United States General Accounting Office

GAO

Report to the Chairman, Committee on Agriculture, House of Representatives

August 1999

RURAL DEVELOPMENT

Rural Business-Cooperative Service Business Loan Losses

GAO

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GAO/RCED-99-249

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-283280

August 25, 1999

The Honorable Larry Combest
Chairman, Committee on Agriculture
House of Representatives

Dear Mr. Chairman:

The Guaranteed Business and Industry Loan Program—one of the loan programs administered by the Rural Business-Cooperative Service in the U.S. Department of Agriculture (USDA)—guarantees the repayment of bank loans for almost any business project that creates or retains jobs in a rural area. The loans selected for a Service guarantee are to be "quality loans" providing lasting community benefits. In January 1999, we reported to you that this program had losses of over $24 million in the 1990s.[1] As of June 30, 1999, the program had over 1,980 borrowers and $2.6 billion in outstanding loan principal and 130 delinquent borrowers who owed $167 million. At your request, to gain an understanding of the reasons for the losses being incurred by the program, we examined the Service's experience with business and industry guaranteed loans made during fiscal year 1994 through fiscal year 1998 on which the Service paid losses. Thus far, the Service has paid losses of $13.4 million on loans of $35.6 million that it guaranteed during that period; these loans were obtained by 24 borrowers in 15 states.

Results in Brief

The level of losses associated with the Rural Business-Cooperative Service's Guaranteed Business and Industry Loan Program has been relatively low in recent years, compared with the size of the entire loan portfolio. Nevertheless, the Service did not follow its own requirements[2] in making guarantees on loans to 18 of the 24 borrowers, thereby contributing to the losses. Specifically, the loans to these 18 borrowers did not meet the Service's guarantee requirements because 11 loans were missing feasibility studies—thoughtful evaluations of prospective borrowers' business proposals[3]—that Service officials should have

[1] Rural Development: Rural Business-Cooperative Service's Lending and the Financial Condition of Its Loan Portfolio, (GAO/RCED-99-10, Jan.12, 1999).

[2] The Service's lending and servicing requirements for guaranteed business and industry loans are contained in federal regulations (7 C.F.R. 4279 and 4287), supplemented by instructions from the Service.

[3] Feasibility studies are to be performed by a recognized independent consultant and include assessments of the business market and of the technical, financial, and managerial feasibility of the business proposal (7 C.F.R. 4279.150).

obtained; 3 others had feasibility studies with significant flaws; and 4 were questionable, given the business risk and the potential for loss of collateral. For the remaining six borrowers, the information we obtained from the Service's loan files was insufficient to pinpoint problems. Service field officials said that they had not obtained feasibility studies and other documentation when information provided by lenders and borrowers about the businesses and business plans appeared to provide an adequate basis for their guarantee decisions. They also said that they have been operating in an environment that occasionally fosters lending to riskier businesses in order to achieve the program's goals of maintaining or increasing jobs in rural areas and that they occasionally feel pressure to use all of the loan guarantee authority allocated to their offices. Our findings are similar to the results of internal quality control reviews performed by the Service of its guarantee decisions in 13 states during fiscal years 1997 and 1998. Through these reviews, the Service found that its offices had made guarantee decisions without feasibility studies and other required documents, such as business plans.

We make a recommendation to USDA aimed at reducing future losses by clarifying when feasibility studies should be obtained.

Background

Under the Guaranteed Business and Industry Loan Program, a loan is made by a lender, such as a local bank, and the Service agrees to guarantee the loan's repayment in the event of a loss. According to the program's regulations, business and industry guaranteed loans are to be quality loans that provide lasting benefits. The Service is responsible, in part, for determining whether a borrower is eligible, whether a proposed loan is for an eligible purpose, and whether the borrower is able to repay the loan and has sufficient collateral and equity. Within USDA's organization, the Service is located in the Rural Development mission area. The agency's national office in Washington, D.C., provides policy direction and guidance on loan-making and loan-servicing and reviews and approves certain loans. Many of the loan-making and -servicing functions are performed by staff in the Rural Development mission area who are located in field offices throughout the country.

The maximum loan currently allowed by the Service is $25 million. The directors of USDA's Rural Development state offices have the authority to approve guarantees on loans of less than $5 million and must forward applications for guarantees of $5 million or more for concurrence by Service headquarters officials. The Service's guarantees generally range from 60 percent on loans of more than $10 million to 80 percent on loans of $5 million or less. In addition, the Administrator of the Service can approve a guarantee of up to 90 percent on loans of $10 million or less. The interest rate on a guaranteed loan is the rate agreed to by the lender and the borrower. According to Service officials, this rate is generally the lender's prime rate—the rate a lender charges its best customers—plus 1 to 1.5 percentage points.

The Service's lending has increased sharply in the past several years. During fiscal year 1994 through fiscal year 1998, over 1,380 borrowers obtained about 1,620 guaranteed loans with about $1.8 billion in outstanding principal as of September 30, 1998. The Service made almost 64 percent of these loans during the last 2 fiscal years (1997 and 1998).

More Consistent Application of Lending Requirements Could Have Limited Losses

During fiscal year 1994 through fiscal year 1998, the Service did not follow its own lending requirements in guaranteeing loans to 18 of the 24 borrowers who obtained loans on which it paid losses. Of the loans to 18 borrowers, 11 were missing feasibility studies, 3 had feasibility studies with significant flaws, and 4 were questionable, considering the risk of the businesses and their potential for losses. For the remaining six borrowers, the information we obtained from the Service's loan files was insufficient to clearly identify specific problems with a guarantee—or there may not have been problems. Thus far, the Service has paid losses of $13.4 million on the $35.6 million loaned to the 24 borrowers.[4] Appendix 1 lists these borrower's loans, identifies some of the documents contained in the Service's loan files for them, and indicates the number of months to delinquency and the amounts of the loan losses.

The Service's lending regulations and requirements are intended to ensure that borrowers' business projects are sound, that the borrowers are creditworthy, and that the government's risk of loss is minimized. Before December 23, 1996, the Service's lending regulations required a loan application to include, among other things, a feasibility study in all cases unless a waiver was provided by the Service's staff,[5] financial information on the past performance of the borrower's businesses, and a forecast of the business's financial performance. Twenty of the 24 borrowers in our

[4]Losses on a few of the loans were not final as of June 1999—the loss rate on the 24 loans is 38 percent, while loan losses have been about a 13 percent over the life of the program, from 1974 through 1998.

[5]The requirement for a feasibility study could be waived for existing businesses when there was thorough documentation showing that the financial interests of the lender and the government were protected.

review obtained guarantees on loans when these requirements were in effect. On December 23, 1996, the Service stopped requiring a feasibility study and gave its staff the flexibility to request a feasibility study for start-up businesses or when a business proposal would significantly affect the financial operations of the business. The Service Director responsible for loan making explained that while the Service has not issued further instructions, it expects its staff to request a feasibility study when an existing business has been less than very successful, there are indications of weakness, or a new or existing business's forecasts of future results appear overly optimistic. Furthermore, a borrower's loan application must contain, among other things, a detailed business plan[6] and a thorough analysis of the borrower's creditworthiness by the lender. The regulations state that the lender is to determine credit quality and to provide an analysis of the business that addresses the adequacy of the equity, cash flow, collateral, history, and management, as well as the current status of the industry. The lender is also responsible for ensuring that appraisal values adequately reflect the actual value of the collateral. Four of the 24 borrowers in our review obtained loans under these latter requirements. Once the Service obtains complete information from the borrower and the lender, it requires its staff to evaluate a proposed loan as a basis for making its guarantee decision.

Our review of loan file documents and discussions with field office and headquarters officials showed that the Service guaranteed loans to 11 businesses without the feasibility studies that it should have obtained. These businesses should have prepared feasibility studies for the following reasons:

- Four were start-up businesses that obtained guarantees on loans before December 23, 1996, when the Service's regulations required feasibility studies for new businesses. These borrowers obtained the Service's guarantees on loans of $800,000 to $2 million. The borrowers became delinquent on their loans within 3 to 23 months, and the Service paid losses totaling $2.1 million on these loans.
- Six were existing businesses that obtained loans from $1 million to $5 million that were significant for their financial operations. Five of these six businesses had recently experienced financial difficulties, including losses, and the remaining business was depending on increasing sales

[6]The regulations also state that if a feasibility study is sufficiently thorough, it may not require a separate business plan (7 C.F.R. 4279.161). The regulations call for a business plan that, at a minimum, includes a description of the business and project, management experience, products and services, proposed use of funds, availability of labor, and materials and supplies, and the names of any corporate parent, affiliates, and subsidiaries.

within its existing market to repay its loan. These businesses became delinquent on their loans between 1 and 51 months, and the Service paid losses of $3.2 million on these loans.

- One borrower obtained a loan of $262,000 to complete the purchase of an ongoing business that appeared successful. When the loan was made, the Service's regulations stated that Service officials could waive the feasibility study requirement if they provided a thoroughly documented justification showing that the financial interests of the lender and the government were protected. However, the borrower's loan file did not contain documentation of a decision to waive a feasibility study. This borrower became delinquent within 15 months, and the Service paid a loss of $178,000 on the loan.

The following four cases illustrate situations in which feasibility studies would have assisted the Service in deciding whether to guarantee a loan:

- An Ohio borrower. This borrower obtained a $1.7 million loan with an 80-percent guarantee in September 1994 to finance the purchase, expansion, and modernization of a trout hatchery and farm. According to the lender, this business was a start-up project. Relying on background information on the industry and an analysis of financial projections for the proposed business, the lender endorsed a loan to this borrower. However, the lender stated that its evaluation of the project was limited in scope and that it had been unable to find reliable industry financial standards for comparison with the company's projections. Despite these limitations, the Service stated in its project summary that a feasibility study was not necessary because the lender had evaluated the project. About 3 months after obtaining the loan, in December 1994, the borrower defaulted on a loan payment and thereafter was continuously late in making payments. The borrower filed for bankruptcy in June 1996, and the Service paid a loss of $270,000 on the loan.
- A Louisiana borrower. This borrower obtained a loan of about $1.5 million with an 80-percent guarantee in January 1995 to refinance existing debt and provide working capital to expand the borrower's business of manufacturing engines for marine vessels. The company had been weakened financially by the research and development expenses of developing a new engine—a type of pump engine described as a "totally new" propulsion system for the pleasure boat market, including jet skis, inboard boats, inboard/outboard boats, and outboard boats. Although the company was introducing a new product in a market segment that was also new for the company, the loan file shows that a feasibility study was not obtained. The company had sales and warranty problems and sold its

assets late in 1997. The Service subsequently paid a loss of about $70,000 on the loan.

- A Maine borrower. A Cadillac, Oldsmobile, Volvo, and Mitsubishi dealer obtained a $2.5 million guaranteed loan in April 1995 to consolidate two sales outlets at a more desirable and visible location. Field officials did not require a feasibility study of this business, even though success at the new location depended on expanding sales within the existing sales market by 20 percent. After the relocation, problems with access to the site and the placement of signs became evident. In an effort to help the borrower, the lender deferred the principal payments and reduced the interest rate for the last half of 1996. According to a consultant hired by the company 2 years after the loan was obtained, the sales potential in that area for the dealer's car lines was too limited to support a profitable business at the debt level the borrower had incurred. The borrower defaulted shortly after receiving the consultant's report, and the Service paid a loss of over $1 million after the business was sold.
- A Pennsylvania borrower. The company, which produced frozen stromboli, obtained three loans guaranteed by the Service totaling $950,000 in March 1997 to relocate and expand, but its plans proved to be unrealistic. The company had planned to relocate, restart production with newly manufactured equipment, and multiply sales 5 times in one year. The bank noted that the company had identified customers but did not yet have contracts that would sustain its sales goals. Moreover, this company had incurred operating and net losses for the previous 3 years, and sales had declined over the past 4 years—from about $1.6 million to $1 million per year. A Dun and Bradstreet report obtained by the lender rated the company as having the highest risk possible. Despite these problems, the Service did not require a feasibility study or obtain a business plan. After the relocation, the company immediately experienced start-up problems with its new equipment and obtained an additional loan of $270,000, also guaranteed by the Service, to provide more operating cash. However, the production problems proved too difficult to overcome; the company missed a loan payment 1 month later, in July 1997; and the company lost customers. These conditions eventually led to closure. While the value of the company's collateral was estimated to be over $1 million, the sale of its assets brought much less, and the Service paid a loss of $849,000.

Besides making guarantee decisions without feasibility studies, the Service based at least three guarantee decisions on feasibility studies with notable flaws. For example, one of the feasibility studies examined a troubled business seeking additional financing but did not conclude that a guaranteed loan would enable the business to succeed. The business obtained two loans guaranteed by the Service totaling almost $5 million but continued to decline. It defaulted 27 months later, and the Service paid a loss of $1.6 million on these loans.

Four other loans did not meet the Service's standards for quality. Specifically, the businesses had considerable potential for failure along with minimal collateral for recovery in the event of loss. For example, one company planned to introduce an innovative tool for servicing oil field equipment. It offered a patent and related production equipment as collateral but became delinquent on its loan within 3 months, after discovering that the depressed oil industry had no immediate interest in the product. The Service paid an estimated loss of $1.4 million on the company's $1.5 million loan. Another company planned to extract metals from wastes, proceeding directly from a laboratory experiment to commercial production. The feasibility study endorsed the process while also raising questions. The commercial plant and an acre of land were pledged as collateral. The plant did not work, and the company made only one payment on its loan. The Service paid an estimated loss of $900,000 on a $950,000 loan.

Service officials cited several reasons for approving guarantees on loans without feasibility studies and on loans that appeared to be somewhat risky. In some cases, field office loan specialists said that feasibility studies did not seem necessary because descriptions of projects and financial projections appeared sufficient. Furthermore, they said the risks being taken in some cases were not altogether different from those taken with some other loans that were performing well. These specialists also said that some of the lenders had excellent reputations. As a result, they said, the Service could rely on the lenders' evaluations of business proposals. Moreover, state office staff said they have not required feasibility studies when it appeared to them that (1) the business concepts were known and likely to be sound and (2) the government's financial interests were protected. In addition, field office staff in the four states we visited said they heavily weigh opportunities to save jobs or increase employment when they make decisions about guaranteeing loans. They also said that one of the goals for this program is to use the full amount of the Service's guarantee authority and that on occasion they feel pressure to accomplish this goal as well. In some cases, staff said, they operate in an environment that fosters lending to riskier businesses, and some borrowers might not have been able to obtain a loan without a Service guarantee. In addition, the intensity of local interest in assisting some businesses can affect the Service's decisions.

The Service itself has identified similar deficiencies through quality control reviews of its field offices performed by its headquarters staff over the past several years. These problems included guarantee decisions made without feasibility studies, business plans, and lenders' analyses of borrowers' creditworthiness. For example, during fiscal years 1997 and 1998, the Service's quality control reviews in 8 of 13 state offices found instances in which feasibility studies were inappropriately waived, business plans were inappropriately substituted for feasibility studies, and loan files did not show that the Service had reviewed lenders' analyses of prospective borrowers' businesses. The Service also found instances in which borrowers had insufficient equity invested in their businesses to meet the Service's minimum standards or borrowers' equity could not be determined because field office staff had not obtained the accounting statements needed to do so. The Service has implemented a variety of actions intended to correct the problems found in its field offices. These actions include having headquarters officials review loan documentation before a loan is approved. The Service has continued to find some similar problems through quality control reviews in fiscal year 1999.

Conclusion

Some of the Service's losses could have been avoided if the agency had obtained feasibility studies to provide a basis for making more informed lending decisions. However, the Service has not laid out clear guidance to help its field office staff determine when to obtain these studies. As a result, there is no assurance that feasibility studies will be obtained when they are needed for making prudent lending decisions. Prudent and well-supported lending decisions are especially important in light of the increased pace with which the Service is guaranteeing loans.

Recommendation

We recommend that the Secretary of Agriculture direct the Service to (1) clarify when it expects feasibility studies to be obtained and (2) emphasize to its field offices the importance of carefully evaluating these studies before making lending decisions.

Agency Comments

We provided the U.S. Department of Agriculture with a draft of this report for review and comment. The Department stated that it has observed some of the same issues raised in our report and that it would (1) issue an instruction to its staff clarifying the requirements for obtaining feasibility studies and (2) emphasize the importance of carefully evaluating these studies before making lending decisions. In addition, the Department said that it would use our findings to support future consideration of regulatory changes clarifying its requirements for obtaining and analyzing feasibility studies. The Department also provided a few technical comments, which we incorporated as appropriate. The Department's comments are presented in appendix II.

Scope and Methodology

To identify loans made during fiscal year 1994 through fiscal year 1998 on which losses occurred, we obtained and analyzed information from the computerized databases in USDA's Rural Development agency's St. Louis, Missouri, Finance Office, where financial and statistical data on business loans are maintained. We did not verify the accuracy of the information contained in these databases. We selected four states—Texas, Missouri, Maine, and Pennsylvania—for visits because they had the highest numbers of delinquent and problem loans during the period. During our state office visits, we reviewed Service loan files and interviewed knowledgeable staff. In addition, for loans that incurred losses during the same 5-year period for the 11 states with loan losses that we did not visit, we obtained and reviewed specific documentation from each loan file, such as the loan project summary, lender's credit analysis, feasibility study, business plan, reports of visits with the borrower, and reports of delinquencies and losses. We also obtained information about the quality control reviews the Service conducts of its field offices. We performed our work from February through July 1999 in accordance with generally accepted government auditing standards.

As agreed, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies of this report to the appropriate Senate and House committees; interested Members of Congress; the Honorable Dan Glickman, Secretary of Agriculture; the Honorable Dayton Watkins, Administrator of the Rural Business-Cooperative Service; the Honorable Jacob Lew, Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

Please call me at (202) 512-9889 if you or your staff have any questions about his report. Key contributors to this report were Charles Adams, Larry Van Sickle, and Jerry Hall.

Sincerely yours,

Robert E. Robertson
Associate Director, Food
and Agriculture Issues

Contents

Abbreviations

GAO	General Accounting Office
USDA	U.S. Department of Agriculture

Loans, Loan Losses, and Loan File Documentation for 24 Guaranteed Business and Industry Loans

State	Type of business	Purpose of loan	Loan amount	Date of loan	Months to delinquency
New start-up businesses without feasibility studies					
Ohio	Trout hatchery and farm	Finance the acquisition, modernization, and expansion of an existing facility. The lender identified this project as a new business.	$1,700,000	9/19/94	3
Missouri	Assemble, finish, and sell aircraft and component parts.	Purchase machinery, equipment inventory, tooling, and proprietary materials and start up at a new site.	$1,960,500	3/28/95	23
North Dakota	Establish a cooperative for carrot production, processing, and marketing.	Buy building, and purchase refrigeration and aeration equipment.	$800,000	9/26/96	4
Tennessee	Mobile home manufacturing	Obtain working capital and refinance construction debt on a new facility.	$1,140,000	2/15/96	20

Loss	Feasibility study	Business plan	Lender's credit analysis	Service evaluation	Comments
$270,927	No	[a]	Yes	Yes	The lender supported the project but stated that its evaluation of the project was limited. A feasibility study was not prepared. The business had operating problems, was cash-starved, and sold fish at a discount before they reached full size, leading to failure. Fish kills also occurred.
$1,078,619	Waived	Yes	Yes	Yes[b]	A feasibility study of this new aircraft business was needed. After obtaining the loan, the owners decided to change their plans and increase the capacity of the proven airplane they had planned to produce, which had been certified by the Federal Aviation Administration. The changes to this crop duster required recertification, which slowed the start-up of production. Also, there were management and inventory problems.
$441,072	No	Yes	Yes	Yes[b]	A new co-op proposed to start the first large-scale carrot production in North Dakota. A feasibility study was not obtained, and the business plan was not prepared by the company. The manager had only 1 year of experience in carrot research and no business management experience. The growers did not meet their production commitments, and the co-op members did not have a written cooperative agreement.
$334,845	Waived	Yes	[a]	Yes	A feasibility study of this new manufacturing business was needed. Management was not skilled in this business or in manufacturing. The company did not achieve the production levels needed to succeed. There were quality control problems, poor control of expenses and production materials, and accounting deficiencies.

(continued)

State	Type of business	Purpose of loan	Loan amount	Date of loan	Months to delinquency
Existing businesses without feasibility studies					
Maine	Family clothing and footwear	Restructure debt to pay off loans held by an out-of-state creditor.	$1,000,000	1/20/94	51
Louisiana	Rice mill operation	Acquire rice milling equipment, and debt refinancing	$5,000,000	11/16/94	30
Louisiana	Marine vessel engine manufacturing	Refinance existing debt and provide working capital to introduce new marine engine	$1,508,500	1/4/95	35
Oklahoma	High-precision job shop for automated machine parts	Refinance debt and obtain working capital	$1,250,000	4/19/95	24
Maine	Automobile dealership	Relocate and construct new facility to consolidate and expand business	$2,478,500	4/19/95	25

Loss	Feasibility study	Business plan	Lender's credit analysis	Service evaluation	Comments
$95,741	Waived	[a]	Yes	Yes	The company had sustained losses for several years before obtaining the loan because of increasing competition from other retailers. A feasibility study was waived because collateral appeared sufficient, but past performance indicated a troubled company, so a feasibility study should have been done. The company started closing stores 3 months after obtaining the loan because of losses. The owners struggled with declining sales until liquidation was the only option.
$928,934	No	[a]	Yes	Yes[b]	As sales declined during a renovation in 1994, the company incurred net losses. A feasibility study would have been prudent. After obtaining the loan, the business was affected by competition from Mexico and the death of the owner. Service officials indicated there were concerns about financial irregularities.
$69,818	No	Yes	Yes	Yes	A service loan specialist advised against guaranteeing this loan, saying the company would be too highly leveraged and vulnerable to losses. A feasibility study should have been done. However, the loan guarantee was approved without comment. Warranty expenses on the company's new engine were higher than expected, sales lagged, and liquidity problems developed.
$171,650	No	Yes	Yes	Yes[b]	The company had a $332,000 loss the year before the loan guarantee was approved. The company had poor liquidity ratios and high indebtedness with the loan—a feasibility study should have been done. Management problems were evident—the owner was inattentive to the business—and losses continued as products were priced below cost.
$1,037,518	Waived	[a]	Yes	Yes[b]	The business needed to increase its sales to succeed in its new location—it could have benefited from a feasibility study. After sales problems developed, a business consultant hired by the company stated that the borrower's investment in the new facility was too large for the sales market. The company then filed for bankruptcy and sold the business to another auto dealership at a significiant loss.

(continued)

State	Type of business	Purpose of loan	Loan amount	Date of loan	Months to delinquency
North Carolina Carolina	Physical therapy	Finance the purchase of a business	$262,000	3/29/96	15
Pennsylvania	Producing and marketing frozen stromboli	Obtain 4 loans to relocate and purchase equipment to expand production	$450,000 300,000 200,000 270,000 $1,220,000	3/25/97 3/25/97 3/25/97 6/25/97	4 1
Businesses with flawed feasibility studies					
South Carolina	Spawning and growing clams	Obtain working capital to construct a building, purchase equipment, and improve a leasehold.	$2,500,000	1/28/94	45
South Dakota	Grain elevator and seed business	Obtain two loans—one for working capital and one for debt refinancing	$3,200,000 1,750,000 $4,950,000	11/18/94	27

Loss	Feasibility study	Business plan	Lender's credit analysis	Service evaluation	Comments
$177,578	No	[a]	[a]	Yes	This was an on-going business, but its market risk was not clear. The loan file did not document the basis for not obtaining a feasibility study. After the loan was made, doctors began directing patients to the local hospital for therapy, and the business failed.
$305,850 211,040 142,156 189,866 $848,912	No	No	Yes	Yes	The bank's credit analysis noted that the guarantee would greatly mitigate the fact that the company had losses in 3 of the 4 previous years, with sales declining from $1.6 million to $1 million—a feasibility study should have been done. After expansion, the company experienced production difficulties because of problems with new equipment. It was unable to overcome these problems and sales declined.
$1,474,687	Yes	[a]	Yes	Yes	The Service guaranteed a loan to get this business started in 1991. The feasibility study for the 1991 loan was prepared by a researcher who became the company's scientist—and it called for a very large expansion of a noncommercial project developed by this individual. Although the original study was not done by an independent consultant, as required, and the company had sustained losses, the feasibility of the project was not reexamined before this additional loan was made. Production problems continued, and creditors eventually forced the company into bankruptcy.
$936,368 661,436 $1,597,804	Yes	Yes	Yes	Yes	This was a long-established business. A feasibility study identified significant concerns with its organization, management, and sales. However, the study did not conclude whether the company could succeed with a loan. After obtaining the loan, sales and profit margins were lower than forecast because of a depressed market. The company was not in compliance with its loan terms 7 months after receiving the loan.

(continued)

State	Type of business	Purpose of loan	Loan amount	Date of loan	Months to delinquency
Pennsylvania	Aluminum windows, doors and vinyl replacement windows	Obtain two loans to refinance the debt of a company in bankruptcy reorganization	$1,000,000 1,000,000 $2,000,000	7/31/96	3
Businesses with considerable risk of loss					
Texas	Maintenance tool and technology	Purchase land, building, machinery, and equipment and obtain working capital	$1,499,000	1/19/95	3
Iowa	Bowling alley	Purchase an on-going business	$420,000	5/12/95	11
Missouri	Waste recycling	Purchase equipment and property and construct building	$950,000	3/6/97	13
Missouri	Restaurant	Open and furnish a start-up restaurant	$190,000	8/27/97	2
Other businesses					
Mississippi	Manufacture fire trucks, fire-fighting equipment business	Construct a building and purchase land, machinery, and equipment	$400,000	4/28/94	46
Missouri	Restaurant and bar	Assume a loan for an existing restaurant and bar	$140,000	8/18/95	5

Loss	Feasibility study	Business plan	Lender's credit analysis	Service evaluation	Comments
$704,945 811,434 $1,516,379	Yes	[a]	Yes	Yes	The company was in Chapter 11 bankruptcy proceedings and hoping to restart when it obtained loans. The company had a history of declining sales and proposed to reestablish sales with prior customers and develop a new product line. The feasibility study was not clear about the potential for quickly reviving sales levels. After the loan was made, the company found that prior customers had made other plans, and the business failed.
$1,400,000 (est.)	Yes	[a]	Yes	Yes[b]	The idea was innovative but could not be marketed in a depressed oil industry. Only one loan payment was made, and that was 7 months late.
$191,073	Waived	[a]	Yes	Yes[b]	A special disaster loan was made to a bowling alley mechanic with some day-to-day experience in operations but no financial management experience. Waiving the feasibility study was questionable because the business was highly leveraged with loans. Financial management of the business was weak.
$900,000 (est.)	Yes	Yes	Yes	Yes[b]	This project was designed to commercialize a laboratory experiment. The feasibility study did not clearly identify the problems with this idea. The plant equipment could not extract metals from waste streams as envisioned and could not be put into operation.
$150,000 (est.)	No	Yes	Yes	Yes	The restaurant was located at a distance from the lunchtime crowds on which it depended. A feasibility study might have identified this location problem. The restaurant also developed a poor reputation for quality, and there were management and partnership troubles.
$61,505	Waived	[a]	[a]	No	The loan application indicates a successful company, but key financial documents were not on file, including an evaluation of the loan application. The company sustained losses after obtaining the loan.
$114,713	No	[a]	[a]	Yes[b]	The purchaser owned another restaurant. The business failed through lack of customers, poor management, and personal problems.

(continued)

State	Type of business	Purpose of loan	Loan amount	Date of loan	Months to delinquency
Wisconsin	Long-distance hauling and transportation broker	Refinance debt and purchase additional trucks	$2,450,000	12/21/95	12
Maine	Craft and hobby	Construct a new facility on leased land and purchase equipment, and fixtures	$950,000	12/29/95	6
Texas	Franchise restaurant	Construct a building and purchase machinery and equipment	$800,000	12/31/96	8
Missouri	Specialty bakery	Purchase a building and equipment (two loans)	$37,300 22,800 $60,100	7/22/97	3
Total			**$35,638,600**		

Loss	Feasibility study	Business plan	Lender's credit analysis	Service evaluation	Comments
$80,886	Waived	Yes	Yes	Yes[b]	Freight rates and volume experienced downward pressure. Rising fuel costs led to losses.
$127,738	Waived	[a]	Yes	Yes	This company's business appeared to be sound, but a competitor decided to hold a liquidation sale at the same mall, continuing for months. The business was unable to continue making lease and loan payments while sustaining heavy losses.
$400,000	Yes	Yes	Yes	Yes	This franchise sit-down restaurant opportunity along a well-traveled highway appeared to be viable. However, it was located next to a truck stop and had very limited sales.
$22,740	No	No	Yes	Yes[b]	This was a very small business. The borrower walked away from the business after 3 months without explanation and mailed the keys to the lender.
$13,493,139					

[a]Not required when the loan was made.

[b]Service evaluation was incorporated in the project summary document with limited narrative.

Source: Service's automated financial records, loan files, and Service officials.

Comments From the U.S. Department of Agriculture

USDA

United States Department of Agriculture
Rural Development

Rural Business–Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

AUG -9 1999

SUBJECT: General Accounting Office Draft Report:
"Rural Development: Rural Business-Cooperative Service
Business Loan Losses" (GAO/RECD-99-249)

TO: Robert E. Robertson
Associate Director
Food and Agriculture Issues
General Accounting Office

THROUGH: Sherie Hinton Henry
Director
Financial Management Division
Rural Development

Roy Jones 8/11/99

We have reviewed a copy of the subject report, copy attached, and offer the following comments:

Now on p. 2.

- Page 3, **BACKGROUND**, second paragraph, line 3: Reference to ". . . officials approve guarantees . . ." should be revised to read ". . . officials concur in guarantees . . ."

Now on p. 9.

- Page 11, **SCOPE AND METHODOLOGY:** First paragraph, lines 2 and 3: Reference to "Farm Service Agency" and "farm loans" should be replaced by "Rural Development Agencies'" and "business loans", respectively.

As indicated in your draft report, the National Office, based upon our Business Programs Assessment Review reports and post reviews conducted over the past 2 years, has observed some of the same concerns raised in your report. As a result, further training was provided to Business Programs staff who attended our recently held Business Programs Training Meeting in Kansas City, Missouri, the week of August 2-6, 1999. The differences between an acceptable Business Plans and Feasibility Study were stressed, and a sample of an acceptable Feasibility Study and Business Plan, to be utilized in future loan reviews, were

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"Rural Development: Rural Business-Cooperative Service
Business Loan Losses" (GAO/RECD-99-249)

provided. During the discussions, we explained the difference between a Business Plan and a Feasibility Study and discussed different cases when a feasibility study should be required.

In response to your recommendation, we intend to issue an Administrative Notice or Unnumbered Letter to our field staff, within 45 days, which will further clarify requirements for obtaining feasibility studies and emphasize to the field the importance of carefully evaluating these studies before making a lending decision.

We would like to thank the General Accounting Office for their review of the losses that have occurred on the Business and Industry Guaranteed Loan Program for loans originating since 1994. We will use your findings to support future consideration for amending regulations to clarify requirements for feasibility studies and the analysis to be conducted and documented by field staff of the feasibility studies received prior to making funding decisions.

Dayton J. Watkins

DAYTON J. WATKINS
Administrator
Rural Business-Cooperative Service

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