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REPORT TO THE CONGRESS



Farmers Home Administration Procedures And Policies On The Use Of Independent Auditors Should Be Strengthened B-170874

Department of Agriculture

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

JAN. 22, 1971

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

B-170874

To the President of the Senate and the
Speaker of the House of Representatives

This is our report pointing out that Farmers Home Administration, Department of Agriculture, procedures and policies on the use of independent auditors should be strengthened. Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67). 255

Copies of this report are being sent to the Director, Office of Management and Budget, and to the Secretary of Agriculture.

A handwritten signature in cursive script that reads "James B. Stacks".

Comptroller General
of the United States

D I G E S T

WHY THE REVIEW WAS MADE

The Farmers Home Administration (FHA) makes loans to rural public and private nonprofit associations and organizations to finance various undertakings, such as the development of water and sewer facilities, recreational facilities, and rural housing projects. Loans outstanding for these and other purposes totaled \$942 million to 7,375 borrowers as of January 1, 1970. FHA uses reports of independent auditors in administering these loans.

The General Accounting Office (GAO) undertook its review of the use of independent auditors because of indications from earlier reviews of FHA operations that the reports prepared by independent auditors were not being used and--in many instances--did not meet FHA's needs.

GAO expanded its review to include the Rural Electrification Administration because it is the other principal agency in the Department of Agriculture that uses reports of independent auditors in administering loan programs.

FINDINGS AND CONCLUSIONS

The Rural Electrification Administration has established a sound program for using independent auditors, including a means of assuring that only professionally qualified accountants are selected to make audits. FHA needs to strengthen its procedures and practices for using independent auditors. (See p. 9.)

Auditors' qualifications

FHA has not provided clear guidelines to its field staff for determining whether the auditors engaged by its borrowers possess the independence and professional qualifications essential to the conduct of audits and preparation of required reports in accordance with generally accepted auditing standards. FHA generally does not advise or assist borrowers in the selection of auditors or otherwise determine that the auditors are qualified. (See p. 9.)

Guidance for Federal departments and agencies concerning qualifications of public accountants' making audits of federally chartered, financed or regulated private organizations was provided September 15, 1970, by the

Comptroller General in a letter to agency heads. The Comptroller General recommended that Federal departments and agencies require that audits be conducted in accordance with generally accepted auditing standards by independent certified public accountants, or by independent licensed public accountants who are certified or licensed by a regulatory authority of a State on or before December 31, 1970. Certain exceptions to that requirement were allowed. (See p. 11.)

In effect the language recommended by the Comptroller General provides that all audits after December 31, 1975, be made by certified public accountants except for those licensed public accountants who receive their licenses on or before December 31, 1970. This provision provides for a terminating class of public accountants who will continue to be eligible for such audit work throughout their active careers. (See app. III.)

Quality of audits

FHA has not properly defined or effectively communicated its auditing and reporting requirements to borrowers and their independent auditors.

GAO's examination of 79 audit reports prepared for FHA borrowers in Colorado and Idaho showed that 43 reports did not contain the required auditors' opinions on the financial statements. Of the 43 reports, 19 included a statement that the financial statements were prepared from the borrower's records without audit. Only five of the 79 reports were substantially responsive to FHA's reporting requirements. (See pp. 16 and 17.)

FHA supervision

Instructions have not been developed on how FHA personnel are to review and use audit reports prepared by independent auditors. As a result, agency officials (1) have accepted audit reports that did not meet FHA minimum requirements and (2) have not taken action to obtain audit reports from borrowers who failed to furnish the reports to FHA. (See p. 19.)

FHA instructions relating to the use of independent auditors were prepared by personnel responsible for association loan program operations without the advice or assistance of professionally qualified accountants or auditors. GAO concluded that technically qualified personnel should develop or assist headquarters' program personnel in developing such instructions. (See p. 21.)

Conclusion

Audit reports prepared by qualified independent auditors can be useful to FHA in supervising its borrowers, particularly from the standpoint of isolating and analyzing problem areas and evaluating the financial position and results of borrowers' operations.

Because of the potential value of properly prepared audit reports, it is important for FHA to ensure that audit reports prepared for borrowers by

independent auditors meet generally accepted auditing standards and that they are effectively used in the administration of its loan programs.

RECOMMENDATIONS OR SUGGESTIONS

The Administrator of FHA should:

- Establish the qualifications of independent auditors in line with the language recommended in the Comptroller General's letter.
- Define FHA's role in the selection of auditors engaged by borrowers.
- Define auditing and reporting requirements with respect to (1) the auditing and reporting standards for making an audit and for preparing the report and (2) the required minimum scope of audit, including any procedures to be used in tailoring reports to meet FHA's specific needs.
- Require that borrowers and auditors be furnished FHA requirements which the auditors must meet in the performance of audits and preparation of audit reports.
- Provide FHA personnel with guidance for the review and use of the independent auditors' reports.

The Administrator should also see that qualified personnel are assigned to functions relating to the use of independent auditors and that the county supervisors are given training and assistance as they may require in the review and use of audit reports. (See p. 24.)

GAO made no recommendations or suggestions to the Rural Electrification Administration.

AGENCY ACTIONS AND UNRESOLVED ISSUES

The Administrator, FHA, stated (see app. I) that FHA's instructions are being revised generally in line with GAO's recommendations and that standards would be established by which borrowers can select an independent auditor acceptable to FHA.

Although the Administrator stated that FHA would not participate directly in the selection of auditors by borrowers, FHA officials advised GAO in further discussions that appropriate action would be taken in those instances where reviews of independent auditors' reports evidenced noncompliance with FHA established requirements.

The Administrator stated that FHA's professional staff at the national headquarters and at certain field offices would be increased to ensure that

functions relating to the use of independent auditors are performed by qualified individuals.

GAO believes that FHA's planned actions are responsive to its recommendations and should result in upgrading and strengthening materially the usefulness of independent auditors' reports.

MATTERS FOR CONSIDERATION BY THE CONGRESS

GAO is bringing this matter to the attention of the Congress because of (1) the significance of the FHA and Rural Electrification Administration programs where reliance is placed on the work of independent auditors and (2) increasing congressional interest in the development of sound programs for the use of independent auditors in the administration of Federal programs.

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ABBREVIATIONS

FHA Farmers Home Administration
GAO General Accounting Office
OIG Office of the Inspector General
REA Rural Electrification Administration

D I G E S T

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FHA has not provided clear guidelines to its field staff for determining whether the auditors engaged by its borrowers possess the independence and professional qualifications essential to the conduct of audits and preparation of required reports in accordance with generally accepted auditing standards. FHA generally does not advise or assist borrowers in the selection of auditors or otherwise determine that the auditors are qualified. (See p. 9.)

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FHA instructions relating to the use of independent auditors were prepared by personnel responsible for association loan program operations without the advice or assistance of professionally qualified accountants or auditors. GAO concluded that technically qualified personnel should develop or assist headquarters' program personnel in developing such instructions. (See p. 21.)

Conclusion

Audit reports prepared by qualified independent auditors can be useful to FHA in supervising its borrowers, particularly from the standpoint of isolating and analyzing problem areas and evaluating the financial position and results of borrowers' operations.

Because of the potential value of properly prepared audit reports, it is important for FHA to ensure that audit reports prepared for borrowers by

independent auditors meet generally accepted auditing standards and that they are effectively used in the administration of its loan programs.

RECOMMENDATIONS OR SUGGESTIONS

The Administrator of FHA should:

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- Define FHA's role in the selection of auditors engaged by borrowers.
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- Require that borrowers and auditors be furnished FHA requirements which the auditors must meet in the performance of audits and preparation of audit reports.
- Provide FHA personnel with guidance for the review and use of the independent auditors' reports.

The Administrator should also see that qualified personnel are assigned to functions relating to the use of independent auditors and that the county supervisors are given training and assistance as they may require in the review and use of audit reports. (See p. 24.)

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The Administrator stated that FHA's professional staff at the national headquarters and at certain field offices would be increased to ensure that

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CHAPTER 1

INTRODUCTION

The General Accounting Office reviewed how independent auditors are used by the Farmers Home Administration and the Rural Electrification Administration (REA), Department of Agriculture, in administering their loan programs. The matters discussed in this report should not be considered typical of the manner in which either agency administers other aspects of its loan programs. The scope of our review is described on page 27 of this report.

Principal officials of the Department of Agriculture responsible for administration of the matters discussed in this report are listed in appendix IV.

FHA ORGANIZATION AND ADMINISTRATIVE REQUIREMENTS FOR USE OF INDEPENDENT AUDITORS

FHA was established on November 1, 1946, pursuant to the Farmers Home Administration Act of 1946 (60 Stat. 1062), to simplify and improve credit services available to farmers and to promote farm ownership. FHA makes direct and insured loans to public and private nonprofit associations and organizations for (1) the development of water and sewer systems, (2) land conservation practices such as the construction of soil and water conserving facilities and shifts in land uses, (3) the development of rural recreational projects, (4) the development of rural housing projects--primarily for senior citizens and farm labor, and (5) the creation of cooperatives providing essential processing, purchasing, or marketing services, supplies or facilities to predominantly low-income rural families. The loans are made pursuant to the Consolidated Farmers Home Administration Act of 1961, as amended (7 U.S.C. 1926); the Watershed Protection and Flood Prevention Act of 1954, as amended (16 U.S.C. 1006a); Title V of the Housing Act of 1949, as amended (42 U.S.C. 1471); and the Economic Opportunity Act of 1964, as amended (42 U.S.C. 2852).

FHA maintains 41 State offices--which serve the 50 States, the District of Columbia, Puerto Rico, and the

Virgin Islands--and about 1,700 county offices. Each FHA State office is headed by an FHA State director who is responsible for all program operations within his territorial jurisdiction. The FHA county offices, each under the supervision of an FHA county supervisor, are located throughout the country to serve all agricultural counties. Applications for all loans are made to the county offices. County office operations are subject to review by FHA district supervisors and other FHA State office officials.

Under FHA instructions, a borrower, after receiving a loan, is provided with FHA supervision necessary to accomplish the objectives of the loan. Methods of supervision include organizational and development planning; construction conferences; long-term, annual, and other periodic planning; accounts and records inspection; facility inspections; attendance at membership and governing body meetings; and analysis of accounting and audit reports.

With respect to audit reports, FHA instructions require each borrower to submit an annual audit report within 60 days after the close of the borrower's fiscal year. The instructions also provide that:

- When a borrower's total outstanding indebtedness to FHA exceeds \$25,000 or the loan is delinquent, an audit report will be prepared by a qualified independent auditor.
- When a borrower's total outstanding indebtedness to FHA is \$25,000 or less and the loan is current, the audit may be made by a committee of the membership not to include any officer, director, or employee of the borrower.

The number and total dollar volume of association and organization loans made by FHA has increased substantially in recent years. At January 1, 1964, loans of about \$54 million had been made to 750 borrowers, of which about \$47 million was outstanding to 649 borrowers. By January 1, 1970, cumulative loans of about \$1 billion had been made to 7,720 borrowers, of which about \$942 million was outstanding to 7,375 borrowers. As of that date, 1,508 borrowers, or 20 percent, were delinquent about \$13 million on their

outstanding loans. The percentage of borrowers delinquent ranged from a low of 4 percent for watershed loans to a high of 43 percent for loans to economic opportunity cooperatives. FHA advised us that by April 30, 1970, the overall delinquency rate had decreased to 10 percent.

The status at January 1, 1970, of the various types of organization and association loans made by FHA is shown in the following schedule.

Type of <u>loan</u>	<u>Number of borrowers</u>		Percent of bor- rowers de- linquent on their <u>loans</u>	De- linquent amounts
	Having out- standing <u>loans</u>	De- linquent on their out- standing <u>loans</u>		
Association	4,745	843	18	\$10,381,419
Watershed	399	17	4	494,392
Housing	1,014	143	14	932,224
Renewal and resource conservation development	65	7	11	34,665
Economic opportunity cooperative	<u>1,152</u>	<u>498</u>	<u>43</u>	<u>1,774,686</u>
Total	<u>7,375</u>	<u>1,508</u>	<u>20</u>	<u>\$13,617,386</u>

At January 1, 1970, cumulative loans of about \$62 million had been made to 443 borrowers in Colorado and Idaho--the two States where we made our review--of which about \$57 million was outstanding to 374 borrowers. As of that date, 92 borrowers, or 25 percent, were delinquent about \$977,000.

FHA's program planning data for fiscal year 1970-74 indicate that the total dollar volume of loans to association and organization borrowers will continue to grow at a rapid pace. FHA estimates that loans totaling \$1.2 billion will be made during the 5-year period. In addition to being authorized to make loans for established programs, FHA is authorized under section 524 of the Housing Act of

1949, as amended (42 U.S.C. 1490d), to make loans to public or private nonprofit organizations for the acquisition and development of land as building sites to be subdivided and sold to eligible applicants.

REA ORGANIZATION AND ADMINISTRATIVE
REQUIREMENTS FOR USE OF INDEPENDENT AUDITORS

REA was established on May 11, 1935, by Executive Order 7037. Pursuant to the Rural Electrification Act of 1936, as amended (7 U.S.C. 901), REA makes loans to (1) private companies and cooperatives for the extension of electric and telephone service to rural areas and for the improvement of existing telephone service to rural areas and (2) cooperative associations and public bodies for necessary additional facilities to meet the increasing need for power on existing rural electric systems.

REA requires its borrowers to have their accounts and supporting records audited annually by independent certified public accountants (CPAs) selected by the borrowers and approved by REA. Specific auditing and reporting requirements are published in an REA bulletin for use by the borrowers and CPAs.

At January 1, 1970, REA had made loans totaling \$8.8 billion to 1,963 borrowers, of which about \$5.2 billion was outstanding to 1,828 borrowers. Of these borrowers, 11 were delinquent about \$2 million.

CHAPTER 2

FHA SHOULD STRENGTHEN PROCEDURES AND PRACTICES

RELATING TO ITS USE OF INDEPENDENT AUDITORS

On the basis of our review, we concluded that (1) FHA should strengthen its procedures and practices relating to the use of independent auditors in administering its loan programs and (2) REA has established a sound program for the use of independent auditors. Specifically, FHA should:

- Clearly define the minimum professional qualifications of independent auditors and its role in the selection of such auditors.
- Properly define auditing and reporting requirements and communicate such requirements to all borrowers and their independent auditors.
- Develop procedures for the review and use of audit reports.
- Ensure that functions relating to the use of independent auditors are performed or supervised by qualified personnel.

The following sections of this chapter discuss the areas where improvements should be made by FHA and describe the procedures and practices being followed by REA in each of these areas.

FHA SHOULD CLEARLY DEFINE THE MINIMUM PROFESSIONAL QUALIFICATIONS OF INDEPENDENT AUDITORS AND ITS ROLE IN THE SELECTION OF SUCH AUDITORS

FHA has not provided any clear guidelines to its field personnel for determining whether auditors engaged by its borrowers possess independence and professional qualifications essential to the conduct of audits and preparation of

required reports in accordance with generally accepted auditing standards.¹

FHA's only written instructions concerning auditors' qualifications state that:

"*** the audit report will be prepared by a qualified independent auditor. The State Director may require, in any particular case, that the auditor be a Certified Public Accountant."

The instructions do not:

- Describe any minimum professional qualifications in terms of technical training, experience, independence, or recognition which would be acceptable to FHA in those cases where the State director does not require that the auditor be a CPA.
- Require FHA personnel to advise or assist borrowers in the selection of auditors.

We discussed with 18 FHA county supervisors in Colorado and Idaho their involvement in the selection of auditors. The supervisors informed us that generally they did not (1) provide advice and assistance to borrowers in the selection of auditors or (2) determine that the persons selected by the borrowers were qualified to conduct audits and prepare reports.

We selected for examination 79 of 125 audit reports prepared for FHA borrowers in Colorado and Idaho in calendar years 1968 and 1969. Generally our selection included audit reports for all borrowers having outstanding loan balances of \$100,000 or more at January 1, 1969. Our examination showed that

¹Those standards which have been adopted by the accounting profession to apply to audits of accounts, financial transactions, and financial statements of an organization.

--55 reports were prepared by accountants who were certified and licensed by a regulating authority of a State and

--24 reports were prepared by persons who were not certified and licensed to practice as independent auditors by the States and whose qualifications were not otherwise determinable from the reports or FHA records.

Although the majority of the audit reports were prepared by accountants who were certified and licensed, most of the reports did not contain all the information required by FHA instructions or indicate that the audit met generally accepted auditing standards. This problem is discussed in detail beginning on page 16 of this report.

In a letter to heads of Federal departments and agencies dated September 15, 1970 (see app. III), the Comptroller General discussed the qualifications which public accountants making audits of federally chartered, financed, or regulated private organizations should have. The Comptroller General recommended that the following language be included in regulations issued by departments and agencies prescribing the qualifications of public accountants selected to audit programs administered by the departments and agencies.

"Such audits shall be conducted in accordance with generally accepted auditing standards by independent certified public accountants or by independent licensed public accountants, licensed on or before December 31, 1970, who are certified or licensed by a regulatory authority of a State or other political subdivision of the United States: Except that independent public accountants licensed to practice by such regulatory authority after December 31, 1970, and persons who, although not so certified or licensed, meet, in the opinion of the Secretary, standards of education and experience representative of the highest prescribed by the licensing authorities of the several States which provide for the continuing licensing of public accountants and which are prescribed by the Secretary

in appropriate regulations may perform such audits until December 31, 1975: Provided, that if the Secretary deems it necessary in the public interest, he may prescribe by regulation higher standards than those required for the practice of public accountancy by the regulatory authorities of the States."

In effect the language recommended by the Comptroller General provides for all audits after December 31, 1975, to be made by CPAs except for those licensed public accountants who receive their licenses on or before December 31, 1970. This provision provides for a terminating class of public accountants who will continue to be eligible for such audit work throughout their active careers.

REA procedures for selection and approval of independent auditors

REA has established the following procedures relating to its participation in the selection and approval of independent auditors.

1. Upon notification from REA to engage an independent CPA to audit its records, the borrower's board of directors is responsible for selecting a CPA subject to REA approval. Although REA policy does not require the accountant selected by the borrower to be a CPA of the State in which the borrower is located, he must be licensed by a State or territory or the District of Columbia.
2. In selecting the CPA, the borrower's board of directors is to consider the qualifications of available accountants with emphasis on their experience in performing audits of utilities and on their ability to complete the audit and submit the report within the required time limit.
3. After selection of the CPA, the borrower is required to advise REA by letter of its selection and to submit a certified copy of the resolution adopted by

the board of directors covering such action. If the borrower's selection of a CPA is not satisfactory to REA, the borrower is advised prior to the date the audit is to begin.

AUDITING AND REPORTING REQUIREMENTS SHOULD
BE PROPERLY DEFINED AND COMMUNICATED BY FHA
TO BORROWERS AND INDEPENDENT AUDITORS

FHA has not properly defined and generally has not communicated its auditing and reporting requirements to borrowers and their independent auditors. Such action is needed to provide assurance to FHA that audits will provide the information needed for an evaluation of the borrowers' financial status and results of their operations.

FHA instructions state that audit reports will be dated as of the close of the fiscal year and will include at least the following information.

- "I The auditor's opinion regarding the extent to which the audit report represents the financial position of the borrower.
- "II The auditor's comments and recommendations on items such as:
 - A Adequacy of accounts and records including suggestions for improvement, if any.
 - B Adequacy of managerial practices, including suggestions for improvement, if any.
- "III The name, address, and date of expiration of the term of directors and officers.
- "IV Balance Sheet showing at least the following:
 - A Assets and other debits.
 - B Liabilities and other credits, including reserves.
 - C Member or stockholder equities or surpluses.
 - D Fund balances.

"V A Statement of Income and Expenses showing sources of income and major categories of expenses for the year.

"VI A list of accounts receivable showing the name, amount, and whether the accounts are delinquent.

"VII Other appropriate information such as:

A Amount of property insurance, liability insurance, and workman's compensation insurance.

B Status of taxes, if any.

"VIII Any unusual items."

The instructions do not contain any statement regarding the auditing and reporting standards to be followed in making the audit and in preparing the report and the minimum scope of audit required that would give consideration to any audit procedures which the auditor should follow in tailoring the audit report to meet specific needs of FHA. FHA's instructions do not require the auditor to (1) comment on a borrower's compliance with requirements of FHA loan agreements or (2) provide special analyses of a borrower's operations which could be useful to FHA in supervising a borrower's activities.

For example FHA loan agreements require that certain cash reserves be established and maintained by borrowers, but the instructions do not require the auditor to comment on the extent of a borrower's compliance with this requirement. Special analyses which we believe could be useful to FHA include (1) evaluations of internal controls and financial policies and (2) contrasts of borrowers' actual financial progress with loan objectives and annual operating budgets.

In our view, because FHA is operating nationwide loan programs, an improved statement of auditing and reporting requirements would

- promote uniformity in audit reports,
- help to ensure that sufficient information is provided for an evaluation of a borrower's financial status and results of operations, and
- provide assurance--in those cases where audits are made by other than CPAs--that such audits meet generally accepted auditing and reporting standards.

FHA instructions also do not contain any statement that FHA county or State officials are to communicate FHA's requirements to borrowers and their independent auditors. Fifteen of 18 county supervisors contacted by us indicated that they did not normally communicate the requirements to borrowers or their auditors.

Audit reports received by FHA in the two States included in our review, for the most part, did not meet many of the requirements established by FHA. For example our examination of 79 audit reports showed that 43 reports did not contain the required auditors' opinions on the financial statements. Of the 43 reports, 19 included a statement that the financial statements were prepared from the borrowers' records without audit. Only five of the 79 reports were substantially responsive to FHA's reporting requirements.

The tabulation below shows the extent to which the 79 audit reports did not meet FHA's minimum reporting requirements.

<u>FHA requirement</u>	<u>Meeting FHA requirement</u>	<u>Not meeting FHA requirement</u>	<u>Percent not meeting FHA requirement</u>
Auditor's opinion on borrower's financial position	36	43	54
Auditor's comments on adequacy of records	18	61	77
Auditor's comments on adequacy of managerial practices	11	68	86
List of directors and officers	17	62	78
Balance sheet	71	8	10
Statement of income and expenses	69	10	13
List of accounts receivable	25	54	68
Information on:			
Insurance coverage	15	64	81
Status of taxes	15	64	81

The following two cases illustrate the need for FHA to communicate its auditing and reporting requirements to all borrowers and their independent auditors in order to have some assurance that adequate audits are conducted and that the reports provide required information.

1. Borrower A, a grazing association in Colorado, obtained an initial loan from FHA in 1966. The association owed FHA about \$1.7 million and was delinquent about \$31,000 at January 1, 1969. For the borrower's fiscal year ended November 1968, the borrower's auditor, a certified public accountant, indicated in his report that the financial statements were "unaudited." The auditor clearly stated in his report that a complete examination was not made and that, for this reason, he was not expressing an opinion on the financial statements. The auditor's report included a balance sheet and statement of income and expenses.

At the time of our fieldwork, the county supervisor informed us that FHA's requirements for audits and reports had not been communicated to the borrower or the borrower's auditor, and that the county office had accepted whatever the auditor provided in the way of an audit report.

2. Borrower B, a recreation organization in Idaho, owed FHA about \$114,000 and was delinquent about \$24,000 at January 1, 1969. Financial statements received by FHA from this borrower for the borrower's year ended June 30, 1969, contained a comment by the CPA firm to the effect that the financial statements were prepared without independent verification. The county supervisor informed us that he had not communicated FHA's auditing and reporting requirements to the borrower or the auditor.

REA auditing and reporting requirements

REA has established comprehensive auditing and reporting requirements which are furnished to both borrowers and independent auditors in an REA bulletin. According to the bulletin, REA has found--in administering a national loan program--that the quality of audit reports varies considerably. Because of this, REA auditing and reporting requirements were established to

- promote uniformity in audit reports,
- ensure audit reports provide sufficient information for a comprehensive evaluation of borrowers' financial status and results of operations, and
- give some assurance that adequate audit procedures are followed.

In general the minimum audit acceptable to REA is one performed in accordance with auditing standards equivalent to those established by the American Institute of Certified Public Accountants. Also REA requires performance of certain audit procedures which it deems necessary to an evaluation of borrowers' financial status and compliance with REA loan agreement requirements. REA's bulletin specifically points out that REA's requirements are considered the minimum and are not intended to limit the auditor's judgment concerning additional work necessary to make a proper audit and prepare an adequate and appropriate report.

REA requires the CPA, upon completion of the audit to submit an audit report containing certain financial statements and supplementary analyses, comments on the financial statements, and an opinion of the fairness with which the statements present the financial position of the borrower and the fairness of the supplementary analyses and balance sheet comments. REA's bulletin includes sample forms, formats, and comments for use by CPAs in preparing acceptable audit reports.

Our review of 29 audit reports submitted to REA by borrowers in Colorado and Wyoming showed that the reports substantially conformed with REA auditing and reporting requirements. In three of the reports, the CPAs did not present the subdivisions of detailed account balances on the balance sheet and income statements in the format required by REA. REA pointed out the specific deviations in audit review letters to the concerned borrowers and the CPAs who performed the audits.

PROCEDURES FOR REVIEW AND USE OF
AUDIT REPORTS BY FHA SHOULD BE DEVELOPED

FHA has not developed any instructions concerning the review and use by FHA personnel of audit reports prepared by independent auditors. In the absence of any instructions to reject inadequate reports, FHA personnel have accepted audit reports which did not contain the minimum information which FHA considered essential to constitute satisfactory audit reports. Also, in instances where borrowers did not furnish audit reports, FHA personnel did not take follow-up action to obtain the required reports.

As previously pointed out on page 16, of the 79 audit reports we examined, only five were substantially responsive to FHA's minimum requirements. Also, in the two States included in our review, 38 borrowers had not furnished required audit reports for the most recent fiscal year. FHA State officials were aware that action to obtain required reports was not taken.

In our discussions with FHA county supervisors and FHA State officials, they indicated that detailed analyses of audit reports to determine whether such reports complied with FHA's minimum reporting requirements generally were not made. From these discussions, we concluded that county supervisors, the primary FHA officials responsible for review of audit reports and supervision of borrowers:

- Did not have a clear understanding of the significance of audits, audit reports, auditors' opinions on financial statements, and financial statement analysis.
- Were not using audit reports in evaluating the borrower's financial position and results of its operations.

A January 1970 audit report issued by the Office of the Inspector General (OIG), Department of Agriculture, on FHA's association recreation loan program included a statement that county supervisors had advised OIG that they were not bookkeepers, that they did not understand financial management, and that they had never received any financial

training from the State offices in the financial management of associations. (See p. 23.)

In our opinion, the fact that county supervisors generally do not have formal training and experience in financial management increases the importance of clear, complete instructions on the review and use of audit reports.

REA procedures for review
and use of audit reports

REA's bulletin states that, upon receipt of the audit report by a borrower, the board of directors and management should carefully review the report and should take corrective action to eliminate any unsound practices.

Copies of the audit report submitted to REA are reviewed for information relating to the borrower's operations and financial status and for conformance with REA's auditing and reporting requirements. After its review of the report, REA furnishes the borrower and the CPA with any comments or recommendations it may have.

Also REA field accountants evaluate the adequacy of the audit of the borrower's records. REA's Borrowers' Audit Standards Staff examines selected audit work papers of CPAs to determine the conformance with REA's minimum standards for audit. This review function is performed to provide assurance that the reports submitted are based on examinations carried out in accordance with acceptable standards.

As previously discussed on page 18, audit reports received by REA substantially conform with REA requirements. In those instances where a report did not conform, REA pointed out the deviations to the borrower and to the CPA.

INSTRUCTIONS RELATING TO USE OF
INDEPENDENT AUDITORS SHOULD BE
DEVELOPED BY QUALIFIED FHA PERSONNEL

Because the problems previously discussed in this report stemmed to a large extent from the lack of adequate and complete agency instructions relating to audits by independent auditors, we inquired as to the placement of responsibility in FHA for the preparation of such instructions. We were advised that the instructions had been prepared by personnel responsible for association loan program operations in FHA's Washington headquarters without the advice or assistance of professionally qualified accountants or auditors.

In our opinion, FHA, to derive maximum benefit from the reports prepared by independent auditors, should have technically qualified personnel develop or assist the headquarters' program personnel in developing instructions which can be used as a basis for correcting the problems found in our review. Also we believe that, once the instructions are developed, FHA will have to provide the county supervisors with the assistance that they need in the review and use of audit reports.

REA organization relating to use
of independent auditors

REA's Borrowers' Financial Management Division administers activities concerned with borrowers' accounting and audits of borrowers' records. The Division has a Borrowers' Audit Standards Staff, a Technical Accounting Staff, and a Borrowers' Accounting Branch.

The Borrowers' Audit Standards Staff develops proposed policies, procedures, and standards for the use of CPAs and for agency examination programs. The Staff develops also criteria and techniques for the review by REA of audit reports prepared by CPAs. This Staff is responsible for the examination of CPA workpapers, as necessary, to determine conformance with REA's minimum standards for audits.

The Technical Accounting Staff is responsible for developing and evaluating broad and basic accounting policies, systems, and procedures with respect to borrowers' accounting operations.

The Borrowers' Accounting Branch:

- Appraises borrowers' accounting systems and procedures and recommends changes as necessary.
- Provides advice and assistance to borrowers in the installation and operation of accounting systems.
- Examines borrowers' records to ensure that loan funds are expended properly.
- Conducts regular financial audits of borrowers not audited by CPAs.
- Identifies deficiencies which tend to delay the borrowers' attainment of program objectives and recommends plans for remedial action.

The Branch is responsible for the review of audit reports by CPAs to determine conformance with acceptable accounting practices, procedures, and standards, and compliance with REA's requirements. In cases of nonconformance or noncompliance, the Branch is responsible for determining that appropriate action is taken. In addition, the Branch approves the borrower's selection of a CPA.

CHAPTER 3

RECENT INTERNAL AUDIT WORK

RELATING TO FHA'S USE OF REPORTS

BY INDEPENDENT AUDITORS

OIG issued a report in January 1970 dealing with FHA's recreation association loan program in 14 States, including the two States where we made our review. The OIG report, which covered 107 associations, pointed out, among other things, that the associations did not have proper audits.

With respect to 90 associations required to have audits by an independent auditor, the OIG report pointed out that

--43 associations had submitted audit reports which did not comply with FHA's reporting requirements--8 of these associations had audit reports which were not prepared by independent auditors,

--24 associations had not submitted audit reports to FHA, and

--23 associations had submitted audit reports which complied with FHA's reporting requirements but contained the auditors' qualifying statements that the borrower's records did not adequately support certain balance sheet or income account transactions.

The OIG report recommended that the Administrator, FHA, revise the agency's instructions to require that associations enter into agreement with a qualified accountant before loan closing to (1) set up an accounting system, (2) train and supervise the person who is to maintain the records, and (3) furnish an adequate audit of the books when required. OIG recommended also that FHA State offices review and approve the borrowers' accounting systems and contracts with accountants.

In March 1970 we were advised by an OIG official that FHA had promised to make procedural changes in line with the recommendations contained in the OIG report.

CHAPTER 4

CONCLUSIONS, RECOMMENDATIONS, AND AGENCY COMMENTS

CONCLUSIONS

Audit reports prepared by qualified independent auditors can be useful to FHA in supervising organization-type borrowers, particularly from the standpoint of isolating and analyzing problem areas and evaluating the financial position and results of borrowers' operations. Because of the potential value of properly prepared audit reports, it is important for FHA to ensure that audit reports prepared for borrowers by independent auditors meet generally accepted auditing standards and that they are effectively used in the administration of its loan programs.

RECOMMENDATIONS TO THE ADMINISTRATOR, FHA

We recommend that the Administrator, FHA, have agency instructions for the use of independent auditors revised to:

- Establish the qualifications of independent auditors in line with the language recommended in the Comptroller General's September 15, 1970, letter to heads of Federal departments and agencies. (See app. III.)
- Define FHA's role in the selection of auditors engaged by borrowers.
- Define auditing and reporting requirements with respect to (1) the auditing and reporting standards for making an audit and for preparing the report and (2) the required minimum scope of audit, including any procedures to be used in tailoring reports to meet FHA's specific needs.
- Require that borrowers and auditors be furnished FHA requirements which the auditors must meet in the performance of audits and preparation of audit reports.

--Provide FHA personnel with guidance for the review and use of the independent auditors' reports.

In the event that the Administrator requires outside assistance and advice in the development of improved procedures and requirements, we suggest that he call upon OIG and REA. Also the American Institute of Certified Public Accountants' Committee on Relations with Federal Government Agencies is available to provide Federal agencies with advice and assistance in such matters.

We recommend also that the Administrator take steps to ensure that functions relating to the use of independent auditors are performed by qualified personnel and that the county supervisors are given training and assistance that they may require in the review and use of audit reports.

FHA COMMENTS

The Administrator, FHA, advised us by letter dated August 10, 1970 (see app. I), that FHA was revising its supervision and servicing instructions and that the revised instructions would include an exhibit which would be provided to FHA's borrowers and their accountants. He stated that the exhibit would define:

- The minimum professional qualifications of independent auditors in line with the language recommended in the Comptroller General's September 15, 1970, letter.
- Auditing and reporting requirements with respect to (a) scope, (b) the auditing and reporting standards to be followed in making the audit and in preparing the report, and (c) the audit procedures to be used by the auditor in tailoring the report to the needs of FHA. The auditing requirements for the various types of loans are to be detailed separately and will include requirements for nonprofit organizations, public bodies, recreation associations, grazing associations, watershed and irrigation associations, economic opportunity cooperatives, labor and rental housing organizations, and individuals.

The Administrator stated also that (1) the revised instructions would include detailed requirements for the review and use of independent auditors' reports by FHA field personnel and (2) FHA would increase its professional staff at the national headquarters office and certain field offices to ensure that functions relating to the use of independent auditors are performed by qualified personnel.

The Administrator stated the belief that FHA field personnel should not assist borrowers in the selection of their auditors. He did state, however, that FHA would establish standards by which borrowers can select an independent auditor acceptable to FHA. In further discussions, FHA officials stated that appropriate action would be taken in those instances where reviews of independent auditor's reports evidenced noncompliance with FHA established requirements.

We believe that the actions planned by FHA are fully responsive to our recommendations and should result in materially upgrading and strengthening the usefulness of independent auditors' reports.

REA COMMENTS

The Administrator, REA, advised us by letter dated June 15, 1970 (see app. II), that he was pleased that we found REA's procedures and practices relating to its use of independent auditors sound. He also stated that REA would be willing to provide assistance to FHA in the development of its procedures and requirements relating to independent auditors.

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OIG officials advised us that the Department of Agriculture would issue regulations prescribing the qualifications of public accountants selected to audit programs administered by Federal departments and agencies along the lines recommended by the Comptroller General in his September 15, 1970, letter.

CHAPTER 5

SCOPE OF REVIEW

Our review was made at the FHA and the REA headquarters offices in Washington, D.C.; at the FHA Finance Office in St. Louis, Missouri; at FHA State Offices in Denver, Colorado, and Boise, Idaho; at 10 FHA county offices in Colorado and eight county offices in Idaho; and at the REA Field Accountant's office in Brighton, Colorado.

We reviewed the pertinent provisions of applicable legislation and the procedures and practices followed by FHA and REA in the use of independent auditors. We examined audit reports and agency records of 79 FHA borrowers located in Colorado and Idaho, and 29 REA borrowers located in Colorado and Wyoming.

We also discussed various matters with FHA and REA officials.

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APPENDIXES

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UNITED STATES DEPARTMENT OF AGRICULTURE
FARMERS HOME ADMINISTRATION
WASHINGTON, D.C. 20250

OFFICE OF THE ADMINISTRATOR

Mr. Victor L. Lowe
Associate Director
U. S. General Accounting Office
Civil Division
Washington, D. C. 20548

AUG 10 1970

Dear Mr. Lowe:

Thank you for sending me copies of your draft report to the Congress on the review of the use of independent auditors by the Farmers Home Administration (FHA) and the Rural Electrification Administration (REA).

On page three of your report you comment on the delinquent association borrowers of FHA as at January 1, 1969. We feel that if you are going to include these figures you should show more detail, because over 36 percent of the delinquencies reported are Economic Opportunity Cooperative borrowers. These are high risk loans to low income rural residents. Also loan repayments from public bodies are due on January 1 and their fiscal agents, in some instances, issue checks to FHA on or after January 1.

We have detailed the number of delinquent loans by type at January 1, April 30, and June 30 for both 1969 and 1970 on Exhibit A. A further breakdown by loan category is detailed on Exhibit B for January 1, January 31, and April 30, 1970, which indicates the percentage of delinquent association loans, other than the Economic Opportunity Cooperatives, is 16, 9, and 8, respectively. [See GAO note.]

Exhibit C details the dollar amounts of outstanding loans and the amounts reported delinquent at January 1, 1970 by loan types. Exhibit D details the cumulative amounts advanced for Organization and Association Loans Nationally and for Colorado and Idaho, and the amount of such loans outstanding January 1, 1970. This information was requested in your letter of May 28, 1970.

You mention that REA has made 1,963 loans in the past 35 years and that it has published specific auditing and reporting requirements for

GAO note: The detailed information on delinquencies by loan programs furnished by FHA is shown on page 7 of this report. Therefore, the exhibits to FHA's letter are not included.

borrowers. FHA has made about 7,000 loans (representing less than one percent of all loans made) to organization and association borrowers in the past six years. FHA has recently added an accountant to its Community Services Division staff to develop the auditing and reporting requirements for organization and association borrowers.

We are presently rewriting our supervision and servicing instructions and we will include an exhibit that will be given to borrowers and their accountants which will:

1. Define the minimum professional qualifications of independent auditors in line with the language recommended in the Comptroller General's May 12, 1970 letter B-148144. [See GAO note.]

2. Define the auditing and reporting requirements with respect to (a) scope, (b) the auditing and reporting standards to be followed in making the audit and preparing the report and, (c) the audit procedures to be used by the auditor in tailoring the report to the needs of FHA.

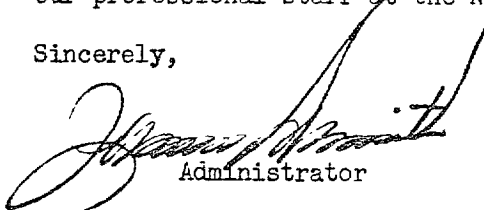
Auditing requirements for the various types of loans will be detailed separately. These will include: Nonprofit organizations; public bodies; recreation associations; grazing associations; watershed and irrigation associations; economic opportunity cooperatives; labor and rental housing organizations and individuals.

Our revised instructions will include detailed requirements for the review and use of independent auditors' reports by FHA field personnel.

We do not believe that FHA personnel should assist borrowers in the selection and approval of auditors. We have never followed this practice with other professionals such as attorneys, engineers and planners. To do so would put the agency in a position of determining whether particular individuals qualify for the position. FHA will, however, establish standards by which borrowers may select an independent auditor acceptable to the agency.

In order to ensure that functions relating to the use of independent auditors are performed by qualified personnel, we intend to increase our professional staff at the National Office and certain field offices.

Sincerely,



Administrator

GAO note: In a letter to the heads of Federal departments and agencies dated September 15, 1970, the Comptroller General recommended somewhat different language than that recommended in the May 12, 1970, letter referred to by FHA. (See app. III.) FHA officials advised us that the September 15 letter will be used in rewriting its instructions.

UNITED STATES DEPARTMENT OF AGRICULTURE
RURAL ELECTRIFICATION ADMINISTRATION
WASHINGTON, D.C. 20250

Jun 15, 1970

Mr. Victor L. Lowe
Associate Director, Civil Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Lowe:

We thank you for the opportunity to review the draft of the proposed report to the Congress on the use of independent auditors by the Farmers Home Administration and the Rural Electrification Administration, Department of Agriculture.

We are pleased that you found REA's procedures and practices sound for its use of independent auditors.

In accordance with your request, we offer the following comments for your consideration:

1. Page 4 - Line 12 - We suggest that this statement be broadened to show that the electrification loans are made primarily to cooperative associations and public bodies and that telephone loans are made to both private companies and cooperatives. As of January 1, 1970, there were loans outstanding to 1,828 borrowers as follows:

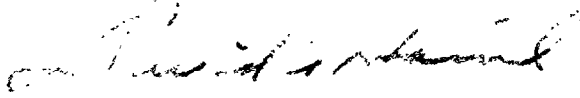
<u>Type of Organization</u>	<u>Electric</u>	<u>Telephone</u>
Cooperatives	920	232
Public Bodies	64	-
Private Companies	2	610
	<u>986</u>	<u>842</u>

2. Page 17 - Last Line - Suggest this sentence be modified to read: "In addition, the Branch approves CPA's to perform audit services for borrowers."

APPENDIX II
Page 2

Should the Farmers Home Administration desire our assistance in the development of procedures and requirements, we will be glad to work with them.

Sincerely,



Administrator

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

B-148144

September 15, 1970

HEADS OF FEDERAL DEPARTMENTS AND AGENCIES

Subject: Qualifications of public accountants making audits of federally chartered, financed, or regulated private organizations

By our circular letter of May 12, 1970, (B-148144) we advised you of a change in our position regarding the qualifications of those who may be selected to audit federally chartered, financed or regulated private organizations. The major change from our previously announced position was that after December 31, 1975, only certified public accountants should be selected to make such audits.

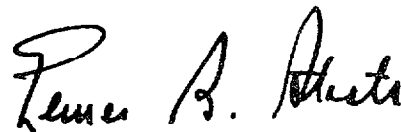
Since announcing this revised position we have received information and have had consultations which convinced us of the desirability of making a further revision in our position. Instead of limiting such audits to only certified public accountants after December 31, 1975, we believe it equitable that those licensed public accountants who received their licenses on or before December 31, 1970, also be permitted to perform such audits after the December 31, 1975, cut off date. This has the effect of creating a terminating class of public accountants who throughout their active careers will continue to be eligible for such work.

In accordance with this revised position, we recommended to the House Committee on Education and Labor, in lieu of our previous proposal, the inclusion of the following language in a bill it is considering.

"Such audits shall be conducted in accordance with generally accepted auditing standards by independent certified public accountants or by independent licensed public accountants, licensed on or before December 31, 1970, who are certified or licensed by a regulatory authority of a State or other political subdivision of the United States: Except that independent public accountants licensed to

practice by such regulatory authority after December 31, 1970, and persons who, although not so certified or licensed, meet, in the opinion of the Secretary, standards of education and experience representative of the highest prescribed by the licensing authorities of the several States which provide for the continuing licensing of public accountants and which are prescribed by the Secretary in appropriate regulations may perform such audits until December 31, 1975: Provided, that if the Secretary deems it necessary in the public interest, he may prescribe by regulation higher standards than those required for the practice of public accountancy by the regulatory authorities of the States."

We recommend that the position expressed in the above language, rather than that proposed in our May 12, 1970 letter, be incorporated in regulations issued by departments and agencies prescribing the qualifications of public accountants selected to audit programs administered by the departments and agencies.



Comptroller General
of the United States

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PRINCIPAL OFFICIALS OF
THE DEPARTMENT OF AGRICULTURE
RESPONSIBLE FOR ADMINISTRATION OF THE MATTERS
DISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
SECRETARY OF AGRICULTURE:		
Clifford M. Hardin	Jan. 1969	Present
Orville L. Freeman	Jan. 1961	Jan. 1969
ASSISTANT SECRETARY OF AGRICULTURE FOR RURAL DEVELOPMENT AND CON- SERVATION:		
Thomas K. Cowden	Apr. 1969	Present
John A. Baker	Mar. 1961	Jan. 1969
ADMINISTRATOR, FARMERS HOME ADMINISTRATION:		
James V. Smith	Jan. 1969	Present
Howard Bertsch	Apr. 1961	Jan. 1969
ADMINISTRATOR, RURAL ELECTRIFI- CATION ADMINISTRATION:		
David A. Hamil	Jan. 1969	Present
Norman M. Clapp	Mar. 1961	Jan. 1969

