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Report to the Congress; by Elmer B. Staats, Comptroller General.

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The business and industrial loan program of the Farmers Home Administration (FmHA) was established to help to save and create jobs in rural areas. The Congress appropriated and the agency obligated about $550 million in loans during fiscal years 1974 and 1975, of which $117 million was designated for programs in Alabama, Arkansas, Georgia, Louisiana, Mississippi, and Tennessee. Findings/Conclusions: The Congress needs accurate data to judge the program's effectiveness. Although the agency reported that 29,800 jobs were saved and created in fiscal year 1975, data supplied by the borrowers on approved loans showed that only about 11,100 jobs were saved and created. The higher number included figures for loans which had not been approved or which had been deobligated as of June 30, 1976. Further, the job data supplied by borrowers for 27 loans reviewed was overstated by more than 100%. The agency is developing a management information system for all its programs, but the accuracy of the information put into the system needs to be veritied. Recommendations: The FmHA could take a number of actions to more accurately report accomplishments so that the Congress can better determine the program's effectiveness, improve loan application assessments, provide better loan servicing, and increase guidance to borrowers. In addition, action could be taken to attain enough qualified staff. (Author/SC)

REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

Farmers Home Administration's Business And Industrial Loan Program Can Be Improved

Creation of job-producing businesses is the key to rural development. To this end, the business and industrial loan program of the Farmers Home Administration, Department of Agriculture, helps to save and create jobs in rural areas.

The agency could take a number of actions to

--more accurately report accomplishments so that the Congress can better determine the program's effectiveness,

--improve loan application assessments,

--provide better loan servicing, and

--increase guidance to borrowers.

Also, action could be taken to attain enough qualified staff.

CED-77-126

SEPTEMBER 30, 1977

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

B-114873

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

This report describes our review of the Farmers Home Administration's business and industrial loan program. Because of the important role this relatively new program can play in developing rural areas, we sought to assess the agency's administration of the program and to determine what improvements are needed to make it more effective.

This 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).

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of Agriculture; and the Administrator, Small Business Administration.

Elmer B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

FARMERS HOME ADMINISTRATION'S BUSINESS AND INDUSTRIAL LOAN PROGRAM CAN BE IMPROVED

D I G E S T

The Farmers Home Administration can improve its business and industrial loan program to

--measure and report more accurately program accomplishments,

--better assess proposed loans,

--provide better loan servicing and management assistance to borrowers, and

--attain enough qualified staff.

The program, initially carried out during harsh economic conditions, has helped rural areas by saving existing jobs or creating new ones; however, several problems need the attention of management.

The Congress appropriated and the agency obligated about $550 million in loans during fiscal years 1974-75. Alabama, Arkansas, Georgia, Louisiana, Mississippi, and Tennessee accounted for loans of about $117 million (21 percent) during this time. The report looks at the program in these States.

MEASURING AND EVALUATING PROGRAM RESULTS

The Congress needs accurate data to judge the program's effectiveness.

Although the agency reported that 29,800 jobs were saved and created in fiscal year 1975, data supplied by the borrowers on approved loans showed that only about 11,100 jobs were saved and created. The higher number included figures for loans which had not been approved or which had been deobligated as of June 30, 1976. Further, the job data supplied by borrowers for 27 loans reviewed was overstated by more th[illegible] 100 percent. (See pp. 6 to 11.)

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CED-77-126

Management needs more and better data to effectively evaluate the program. The agency is developing a management information system for all its programs, but the accuracy of the employment data and other information put into the system needs to be verified. Also, the quality of the jobs saved and created should be reported. (See pp. 11 and 12.)

Criteria for determining what investment should be made to save or create a job and analysis and verification of data submitted by loan applicants are needed for the program to do the most good. For loans reviewed, investment per job saved or created ranged from $1,600 to $90,000 using the job data submitted by borrowers, and from $1,300 to $200,000 using actual employment data. (See pp. 12 and 13.)

Specific recommendations for more accurately reporting data and for saving and creating the most jobs are on page 14.

EVALUATING PROPOSED LOANS

Does the loan applicant have a good chance of succeeding? This question must be answered before making loans. Regulations governing loan evaluation procedures need to be clarified and procedures need to be followed.

More experienced staff and clearer instructions would reduce loan processing time (an average of 252 days for loans GAO reviewed) and, at the same time, increase the quality of the loans approved. (See pp. 17 to 21.)

Better analysis of a loan applicant's financial condition and the economic feasibility of a proposed project would better indicate that the businesses financed can succeed. Although the loans reviewed were outstanding for relatively short periods--from 8 to 26 months--several businesses either had gone out of business, filed for bankruptcy, fallen behind on their loan payments, or operated without profit. (See pp. 21 to 28.)

To make sure the applicants have enough collateral to repay loans in cases of default, the agency should

--require that appraisals be made by independent appraisers and reviewed by agency personnel,

--provide additional guidance on appraisal methods used, and

--obtain more accurate data on the net worth of borrowers and others personally guaranteeing the repayment of loans. (See pp. 28 to 31.)

Loans which merely transfer the risk of loss from banks and other creditors to the agency should not be approved. (See pp. 32 and 33.)

Recommendations directed at (1) improving loan evaluations, (2) better establishing loan security, and (3) eliminating the use of loans which transfer loan risks to the agency are on pages 38 and 39.

LOAN SERVICING AND MANAGEMENT ASSISTANCE

Borrowers' problems can be identified and analyzed better. For example:

--Lenders need to promptly notify the agency of borrowers' delinquencies.

--The agency and the lenders need to analyze borrowers' financial statements more quickly and effectively and make more frequent and better planned visits to borrowers.

--The agency needs to establish procedures on the use of loan proceeds to see that they are used as authorized. (See pp. 42 to 50.)

Because agency and lender personnel lack the time and/or expertise to effectively assist borrowers, the agency should set up a staff, aided by consultants, to provide management assistance. (See pp. 50 to 54.) Specific recommendations are on pages 56 and 57.

ACTIONS TO CORRECT STAFFING PROBLEMS

When starting the program, the agency filled most positions with personnel with agricultural backgrounds. This is still being done even though

--the former Administrator stated that experience in the agency's lending programs was not the type being sought,

--the need for staff with more diverse backgrounds had been brought to the agency's attention, and

--agriculturally oriented programs accounted for only about 30 percent of the agency's fiscal year 1976 expenditures.

The agency has not followed fully the recommendation of the Senate Committee on Appropriations that staffing levels keep pace with loan and grant activity. (See pp. 61 to 64.) Recommended actions for attaining the staff needed are on page 64.

AGENCY COMMENTS

The agency agrees with GAO on the general improvements needed in the program and cited actions taken and planned to achieve these improvements. The agency did disagree with some specific recommended actions and GAO's position on these matters is contained in the report.

The agency's comments are incorporated in pertinent sections of the report and included as appendix III.

C O N T E N T S

ABBREVIATIONS

B&I	business and industrial
DOL	Department of Labor
FmHA	Farmers Home Administration
GAO	General Accounting Office
SBA	Small Business Administration
USDA	United States Department of Agriculture

CHAPTER 1

INTRODUCTION

Through recent legislation, the Nation has been committed to revitalizing and developing rural areas as a means of achieving a balanced national growth. As part of that commitment, the Congress enacted on August 30, 1972, the Rural Development Act of 1972 (Public Law 92-419). The act's principal thrust is toward providing jobs and increased business income in rural America through encouragement of rural industrialization and increased business activity and income.

Section 310B(a) of the Consolidated Farm and Rural Development Act, as amended by section 118 of the Rural Development Act of 1972 (7 U.S.C. 1932 (Supp. II, 1972)), authorized the Secretary of Agriculture to guarantee, insure, or make direct loans to public, private, or cooperative organizations or individuals for improving, developing, or financing business, industry, and employment and improving the economic climate in rural areas. Section 306(a)(7) of the Consolidated Act, as amended (7 U.S.C. 1926 (Supp. II, 1972)), defines a rural area, for purposes of loans and grants to private business enterprises, as any area that is not within the outer boundary of any city having a population of 50,000 or more and its immediately adjacent urbanized and urbanizing areas with a population density of more than 100 persons per square mile.

BUSINESS AND INDUSTRIAL LOAN PROGRAM

The Secretary of Agriculture delegated responsibility for carrying out the business and industrial (B&I) loan program to the Administrator, Farmers Home Administration (FmHA), under the supervision of the Assistant Secretary for Rural Development.

The primary purpose of the program is to improve the economic climate in rural areas by saving existing and/or creating new jobs. In addition, FmHA officials stated that other program purposes include encouraging and stimulating rural industry and increasing the tax base of, and the flow of funds into, rural communities. These purposes are to be achieved by assisting and encouraging local lenders in making loans to commercial business and industrial enterprises to expand or locate their operations in rural areas.

Two types of loans have been made under the program--guaranteed and insured. A guaranteed loan is made by an approved lending institution with FmHA guaranteeing to pay up to 90 percent of the principal and interest of the outstanding loan balance to the lender in case the borrower defaults. Lenders are responsible for servicing loans guaranteed by FmHA, including all actions necessary to collect the indebtedness and to protect the loan security. An insured loan is made and serviced directly by FmHA. These loans are made available to applicants, including public entities, which are unable to obtain loans elsewhere at reasonable interest rates and terms.

Guaranteed and insured loans may be used for:

--Business and industrial construction, conversion, acquisition, repair, and modernization.

--Purchase of land, machinery, equipment, supplies, materials, furniture, and fixtures.

--Startup costs and working capital.

--Refinancing debt, when refinancing results in a sound loan and protects the Government's interest.

Maximum loan terms are 30 years for loans made to purchase land and to construct, improve, or purchase buildings and permanent fixtures; 15 years for loans made to purchase machinery and equipment; and 7 years for loans made for working capital. Maximum loan terms for loans made to refinance debt vary with the estimated life of the collateral securing the loan. Interest rates charged for guaranteed loans are agreed upon by the lender and applicant while interest rates for insured loans are based on rates paid by the U.S. Treasury on obligations of similar maturity.

In determining which loan applications and projects will be funded, FmHA has established, in the following order, priorities for projects which will:

--Save existing jobs.

--Enlarge, extend, or otherwise improve existing businesses and industries.

--Create the highest number of permanent employment opportunities.

--Contribute to the overall economic stability of the rural areas but generate little or no permanent employment opportunities beyond the owner-entrepreneur.

ADMINISTERING THE PROGRAM

FmHA administers the program through a national headquarters office in Washington, D.C.; a national finance office in St. Louis, Missouri; and a field structure of State and county offices.

At the national level, an Assistant Administrator is responsible for overseeing the program, and also for providing leadership and program direction, formulating and coordinating policies, analyzing and projecting program needs and trends, and evaluating program effectiveness. The business and industrial loan division, headed by a director reporting to the Assistant Administrator, is responsible for developing and recommending program operating plans and procedures; coordinating and working with other agencies, public interest groups, and professional and business societies in promoting and managing the program; and conducting program evaluations at State and county offices. The national finance office develops and executes FmHA's financial and program accounting and reporting requirements.

FmHA's 42 State offices, each headed by a director, are responsible for administering all FmHA programs and activities in one or more States and for supervising county office operations. The day-to-day operations of the program at the State level are carried out by a supervisory loan specialist who may be assisted by one or more loan specialists. The supervisory loan specialist is responsible for overseeing all facets of the program at the State level including loan processing and approval, monitoring of lenders' loan servicing activities, and providing management assistance to borrowers.

Although not an administrative level, FmHA has district directors who are responsible for assisting from 6 to 10 county offices.

FmHA has about 1,800 county offices, each headed by a supervisor, which serve as the focal point for the B&I program as well as other FmHA programs. The county supervisor serves as the local contact person for FmHA and performs loan processing and servicing activities, provides technical assistance and guidance to loan applicants, and promotes and publicizes FmHA programs locally.

PROGRAM IMPLEMENTATION, FUNDING, AND LOAN STATUS

Proposed regulations to implement the program were published in the Federal Register in June 1973 and final regulations in October 1973. Funds were appropriated by the Congress in October 1973 and the first loans were obligated in December 1973.

During fiscal years 1974-75, the Congress appropriated, and FmHA obligated, $550 million in loan authorizations. The following schedule shows the status of the loans as of June 30, 1975.

	Number	Amount
		(millions)
Loans closed (note a)	299	$ 86.8
Loans in process	545	436.9
Loans deobligated	93	26.3
Total	937	$550.0

a/Loans which FmHA has contracted to make or guarantee.

At June 30, 1975, FmHA had an unfunded backlog of about 1,000 requests for a total of about $1 billion of financial assistance. An FmHA official told us, however, that this figure could be misleading because it included requests which, for reasons such as ineligibility, would not be funded.

For fiscal years 1976-77, the Congress appropriated an additional $787.5 million in loan authority (this amount included $87.5 million for the transitional quarter July 1 through September 30, 1976). For fiscal year 1978, the Congress increased the appropriation to $1 billion in loan authority.

SCOPE OF REVIEW

We reviewed the operation and administration of the program at the national headquarters and the finance office and in six State offices--Alabama, Arkansas, Georgia, Louisiana, Mississippi, and Tennessee. During fiscal years 1974-75, the six State offices had obligated about $117 million in loan authority, or about 21 percent of the national total. The following schedule shows the status of the loans as of June 30, 1975.

	Number	Amount (millions)
Loans closed	66	$ 22.5
Loans in process	89	88.0
Loans deobligated	30	6.2
Total	185	$116.7

We selected for detailed review 35 of the 66 closed loans, or about 53 percent of the loans made in the six States. These 35 loans were made to 34 borrowers. To obtain a more current reading on FmHA's loan processing procedures, we also reviewed 10 loans in process at June 30, 1975. (See app. I for a list of the loans reviewed.) In making our review we interviewed agency officials and representatives of lending institutions, State and local governments, and other community groups and organizations; reviewed laws, regulations, policies, and FmHA procedures; and examined agency and lender records. We visited projects, interviewed borrowers, and examined borrower records. We also hired a consultant to assist us in determining the adequacy of FmHA's and the lenders' evaluations of the loans reviewed.

EFFECT OF THE ECONOMY ON THE PROGRAM

The implementation of the B&I program in fiscal year 1974 coincided with a downturn in the overall economy which adversely affected the business community. During the first 2 years in which the program was in operation, the Nation was experiencing a severe recession and, at the same time, unusually high inflation and interest rates.

Although the effect that the state of the economy had on the program cannot be precisely measured, we believe that, in judging the overall effectiveness of the program, consideration should be given to the fact that the program was implemented during a time of high interest rates, soft consumer demand, low profit margins and curtailed capital expenditures. Had the overall economy been stronger, more businesses in better financial condition may have sought B&I loans and provided FmHA a larger universe from which loans could have been selected. Further, a stronger economy may have alleviated some of the financial problems of the firms that obtained loans.

CHAPTER 2

PROGRAM RESULTS OVERSTATED--A BETTER SYSTEM IS NEEDED TO MEASURE AND EVALUATE PROGRAM ACCOMPLISHMENTS

FmHA provided the Congress with information overstating the accomplishments achieved through its business and industrial loan program. More accurate data is needed to enable the Congress to better judge the overall effectiveness of this relatively new program and to determine whether the accomplishments being achieved are commensurate with the investment being made and whether changes in program operation and/or funding levels should be made. To provide the Congress with more accurate data, FmHA should

--include as program accomplishments the number of jobs reportedly saved and created for only those loans actually made rather than including job data for loans that are in process or that have been deobligated,

--verify and analyze the job data provided by loan applicants to assure its accuracy and reasonableness, and

--determine and report on the actual number of jobs saved and created by the businesses assisted.

FmHA has established no formal criteria to determine the reasonableness of the investment required to save and/or create jobs in approving loans. Such criteria is needed so that the limited resources available are applied to those projects which will save and/or create the most jobs.

OVERSTATEMENT OF PROGRAM ACCOMPLISHMENTS

During joint hearings held in January and February 1976 by House and Senate subcommittees, 1/ FmHA reported that during fiscal years 1974-75 it obligated about $550 million in loan authorizations which resulted in about 48,900 jobs saved and created. The program accomplishment

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1/Subcommittee on Conservation and Credit of the House Committee on Agriculture and Subcommittee on Rural Development of the Senate Committee on Agriculture and Forestry.

data reported by FmHA was overstated because (1) data was included for loans not yet made and for loans that were deobligated, (2) there was duplicate counting of the loans obligated, and (3) the number of jobs reported to be saved and created by the loans was based on data provided by borrowers which was overstated.

FmHA reported that 29,800 jobs would be saved and created by the loans obligated during fiscal year 1975; however, only 37 percent of these loans were closed as of June 30, 1976. According to data provided by the borrowers, the closed loans saved and created about 11,100 jobs, about 37 percent of that reported. As discussed below, comparable job data for loans obligated during fiscal year 1974 could not be determined.

Further, we found that the job data provided by the borrowers was overstated. Using the borrowers' data, FmHA reported that 1,881 jobs were saved and created by 27 of the 35 closed loans we reviewed. (Information on the number of jobs reported to the Congress to have been saved and created by the remaining eight loans was not available.) We determined, however, that the actual number of full-time jobs saved and created by the 27 loans was 920, about 49 percent of that reported.

Accomplishments should be categorized by loans closed and in process

In reporting program accomplishments to the Congress, we believe it would be more meaningful if FmHA categorized the data by loans closed and in process. Loans deobligated and those counted more than once should be deleted from accomplishment data.

Although FmHA reported that funds were obligated for 937 loans during fiscal years 1974-75, some loans were counted two or more times. Eliminating such duplications, we determined that the actual number of loans for which FmHA obligated funds was 856, a difference of 81 loans from that reported. FmHA officials advised us that corrective action is being taken to eliminate the duplicative counting of loans. The status of the 856 loans as of June 30, 1976, is shown below.

Loan status	Number	Percent	Amount	Percent
			(millions)	
Closed	375	44	$129.2	23
In process	311	36	334.7	61
Deobligated	170	20	86.0	16
Total	856	100	$549.9	100

Although FmHA maintained information on the number of jobs saved and/or created for individual loans obligated during fiscal year 1974, the data was incomplete and, therefore, we could not determine the number of jobs which should be deleted from the program accomplishment data for that year. For loans obligated during fiscal year 1975, FmHA reported to the Congress that 29,800 jobs were saved and created. However, most of the loans were either still in process or had been deobligated as of June 30, 1976. As shown below, the 183 closed loans, according to data provided by the borrowers, saved and created about 11,100 jobs, or about 37 percent of that reported.

Loan status as of June 30, 1976	Number of loans	Percent	Number of jobs saved and created (note a)	Percent
Closed	183	37	11,100	37
In process	242	50	14,800	50
Deobligated	64	13	3,900	13
Total	b/ 489	100	29,800	100

a/The number of jobs reported is based on data supplied by the borrowers.
b/Represents unduplicated loans.

In reporting on program accomplishments to the Congress, we believe that information on the number of jobs expected to be saved and created by the loans in process should be shown separately from the data for approved loans because no jobs are saved or created until the loan is closed. Job data for deobligated loans should not be shown at all.

Reported accomplishments based on overstated job data provided by borrowers

The reported number of jobs saved and created by the program is obtained by FmHA from information supplied to it by loan applicants with little or no verification or analysis to determine whether it is accurate and reasonable. Such verification and analysis is needed not only to report accurately on program accomplishments but also to determine whether the loan investment per job saved or created is reasonable in reaching a decision on loan approvals. Further, FmHA should obtain information on the actual number of jobs saved and created, 1 year after the loans are closed, so that comparisons between anticipated and actual program accomplishments can be made, evaluated, and reported on.

Loan applicants provide employment data to FmHA on a number of different forms. The information provided by existing businesses shows the number of people employed at the time the form is completed--this number is used to report on the jobs to be saved. Both existing and new businesses provide information on the anticipated number of new jobs the loan will create initially, 1-year after the loan is closed, and when operating at full capacity.

We were able to determine the source of the job data reported to the Congress for only 27 of the 35 closed loans reviewed. These loans were reported to have saved and created 1,881 jobs. Through discussions with the borrowers and selected verification of payroll records, however, we determined that the actual number of jobs saved and created at the time of our visits to the borrowers in terms of full-time job equivalents was 920, or about 49 percent of the total reported. (See app. II.) We determined that the remaining eight closed loans actually saved and created 181 jobs, whereas the borrowers, when applying for the loans, said that they would save and create 306 jobs.

No one form was consistently used as the source of the job data reported to the Congress. Also, no one employment figure was consistently used; i.e., for some loans the estimated number of jobs to be created initially was used and for others it was the estimated number to be created 1 year after loan closing or when operating at full capacity. Other problems noted were that

--the employment data provided to FmHA on 25 loans made to 24 existing businesses, i.e., the actual number of people employed at the time of application, were incorrect in 12 cases and

--no distinction was made between full-time and seasonal or part-time employees for 15 of 16 loans made to businesses employing seasonal or part-time employees.

Also, 4 of the 24 borrowers who obtained loans for existing businesses told us that the loans were for the transfer of ownership and, therefore, no jobs were actually saved. In determining the actual number of jobs saved and created, however, we included the employees of the four businesses.

The following examples illustrate some of the problems in reporting program accomplishments.

--One borrower reported that his firm employed 200 people at the time of loan application and estimated it would employ 400 people 1 year later. At the time of our visit, 22 months after the loan was closed, the firm was going out of business and employed only 15 people.

--In another case the borrower reported that his firm employed 14 people. This figure was accepted by FmHA without verification. At the time of our visit, about 15 months after the loan was closed, the firm employed 13 seasonal employees and one full-time employee. The borrower told us that this was about the same situation as when the loan was approved. The full-time equivalent for the seasonal employees, who worked only 2 months of the year, would be two jobs. Therefore, in reporting jobs saved and in considering this loan for approval, it would have been more accurate to show that the loan saved 3 full-time job equivalents rather than 14 jobs.

--Although FmHA considered one loan made to an existing business as having saved and created 12 jobs (no breakout was available between jobs saved and created), the borrower told us that the loan did not save any jobs but rather merely enabled him to buy the firm--that is, the loan was made to transfer the ownership of a viable business. He said that one new job had been created. We do not believe loans made to transfer ownership should be routinely treated as having saved jobs. This procedure results in overstating program accomplishments and, because loans made to save jobs are to be given first priority, could result in giving priority to a loan of this type over another which would actually save and/or create jobs.

To provide the Congress with more accurate data, we believe FmHA should verify and analyze the job data submitted by loan applicants and obtain and report on the actual number of jobs saved and created by the borrowers 1 year after they have received the loans.

FmHA's management information system

We discussed the need for overall program accomplishment data with a U.S. Department of Agriculture (USDA) official in August 1975. Subsequent to this discussion, FmHA began requiring State offices to prepare monthly reports showing summary information on the number of jobs saved and created, the number and dollar amounts of loans categorized by size of population, 1/ and the number and amounts of loans deobligated and the reasons for the deobligations. No information is obtained, however, on the quality of jobs saved and created; i.e., whether the jobs are part-time or seasonal and the amount of wages and salaries paid.

FmHA currently has underway a long-range effort to develop a unified management information system covering all of its programs. As part of this system, which is expected to be operational sometime after November 1978, FmHA intends to develop criteria for monitoring the impact and assessing the effectiveness of the B&I program. Some of the information the system is to provide includes

--number of jobs saved and created in relation to loan amounts invested;

--location and size of populations served by the projects financed;

--industrywide statistics, including financial ratios, for use in comparing proposed projects against industry trends;

--amount of losses incurred relative to other FmHA programs; and

--ages and amounts of loan repayment delinquencies.

1/The act requires that priority be given to communities with a population of 25,000 or less.

The system should help provide management with the data necessary to evaluate overall program effectiveness. We believe, however, that action should be taken so that the information put into the system, particularly on jobs saved and created, is accurate and that information is obtained showing the quality of the jobs saved and created.

CRITERIA NEEDED IN JUDGING REASONABLENESS OF LOAN INVESTMENT REQUIRED TO SAVE AND CREATE JOBS

FmHA has no formal loan approval criteria to use in determining what a reasonable investment should be to save or create one job. As a result, loan funds are not necessarily applied in a way to save and create the maximum number of jobs. Using the job data shown on the borrowers' applications, the investment per job ranged from about $1,600 to $90,000 for the 35 closed loans reviewed. Using the actual job data for those borrowers whose businesses were viable at the time of our visits, the investment ranged from about $1,300 to $200,000 per job.

Without (1) verifying the accuracy of the number of jobs reported as saved and (2) analyzing the reasonableness of estimates of jobs to be created by loan applicants and comparing this to loan approval criteria, loans could be approved which require extremely high investments per job saved or created. Using the actual data at the time of our visits for the first two examples cited on page 10, the investment required for each job saved or created was about $66,700 and $200,000, respectively. No calculation was made for the last example which involved a $480,000 loan made to transfer the ownership of the business.

In making our review at FmHA headquarters, we learned that FmHA's Utah State office obligated $30 million in fiscal year 1975 for a loan which the applicant estimated would create 100 jobs, an investment of $300,000 per job. Although a USDA official told us in August 1975 that FmHA would probably not guarantee the loan, it had not been deobligated as of August 1977. If deobligated, FmHA would lose the use of these loan authorizations because they cannot now be reobligated.

The above examples demonstrate the need for FmHA to obtain accurate job data and to develop and use loan investment approval criteria, particularly when compared to the criteria used by the Economic Development Administration, Department of Commerce, in operating its business loan program--a maximum of $10,000 and a target of $6,000 per job. Another loan investment figure often cited by FmHA and other USDA officials is $20,000 per job.

Although USDA's Economic Research Service had developed information showing which types of industries and businesses create the most jobs for the lowest investment, FmHA has not used this data to develop loan investment approval criteria or to otherwise maximize the impact of the program in saving and creating jobs by giving priority to loans for businesses which are the most labor intensive.

CONCLUSIONS

FmHA needs to establish uniform policies and procedures so that program accomplishment data is systematically gathered, evaluated, and reported. More accurate program accomplishment data is needed to make informed judgments on (1) the overall effectiveness of the program, (2) whether the program achievements are adequate in relation to the investment being made, and (3) what, if any, changes should be made to the program and/or level of funding.

Instructions should be established requiring FmHA officials at the State and county levels to verify and analyze job data submitted by loan applicants to insure its accuracy and reasonableness. To make the program more effective in meeting its major objective of saving and creating jobs, better job data, along with loan approval criteria, is needed for reaching knowledgeable decisions at the State and national office levels as to whether a loan should or should not be approved. The instructions should also require FmHA personnel to follow up with borrowers 1 year after the loans are made to determine the actual number of jobs saved and created so that comparisons between anticipated and actual program accomplishments can be made, evaluated, and reported on.

Action has been and is being taken by FmHA to provide management with the program data needed to evaluate the overall effectiveness of the program. As discussed above, however, increased efforts are needed to help insure the accuracy of the data obtained. Also, information should be obtained on the quality of the jobs saved and created to help evaluate the effectiveness of the program.

FmHA should obtain and disseminate to its State and county offices information as to which industries and businesses are labor intensive and encourage its staff to use this data to judge the reasonableness of job data submitted by loan applicants.

RECOMMENDATIONS

We recommend that the Secretary of Agriculture direct the FmHA Administrator to take the following actions:

--Develop and issue instructions requiring that (1) job data submitted by loan applicants be verified and analyzed, (2) information on the actual number of jobs saved and/or created by the loans and on the quality of such jobs be obtained and presented to the Congress, and (3) program accomplishment data presented to the Congress be categorized by loans made and in process rather than on the basis of loan obligation data.

--Establish criteria for loan approval which relate dollars invested to jobs saved and/or created.

--Obtain and disseminate information as to which industries and businesses are labor intensive for use in judging reasonableness of job data submitted by loan applicants.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on a draft of our report (see app. III), FmHA agreed with the need to verify job data. The agency said that this will be emphasized in training sessions and that instructions will be issued to the State directors to evaluate applicants' job projections and, for the loans made, to review borrowers' job data during field visits to their plants and offices. FmHA said that it will implement a manual reporting system to provide the needed job data suggested by our report and that when the unified management information system is implemented, it will be able to provide updated reports on employment figures for management and the Congress.

FmHA said that there appears to be the implication in our report that FmHA deliberately overstated the accomplishments of the program, which is absolutely not true. The agency said that when a new program is started, it is almost impossible to accurately report the actual number of jobs saved or created because many of the loans have not been closed. Therefore, the agency said it has always reported the number of dollars obligated and the number of jobs saved and created as reported by the applicant.

Our report does not address the question of whether FmHA deliberately overstated the accomplishments of the program. As our report states, however, we believe that in reporting on program accomplishments to the Congress, information on the number of jobs expected to be saved and created by the loans in process should be shown separately from the data for approved loans and that job data for deobligated loans should not be shown at all. While the information is not available to do this for the first year of the program, it is available for subsequent years.

On July 8, 1977, FmHA issued a memorandum to its State directors setting forth the actions to be taken as a result of our report. (A copy of FmHA's memorandum is attached to its comments on our report--see app. III.) In its memorandum, FmHA said that for an application having a high job-cost ratio, the loan file should be documented with the reasons for recommending its approval, the priority placed on the application, and the supplemental benefits that will accrue to the community's economy in which the project will be located.

FmHA said that although it has indicated to its personnel during training sessions that a $20,000 loan investment per job is desirable it disagrees with our recommendation that criteria be established for loan approval relating dollars invested to jobs saved and/or created. FmHA stated that:

"* * * The creation of permanent stable jobs, effect on the tax base, flow of funds into the community, and other beneficial effects on the community will also be evaluated and used as criteria for loan consideration in determining which projects will be funded. A maximum job cost figure would preclude loans in many areas that have natural resources, the development of which would require substantial fixed asset costs."

We appreciate the concerns raised by FmHA and believe the proposed instructions to its State directors may be beneficial. Nevertheless, in view of the fact that the program's major objective is to improve the economic climate of rural areas by saving and/or creating jobs, we believe formal criteria is warranted. This is not to say, however, that exceptions to such criteria could not be provided for.

In commenting on our recommendation to obtain and disseminate information to its field offices as to which industries and businesses are labor intensive for use in judging the reasonableness of job data submitted by loan applicants, FmHA said that distributing such information to field personnel would serve no useful purpose because the disadvantages would outweigh the benefits. It did not say what these disadvantages would be.

CHAPTER 3

IMPROVEMENTS NEEDED IN POLICIES AND PROCEDURES

TO EVALUATE PROPOSED LOANS

FmHA needs to improve its loan evaluation policies and procedures to attain its goal of approving only quality loans. Although FmHA has improved and refined its procedures and its personnel have gained experience since the program was implemented in October 1973, further refinements to its procedures are needed along with greater assurance that FmHA personnel have the time and capability to adequately carry out the required procedures.

We believe that clearer instructions and more experienced staff would reduce loan processing time--which averaged 252 days for the 35 loans we reviewed--and increase the quality of loans approved. Actions are needed so that

--FmHA and lender personnel responsible for evaluating loans obtain and analyze the financial and economic data necessary to determine the soundness and economic feasibility of the businesses financed,

--the methods followed in appraising property securing loans are adequate to determine the fair-market value of the property and that adequate analyses are made of the financial condition of loan guarantors, and

--lenders' exposure to loss on prior loans are not reduced through loans guaranteed by FmHA.

LOAN PROCESSING PROCEDURES

Clearer instructions setting forth the responsibilities of the applicants, lenders, and FmHA personnel could assist in processing loans more effectively and efficiently. The loan processing procedures, which can be involved and complicated, are outlined below.

Generally, lenders assist applicants in preparing and processing applications for guaranteed loans. Ordinarily, a preapplication letter is submitted prior to submitting a formal application to FmHA. Among other things, the preapplication letter includes a brief description of the proposed project, including information on the employment opportunities to be generated. The applicant may also provide copies of any available feasibility studies, financial statements, or other pertinent information at this time. Since April 1975, FmHA has permitted applicants, at their option, to omit the preapplication step and submit a completed application form.

In an effort to coordinate Federal, State, and local government efforts, applicants are ordinarily required to obtain clearance from State and local governments for loans of more than $100,000. Smaller loans for projects that have no significant impact outside the local community are exempt from this approval process.

During fiscal years 1974-75, all loans had to be processed through FmHA's national office. The preapplication and accompanying data were reviewed at the FmHA State office and, if the proposed project appeared feasible, information on the loan was submitted to the national office for its review. Generally, at this time the applicant was requested to provide FmHA with the necessary data for forwarding to the Department of Labor (DOL) so that it could, as required by section 118 of the Rural Development Act of 1972 (7 U.S.C. 1932), certify that the loan would not result in a transfer of employment or business from one area to another and that it would not result in an overproduction of products or services in the area.

Currently FmHA State offices can approve loans for which the guaranteed indebtedness does not exceed $500,000 without prior review and concurrence by the national office. The State office can also approve loans for which the guaranteed indebtedness does not exceed $750,000, provided the loan has been reviewed and concurred with by an official designated by the national office. The national office must review and concur with approving all loans for which the guaranteed indebtedness exceeds $750,000 and with all insured loans, regardless of the amount.

The average and range of processing time required for each stage of the loan approval process is shown on the next page.

Loan processing stage	Number of loans reviewed	Loan processing time (days) Average	Range
Preapplication to State office approval	a/ 32	87	11 to 234
State office approval to national office concurrence	b/ 33	36	10 to 91
National office concurrence to conditional commitment	c/ 34	61	2 to 176
Conditional commitment to loan closing (excluding construction time)	d/ 35	61	1 to 251
Total (excluding construction time)	35	252	74 to 551

a/The preapplication stage was omitted for one loan and we were unable to determine the processing time required for this stage for two loans.

b/We were unable to determine the processing time required for this stage for two loans.

c/We were unable to determine the processing time required for this stage for one loan.

d/FmHA officials stated that they have little or no control over the length of time required for this stage which primarily involves actions by applicants and lenders.

Our review of the loan files and discussions with lenders, borrowers, and FmHA officials indicated that the following factors contributed to delays in processing loan applications:

--FmHA regulations were unclear and frequently changed.

--FmHA personnel were inexperienced, inadequately trained, and unable to handle the work load.

--Applicants experienced difficulties in finding lenders willing to make loans.

--National office review was lengthy.

--Borrowers and lenders did not supply needed information in a timely manner.

We believe that more experienced staff and clearer instructions could have helped minimize loan processing time and, at the same time, increased the quality of the loans approved. We recognize that some of these problems occurred because the program was relatively new and that clearer regulations and more experienced staff should decrease the loan processing time in the future.

The following examples illustrate some of the difficulties and complications experienced in processing a loan.

A $300,000 loan guaranteed by FmHA in June 1975 required 282 days to process. Some of the major factors contributing to the length of processing time are discussed below.

--The borrower submitted the application about 2 months after submitting the preapplication material. According to the borrower, an FmHA official was under the mistaken impression that FmHA had contacted him earlier and asked that the application be submitted.

--The State office required about 113 days to review and approve the application. The record showed that this process was delayed because of the need to obtain additional information from the borrower and the lender.

--The FmHA national office required about 19 days to review the loan. This process was delayed somewhat because the State office had submitted incomplete information to the national office.

--FmHA guaranteed the loan about 2 months after issuing the conditional commitment to guarantee the loan. A delay in this process occurred because FmHA did not ask the borrower to submit the projected cash flow statements with the preapplication or application material but rather waited until after the loan was conditionally approved.

--Part of the delay in processing the loan occurred because FmHA did not obtain and submit the material to DOL for its certification after receiving the preapplication but rather waited until about 6 months later. DOL certification required about 3 months.

A $63,000 loan guaranteed by FmHA in April 1975 required 233 days to process, excluding project construction time. Some of the major factors contributing to delays in processing are discussed below.

--A delay of about 1 month occurred because the county supervisor did not submit all required information with the preapplication and time was lost when the State office had to request it.

--A delay of about 2 months occurred because the county supervisor submitted incomplete information with the application and the State office had to return the application for completion.

--A delay of about 1 month occurred in final approval because of the need to wait for character clearances on the borrowers and the DOL certification.

--A delay of about 1-1/2 months occurred because the lender incorrectly prepared the loan closing documents.

--The county supervisor and the State B&I loan specialist said their inexperience and inadequate training contributed to delays in processing this loan.

BUSINESSES' POTENTIAL FOR SUCCESS NOT ADEQUATELY EVALUATED

We noted a number of weaknesses in the loan evaluations made by FmHA and the lenders. Correction of these weaknesses is needed if FmHA is to achieve its goal of making only quality loans. FmHA and lender personnel responsible for approving the loans did not

--obtain required financial data--both historical and projected,

--obtain updated financial data before approving loans,

--question sales and profit projections of applicants which appeared overly optimistic and/or inadequately supported,

--adequately determine why existing businesses were operating at a loss or experiencing problems,

--require applicants to contribute sufficient equity to the businesses,

--adequately evaluate applicants' management capability or market analysis,

--obtain sufficient information to make a complete and adequate evaluation, and

--effectively use consultants in evaluating loans.

Some of the problems noted above apparently occurred because FmHA personnel and lenders were not sufficiently familiar with FmHA's regulations and instructions on evaluating proposed loans. In interviews with the FmHA county supervisors and lenders involved in the loans reviewed, we were told by 24 of the 32 lenders and 22 of the 33 supervisors that they were not familiar enough with FmHA project feasibility requirements to comment on their adequacy. Other comments received from FmHA personnel as to why FmHA requirements were not followed were that they did not believe the data was needed and that they did not have sufficient time to obtain and/or analyze the data.

Other reasons for the problems noted appeared to be that the FmHA regulations and instructions were silent or vague on the types of data to be obtained and the techniques to be used in evaluating proposed loans. In fact, 22 of the lenders and 11 of the supervisors interviewed told us that they believed there was a need for FmHA to develop a lenders handbook which, among other things, would describe the lender's responsibilities for making and servicing loans.

The loans reviewed had been made for relatively short periods of time at the time of our visits to the borrowers--from 8 to 26 months. (See app. I.) Because of this, it is difficult to accurately gage the effect the noted loan evaluation weaknesses will have on the success or failure of the loans in terms of providing lasting benefits to the rural communities. Several of the borrowers, however, had experienced financial difficulties at the time of our visits as follows.

--One borrower closed his business (loan was paid in full) and another was in the process of going out of business after their businesses failed.

--One borrower had filed for bankruptcy.

--Four borrowers (including the borrower who had filed for bankruptcy) were delinquent on their loan payments from 47 to 161 days.

--Because of unprofitable operations, one borrower changed his manufacturing operations from mobile homes to cabinets and trunks, another had to lease part of his business premises, and another sold his business.

Need for improvements in obtaining and analyzing financial data

Reviewing and analyzing a business' financial data is an important element in judging its potential for success. Recognizing this, FmHA requires existing businesses, when applying for a loan, to submit audited financial statements for the latest 3 fiscal years.

Of the 25 loans we reviewed which were made to existing businesses, however, the financial statements were not obtained for all 3 fiscal years in 16 cases and statements obtained for 21 of the loans were not audited as required. Further, the financial data reviewed was generally not current. The elapsed time between the period covered by the latest financial statements obtained by FmHA for review and the dates the loans were closed averaged 193 days and ranged from 61 to 455 days.

Loan applicants for both existing and new businesses are required to provide FmHA with 3-year projected profit and loss and cash flow statements along with a list of assumptions upon which the projections are based. These projections, along with the financial statements submitted by existing businesses, are to be reviewed by FmHA and lenders for loan approval purposes. Adequate analysis of this data is crucial in determining whether a business will generate sufficient cash flow and income to be viable.

For 24 of the 35 closed loans reviewed, projected financial statements were not obtained in 4 cases and the statements did not cover the required 3-year period in 20 cases. Further, in 29 of the 31 cases where projected statements were received for all or part of the 3-year period, the assumptions upon which they were based were either inadequate or were not obtained. We do not believe projections can be fully and adequately analyzed without knowing the assumptions upon which they are based.

Furthermore, even in those cases where the required financial statements were obtained, they were not always adequately reviewed and evaluated by FmHA and the lenders. In some cases we found that the projections were based on erroneous data and in some cases the projections appeared to be unrealistic when compared to the business' sales and profits of prior years.

For example, in the case of a $14,000 loan approved in August 1974, the applicant submitted financial projections for a 1-year period only, and the projected earnings were overstated because the income was not reduced by the cost of goods to be sold.

In the case of a $560,000 loan approved in October 1974, FmHA personnel did not question the basis for the applicant's projections even though projected sales were about 590 percent above those actually achieved in the prior 10-month period.

In the case of a $1.7 million loan in process as of June 30, 1975 (closed in November 1975), the State office, in replying to a national office inquiry, stated that "the applicant's projections and assumptions are of significant validity to be realistic and attainable." This statement is questionable when a comparison of the projections to prior achievements is made as shown on the next page. Further, no support or rationale was used to explain how the optimistic sales and profit projections shown on the next page would be achieved.

Fiscal year	Amount of sales	Amount of profit or loss (-)
1974 (actual)	$ 6,963,469	$ -785,053
1975 (actual)	7,167,030	-1,264,606
1976 (projected)	13,000,000	1,470,000
1977 (projected)	16,000,000	2,190,000
1978 (projected)	18,000,000	2,510,000

Another area which indicated that FmHA and lenders were not adequately reviewing and/or considering financial data was in regard to FmHA's requirement that applicants have sufficient tangible assets in the business. In this regard, FmHA's regulations provide that applicants normally be required to have a minimum of 10 percent equity 1/ in the business unless other credit factors warrant a higher percentage. For 6 of the 35 loans we reviewed, however, the 10-percent equity requirement was not met. For 2 of the 6 loans, the applicant actually had a negative equity, i.e., his liabilities exceeded his assets.

One example in which a borrower did not have the minimum equity required involved a $175,000 loan FmHA guaranteed in July 1974. An unaudited balance sheet dated December 31, 1973, the latest data available to FmHA at the time of loan approval, showed that the company had assets of about $91,200 and liabilities of about $89,000, or an equity of about $2,200 (2.4 percent). This showed a significantly undercapitalized condition in that for every $40 owed creditors the borrower had only $1 invested in the business.

In February 1975, FmHA made an insured loan of $900,000. The last audited financial statements prior to loan approval showed an equity of 1.8 percent in May 1973, unaudited statements showed an equity of 4.4 percent in May 1974, and in April 1975, 2 months after loan approval, the reported equity was nine-tenths of 1 percent.

To be of maximum use to FmHA in evaluating and approving loans, financial statements should be audited to help insure the reliability of the data presented. Also, the most current statements available should be obtained to assist in making informed judgments about loan approvals. The

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1/Equity is defined as the difference between the assets and liabilities, or the net worth, of a business.

following schedule shows that FmHA did not, in many instances, use current and reliable data in reaching final decisions in approving the 25 loans made to existing businesses.

Number of days between dates of current statements and dates loans approved	Number of statements		
	Audited	Unaudited	Total
Under 100	1	4	5
101 to 200	2	6	8
201 to 300	-	8	8
301 to 400	1	1	2
401 to 500	1	-	1
	5	19	a/ 24

a/We were unable to determine whether or not one statement was audited.

The loan of $1.7 million discussed on pages 24 and 25 also serves as an example of FmHA personnel not obtaining and considering the latest financial data available. The loan was guaranteed by FmHA in November 1975. Although FmHA personnel were made aware that audited financial statements of the applicant's operations for the fiscal year ending June 30, 1975, were available and differed materially from the prior year statements, they were not obtained and reviewed before the loan was approved. An FmHA official, when asked whether he recalled being made aware of this information, indicated to us that he had but said that he did not obtain or review the statements because he was extremely busy about the time this loan was closed. The material changes in the applicant's financial condition are shown below.

	Period covered by financial statements			
	FY 1973	FY 1974	9-month period ending 3/31/75 (note a)	FY 1975
Net worth (equity)	$2,159,697	$1,387,369	$289,810	$ 122,763
Net loss	365,049	785,053	Not shown	1,264,606

a/Unaudited statements.

FmHA regulations provide that lenders are accountable for making and servicing loans in a manner that will properly protect FmHA's interest. The regulations provide that lenders are responsible for conducting certain investigations necessary to determine the soundness of the loan and that the contract of guarantee is unenforceable if it is determined that the lender did not comply with its loanmaking responsibilities.

Despite these requirements, however, for all of the 32 guaranteed loans reviewed, the lenders either had not performed any detailed analysis or had not provided FmHA documentation on their analyses. Documentation of any analysis made by the lenders is necessary to enable FmHA to determine whether a lender has adequately fulfilled its loan evaluation responsibilities and to assist FmHA in judging the soundness of the loan.

Economic and technical feasibility studies

FmHA regulations require lenders to submit to FmHA an acceptable economic and technical feasibility study covering (1) engineering matters, (2) adequacy and required training of management personnel and labor supply, (3) adequacy and sources of raw materials and supplies, (4) adequacy of buildings, land development, and transportation, (5) market analysis, and (6) adequacy of power, water, and waste disposal services.

In reviewing the 35 loans, we found that there was a wide range in the degree of sophistication and quality of the feasibility studies performed. For example, in the case of a loan made to establish a restaurant, the market analysis was limited to FmHA personnel questioning several local leaders about the need for a restaurant, while in other cases, more comprehensive market analyses were made. We believe there is a need for additional guidance to obtain more uniformity in the quality of the studies, particularly market analyses and assessments of management capability.

Market analyses include a review of such matters as marketing agreements and contracts, sales trends of the firm and the industry, and surveys to determine supply and demand. These matters were not always considered by FmHA and the lenders in approving the loans we reviewed. In six cases the applicants' prior sales did not support projections and in three cases publications on industry trends were not consulted.

For example, a Department of Commerce publication available prior to FmHA's approval of a $110,000 loan in June 1975 to a foreign car dealer stated that sales of foreign cars had decreased substantially and would decrease further. The State B&I loan specialist, however, did not consult this or any similar publication. The borrower gave up his foreign car dealership franchise in April 1976, citing depressed foreign car sales as a major reason for his failure. Although the borrower continued selling used cars and his loan payments were current as of December 1976, he told us that he plans to go out of business entirely.

Management capability should have been questioned or evaluated more thoroughly by FmHA and/or the lender for nine of the loans reviewed. For example, although analyses of applicants' financial statements revealed problems, such as lack of profits, inadequate working capital, and undercapitalization--factors indicative of management weaknesses--these matters were not always addressed so that corrective action could be taken. The two loans discussed in detail on pages 33 through 37 illustrate some of these problems.

Since July 1974, FmHA has required that feasibility studies be made by independent recognized consultants for all loans of $1 million or more. FmHA may grant exemptions to this requirement when the credit factors of the applicant are such that a sound credit determination can be reached without an independent study. The costs of feasibility studies are to be paid by the applicants and may be included in the loan amount requested.

Five of the 35 closed loans and 5 of the 10 loans in process that we reviewed were for $1 million or more. For 6 of these 10 loans FmHA waived the requirement for an independent feasibility study. There were factors, however, which raise questions as to whether FmHA's exemption criteria for credit worthiness were met. In the case of two of the six loans, for example, the applicants did not meet the 10-percent equity requirement.

NEED FOR IMPROVEMENTS IN DETERMINING ADEQUACY OF LOAN SECURITY

FmHA regulations require that B&I loans be fully secured by collateral and that, usually, the personal and corporate guarantee 1/ of the borrower will also be obtained. The regulations, however, do not require that appraisals of collateral be made by independent appraisers, nor do they provide guidance on the types of appraisal methods to be used. Further, in at least 5 of the 45 cases reviewed, FmHA personnel did not adequately review and analyze the value assigned to the collateral. Also, FmHA personnel did not always adequately review and verify the financial data submitted in conjunction with personal and corporate guarantees.

Appraisal procedures

FmHA regulations provide that property serving as collateral for loans will be appraised by a qualified appraiser to determine its "current value." FmHA personnel generally make the appraisals for insured loans. For guaranteed loans, lenders are responsible for determining that the appraisers used are adequately qualified and experienced. In evaluating loans for approval, FmHA personnel are required to determine whether the collateral is sufficient to reasonably assure the repayment of the loan in case of default.

For many of the loans reviewed, those closed and in process, FmHA did not adequately review the qualifications and/or independence of the appraiser. For 9 of the 45 loans, the appraisal was made by an official of the lending institution and in 3 cases by individuals employed by the borrower. In 2 of the 9 instances where the appraisal was made by the lender, the lenders' exposure to loss on prior loans made to the applicant was reduced. (See pp. 32 and 33 for a discussion of reductions in exposure to losses.)

For the remaining 33 loans, all or part of the collateral was appraised by independent appraisers in 25 cases and cost or book value was used in lieu of appraisals in 8 cases. FmHA regulations do not specify or provide guidance on the types of appraisal methods acceptable, nor do they provide guidance on the use of cost data in lieu of appraisals and the extent to which such cost data is to be verified.

1/A personal guarantee is, in effect, a pledge of one's personal assets to repay the loan in case of default. Where a parent corporation is involved, a corporate guarantee may be required.

The above problems, when coupled with lack of an adequate review and analysis of the values assigned collateral by FmHA personnel, can result in questionable values. The following example illustrates the need for additional guidance on the types of acceptable appraisal methods and the need for FmHA personnel to be more deligent in reviewing and analyzing appraisals.

In March 1975 FmHA guaranteed a $2.2 million loan to refinance the existing debt of a manufacturer. In February 1975 an independent appraiser reported that the collateral, made up of land, buildings, and equipment, had the same $5.5 million "in-use market value" as it had when he previously appraised it in February 1973.

The appraiser, in making the 1973 appraisal, stated that his appraisal was based on the income appraisal method and a major assumption was that the firm would continue profitable operations. However, in January 1975, about 1 month before the updated appraisal was made, the firm's reported loss for the prior 9-month period was about $1.3 million. We believe that this and other significant factors affecting the appraisal could have been uncovered by FmHA personnel had they more carefully reviewed the appraisal.

Furthermore, the lender obtained a third appraisal in May 1976 after the firm filed a petition for bankruptcy. This appraisal established the "current-market value" of the property at $1.3 million. On the basis of this value FmHA could lose up to about $900,000, i.e., 90 percent of the difference between the outstanding loan balance of about $2.3 million in April 1976 and the estimated market value of $1.3 million. 1/

This example illustrates the need for FmHA to provide guidance to its personnel on the different types of appraisal methods which are acceptable. We believe that for loan security purposes, appraisal methods designed to arrive at fair-market values would be most appropriate.

In seven cases in which cost or book value was used to establish the value of collateral, there was little or no

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1/In our update of this matter in August 1977, an agency official told us that the property was sold during foreclosure for $700,000.

cost verification made. On the other hand, for one insured loan the county supervisor approved individual requisitions for loan funds covering expenditures made in conjunction with the project.

Personal guarantees

FmHA regulations provide that personal guarantees of borrowers and others having a substantial interest in the business will usually be required. Guarantees of parent, subsidiary, or affiliated companies may also be required.

The regulations provide that the personal guarantees will be required in sufficient amounts to reasonably assure repayment of the loan and provide adequate security. The personal guarantee requirement may be waived by FmHA in certain instances where the proposed guarantors cannot provide the guarantee. Guarantors are required to provide FmHA with current financial statements showing their personal net worth.

For nearly all of the 45 loans reviewed, FmHA personnel did not adequately review and verify the financial data submitted by the guarantors. For example, we found 12 instances where the reported figure for the guarantor's personal net worth included his interest in the firm receiving the loan which, according to FmHA's regulations, should not be included. We believe this information would have been discovered had FmHA personnel adequately reviewed the guarantors' financial statements. The following example illustrates this point.

In June 1975, FmHA guaranteed a $110,000 loan. The guarantor's financial statements showed his personal net worth to be about $216,000; however, about $176,000 of this amount represented his interest in the firm receiving the loan. The guarantor's personal net worth for loan purposes, therefore, was only about $40,000.

Also, financial statements submitted by the guarantors were not current and were not updated before the loan was approved. The average number of days between the dates of the statements submitted and the dates 33 of the 35 closed loans were approved was 211 days, and ranged from 14 to 440 days. For the two remaining closed loans FmHA did not obtain personal guarantees.

LOANS USED FOR REFINANCING PURPOSES SHOULD NOT BE USED TO REDUCE LENDERS' EXPOSURE TO LOSS ON PRIOR LOANS

In September 1974 FmHA revised its regulations to provide that loans would not ordinarily be made to refinance debts, except that, with national office approval, loans could be so used when necessary for the success of a project and arrangements for continuing the debt could not be made.

FmHA revised its regulations again in December 1975 to allow loans for refinancing debts of sound projects when determined necessary to stabilize the economic base of the rural area and increase or maintain employment. In evaluating loans for refinancing debt, FmHA personnel are to determine whether the loan is essential to restructure the applicant's debts, enabling the business to succeed rather than merely converting an unsound loan to a guaranteed basis or to bail out lenders having such loans.

Despite the rather rigid FmHA requirements, loans were frequently made to refinance debts. Nineteen of the 35 guaranteed loans closed at the time of our review resulted in reducing exposure to losses by participating lenders and repayment of debts to other lenders and creditors. The following schedule shows for the 19 loans the lenders' and creditors' exposures before and after the loan guarantee.

	Exposure before loan guarantee	Exposure after loan guarantee	Reduction in exposure
	(millions)		
Participating lenders	$ 9.5	$1.6	$ 7.9
Other lenders and creditors	6.0	-	6.0
Total	$15.5	$1.6	$13.9

An example of a lender's reduced exposure involved a loan of $500,000 guaranteed by FmHA in May 1975. About $345,000 of the loan proceeds were used to refinance existing debt owed the lender, thereby reducing the lender's exposure to loss by about $295,000 as shown on the next page.

Exposure before loan	$345,000
Less exposure after loan (10 percent of $500,000)	50,000
Reduction	$295,000

As discussed on page 50, the use of the loan proceeds to reduce the lender's exposure appeared to be contrary to FmHA's understanding of how the funds were to be used.

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The following two examples are discussed in detail to present a more complete description of some of the problems involved in evaluating loans.

Example 1--On March 24, 1975, FmHA guaranteed a $2.2 million loan to an existing business to refinance the following outstanding debts: $900,000 to the lead lender of the guaranteed loan, $800,000 to a participating lender in the guaranteed loan, and $500,000 to other creditors.

FmHA's decision to guarantee the loan was based, in part, on its review of the business' independently audited financial statements for the 3-year period ending March 31, 1974; projected sales and profit and cash flow figures for the 3-year period ending August 31, 1977; an independent appraiser's report on the value of the collateral securing the loan; and unaudited personal financial statements of the guarantors.

Financial statements FmHA obtained before guaranteeing the loan showed that the business, as of March 31, 1974, was undercapitalized in that the stockholders' equity was about 8 percent rather than the 10 percent required by FmHA regulations. Because of this, FmHA and the lender required the applicant to convert, by March 31, 1975, about $500,000 of debts owed to its stockholders to preferred stock.

In reviewing the projected sales and income figures, FmHA did not question the projected sales for the 1-year period ending August 1975, which were 18-percent higher than the company's prior year sales, even though the applicant failed to provide FmHA with its assumptions supporting the projected figures. Information available at the time of FmHA's review indicated that there was an industrywide decline in sales of the company's major project. Despite the lower than required equity and the absence of assumptions to support projected sales, FmHA waived the requirement for an independent feasibility study.

Although updated financial data was available before FmHA conditionally guaranteed and approved the loan in March 1975, FmHA's decision to guarantee the loan was based on financial data which was almost 1 year old. The updated financial data showed that the firm's financial situation had deteriorated during the 1-year period. An unaudited interim financial statement for the 9-month period ending January 4, 1975, showed that the firm's net worth had plunged from $614,000 to a negative net worth of about $670,000, sales had decreased from about $15.3 million to about $12.7 million (annualized basis), costs of goods sold were about $50,000 less than actual sales, and the firm incurred a net loss of about $1.3 million. Also, a major credit service classified in September 1974 the financial condition of the firm as "unbalanced" and commented that debt exceeded equity by more than 10 to 1.

FmHA did not follow up on the agreement that the firm convert $500,000 owed to its stockholders to preferred stock. We found that the agreement was not fully complied with in that only about $270,000 was converted. We believe FmHA should have assured compliance before guaranteeing the loan.

As discussed on page 30, FmHA accepted an appraisal of the collateral made in February 1973 and updated in February 1975 which was based on in-use market value rather than fair-market value. The appraiser used the income appraisal method and stated in his appraisal report that this was an important contingent condition. In fact, the February 13, 1975, update was based on the assumption that the firm would continue profitable operations. However, the 9-month interim financial statement through January 4, 1975, showed a $1.3 million loss. After the firm filed for bankruptcy, a third appraisal which was made in May 1976, established the "current-market value" of the collateral at $1.3 million, or $4.2 million less than the $5.5 million appraised value accepted by FmHA less than 16 months earlier.

Two of the six banks participating in the guaranteed loan had reductions in exposure to loss--the lead lender which made a $800,000 loan and a second bank which made a $100,000 loan.

The loan guarantee reduced lenders' and other creditors' exposure by about $2.1 million as shown below.

	Participating lenders (note a) Lender A	Lender B	Other creditors	Total
Exposure before loan	$928,110	$806,806	$508,267	$2,243,183
Less exposure after loan	80,000	10,000	-	90,000
Reduction	$848,110	$796,806	$508,267	$2,153,183

a/Lender A, the lead lender, loaned the applicant $800,000 and lender B loaned the applicant $100,000. The remaining $1.3 million of the loan was made by four participating lenders who had no reduction in exposure to loss.

The firm filed for bankruptcy in February 1976 and liquidation losses to the Government appear likely.

Example 2--On July 24, 1974, FmHA guaranteed a $175,000 loan to an existing business to be used as follows: $67,000 for plant expansion, $67,000 for working capital, and $41,000 for debt retirement.

FmHA's decision to guarantee the loan was based on preapplication material; the favorable performance of the industry, including the number of businesses expanding their operations; the lender's determination that the loan was sound; and on the value of the collateral pledged as security for the loan.

The preapplication package included certain material prepared by a Mississippi State agency, an unaudited financial statement covering a 4-month period, 2-year projected income and cash flow statements, and a projected balance sheet for the first year of operation.

Although FmHA based its decision, in part, on the material prepared by the State agency and the lender's opinion that the business operation was sound, an official of the State agency that prepared the material told us that the agency neither evaluated the feasibility of the loan nor the firm's financial data, but rather merely assembled application information and helped the applicant in his dealings with FmHA. The lender told us that his opinion regarding the soundness of the loan was based on the information presented by the State agency. The lender also said that the loan was marginal but thought assistance was warranted because (1) the applicant was a good customer, (2) the loan would be used to create jobs, (3) there was a demand for the firm's product, and (4) the business would be an asset to the community.

The 4-month financial statement submitted with the preapplication (only statement available because the business was organized in September 1973) was unaudited and unsigned and apparently was not evaluated by the lender or FmHA. Our review of the statement showed that the firm was undercapitalized in that its net equity was less than 3 percent rather than the 10 percent required by FmHA. In addition, the statement showed a bank overdraft of more than $17,000.

In reviewing the projected sales and income, neither the lender nor FmHA questioned the projected sales for the 1-year period ending December 31, 1974, of $2.2 million although actual sales for the 4-month period ending December 31, 1974, were only about $100,000. The applicant did not furnish FmHA the assumptions supporting the projected figures, but did state that the firm planned to establish new product lines and double its operating capacity.

We believe the lender and FmHA should have questioned this statement based on the 4-month financial statement which showed an undercapitalized position and profit of only about $1,200. Also, the lender and FmHA should have questioned the projected sales figures based on available information which showed that the industry was experiencing a slowdown and that several competitors in the surrounding vicinity had been found to be experiencing problems due to the depressed economy.

FmHA did not update the financial data of the business between the time of preapplication and loan approval, about 7 months. Had FmHA updated the economic and financial condition, it would have learned that (1) due to a truck strike the business could not ship its product and, as a result, lost its largest customer, (2) a shortage of working capital was adversely affecting its manufacturing operations, (3) bank overdrafts were common, and (4) the business was losing money.

In April 1975 the lender considered initiating foreclosure proceedings because the borrower was delinquent on his loan repayments. However, at the time of our visit in June

1976 the borrower had managed to bring his loan payments current by leasing part of the premises to other firms.

The collateral securing the loan was appraised at about $230,000 which, if accurate, would be sufficient to prevent any losses to the Government in case of default. A personal guarantee was also obtained from the applicant.

About $75,000 of the loan proceeds was used to repay existing debts to the lender, thereby reducing the lender's potential exposure to loss from $75,000 to $17,500 (10 percent of its $175,000 guaranteed loan).

CONCLUSIONS

FmHA, in order to achieve its goal of making quality loans and to provide for more lasting economic benefits to rural areas, should take action to (1) further revise, clarify, and strengthen its regulations and instructions governing loan approval procedures and (2) see that its procedures are followed.

Definitive criteria for determining a loan applicant's potential for success is needed. Unless FmHA and lenders adequately analyze and verify information applicants submit, many of the weaknesses observed will continue to occur. Because each loan presents a number of different circumstances, however, FmHA must emphasize to its personnel and participating lenders that each loan applicant's financial statements and projections must be adequately analyzed and all questionable items challenged and clarified. Furthermore, the results of each analysis should be documented.

FmHA and lenders must obtain sufficient information, including updated and independently audited financial statements and projected sales, profit, and cash flow statements supported by assumptions to permit an adequate evaluation of a business' potential for success. Moreover, FmHA needs to incorporate into its procedures the various techniques, such as financial ratio analyses, to be used in evaluating and approving loans.

To attain greater uniformity in the quality of evaluations of loan applicants' financial data and overall economic feasibility, FmHA should develop a handbook for lenders. The handbook should set forth FmHA's requirements for loan approval and clearly state the responsibilities of the lenders in this process.

Regarding economic feasibility studies, FmHA needs to provide additional guidance on what constitutes an adequate study, stressing particularly management capability and market analysis, and closely monitor all loan applications for $1 million and over to see that the regulations requiring feasibility studies by independent consultants are followed. Also, FmHA should require feasibility studies by independent consultants for loans of less than $1 million which could be considered marginal, i.e., one where the applicant is experiencing losses, has inadequate security, does not have sufficient equity, etc.

To see that collateral securing loans is adequate, appraisers should be independent and required to use appraisal methods designed to establish fair-market values. In those instances where cost data is used in lieu of an appraisal to determine the value of the collateral, such cost data should be adequately verified and reviewed for accuracy. Further, all appraisals should be analyzed by FmHA personnel experienced with appraisals to determine whether the procedures followed in arriving at the appraised value were adequate.

In determining whether personal guarantees provide the loan security necessary, the most accurate and current data available on the guarantor's personal net worth must be obtained. To accomplish this, FmHA personnel should review and verify the data provided by the guarantors in their financial statements.

FmHA approved a number of loans involving the refinancing of debts of participating lenders and payments to other lenders and creditors. Some of these approvals were questionable because they reduced the participating lenders' exposure to loss or bailed out lenders and creditors which were in a position to sustain a loss. Such questions of lender bailouts could be eliminated by requiring participating lenders to maintain the same level of exposure they had on any prior loans being paid with the proceeds of loans guaranteed by FmHA.

RECOMMENDATIONS

We recommend that the Secretary of Agriculture direct the FmHA Administrator to:

--Emphasize to FmHA personnel and lenders the need to follow prescribed loan evaluation procedures, require applicants to submit all needed information--including current financial data, fully analyze the information provided, and document their justification for recommending loan approval, including an explanation of any questionable items and the disposition made thereof.

--Clarify guidelines on how FmHA personnel and lenders should analyze and verify information borrowers submit and develop a lenders handbook setting forth the lenders' responsibilities in approving and servicing loans.

--More closely monitor loans being approved for $1 million or more to see that FmHA's regulations requiring feasibility studies by independent consultants are more closely followed and require feasibility studies by independent consultants for loans of less than $1 million which are of marginal quality.

--Revise the regulations governing appraisals to require that (1) appraisals of collateral used to secure guaranteed loans be made by appraisers that are independent of both the borrower and lender, (2) appraisal methods be used which are designed to arrive at the fair-market value of property serving as collateral, (3) adequate verification of the cost of the property serving as collateral be required when such cost is to be used in lieu of an appraisal, and (4) all appraisals be analyzed by FmHA personnel with experience in appraisal methods and techniques.

--Emphasize to FmHA personnel the need to review and verify current financial data of borrowers and others providing personal guarantees.

--Require that lenders participating in loans guaranteed by FmHA maintain the same level of exposure they had on prior loans.

AGENCY COMMENTS AND OUR EVALUATION

FmHA said that many of the program deficiencies indicated by our report have been improved considerably by further training of personnel, revision of its regulations in December 1975, and the use of a new project summary form developed in July 1976. It said that these actions will be enforced further by the instructions issued on July 8, 1977, to State directors. FmHA said also that the completion of the project summary by its personnel assures that the most important credit factors have been considered and documented for each loan. (The project summary calls for information on projected employment, market analysis, management capability, financial statements on past and projected operations, type and value of loan collateral, applicant repayment ability, lender servicing plan, and field personnel's comments and recommendations concerning loan approval.)

FmHA said that it (1) will assess the need for a lenders handbook setting forth lenders' responsibilities in approving and servicing loans and (2) agreed with our recommendations concerning feasibility studies.

In commenting on our recommendations concerning appraisals, FmHA said that it has revised its regulations to require the use of qualified appraisers and that its forms provide for the use of fair-market values. FmHA said that for small loans, its regulations provide flexibility for estimating market value by lenders and FmHA personnel because costs for professional appraisals on such loans could be prohibitive. It said that it is also conducting training courses on how to evaluate appraisals.

FmHA's revised regulations neither require the use of independent appraisers nor do they provide guidance on the circumstances under which independent appraisers should be used. In view of our findings that FmHA personnel accepted appraisals made by officials of lending institutions--including those whose exposure to loss was reduced--and of borrowers' firms, we believe that further guidance is warranted concerning the need to use independent appraisers. Regarding FmHA's comments on possible exceptions for small loans, we would point out that Government agencies operating housing loan programs (including FmHA), which involve relatively small loans, require that appraisals be made by their own personnel, personnel of other Government agencies, or by independent apraisers.

FmHA agreed that current financial statements are desirable and should be secured at the time the application is accepted but indicated, however, that this was difficult in some cases because the processing time for its loans is sometimes lengthy. FmHA said that it requires lenders to certify prior to the issuance of the guarantee that there has been no adverse change in the borrower's financial condition. FmHA also said that its field staff was advised of the importance of reviewing and analyzing current financial statements of guarantors by the July 8 memorandum to its State directors.

FmHA said that while it agrees with us that in refinancing debts it is desirable to keep the lender from reducing its exposure, as a practical matter, this is not always feasible. FmHA explained that many small communities have only one bank and that if it prohibited lenders from reducing their exposure, many businesses would cease to exist because of a lack of financing. Such a prohibition, FmHA said, may lead to forcing borrowers to change lenders to avoid regulation requirements and also could eliminate the ability of banks to provide a line of credit for short term financing needs due to lending limits or bank liquidity. Nevertheless, in its July 8 memorandum, FmHA advised its State directors that in cases where the lender is reducing its exposure, the loan file should be carefully documented and that refinancing must make good economic sense and save existing employment.

If FmHA is to continue the practice of guaranteeing loans which result in reductions in lenders' exposure to loss, we believe that, as a minimum, FmHA should require that such loans be approved at the national office level and that the reasons why it was not feasible to require the lender to maintain the same level of exposure be documented.

CHAPTER 4

IMPROVEMENTS IN LOAN SERVICING AND MANAGEMENT ASSISTANCE EFFORTS COULD ENHANCE BORROWERS' CHANCES OF SUCCESS

FmHA could increase its chances that business and industrial loans will provide lasting benefits to rural communities by improving its loan servicing and management assistance efforts. More effective measures are needed for (1) the timely identification of actual and potential problems of borrowers and the analysis of such problems to determine their causes and possible solutions, (2) assurance that loan proceeds are used only for approved and authorized purposes, and (3) the development of a management assistance program.

BETTER AND MORE TIMELY INFORMATION NEEDED ON BORROWERS' PROBLEMS AND PROGRESS

An effective loan servicing program designed to result in quality loans requires that early identification of actual and potential problems so that corrective actions can be taken. Improvements needed in this aspect of FmHA's B&I loan program include

--prompt notification of borrower delinquencies by lenders to FmHA,

--an effective followup system so that borrowers submit required financial statements,

--a documented evaluation of borrowers' financial statements by lenders,

--more timely and effective analysis of borrowers' financial statements by FmHA, and

--more frequent and better planned visits to borrowers by both lenders and FmHA personnel.

Lenders have the primary responsibility for servicing guaranteed loans, including obtaining and analyzing borrower financial statements and protecting and monitoring security. FmHA is responsible for supervising the loan servicing performed by the lenders and for servicing the insured loans it makes.

According to FmHA the primary purpose of loan servicing is to prevent problems. FmHA maintains that prompt followup on delinquent payments and early recognition and solution of problems are keys to resolving delinquencies.

The lenders' servicing role appeared to be limited primarily to collecting and overseeing loan repayments. Little or no effort was made by lenders to document any analyses of borrowers' financial statements or of the results of any visits to borrowers' businesses. These problems occurred, in part at least, because some of the lenders were not adequately aware of their responsibilities--three of the lenders we visited did not even have copies of FmHA's regulations and others told us that they were not familiar enough with the regulations to comment on their adequacy.

FmHA has no formalized method of supervising the lenders' loan servicing role. FmHA personnel sometimes visited lenders, but FmHA regulations neither require nor discuss visits to lenders, nor do they prescribe any other procedures for providing adequate supervision.

FmHA personnel are also required to obtain and analyze borrowers' financial statements. Although this duplicates the lenders' responsibilities, we believe it is highly desirable considering that FmHA has no assurance that the lenders are performing this function adequately and that FmHA is responsible for up to 90 percent of any loss incurred. However, 30 of the 33 supervisors interviewed told us that they lacked sufficient time to service loans adequately.

The benefits of FmHA's analyses of financial statements were diminished, however, because the statements were not received or reviewed in a timely manner. Several of the FmHA supervisors told us that they lacked the time to follow up on overdue statements and several of the loan specialists told us that their workload prevented them from promptly reviewing the statements received. Fourteen of the supervisors we questioned said that they were not sufficiently trained or experienced to service B&I loans adequately.

<u>More timely notification of borrower delinquency needed</u>

A clear signal that borrowers may be experiencing problems and need assistance is sounded when they fail to make loan repayments on time. Lenders and FmHA must react promptly and effectively to such warnings to have an effective loan servicing program which will help keep losses to a minimum.

We found four cases where lenders either did not notify FmHA of delinquencies or did not notify it in a timely manner, i.e., within 60 days after the due date. In fact, such notification was not a requirement until December 10, 1975, when FmHA began requiring lenders to agree to notify the agency when a borrower is 30 days past due on a payment and is unlikely to bring his account current within 60 days, or if the borrower has not provided the required financial statements or is otherwise in default.

The requirement is lacking, however, in that it does not establish a precise time within which a lender must notify FmHA of a borrower's delinquency nor does it prescribe any penalty for noncompliance. Rather, the requirement makes notification contingent upon the lender's judgment as to whether the borrower is unlikely to bring his account current within 60 days. Establishing a precise cutoff period for notification would eliminate any question about the lender's responsibility and his compliance with the lender's agreement.

<u>Borrowers' financial statements could be more effectively used as loan servicing tool</u>

Our review showed that:

--lenders were not adequately analyzing borrowers' financial statements;

--financial statements were not being received timely or, in some cases, at all;

--nearly all State and county offices visited lacked an adequate system to determine when financial statements were overdue and when followup action could be taken to obtain them;

--FmHA personnel were not timely analyzing financial statements and preparing the resultant "spread sheets;" and

--many annual financial statements were not audited as required.

Recognizing the need to obtain and review borrowers' financial statements, FmHA's initial regulations provided that lenders would require borrowers, with loans of $100,000 or more, to submit audited financial statements annually and, at a minimum, 6-month interim financial statements signed by the borrower or his representative. According to an official of the national office, unaudited annual statements are required from borrowers with loans of less than $100,000.

FmHA regulations revised in September 1974 required that the submission of financial statements and other management reports, other than the required annual statements, be on a basis and frequency acceptable to the borrower, lender, and FmHA. The regulations indicated that in some cases monthly statements may be necessary, but required that statements be submitted at least semiannually.

FmHA's current regulations provide that monthly financial statements be required for new business enterprises and those businesses needing close monitoring. The statement submission schedule agreed on is made part of the contractual agreement between FmHA and the lender as well as the agreement between the lender and the borrower.

To see that the borrowers' statements were being adequately analyzed, the national office, in July 1974, issued instructions requiring that certain key data included on the financial statements be analyzed by State office personnel. This analysis is documented on a spread sheet and submitted to the national office for review.

To be of maximum use in monitoring borrowers' operations, financial statements must be received and reviewed in a timely manner. Also, any analysis of the financial statements should be documented and made a part of the borrowers' loan records for future reference and comparison, and the results of the analysis should be brought to the attention of the borrowers for any corrective actions required.

The lenders we visited generally did not use the financial statements effectively in monitoring and analyzing borrowers' operations. We found that

--generally little or no effort was made to monitor the receipt of financial statements so that followup action could be taken to obtain them in a timely manner,

--nine lenders said they did not analyze financial statements because they lacked the time and/or the expertise, and

--lenders provided FmHA with written comments on only 3 of 64 financial statements obtained from borrowers with guaranteed loans.

Lenders will have to establish monitoring systems if they are to comply with the contractual provision to notify FmHA when borrowers do not provide required financial statements.

Of 67 financial statements received by FmHA for the 35 closed loans (3 financial statements were from borrowers with insured loans), 24 were received within 60 days of the ending date of the period covered by the statements, 32 were received in over 60 days, and the date received could not be determined for 11. Further, 56 statements that were due had not been received, 42 of which were overdue for more than 60 days.

Of the six FmHA State offices visited, only one had developed and implemented a systematic method of monitoring financial statement due dates so that followup action could be taken to receive those overdue. The monitoring system in the one State office called for sending a notice to the supervisor for any audited statements not received within 60 days of the ending date of the period covered and for any unaudited statements not received within 30 days of the ending date.

Twenty-one of the 33 county offices we visited were not systematically monitoring the receipt of financial statements. One county supervisor told us that he had established a monitoring system but was too busy to implement it.

FmHA regulations prescribe a county office management system to assist in planning, organizing, and accomplishing county office activities. As part of this system, a card file with pertinent information is maintained for each borrower. This system, if used properly, could alert the supervisors to the need for followup action on overdue financial statements.

The problems observed involving the receipt of the financial statements were compounded by the delay or absence of statement analysis by FmHA.

The State offices visited had prepared and submitted the required spread sheet analyses to the national office on only 30 of the 67 financial statements they received. Of the 30 spread sheets prepared, 7 were submitted in over 60 days. Of the 37 statements for which no spread sheets were submitted, 20 had been on hand for over 60 days.

Recognizing the need for reliable information, FmHA regulations require that the annual statements of borrowers with loans of $100,000 or more be audited by independent public accountants. This requirement, however, was not complied with for 14 of the 25 annual statements FmHA received from borrowers with loans of $100,000 or more. Furthermore, FmHA generally took no corrective action when the borrowers submitted unaudited annual statements.

Visits to borrowers

Visits to borrowers are an important aspect of a loan servicing program. Although FmHA regulations encouraged visits to borrowers before December 1975, it was not until then that such visits were required. Some visits were made by FmHA and lender personnel in connection with the 35 loans reviewed. The visits, however, were infrequent, sporadic, and lacked comprehensiveness. Further, visit results were seldom documented.

The value of obtaining and analyzing borrower financial statements by FmHA and the lenders is diminished when appropriate followup action is not taken. Once potential or actual problems are identified, visits could be useful to discuss such problems with the borrowers and reach agreement on corrective actions to be taken. Also, visits to borrowers are necessary to inspect the physical condition of the plant and equipment and any property serving as collateral.

In December 1975 FmHA revised its regulations to require its personnel, accompanied by lenders if possible, to visit borrowers in accordance with the following schedule:

--Monthly for new businesses until the business is stabilized.

--At least quarterly for businesses less than 3 years old.

--At least annually for businesses more than 3 years old.

--As often as needed for businesses requiring special attention.

To increase the effectiveness of visits, we believe FmHA should establish guidelines on the matters to be considered by FmHA and lender personnel. One of these matters should be a discussion on the views of FmHA and lenders concerning the results of their analyses of the borrowers' financial statements. Furthermore, FmHA should require that the results of such visits be documented, particularly any agreements reached to resolve actual or potential problems.

The following examples illustrate some of the situations concerning visits to borrowers.

--In April 1974 FmHA guaranteed a $40,000 loan to an existing business. The county supervisor made three visits to the business during the 22-month period after the loan was made, one visit was made to discuss the business in general and two were made to inquire about overdue financial statements.

--In July 1974 FmHA guaranteed a $25,000 loan to an existing business. No visits were made by FmHA personnel during the 21-month period after the loan was made. Although the lender told us he had visited the business four times, the borrower said the lender had never visited him.

--In March 1975 FmHA guaranteed a $505,800 loan to a new business. No visits were made by FmHA personnel during the 11-month period after the loan was made. Although the lender told us he had visited the business one time, the borrower told us he could not recall a visit by the lender.

FmHA monitoring of lender operations

Lenders have primary responsibility for evaluating and approving loans as well as servicing the loans once they are made. FmHA personnel are to supervise the lenders to see that they carry out their responsibilities adequately. FmHA needs to establish a formalized monitoring process to adequately accomplish its supervisory role and see that the lenders carry out their responsibilities effectively.

In carrying out their supervisory role, FmHA personnel do, to some degree, review and evaluate lender operations, although this is not their primary objective. FmHA personnel generally had frequent contacts with lenders during the loan evaluation process, and in this regard some review and evaluation of lender operations is being made, if only in an informal manner. Once the loans were made, however, FmHA contacts with lenders were minimal and, hence, little information was obtained regarding the lenders' loan servicing role. Furthermore, no provision is made to provide feedback to top management on the effectiveness with which lenders perform their responsibilities on a formalized basis.

BETTER CONTROL NEEDED OVER USE OF LOAN PROCEEDS

FmHA did not verify whether loan proceeds were used in accordance with approved and authorized purposes for 11 of the 35 loans we reviewed. Further, FmHA regulations do not provide any guidance on the manner in which the use of proceeds from guaranteed and insured loans will be controlled.

Loans should be approved for specific purposes designed to enhance a business' chances of success. Once these purposes are agreed on, appropriate controls are needed so that borrowers use the loan proceeds accordingly. Controls are also needed so that the loan proceeds are used for purposes authorized by law and FmHA regulation.

FmHA requires lenders to agree that loan proceeds will be used in accordance with its regulations and the purposes listed on the borrower's loan application. FmHA does not, however, require the lenders to advise it on how loan proceeds are disbursed. Further, regulations are silent on the manner in which FmHA will assure itself that the proceeds for guaranteed and insured loans are used as approved and authorized.

We were unable to determine whether the proceeds were used as approved and authorized by FmHA in four cases because it was not clearly stated in writing exactly how they were to be used and/or there were inadequate records supporting expenditures made with loan proceeds. This was particularly true for loans made to existing businesses when the only written document showing how the proceeds were to be used was the loan application which merely shows the amount of the loan funds to be used for each of the following categories: land acquisition, new buildings or plant construction, debt payment, working capital, acquisition and/or repair of machinery and equipment, and other.

On the other hand there were four instances where control over the use of loan proceeds was good. This was particularly true in two instances where documentation on the manner in which the loan funds would be used was obtained at time of loan closing.

The following examples illustrate some of the problems we noted in regard to the loans where the use of loan proceeds were either questionable and/or not verified by FmHA.

FmHA guaranteed a loan for $500,000 in May 1975. According to the loan application, about $430,000 was to be used for working capital. In January 1975 the State office advised the national office that the working capital portion of the loan was needed to finance inventory, raw materials, and accounts receivable and that no part of the proceeds for working capital was to be used to pay off debts the borrower then owed the lender. This restriction on the use of the proceeds was not, however, made a formal condition of the loan agreement.

Although FmHA's loan file did not show how the proceeds were used, in reviewing the borrower's financial statements we noted that about $469,000 of current liabilities was paid, indicating that the borrower's prior debts to the lender were also paid. We brought this matter to the attention of an FmHA official who in turn asked the lender whether the loan proceeds had been used to repay the prior debts. The lender advised FmHA by letter dated April 1, 1976, that about $345,000 of the loan proceeds was used to repay the borrower's prior debts.

FmHA guaranteed a $1.25 million loan on October 1, 1975. The borrower owned a manufacturing division which was located in a rural area and a sales and shipping facility located in an urban area. The loan application indicated that the loan was to be used for the rural facility.

In notes to the borrower's financial statement covering the 2-year period ending August 31, 1975, the auditor stated that the borrower, in anticipation of the $1.25 million loan, obtained interim financing of $700,000 of which $577,000 was used to repay debts owed in connection with the urban sales and shipping facility. In view of the fact that the FmHA guarantee loan proceeds were then used to cover the interim financing, the loan proceeds were used for an ineligible purpose because they were used for a business operation located in an urban area.

IMPROVEMENTS NEEDED IN MANAGEMENT ASSISTANCE PROGRAM

FmHA has no management assistance program as such, but instead relies on its State office loan specialists and county supervisors as well as lenders to assist borrowers with their problems. Neither FmHA personnel nor the lenders, however, appear to have the necessary time and/or expertise to provide effective management assistance.

Among other responsibilities, the State office loan specialists are to see that borrowers receive adequate guidance in carrying out approved management practices, including the proper use of credit, income, and other resources. According to an FmHA official, this can be done by the loan specialists themselves or by supervisors and lenders.

In implementing the program, FmHA established a position of supervisory loan specialist in each of its 42 State offices. By December 1973 the 42 positions were filled mostly by personnel from within the agency. FmHA also established a loan specialist position and authorized each State office to fill this position in July 1975. The majority of these positions were also filled by personnel from within the agency.

All but one of the supervisory and nonsupervisory loan specialists (referred to herein collectively as loan specialists) in each of the six State offices we visited had received both the basic and advanced 1-week financial analysis courses provided by FmHA. According to FmHA, the objective of the basic course is to assist the individual to obtain a thorough knowledge of credit and financial analysis, including an understanding of the structure, operations, management, and unique problems and trends of a business operation. The objective of the advanced course is to provide the individual with a knowledge of advanced conceptual approaches to credit and financial analysis and to further develop his or her credit judgment.

This training, although limited, may be adequate to enable loan specialists to analyze a business' operations and financial data to detect major problems. Once detected, however, arrangements must be made to assist the borrower in solving the problem. It is not clear whether loan specialists have the time and/or training and experience needed to assist in the solution of the more complex problems which could arise.

The loan specialists we interviewed often told us that they lacked the time to adequately service the loans. This problem will be compounded as additional loans are approved. The loan specialists also face a logistics problem in assisting borrowers who are located throughout the State(s) served.

The supervisors also appeared to lack the time, training, and/or experience to provide borrowers with any degree of management assistance. Thirty-two of the 33 supervisors we questioned during the period of February through July 1976 had academic backgrounds in agriculture, while only about four had any background in business and economics. Furthermore,

--only 10 supervisors had attended FmHA's basic credit and financial analysis course and none had attended the advanced course;

--30 supervisors said that they did not have sufficient time to provide adequate loan servicing; and

--14 said additional personnel, such as loan specialists, are needed to service the loans.

In implementing the program, FmHA decided to use most of its appropriated loan authority to guarantee loans which are made and serviced by lenders rather than to make insured loans which are made and serviced by FmHA. The loan servicing role of most of the lenders we visited, however, was limited primarily to collecting and overseeing loan repayments. Even if they desired to provide management assistance, it is doubtful they could in view of the fact that 17 of the 31 lenders interviewed indicated to us that they did not have the time and/or expertise to provide borrowers with any degree of such assistance. This was particularly true for the small rural lenders.

We believe FmHA should develop some means of providing management assistance to borrowers in need of such assistance. This could be done by developing its own counseling program or by arranging for other organizations and groups to provide this service.

For example, the Small Business Administration (SBA) has a management assistance program available to SBA and non-SBA borrowers alike. On June 30, 1976, SBA employed about 320 management assistance counselors. During fiscal year 1976, SBA's management assistance counselors had about 64,000 counseling sessions. SBA also has outside consultant groups providing management assistance to small businesses. These groups had about 143,000 counseling sessions during fiscal year 1976. Most of the counseling sessions conducted by SBA and its consultants were with non-SBA borrowers.

The SBA consultants providing management assistance are listed below.

--Service Corps of Retired Executives (SCORE). This is an organization of retired business executives who volunteer their services to help small business owners solve their problems.

--Active Corps of Executives (ACE). This is an organization of volunteers drawn from the ranks of active executives in industry, trade associations, educational institutions, and the professions.

--Small Business Institute (SBI). This is a program which provides faculty-supervised management counseling to small businesses by university graduate and undergraduate students.

--The Call Contract Program. This program employs consultants to provide management and technical assistance to small business owners who are eligible under the Economic Opportunity Act of 1964.

--The Professional Association Program. Under this program members of professional associations, such as the National Association of Accountants, provide management and technical assistance to small businesses on a voluntary basis.

The following examples illustrate some of the types of problems experienced by borrowers which, with some assistance, could possibly have been dealt with more effectively.

FmHA guaranteed a $560,000 loan to a mobile home manufacturer in October 1974. The borrower discontinued its mobile home operation less than 6 months after getting the loan because of decreased sales and began manufacturing cabinets and trunks. After getting the loan, the firm incurred severe losses and its assets declined while its debts continued to increase, resulting in a large negative net worth. The firm had experienced similar problems before receiving the FmHA guaranteed loan. Therefore, the need for management assistance could have been detected and dealt with at the time of loan approval as provided for in FmHA regulations.

The loan specialist said that the firm's present business could not continue to maintain the operation. Despite this opinion and the firm's history of problems, neither FmHA nor the lender made any effort to provide management assistance to the borrower. The lender and the FmHA county supervisor told us that they were not qualified to provide management assistance to the borrower.

FmHA guaranteed a $45,000 loan in March 1974 to the owner of a farm supply store. In May 1976 the borrower was 3 months delinquent on his loan repayments. Because the business did not generate sufficient income, the borrower had taken a part-time job. His wife operated the business in his absence.

The loan specialist attributed the business' financial troubles to poor management. He said that the borrower had more experience in sales than with management. Moreover, the lender told us that he required a guaranteed loan because the borrower lacked managerial capabilities. Despite the business' financial problems and the doubts about the borrower's management ability, neither FmHA nor the lender provided the borrower any management assistance.

FmHA guaranteed a $500,000 loan in May 1975. The borrower became delinquent 4 months after receiving the loan. His difficulties arose due to decreased sales and increased inventory costs.

In September 1975 the lender and the FmHA county supervisor considered asking SCORE to help the borrower, but did not. The lender notified FmHA in November 1975 that the loan would be in serious trouble unless "drastic measures" were taken. FmHA asked the lender to determine what should be done to help the borrower overcome his problems. Although the borrower was 5 months delinquent by January 1976, no decision was reached on the action to be taken to assist the borrower.

In March 1976 a meeting was held between FmHA, the lender, and the borrower in which it was decided that the lender would consider deferring the monthly loan payments for principal if the borrower's problems continued. No specific actions were agreed to, however, concerning the manner in which the borrower's problems would be resolved.

CONCLUSIONS

Effective loan servicing and management assistance programs are needed so that the businesses financed and the jobs saved and created through FmHA's business and industrial loan program are permanent. To do this FmHA needs to obtain better and more timely information on borrowers' problems and progress and establish a management assistance program.

Lenders must be fully aware of their servicing responsibilities particularly on such matters as obtaining and analyzing borrowers' financial statements, visiting borrowers' businesses, and assisting borrowers with their problems. This guidance should be included in the lenders handbook we are recommending FmHA develop. FmHA should establish policies and procedures governing its supervisory role to see that the lenders carry out their responsibilities in an adequate manner.

To see that lenders provide FmHA with timely notification of borrowers' delinquencies, FmHA should revise the lender's agreement to prescribe a definite cutoff period for lenders to provide notification, and to help attain compliance, impose a penalty upon lenders who fail to provide such notification.

To make more effective use of borrowers' financial statements as a loan servicing tool, FmHA State and county offices should obtain and analyze borrower financial statements in a timely manner. Also, the requirement for independently audited financial statements should be enforced so that the data obtained is reliable. Those State and county offices that are unable to fully carry out their responsibilities because of the lack of an adequate staff should advise the national office of this so that corrective actions can be taken.

FmHA and lender visits to borrowers were infrequent, sporadic, and lacked comprehensiveness. Although FmHA revised its regulations in December 1975 to require periodic visits to borrowers, because so many of the supervisors told us that they lacked the time to adequately service loans--30 of 33 supervisors interviewed--it is questionable as to whether this requirement can be fully implemented. Therefore, FmHA should closely monitor this requirement to see that the staffing is sufficient to make the required visits.

So that comprehensive reviews are made duri visits, FmHA should provide the supervisors and lenders with a checklist of what is to be accomplished during these visits. Such visits should include an inspection of collateral and a discussion of the results of the analyses made by FmHA and the lender of the borrower's financial statements.

To see that loan proceeds are used in accordance with approved and authorized purposes, borrowers should be required to specify in writing how the loan proceeds are to be used and be required to submit settlement sheets showing how the proceeds were disbursed. In this way FmHA can see to it that the proceeds are used as authorized.

Although an effective loan servicing program will identify borrower problems so that corrective actions can be taken, some borrowers do not possess the management capability needed to deal with the problems identified. FmHA should develop a formalized management assistance program to provide borrowers with assistance. The program should include a staff of management assistance counselors to provide assistance to borrowers to be augmented, when necessary, by outside consultant organizations.

RECOMMENDATIONS

We recommend that the Secretary of Agriculture direct the FmHA Administrator to:

--Provide additional guidance to lenders on their loan servicing responsibilities.

--Require lenders to notify FmHA of a default by a borrower within a specified number of days and impose a penalty for noncompliance.

--Establish policies and procedures governing the supervision and review of lenders' loan servicing operations.

--Obtain better and more timely information on borrower operations by (1) requiring county offices to implement a system of monitoring borrower financial statements so that followup action can be taken to obtain any statements not submitted on time and (2) establishing time frames for State office personnel to follow in performing the required analyses of financial statements received. State and county offices unable to perform these or other required tasks because of inadequate staffing should be required to advise the Administrator of this fact so that corrective actions can be taken.

--Require the enforcement of the requirement that annual financial statements of borrowers with loans of $100,000 or more be audited by independent public accountants and emphasize to the lenders and borrowers that borrowers failing to meet this requirement are in default of their loan agreements.

--Monitor personnel efforts to comply with requirements concerning visits to borrowers' businesses to determine whether staffing levels need to be adjusted in order to make the required visits.

--Provide additional guidance on the objectives to be accomplished through visits to borrowers made by supervisors and lenders.

--Require (1) borrowers to specify as part of their written loan agreement how loan proceeds will be used, (2) lenders to provide FmHA with detailed data showing how the loan proceeds were disbursed, and (3) FmHA personnel to verify that proceeds are used in accordance with the loan agreement.

--Develop a formalized management assistance program including the establishment of a staff of management assistance counselors. Agreements with outside consultant firms should be entered into to help provide the service to borrowers in need.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on our report, FmHA said that it has set out the duties and responsibilities of the lender in the lender's agreement. As discussed earlier it is also considering the development of a lenders handbook.

In commenting on our recommendation to require that lenders notify it when borrowers are delinquent on their loan repayments for a specified number of days, FmHA said that its regulations requiring lenders to notify FmHA when loan repayments are 30 days past due and are not likely to be brought current within 60 days, provides the lender latitude in working out problem loans and eliminates a lot of unnecessary correspondence and servicing problems. Further, FmHA said that (1) it is stated in the lender's agreement that improper servicing of the loan could lead to FmHA's not paying the request for loss settlement and (2) its regulations provide for debarment of lenders who do not service loans properly.

As stated in the report, FmHA's requirement makes notification of delinquencies contingent upon the lender's judgment as to whether the borrower is unlikely to bring his account current within 60 days. We believe that the present regulation would, in effect, encourage lenders to wait the full 60 days prior to notifying FmHA of delinquencies and that FmHA would find it difficult to impose a penalty on a lender that did not notify it of a delinquency in less than 60 days.

In contrast, under SBA's regulations a lender must agree to notify SBA of delinquencies within 45 days of the due date. If the lender fails to do so, SBA will not reimburse the lender for the interest earned from the date of default (delinquency) to the date the notice of default was received by SBA when a lender places a demand on SBA to purchase the guaranteed portion of the loan. Also, SBA regulations provide that it

> " * * * shall not purchase the guaranteed percentage unless SBA shall first determine that said delay in notification of default did not cause any substantial harm to the Government. * * *"

SBA's regulations are more in line with what we believe is needed to adequately protect the Government's interest. That is, a precise period of time within which the lender must notify FmHA of delinquencies should be specified in the agreement between FmHA and the lender, including a provision setting forth those penalties that will be imposed for failing to provide the required notification within the specified period.

FmHA did not specifically state whether or not it agreed with us that policies and procedures governing the supervision and review of lenders' loan servicing operations should be established. It did say, however, that it had implemented a system whereby national office personnel review field offices for compliance with FmHA regulations and loan conditions and also make periodic reviews of lenders.

In commenting on our recommendations to obtain better and more timely information and on enforcing the requirements for audited financial statements, FmHA said the regulations now set forth appropriate loan servicing monitoring and provide for the monitoring of the receipt of audited statements. FmHA said also that a field visit guide was being developed to strengthen the review of borrowers' records (FmHA attached a draft of the guide to its comments--see app. III) and that it will continue to emphasize the need to obtain and analyze borrowers' financial statements in a timely manner in its training programs and monitoring efforts.

Further, in its July 8 memorandum, FmHA advised its State directors of the need to implement appropriate follow-up systems at State and county office levels to assure receipt of the required financial statements.

Concerning field visits to borrowers' businesses, FmHA said it believes that at present funding levels it has adequate staff to properly monitor the loans and that the uniform monitoring procedures being developed will help assure that its objectives for the visits are met.

On the basis of our review, we believe it is at least questionable as to whether FmHA has adequate staff to implement its procedures concerning visits to borrowers. Particularly in view of the fact that nearly all of the county supervisors we interviewed said that they lacked the time to adequately service loans.

Concerning the verification of loan proceeds FmHA stated:

> "Our regulations provide that the district director will make an audit of the borrower immediately prior to the issuance of the guarantee. As a part of this audit, he is required to verify that funds will be used for authorized purposes by checking the issuance of checks with the loan purposes specified in the application. Also, the lender certifies in the lender's agreement that funds will be used for authorized purposes. Subsequent field visits would disclose any irregularities in use of funds."

In addition, in its July 8 memorandum FmHA advised the State directors to instruct the district directors of the importance of the preguarantee audit to assure that the loan funds are used for the authorized purposes approved when the application was reviewed and that the loan will produce the desired results.

FmHA's actions should help improve the problems found during our audit regarding the use of loan proceeds. However, we believe our recommendations are still valid in that they provide for a more complete solution. For example, we had difficulty in verifying that loan proceeds were used as intended for some loans because of a lack of any documentation specifying what was intended. Unless borrowers are required to specify in writing how the loan proceeds will be used, the district directors may face the same problem in their audits.

FmHA agreed with our recommendation concerning the establishment of a formal management assistance program and said that it believes that many of the SBA programs would be useful in providing management assistance to borrowers.

CHAPTER 5

PROGRAM STAFFING--A PROBLEM NEEDING TO BE RESOLVED

The program could have been implemented and operated more effectively had FmHA taken the necessary actions to insure that it had a sufficient staff of experienced or trained employees; however, most staff positions were filled with FmHA personnel having agricultural backgrounds.

FmHA has instituted training programs for its personnel, and many have taken one or both of two 1-week financial and credit analysis courses. Because of the complexity of the program and the fact that the needs of the program were immediate, we believe the staff should have been supplemented to a greater degree with personnel having prior experience in making business loans.

The need for adequate staffing with more diverse technical skills had been brought to FmHA's attention by us and others in the past on several occasions. For example, we made several recommendations regarding the implementation of the business and industrial loan program in a May 1973 report 1/ to the Congress, one of which was that FmHA take such action as is necessary to insure that it have a sufficient staff of experienced or trained employees to properly implement the program. FmHA personnel needs were the subject of a report 2/ we issued in September 1975 wherein we concluded that, until FmHA hires and trains enough technically skilled employees, it will not be able to effectively implement the newer rural development programs on more than a limited basis.

In implementing the program, FmHA established a business and industrial loan division at the national level in August 1973 which was staffed with three professional employees. As of June 30, 1976, this division had 12 professional employees, 7 of whom were hired from other Federal agencies and private organizations because of their business loan experience.

1/"Ways to Improve Effectiveness of Rural Business Loan Programs" (B-114873, May 2, 1973).

2/"Personnel Management Improvements Initiated or Needed to Help Farmers Home Administration Meet Its Expanded Missions" (RED-76-16, Sept. 10, 1975).

Staffing at the State level also began in May 1973 and by December 1973 business loan specialists had been appointed in each of the 42 State offices. Nearly all these positions were filled by promoting or reassigning FmHA employees, most of whom lacked experience in making business and industrial type loans. In fact, an FmHA official indicated that all loans had to be processed through the national office during the first 2 years of the program's life primarily because of the lack of experience and training of State office personnel.

To help correct this situation, the former Administrator of FmHA authorized each State director to hire an additional loan specialist effective July 7, 1975. In advising the State directors of this action, the former Administrator said that persons assigned to these positions should have strong commercial lending backgrounds, such as that possessed by key bank officials. Further, he said that credit experience in FmHA lending programs was not what was being sought because the new B&I loan program is quite different from FmHA's other programs.

Nevertheless, of the 27 people hired to fill these positions as of October 31, 1976, only 3 were hired from outside the agency. FmHA officials cited employee opposition and resistance to hiring non-FmHA personnel to fill these positions as the major factor for FmHA's limited success in this regard.

Historically, FmHA's practice has been to hire persons with agriculture-related education and/or experience for county offices and to train them in administering FmHA programs. This practice has resulted in most FmHA employees having agricultural backgrounds although agriculturally oriented programs accounted for only about 30 percent of FmHA loan and grant expenditures in fiscal year 1976.

As the former Administrator indicated, credit experience in FmHA programs would not necessarily be sufficient to qualify for a loan specialist position in the B&I program. Not only are the loan purposes quite different but the size of the loans made are much larger. There are no maximum amounts prescribed for B&I loans and many loans are made for over $1 million, whereas farm ownership and operating loans, for example, are limited by law to $100,000 and $50,000 respectively.

FmHA staffing levels have not kept pace with its overall loan and grant activity. Between June 30, 1973, and June 30, 1976, FmHA's full-time permanent staff decreased from 7,161 to 6,860 employees, or about 3 percent, while the amount of loans and grants made increased from about $3.8 billion to $5.4 billion, or about 42 percent, and outstanding loan balances increased from $9.6 billion to $18.5 billion, or about 93 percent.

A comparison of FmHA full-time permanent staff, by organizational level, as of June 30, 1973, and June 30, 1976, follows:

Organization level	Number of full-time permanent employees June 30, 1973	Number of full-time permanent employees June 30, 1976	Increase decrease (-)
Headquarters	268	317	49
Finance office	462	376	-86
State	894	976	82
District	295	280	-15
County	5,242	4,911	-331
Total	7,161	6,860	-301

The decrease in full-time employees was offset to some degree by an increase of about 700 part-time permanent employees. We could not categorize the part-time employees by organizational level because FmHA records do not show this information.

The Congress recognized the need for FmHA to increase its full-time permanent staff by appropriating $12 million more than the amount requested by the administration in the fiscal year 1976 budget. The report of the Senate Committee on Appropriations specifically stated the Committee's recommendation that the additional funds were needed to provide more adequate staffing. Subsequently, a Member of Congress stated his understanding that it was intended that the additional funds be used to hire between 750 and 1,000 additional full-time permanent employees. However, contrary to the Committee's recommendation as well as the Member's understanding as to the intended purpose of the additional funds, only about $4 million of this amount was expended in hiring

400 full-time, 200 part-time, and 100 temporary employees. The remaining funds were used for pay increases, travel expenses, postage expenses, and training. For the fiscal year 1977 budget, the administration proposed no changes in FmHA's full-time staffing level. Nevertheless, the Congress appropriated about $7.8 million more than that requested by the administration for salaries and expenses.

CONCLUSIONS

FmHA has assisted many businesses to save and create jobs in rural areas. As this report points out, however, problems exist which are in need of management attention. To solve these problems and increase the overall effectiveness of the program, FmHA must have a sufficient number of qualified staff. The Congress has appropriated additional moneys to help provide the staff needed. FmHA must take the necessary action to see that its future hiring efforts are directed to acquiring employees with the technical backgrounds needed to fully implement its newer programs, such as the B&I program.

RECOMMENDATION

We recommend that the Secretary of Agriculture direct the FmHA Administrator to take such actions as are necessary so that employees hired in the future have the educational and technical backgrounds needed to more adequately implement its programs.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on our report, FmHA stated:

"This program was implemented at a time when FmHA was instructed to make a reduction in personnel of 10 percent. It was very difficult to justify to FmHA employees the hiring of outside talent under these conditions. The agency has continually been updating its requirements for loan officers. When the program was first implemented, the use of FmHA personnel was an expeditious means of staffing for the program.

"We would like to take issue with the audit's conclusion. The fact that we met all allocation allotments each year with a reasonable delinquency rate, we believe, points to an outstanding job performed by those loan specialists with primarily agricultural backgrounds. It must be noted that all these loan officers had prior lending experience in housing, community programs, and farmer programs. Present and future training courses and FmHA personnel development programs were designed to provide for further development of B&I loan officers.

"We agree that under ideal conditions personnel with a commercial loan background would be desirable. FmHA has implemented a 2-year graduate program in financial management leading to an advanced degree. This program is designed to provide future management for the agency and properly trained personnel to implement the various FmHA programs and respective objectives."

While we can sympathize with FmHA's statement that it would find it difficult to justify to FmHA employees the hiring of outside talent at a time when it was instructed to make a 10-percent reduction in personnel, we believe that in implementing any new program, an agency's first consideration must be to insure that the program will be operated as efficiently and effectively as possible. The most important ingredient to accomplishing this objective is staff--both in number and quality.

Our report points out a number of problems experienced in operating the B&I program. We believe that similar problems may be avoided or minimized in the future if FmHA takes the action necessary to attain a sufficient number of qualified staff.

SCHEDULE OF LOANS REVIEWED BY GAO

Loan number	Amount	Date closed or obligation approved	New or existing business	At time of GAO visit (note a) Months in operation since loan closed	Payment status
Loans closed as of June 30, 1975					
1	$ 1,371,456	2/75	New	12	Current
2	40,000	4/74	Existing	22	"
3	505,800	3/75	New	11	"
4	60,000	11/74	"	11	"
5	900,000	2/75	"	12	"
6	359,000	2/75	Existing	13	"
7	300,000	2/74	"	25	"
8	63,000	4/75	New	11	"
9	560,000	10/74	Existing	18	b/ Current
10	817,053	3/75	"	14	Delinquent
11	110,000	6/75	"	10	c/ Current
12	500,000	6/75	"	10	Current
13	351,000	2/75	New	12	"
14	250,000	4/75	Existing	11	"
15	2,200,000	3/75	"	15	d/ Delinquent
16	500,000	5/75	"	9	Delinquent
17	400,000	12/74	"	14	Current
18	600,000	11/74	"	15	"
19	1,400,000	12/74	"	14	"
20	300,000	6/75	"	8	"
21	45,000	3/74	New	26	Delinquent
22	2,697,266	7/74	Existing	21	Current
23	25,000	7/74	"	21	"
24	170,000	8/74	"	21	"
25	30,000	7/74	"	21	"
26	100,000	10/74	New	19	Paid in full
27	14,000	8/74	Existing	20	Current
28	19,000	4/75	New	10	e/ Paid in full
29	480,000	6/75	Existing	12	Current
30	1,000,000	9/74	"	22	e/ Paid in full
31	10,000	1/75	"	17	Current
32	175,000	7/74	"	23	"
33	200,000	2/75	New	17	"
34 (note f)	300,000	2/75	Existing	16	"
35 (note f)	600,000	5/75	"	13	"
Total	$17,452,575				
Loans in process as of June 30, 1975					
36	$ 1,800,000	6/75	Existing	10	Current
37	6,400,000	6/74	"	5	"
38	1,250,000	5/75	"	Not visited	
39	1,700,000	4/75	"	"	
40	85,700	6/75	"	"	
41	86,350	4/75	New	"	
42	85,000	3/75	"	"	
43	3,000,000	4/75	Existing	"	
44	650,000	4/75	New	"	
45	400,000	4/75	"	"	
Total	$15,457,050				
Total	$32,909,625				

a/GAO visits were made during the period February-July 1976.

b/Although the loan was current, the company had experienced financial difficulties and was no longer in the business for which the loan was made.

c/Although the loan was current, the company had experienced financial difficulties and was in the process of going out of business.

d/The company had filed a bankruptcy petition.

e/The loan was repaid after the business failed.

f/Loan numbers 34 and 35 were made to the same borrower.

COMPARISON OF EMPLOYMENT DATA REPORTED TO THE CONGRESS WITH ACTUAL AT TIME OF OUR VISIT

Loan number	Employment reported to the Congress	Number employed at time of our visit (note a)	Number over or under(-) employment reported to the Congress	Number of months since loan closed at time of our visit
1	100	31	-69	12
2	5	3	-2	22
4	5	7	2	11
5	75	42	-33	12
7	42	16	-26	25
8	5	4	-1	11
9	44	13	-31	18
10	43	83	40	14
11	7	1	-6	10
12 (note b)	30	24	-6	10
13	7	15	8	12
14	38	92	54	11
15	900	20	-880	15
16	70	15	-55	9
17	47	40	-7	14
18	14	3	-11	15
19 (note c)	97	80	-17	14
20 (note c)	32	42	10	8
21	3	3	-	26
22	220	298	78	21
23 (note c)	11	4	-7	21
24	20	19	-1	21
25	7	6	-1	21
26	16	12	-4	19
27	25	11	-14	20
28	6	-	-6	10
29 (note c)	12	36	24	12
Total	1,881	920	-961	

a/GAO visits were made during the period February-July 1976. Part-time and seasonal employees are shown as full-time equivalents.

b/Employment reported to the Congress and the number employed applies only to new jobs created by this loan. The borrower had 59 employees when the loan was made.

c/Although we show the number of employees at the time of our visit, the borrower told us that the purpose of the loan was to transfer ownership of the business and therefore no jobs were actually saved.

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

Mr. Henry Eschwege
Director, Community and Economic
Development Division
U.S. General Accounting Office
Washington, DC 20548

JUL 27 1977

Dear Mr. Eschwege:

This is in response to your letter forwarding draft copies of the audit conducted on the business and industrial loan program.

The Farmers Home Administration agrees with GAO in the improvements needed in this program as set forth in the digest of the report. FmHA appreciates that the audit recognizes that this program was implemented at a time when we were in one of the worst recessions in this country's history. However, there is one other important factor that influenced the beginning of this program that was omitted. When this program was implemented, FmHA was ordered to make a 10 percent reduction in FmHA personnel.

Our comments will be made in the same order as the various sections in the draft audit report were presented:

Chapter II

The verification of job data is a part of the loan evaluation and should be done in every case. We will emphasize this fact in our upcoming training meetings, will issue instructions to our state directors to verify job projections and later provide for review of job data on subsequent field visits with appropriate documentation made in the loan file. FmHA will implement a manual reporting system to provide the needed job data suggested by this report. When the agency UMIS system is implemented, we will be able to provide updated reports on employment figures for management and Congress.

There appears to be the implication in the audit that FmHA deliberately overstated the accomplishments of the program. This is absolutely not true. When a new program is started, it is almost impossible to accurately report the actual number of jobs created or saved because many of the loans have not been closed and the construction completed. Therefore, FmHA has always reported the number of dollars obligated and the number of jobs saved and created as reported by the applicant.

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Secretary of Agriculture, Washington, D.C. 20250

this agency has indicated to all B&I personnel in its training meetings that a $20,000 per job investment is desirable. We disagree with the report recommendation that a dollar job cost figure should be established. The creation of permanent stable jobs, effect on the tax base, flow of funds into the community, and other beneficial effects on the community will also be evaluated and used as criteria for loan consideration in determining which projects will be funded. A maximum job cost figure would preclude loans in many areas that have natural resources, the development of which would require substantial fixed asset costs. We do not believe information on labor intensive industries distributed to field personnel would serve any useful purpose as the disadvantages are greater than the benefits.

Chapter III

1. Many of the areas pointed out by this audit report indicating deficiencies have been improved considerably by further training of personnel and by a total revision of the regulations in December 1975 and use of the new project summary form developed in July 1976 (see attached project summary). This will be enforced further by instructions to the field (see attached letter). The completion of the project summary by FmHA personnel assures that the most important credit factors have been considered and documented for each loan. [See GAO note, p. 76.]

On August 4, 1976, FmHA revised its application form (see attached). Part B of the form requires the lender to analyze the application and set forth its recommendations. Also, a lender's agreement (see attached) sets forth detailed certifications by the lender and loan servicing requirements. We will assess the need for a lender's handbook. [See GAO note, p. 76.]

2. We agree with the recommendation of this report. We will monitor this closer.

3. We have revised our regulations to require qualified appraisals and our forms do provide for fair market values. On small loans, regulations provide flexibility for estimating market value by lenders and FmHA because costs for professional appraisals on small loans could be prohibitive. We are also conducting courses to teach our personnel how to evaluate appraisals.

We agree that current financial statements are desirable and they are secured at the time the application is accepted. However, the processing time for our loans is sometimes lengthy. To help in this regard, we require the lender to certify prior to the issuance of the guarantee that there has been no adverse change in the borrower's financial condition. We have instructed our field staff of the importance of reviewing and analyzing current financial statements of guarantors (see attached letter).

Analysis of cost of property is considered by the loan reviewer. FmHA has accountants, engineers and architects who assist the loan reviewer in determining the value of property.

4. We agree with the report that in refinancing debts it is desirable to keep the lender from reducing its exposure. However, as a practical matter, this is not always feasible. In many small communities there is only one bank and a prohibition against the lender reducing its exposure would cause many businesses to cease to exist through lack of financing. This might also lead to forcing borrowers to change lenders to avoid regulation requirements. It could also eliminate the ability of the bank to provide a line of credit for short-term financing needs due to lending limits or bank liquidity.

Chapter IV

1. FmHA has set out in the lender's agreement the duties and responsibilities of the lender. The regulations provide that the lender notify FmHA when the loan is 30 days past due and the loan is not likely to be brought current within 60 days. We feel that this gives the lender latitude in working out problem loans and eliminates a lot of unnecessary correspondence and servicing problems. It is clearly stated in the lender's agreement that improper servicing of the loan could lead to FmHA's not paying the request for loss settlement. FmHA does have regulations for debarment of lenders who do not service loans properly.

2. FmHA has implemented a system for review of field offices by National Office loan officers. The review includes but is not limited to checking loan dockets for compliance with FmHA regulations and conditions established prior to loan approval. In addition, periodic field reviews are made of the lender.

3. The regulations now set forth appropriate loan servicing monitoring. The lender has the primary responsibility to service the loans. FmHA has in process of development a field visit guide which will strengthen the agency's review of borrowers' records.

We are in agreement with the audit that borrowers' financial statements should be obtained in a timely manner and analyzed promptly to provide an early warning system. This requirement has been in our regulations from the beginning of the program. We will continue to emphasize this in our training programs and monitoring of state office operations.

4. FmHA regulations do require annual audited financial statements. This is addressed in the lender's agreement and the loan agreement between the borrower and lender. FmHA regulations do provide for the monitoring of the receipt of these statements and the lender's comments after they have been analyzed.

5. At present funding levels, FmHA feels it has adequate staff to properly monitor its loans. As mentioned above, we are establishing uniform monitoring procedures to assure that FmHA objectives will be accomplished.

6. Our regulations provide that the district director will make an audit of the borrower immediately prior to the issuance of the guarantee. As a part of this audit, he is required to verify that funds will be used for authorized purposes by checking the issuance of checks with the loan purposes specified in the application. Also, the lender certifies in the lender's agreement that funds will be used for authorized purposes. Subsequent field visits would disclose any irregularities in use of funds.

7. We agree with the report that FmHA should have as one of its goals a more formalized management assistance program for borrowers. Many of the Small Business Administration assistance programs, we feel, would be useful. At the present time, FmHA has used outside consultants to help us with problem loans in a number of specific cases. We had funds in our budget to hire qualified consultants on a retainer basis who would be available when needed; however, we were unable to do this due to procurement regulations prohibiting the hiring of consultants on this basis.

Chapter V

This program was implemented at a time when FmHA was instructed to make a reduction in personnel of 10 percent. It was very difficult to justify to FmHA employees the hiring of outside talent under these conditions. The agency has continually been updating its requirements for loan officers. When the program was first implemented, the use of FmHA personnel was an expeditious means of staffing for the program.

We would like to take issue with the audit's conclusion. The fact that we met all allocation allotments each year with a reasonable delinquency rate, we believe, points to an outstanding job performed by those loan specialists with primarily agricultural backgrounds. It must be noted that all these loan officers had prior lending experience in housing, community programs, and farmer programs. Present and future training courses and FmHA personnel development programs were designed to provide for further development of B&I loan officers.

We agree that under ideal conditions personnel with a commercial loan background would be desirable. FmHA has implemented a 2-year graduate program in financial management leading to an advanced degree. This program is designed to provide future management for the agency and properly trained personnel to implement the various FmHA programs and respective objectives.

Sincerely,

GORDON CAVANAUGH
Administrator

Attachments

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

July 8, 1977

SUBJECT: Business and Industry Loan Making and Servicing (General Accounting Office Audit)

TO: All State Directors

As you probably know, the General Accounting Office (GAO) has recently completed an indepth audit of our business and industrial (B&I) loan program. The audit covered the years 1974-75 and included the review of the National Office, Finance Office, and six State Offices, which represented about 21 percent of our total B&I program.

It was noted that many areas of our program need to be improved. In order for us to continue toward our goal of improving service to our applicants, borrowers, and lenders, and providing for a more efficient organization, the following major areas need to be reevaluated and streamlined:

1. Document the file completely with the analysis of the loan. This includes, among other things, completely filling out the Form FmHA 449-29, "Project Summary," including the recommendations of the County Supervisor and District Director. This procedure is to be followed whether a State or National Office review of the project is required. It is essential that our applications are properly analyzed. In the future, any incomplete project summaries forwarded to the National Office will be returned with the file without review.

2. If personal or corporate guarantees are obtained for the project, make sure you review their current financial statements, including a close examination of the guarantor's net worth. Copies of these financial statements should be in the file together with the loan officer's comments and evaluations.

3. Carefully document the file on those cases where the lender is requesting refinancing, and particularly where the lender is reducing his exposure on existing loans. Keep in mind that refinancing must make good economic sense and will, in fact, save existing employment.

4. In servicing loans, be sure that the lender and borrower fully realize the importance of our requirements to monitor periodic borrower's financial statements. Timely review of the financial statements and their analysis with proper documentation in the file is imperative as a means of early detection of potential problem loans. Appropriate followup systems need to be implemented at State and county levels to assure FmHA's receipt of the borrower's periodic and annual audit financial statements.

Farmers Home Administration is an Equal Opportunity Lender. Complaints of racial or ethnic discrimination should be sent to: Secretary of Agriculture, Washington, D.C. 20250

5. Instruct the District Director of the importance of the preguarantee audit. Loan funds must be used for the authorized purposes approved when the application was reviewed. This audit is FmHA's assurance that the funds obligated and the purposes stated will produce the desired results. The audit must include the review requirements set forth in Section 1980.454 of FmHA Instruction 1980-E.

6. Verify the job projections. This is part of the loan analysis. Job projections should tie in with the applicant's projected salaries and wages as reflected on the financial statements. Also, keep in mind the job cost ratio. We had indicated earlier in our training meetings that a rule of thumb of $20,000 per job investment is desirable, but we do not want to establish a definite dollar figure. Should an application have a high job cost ratio, document the file with the reasons for recommending the application, the priority you placed on the application, and the supplemental benefits that will accrue to the economy in the local community.

7. We need to reduce our loan processing time to a more reasonable level. The GAO report indicated that the average processing time of loans reviewed was 252 days, of which an average of 61 days covered the period of time from which National Office concurrence was given to the State issuing the conditional commitment. Also, between issuance of the conditional commitment and loan closing (excluding construction time) was an average of 61 days. The following schedule reflects some of the average processing times:

From preapplication to State Office approval	87 days
State Office approval to National Office concurrence	36 days
National Office concurrence to Issuance of conditional commitment	61 days
Conditional commitment to loan closing (excludes construction)	61 days

8. On periodic field visits, make sure that requirements of the loan agreement are being met. Document the files on current employment versus company projections at loan closing, physical appearance of the business, business payroll, taxes, inventories, and special problems, etc. We will be working on a guide to assist you in this area.

I expect you to follow through with implementing the necessary procedures and training to meet the deficiencies noted.

GORDON CAVANAUGH
Administrator

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Business and Industrial Loan Program

Field Visit Reports

I GENERAL. The following may be used by the County Supervisor, District Director, B&I Chief or other designated FmHA employee as a guide for the preparation of the field visit reports as required in §1980.469 Administrative. This guide does not replace Form FmHA 424-12 "Inspection Report," which is used in accordance with FmHA Instruction 424.1.

II INITIAL FIELD VISIT. At the initial field visit the reviewer should discuss with the Lender the following items:

A Any special requirements of the Lender's Loan Agreement which need monitoring by the lender.

B Lender's servicing responsibilities as outlined in Form FmHA 449-35 with attention to Lender's analysis and follow-up of borrower's financial statements; annual audit report, arranging schedule for future fiield visits and responsibilty to notify FmHA promptly of delinquency or problem loans.

III SUBSEQUENT FIELD VISITS. Reviewer should be particularly aware of any significant changes in the borrowers operations and financial position.

IV PRIOR REVIEW OF FILE. Before going on field visit briefly review the loan file and the latest field visit report.

V PROBLEM AND DELINQUENT LOANS. The reviewer is responsible to promptly notify the State Director of problem or delinquent loans.

VI ADDITIONAL INFORMATION. Financial Statements, newspapers or magazine articles, charts, etc. may be attached to the report.

VII CONCLUSIONS AND RECOMMENDATIONS. Make constructive comments and suggestions to assist others in making decsion on servicing actions. Comments should include the reviewers opinion on how the Lender is performing his servicing responsibilities.

APPENDIX III

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Business and Industrial Loan Program
Field Visit Report

Report Number ____________
(Use consecutive order beginning with No. 1)

Date of Visit ________

Borrower's ID No. ________

Name of Borrower: ____________________

Address: ____________________
Street County State

Fiscal Year End: ____________

Persons present or contacted on visit: ____________________

Original Amount of Loan $__________ Present Princpal Balance $________

Is loan(s) current? ____ If no explain ____________________

Number of jobs projected at time of application ____________ Current
(See Form FmHA 449-22)
number of jobs ________. (Verify by reviewing Borrower's quarterly FICA reports, payroll records or personal count.)

Comments: ____________________

Latest Annual Local, State and Federal Taxes borrower is paying $__________.

Latest Annual Payroll $____________.

Are the premises and facilties maintained in an orderly, clean and safe manner? ____ If no explain.

Is the inventory (raw materials and finished) properly stored and protected? ________ If no, explain.

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Is the business experiencing any problems in obtaining the necessary raw materials or marketing of its products or services?

Does the overall operation appear to be functioning smoothly , or does it appear disorganized?

Are there any labor union problems, civil suits, tax or creditor's actions taken against he borrower?

Has there been any change in methods of production, products or terms of sales?

Is the borrower providing adequate financial statements to the lender for his analysis?

Is the bookkeeping system adequate?

Review and attach latest financial statements. Comment on sales, inventory and profit trends, accounts receivables and payables, debt payments, etc.

General Comments: (May include information on recent fires, damages, floods, new competition, new construction or development significant changes in area which effects the business, any new loans made to borrower, changes in management, other problems, etc.)

Conditions and recommendations:

County Supervisor

District Director

GAO note: The attached project summary, application form, and lender's agreement referred to have been deleted because of their volume.

PRINCIPAL DEPARTMENT OF AGRICULTURE OFFICIALS RESPONSIBLE FOR ADMINISTERING ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
SECRETARY OF AGRICULTURE:		
Bob S. Bergland	Jan. 1977	Present
John A. Knebel	Nov. 1976	Jan. 1977
John A. Knebel (acting)	Oct. 1976	Nov. 1976
Earl L. Butz	Dec. 1971	Oct. 1976
ASSISTANT SECRETARY FOR RURAL DEVELOPMENT (note a):		
Alex P. Mercure	Apr. 1977	Present
Vacant	Feb. 1977	Apr. 1977
William H. Walker III	Dec. 1975	Feb. 1977
James E. Bostic, Jr. (acting)	July 1975	Dec. 1975
William W. Erwin	Jan. 1973	July 1975
Thomas K. Cowden	May 1969	Jan. 1973
ADMINISTRATOR, FARMERS HOME ADMINISTRATION:		
Gordon Cavanaugh	June 1977	Present
Denton E. Sprague (acting)	Apr. 1977	June 1977
Frank W. Naylor (acting)	Jan. 1977	Apr. 1977
Frank B. Elliott	Aug. 1973	Jan. 1977
Frank B. Elliott (acting)	Mar. 1973	Aug. 1973
Vacant	Feb. 1973	Mar. 1973
James V. Smith	Mar. 1969	Feb. 1973

a/Until January 1973 the title of this position was Assistant Secretary of Agriculture for Rural Development and Conservation.

(02875)