June 30, 2009

REPLY TO
ATTN OF: 03703-1-Te

TO: Douglas J. Caruso
Administrator
Farm Service Agency

ATTN: T. Mike McCann
Director
Operations Review and Analysis Staff

FROM: Robert W. Young /s/
Assistant Inspector General
for Audit

SUBJECT: American Recovery and Reinvestment Act – Direct Farm Operating Loans – Phase 1(1)

The American Recovery and Reinvestment Act of 2009 (Recovery Act) includes measures to modernize our Nation's infrastructure, enhance energy independence, expand educational opportunities, preserve and improve affordable health care, provide tax relief, and protect those in greatest need. Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of the funds. On April 2, 2009, the Office of Management and Budget (OMB) issued guidance, "Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009," requiring Federal agencies to establish rigorous internal controls, oversight mechanisms, and other approaches to meet the accountability objectives of the Recovery Act. In this guidance, OMB stressed the need for agencies to use appropriate internal control assessments to assess the risk of program waste, fraud, and/or abuse. Based on these assessments agencies were to develop defined strategies to prevent or timely detect, waste, fraud, or abuse.

The Farm Service Agency (FSA) is responsible for making direct farm loans with Government funds. FSA also services these loans and provides its direct loan customers with supervision and credit counseling so they have a better chance for success. A farm operating loan is one type of loan available under the direct loan program. For fiscal year 2008, 11,171 direct farm operating loans were obligated totaling $506 million. On March 9, 2009, the Farm Service Agency (FSA) was authorized to begin distributing Recovery Act funds, including funds totaling over $173 million for direct farm loans. As of May 31, 2009, for the current fiscal year, 14,086 direct farm operating loans have been obligated totaling about $845 million, which includes Recovery Act funds of over $173 million (20 percent of the total obligations). FSA has requested another

$400 million in non-Recovery Act funding for the backlog of approved, but unfunded, loan applications.

Our role, as mandated by the Recovery Act, is to oversee agency activities and to ensure funds are expended in a manner that minimizes the risk of improper use. On May 12, 2009, we held an entrance conference with members of your staff and briefed them on the objective of our ongoing review of Recovery Act funding for the Direct Farm Operating Loan Program. To accomplish our objective, we are in the process of assessing the program's policies and procedures, as well as its internal controls.

Our preliminary review of FSA's current internal controls and processes identified concerns regarding current compliance procedures and whether they can adequately address the oversight and accountability requirements of the Recovery Act and OMB guidance. FSA's current compliance review process does not ensure that reviews of direct farm operating loans are performed early on during the loan making process. Current compliance procedures may not detect improper use of Recovery Act funds or ineligible borrowers until months after loan closing. Also, given the relatively smaller number of direct farm operating loans in the total population from which compliance review samples are drawn, there is no assurance that FSA will sample a sufficient number of Recovery Act-funded loans to provide adequate assurance as to the accountability and propriety of Recovery Act expenditures.

FSA's compliance procedures for the Direct Farm Operating Loan Program include the following reviews:

> <u>Farm Loan Program Risk Assessment (FLPRA)</u> – FLPRA reviews are conducted at the end of each year and provide the Farm Loan Programs (FLP) National Office staff and State managers an overall evaluation of State FLP operations. Recommendations for improvements are included in the FLPRA as needed. FLPRA reviews use a risk-based approach with established review objectives, scope, and frequency. FLP National Office staff select at the beginning of each fiscal year approximately 10-13 State offices for review; however, the reviews are based on and focus on the prior year's activities. For the 13 State offices scheduled for review in fiscal year 2009, the State offices were selected based on data that predate the passage of the Recovery Act. Nine of the State office reviews have been completed. The remaining four State office reviews will be conducted from June through September 2009.
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> In order to determine if the State office is providing adequate oversight and direction with respect to the administration of direct loan making, FLPRA reviewers select a sample of new loans closed in the prior 18 months. Therefore, for most of the FLPRA reviews completed so far this year, the sampled loans would have been selected from a population of loans closed months prior to passage of the Recovery Act. Also, according to the FLP National Office staff, many of the Recovery Act-funded loans have not been closed because of pending accounting adjustments and are therefore not in the universe for sample selection.

Yearend Analysis – State offices are required to perform analyses on all borrowers. However, these reviews are performed at yearend or to coincide with the end of a borrower's production and marketing cycle, which generally occurs when the first annual loan payment is due. Since these reviews are performed retrospectively, that is, near the end of the loan period, the State offices will have no assurance early on as to whether funds were distributed to eligible borrowers for eligible purposes.

County Office Review Program (CORP) – The CORP measures and evaluates the effectiveness of internal controls over agency assets in the prevention and detection of fraud, waste, and abuse. According to CORP procedures, these county office reviews consist of two parts – county office administration reviews and targeted reviews of selected programs. The administration reviews focus primarily on procedural administrative matters, while the targeted reviews are designed to review a specific program or program area. However, CORP reviews often do not include FLP.

District Director (DD) Review – The DD reviews are performed on a quarterly basis each year and may include a review of loan making and loan servicing activities. However, the DD reviews primarily focus on evaluating whether the loans were processed in accordance with policies and procedures, as opposed to validating whether the borrower was eligible and whether loan funds were properly used.

We discussed our concerns with the FLP national office staff on May 12 and May 26, 2009. At that time, we recommended that for direct farm operating loans funded by the Recovery Act, that FSA should consider the following:

1. Revise FLPRA procedures to include reviews performed earlier in the loan cycle to timely ensure that borrowers are eligible and funds are properly used.

2. Revise sampling procedures in these compliance reviews to ensure that adequate samples of Recovery Act-funded loans are selected for review.

The national officials generally agreed with our recommendations and agreed to determine the most appropriate form of action based on the available resources.

Please provide a written response to this letter within 5 days, outlining your proposed actions. If you have any questions, please contact me at 720-6945, or have a member of your staff contact Ernest M. Hayashi, Director, Farm and Foreign Agricultural Division, at 720-2887.

United States Department of Agriculture

Farm and Foreign Agricultural Services

Farm Service Agency

Operations Review and Analysis Staff

1400 Independence Ave, SW
Stop 0540
Washington, DC
20250-0540

DATE: July 20, 2009

TO: Robert W. Young
Assistant Inspector General
for Audit

FROM: T. Mike McCann
Agency Liaison Officer
for the Farm Service Agency

SUBJECT: American Recovery and Reinvestment Act – Direct Farm Operating Loans – Phase 1 (1) - (03703-1-TE) – Your June 30 Memorandum

During the past 6 weeks, the Agency has addressed dozens of inquiries and questions related to the direct operating loans funded through the American Recovery and Reinvestment Act (ARRA). We would like to reiterate that Congress appropriated this money for an existing program, not a new program. As such, loans funded through the ARRA are subject to the established regulations, policies, and procedures governing loan origination and subsequent loan servicing. Likewise, these loans will be subject to review through the various elements of the Farm Loan Programs' Internal Controls program.

Additionally, the obligation of loans funded by ARRA was carried out in accordance with our ARRA Implementation Plan. This plan, which detailed specifically how ARRA appropriations would be used, was approved by the Department and the Office of Management and Budget.

We believe that by processing, funding, and servicing these loans in accordance with existing regulations and procedures, we have met the requirements and intent of ARRA.

Provided below are responses to your recommendations on what the Farm Service Agency (FSA) should consider for direct farm operating loans funded by ARRA.

Recommendation 1:

Revise Farm Loan Program Risk Assessment (FLPRA) procedures to include reviews performed earlier in the loan cycle to timely ensure that borrowers are eligible and funds are properly used.

Response to Recommendation 1:

The FLPRA review process is not designed to evaluate the accuracy of borrower eligibility determinations made during the loan approval process or to monitor borrower funds usage. Therefore, it is not necessary to revise the FLPRA process. FLPRA, which is one component of the Farm Loan Program internal controls program, is a management tool developed to evaluate the potential for risk in three areas – program objectives, financial integrity, and program management.

Direct operating loans funded by ARRA are subject to the same evaluation, approval, and review processes as all other direct operating loans. Authorized Agency officials determine applicant eligibility in accordance with the requirements established in FSA Handbook 3-FLP, Direct Loan Making. If a favorable eligibility determination is made, an authorized Agency official makes a credit decision based on a review of the farm business plan for the farm operation, the adequacy of the security, and the credit worthiness of the applicant. The Agency official also verifies the proposed loan is compliant with applicable Agency regulations and handbooks with regard to loan purpose, loan funds, dollar limitations, and environmental restrictions.

Once issued, loans are subject to review through internal control processes such as the District Direct Oversight Reviews and County Operations Review Program. In addition, State Offices are required to perform Credit Quality Reviews each year. Credit Quality Reviews are used to monitor and evaluate the State's credit quality standards, including loan eligibility and use of funds, and to determine whether an employee's loan approval and/or servicing authority will be granted, revised, limited, or revoked.

Recommendation 2:

Revise sampling procedures in these compliance reviews to ensure that adequate samples of Recovery Act funded loans are selected for review.

Response to Recommendation 2:

To ensure that an adequate sample of loans funded through the Recovery Act are reviewed, FSA will amend FSA Handbook 1-FLP, General Program Administration, to require that loans reviewed as part of the Credit Quality Reviews (1-FLP, Par. 28 A) will include at least 1 loan made with Recovery Act funds.

If you have any questions regarding these responses, please contact Mike Hinton, Branch Chief, Direct Loans and Funds Management Branch, at 202-720-1472, or via email at: Mike.Hinton@wdc.usda.gov.