private company; and devised a strategy to develop and implement performance measures at FCA. The project was divided into two phases. Phase I included the identification and evaluation of the Agency's primary desired outcomes and the development of some preliminary measures for those outcomes. The desired outcomes, which closely track the goals included in the Agency's Strategic Plan, are listed below:

1. Effective risk identification and corrective action
2. Effective regulation and public policy
3. Effective and efficient Agency administration
4. Effective external relationships

During Phase II, the Agency will develop additional measures that assess the effect of the strategies and actions included in the Strategic Plan. Further, the FCA will evaluate the Phase I preliminary measures in order to validate their appropriateness, identify needed data collection systems, and establish monitoring and reporting requirements. Although work on these steps will continue well into the future, the FCA will satisfy GPRA's initial requirements to provide a performance plan by the fall of 1997.

Regulations and Policy Statements

One of FCA's main responsibilities is to promulgate regulations to implement the Act. In addition, an important Agency goal is to reduce unnecessary regulatory burden. The following final and proposed regulations were adopted by the FCA Board during FY 1996.

Final Regulations

Regulatory Burden—The FCA Board adopted a final statement on regulatory burden in the second phase of an ongoing effort to reduce regulatory burdens on the System. This statement informed the public of regulations that the FCA will retain without amendment because they are necessary to implement or interpret the Act or to protect the safety and soundness of the System. The FCA also identified pending or future actions that will respond to the remaining regulatory burden issues. (Adopted November 16, 1995; published November 24, 1995 (60 FR 57913); effective November 24, 1995)

Director Elections—The FCA Board adopted a final rule amending 12 CFR Parts 615 and 620 to allow greater flexibility in the method for electing directors of System associations and a bank for cooperatives, consistent with cooperative principles. The amendments permit regional election of directors. (Adopted November 16, 1995; published November 24, 1995 (60 FR 57919); effective January 2, 1996)

Global Debt—The FCA Board adopted as final without change an interim rule amending 12 CFR Part 615 that clarifies the Funding Corporation's statutory authority to use more than one fiscal agent to facilitate the sale of Systemwide debt securities. The rule permits the Funding Corporation to employ fiscal agents other than Federal Reserve Banks for issuance of dollar-denominated Systemwide debt securities in foreign capital markets. The rule recognizes the authority of the Funding Corporation to issue, sell, and distribute System debt securities on behalf of the FCS banks on a global basis and allows the banks to engage in debt marketing practices used by other Government-sponsored enterprises. (Adopted March 1, 1996; published March 25, 1996 (61 FR 12015); effective January 2, 1996)

Ten-Day Notification—The FCA Board adopted amendments to 12 CFR Part 614 governing disclosure of loan information. The FCA removed the requirement that System institutions give borrowers a 10-day prior notification of a change in the interest rate on their variable-rate loans and replaced it with a 10-day post notification for interest rate changes for administered-rate loans and a 30-day post notification for loans tied to an external index. The requirement to notify borrowers of a decrease in interest rate no later than the day of the decrease has been changed to the same standard as an increase. This action reduces the burden on institutions of a delay in interest rate changes while still providing borrowers with timely notice of a change. (Adopted March 12, 1996; published March 20, 1996 (61 FR 11303); effective May 3, 1996)

Farmer Mac Book-Entry Procedures—The FCA Board adopted a final rule adding a new Subpart S to 12 CFR Part 615 authorizing the issuance of Farmer Mac securities in book-entry format. Farmer Mac will use the Federal Reserve Banks' book-entry system in connection with the issuance and settlement of its unsecured debt securities and its guaranteed securities using substantially the same procedures as all other Government-sponsored enterprises. (Adopted June 13, 1996; published June 20, 1996 (61 FR 31392); effective June 13, 1996)

Foreign-Denominated Debt— The FCA Board adopted an ANPRM published on November 24, 1995 (60 FR 57963) to assist it in determining whether the issuance of System debt securities denominated in foreign currencies raises any unique safety and soundness concerns that need to be addressed through amendments to 12 CFR Part 615. The FCA Board subsequently gave notice, through a resolution of the ANPRM, that no amendments are planned as a result of the ANPRM concerning the proposed issuance of FCS securities denominated in foreign currencies by the Funding Corporation on behalf of the FCS banks. (Adopted August 28, 1996; published September 11, 1996 (61 FR 47829); effective August 28, 1996)

Flood Insurance—The FCA Board adopted a joint final rule with other Federal banking regulators amending Subpart S of 12 CFR Part 614 regarding loans in areas having special flood hazards. This action was required by statute to implement the provisions of the National Flood Insurance Reform Act of 1994, which requires the participation of the System in the National Flood Insurance Program. The joint final rule establishes new escrow requirements for flood insurance premiums, adds references to the statutory authority and the requirement for lenders and servicers to "force place" flood insurance under certain circumstances, enhances flood hazard notice requirements, sets forth new authority for lenders to charge fees for determining whether a property is located in a special flood hazard area, and contains various other provisions necessary to implement the National Flood Insurance Reform Act of 1994. (Adopted August 8, 1996; published August 29, 1996 (61 FR 45684); effective October 4, 1996)

Proposed Regulations

Loan Underwriting—The FCA Board adopted a proposed rule to amend 12 CFR Parts 614 and 619 relating to loan underwriting in response to comments received from the Board's initiative to reduce regulatory burden, streamline the regulations, and set clear minimum regulatory standards where practicable. The proposed regulations would require each institution to adopt loan underwriting policies and standards, eliminate unnecessary regulations, and make other changes to the regulations governing prudent credit administration, the lending authority of PCAs, and collateral evaluations. (Adopted March 12, 1996; published April 15, 1996 (61 FR 16403))

Other Financing Institutions (OFI)—The FCA Board adopted an ANPRM concerning potential revisions to the regulations in Subpart P of 12 CFR Part 614 that govern the funding and discount relationship between System banks and non-System OFIs. The ANPRM sought comments about how the OFI regulations could be revised to better implement the statutory provisions. Several interested parties advised the FCA that additional time was needed to prepare thoughtful responses to the questions in the ANPRM. For this reason, the FCA extended the comment period until August 30, 1996. (Adopted May 9, 1996; published May 17, 1996 (61 FR 24907); extension adopted July 11, 1996; published July 17, 1996 (61 FR 37230))

Capital Adequacy and Customer Eligibility—The FCA Board adopted proposed amendments (reproposed rule) to 12 CFR Parts 613, 614, 615, 618, 619, 620, and 626 governing the capital adequacy provisions and customer eligibility provisions for System institutions. The proposed rule adds core surplus and total surplus standards for System banks and associations and the Farm Credit Leasing Services Corporation (Leasing Corporation); adds a collateral ratio for banks; and adds procedures for setting higher capital standards for individual institutions and for issuing capital directives, when warranted. This rule also incorporates recent statutory amendments that expand eligibility for loans from a bank for cooperatives, and it implements the new authorities of System banks and associations to participate with non-System lenders in loans to similar entities. Subsequent to the closing of the comment period for the original proposal, the Farm Credit System Reform Act of 1996 was enacted, necessitating certain conforming changes in the rule. The reproposal also eliminates restrictions in the current eligibility regulations that are not required by the Act, and it makes other technical, clarifying, and conforming changes. (Adopted June 25, 1996; published August 13, 1996 (61 FR 42092))

Quarterly Report—The FCA Board adopted a proposed rule to amend 12 CFR Parts 620 and 630 governing the preparation, filing, and distribution of System bank and association reports to shareholders and investors. The proposal would implement the recent statutory amendment that eliminates the requirement that FCS institutions disseminate quarterly reports to shareholders. To further promote shareholders' access to timely information and full disclosure regarding adverse events affecting their institutions, the proposal would require that FCS institutions prepare and distribute a notice to shareholders when their permanent capital falls below the regulatory minimum standard. The proposal would also remove the requirement that banks present their financial statements on a combined basis with their related associations to ensure that the preparation of FCS institutions' financial statements is solely guided by generally accepted accounting principles. (Adopted August 28, 1996; published October 11, 1996 (61 FR 53331))

Policy Statements

During FY 1996, the FCA Board adopted or amended the following policies. In addition to these actions, the FCA Board terminated 11 policy statements and made technical amendments to 4 policy statements.

Rules for the Transaction of Business and Operational Responsibilities of the Farm Credit Administration Board—This FCA Board action amended Article VIII, Board Member and Related Expenses, of this policy statement. This amendment authorizes that expenditures incurred in connection with official functions may be reimbursed from the Representation and Reception Fund only in accordance with the statement of policy and consistent with decisions of the Comptroller General of the United States. "Official functions" include meetings and other contacts with the public for the purpose of explaining or furthering the Agency's mission. (Amended January 2, 1996)

Further, the FCA Board added informational memorandums to the section of this policy statement entitled "Documents Which Are Mailed in Mass to Farm Credit Institutions Which Do Not Have To Be Reviewed by the FCA Board Prior to Distribution." Informational memorandums are communications that do not communicate Agency policy or legal interpretations; substantive Agency positions on examination, corporate, or accounting issues; or no-action positions. (Amended August 26, 1996)

Association Structure—This policy allows unlike associations whose territories are not identical to submit merger proposals to the FCA for consideration when such mergers promote efficiencies, result in viable financial institutions, and have minimal adverse effect on other FCS institutions. Should a nonexclusive charter be issued under this policy, the FCA Board would consider applications from affected associations to convert to an ACA or to propose an alternative acceptable to FCA. This policy supersedes the November 21, 1988, FCA Board Policy Statement on Granting Nonexclusive Charters to Associations and the January 6, 1989, FCA Board Policy Statement on Section 411 Mergers Resulting in Nonexclusive Charters. (Adopted April 23, 1996)

Disaster Relief Efforts by FCS Institutions—This policy provides guidance for FCS institutions in instances when specific sections of the country or segments of the agricultural community are declared to be disaster areas. When a disaster area includes a rural community where an FCS institution is located or does business, the institution may be affected by physical damage or incapacitation of employees and/or by damage to entities with loans from the institution. This policy encourages System institutions operating in disaster-affected areas to work within their communities to alleviate pressures on borrowers under stress. (Adopted June 13, 1996)

Examination

The OE conducted 257 examinations in FY 1996. Management has established criteria, including institution size and risk factors, for examinations beginning in FY 1997 to implement the 18-month cycle where appropriate. Conversely, the OE increases its examination presence in higher risk institutions. For instance, institutions with portfolios affected by the drought in the southern plains and those with exposure to losses from the use of hedge-to-arrive contracts may be subject to examination cycles much shorter than 18 months.

Examination resources are deployed on the basis of the level of risk in each institution. As part of this risk-based examination approach, off-site examinations continue to be conducted on low-risk institutions as evidenced by their capital, asset quality, management, earnings, and liquidity ratings. The off-site examination program allows the FCA to deploy its examination workforce in the most efficient way. The program, which began in FY 1993 with the completion of six off-site examinations of direct lender institutions, grew to 96 examinations in FY 1996. The FY 1996 total consisted of 38 examinations of direct lender institutions and 58 examinations of FLBAs, agent associations of FCBs.

The FCA rating system is similar to that used by other Federal banking regulators; however, it has been modified to reflect the nondepository nature of FCS institutions. The ratings are on a scale of 1 to 5, with a 5 designating the most severe regulatory concern. A 5 rating means there is an extremely high immediate or near-term probability of failure. A rating of 3 means an institution exhibits a combination of financial, management, operational, or compliance weaknesses ranging from unsatisfactory to moderately severe. A 1 rating means an institution is basically sound in every respect. The percentage of FCS institutions rated 3 has dropped considerably during the past several years. There are currently no institutions rated 4 or 5. On September 30, 1996, institutions rated 1 or 2 represented 94.5 percent of all rated System institutions.

To enhance examination focus, the OE has established certain specialized examination functions with pertinent formal training. For instance, positions have been established in the field offices for examiners with special expertise in capital markets. These examiners receive ongoing training related to interest rate risk and its measurement, asset pricing, investments, liquidity, and derivative products. Field office positions have also been established for information systems (IS) examiners. IS examiners are specially trained to evaluate technical areas related to computer technology and information systems. Following appropriate training and experience, IS examiners are required to pass the independently administered Certified Information Systems Auditor examination. Additionally, the OE is establishing a quality assurance position for examiners in each of the field offices. These examiners will be responsible for ensuring that quality control in the examination process is maintained as the OE closes its regional offices and streamlines its operations. Beyond these specialty areas, the OE's training philosophy emphasizes an examination staff trained in a variety of core examination areas.

The OE has also instituted several internal projects to improve operating efficiency and to enhance risk evaluation. One of these projects is currently evaluating ways to directly access loan account information systems at FCS institutions. A related project aims to establish a uniform system to identify and respond to deteriorating trends in 1- and 2-rated institutions. These projects could significantly improve the Agency's ability to foresee and counteract risks to the System.

Enforcement

Agency staff, with the FCA Board's approval, apply appropriate enforcement measures to FCS institutions operating in an unsafe or unsound manner or violating applicable laws or regulations. FCA has various forms of enforcement authority it can use to ensure that the operations of FCS institutions are safe and sound and comply with statutes and regulations. This authority includes the power to issue agreements and orders to cease and desist; levy civil money penalties; and suspend, remove, or prohibit officers, directors, and any other persons from participating in the conduct of the affairs of FCS institutions. Once enforcement actions have been taken, the OPDRC, in conjunction with the OE, oversees the performance of the FCS institutions to ensure compliance with the terms of the enforcement actions.

The number of problem institutions and the level of enforcement activity continued to decline during FY 1996. In addition to an improved agricultural economy, this trend reflects the Agency's efforts to reduce the risk to FCSIC, FCS institution customer/shareholders, and investors in FCS obligations. During FY 1996, the Agency issued four supervisory letters and four followup letters to institutions operating under existing enforcement actions. No orders to cease and desist or agreements were executed.

The improving financial and credit conditions of FCS institutions, coupled with satisfactory compliance with existing enforcement actions, resulted in the Agency's terminating such actions on eight institutions during FY 1996. At the end of FY 1995, 12 FCS institutions with aggregate assets of $7.4 billion were under some form of enforcement action. At the end of FY 1996, six institutions with $927 million in assets were under enforcement action. As of September 30, 1996, no institutions were in receivership.

Corporate Activity

During FY 1996, the FCA Board approved seven corporate applications, consisting of three association mergers, one reaffiliation of an association to another FCB, and three association charter amendments for name changes and/or headquarters relocations. Figure 2 on page 17 depicts the chartered territories of FCS banks.

Audits and Investigations

During FY 1996, the OIG issued seven audit reports, listed below. In addition to these audits, the OIG contracted with the independent accounting firm of Urbach Kahn & Werlin PC to audit FCA's financial statements for the year ended September 30, 1996. The final audit report, included as part of this annual report, was issued on November 27, 1996.

Audits

The OIG staff performed and issued reports for the following audits:

- Value Engineering (Audit A95-06)
- Office of Secondary Market Oversight (Audit A95-03)
- Loan Participation Requirements Bookletter (Audit A96-05)
- FCA's Practices Versus FCA's Expectations of Farm Credit System Institutions (Audit A96-01)

The OIG contracted for the following audits:

- Blue Cross/Blue Shield's Management and Reporting of FCA's Rate Stabilization Reserve Fund (A94-04)
- FY 1995 Financial Statements (A95-08)
- Audit of FCA's EDP Systems Migration Strategy (Audit A96-02)

The OIG administers an ongoing survey of FCS institutions. The survey is designed to provide the FCA Board with feedback concerning FCA's examination and enforcement activities. A report of results is issued each year.

Summaries of audit reports are published in the OIG's Semiannual Report to the Congress. Copies of semiannual reports or the audit reports themselves may be obtained upon request from the OIG.

Investigations
OIG investigations focus on violations of law or misconduct by FCA employees and contractors as well as allegations of irregularities or abuse in FCA programs and operations. Four investigations were open at the beginning of FY 1996, with seven additional investigations opened during the year. Six investigations were closed during the year, and five remained open as of September 30, 1996. The six closed investigations did not result in any criminal referrals or administrative actions. The OIG Hotline (1-800-437-7322) is the primary vehicle used by Agency employees and the public to report fraud, waste, abuse, and mismanagement. The OIG received 132 Hotline calls during the year, and seven investigations were opened based on the information received through these calls. All Hotline calls are carefully evaluated, investigated, or referred, as warranted.

Oversight of the Federal Agricultural Mortgage Corporation

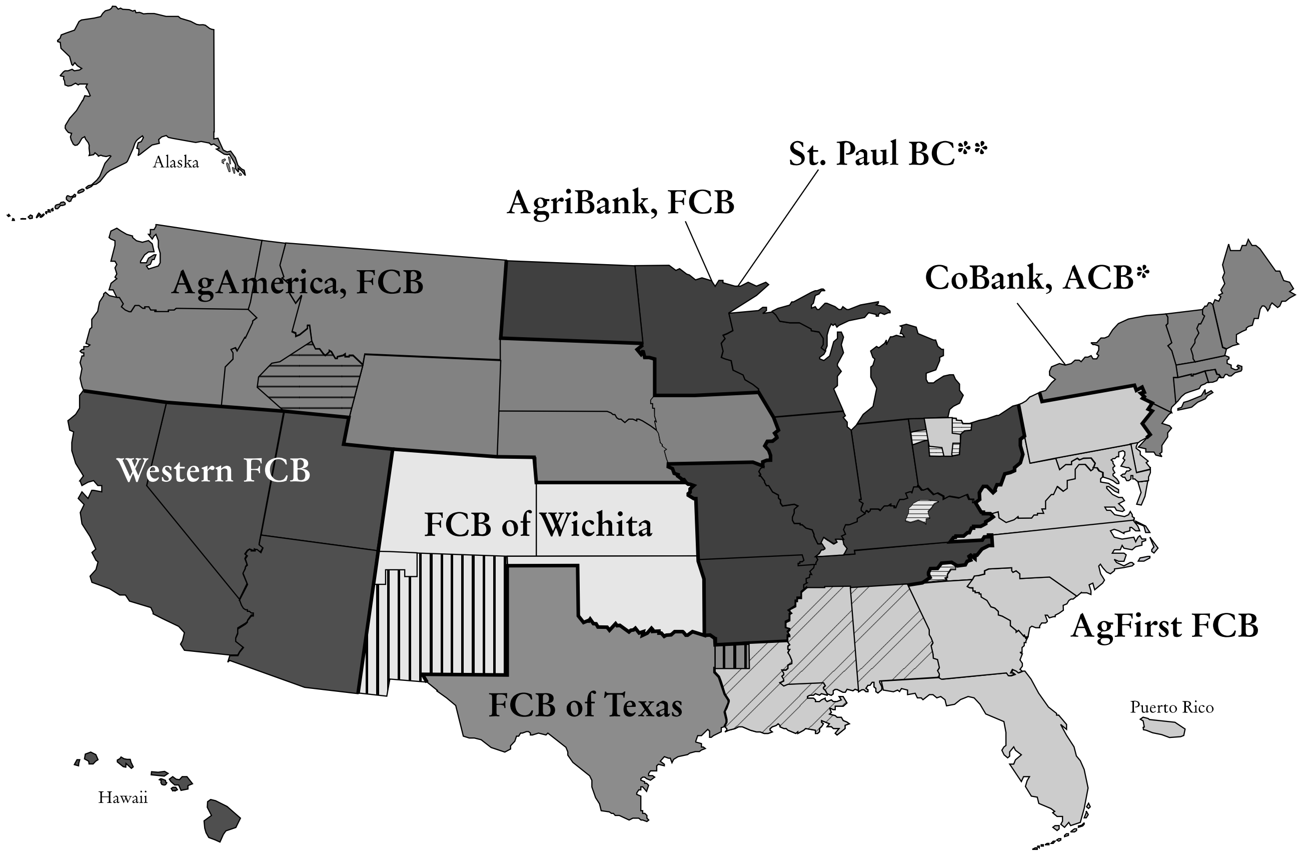
Farmer Mac is regulated by the FCA through the Office of Secondary Market Oversight (OSMO), which was established in 1992, as required by Public Law 102-237, to provide for the general supervision of the safe and sound performance of Farmer Mac. The statute prescribes that the OSMO be a separate office whose activities are generally carried out by individuals not responsible for the supervision of FCS institutions.

In addition to monitoring Farmer Mac business activities and conducting the annual examination, the OSMO was involved in implementing the provisions of the Farm Credit System Reform Act of 1996. In implementing this legislation, the OSMO developed regulations governing Farmer Mac access to the book-entry system of the Federal Reserve System; prepared regulations for a Farmer Mac receivership or conservatorship to be considered by the FCA Board early in FY 1997; and continued to research risk-based capital regulations. The OSMO also implemented a congressional request for joint monitoring of Farmer Mac's financial condition and operations by the FCA and the Department of Treasury. Finally, the OSMO conducted a special examination of the first Farmer Mac loan pool using authorities granted by the 1996 legislation.

Figure 2

Chartered Territories of Farm Credit System Banks

(As of September 30, 1996)



AgAmerica, FCB	Western FCB	FCB of Wichita	FCB of Texas	AgriBank, FCB	CoBank, ACB	AgFirst FCB
1 ACA	4 ACAs	22 FLBAs	47 FLBAs	11 ACAs	5 ACAs	39 ACAs
1 FLCA	12 FLCAs	18 PCAs	16 PCAs	19 FLCAs		1 PCA
1 PCA	11 PCAs			19 PCAs		

The Albuquerque and Eastern New Mexico PCAs are funded by the FCB of Texas. The Southern New Mexico PCA is funded by the FCB of Wichita.

The FLBAs in Alabama, Louisiana, and Mississippi generate and service loans for the FCB of Texas. The First South PCA is funded by AgFirst FCB.

The Northwest Louisiana PCA is funded by the FCB of Texas.

*The CoBank, ACB serves cooperatives nationwide and ACAs in the indicated area.

**The St. Paul BC also serves cooperatives nationwide.

The AG CREDIT, ACA (Ohio), Central Kentucky ACA (Kentucky), Chattanooga ACA (Tennessee), and Jackson Purchase ACA (Kentucky) are funded by the AgFirst FCB.

The Mid-America ACA, funded by AgriBank, FCB, is also authorized to lend in this territory.

The Eastern Idaho ACA is funded by the Western FCB.

Farm Credit Administration Annual Financial Report

September 30, 1996

Farm Credit Administration

Office of Inspector General
1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4030

November 27, 1996

The Honorable Marsha P. Martin
Chairman of the Board
Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090

Dear Ms. Martin:

This report presents the opinion on the Farm Credit Administration's (FCA) Principal Statements for the fiscal years ended September 30, 1996 and 1995. Reports on the FCA's internal control structure and on its compliance with applicable laws and regulations are also provided.

The Office of Inspector General (OIG) contracted with Urbach Kahn & Werlin, PC (UKW), Certified Public Accountants, to perform the audit. To fulfill our audit responsibilities under Government Auditing Standards and FCA PPM 100 for ensuring the quality of audit work performed, we monitored the progress of the audit, reviewed supporting workpapers and performed other procedures deemed necessary to ensure compliance with Government Auditing Standards.

It is the opinion of UKW that the FCA's Principal Statements present fairly, in all material respects, the financial position of FCA as of September 30, 1996 and 1995, and the results of its operations and changes in net position, and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The UKW report on internal control structure disclosed no material weaknesses in internal controls; however, it did disclose conditions existing during fiscal year 1996 which UKW considered to be reportable. Specifically, UKW reported that 1) FCA's core financial management system does not comply with standards and lacks properly designed controls and 2) the controls within property management need improvement.

The UKW report on compliance with laws and regulations disclosed two instances of noncompliance with applicable laws and regulations that are required to be reported under Government Auditing Standards. Specifically, UKW reported that interest due under the Prompt Pay Act was not paid by FCA and material nonconformances of FCA's core financial management system were not reported in FCA's annual FMFIA assurance letter. UKW's consideration of these instances of noncompliance does not affect their opinion that the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

The fiscal year 1996 financial statement audit was conducted in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. The Principal Statements were prepared in accordance with generally accepted accounting principles.

The FCA's management is responsible for preparing the Annual Financial Statements in conformity with applicable standards, establishing and maintaining internal controls and systems, and complying with applicable laws and regulations.

During the course of its audit, UKW identified other matters which are not reportable but nevertheless warrant management's attention. These are being communicated in a separate letter for management's consideration.

Sincerely,

Patricia Wensel for

Eldon W. Stoehr
Inspector General

Farm Credit Administration
Report of Management

The accompanying financial statements and related financial information appearing throughout the 1996 Annual Financial Report (Report) have been prepared by management of the Farm Credit Administration (Agency) in accordance with generally accepted accounting principles appropriate in the circumstances. Amounts which must be based on estimates represent the best estimates and judgments of management. Management is responsible for the integrity, objectivity, consistency, and fair presentation of the financial statements and financial information contained in this Report.

Management maintains and depends upon an internal accounting control system designed to provide reasonable assurance that transactions are properly authorized and recorded, that the financial records are reliable as the basis for the preparation of all financial statements, and that the assets of the Agency are safeguarded. The design and implementation of all systems of internal control are based on judgments required to evaluate the costs of controls in relation to the expected benefits and to determine the appropriate balance between these costs and benefits. The Agency's Inspector General performs various audits of the accounting systems and internal controls. Audit reports including appropriate recommendations are made to the Board of Directors.

The financial statements have been examined by independent public accountants whose report appears elsewhere in this Report. In addition, in planning and performing the audit of the Agency's financial statements, the independent public accountants obtained an understanding of the internal control structure and assessed the control risk in order to determine their audit procedures for the purpose of expressing their opinion on the financial statements. Their report on the internal control structure appears elsewhere in this Report.

The financial statements, in the opinion of management, fairly present the financial condition of the Agency. The undersigned certify that the 1996 Annual Financial Report has been prepared in accordance with all applicable statutory or regulatory requirements and that the information contained herein is true, accurate, and complete to the best of our knowledge.

David C. Lavoie
Chief Operating Officer

Michael L. Young, Acting Director
Office of Resources Management

Thomas J. Holland, Chief
Fiscal Resources Division

Management Discussion and Analysis

The following commentary reviews the financial condition and results of operations of the Farm Credit Administration (FCA or Agency) for the fiscal years (FY) ended September 30, 1996, and September 30, 1995. This information should be read in conjunction with the financial statements, notes to the financial statements, and other sections of this annual financial report.

Summary

Operating expenses for FY 1996 were $36.1 million, a decrease of 8.6 percent from FY 1995 expenses. In FY 1996, the Agency had expenses in excess of revenues of $540,000, compared with expenses in excess of revenues of $778,000 in FY 1995. Revenues for FY 1996 were $35.5 million, compared with $38.7 million in FY 1995. The Agency's budgetary obligations for FY 1996 were $2.3 million less than the $38.1 million approved by the FCA Board. The differences between obligations and operating expenses is primarily due to timing and is further explained in the notes to the financial statements. Also a reconciliation of budget and actual expenses is provided in the body of the report. The Agency derived almost all its revenue from assessments, interest income and reimbursable activity.

Cash, Cash Equivalents, Investments, and Cash Flow

The Agency does not have borrowing authority from the U.S. Treasury. Almost all Agency cash is derived from assessments, reimbursable activity, and interest income. Cash over and above that needed to fund the operation of the Agency is refunded to Farm Credit System (System) institutions. The Agency is authorized to invest in public debt securities and securities suitable to its needs. Cash to be received from FY 1997 assessments and reimbursable activity is based on the FCA Board-approved budget and is expected to be adequate to fund the operations of the Agency.

Included in cash and cash equivalents are cash and investments with an average maturity date of 31 days or less. Investments with maturities of greater than 31 days are classified as investments in the Statement of Financial Position. Cash and cash equivalents at the end of FY 1996 were $4.3 million less than that at the end of FY 1995. The primary reasons for the change include the results of normal operations, a reduction in the amount of prepaid assessments received, as well as the increase in investments with maturities of greater than 31 days in the amount of $2.2 million.

In addition, the Agency received $113,000 in payment of the final amounts due from a health insurance rate stabilization fund related to an FCA health plan that was canceled in FY 1993.

Property and Equipment

At the end of FY 1996, net property and equipment amounted to $743,000, a decrease of $257,000 from the $1 million at the end of FY 1995. This decrease was primarily a result of depreciation recorded during the year in the amount of $481,000 offset by the purchase of computer hardware and software and copy machines. The purchase of the computer equipment is related to the continued implementation of the new client/server computing architecture that will modernize the Agency's information systems by replacing outdated technology and processes and will result in future cost savings.

In accordance with the provisions of the Farm Credit Act of 1971, as amended, the Agency occupies facilities furnished by the FCS Building Association, a service corporation owned by the System. Because these facilities are provided at no cost, the financial statements of the Agency do not reflect assets of land or buildings, nor do the results of operations reflect rent expense. If the Agency were charged for facilities, the results of operations for FY 1996 and FY 1995 would have reported rent expense of $3.3 million and $3.1 million, respectively.

Accounts Payable

Accounts payable at the end of FY 1996 decreased to $488,000, from the $3.7 million reported at the end of FY 1995. The decrease is primarily the result of the liquidation of the $2.5 million liability paid to the Office of Personnel Management that allowed a number of retirees and employees to enter the Federal Employees Health Benefits (FEHB) program. The remaining decrease is related to the timing of invoice receipts and disbursements.

Accrued Payroll, Benefits, and Annual Leave

The amount of accrued payroll and benefits increased by $598,000 from that outstanding at the end of FY 1995. Balances in these accounts are a result of timing between recognition of expenses and their actual payment. The FY 1995 balance represented approximately one full pay period, while the 1996 balance represents one full pay period accrual plus an estimate for severance payments and voluntary separation incentive payments (VSIPs). These severance payments and VSIPs are related to the anticipated reduction in staff as a result of the Agency's Five-Year Staffing and Structure Plan (Staffing Plan) that was implemented during FY 1996.

The increase in the accrued annual leave liability represents the net increase in the amount due to employees for annual leave earned but not yet taken reduced by lump sum leave payments to employees who have left the Agency.

Other Accrued Expenses

The $1.5 million increase in the liability for other accrued expenses from the $419,000 reported in FY 1995 is largely a result of the accrual of employee moving expenses. As part of the Staffing Plan, certain employees are being moved because of resource needs and workloads that reflect, among other things, structural changes taking place in the System.

Due to System Institutions

The amount due to System institutions is the difference between (1) the amounts received from assessments and other reimbursable activity, interest, and other income and (2) the amount needed by the Agency to fund budgetary obligations and maintain necessary reserves. The balance outstanding at the end of FY 1995 was refunded to assessed institutions during FY 1996. The balance outstanding at the end of FY 1996 will be refunded during FY 1997.

Prepaid Assessments

Certain System institutions historically prepay part of their first quarter fiscal year assessment, which is due by the beginning of the fiscal year. The reduction of approximately $691,000 from the FY 1995 amount is a result of a reduction in the number of institutions that elected to prepay as well as a reduction in the amount of the first quarter assessment due.

Total Revenues

The Agency receives most of its revenue from assessments paid by System institutions and reimbursable activity. This revenue is available to pay the administrative expenses of the Agency and to fund the acquisition of fixed assets. Other revenue is received from interest earned on investments and other miscellaneous sources.

Total revenues for FY 1996 were $3.2 million less than FY 1995 revenues, reflecting the Agency practice of refunding to System institutions amounts in excess of those needed by the Agency for budgetary obligations. Revenue for a given fiscal year is recognized only to the extent necessary to offset net obligations incurred by the Agency during the year.

Interest income for FY 1996 was $174,000 less than FY 1995. This was chiefly a result of a decrease in the average rate of interest earned on cash equivalents and investments from 5.09 percent in FY 1995 to 4.97 percent in FY 1996 and a decrease in the average daily amount invested from $16.7 million in FY 1995 to $14.0 million in FY 1996. Other income recorded by the Agency was $22,000 higher than that recorded during FY 1995 and consisted primarily of increases in income from other miscellaneous sources.

Operating Expenses

Total operating expenses for the Agency in FY 1996 decreased by $3.4 million from the $39.5 million incurred in FY 1995. Although the staffing level dropped in FY 1996 as a result of implementing the Staffing Plan, the full benefit of that reduction will not be achieved until future years, primarily because of the expenses incurred in FY 1996 to implement the plan. These expenses—severance payments, VSIPs, and employee moving expenses—were greater than the reduction in salary and benefits that resulted from a reduced staffing level. Also affecting the change in benefits from FY 1995 to FY 1996 was the one-time charge of $2.5 million recorded in FY 1995 in connection with the legislation that allowed a number of retirees and employees to enter the FEHB program. The reduction in travel expenses of $366,000 from FY 1995 is a result of a decrease in travel costs and is attributed in part to an increase in the number of off-site examinations. The reduction in other operating expenses of $1.3 million is due primarily to the acquisition of computer hardware and software that took place in FY 1995 related to the migration to a client/server computing architecture.

INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

FARM CREDIT ADMINISTRATION
The Board and Office of Inspector General

We have audited the accompanying statements of financial position of Farm Credit Administration (FCA) as of September 30, 1996 and 1995, and the related statements of operations and changes in net position, and cash flows for the years then ended. These financial statements are the responsibility of 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 generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. 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 FCA as of September 30, 1996 and 1995, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 7, 1996 on our consideration of FCA's internal control structure and a report also dated November 7, 1996 on its compliance with laws and regulations.

Urbach Kahn & Werlin PC

Washington, DC
November 7, 1996

GOVERNMENT AUDIT AND CONSULTING GROUP
1444 Eye Street NW, Washington, DC 20005 (202) 296-2020 FAX (202) 223-8488
Worldwide Coverage through Urbach Hacker Young International

UK
S&W Urbach Kahn & Werlin PC
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL STRUCTURE

FARM CREDIT ADMINISTRATION
The Board and Office of Inspector General

We have audited the financial statements of Farm Credit Administration (FCA) as of and for the year ended September 30, 1996, and have issued our report thereon dated November 7, 1996.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of FCA is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of FCA for the year ended September 30, 1996, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted two matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgement, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions we noted are as follows:

GOVERNMENT AUDIT AND CONSULTING GROUP
1444 Eye Street NW, Washington, DC 20005 (202) 296-2020 FAX (202) 223-8488
Worldwide Coverage through Urbach Hacker Young International

FCA's core financial management system does not comply with relevant Office of Management and Budget standards and lacks properly designed controls: FCA's core financial management system, an off-the-shelf software system certified by the General Services Administration (GSA), contains significant weaknesses and limitations which have required agency management to develop additional external manual processes and controls. Recently documented cases of lost data and improperly processed transactions further demonstrate the lack of adequate controls within the system.

Specific deficiencies identified include:

- Inability to prepare required reports, including a budget execution report (SF-133);
- Manual data exportation procedures required for regular processing of data, to produce management reports;
- Inability to track and report performance measures which will be required under the Government Performance and Results Act;
- Inability to recover from interrupted postings without manual intervention;
- Inadequate automated interfaces with related financial applications resulting in limited integration;
- Inability to efficiently roll forward year end general ledger balances;
- Processing problems related to a platform upgrade;
- System weaknesses which require significant assistance and maintenance by EDP support staff with systems responsibility.

FCA has developed external controls to address many of the individual weaknesses and limitations of the system and we did not identify significant deficiencies in FCA's ability to provide timely financial information to management. However, we believe the overall instability and unreliability of the system, and the aggregate system control problems identified above, to be significant weaknesses in the current system's operations. FCA's strategic plan includes an initiative to convert the agency's current operating platform to one that does not readily support the operating system used by the core financial management system. It is our understanding that a new version of the system is available from the software manufacturer, however it is currently not known whether the new version will adequately address the system deficiencies. FCA's strategic plan also includes an initiative to redesign the financial management system which might include replacing the three year old system entirely.

We recommend FCA determine whether the new version is available as an upgrade to the current system, and whether weaknesses in the current system will be corrected in the upgrade version. If a cost-effective upgrade/conversion option from the software manufacturer is not available, we recommend FCA focus its strategic planning efforts on the replacement of the current system. In that instance, we recommend FCA expand its timeline and resources for assessing and documenting the requirements for a new financial management system to address current problems and any potential problems related to the network platform changes planned for 1997.

Inadequate segregation of duties over the property management system: As a result of recent staff reductions and reassignments, responsibility for maintaining FCA's property management system as well as supervisory responsibility for the annual property certification process is currently assigned to one Property Management Specialist within the Contracting and Procurement Office. In addition, approximately 900 assets (36% of all accountable assets) maintained in the property management system are assigned to the Contracting and Procurement Office with custodial responsibility assigned to the same Property Management Specialist.

UK
&W

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL STRUCTURE, CONTINUED

This lack of segregation of duties does not provide FCA with adequate assurance these assets are adequately safeguarded against loss or misuse. We recommend FCA assign the Property Management Specialist function to a department independent of the procurement function. We also recommend a separate independent department be responsible for the annual certification process.

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities 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.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to FCA's management in a separate letter dated November 7, 1996.

This report is intended for the information of the Board and the Office of Inspector General and management of FCA. However, this report is a matter of public record and its distribution is not limited.

Urbach Kahn & Werlin PC

Washington, DC
November 7, 1996

UK S&W Urbach Kahn & Werlin PC
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

FARM CREDIT ADMINISTRATION
The Board and Office of Inspector General

We have audited the financial statements of Farm Credit Administration (FCA) as of and for the year ended September 30, 1996, and have issued our report thereon dated November 7, 1996.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws and regulations applicable to FCA is the responsibility of FCA's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of FCA's compliance with certain provisions of applicable laws and regulations. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed the following instances of noncompliance that are required to be reported herein under *Government Auditing Standards*:

Interest due under the Prompt Payment Act not paid by FCA: There were approximately 500 payments to FCA vendors (out of approximately 5,000) which did not include interest due in accordance with the Prompt Payment Act (the Act). The Act requires federal agencies to pay interest on disbursements not made within thirty days from the date the invoice is received by the agency. Interest due, but not paid, as a result of these payments was approximately $6,000. As a result of this finding, FCA included an accrual for this interest liability in its financial statements for the fiscal year ended September 30, 1996. We recommend FCA ensure that system and management controls are in place to provide that future late payments include interest in accordance with the Act.

Material nonconformances of core financial management system not reported in annual FMFIA report: FCA's financial management system does not comply with the requirements of OMB Circular A-127, *Financial Management Systems* and the Joint Financial Management Improvement Program's Core Financial Management System Requirements. In its 1995 Federal Managers' Financial Integrity Act (FMFIA) report submitted during fiscal year 1996, FCA did not report a material noncompliance of the core financial management system in accordance with Section 4 of FMFIA. Although FCA has established compensating manual controls to address significant weaknesses of its core financial management system, we consider the deficiencies of the system, as discussed in the Report on Internal Control Structure, to be reportable as material nonconformances for FMFIA reporting requirements.

GOVERNMENT AUDIT AND CONSULTING GROUP
1444 Eye Street NW, Washington, DC 20005 (202) 296-2020 FAX (202) 223-8488
Worldwide Coverage through Urbach Hacker Young International

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS, CONTINUED

We considered these instances of non-compliance in forming our opinion on whether FCA's financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated November 7, 1996, on those financial statements.

This report is intended for the information of the Board and the Office of Inspector General and management of FCA. However, this report is a matter of public record and its distribution is not limited.

Urbach Kahn & Werlin PC

Washington, DC
November 7, 1996

FARM CREDIT ADMINISTRATION
STATEMENTS OF FINANCIAL POSITION

	September 30 1996	1995
ASSETS		
Cash and cash equivalents (Note 3)	$10,181,390	$14,508,304
Investments (Note 4)	2,228,204	–
Accounts receivable (Note 5)	283,081	227,804
Prepaid expenses	140,037	15,908
Health insurance fund (Note 6)	–	112,905
Life insurance fund (Note 6)	72,402	97,116
Net property and equipment (Note 7)	743,445	1,002,152
TOTAL ASSETS	$13,648,559	$15,964,189
LIABILITIES AND NET POSITION		
LIABILITIES		
Accounts payable (Note 8)	$ 488,222	$ 3,656,963
Accrued payroll and benefits	1,717,848	1,120,205
Accrued annual leave	2,242,342	2,230,191
Other accrued expenses	1,901,800	419,055
Due to System institutions (Note 9)	3,113,929	3,122,725
Prepaid assessments (Note 10)	3,435,046	4,125,939
TOTAL LIABILITIES	$12,899,187	$14,675,078
Commitments and contingencies (Note 13)		
Net position (Note 11)	749,372	1,289,111
TOTAL LIABILITIES AND NET POSITION	$13,648,559	$15,964,189

The accompanying notes are an integral part of these financial statements.

FARM CREDIT ADMINISTRATION
STATEMENTS OF OPERATIONS AND CHANGES IN NET POSITION

	For the Year Ended September 30 1996	1995
REVENUES		
Assessments and reimbursable revenue	$34,777,585	$37,780,108
Interest	702,261	875,996
Other	55,252	33,493
Total revenues	35,535,098	38,689,597
EXPENSES		
Salaries	24,279,054	25,302,882
Benefits	7,818,796	8,621,140
Travel	1,502,088	1,868,202
Other operating expenses	1,993,645	3,289,966
Depreciation expense	481,254	385,687
Total expenses	36,074,837	39,467,877
Excess expenses over revenues	(539,739)	(778,280)
Net position, beginning of year	1,289,111	2,067,391
Net position, end of year	$ 749,372	$ 1,289,111

The accompanying notes are an integral part of these financial statements.

FARM CREDIT ADMINISTRATION
STATEMENTS OF CASH FLOWS

	For the Year Ended September 30 1996	1995
CASH PROVIDED (USED) BY OPERATING ACTIVITIES		
CASH PROVIDED:		
Assessments and reimbursable revenue	$33,971,834	$35,565,878
Liquidation of health insurance rate stabilization fund	112,905	898,800
Interest on investments	664,608	849,931
Other revenues	55,252	46,897
Total cash provided by operating activities	34,804,599	37,361,506
CASH USED:		
Salaries and benefits	(31,457,955)	(31,076,295)
Travel	(1,570,338)	(1,778,709)
Cash paid to vendors	(3,684,733)	(2,918,247)
Total cash used by operating activities	(36,713,026)	(35,773,251)
Net cash (used) provided by operating activities	(1,908,427)	1,588,255
CASH FLOWS FROM INVESTING ACTIVITIES		
Payments for purchase of equipment	(222,548)	(1,082,095)
Purchase of investments	(2,195,939)	–
Net cash used in investing activities	(2,418,487)	(1,082,095)
Net (decrease) increase in cash and cash equivalents	(4,326,914)	506,160
Cash and cash equivalents, beginning of year	14,508,304	14,002,144
Cash and cash equivalents, end of year	$10,181,390	$14,508,304
CASH FLOWS FROM OPERATING ACTIVITIES		
Excess of expenses over revenues	($ 539,739)	($ 778,280)
Adjustments to reconcile excess of expenses over revenues to net cash (used) provided by operating activities:		
Depreciation	481,254	385,687
Amortization of discount on investments	(32,263)	–
Changes in:		
Accounts receivable	(55,277)	30,156
Prepaid expenses	(124,129)	14,712
Health insurance fund	112,905	885,761
Life insurance fund	24,713	5,139
Accounts payable	(3,168,741)	2,837,024
Accrued payroll and benefits	597,643	(62,661)
Accrued annual leave	12,151	108,732
Due to System institutions	(8,796)	(1,891,355)
Prepaid assessments	(690,893)	(353,132)
Other accrued operating expenses	1,482,745	406,472
Net cash (used) provided by operating activities	($ 1,908,427)	$ 1,588,255

The accompanying notes are an integral part of these statements.

Notes to Financial Statements

NOTE 1. ORGANIZATION AND MISSION

The Farm Credit Administration (FCA or Agency) is an independent agency in the Executive Branch of the United States Government. FCA is responsible for the regulation and examination of the banks, associations, and related entities that collectively comprise the Farm Credit System (System). Specifically, FCA is empowered to ensure safe and sound operations of all System institutions. Initially created by an Executive Order of the President in 1933, FCA now derives its power and authority from the Farm Credit Act of 1971, as amended (Act). The Act requires System institutions to be examined periodically by FCA. Management of FCA is vested in a full-time, three-person board whose members are appointed by the President with the advice and consent of the Senate.

The System is a nationwide network of borrower-owned lending institutions and specialized service organizations. System institutions consist of Farm Credit Banks, related associations, one Bank for Cooperatives, one Agricultural Credit Bank and other related entities. The institutions within the System provide credit and credit-related services to farmers, ranchers, producers and harvesters of aquatic products, rural homeowners, certain farm-related businesses, agricultural and aquatic cooperatives, rural utilities, and certain foreign and domestic entities in connection with international activities.

FCA operates under authorities conferred by the Act. The operations of FCA are financed by means of a revolving fund. This fund is reimbursed primarily from assessments received from System institutions examined by FCA. Institutions are assessed or otherwise charged directly and billed in accordance with a formula established by FCA regulations for services performed by FCA. All of FCA's administrative expenses are paid by the institutions it examines, regulates, or for which it provides reimbursable services. In accordance with FCA regulations, adjustments of the assessments paid shall be based on FCA's administrative operating expenses incurred in the applicable fiscal year, plus any funds required to maintain reserves pursuant to the Act. Historically, the amount credited has been based on the amount received by FCA, either from direct assessments, reimbursable activity, or other sources, compared to that obligated by FCA for operating expenses. In recent times, there have been no adjustments that resulted in additional charges to the institutions.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of accounting - The accompanying financial statements have been prepared in accordance with generally accepted accounting principles. FCA's transactions are recorded on the accrual basis of accounting. Under this method, revenues are recognized when earned to the extent that they will not be refunded to System institutions and expenses are recognized when liabilities are incurred, without regard to payment of cash. Certain amounts in prior year financial statements have been reclassified to conform to current financial statement presentation.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The Chief Financial Officers Act of 1990 (CFO Act) mandated certain Federal agencies to develop financial statements that provide information useful to Congress, Government officials, and the public. OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*, prescribes a framework for Federal agencies to develop financial statements. FCA is not mandated to adhere to the CFO Act. FCA management has, nevertheless, elected to develop financial statements and have those statements audited. FCA management further believes presentation under generally accepted accounting principles more fully discloses the Agency's financial position, results of operations and changes in net position, and cash flows. In this regard, a Statement of Budgetary Resources and Actual Expense is not included as one of FCA's principal statements. The relevant information for fiscal year (FY) 1996, however, is provided in the notes to financial statements.

Cash and cash equivalents - Cash and cash equivalents consist of cash and short-term, highly liquid investments with the U.S. Treasury for the purpose of managing excess funds. The market value of the short-term investments is equivalent to cost.

Investments - The FCA is authorized by the Act to invest in public debt securities with maturities suitable to the needs of the FCA. All investments are classified as held to maturity and carried at cost, adjusted for unamortized premiums or discounts. Premiums and discounts are amortized using the straight-line method (which approximates the interest method) over the term of the respective issues.

Property and equipment - As more fully disclosed under Note 7, property and equipment, including computer software, are recorded at cost, net of an allowance for accumulated depreciation. Repairs and maintenance costs are expensed as incurred. The straight-line method of depreciation is utilized to allocate the cost of property and equipment that generally cost $5,000 or more over their estimated useful lives, which approximate three years.

In accordance with the Act, FCA occupies buildings and uses land owned and leased by the FCS Building Association (Association), an entity owned by the banks in the System. While the Association is privately owned, oversight of its activities is vested with the FCA Board. FCA is not charged for the use of the buildings or land, owned or leased, and the Association is responsible for maintenance and repair of buildings and land improvements.

Postretirement benefits - Employees of FCA will become eligible for healthcare and life insurance benefits when they retire. Prior to FY 1996, certain employees and retirees of FCA participated in an FCA health plan. Statement of Financial Accounting Standard No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* would have required the accrual of the expected cost of providing benefits for those employees and retirees participating in the plan. However, with the termination of the FCA health plan, those benefits will now be provided to all of FCA's employees through a Federal retirement program. Accordingly, no liability has been accrued for employees.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

On October 21, 1995, the President of the United States signed legislation that allowed those employees and retirees covered by the FCA health plan to participate in the Federal Employees Health Benefits program (FEHB). The legislation covers individuals who on September 30, 1995, were covered by a health benefits plan administered by FCA. In 1995, FCA accrued a charge of $2.5 million (included in accounts payable at September 30, 1995), representing the estimated amount needed to settle its obligation relating to postretirement health benefits.

The $2.5 million was the estimate of the present value of its obligation as determined by the Office of Personnel Management (OPM) and was the amount FCA was obligated to pay to OPM in order for those employees and retirees currently covered by the FCA health plan to participate in FEHB. The payment was made to OPM in 1996. This payment relieved FCA of any obligations to provide postretirement health benefits to those employees and retirees.

Annual, sick, and other leave - Annual leave is accrued as a liability when earned, with an offsetting reduction for leave taken. The balance in the accrued annual leave account reflects current pay rates. Sick leave and other types of nonvested leave are expensed as the leave is taken.

Assessments - A substantial portion of FCA's revenues is based upon direct assessments billed to institutions of the System that are examined by FCA. FCA also recognizes revenues based on examination services provided by the Office of Examination. Direct assessments are derived using a formula established in FCA regulations and are based, in part, upon the overall financial health of the institution being assessed.

NOTE 3. CASH AND CASH EQUIVALENTS

Cash and cash equivalents consisted of the following:

	September 30	
	1996	1995
Revolving fund	$ 1,193,704	$ 1,736,322
Cash equivalents	8,987,686	12,771,982
	$10,181,390	$14,508,304

Interest income earned on cash and cash equivalents approximated $662,000 and $850,000 for FY 1996 and 1995, respectively.

NOTE 4. INVESTMENTS

The maturity, amortized cost and yield of the investment securities held at September 30, 1996, was as follows:

	September 30		
	Amortized Cost	Yield	Maturity
U.S. Treasury Securities	$2,228,204	5.49%	June 27, 1997

Interest income earned on long term investments was $32,263 during FY 1996.

NOTE 5. ACCOUNTS RECEIVABLE

Accounts receivable consisted of the following:

	September 30	
	1996	**1995**
Assessments due from other System entities and other assessed institutions	$196,863	$163,072
Intra-Government receivables for reimbursable services	76,991	51,721
Miscellaneous other receivables	9,227	13,011
	$283,081	$227,804

NOTE 6. HEALTH AND LIFE INSURANCE FUNDS

FCA health and life insurance rate stabilization funds were as follows:

	September 30	
	1996	**1995**
Health insurance fund	$ –	$112,905
Life insurance fund	72,402	97,116
	$72,402	$210,021

The health insurance stabilization fund was closed during FY 1996, and the balance in the fund was refunded to the Agency. Interest earned on these funds approximated $7,600 and $26,000 for FY 1996 and 1995, respectively.

NOTE 7. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following:

	September 30	
	1996	**1995**
Property and equipment	$2,146,811	$1,924,263
Less accumulated depreciation	(1,403,366)	(922,111)
	$ 743,445	$1,002,152

In accordance with the Act, FCA occupies buildings owned and leased by the Association. The FCA administrative headquarters building and land are located in McLean, Virginia. In addition, the Association leases office space for FCA regional facilities on behalf of FCA at various locations throughout the United States. Rent is provided at no cost to FCA.

NOTE 7. PROPERTY AND EQUIPMENT (CONTINUED)

Assuming FCA was charged market rates for the space provided by the Association, the results of operations for FY 1996 and 1995 would have reflected rent expense of approximately $3,275,000 and $3,060,000, respectively, and the amount due to System institutions presented on the statement of financial position would have been correspondingly reduced.

NOTE 8. ACCOUNTS PAYABLE

Accounts payable consisted of the following:

	September 30	
	1996	**1995**
Federal sources	$ 39,641	$2,605,423
Non-Federal sources	448,581	1,051,540
	$488,222	$3,656,963

NOTE 9. DUE TO SYSTEM INSTITUTIONS

Due to System institutions represents the cumulative excess of all funds received by FCA from direct assessments, reimbursable activities, and other sources over obligations incurred. These amounts, which will generally be refunded prior to the end of the next fiscal year, are non-interest bearing obligations. Included in the September 30, 1995, balance is approximately $2,594,000 related to FY 1995 activity, and approximately $530,000 resulting from prior years' activity. These amounts were refunded to the System institutions during FY 1996. Included in the September 30, 1996, balance is approximately $2,874,000 relating to FY 1996 activity and $240,000 relating to prior years' activity. It is expected that these items will be refunded during FY 1997.

NOTE 10. PREPAID ASSESSMENTS

Prepaid assessments represent prepayments received from assessed institutions as of the end of the fiscal year. Such amounts will be used to fund subsequent fiscal year operations.

NOTE 11. NET POSITION

Changes in the individual components of net position occurred as follows during FY 1996:

	Unexpended Obligations	Net Capital Invested in Fixed Assets	Future Funding Requirements	Total
Beginning balance October 1, 1995	$286,959	$ 1,002,152	$ –	$1,289,111
Excess of fiscal year 1996 expenses over revenues	280,590	(258,707)	(561,622)	(539,739)
Ending balance September 30, 1996	$567,549	$ 743,445	$(561,622)	$ 749,372

The balance in net position generally represents the difference between items that: (1) have been obligated for budgetary purposes, and (2) expenses recorded on the accrual basis of accounting. Unexpended obligations represent items that do not meet the criteria for recording liabilities, but are appropriately recognized as an obligation of budgetary resources, and in most cases will result in future recognition of expenses. The balance in the Future Funding Requirements account represents items that have been accrued in accordance with generally accepted accounting principles, but have not been obligated for budgetary purposes. This amount relates to severance and Voluntary Separation Incentive Payments accrued as a result of the Agency's Five-Year Staffing and Structure Plan. The investment in fixed assets represents items that were fully expended for budgetary purposes but are being depreciated in accordance with generally accepted accounting principles.

NOTE 12. EMPLOYEE BENEFIT PLANS

Retirement - Substantially all of FCA's employees are covered under either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS) to which the FCA makes contributions according to plan requirements. FCA's contribution to both plans was approximately $2,600,000 and $2,700,000 for FY 1996 and 1995, respectively.

CSRS and FERS are multi-employer plans. Although FCA funds a portion of pension benefits relating to its employees and provides for the necessary payroll withholdings, it does not maintain or report information with respect to the assets of the plans, nor does it report actuarial data with respect to accumulated plan benefits or the pension liability relative to its employees. The reporting of such amounts is the responsibility of OPM.

NOTE 12. EMPLOYEE BENEFIT PLANS (CONTINUED)

Accrued leave - FCA's employees earn annual leave (vacation and personal time) based on years of service and sick leave based on a fixed amount for each employee. Annual leave is accrued as a liability as earned, generally up to 240 hours per employee. The liability is based on current pay rates and is reduced as leave is taken. Any outstanding balance is payable to employees upon separation. Sick leave is not vested and is expensed as used.

Health benefits and life insurance - Through FY 1995, FCA provided health care and life insurance benefits for employees. Subsequently, all of these benefits are provided through the Federal Government-wide FEHB plan. Under this plan, premium costs are shared between FCA and the employees, as explained more fully in Note 2. Amounts paid by FCA for health care and life insurance were approximately $1,022,000 and $1,306,000 for FY 1996 and 1995, respectively. Excluded from the 1995 amount is the accrual of $2.5 million relating to the settlement of FCA's obligation to provide postretirement health benefits to a number of retirees and employees.

NOTE 13. COMMITMENTS AND CONTINGENCIES

FCA is involved in various administrative proceedings, legal actions, and claims incidental to its operations. In the opinion of FCA management and legal counsel, the ultimate resolution of these proceedings, actions, and claims will not have a material effect on its financial position.

NOTE 14. CONGRESSIONAL LIMITATION ON ADMINISTRATIVE EXPENSES

Except for FY 1996, Congress has historically placed an annual spending limit on the amount of administrative expenses that can be obligated by the FCA in a given fiscal year, exclusive of reimbursable activities. The statutory limitation for FY 1995 was $40,420,000. During FY 1995, FCA had actual obligations of approximately $38,945,000 subject to the limitation. In addition, during FY 1995, FCA incurred obligations of approximately $283,000 related to reimbursable activities.

NOTE 15. RECONCILIATION OF BUDGET AND ACTUAL EXPENSES

The reconciliation between budgetary obligations and accrued expenses as of September 30, 1996, is as follows:

Budget resources		$38,115,298
Budgetary obligations:		
	Direct	$35,526,119
	Reimbursed	250,697
		$35,776,816
Actual expenses		$36,074,837
Add:	Fiscal year 1996 undelivered orders	530,650
	Fiscal year 1996 purchases of fixed assets	222,548
	Rate stabilization fund adjustment	(31,718)
	Other	1,776
Less:	Fiscal year 1996 depreciation expense	481,255
	Liquidation of prior year undelivered orders	(21,600)
	Accrued severance	261,622
	Accrued buyouts	300,000
Budgetary obligations		$35,776,816

NOTE 16. RELATED PARTIES

FCA provided services to the Farm Credit System Insurance Corporation (FCSIC) under an Inter-Agency agreement. Such services include examinations and administrative and legal support services. FCA had receivables due from FCSIC of $76,541 and $51,000 at September 30, 1996 and 1995, respectively. FCA provided services to FCSIC which totaled approximately $170,000 and $283,000 for FY 1996 and 1995, respectively.

Farm Credit Administration

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

December 3, 1996

Mr. Eldon Stoehr
Inspector General
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Dear Mr. Stoehr:

We are pleased that the auditors have, for the third consecutive year, concluded that the financial statements of the Farm Credit Administration are fairly presented in all material respects in accordance with generally accepted accounting principles. We appreciate the opportunity to comment and the attachments to this memorandum provide management's response to the reports on internal controls and compliance.

We have identified items or comments made by the auditors that need clarification. We recognize that there may be opinions and conclusions reached by the auditors that involve matters of judgment with which management may disagree and have identified such matters, as well as management's basis for its opinions.

Sincerely,

David C. Lavoie
Chief Operating Officer

Enclosure

Management's Comments on Independent Auditor's Report On Internal Control Structure

The auditors identified two matters that they considered reportable conditions under standards established by the American Institute of Certified Public Accountants.

One reportable condition relates to the Farm Credit Administration's (FCA or Agency) core financial management system (system). In the judgment of the auditors, the system does not comply with standards and lacks properly designed controls. The auditors concluded that, in their judgment, the system contains significant weaknesses and limitations which have required Agency management to develop additional external manual processes and controls. The auditors acknowledge that the FCA has developed adequate system controls and as a result the auditors did not identify any significant weaknesses in FCA's ability to provide timely financial information to management. In addition, the FCA's financial statements for the year ended September 30,1996 received an unqualified opinion by the auditors.

Management does not agree with the conclusions reached by auditors that weaknesses in the system are significant enough to be considered a reportable condition. A reportable condition involves matters relating to significant deficiencies in the design or operation of the internal control structure that could adversely affect the Agency's ability to record, process, summarize, and report data consistent with the assertions of management in the financial statements. We do not believe this condition exists when the internal control structure and the results produced by the system are viewed in their entirety. There have been some problems over the last 3-plus years of operations, but our experience has shown that the controls in place have worked. Management does agree that it has a continued responsibility to evaluate the needs of the Agency in view of the ever changing requirements imposed by the Federal Government as well as the changing needs of FCA's management. Also of significant concern to management in its evaluation is the possibility of continued timely and cost efficient services from the commercial software vendor whose core system we have put to good use. The vendor has developed a revised version of the system that may result in the vendor having less time available to support the current version of the system that FCA uses. All of these factors are currently being considered and are being addressed as part of the Agency's Strategic Plan. Certain events may accelerate this initiative and have an impact on management's approach and the direction it takes regarding any changes to the existing system.

Given that the auditors acknowledged that controls are adequate, we must question the basis for concluding our system is a reportable condition. During the exit conference, the Audit Manager admitted that one of the reasons for treating the system in this manner is that it would send a message to the government entities that approved the off-the-shelf system for use government-wide (Treasury, Office of Management and Budget (OMB), and the General Services Administration). We once again object to the notion that other government entities will be put on notice by including our system as a reportable condition. We consider this strategy inappropriate.

Management does not believe that the eight deficiencies noted on page 3 of the audit report are fully accurate or placed in the proper context. Specific responses were provided under separate cover. In addition, we have not been provided with any documentation that supports the statement on page 3 of the report regarding the overall instability and unreliability of the system.

As mentioned earlier, the Strategic Plan requires a review of the current system. This is underway and we will consider the changing needs of management as well as the requirements for Federal agencies. We don't believe it is appropriate that the audit report references the fact that a new version of the software is available from a software manufacturer. Our decision will be based on an evaluation of our needs and any purchases required will be made in accordance with the Federal Government procurement rules for acquiring goods and services.

We also need more detail on the problems the auditors foresee related to the network platform changes planned for 1997. These problems are not documented in the report. As mentioned earlier, FCA is anticipating moving to Windows NT for a client operating system. IRD technical staff believes this will be an improvement to the situation, not a problem.

The second reportable condition concerns inadequate segregation of duties over the property management system due to our recent reorganization. We agree with the auditor's recommendations to assign the property management specialist function to a department independent of the procurement function, and that the annual property certification be performed by a department independent of the property management specialist function. Both of these actions will occur within the next six months.

Management's Comments on Independent Auditor's Report on Compliance with Laws and Regulations

1. Interest due under the Prompt Payment Act not paid by FCA

We agree with this finding and are taking the necessary steps to ensure compliance with the Prompt Payment Act. We will also pay to those vendors the amounts due.

2. Material nonconformances of core financial management system not reported in annual FMFIA report

The auditors concluded that FCA management violated the Federal Managers' Financial Integrity Act (FMFIA) by omitting mention of material noncompliance issues with GLOWS in the Agency's 1995 FMFIA report. In management's opinion, the Agency did not violate FMFIA, and no material weakness of the GLOWS system existed either then or now.

Circular No. A-123, Management Accountability and Control (A-123), issued by the OMB, implemented FMFIA. A-123 requires the head of each executive agency to annually submit to the President and the Congress: (1) a statement on whether there is reasonable assurance that the agency's controls are achieving their intended objective; and (2) a report on material weaknesses

2

in the agency's controls. Only deficiencies that the agency head determines to be significant enough to be reported outside the Agency shall be considered material weaknesses. To make such an assertion, the head of an agency uses information from a variety of sources such as internal management reviews and assessments; management knowledge gained from daily operations; audits of Agency financial statements conducted pursuant to the Chief Financial Officers Act, and the resulting reports on the financial statements, internal controls and compliance with laws and regulations; and other relevant information.

A-123 specifically addresses the criteria to be used in characterizing Agency deficiencies as material weaknesses. A-123 compares its criteria for external reporting of material weaknesses by management to the criteria used for material weaknesses identified by auditors in their internal control report to management. A-123 is clear on the fact that independent auditors have a different threshold to meet and responsibility to report to Agency management those types of weaknesses at any level in the organization, even if management of the audited entity would not report the weakness outside the agency. Under A-123, management exercises its discretion and judgment as to the relative risk and significance of the deficiencies and decides which items will be reported.

Based on its assessment of existing controls and procedures as well as unqualified audit opinions for two consecutive years, Agency management determined in December, 1995 that a material weakness related to GLOWS did not exist for FMFIA reporting purposes. Accordingly, FCA management exercised its discretion and reported no material weakness in its 1995 Annual FMFIA report. It is worth noting that the auditor's FY 1995 audit report also included no material weakness or reportable condition concerning FCA's accounting system.

Again, we appreciate the opportunity to comment. We have provided more expansive comments, including responses to specific deficiencies identified, under separate cover.

UKW'S RESPONSE TO MANAGEMENT'S COMMENTS ON THE FINANCIAL MANAGEMENT SYSTEM FINDINGS

UKW believes it is appropriate to report on weaknesses and deficiencies in an agency's core financial system when the system does not function as intended and the agency must provide substantial manual intervention to process significant volumes of financial transactions and prepare standard financial reports for management. We do not disagree with management's assertion that financial management systems typically incorporate a certain level of external manual processing to support the automated components of such systems. However, we believe there is continued and increasing risk to FCA's automated systems' ability to produce timely and accurate financial information, despite the external manual processing controls in place. Our report specifically expresses concerns regarding the risks and problems with the automated portion of FCA's system and the quantity and complexity of external procedures and controls which FCA must apply to the automated portion of its system to maintain its overall integrity.

UKW believes the findings are reported and classified in accordance with Government Auditing Standards issued by the Comptroller General of the United States.

UK
&W

Additional Information

A discussion of the financial condition and performance of the Farm Credit System (FCS) may be found in the Farm Credit Administration (FCA) report *Risk Analysis of Farm Credit System Operations*, published for the quarters ended March 31, June 30, and September 30, and FCA's *Annual Report on the Financial Condition and Performance of the Farm Credit System,* to be published for the year ended December 31, 1996. These publications and annual reports of FCA may be obtained from the Office of Congressional and Public Affairs, FCA, 1501 Farm Credit Drive, McLean, VA 22102-5090; telephone (703) 883-4056.

Disclosure to investors in FCS securities is made by the Federal Farm Credit Banks Funding Corporation through annual and quarterly information statements, published as part of the *Report to Investors*, and through its *Summary Report of the Condition and Performance of the Farm Credit System*, published each quarter. Copies of these reports are available from the Federal Farm Credit Banks Funding Corporation, 10 Exchange Place, Suite 1401, Jersey City, NJ 07302; telephone (201) 200-8000.

The Farm Credit System Insurance Corporation (FCSIC), which ensures the timely payment of principal and interest on insured securities issued by FCS banks, publishes an annual report. Copies may be obtained from the FCSIC, 1501 Farm Credit Drive, McLean, VA 22102-0826; telephone (703) 883-4380.

In addition, FCS banks and associations are required by regulation to make annual and quarterly financial disclosures available to their stockholders. Copies of these documents are available for public inspection at FCA headquarters in McLean, Virginia.

Copies Are Available From:
Office of Congressional and Public Affairs
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090
703.883.4056