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UNITED STATES GENERAL ACCOUNTING OFFICE

REPORT TO THE CONGRESS

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Ways To Improve Effectiveness Of Rural Business Loan Programs

B-114873

Farmers Home Administration
Department of Agriculture

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

MAY 2, 1973

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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 is our report on ways to improve the effectiveness of rural business loan programs administered by the Farmers Home Administration, Department of Agriculture.

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of Agriculture; and the Director, Office of Economic Opportunity.

Elmer B. Staats

Comptroller General
of the United States

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ABBREVIATIONS

FCS Farmer Cooperative Service

FHA Farmers Home Administration

GAO General Accounting Office

OEO Office of Economic Opportunity

OIG Office of the Inspector General

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WHY THE REVIEW WAS MADE

GAO reviewed the Economic Opportunity Cooperative Loan Program to determine the effectiveness of Farmers Home Administration (FHA) procedures and criteria for evaluating and approving loan applications, for assisting cooperatives, and for evaluating cooperative activities.

Although loans are no longer being made under the cooperative loan program, the Rural Development Act of 1972, approved August 30, 1972, authorizes FHA to make, insure, or guarantee business loans in rural areas. GAO believes its findings should be helpful to FHA in administering the business loan programs.

FINDINGS AND CONCLUSIONS

The Economic Opportunity Cooperative Loan Program was one of several experimental programs authorized by the Economic Opportunity Act of 1964 to assist low-income persons in improving their economic condition.

From the program's inception in 1964 to its termination on June 30, 1971, FHA, under a delegation of authority from the Office of Economic Opportunity (OEO), made 1,455 loans totaling about $20.9 million to 1,315 cooperative associations whose members were predominantly low-income rural families. As of December 31, 1972, FHA was servicing loans to 585 cooperatives.

Many economic opportunity cooperatives encountered problems and therefore failed to stay in business or became delinquent on their loan repayments. Not all problems encountered by the cooperatives could have been foreseen. But FHA might have minimized the problems and enhanced the likelihood of the cooperatives' success had it seen to it that cooperatives were conceived and operated more soundly.

Cooperatives' problems

FHA State offices reported a variety of problems encountered by cooperatives which had been or were being liquidated or which had otherwise terminated their operations. These included: weak management, poor membership participation, adverse market conditions, lack of operating funds, and inadequate accounting and financial reporting systems.

GAO's review of 10 active cooperatives--7 of which were delinquent in loan repayments as of January 1, 1972--showed that these cooperatives had some of the same problems as the cooperatives whose operations had been or were being terminated.

Many problems experienced by the cooperatives could have been identified and corrected had FHA required adequate determinations of the economic soundness and feasibility of cooperative projects and had improvements been made in FHA's policies and procedures for supervising and

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evaluating cooperatives' activities. (See p. 11.)

Preapproval procedures

FHA procedures for approving loans did not require that feasibility studies be made before loans were approved or that, when practical, the cooperatives enter into marketing agreements with their members, processors, and distributors.

FHA did not provide guidelines to identify those factors which its employees were to consider in guiding applicants in the development of economically sound and feasible cooperatives. (See p. 14.)

In addition, FHA instructions did not require FHA employees to encourage cooperatives to obtain competent managers. For the 10 cooperatives GAO reviewed, FHA employees, in some instances, did not seek to obtain needed training for cooperative management employees although required by FHA instructions. (See p. 16.)

Examples of cases in which feasibility studies, marketing agreements, and good, well-trained cooperative management might have minimized problems are presented on pages 15 to 17 together with results of a study of 48 FHA-financed cooperatives by the Department's Farmer Cooperative Service (FCS).

Financial management

The 10 cooperatives, which GAO reviewed, and the FHA employees responsible for supervising them had not always complied with FHA instructions concerning accounting records, financial reports, and annual audits. (See p. 19.)

Although FHA instructions permitted cooperatives to use loan funds for operating capital, FCS reported that funds designated for such use seemed to be much less than actually needed by the average cooperative in the early stages of its development. FCS said operating capital was a critical factor in the success of new cooperatives. (See p. 20.)

Supervision

FHA's State, district, and county office employees often lacked time, training, or experience needed to give the 10 cooperatives that GAO reviewed effective supervision. As a result, many problems experienced by the cooperatives were not detected, were detected late, or were not corrected.

From 1960 to 1971 the number of loans and grants made under all FHA programs increased 624 percent and active loans requiring supervision increased 269 percent, although FHA staffing increased only 77 percent. At one State office, an FHA official told GAO that the increased workload had resulted in emphasizing loan-making rather than loan-servicing. (See p. 21.)

Program and project goals

FHA had not defined the cooperative loan program's objective in terms of specific program and project goals. Such goals could have helped FHA measure whether cooperative loans were effective in achieving the program's objective and whether the benefits received by cooperative members and the number of members receiving them fell short of, met, or exceeded expectations.

Measuring and evaluating cooperatives' progress in meeting specific project goals could have shown FHA and cooperative management where corrective action or technical and other assistance was needed. (See p. 26.)

Conclusions

If cooperatives and other business enterprises to be assisted under the Rural Development Act of 1972 are to have a reasonable chance to succeed, FHA should make sure they are conceived and operated on a sound business basis and establish guidelines and requirements to assist in achieving this objective.

RECOMMENDATIONS

In implementing the Rural Development Act of 1972, FHA should

--develop guidelines and instructions which will require that, before loans are approved, appropriate provision be made for project feasibility studies; marketing agreements, when practical; competent management of cooperatives and provision for necessary training; and sufficient funds for operating capital;

--take such action as is necessary to insure that it has a sufficient staff of experienced or trained employees to properly implement the guidelines and instructions and to properly supervise the activities of loan recipients; and

--express program objectives in terms of specific goals, when practical, and use these goals to measure program effectiveness periodically. (See p. 28.)

AGENCY ACTIONS AND UNRESOLVED ISSUES

The Department said:

--It agreed completely that regulations for implementing the Rural Development Act of 1972 should contain guidelines on feasibility studies, marketing agreements, competent borrower management, and funds for operating capital.

--FHA had taken some steps to provide effective training for its employees and had considered the need for additional staffing of new types of professional and technical skills.

--When practical FHA would express program objectives in specific goals and use such goals to periodically measure program effectiveness.

--OEO found a draft of this report generally acceptable. (See p. 28.)

MATTERS FOR CONSIDERATION BY THE CONGRESS

This report contains suggestions on ways FHA could improve the effectiveness of rural business loan programs authorized by the Rural Development Act of 1972 to avoid problems similar to those FHA encountered in administering business loans to cooperatives under the Economic Opportunity Cooperative Loan Program. This information should be of assistance to those committees and Members of Congress with legislative responsibilities related to the revitalization of rural areas and the effective implementation of Federal rural development programs.

CHAPTER 1

INTRODUCTION

The Economic Opportunity Act of 1964, as amended (42 U.S.C. 2841), authorized several special programs to combat poverty in rural areas. Under one of these programs--the Economic Opportunity Cooperative Loan Program--loans were authorized to help establish new cooperatives and finance existing cooperatives whose members were predominantly low-income rural families. The Office of Economic Opportunity (OEO) delegated responsibility for administering the loan program to the Secretary of Agriculture who redelegated the responsibility to the Farmers Home Administration (FHA), Department of Agriculture.

In addition to the loans received from FHA, some cooperatives received grants, through local community action programs, to help cover administrative and operating expenses. The grants were administered directly by OEO.

From inception of the loan program through June 30, 1971, FHA made 1,455 loans totaling about $20.9 million to 1,315 cooperatives. FHA stated that, in changing the order of priorities for available poverty funds, OEO and the Office of Management and Budget decided to discontinue the program on June 30, 1971. As of December 31, 1972, FHA was servicing 585 cooperatives which still had active loans.

Although loans are no longer being made under the Economic Opportunity Cooperative Loan Program, the Rural Development Act of 1972 (86 Stat. 657), approved August 30, 1972, authorizes FHA to make, insure, or guarantee loans to (1) public, private, or cooperative organizations for improving, developing, or financing business, industry, and employment in rural communities and (2) rural residents acquiring or establishing small business enterprises in rural areas.

We reviewed the Economic Opportunity Cooperative Loan Program to determine the effectiveness of FHA procedures and criteria for evaluating and approving cooperative loan applications, for assisting cooperatives, and for evaluating cooperative activities. Our findings should be helpful to FHA in administering the business loan and grant programs authorized by the Rural Development Act of 1972.

THE ECONOMIC OPPORTUNITY COOPERATIVE LOAN PROGRAM

The Economic Opportunity Act was enacted by the Congress to strengthen, supplement, and coordinate efforts to eliminate poverty in the United States. Title III authorized the establishment of special programs to meet some of the special problems of rural poverty and thereby to raise and maintain the income and living standards of low-income rural families. Under one of these programs, the Director, OEO, was authorized to make loans to cooperative associations which furnished essential processing, purchasing, or marketing services, supplies, or facilities predominantly to low-income rural families.

According to the act, loans were subject to the following terms and conditions:

- --There was to be a reasonable assurance of loan repayment.
- --Credit was to be otherwise unavailable on reasonable terms from private sources or other Federal, State, or local programs.
- --The amount of the loan, together with other available funds, was to be adequate to insure completing the project or achieving the purposes for which the loan was made.
- --The loan was to bear interest at a rate not less than (1) a rate determined by the Secretary of Treasury, taking into consideration the average market yield on outstanding Treasury obligations of comparable maturity, and (2) such additional charge, if any, toward covering other costs of the program as the Director might determine to be consistent with its purposes.
- --The loan was to be repayable within 30 years.
- --No financial or other assistance was to be provided to any cooperative organization for producing agricultural commodities or for manufacturing purposes.

For a cooperative to obtain a loan, program regulations required that at least two-thirds of the cooperative's owners (members) be low-income rural families and that the cooperative's services and facilities be furnished predominantly to low-income rural families. The loans were available for (1) services and related facilities necessary to process, purchase, or market goods, (2) improvements to building sites or construction of buildings essential to a cooperative's business, (3) operating capital, including charges for management and technical services, (4) organizing the cooperative, and (5) refinancing certain debts incurred by the cooperative before filing a loan application.

Members of the cooperative generally elected a board of directors to conduct affairs, set basic policies and objectives, employ a manager, and periodically review the cooperatives's operations to help insure that established policies and objectives were followed. The manager was responsible for carrying out the policies and objectives determined by the board of directors, hiring employees, and managing day-to-day business.

In cooperatives that were small or whose services were limited, all members could compose the board of directors and one member of the board of directors could be designated to manage the business.

PROGRAM ADMINISTRATION

The Director, OEO, delegated responsibility for carrying out the cooperative loan program to the Secretary of Agriculture in October 1964. In his delegation, the Director stated that the delegated powers were to be exercised pursuant to policies, standards, criteria, and procedures set forth in rules and regulations which were to be prescribed jointly by the Director and the Secretary.

The Secretary redelegated the responsibility for administering the program to FHA. FHA integrated the program into its existing loan operations.

FHA's headquarters office in Washington, D.C., is responsible for (1) directing FHA activities within the framework of overall policies established by the Department of Agriculture, (2) preparing and controlling budgets, and

(3) directing the operations of 41 FHA State offices, 269 FHA district offices, and about 1,700 FHA county offices.

The county offices, which are supervised through the district offices by the State offices, form the network for making and servicing various FHA loans, including cooperative loans. Each county office was primarily responsible for the following functions.

1. Publicizing the program in its geographical area.

2. Insuring that prospective loans were for purposes authorized by the program.

3. Preparing and evaluating borrowers' financial plans toward achieving loan objectives.

4. Approving and servicing loans, excluding those which required State office or headquarters approval.

5. Providing other assistance and guidance to borrowers.

ASSISTANCE AVAILABLE FROM FARMER COOPERATIVE SERVICE AND COOPERATIVE EXTENSION SERVICE

The Farmer Cooperative Service (FCS)--an agency within the Department of Agriculture--and the Cooperative Extension Service--a partnership of the Department's Extension Service, the States' land grant colleges, and county governments--were available to assist FHA in providing technical and management assistance to cooperatives.

The activities of FCS and/or the Cooperative Extension Service include

--making surveys and analyses of the operational practices and problems of cooperatives upon their request;

--conferring with and advising committees or groups of producers interested in forming cooperatives;

--promoting, or cooperating with educational and marketing agencies, cooperative agencies, and others to promote the knowledge of cooperative principles and practices;

--conducting training sessions for managers and boards of directors of cooperatives, and other persons interested in cooperative development;

--issuing and distributing publications aimed at cooperatives; and

--conducting studies concerning particular cooperative problems.

STATUS OF PROGRAM AT DECEMBER 31, 1972

Of the 1,315 cooperatives for which FHA had approved loans, from inception of the program through June 30, 1971, only 585 had active loans as of December 31, 1972. Loans to the remaining 730 cooperatives had been repaid in full or else the cooperatives had been or were being liquidated.[1] Of the 585 cooperatives with active loans, 258 were delinquent in their loan repayments.

COOPERATIVES COVERED BY OUR REVIEW

Our review consisted primarily of examining the activities of 10 cooperatives selected from 83 active cooperatives each of which had an FHA loan of $40,000 to $800,000 as of December 31, 1969. These 83 cooperatives represented 7 percent of the 1,168 active cooperatives as of December 31, 1969, and accounted for about 60 percent of the total amount of loans made to the active cooperatives.

The 10 cooperatives were located in Kentucky, Louisiana, Mississippi, Minnesota, Ohio, Tennessee, and Wisconsin. Five were involved primarily in purchasing agricultural or handicraft items produced by the members for resale in the commercial market or providing members a central marketing place for their products; four were involved primarily in

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[1] When a cooperative is liquidated, its assets are used to pay off the loans and any unpaid balances are written-off by FHA.

providing members with such services as land clearing, grain storage, brokerage, or crop harvesting; and one purchased whole milk from its members and processed the milk into cheese for sale.

CHAPTER 2

WAYS TO IMPROVE THE EFFECTIVENESS OF RURAL BUSINESS LOAN PROGRAMS

Many cooperatives encountered problems and therefore failed to stay in business or became delinquent on their loan repayments. Not all of the problems encountered by the cooperatives could have been foreseen and the Economic Opportunity Cooperative Loan Program was an experimental program which involved high-risk loans not generally available in normal business practice. Nevertheless, FHA might have minimized the problems and enhanced the likelihood of the cooperatives' success had it seen to it that cooperatives were conceived and operated more soundly.

We believe that the program would have been more effective if (1) FHA had adequate procedures concerning project feasibility studies, marketing agreements, cooperative management and training, and operating capital and (2) its employees had the necessary experience, training, or time to properly implement the program.

Although loans are no longer being made under the Economic Opportunity Cooperative Loan Program, the Rural Development Act of 1972 authorizes FHA to make, insure, or guarantee loans to public, private, or cooperative organizations for improving, developing, or financing business, industry, and employment in rural communities and to rural residents acquiring or establishing small business enterprises in rural areas. Unless FHA makes the improvements discussed in this report to avoid problems similar to those it encountered in administering the Economic Opportunity Cooperative Loan Program, the effectiveness of the Rural Development Act of 1972 may be impaired.

PROBLEMS ENCOUNTERED BY COOPERATIVES

Information obtained from FHA State and county offices on 169 cooperatives which had been liquidated or were in the process of liquidation as of December 31, 1970, showed one or more of the following reasons for the cooperatives' failures:

--Weak management.

--Lack of member participation.

--Adverse market conditions.

--Inadequate collection of accounts receivable.

--Facilities and/or equipment in various stages of disrepair and funds not available for maintenance.

Also, for the 166 cooperatives which had repaid their loans and ceased operations before December 31, 1970, FHA information showed that the cooperatives had cited one or more of the following reasons for terminating their operations:

--Poor health, advancing age, or death of members, or members reduced farming operations, retired from farming, or moved to other locations.

--Inadequate demand for services, insufficient use of services, dissatisfaction or lack of cooperation among members, and inability to replace members who resigned.

--Equipment and/or facilities were sold to members or nonmembers, destroyed or stolen, or became considerably worn or inoperable.

--Cooperative operations were economically infeasible or physically impossible to perform.

Our review of 10 cooperatives showed that they experienced some of the problems encountered by cooperatives which had been or were being liquidated or by those which terminated their operations after loan repayment. Problems at one or more of the 10 cooperatives included:

--Limited experience or training of managerial personnel.

--Unrealistic budgeting of income and expenses.

--Inadequate pricing policies.

--Inadequate accounting systems.

--Inadequate and/or untimely preparation and use of financial reports and audits.

--Insufficient volume of production or sales.

--Declining membership.

Many of the problems experienced by the cooperatives could have been identified and corrected had FHA required adequate determinations of the economic soundness and feasibility of cooperative projects and had improvements been made in FHA's policies and procedures for supervising and evaluating the cooperatives' activities.

Each of the 10 cooperatives incurred a loss in 1 or more years of operation after receiving an FHA loan. Only two of the cooperatives showed a cumulative profit after receiving an FHA loan. The following table shows the cumulative profit or loss at the time of our fieldwork for the number of years the 10 cooperatives had been operating since receiving an FHA loan; the total amount of loans received; and the status of the loans on January 1, 1972.

Cooperative	Years of operation	Cumulative profit or loss (-)	Total loan funds received (note a)	Status of loan 1-1-72
A	3	$ -65,700	$135,400	Delinquent
B	5	-46,700	107,500	Delinquent
C	6	-64,900	50,000	Current
D	5	-53,200	200,000	Delinquent
E	5	-11,900	60,000	Delinquent
F	6	700	63,800	Delinquent
G	4	-4,500	251,500	Current
H	6	2,100	61,700	Current
I	6	-16,300	50,000	Delinquent
J	2	-180,900	199,000	Delinquent

[a]At the time of our fieldwork, OEO had approved grants of $75,000 and $169,639 to Cooperatives C and J, respectively, for administrative and operating expenses.

REQUIRE FEASIBILITY STUDIES AND MARKETING AGREEMENTS

FHA procedures for approving loans under the Economic Opportunity Cooperative Loan Program did not require that a feasibility study be made before approving cooperative loans. Although the procedures required FHA employees to provide technical and management guidance to cooperatives in developing economically sound and feasible projects, these procedures did not identify what factors the employees were to consider in guiding cooperatives during their developmental stage.

In the case of marketing cooperatives, FHA did not require (1) existing or new members to enter marketing agreements whereby they would agree to deliver a specified portion of their production to the cooperative and (2) cooperatives to develop marketing agreements with processors and distributors. FHA employees were required to make a survey of the potential members' interest in using the cooperative and the extent to which potential members planned to do so; however, marketing agreements would have provided greater assurance of member participation and better control over production.

In April 1965, shortly after FHA began making economic opportunity cooperative loans, FCS issued a circular on how to start a cooperative. The circular stated that a survey--feasibility study--of all aspects of a proposed cooperative should be made to determine whether it was likely to be successful.

FCS stated that the main areas to be surveyed included: need for, or alternatives to, forming a cooperative; potential membership and volume of business; needed management skills, facilities, and capital; and operating cost. Other important factors which FCS stated should be considered included scope of the business, territory to be covered, membership qualifications, location of the business, method of payment for products sold by the cooperative, and pricing supplies and services bought by or sold to members.

FCS also stated that marketing agreements were (1) necessary to insure that the cooperative had sufficient control over the products to be delivered so that it could function properly and (2) especially helpful in the first few years of operation while the cooperative was establishing its reputation as a going, responsible, and successful business.

The following examples pertain to cases in which feasibility studies or marketing agreements might have detected, for correction before beginning cooperative operations, some of the problems encountered by the 10 cooperatives in our review. The letter designation for each cooperative corresponds to those shown in the table on page 13.

Cooperative A, a handicraft cooperative which sold items at retail and at wholesale, experienced problems in generating sales sufficient to cover costs. After less than a year of operation, the cooperative received a second FHA loan to establish a second retail store. No feasibility study had been made to support its establishment. The second store closed about a year later because income from sales was not sufficient to cover costs.

During the first year of operation, Cooperative A had no markup on its wholesale sales. An FCS study of Cooperative A's operation showed that its retail sales-pricing policy called for a 40-percent markup, although other craft shops reportedly worked on a 50-percent markup. In addition, many items the cooperative purchased were of inferior quality and unsalable.

Also some members of Cooperative A sold to competitors rather than to the cooperative when they could get better prices. No marketing agreements had been made with individual members regarding specifically what and how much each would sell to the cooperative. Marketing agreements, in our opinion, would have given the cooperative better control over the items to be produced and marketed.

Cooperative B, a service cooperative which provided land clearing and restoration services, had not included a depreciation factor in determining the rates it would charge for its services. Including a depreciation factor could have lowered the cooperative's cumulative loss as shown on page 13.

Cooperative C, a handicraft marketing cooperative, experienced problems in obtaining handicraft items of suitable quality. Because of this, the cooperative purchased low-quality items from its members which later proved to be unsalable. FHA had not evaluated the cooperative in terms of the market for the items which could be produced. No feasibility study had been made of production or the sales volume necessary to break even nor had any marketing surveys been made.

Cooperative D, an organization of pulpwood producers, had problems securing pulpwood buyers because buyers were reluctant to buy from an organized group. This problem was not recognized by FHA for almost 2 years after approval of the loan to the cooperative. Information we obtained indicated that the buyers' reluctance to buy from an organized group existed before formation of the cooperative.

In FCS's study of 48 cooperatives which had been financed with economic opportunity cooperative loans, it found that nearly all loans to the 48 cooperatives were made without the benefit of feasibility studies to determine the overall economic soundness of the cooperative ventures. FCS stated that many organizational, development, and operating problems that might have been identified and solved earlier had to be faced after the cooperatives began operations. FCS stated also that it believed feasibility studies would not have been practical for some small machinery cooperatives but that experience had shown that a feasibility study is basic and generally should be the first step in determining the desirability of making loans.

The FCS study showed also that most members of marketing cooperatives had no marketing agreements with their cooperatives and that many cooperatives had no marketing agreements with processors and distributors. FCS stated that either production and marketing agreements should be signed with processors, or a sound marketing program should be developed before a cooperative begins operations.

REQUIRE THE HIRING OF COMPETENT COOPERATIVE MANAGEMENT OR PROVIDE TRAINING

FHA instructions did not require its employees to encourage cooperatives to obtain competent managers. Also FHA employees did not, in some instances, seek to obtain needed training for cooperative management employees.

FHA instructions stated that cooperatives should be encouraged to develop and use their members' skills and abilities in managing enterprises. The instructions did not specify what qualifications a potential manager should have. In addition, if the necessary skills were not available locally, FHA employees were to help local leaders seek out people with potential ability and provide training.

In its circular on how to start a cooperative, FCS stated that, in most instances, a cooperative needs a full-time manager, competent to run an efficient business. FCS stated also that, without good management, a new cooperative would not be able to perform satisfactorily the services for which it was organized. FCS stated that the manager should (1) understand business principles and practices and the significance of a cooperative business enterprise; (2) be familiar with the kind of goods and services the cooperative provides; (3) be able to plan operations and set up controls to insure that plans are carried out; (4) use the resources--land, labor, and capital--most efficiently; and (5) demonstrate an ability to get things done.

According to the manager of Cooperative A, before associating with the cooperative, she and most members of the cooperative's board of directors had limited business education and business experience. FHA records showed that, in October 1969, FHA recognized the need to train the cooperative's management personnel and that, in May 1970, FCS proposed that the cooperative hire a marketing specialist and a handicraft design expert to identify and maximize sales opportunities. At the time of our fieldwork, these experts had not been hired nor had training been provided to the management personnel.

According to the manager of Cooperative B, neither he nor the board of directors had any training or experience in managing the personnel, equipment, or finances associated with the cooperative's land clearing and pasture renovation services. The cooperative sustained losses during 1966, 1967, and 1968, but FHA did not obtain any management training or technical assistance for the cooperative during that period even though FHA recognized the need for such assistance.

In 1969 FHA obtained technical assistance for this cooperative from the Cooperative Extension Service in the form of an equipment utilization and rate study. FHA had not secured management training assistance for the cooperative nor had it requested management assistance from FCS.

The FCS study of 48 cooperatives disclosed that few cooperative educational training programs had been developed for cooperative members. FCS concluded that a definite need existed for educational programs in production practices, cooperative management (including business practices), and member responsibility and support.

REQUIRE ADHERENCE TO FHA INSTRUCTIONS CONCERNING ACCOUNTING RECORDS, FINANCIAL REPORTS, AND ANNUAL AUDITS

The 10 cooperatives in our review and the FHA employees responsible for supervising them had not always complied with FHA instructions concerning accounting records, financial reports, and annual audits. Of the 10 cooperatives included in our review, 7 had accounting and financial reporting problems.

FHA instructions stated that its employees were to give special attention to seeing that cooperatives established and maintained accounts, records, and controls sufficient to provide an accurate, permanent, and current record of the cooperatives' operations. The records and accounts to be used and the person responsible for maintaining them were to be determined before loan closing.

In addition, FHA instructions stated that it was essential that a reporting system be established at the outset. The instructions stated that timely reports were needed to furnish information to the governing body so that it could make management decisions essential to efficient operations, provide information for members or users, and provide FHA with periodic information that would indicate trends and reflect the guidance and supervision needed. The instructions stated that timely analysis of reports helps to reveal potential problems and allows corrective action before these problems adversely affect cooperative operations.

Between 1965 and 1968, Cooperative C maintained a checkbook but no accounting journals or ledgers. No independent audits or bank reconciliations were made until December 1968, almost 3 years after the cooperative received its first FHA loan. According to the cooperative's auditor, it would be virtually impossible to determine whether cooperative funds had been lost or misused before late 1970 because of incomplete records.

The only accounting records Cooperative H maintained were a checkbook and rental receipt slips. No financial reports on the cooperative's 1968 operations were prepared although required by FHA. For the other years, reported financial data was often improperly classified. For fiscal years 1969 and 1970, the cooperative did not obtain an independent annual audit although required by FHA.

The reliability of financial operating information reported by Cooperative I was questionable. Basic records normally retained and needed to test the accuracy and validity of reported information could not be located or were incomplete.

FCS found that FHA generally gave directions on record-keeping and budget preparation to the 48 cooperatives covered in its study. FCS reported that, in 1970, 44 of the 48 cooperatives kept some records of their operations and that budgets had been prepared for 42 of the cooperatives. FCS stated that FHA was generally responsible for total or partial preparation of budgets of 32 of the cooperatives and that, in 10 cooperatives, the manager or members of the board of directors had prepared the budgets. FCS stated in its report, however, that management decisions, in some instances, were made without adequate records.

FCS stated that, for most cooperatives, this was the management's first venture into a business operation and that few realized the importance of basing decisions on reliable records. FCS recommended that, in future cooperative loan programs, funds be included in the loans to insure that adequate records are kept and realistic budgets are prepared.

PROVIDE FOR ADEQUATE OPERATING CAPITAL

Although FHA instructions permitted cooperatives to use loan funds for operating capital, FCS reported that the amount of loan funds designated for operating needs in the development stages of the cooperatives it studied seemed to be much lower than the amount needed by the average cooperative. FCS stated that cooperatives needed operating capital to hire qualified staff, to purchase supplies, and to pay cooperative members at the time of delivery for products to be marketed through the cooperative. FCS stated also that operating capital was a critical factor in the success of new cooperatives and adequate loan funds should be designated for that purpose.

PROVIDE FOR ADEQUATE FHA SUPERVISION

FHA's supervision of cooperative activities had not been effective. Many of the problems experienced by the cooperatives were not detected, were detected late, or were not corrected when detected because FHA employees often lacked the necessary training, experience, and time to properly supervise cooperative activities. In some instances, FHA employees were unaware that assistance could be obtained from FCS or else failed to request such assistance.

FHA instructions stated that FHA State office employees were responsible for coordinating, directing, and monitoring supervisory activities; developing training programs on the most effective supervisory methods; and allocating a sufficient amount of time to supervision and training. FHA district supervisors were responsible for providing guidance, leadership, and training to county supervisors; keeping informed regarding the supervision given to cooperatives; determining that county supervisors carried out their responsibilities; and consulting with or requesting assistance of State office employees on special training and servicing problems.

FHA's supervision of cooperatives, however, was primarily the responsibility of the county supervisor. FHA instructions stated, in part, that the county supervisor was to

--select and use the most effective supervisory methods;

--organize work to insure that a proper proportion of time was used for supervision;

--help cooperatives to recognize and analyze their problems; and

--provide guidance to see that cooperatives elect strong leaders, generate membership interest, disseminate information helpful to members, and hold successful annual meetings.

County supervisors were required to visit cooperatives at least once a year or when necessary to assist with development of the cooperative, evaluate operational policies, note management problems, determine participation in the cooperative, inspect and insure proper maintenance and protection of property, plan for needed improvements, and encourage effective cooperative meetings. County supervisors were also responsible for obtaining and analyzing cooperative accounting reports and annual audits and for preparing an annual evaluation of each cooperative.

FHA employees at the State, district, and county offices responsible for supervising the 10 cooperatives covered by our review often lacked the time, training, or experience needed to effectively supervise cooperative activities. All but one of the FHA employees we contacted who were directly responsible for supervising the 10 cooperatives had agricultural backgrounds. One had a background in engineering. These employees told us they had received little or no training from FHA on identifying, analyzing, or resolving cooperative problems and most of them said that they lacked sufficient time to adequately supervise large cooperatives.

Some FHA officials attributed the lack of sufficient time for adequate supervision to the fact that FHA's workload had greatly expanded without appropriate increases in staffing. The FHA Administrator reported during the 1971 appropriation hearings that, from 1960 to 1971, the number of loans and grants made by FHA under all its programs increased 624 percent, although staffing increased only 77 percent. Besides the increase in the number of loans and grants made, the number of active loans requiring supervision had increased 269 percent from 1960 to 1971. At one of the State offices included in our review, an FHA official told us that the increased workload had resulted in the practice of emphasizing loan-making rather than loan-servicing.

Although 4 of the 10 cooperatives included in our review had received some assistance from FCS, some FHA county, district, and State employees told us that they had never heard of FCS or that they were unaware of the kind of assistance that could be obtained. Some examples follow.

The district and county supervisors responsible for supervising Cooperative A had agricultural backgrounds and each told us that he had not had any experience or training in how to supervise cooperative loans. The county supervisor had 220 borrowers under various FHA programs to service in addition to initiating, developing, and servicing new loans. The district supervisor was supervising 2,562 FHA borrowers distributed among 10 county offices.

In February 1970, about 2 years after the cooperative had received its initial loan, FCS was requested to perform a management study for the cooperative. The county supervisor told us that he had never heard of FCS until it was requested to make the study.

The FHA county supervisor for Cooperative G told us that his supervision had not been as effective as it should have been because he could not spend enough time with the cooperative. At the time of our review, the county supervisor had 520 borrowers to supervise under various loan programs. He had three assistants; however, two had been on duty in that county office for less than 60 days.

According to the county supervisor, he had been aware of the availability of FCS assistance but such assistance had not been requested because the cooperative's problems were known to the board of directors and FHA. The county supervisor's annual evaluation did not indicate any problems until June 1970. Some of the problems indicated at that time were lack of operating capital, failure of some members to understand the cooperative movement, loss of packing crates, and inadequate management. The cooperative's manager told us that the cooperative had considerable crate losses during 1967-68, its first year of operation.

The FHA county supervisor for Cooperative I told us that he was unable to devote the required time to the cooperative and that another assistant supervisor was needed to help with the workload. The county supervisor was responsible for supervising 832 borrowers and had 2 assistant supervisors at the time of our review. As early as 1966, the county supervisor recognized that the cooperative had poor management and accounting records; however, the county supervisor told us that he had not asked for assistance from FCS because he was not aware that such assistance was available.

The district and county supervisors responsible for the supervision of Cooperative D told us that they had college degrees with agricultural backgrounds and that they had received no special training in supervising business cooperatives. The county supervisor said that he could not possibly devote a sufficient amount of time to supervising cooperative loans with the limited staff available. The district supervisor said that he could not effectively analyze reports.

Both the district and county supervisors told us that they did not know that FCS made staff available on request to assist cooperatives.

At the FHA State office responsible for supervising Cooperative G, the supervising official told us that the number of employees at the State and county levels was not sufficient to properly supervise cooperative activities. This official said that he had discussed the need for additional staff with the State director but that the State director allocated available positions where he believed they were most needed.

The FHA State officials responsible for supervising Cooperatives H and I had agricultural backgrounds. These officials told us that they had not received any training from FHA that would enable them to make effective financial and operating analyses of cooperatives.

According to one official at this office, the major problems in supervising cooperatives were that county and district supervisors were inexperienced in working with group loans and that FHA did not have a sufficient number of employees to provide the increased supervision required to supplement inadequate cooperative management. The officials at this office stated that, although some training had been provided district and county employees at annual program meetings, additional training was needed.

FCS found that, in most instances, the supervision of the 48 cooperatives covered in its study had been sufficient to protect the best interest of the cooperatives and the Government. FCS stated, however, that, if more properly trained personnel had been available to provide adequate supervision, particularly before loans were made, the delinquency record undoubtedly would have been more favorable.

In August 1971 the Department's Office of the Inspector General (OIG), following a review of FHA activities with emphasis on the rural housing program, reported that the primary thrust of FHA's emphasis and efforts in recent years had been on loan-making, to the detriment of supervision and loan-servicing. OIG recommended that FHA develop procedures at the field level to achieve a balanced program of loan-making and loan-servicing.

OIG reported also that FHA needed to strengthen its staff both in numbers and technical skills to keep pace with the expansion and complexity of its programs and to improve the effectiveness of program administration and implementation. OIG reported that, although agriculturally oriented programs accounted for only 25 percent of FHA loan program expenditures, more than 88 percent of the total FHA professional staff--more than 96 percent at the county level--had educational backgrounds in agricultural management. OIG recommended that FHA expand staffing, both in numbers and technical capabilities.

In addition, OIG recommended that FHA develop and implement an intensified training program for county office employees to insure that they understand and implement policies and procedures, and to assist them in accomplishing FHA program objectives.

ESTABLISH SPECIFIC PROGRAM AND PROJECT GOALS

The objective of the cooperative loan program authorized by the Economic Opportunity Act was to raise and maintain the income and standard of living of low-income rural families. An essential prerequisite to effective administration of such a program is the development of a basis for determining whether the program objective is being accomplished. In developing this basis, the program objective should be translated into specific goals upon which results can be measured.

Although both our review and the FCS study showed that many cooperative members had received increased incomes from their participation in the cooperatives, FHA had not established specific program and project goals for measuring whether cooperative loans were effective in achieving the program objective and whether the benefits received by cooperative members and the number of members receiving them fell short of, met, or exceeded expectations. In addition, none of the 10 cooperatives included in our review had established project goals.

The measurement and evaluation of the cooperatives' progress in meeting specific project goals could have pinpointed shortcomings and shown FHA and cooperative management where corrective action or technical and other assistance was needed.

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FHA officials with whom we discussed the results of our review acknowledged that FHA had experienced problems in administering the Economic Opportunity Cooperative Loan Program and that our review and the FCS study had pointed out a number of areas in which FHA procedures needed to be strengthened. One official said that some of the problems with the program could be attributed to a lack of coordination between OEO and FHA and to the fact that the program was not only an economic program but also a poverty program.

In this connection, the FCS study stated:

"From our discussions with staff people at all levels in Farmers Home Administration and the

Office of Economic Opportunity, it appears there was never a clear-cut policy as to specific responsibility of the two agencies. From the beginning, the Title III Cooperative Program was labeled a poverty program and did not appear to be fully accepted by field staffs as one of the regular agency programs, due primarily to policy indecision of two agencies administering it.

"Title III legislation provided for financial assistance to low-income people. The policies issued jointly by FHA and OEO interpreted the legislation so that two-thirds of the membership of the cooperative and 50 percent of the volume of the gross sales must be from low-income members. These restrictions caused the program to be directed to low-income people with little prior training to manage developing cooperatives. The program could have been more successful in organizing and developing viable cooperatives had the policies been directed by one agency and to the community as a whole rather than to mainly low-income members. However, much progress was made in providing direction and leadership in cooperative development by FHA in the 5-year period."

The FHA official said also that, because OEO had been responsible for making operating grants to cooperatives, he believed that FHA did not have all the tools to properly administer the program. He stated further that, under the Rural Development Act of 1972, FHA would be responsible for administering greatly expanded programs for providing business loans and other assistance to public, private, and cooperative organizations and rural residents, and that FHA would need a new kind of expertise to handle these programs.

CONCLUSIONS

We recognize that, in administering the Economic Opportunity Cooperative Loan Program, FHA needed to consider that it was operating a poverty program and that the difficulties in coordination between FHA and OEO may have been responsible for some of the program deficiencies discussed in this report. The purpose of this report, however, is not to assign responsibility for the deficiencies in the Economic Opportunity Cooperative Loan Program but to point out matters which FHA needs to consider in developing guidelines, procedures, and criteria for implementing the new business loan programs authorized by the Rural Development Act of 1972.

If cooperatives and other business enterprises to be assisted under the Rural Development Act of 1972 are to have a reasonable chance to succeed, FHA should ascertain that they are conceived and operated on a sound business basis and establish guidelines and requirements to assist in achieving this objective.

RECOMMENDATIONS TO THE SECRETARY OF AGRICULTURE

In implementing the Rural Development Act of 1972, we recommend that FHA

--develop guidelines and instructions which will require that, before loans are approved, appropriate provision be made for project feasibility studies; marketing agreements, when practical; competent management of cooperatives and provision for necessary training; and sufficient funds for operating capital;

--take such action as is necessary to insure that it has a sufficient staff of experienced or trained employees to properly implement the guidelines and instructions and to properly supervise the activities of loan recipients; and

--express program objectives in terms of specific goals, when practical, and use such goals to measure program effectiveness periodically.

AGENCY COMMENTS

In commenting on a draft of this report (see app. I), the Department stated that:

--It agreed completely that regulations developed by FHA for implementing the Rural Development Act of 1972 should contain adequate guidelines pertaining to adequate systems for feasibility studies, marketing agreements, competent borrower management, and funds for operating capital.

--It had recognized the necessity for strengthening the cooperative loan program and had been negotiating with OEO for additional requirements to strengthen management, production, and marketing at the time the program was terminated.

--OEO found the draft report to be generally acceptable.

--Regarding the experience and training of FHA employees, FHA had (1) taken steps to provide an effective training program for its employees, including the establishment of a full-time training center, (2) completed a series of meetings with all State directors and their staffs, including district supervisors, at which FHA's new requirements for accounting and financial management reporting systems and audit reports were treated in detail, and (3) established field positions of community program specialists as recommended by OIG.

--It had considered the need for additional staffing of new types of professional and technical skills necessary to implement the new areas of responsibility outlined by the Rural Development Act of 1972.

--When practical, FHA would express the program objectives of the Rural Development Act of 1972 in terms of specific goals and use such goals to periodically measure program effectiveness.

CHAPTER 3

SCOPE OF REVIEW

In addition to our detailed review of 10 cooperatives (see p. 9), we obtained data from FHA State offices on the problems encountered by cooperatives which had been or were being liquidated or which had otherwise ceased operations after loan repayment as of December 31, 1970. We reviewed a July 1972 FCS report on its review of 48 cooperatives which had received economic opportunity cooperative loans from FHA. We reviewed also an August 1971 OIG report on its review of certain FHA loan activities.

Our review was made at the FHA headquarters office, and at the FHA State, district, and county offices in the 7 States where the 10 cooperatives were located. We reviewed (1) FHA policies and procedures for administering the cooperative loan program, (2) pertinent FHA records, documents, and reports relating to FHA's assistance to, and review and evaluation of, the 10 cooperatives, and (3) pertinent records at each cooperative. We also interviewed FHA, OEO, and cooperative employees.

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

OFFICE OF THE ADMINISTRATOR

20 December 1972

Mr. Richard J. Woods, Assistant Director
Resources and Economic Development Division
U.S. General Accounting Office
Washington, D. C.

Dear Mr. Woods:

We are in complete agreement with the General Accounting Office that any regulations developed by the Farmers Home Administration for implementation of the business and industrial loan program under Title I of the Rural Development Act of 1972 should contain adequate guidelines pertaining to adequate systems for feasibility studies, marketing agreements, competent borrower management, and funds for borrower operating capital. We look upon our potential opportunities in connection with the Rural Development Act, however, in an entirely different manner than that which the Economic Opportunity cooperative loan program was conducted. Wherever practical, the Farmers Home Administration will express program objectives in terms of specific goals and use them to periodically measure program effectiveness, within the limitations imposed by authorities and monies provided under the Rural Development Act.

We have been advised by representatives from the Office of the Controller, Office of Economic Opportunity, that the subject report is generally acceptable.

The EO loan program was terminated, we understand, as a result of reordering of priorities by OEO and the Office of Management and Budget. It must be remembered that these loans were made under an agreement with OEO which required that at least two-thirds of the cooperative's members be in the low-income category and that OEO desired an opportunity for local residents to assume and attempt to learn management responsibilities. FHA had recognized the necessity for strengthening this program through the use of additional loan requirements at the time the program was terminated. FHA along with representatives of the Farmer Cooperative Service was negotiating with OEO for additional requirements designed to strengthen management, production, and marketing. Regardless of the fact that EO cooperative loans were made under recognized extremely high-risk conditions, it is interesting to note that a study published in July 1972 by FCS showed that from a random sample of 28 machinery cooperatives and 20 marketing cooperatives, net farm income of machinery cooperative members increased by 33 percent and marketing cooperative members by 5 percent.

The GAO report further recommends that FHA take such action as is necessary to assure that it has a sufficient number of employees with the training and experience necessary to properly implement its guidelines and instructions and to properly supervise and monitor the activities of loan recipients.

Mr. Richard J. Woods

An Office of the Inspector General's report dated August 1971 also recommended that FHA develop procedures and training at the field level in order to have a balanced program of loan making and servicing.

We are pleased to inform you that in the last year FHA has taken productive steps to implement an effective training program for its employees. FHA has established a full-time training center on the University of Oklahoma campus at Norman where training is now being conducted. We have just completed a series of 12 meetings with all state directors and their staffs including district supervisors, at which meetings FHA's new requirements for accounting and financial management reporting systems and audit reports were treated in detail. In addition, we have already instituted the community program specialist (field) as recommended by OIG.

We have also taken into consideration the need for additional staffing of new types of professional and technical skills necessary to implement the new areas of responsibility outlined by the Rural Development Act.

Sincerely,

for

JAMES V. SMITH
Administrator

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

	Tenure of office	
	From	To
SECRETARY OF AGRICULTURE:		
Earl L. Butz	Dec. 1971	Present
Clifford M. Hardin	Jan. 1969	Nov. 1971
Orville L. Freeman	Jan. 1961	Jan. 1969
ASSISTANT SECRETARY FOR RURAL DEVELOPMENT (note a):		
William W. Erwin	Feb. 1973	Present
Thomas K. Cowden	May 1969	Feb. 1973
John A. Baker	March 1961	Jan. 1969
ADMINISTRATOR, FARMERS HOME ADMINISTRATION:		
Vacant	Feb. 1973	Present
James V. Smith	Jan. 1969	Feb. 1973
Howard Bertsch	April 1961	Jan. 1969

[a]Until February 1973, the title of this position was Assistant Secretary of Agriculture for Rural Development and Conservation.

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