



U.S. Department of Agriculture

Office of Inspector General



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

**Audit Report 03703-1-Te
February 2010**



DATE: February 25, 2010

REPLY TO
ATTN OF: 03703-1-Te

TO: Jonathan W. Coppess
Administrator
Farm Service Agency

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

FROM: Rod DeSmet /s/
Acting Assistant Inspector General
for Audit

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

Summary

This report presents the results of our first phase of audit work related to the eligibility of borrowers who obtained direct farm operating loan funds authorized by the American Recovery and Reinvestment Act of 2009 (Recovery Act). The Recovery Act authorized up to \$173,367,000 for the Farm Service Agency (FSA) to fund direct farm operating loans. In enacting the Recovery Act, Congress emphasized the need for accountability and transparency in the expenditure of the funds. In response, the Office of Management and Budget (OMB) issued Governmentwide guidance for carrying out programs and activities authorized by the Recovery Act.¹ The guidance was intended to reinforce work underway at all levels of government and in communities across the nation to carry out the Recovery Act effectively and to establish steps that must be taken to facilitate the accountability and transparency objectives of the Recovery Act.

The Office of Inspector General's (OIG) role, as mandated by the Recovery Act, is to monitor Agency activities and ensure that funds are expended in a manner that minimized the risk of improper use. Our work during this phase evaluated the Agency's policies, procedures, and internal controls in distributing Recovery Act funds. We did not perform

¹ *OMB Guidance M-09-10*, "Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009," dated February 18, 2009, was supplemented, amended, and clarified by *OMB Guidance M-09-15*, "Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009," dated April 3, 2009.

tests to verify FSA's compliance with Agency policies and procedures, nor did we perform tests to verify producers' compliance with program provisions.

In our preliminary review of internal controls, we determined that FSA's compliance review process could be improved to more timely detect ineligible borrowers. Specifically, we found that current compliance procedures do not ensure that reviews of direct farm operating loans are performed in the early phases of the loan making process. In addition, given the relatively smaller number of Recovery Act-funded 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.

On June 30, 2009, we formally notified the Agency about this finding in a fast report and recommended actions to correct the identified weakness. On July 20, 2009, the Agency initially responded with its proposed corrective action to require that loans reviewed as part of the credit quality reviews include at least one loan made with Recovery Act funds. On January 13, 2010, the Agency formally responded to the draft final report, stating that it had implemented its previously proposed corrective action. The Agency's written response is included at the end of this report.

Background

The Department of Agriculture, through FSA, makes direct farm operating loans to family-size farmers and ranchers who cannot obtain commercial credit from other lenders. FSA loans can be used to purchase livestock, equipment, feed, seed, and supplies. The loans also can be used to construct buildings or make farm improvements.

FSA officials are responsible for providing guidance on program activity and for performing compliance reviews of loans. FSA also services these loans and provides its direct loan customers credit counseling and loan supervision so they have a better chance of success in their farming operations. To qualify for a direct loan, the applicant must be able to show sufficient repayment ability and pledge enough collateral to fully secure the loan. FSA has more than 2,346 State and county offices that are the primary distributors of FSA programs in the 48 continental States. FSA also is represented in Hawaii and Puerto Rico.

Each fiscal year, the Agency targets a portion of its direct farm operating loan funds to beginning and socially disadvantaged farmers.² A beginning farmer is an individual or entity who (1) has not operated a farm for more than 10 years, (2) meets the loan eligibility requirements of the program to which he/she is applying, and (3) substantially participates in the operation. If the applicant is an entity, all members must be related by blood or marriage, and all members in a corporation must be eligible beginning farmers. A socially disadvantaged farmer is defined by statute as one who is a member of a socially disadvantaged group. A socially disadvantaged group is a group whose members have been subjected to racial, ethnic, or gender prejudice because of their identity as members of a

² See the "Consolidated Farm and Rural Development Act (Title III of Public Law 87-128, dated August 8, 1961)," as amended by Public Law 111-10, dated March 20, 2009. Section 346(b)(2)(A)(ii)(III) states that an amount that is not less than 50 percent of the total amount made available for direct operating loans shall be reserved for qualified beginning farmers. Section 355(c)(1) states annual target participating rates will be established to ensure that socially disadvantaged farmers will receive loans based on the number of socially disadvantaged farmers in a State in proportion to the total number of farmers in that State.

group without regard to their individual qualities. For purposes of FSA's farm loan programs, socially disadvantaged groups are women, African Americans, American Indians, Alaskan Natives, Hispanics, Asian Americans, and Native Hawaiians or other Pacific Islanders.³

In response to the economic downturn, Congress passed the Recovery Act. The Recovery Act appropriated \$20,440,000 for direct farm operating loans, which resulted in a total loan level of \$173,367,000. On March 9, 2009, FSA was authorized to begin distributing Recovery Act funds through the Direct Farm Operating Loan Program. As of May 31, 2009, for fiscal year 2009, FSA had obligated 14,086 direct farm operating loans totaling about \$845 million. A total of 2,636 loans were obligated using Recovery Act funds. The loans totaled about \$173,131,112, or about 20 percent of the total funds obligated for the Direct Farm Operating Loan Program. Since the Recovery Act funds were appropriated for the existing Direct Farm Operating Loan Program, FSA planned to process, fund, and service any loan using Recovery Act funds in accordance with existing regulations and procedures.

Objective

Our audit objective was to determine if FSA has established effective controls to ensure Recovery Act-funded direct farm operating loans were distributed only to eligible applicants.

Scope and Methodology

The Recovery Act appropriated \$20,440,000 for direct farm operating loans, which resulted in a loan level of \$173,367,000. As of May 31, 2009, for fiscal year 2009, FSA had obligated 14,086 direct farm operating loans totaling about \$845 million, including the Recovery Act funds (2,636 loans totaling about \$173,131,112, or about 20 percent of the total obligations).

We conducted our audit of direct farm operating loans funded by the Recovery Act at FSA's national office in Washington, D.C., and at two State, one servicing, and three county offices in Oklahoma and Texas that were judgmentally selected. We performed our audit fieldwork between April and September 2009.

To accomplish our objective, we assessed the program's policies and procedures, as well as its internal controls, and discussed them with the Agency's national, State, servicing, and county office officials. We examined borrower loan files, recorded file review results in a standardized collection document, and interviewed field staff concerning the direct loan making process. We judgmentally selected 18 borrower loan files with a total of 30 direct farm operating loans that were funded by the Recovery Act. The files were selected because they were located in FSA county offices which issued a large dollar amount of direct operating loans funded by the Recovery Act or which were geographically located near the OIG regional office.

We reviewed loan data in the Agency's Direct Loan System in order to determine the universe and select the sample of loans to be reviewed and make no representation of the

³ *FSA Handbook 3-FLP (Revision 1)*, "Direct Loanmaking," exhibit 2, dated January 6, 2009.

adequacy of the system or the information generated from it beyond the accuracy of reporting required by the Recovery Act.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on the audit objective. The evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Finding 1: Direct Farm Operating Loan Compliance Procedures Could Be Improved to More Timely Detect Ineligible Borrowers

Our preliminary review of FSA's internal controls and processes identified concerns regarding compliance procedures and whether such controls and processes can adequately address the oversight and accountability requirements of the Recovery Act and OMB guidance. Specifically, FSA's compliance review process could be improved to more timely detect improper use of Recovery Act funds or ineligible borrowers. Also, given the relatively smaller number of Recovery Act-funded direct farm operating loans in the total population⁴ 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 Programs include the following reviews:

Farm Loan Program Risk Assessment (FLPRA) – FLPRA reviews are conducted throughout the year and reported 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 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 the prior year's activities. For the 13 State offices scheduled for review in fiscal year 2009, the offices were selected based on data that predated the passage of the Recovery Act.

Year-end Analysis – State offices are required to perform analyses on all borrowers. These reviews are performed at year-end or to coincide with the end of a borrower's production 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 timely assurance whether funds were distributed to eligible borrowers for eligible purposes.

County Operations Review (COR) Program – The COR Program measures and evaluates the effectiveness of internal controls over Agency assets in the prevention and detection of fraud, waste, and abuse. According to COR Program procedures, these county office reviews were implemented to conduct target reviews of high-risk programs and activities in county offices, conduct followup reviews to ensure that corrective actions are properly made and continued,

⁴ As of May 31, 2009, there were 2,636 Recovery Act-funded loans out of the 14,086 total loans that were obligated under the Direct Farm Operating Loan Program.

and report to management on the outcome of COR Program reviews. A target review is designed to review a specific program or program area. Examples of program areas are farm loans, disaster, and administrative. However, COR Program reviews often do not include findings related to FLP.

District Director (DD) Review – DD reviews are performed on a quarterly basis each year and may include a review of loan making and loan servicing activities. 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 the loan funds were properly used.

Credit Quality (CQ) Review – CQ reviews are performed each fiscal year to monitor the performance of loan officers. The State Executive Director issues a State supplement⁵ establishing the method and standards, including what constitutes an acceptable score, for monitoring and evaluating the State’s CQ standards. The supplement must identify the minimum and maximum number of loan files that will be reviewed, as well as the frequency of CQ reviews to obtain and maintain loan approval and servicing authority. For example, we found that the Texas State FSA Office issued a supplement⁶ that requires the farm loan managers to complete at least two direct loan making reviews each fiscal year for each farm loan officer under their supervision. One review should be completed early in the fiscal year to allow for the monitoring and correction of any deficiencies prior to the second review. Further, the supplement has similar review requirements for the DDs and State Executive Director to perform for the staff with loan approval authority under their supervision.

We discussed our concerns with the FLP national office staff on May 12 and May 26, 2009. At that time, we recommended that FSA should consider making changes to existing compliance reviews for direct farm operating loans funded by the Recovery Act. In our fast report, dated June 30, 2009, we formally notified FSA’s national office officials about this finding. The Recovery Act-funded operating loans were obligated by the end of March 2009. The end of the production cycle for these loans will be March 2010. Therefore, we recommend that FSA national office officials take prompt action to mitigate the risk of potential borrower ineligibility.

Recommendation 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.

Agency Response

FSA’s written response to the draft report, dated January 13, 2010, stated that, in accordance with the initial Recovery Act guidance issued by OMB on February 18, 2009, FSA evaluated its existing internal controls and related review processes. FSA’s management determined that the internal controls and review processes were sufficient to provide reasonable assurance that loans funded through the Recovery Act would be issued to eligible borrowers and that funds would be used for authorized purposes.

⁵ The State office will issue a supplement, when appropriate, to provide additional guidance and related information requirements.

⁶ *Texas Notice FLP-564*, “Credit Quality Reviews,” dated April 24, 2006.

FSA further stated that loans funded through the Recovery Act will be subject to the same stringent monitoring and oversight requirements as all FSA FLP. FSA also stated that it has a robust internal control program for its FLP, which consists of *OMB Circular A-123* reviews, FLPRA, the COR Program, and National Office Loan Origination File reviews. Performance metrics are monitored on a continuous basis, with formal reporting performed quarterly and annually.

As referenced in FSA's response to our fast report dated June 30, 2009, FSA believes that it has an effective internal controls system for the loan origination process. Each loan application is evaluated by an authorized FSA official to ensure program requirements are met with respect to eligibility, feasibility, security requirements, and environmental compliance. These requirements are detailed in paragraph 261 of *FSA Handbook 3-FLP*, "Direct Loan Making." Evaluation results must be documented in the Farm Business Plan Credit Presentation. At loan closing, the authorized FSA official completes a final review of the loan package to ensure that program requirements are met.

FSA reiterated its position with respect to revising FLPRA procedures previously addressed in its response to OIG's fast report dated June 30, 2009. FSA stated that the FLPRA review process is not designed to evaluate the accuracy of borrower eligibility decisions made during the loan approval process or to monitor borrower funds usage. Evaluation of these issues is addressed through other internal control review processes, including DD Reviews, the COR Program, and State CQ Reviews. Additionally, individual loan file reviews are not a component of the FLPRA process. As such, FSA does not agree with this recommendation.

OIG Position

We accept the management decision for Recommendation 1. Our decision is based on the fact that we did not perform testing of FLP loan applicant eligibility and use of funds and, therefore, cannot reference errors or mistakes. We plan to test the controls identified by FSA as we continue our assessment of program activities related to the Recovery Act. Furthermore, FSA stated that evaluation of these issues is addressed through other internal control review processes.

Recommendation 2

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

Agency Response

FSA's written response to the draft report, dated January 13, 2010, stated that FSA believes that management decision has been reached on this recommendation. At the audit exit conference, FLP managers agreed to amend *FSA Handbook 1-FLP*, "General Program Administration," to address this recommendation. A handbook amendment was issued on October 27, 2009. Paragraph 28A of the handbook now requires that State supplements for CQ Reviews must specify that, if an office being reviewed issued any loans using Recovery Act funds, a minimum of one loan made using Recovery Act funds must be included in the review.

OIG Position

We accept the management decision for Recommendation 2. We will examine this control further as we continue our assessment of program activities related to the Recovery Act.

We appreciate the courtesies and cooperation extended to us by members of your staff during this audit.

USDA'S

Farm Service Agency

RESPONSE TO AUDIT REPORT



**United States
Department of
Agriculture**

Farm and Foreign
Agricultural
Services

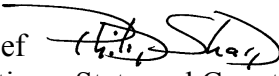
Farm Service
Agency

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DATE: January 13, 2010

TO: Director, Farm and Foreign Agricultural Programs
Office of Inspector General

FROM: Philip Sharp, Chief 
Audits, Investigations, State and County Review Branch

SUBJECT: Response to Official Draft Report, Audit 03703-0001-TE, American
Recovery and Reinvestment Act – Direct Farm Operating Loans (Phase 1)

Recommendation 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.

Agency Response

FSA does not agree with this recommendation.

In accordance with the initial Recovery Act guidance issued by the Office of Management and Budget (OMB) on February 18, 2009, FSA evaluated its existing internal controls and related review processes. Agency management determined that the internal controls and review processes were sufficient to provide reasonable assurance that loans funded through the Recovery Act would be issued to eligible borrowers and that funds would be used for authorized purposes. FSA clearly stated in the Monitoring and Evaluation section of its Recovery Act Program Plan the following:

Monitoring/Evaluation:

- Areas of High Risk: See statement below
- Areas of High Performance: See statement below
- Areas of Low Performance: See statement below
- Plans for Longer Term Impact Evaluation: See statement below

Director, Farm and Foreign Agricultural Programs

Page 2

Each of the above elements will be evaluated through existing evaluation/review processes as loans funded through the Recovery Act will be subject to the same stringent monitoring and oversight requirements as all FSA farm loan programs. FSA has a robust internal control program for its farm loan programs, which consists of:

- OMB Circular A-123 reviews
- Farm Loan Program Risk Assessment (FLPRA)
- County Operations Review (COR) program
- National Office Loan Origination File Reviews

Performance metrics are monitored on an ongoing basis, with formal reporting performed quarterly, and annually.

The Program Plan was developed in March 2009 and approved by OMB. Further, FSA distributed the Recovery Act funds by March 31, 2009, in accordance with the approved plan. Consequently, it is unreasonable for FSA's Farm Loan Programs (FLP) to be evaluated on anything other than the specific plan approved by OMB. FSA's FLP should not be held accountable for any OMB guidance issued after the distribution of the funds.

As referenced in FSA's response to the OIG correspondence dated June 30, 2009, the Agency has an effective internal controls system for the loan origination process. Each loan application is evaluated by an authorized Agency official to ensure program requirements are met with respect to eligibility, feasibility, security requirements, and environmental compliance. These requirements are detailed in Paragraph 261 of Handbook 3-FLP, "Direct Loan Making." Evaluation results must be documented in the Farm Business Plan Credit Presentation. At loan closing, the authorized Agency official completes a final review of the loan package to ensure that program requirements are met.

It is important to note that greater than 80 percent of the Recovery Act funds were used to obligate direct operating loans that were already approved but did not have funding. Therefore, eligibility and feasibility determinations, security requirements, and environmental compliance were already completed on these loans. Additionally, any such loans that were not closed within 90 days of loan approval were reconfirmed by authorized Agency officials to ensure that all program requirements were still met.

With respect to revising FLPRA procedures, FSA previously addressed this issue in its response to the questions contained in the OIG correspondence dated June 30. The FLPRA review process is not designed to evaluate the accuracy of borrower eligibility decisions made during the loan approval process or to monitor borrower funds usage. Evaluation of these issues is addressed through other internal control review processes, including District Director Oversight Reviews, the COR Program, and State Credit Quality Reviews. Additionally, individual loan file reviews are not a component of the FLPRA process.

Recommendation 2

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

Agency Response:

FSA believes that a management decision has been reached on this recommendation. At the audit exit conference, FLP managers agreed to amend Handbook 1-FLP, “General Program Administration”, to address this recommendation. A handbook amendment was issued on October 27, 2009. Paragraph 28A of 1-FLP now requires that State supplements for Credit Quality Reviews must specify that if an office being reviewed issued any loans using Recovery Act funds, a minimum of one loan made using Recovery Act funds must be included in the review. This management decision should be closed.

Additional Comments on the Official Draft

1. Page 3, paragraph 1: The “Background” narrative states that the Recovery Act appropriated \$173,267,000 for direct farm operating loans. The actual appropriation is \$20,440,000. The loan level is \$173,367,000.
2. Page 3, 2nd paragraph from the bottom of the page: We recommend removing this paragraph as it does not properly describe the FLPR process.
3. Pages 3 and 4, Section describing the Year-End Analysis process: Timeliness of distribution of loan funds is not a component of the year-end analysis process.
4. Page 6, Scope and Methodology, paragraph 1: The Recovery Act appropriated \$20,440,000 for the Direct Operating Loan program, which resulted in a loan level of \$173,367,000.