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BY THE COMPTROLLER GENERAL

Report To The Governor, Farm Credit Administration

OF THE UNITED STATES

How The Farm Credit Administration Can Improve Its Use Of Auditing

The cooperative Farm Credit System holds about one third of the Nation's total farm debt. Its supervisory body, the Farm Credit Administration, has recognized the need for independent internal review of its management activities, but it has not gone far enough in encouraging its use.

GAO believes that the Farm Credit Administration should establish a qualified, permanent, independent internal audit unit, rather than continue its present use of part-time internal auditors. The Administration should also encourage development of internal auditing within Farm Credit System banks.

The Administration does not employ an independent external auditing firm to review its financial statements; such a review is made by its Office of Examination. The Office of Examination's position, as a component of the supervisor of the system being audited, leaves its independence open to question. The Farm Credit Administration should use external auditors to ensure that its financial examination procedures are in conformance with generally accepted auditing standards.

UNITED STATES GENERAL ACCOUNTING OFFICE

GGD-81-22

JANUARY 28, 1981

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-197162

The Honorable Donald E. Wilkinson
Governor, Farm Credit Administration

Dear Mr. Wilkinson:

This report describes your agency's use of internal and external auditing and suggests ways of strengthening this use.

We recommend establishing a permanent, independent internal audit group, strengthening support of Farm Credit System Bank internal audit activities, and using an external auditor to provide an independent review of procedures used by the Office of Examination.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Office of Management and Budget; and interested congressional committees and Members.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE GOVERNOR, FARM CREDIT ADMINISTRATION

HOW THE FARM CREDIT ADMINISTRATION CAN IMPROVE ITS USE OF AUDITING

DIGEST

The Farm Credit Administration should establish a permanent, organizationally independent internal audit group and strengthen its support of Farm Credit System Bank internal audit activities by

--providing leadership for the development of professional internal auditing standards;

--furnishing active, consistent support for bank internal auditor professional development activities; and

--reporting consistently to Farm Credit System Bank management on the progress and problems of their bank internal audit units.

In addition, the Farm Credit Administration should augment its annual financial examinations of the Farm Credit System Banks by using an external auditor to independently ensure that the examination procedures used are in conformance with generally accepted auditing standards.

The Farm Credit Act of 1971 (Public Law 92-181, 85 Stat. 583) gives the Farm Credit Administration broad authority to supervise and coordinate the activities of the cooperative Farm Credit System. Within the policies set by the Federal Farm Credit Board, the Farm Credit Administration, an independent Federal agency, supervises and regulates the activities of borrower-owned banks and associations that comprise the Farm Credit System.

Tear Sheet. Upon removal, the report cover date should be noted hereon.

THE FARM CREDIT ADMINISTRATION SHOULD ESTABLISH A PERMANENT, INDEPENDENT INTERNAL AUDIT GROUP

Although the Farm Credit Administration has recognized the need for independent evaluations of its operations, it has not established a permanent, organizationally independent internal auditing group. The Farm Credit Administration has assigned part-time internal review responsibilities to its Office of Examination and to staff located in the Office of the Governor.

Both review efforts have limitations potentially impairing their independence. Because the Office of Examination's major line responsibilities are closely linked to supervisory efforts, its part-time reviews of supervision activities do not meet the test of independence. (See p. 7.) The same problem exists with respect to the part-time management audit activities of the staff of the Office of the Governor. (See p. 9.)

Although Farm Credit Administration management has considered establishing a permanent internal audit group, it has rejected the idea primarily because of the small size of the agency, the complexity of operational issues involving supervision and examination activities, and position ceilings. Despite these concerns, GAO believes that a qualified, permanent, independent internal audit unit is required to meet the Farm Credit Administration's internal review needs, particularly in the examination and supervision areas. (See p. 10.)

THE FARM CREDIT ADMINISTRATION SHOULD STRENGTHEN ITS SUPPORT OF FARM CREDIT BANK INTERNAL AUDIT ACTIVITIES

The Administration has required each district board to establish an internal audit activity encompassing all district bank and association operations. Although the Administration has provided some assistance in the development of internal audit activities across the System, it has not done enough. Specifically, the Administration has not:

--Provided leadership for development of System-wide internal auditing standards. The absence of such standards has hindered the Administration's examination of district internal audit operations and led to uncertainty among System internal auditors as to the criteria against which performance is to be measured. (See p. 12.)

--Furnished active, consistent support to the System's Internal Auditors' Conference. As a result, little has been done through this body to reinforce internal auditing professionalism. (See p. 15.)

--Consistently reported on the progress and problems of internal auditing activities in its reviews of bank operations. Therefore, the districts were provided little incentive to make necessary improvements. (See p. 17.)

Recently, the Administration amended its regulations to allow banks flexibility in establishing their internal audit functions. The impact of this change on bank internal audit functions is uncertain. (See p. 20.)

THE OFFICE OF EXAMINATION'S FINANCIAL EXAMINATION EFFORT SHOULD BE SUPPLEMENTED BY EXTERNAL AUDITORS

The Farm Credit Administration currently uses its Office of Examination as external auditor for the Farm Credit System. In this role, the Office of Examination expresses an opinion to System investors as to the fairness of the year-end financial statements of both the System and its component banks. Although these reviews are to be made in accordance with generally accepted auditing standards, the Office of Examination's position as a component of the supervisor of the System being audited leaves its independence open to question. (See p. 24.)

Other Federal financial regulatory agencies with financial examination responsibilities have sought to limit opportunities to influence auditor independence by involving external auditors in their financial examination process. The Federal Home Loan Bank Board uses external auditors to perform financial examinations at the 12 Federal Home Loan Banks and the Federal Reserve Board uses an external auditor to independently review procedures used by Board examiners during financial examinations of Federal Reserve banks. (See p. 25.)

RECOMMENDATIONS

GAO recommends that the Federal Farm Credit Board direct the Governor of the Farm Credit Administration to:

- --Establish a permanent, independent internal auditing unit within the Farm Credit Administration consistent with professional internal auditing standards. This unit should be organizationally independent of agency line-management functions and report to the highest practicable level within the management structure. (See p. 11.)

- --Provide leadership to the Farm Credit System in developing a set of professional internal auditing standards, which will provide a basis for a more thorough evaluation of the internal audit function as well as encourage professionalism within bank internal audit units. (See p. 22.)

--Furnish active, consistent support for the Farm Credit System Internal Auditors' Conference. (See p. 22.)

--Require that Office of Examination reports to a bank's Board of Directors comment on the quality of the internal auditing system. (See p. 23.)

--Monitor the implementation of the revised Farm Credit System internal control policy to insure that independent bank internal audit functions are maintained. (See p. 23.)

--Augment the financial examinations of the Farm Credit System by using external auditors to ensure that the financial examination procedures used are in conformance with generally accepted auditing standards. (See p. 26.)

AGENCY COMMENTS

The Farm Credit Administration was asked to comment on this report, but it was unable to clear its comments with the Federal Farm Credit Board before the report was issued or within the maximum time permitted by P.L. 96-226.

C O N T E N T S

ABBREVIATIONS

FCA Farm Credit Administration

FCS Farm Credit System

GAO General Accounting Office

OMB Office of Management and Budget

CHAPTER 1

INTRODUCTION

This report evaluates the use of auditing within the Farm Credit Administration (FCA) and its support of the use of auditing within the Farm Credit System (FCS). Auditing may be divided into two types of activities: internal auditing and external auditing.

Internal auditing is an independent appraisal function established in an organization to examine and evaluate its activities as a service to the organization. The overall objective of internal auditing is to assist management in discharging its responsibilities by furnishing information, analyses, appraisals, and recommendations pertinent to the organization's execution of management's policies and procedures. The internal audit function uniquely supplements routine management checks through its independent approach and review methodology.

External auditing refers to audits performed for management by independent certified public accounting firms. These activities are guided by auditing standards adopted by the American Institute of Certified Public Accountants.

Every organization needs an effective system of internal management control. One of the best means of providing management control is the establishment of effective auditing systems. This need and the importance of effective auditing have been recognized by the Congress in a number of laws, particularly the Budget and Accounting Procedures Act of 1950. The act requires the head of each agency to establish and maintain accounting and internal control systems designed to provide effective control over and accountability for all funds, property, and other assets for which the agency is responsible. Auditing is an integral part of such a system.

The need for an effective auditing system has also been recognized in the private sector, particularly the banking industry. Many banks have established internal auditing units, which top management looks to for independent evaluations of operational efficiency and effectiveness. Banks also use certified public accounting firms to independently review their activities.

THE FARM CREDIT SYSTEM, THE FEDERAL FARM CREDIT BOARD, AND THE FARM CREDIT ADMINISTRATION

The Farm Credit Act of 1971 (Public Law 92-181, 85 Stat. 583) gives the Farm Credit Administration broad authority to supervise and coordinate the activities of the cooperative Farm Credit System. Within the policies set by the Federal Farm Credit Board, FCA, an independent Federal agency, supervises and regulates the activities of borrower-owned banks and associations that comprise the Farm Credit System.

The System holds about one-third of the Nation's total farm debt. It provides credit and related services to farmers, ranchers, producers and harvesters of aquatic products, agricultural and aquatic cooperatives, rural homeowners, and certain businesses which provide farmers and ranchers with services essential to their onfarm operating needs. Credit and services are provided through three separate banking organizations--Federal Land Banks, Federal Intermediate Credit Banks, and Banks for Cooperatives. During fiscal year 1979, the System made loans totaling $59.1 billion and had $57.8 billion in loans outstanding at the end of the year. Total loans made during the year and loans outstanding at the end of the period increased 28.9 and 24.3 percent, respectively, over the prior year.

The United States is divided into 12 farm credit districts with a Federal Land Bank, Federal Intermediate Credit Bank, and Bank for Cooperatives located in each district. Each of the System's three banking organizations fills a particular credit need. Twelve Federal Land Banks were established to fill the need for a permanent source of long-term agricultural credit. Federal Land Bank Associations service Federal Land Bank loans.

The 12 Federal Intermediate Credit Banks make loans to farmer cooperatives and discount farmers' short and intermediate term notes which had been given to other financial institutions. Local Production Credit Associations effectively serve as the retail outlets for Federal Intermediate Credit Bank credit services. There are 13 Banks for Cooperatives which provide loan services for farmers' marketing, supply, and business service cooperatives. In addition to 1 bank in each of the 12 districts, there is a Central Bank for Cooperatives which participates with individual Banks for Cooperatives in loans which exceed their individual lending limits.

The System obtains its loan funds primarily through the sale of securities in the Nation's capital markets. During

1979, it issued $75.6 billion in securities and at the end of the year had $52.5 billion in securities outstanding.

The Federal Farm Credit Board is the policymaking body responsible for guiding FCA and the System. The Board prescribes the rules and regulations necessary for implementing the Farm Credit Act of 1971 and directs FCA, which in turn examines and supervises System institutions. Board members are appointed by the President of the United States and are subject to Senate confirmation. The members serve part time and meet six or more times a year. One member is appointed from each of the 12 farm credit districts. These 12 members serve 6-year terms and are not eligible for reappointment. One additional member is appointed by and serves at the pleasure of the Secretary of Agriculture.

The Board appoints the Governor of FCA who carries out pertinent laws, administers rules and regulations, and implements Board policies. The Governor, under the Board's direction is responsible for managing FCA in its supervision, regulation, and examination of the System.

The FCA organization includes four major offices. The offices and their primary responsibilities follow:

--The Office of Supervision supervises banks in all matters except personnel, information, and examination or audit.

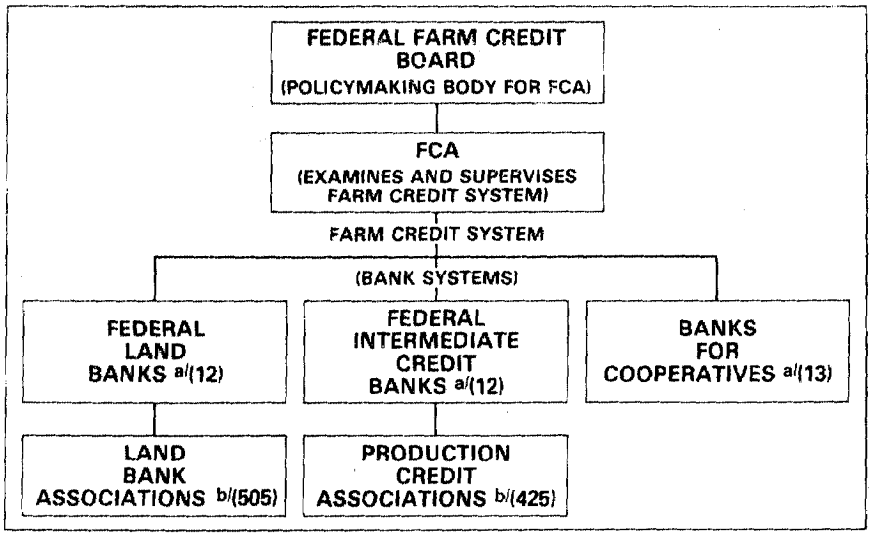
--The Office of Examination supervises and coordinates examinations of banks, associations, and other components of the System.

--The Office of Administration is responsible for providing all internal administrative support services and supervising System personnel and research programs.

--The Office of General Counsel is responsible for performing legal services for the Board, the Governor of FCA, and the FCA staff.

FCA has a 1980 budget of approximately $12.4 million for 284 permanent positions.

The following organization chart shows the relationship between FCA and the System.



a/NUMBER OF BANKS.
b/NUMBER OF ASSOCIATIONS.

STATUS OF FARM CREDIT ADMINISTRATION'S USE OF INTERNAL AUDITING

FCA has recognized the need for independent internal reviews of its management activities; however, it has not established a permanent internal audit unit. As a part of its decentralized regulatory philosophy, FCA has also encouraged the establishment of internal audit units in each Farm Credit System district.

At FCA, internal evaluations of management activities are performed on a part-time basis by staff from both the Office of Examination and from the Office of the Governor. Examination's reviews emphasize evaluations of financial controls and management compliance with agency procedures. The reviews performed by the staff from the Office of the Governor are "management audits" evaluating unit and managerial effectiveness.

In conformance with its decentralized regulatory philosophy, FCA has encouraged the establishment of internal audit units in Farm Credit Banks. FCA has adopted a regulation requiring each Farm Credit District to develop internal control policies and procedures, including an internal audit function. These internal audit units review the activities of the banks in the 12 Farm Credit Districts with staffs of varying number of professionals. The units perform internal audits of Federal Land Banks, Federal Intermediate Credit Banks, and Banks for Cooperatives.

FARM CREDIT ADMINISTRATION'S USE OF EXTERNAL AUDITING

FCA management currently uses external auditors on a limited, special project basis. For example, in 1978, FCA used an external auditor to perform an examination of Farm Credit System internal audit units. FCA also encourages System banks to use external auditors on only a special project basis, although several individual banks use external auditors to provide a wide range of auditing services. FCA currently uses its Office of Examination to perform the role of external auditor for the Farm Credit System.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of this review were to evaluate the use of auditing by the Farm Credit Administration and FCA's support of the use of auditing within the Farm Credit System.

Our findings and conclusions are based primarily on work done at FCA Headquarters in Washington, D.C. We also visited FCA's St. Louis, MO, and Bloomington, MN, Regional Offices and met with Farm Credit bank personnel in Columbia, SC; New Orleans, LA; Baltimore, MD; St. Louis, MO; and St. Paul, MN. We chose these locations to ensure that our data reflects any variations in audit use which may be attributable to regional differences.

We assessed FCA's use of auditing against widely accepted internal and external auditing standards which have been formulated for government and private industry, including banking. We compared FCA internal audit guidelines to the accepted standards and tested their application in selected cases.

We have published policies and procedures for auditing government programs and functions, which the Office of Management and Budget (OMB) embodied in its directives to executive agencies. For private industry, several organizations have issued internal or external auditing standards, including the American Institute of Certified Public Accountants, the Institute of Internal Auditors, Inc., and the Bank Administration Institute.

While these sets of standards may differ slightly as to their organization, they can be subdivided into three categories--general standards, examination or evaluation standards, and reporting standards. General standards applicable to an organization's internal or external audit activity include:

--Independence of auditors from activity audited.

--Professional proficiency of audit staff.

--Full review scope (financial operations, economy and efficiency, and program results).

--Due professional care.

Examination and evaluation standards include:

--Sound audit planning.

--Proper supervision of assistants.

--Adequate supporting evidence.

--Proper reviews of compliance with applicable laws and regulations.

--Complete evaluation of internal controls.

Reporting standards include:

--Timely reports to appropriate officials.

--Clear and accurate language.

--Adequate support of findings.

--Sound recommendations for improvement and consideration of issues requiring further study.

--Constructive tone, including mention of positive findings.

--Fair reporting of auditee's views.

--Adequate description of scope, including mention of information omitted for purposes of confidentiality.

CHAPTER 2

THE FARM CREDIT ADMINISTRATION SHOULD ESTABLISH A PERMANENT, INDEPENDENT INTERNAL AUDIT GROUP

Although the Farm Credit Administration has recognized the need for independent evaluations of its operations, it has not established a permanent internal auditing group, organizationally independent of agency line management. FCA has assigned part-time internal review responsibilities to its Office of Examination and to staff located in the Office of the Governor.

Both of FCA's review efforts have limitations affecting their independence. Because Examination's major line responsibilities deal with FCA's examination effort, which is closely linked to FCA's supervisory effort, Examination's part-time review of supervision efforts does not meet the test of independence. The same problem exists with respect to the part-time management audit activities of the staff of the Office of the Governor.

Although FCA management has considered establishing a permanent internal audit group, it has rejected the idea primarily because of the small size of the agency, the complexity of operational issues involving FCA's supervision and examination activities, and position ceilings. Despite these concerns, we believe that a qualified, permanent, independent internal audit unit is required to meet FCA's internal review needs, particularly in the supervision area.

OFFICE OF EXAMINATION'S INTERNAL REVIEWS OF AGENCY SUPERVISION ACTIVITIES DO NOT MEET THE TEST OF INDEPENDENCE

The Office of Examination's reviews of FCA's supervision activities do not comply with the general auditing standards on independence. The independence of the Office of Examination's evaluation of the performance of the Office of Supervision could be affected by the close working relationship Examination must attempt to maintain with Supervision.

According to professional internal auditing standards, internal audit's independent perspective is affected by several types of influences, including personal relationships. A personal situation or individual viewpoint may prevent an auditor from being impartial when performing audits. For example, an internal auditor may have preconceived ideas about the quality of an operation or personal likes or dislikes of individuals or the objectives of a particular program.

In addition to annually examining all of the 37 Farm Credit System Banks, the Office of Examination makes annual audits or reviews of specific areas within 4 of FCA's major line-management functions. The four specific reviews are:

--Annual review of the accounting and property records (i.e., budget and accounts) of the Administrative Division of the Office of Administration.

--Annual review of the securities transactions records (i.e., cash and securities) of the Office of Finance.

--Annual review of the effectiveness of supervisory programs carried out by the Office of Supervision and other supervisory offices.

--Annual peer review of each of the Office of Examination's divisional offices. (FCA management does not consider this to be an internal audit activity.)

Using typically two to three Examination staff on temporary detail, these reviews are performed generally within 1 to 3 weeks.

Examination has evaluated the supervisory effectiveness of the Office of Supervision's programs and other supervisory efforts in each of the last 4 years. The purpose of the reviews is to provide information to the Governor regarding the effectiveness of FCA's supervisory activities.

The evaluation's approach is to report on the positive and negative aspects of the performance of the supervisory staff. Emphasis is placed on determining whether the Office of Supervision addresses the major problem areas of Farm Credit banks in its supervisory plan and subsequent actions. Therefore, the scope of the review usually entails an analysis of the Office of Supervision's followup on specific problems that have been described in the Office of Examination's reports.

The evaluation is performed by the Directors of the Office of Examination's three divisions. They submit individual reports to the Chief Examiner regarding the performance of the supervisory staff in their respective geographical regions. The Chief Examiner submits a summary report of findings and recommendations to the Governor. Report findings are generally related to whether the Office of Supervision has sufficiently dealt with bank problems as pointed out in Office of Examination reports. In addition, the reports comment on the coordination efforts between the Office of Supervision and the Office of Examination.

The Office of Examination cooperates with and supports the supervisory efforts at FCA by working closely with the Office of Supervision in the agency's development of examination and supervisory plans for Farm Credit System banks and associations. These coordinated activities may hinder the evaluators' ability to render impartial opinions, conclusions, and recommendations when reviewing the effectiveness of supervisory programs. In addition, the scope of this review emphasizes the extent to which the Office of Supervision's staff has followed up on deficiencies that have been documented in Examination's bank examination reports. Examination's reviewers, therefore, have been determining supervisory effectiveness in terms of how extensively their own office's work is being used. For example, in several Examination reports, Supervision was criticized for not effectively using and following up on Examination's findings.

OFFICE OF THE GOVERNOR'S REVIEWS HAVE INDEPENDENCE PROBLEM

Although the management audits of the Office of the Governor's staff have provided useful evaluations to management, these officials have other line management responsibilities which potentially impair their independence. They are actively involved in developing and maintaining the agencywide coordinated supervisory function and directing the agency planning function.

Internal audit's greatest value lies in its independence. Professional internal audit standards note that designing and operating agency systems are not audit functions. Performing such activities is presumed to impair audit objectivity.

In late 1979, the Chief of Staff to the Senior Deputy Governor and the Executive Assistant began conducting "management audits" of various FCA offices. From October 1979 to December 1979, these officials issued six reports, each addressing a major organizational component of FCA operations. The reports generally contained a broad assessment of the specific office's operations and an appraisal of the office's managerial effectiveness. The review approach consisted primarily of reviewing office plans and procedures and interviewing office officials. The officials conducted these reviews on a part-time basis devoting about 25 percent of their time to them. The resulting reports were distributed to the auditee, the Governor's office, and the Federal Farm Credit Board. Followup, as needed, was conducted by the Senior Deputy Governor.

While these reports supplied useful information to agency top management, the involvement of the officials in agencywide system development and planning potentially impairs the independent perspective required of reviewers. Both of the officials report to the Senior Deputy Governor, and their position descriptions note that they are to be actively involved in developing both agencywide management systems and agencywide coordinated supervisory activities. In addition, they have agencywide planning responsibilities. These other responsibilities may put the officials in situations where they are reviewing the efficiency or effectiveness of policies which they participated in formulating, thereby creating a potential for compromising the reviewer's independent perspective. For example, in the 1979 review of the Office of the Governor-Senior Deputy Governor Function, the reviewers were called upon to directly evaluate their own activities.

FARM CREDIT ADMINISTRATION MANAGEMENT BELIEVES A PERMANENT, INDEPENDENT INTERNAL AUDIT UNIT IS NOT NEEDED

FCA management officials believe that their current part-time internal review efforts adequately serve their management needs. Although an independent, permanent internal audit unit has been considered, FCA management officials stated that they rejected the approach because of the small size of the agency, the complexity of FCA operations involving the examination and supervision of the Farm Credit System, and position constraints.

CONCLUSION

The Farm Credit Administration has not established a permanent, independent internal audit group, although it has recognized the need for independent reviews of its operations. FCA has assigned part-time internal review responsibilities to its Office of Examination and to management officials in the Office of the Governor. Both of these review efforts have limitations that could affect their independence. FCA management has rejected the idea of a permanent, independent internal audit unit because of the size of the agency, the complexity of supervision and examination related issues, and position constraints. Although FCA's current review activities have provided useful information to management, we believe a qualified, permanent, independent internal audit unit could better serve FCA's internal review needs, particularly in the examination of supervision activities.

RECOMMENDATION

We recommend the Federal Farm Credit Board direct the Governor of the Farm Credit Administration to establish a permanent, independent internal auditing unit within the Farm Credit Administration consistent with professional internal auditing standards. This unit should be organizationally independent of agency line management functions and report to the highest practicable level within the management structure.

AGENCY COMMENTS

The Farm Credit Administration was asked to comment on this report, but it was unable to clear its comments with the Federal Farm Credit Board before the report was issued.

CHAPTER 3

THE FARM CREDIT ADMINISTRATION

SHOULD STRENGTHEN ITS SUPPORT OF FARM CREDIT

BANK INTERNAL AUDIT ACTIVITIES

FCA has required each district board to establish an internal audit activity encompassing all district bank and association operations. Although FCA has taken certain steps to assist in the development of internal audit activities across the System, it has not done enough. Specifically, FCA has not:

--Provided leadership for development of System-wide internal auditing standards. The absence of such standards has hindered FCA's examination of district internal audit operations and led to uncertainty among System internal auditors as to the criteria against which performance is to be measured.

--Furnished active, consistent support to the Internal Auditors' Conference. As a result, little use has been made of a mechanism to reinforce internal auditing professionalism.

--Consistently reported on the progress and problems of internal auditing activities in its reviews of bank operations. Therefore, districts were provided little incentive to make necessary improvements.

Recently, FCA amended its regulations regarding internal audit to allow banks more flexibility in establishing their internal audit functions. The impact of this change on bank internal audit functions is uncertain.

FARM CREDIT ADMINISTRATION HAS NOT PROVIDED LEADERSHIP TO THE FARM CREDIT SYSTEM TO DEVELOP A SET OF INTERNAL AUDITING STANDARDS

The Farm Credit System is currently operating without a set of professional internal auditing standards. As a result, FCA's review of bank internal audit activities has been hindered by a lack of well-defined criteria to measure the quality of the audits. In addition, several internal audit units are uncertain as to what is expected of them by FCA.

As a result, instances of deviations from generally accepted professional standards are occurring within the system and are not being reported by FCA.

Professional standards are important to an effective internal audit function. The Statement of Principles and Standards for Internal Auditing in the Banking Industry states:

> "Well-defined standards establish and govern professional identity. Auditing standards provide a reference for evaluating audit performance and suggest the nature and the extent of an auditor's abilities. . .Standards are essential to professional performance."

Standards not only reinforce the professional status of an internal auditor, they provide criteria for measuring internal audit operations. The Standards for the Professional Practice of Internal Auditing, released by the Institute of Internal Auditors in 1978, recognized the diverse environments in which internal auditing is performed throughout the world and that these differences will govern the actual practice of internal auditing. Despite these diversities, these standards were written to apply to internal auditing worldwide.

FCA has attempted to provide the FCS with some standardized guidance on internal auditing by issuing internal audit guidelines and establishing a position, within the Office of Supervision, with responsibilities for assisting System internal auditors. FCA's internal audit guidelines contain baseline requirements which provide an outline for each district's internal audit function and criteria for measuring and evaluating performance. They cover such areas as audit planning and audit independence. In addition to these guidelines, a position was established within FCA's Office of Supervision with the responsibility for issuing minimum standards and guidelines for bank internal audit units. Personnel turnover, however, has left this position vacant since mid-1979.

Although the FCA guidelines contain a number of elements of more widely accepted internal audit standards, they do not include adequate standards for

--supervision,

--due professional care,

--reporting,

--report recommendation followup, and

--coordination between the internal and external auditors.

For example, in the reporting area, bank internal audit units are encouraged to develop a reporting system, but other reporting issues addressed in professional internal auditing standards, such as the use of written reports, timeliness and quality of report content (i.e., clarity, brevity, etc.), are not addressed.

Without a set of well-defined performance standards to use in evaluating bank internal audit activities, FCA examiners are using a variety of differing evaluation approaches. Although most of the Examination personnel interviewed used the FCA guidelines in their evaluations, the extent of this use varied widely. Several officials stated that these guidelines are supplemented by other, appropriate but unofficial, criteria. Other criteria used included a questionnaire formulated by a consultant and other established professional internal audit standards.

The lack of a clear set of standards has also contributed to the uncertainty among some bank internal auditors as to what level of performance is expected of them. Although FCA has never proposed adherence to a definitive set of standards, several auditors have made attempts to observe the Institute of Internal Auditors' Standards for the Professional Practice of Internal Auditing. However, these internal auditors have problems in doing so, because these standards cover areas not directly addressed in existing FCA guidelines. As a result, bank management may or may not allow the unit to observe these standards.

This uncertain environment has resulted in bank internal audit practices that deviated from professional standards not being reported by FCA. Our limited review of the internal audit efforts of 15 banks identified 7 operating with departures from professional standards, including:

--No involvement of internal audit in the followup of internal audit report recommendations.

--Audits conducted without written programs.

--Audit evidence poorly organized and unclear.

--Audits completed with no written reports issued.

--Lack of supervisory verification of audit evidence.

None of these instances were reported in FCA regulatory reports to either bank management or FCA management.

FCA needs to adopt a generally accepted set of internal auditing standards, or develop standards itself for adoption by FCS internal auditors, and evaluate the internal auditors for compliance with these standards.

FARM CREDIT ADMINISTRATION HAS NOT FURNISHED ACTIVE, CONSISTENT SUPPORT TO THE FARM CREDIT SYSTEM INTERNAL AUDITORS' CONFERENCES

Although the Farm Credit System's internal auditors have established an internal auditors' conference to encourage internal audit professionalism, FCA has not actively supported it. As a result, a mechanism which could serve to encourage internal audit units to observe FCA internal audit policies and generally strengthen the overall professionalism of internal auditing within the FCS is not being effectively utilized.

Professional internal auditing standards require that internal audit staffs possess adequate professional proficiency to perform the tasks required. To achieve this, a program of continuous training and development is essential. This development may be accomplished through membership in professional societies, attendance at conferences and seminars, college courses, and in-house training programs. The FCS Internal Audit Guidelines recognize the importance of continued professional development and suggest peer group contacts and association with professional activities as well as sharing experiences with other Farm Credit System internal auditors.

Internal auditors' conferences are used as training sessions

For the past several years, the internal auditors in the Farm Credit System have held periodic auditor conferences. The conference is not a formal organization with regularly scheduled meetings, but rather a forum for the communication and exchange of ideas among auditors. It has no authority to promulgate formal policy for internal auditors, but it does provide an avenue for making recommendations directly to bank presidents and indirectly to FCA.

The primary purpose of the conference has been to provide additional training in internal auditing. Agendas have contained a mixture of training sessions, panel discussions, and lectures regarding updates on System activities. Participants in these sessions have been members of bank management, FCA officials, and speakers from the private sector.

Examples of the presentations given include:

--Individual audit group activities.

--Professional standards and audit management.

--Management expectations from internal audit.

--Internal audit programs, schedules, and reports.

The Internal Auditors' Conference does not have any policymaking authority. The auditors can, however, submit recommendations to the 37-Bank Presidents' Conference. For example, in 1978, the Chairman of the Internal Auditors' Conference proposed that the bank presidents approve a formal training program for internal auditors. In addition, a request was made to establish a regularly scheduled annual Internal Auditors' Conference.

<u>Farm Credit Administration's support for Internal Audit Conferences has been weak</u>

Although FCA has occasionally participated in past Internal Auditors' Conferences, the agency has not strongly promoted the use or continuation of the conference or use of it as a vehicle for coordinating system activities.

FCA officials have attended Internal Auditors' Conferences and have made presentations on selected topics. For example, during the 1978 conference, one FCA official spoke on the role of internal auditors in Farm Credit banks. The FCA official encouraged the internal auditors to continue their endeavors to improve the quality of bank management and bank operations.

Since the Internal Auditors' Conference is not a formal organization, requests for the meeting have to be made each year. These requests have to be submitted to and approved by the Presidents' Coordinating Committee, which meets as a part of the annual 37-Bank Presidents' Conference. A request for a conference to be held in 1979 was refused by the Committee because the bank presidents concluded that these Internal Auditors' Conferences did not need to be held on an annual basis. The basis for this decision has never been clarified, although it appears inconsistent with FCA's Internal Audit Guidelines which state:

"* * *internal auditors should be encouraged by the persons to whom he is (sic) responsible to maintain peer group contacts and associations through the activities of professional organizations, as well as discussions and sharing of experiences with other Farm Credit System internal auditors."

FCA's reaction to this decision was silence. FCA officials indicated that they believed this was a System decision which they had no voice in. However, in other instances, FCA officials have indicated that they have a strong informal influence over whether the activities of other System's conferences receive emphasis.

While FCA's management policies stress the encouragement of FCS conferences as policy coordinating devices, FCA has not strongly encouraged the use of the Internal Auditors' Conference as a means for promoting professional internal auditing policies within the system. FCA's management policies state that:

"All Agency offices are responsible for fostering coordination within the Farm Credit System. . . They coordinate System programs and activities through. . .participation in System conferences and committees* * *."

FCA has encouraged the FCS conference structure to promote the adoption of systemwide policies. For example, FCA suggested the adoption of generally accepted accounting principles by Farm Credit bank treasurers at the 37-Bank Treasurers' Conference. However, FCA has not attempted to use the conference system to coordinate internal audit activities or encourage professionalism. For example, when the conference was discussing whether the system should adopt the professional internal auditing standards of the Institute of Internal Auditors Inc., FCA remained silent. The standards were subsequently not adopted, and the FCS still remains without a set of internal auditing standards.

FARM CREDIT ADMINISTRATION HAS NOT CONSISTENTLY REPORTED ON BANK INTERNAL AUDIT ACTIVITIES

FCA's regulatory reporting system does not consistently report on the progress and problems of bank internal auditing units to either the bank boards of directors or the bank presidents involved. Although the System required that significant issues be reported within FCA regulatory reports to bank management, internal auditing is rarely discussed in these reports. Instead, FCA officials asserted these problems are discussed orally in either examination closeout meetings or in supervisory meetings with top bank management. However, a majority of the bank presidents we interviewed did not believe they were being supplied with meaningful feedback from FCA in its evaluation of the performance of their internal auditing units.

FCA regulatory reporting policies note that the reporting of identified issues is guided by the nature and significance of the findings. Significant problems, particularly problems associated with bank internal control policies, are to be reported to both top bank management and the board of directors. This type of regulatory reporting on bank issues is a cornerstone of FCA's decentralized regulatory philosophy of attempting to encourage the development of strong bank management systems. Other findings, judged to be minor in nature and not affecting bank policies, are generally to be reported to bank top management only. Since the activities of bank internal auditing units are guided by internal control policies developed by the board of directors, significant internal audit problems are worthy of being reported to both top bank management and the board of directors.

FCA's regulatory reporting system is a multitiered process with several different types of reports going to recipients both within and outside of FCA. The system contains five different types of reports:

1. External Examination Report--A report on an individual bank issued by the Office of Examination to the bank's board of directors.

2. Internal Examination Report--A report on an individual bank issued by the Office of Examination for internal use within FCA. The report contains findings not considered significant or appropriate for inclusion in the external report.

3. Examination Management Evaluation Report--A report from the Office of Examination for internal (within FCA) use evaluating the quality of the bank board, chief executive officer, organizational effectiveness, and management system being employed.

4. Annual Agency Report to the Board of Directors--A report issued by the Office of Supervision focusing upon bank administration and policy.

5. Management Letter Report--An annual report to the president of the bank to formally communicate to him FCA's evaluation of strengths and weaknesses in bank management.

Most of FCA's regulatory reporting covers activities at specific banks. However, banks in the same district have also pooled resources in joint service offices to provide selected services for the entire credit district. In some districts where joint services offices are used, internal audit services are provided through this mechanism. A separate regulatory report may be issued on the joint service office.

Our review of the entire inventory of 370 FCA regulatory reports available at FCA headquarters, covering the period from July 1977 through March 1979, indicated that both positive and negative internal audit issues were being identified. The need for improvements in internal audit was identified in 58 of these reports. The types of problems ranged from significant to minor and included inadequate staffing, weak audit implementation procedures, and impaired independence.

Although internally distributed FCA regulatory reports generally addressed individual bank internal audit activities, FCA's external regulatory reports, which are distributed to bank management, generally do not address internal auditing activities. We reviewed 53 instances where both internal and external regulatory reports were available for an individual bank. Although internal regulatory reports commented 42 times on bank internal auditing activities, external regulatory reports for the same banks commented on internal auditing only 16 times--13 times in letters to bank presidents and only 3 times in reports to the bank boards of directors. FCA's reporting on internal auditing provided to Offices of Joint Services fared somewhat better. Of 23 instances where both internal and external regulatory reports were available, internal reports commented 13 times while external reports on the same offices commented 10 times. However, none of the external reports on Office of Joint Services' operations were distributed to district boards of directors.

FCA officials attributed the low level of external reporting on internal auditing to insignificant findings; however, this explanation is inconsistent with the relative significance of the issues identified. A comparison of the 16 findings reported to either the boards of directors or the bank presidents with other findings not reported reveals no apparent differences in significance. For example, one of the findings reported to boards of directors discussed the limited amount of internal audit work;

the same issue that was not reported to bank management in another case.

Although FCA officials indicated that many times internal audit issues are discussed orally instead of being included in reports, our interviews of bank officials and our review of supervisory activities indicate that the discussions of these issues were not always effective. In our discussions with 11 bank presidents responsible for 14 banks spread among the 3 FCA examination districts, 6 presidents expressed dissatisfaction with the level of information being provided to them by FCA regarding the status of their internal audit units. Both the amount and quality of information being provided by FCA were criticized by individual presidents.

Our discussions with FCA supervisory personnel and reviews of supervisory plans (which identify the issues to be discussed with bank management for possible correction) did not show that internal audit issues are being orally discussed with bank management. Supervisory officials generally downplayed the importance of bank internal audits. Our review of the supervisory plans for 14 banks with identified internal audit problems did not identify any instances where internal audit was specifically addressed either positively or negatively in the plan.

Although FCA's regulatory reporting system has the objective of attempting to strengthen bank management control systems, regulatory reporting on both the progress and the problems of bank internal audit systems has been weak. As a result, bank management is not receiving effective feedback on its internal audit systems upon which to consider any needed changes.

FARM CREDIT ADMINISTRATION REGULATIONS CHANGED TO ALLOW BANKS MORE FLEXIBILITY IN ESTABLISHING INTERNAL AUDIT FUNCTIONS--OUTCOME UNCERTAIN

FCA's regulatory approach, stressing decentralized decisionmaking, has encouraged individual farm credit banks to develop strong internal control systems, including internal auditing activities. FCA has issued a regulation requiring the establishment of bank internal audit functions, provided a set of guidelines for managing bank internal audit units, and encouraged FCA examiners to both report on and use internal audit work in their bank examinations. Recently, FCA amended its regulations regarding internal audit to allow banks more flexibility in establishing their internal audit functions. The impact of this change on bank internal audit functions is uncertain.

Historically, FCA's regulatory approach has evolved from a highly centralized strategy, where many FCS operating decisions were being made by FCA, to a decentralized strategy in which FCA is actively encouraging System banks to become more involved in the decisionmaking process. To achieve the successful delegation of responsibility and authority inherent in effective decentralized decision-making, FCA is actively attempting to strengthen individual bank financial and management control systems. One financial and management control addressed by FCA has been the internal audit function. A strong internal audit system, operating within an effective internal control system, provides a strong foundation upon which meaningful delegation of authority can be made. Strong individual banks make effective decentralized regulation possible.

Consistent with FCA's objective to establish effective management and financial control systems within each bank, FCA examiners were removed from each credit district and replaced by district internal auditors in 1972. To accomplish this replacement, FCA issued Regulation 8430. This regulation required that each district board establish an internal control policy and provide for an internal audit function to cover all bank and association operations. This requirement for an internal audit function was interpreted by FCA's Office of Examination to mean that each bank should have an internal audit unit.

To further encourage the banks to develop and effectively use their internal audit units, FCA issued Internal Audit Guidelines in 1976. These guidelines described the importance of an effective internal audit unit within a bank's internal control system. In addition, the guidelines discuss some aspects of internal audit, such as independence, audit implementation, and audit program planning.

FCA has also encouraged the development of System internal auditing through its examination and supervision procedures. FCA's Office of Examination has issued procedures designed to encourage the use of bank internal audit work by FCA examiners to either alter or reduce the scope of the FCA examination. In addition, both the examination and supervision functions within FCA have been encouraged to report on any significant financial or managerial control problems identified during their reviews. These control problems could include ineffective internal audit activities.

Because FCA management believed that bank internal audit units were not functioning effectively, it sponsored a study in 1978 of the bank internal audit units by a certified public accounting firm. The report resulting from this study recommended that Regulation 8430 be amended to allow banks more flexibility in designing their internal control systems. The report also reaffirmed the importance of FCS bank internal audit activity as a significant element within bank internal control systems. As a result of this study, the Federal Farm Credit Board recently amended Regulation 8430. Although the amendment still notes the need for an internal audit function at each bank, references to the independent nature of internal audit activities have been deleted. FCA management hopes to enforce this regulation by requiring banks to have an effective internal audit function, but not necessarily an independent internal auditor position. Whether this can be accomplished remains uncertain.

CONCLUSIONS

Although FCA's regulatory policies have encouraged the establishment and use of bank internal audit units within the FCS, FCA has not done enough to emphasize the role and usefulness of internal audit as a management control device. We are uncertain whether bank internal audit will continue to be an independent function under the revised internal control policy. FCA regulators have not consistently reported on bank internal audit issues to bank management; provided leadership for the development of a set of professional auditing standards; or furnished active, consistent support for the use of the Internal Auditors' Conference as a mechanism to encourage professionalism within system internal audit units. As a result, a potentially valuable mechanism to encourage internal audit units to observe FCA internal audit policies and strengthen the professionalism of internal auditing is being neglected.

RECOMMENDATIONS

We recommend that the Federal Farm Credit Board direct the Governor of the Farm Credit Administration to:

--Provide leadership to the FCS to develop a set of professional internal auditing standards which will provide a basis for a more thorough evaluation of internal audits by both FCA and bank management as well as encouraging professionalism within bank internal audit units.

--Furnish active, consistent support for the FCS Internal Auditors' Conference.

--Require that Office of Examination reports to a bank's Board of Directors comment on the quality of the internal auditing system.

--Monitor the implementation of the revised internal control policy to insure that independent bank internal audit functions are maintained.

AGENCY COMMENTS

The Farm Credit Administration was asked to comment on this report, but it was unable to clear its comments with the Federal Farm Credit Board before the report was issued or within the maximum time permitted by P.L. 96-226.

CHAPTER 4

THE OFFICE OF EXAMINATION'S FINANCIAL EXAMINATION EFFORT SHOULD BE SUPPLEMENTED BY EXTERNAL AUDITORS

FCA currently uses its Office of Examination to perform the role of external auditor for the Farm Credit System. In this role, the Office of Examination expresses an opinion to System investors as to the fairness of the System's year-end balance sheet, income statement, and statement of changes in financial position. Although these reviews are to be made in accordance with generally accepted auditing standards, the Office of Examination's position, as a component of the supervisor of the System being audited, leaves its independence open to question.

The expression of an independent opinion on the financial statements of commercial entities actively engaged in obtaining funds through the sale of securities has long been a requirement of the investment community in the United States. These opinions are rendered by certified public accounting firms following generally accepted auditing standards. These standards include auditor independence. The auditor must be recognized as independent, which requires that he be free from any obligation to or interest in the client. According to the American Institute of Certified Public Accountants Statement on Auditing Standards:

> "public confidence...might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence."

> "Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence."

The Office of Examination performs a financial examination of each Farm Credit System Bank annually. The Office of Examination issues an opinion on the System's combined balance sheet, income statement, and statement of changes in financial position, which are included in the annual Farm Credit Banks Report to Investors. The Deputy Governor and Chief Examiner who heads the Office of Examination stated that this examination is made in accordance with generally accepted auditing standards.

The Office of Examination does not use an external auditing firm on an annual basis to review its financial examination procedures. One firm is employed to assist in the process of producing combined financial statements;

however, no report is issued. In addition, a second firm is employed by FCA for special projects. Office of Examination personnel stated that external auditors had been used to perform financial examinations of banks in the past, but the results did not fully meet FCA management's need for a broad assessment of individual bank management performance. External auditors were also used several years ago to review Office of Examination procedures, but that effort has been discontinued.

A detailed review of FCA's financial examination procedures was not within the scope of our review, and thus we cannot express a position on either the technical sufficiency or competency of the financial examinations performed. However, we believe the use of an FCA component to audit an FCA-supervised System poses inherent independence questions. The Office of Examination is not free from the influence of the rest of FCA. For example, the management effectiveness of the Office of Examination is regularly evaluated by FCA officials who are also responsible for FCA's supervision of the Farm Credit System. Opportunities for influencing FCA's Office of Examination are present.

Other Federal financial regulatory agencies with financial examination responsibilities have sought to limit opportunities to influence auditor independence by involving external auditors in their financial examination process. The Federal Home Loan Bank Board uses external auditors to perform financial examinations at each of the 12 Federal Home Loan Bank System Banks. Although the Federal Reserve System's Board of Governors uses its own examiners to perform financial examinations of individual Reserve Banks, the Board also uses an external auditor to independently review its annual financial examination procedures to ensure that its financial examinations are carried out in accordance with generally accepted auditing standards.

In view of the significant amount of private investment in the Farm Credit System (net assets of $800 million as of December 31, 1979) and the System's rapid growth (from $3.5 billion in assets in 1975 to $4.8 billion in assets in 1979 in constant dollars), we believe that an external auditor should be used to annually ensure that the procedures used in the expression of opinions on System financial statements are in accordance with generally accepted auditing standards.

CONCLUSION

FCA currently uses its Office of Examination to perform the role of external auditor for the FCA-supervised Farm Credit System. In this role, the Office of Examination renders an opinion to System investors as to the fairness of the financial statements presented. The Office of Examination's position, as an organizational component of the supervisor of the System being audited, leaves its independence open to question. Other financial regulatory agencies have used external auditors in varying degrees to independently ensure that the financial examination procedures used are in conformance with generally accepted auditing standards.

RECOMMENDATION

We recommend that the Governor of the Farm Credit Administration augment his financial examination efforts by using external auditors to ensure that financial examination procedures used are in conformance with generally accepted auditing standards.

AGENCY COMMENTS

The Farm Credit Administration was asked to comment on this report, but it was unable to clear its comments with the Farm Credit Board before the report was issued or within the maximum time permitted by P.L. 96-226.

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