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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Secretary Of Commerce

Management Of Trade Adjustment Program Shows Progress

Relatively few import-impacted firms that received financial assistance under the Trade Act of 1974 have made the adjustment needed to successfully compete with other firms. Although the program was designed to assist weakened firms, weaknesses in adjustment plans, loan application review and approval activities, and loan servicing activities have hindered the program's rate of success.

The Department of Commerce has taken several actions to improve the program's management. While commendable, the actions do not completely address all weaknesses observed in making and servicing trade loans. GAO is making three recommendations to address these weaknesses.

UNITED STATES GENERAL ACCOUNTING OFFICE

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

B-206677

The Honorable Malcolm Baldrige
The Secretary of Commerce

Dear Mr. Secretary:

This report addresses the limited success of financial assistance provided to import-impacted firms under the Trade Act of 1974, as amended. GAO initiated its review to help the Congress decide whether to reauthorize the firm assistance section of the Trade Act before its September 1982 expiration date. After the review started, the Congress extended this date to September 1983 and Commerce made substantive changes in program management. The report recognizes management improvements that have been made both by the International Trade Administration and the Economic Development Administration and identifies actions that still need to be taken if the program is funded beyond fiscal year 1982.

This report contains recommendations to you on pages 19 and 20. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

Copies of this report are being sent to the above committees; the House Committee on Ways and Means; the Senate Committee on Finance; other interested congressional committees and subcommittees; and the Director, Office of Management and Budget.

Sincerely yours,

Henry Eschwege

Henry Eschwege
Director

GENERAL ACCOUNTING OFFICE
REPORT TO THE
SECRETARY OF COMMERCE

MANAGEMENT OF TRADE
ADJUSTMENT PROGRAM
SHOWS PROGRESS

D I G E S T

The Trade Act of 1974 provides financial and technical assistance to help firms adjust to increased foreign competition. The Department of Commerce transferred program responsibility from the Economic Development Administration to the International Trade Administration in September 1981. The Economic Development Administration retains responsibility for servicing loans approved prior to the transfer.

Relatively few import-impacted firms that received financial assistance under the Trade Act have made the adjustments needed to successfully compete with other firms. While the program is designed to assist weakened firms, its rate of success has been hindered by weaknesses in

--adjustment plans submitted by firms,

--review and approval of loan applications, and

--loan servicing activities.

The International Trade Administration and the Economic Development Administration recently issued program management and debt collection procedures which should correct many of the weaknesses GAO observed. The President has proposed to eliminate the program in fiscal year 1983. If this program continues, GAO is recommending that the International Trade Administration

--require visits to firms before loan approval to evaluate the condition of plant and equipment and assess management,

--require firms to provide more detailed information to support the claim that private financing is not available, and

--develop and issue loan servicing procedures.

The Deputy Assistant Secretary for Trade Adjustment Assistance agreed to take steps to implement each of these recommendations.

SCOPE AND METHODOLOGY

GAO initiated the review to help the Congress decide whether to reauthorize the firm assistance section of the Trade Act before its September 1982 expiration date. After the review started, the Congress extended this date to September 1983. Major procedural changes in program management have been initiated, and because time must elapse before the impact of those changes will be known, GAO evaluated the changes in light of observed program weaknesses to determine if additional changes were needed. (See pp. 3 and 4.)

PROGRAM HAS NOT HELPED MOST FIRMS TO COMPETE SUCCESSFULLY

From program inception in 1975 through March 1, 1982, 299 firms received 339 direct loans totaling $188.0 million and 103 guaranteed loans totaling $141.2 million. (See p. 2.)

Some firms using the program have increased sales and profits. Most, however, continue to struggle; some have not survived. For example, in GAO's sample universe of 169 firms, as of December 31, 1981, 76 firms (45 percent) which had received financial assistance before fiscal year 1980, had loans that were in liquidation or had been liquidated and 34 other firms (20 percent) were delinquent in loan payments. Only 59 firms (35 percent) were current in loan payments. Indications are that even some of these firms may not become competitive. (See p. 5.)

FINANCIALLY WEAK FIRMS RECEIVED LOANS

Of the 36 firms GAO sampled, 23 reported operating losses from about $500 to $1 million for the year preceeding loan application and 7 reported a negative net worth ranging from $23,300 to $6.8 million. The firm reporting a $6.8 million negative net worth received a $1 million direct fixed-asset loan and a $1.5 million guaranteed working-capital loan. This firm had experienced steadily declining sales for the 5 years preceeding loan application. While recommending the loans for approval, the regional office said that although the firm had insufficient collateral, the importance of saving 400 jobs and the firm justified the Government taking a greater risk than usual. The firm failed and the Government lost about $1.8 million. (See pp. 6 and 7.)

WEAKNESSES IN ADJUSTMENT PLANS

The Economic Development Administration required firms requesting financial assistance to provide a plan explaining briefly what they intended to do to adjust and what assistance they needed. GAO found that adjustment plans did not usually identify (1) the reasons why a firm was unable to compete and (2) the difficulties that it had to overcome. Moreover, GAO observed that most plans were directed primarily toward solving immediate problems rather than achieving long-term viability.

The International Trade Administration recognized these shortcomings in adjustment plans and addressed them in its October 1981 procedures. These procedures should correct the problems GAO observed. (See pp. 8 and 9.)

WEAKNESSES IN REVIEW AND APPROVAL OF LOAN APPLICATIONS

The Economic Development Administration largely based loan approval upon analyses of unverified information supplied by loan applicants. GAO's analysis of loan files showed that regional office financial analysts:

--Seldom visited a firm prior to loan approval to evaluate the physical condition of its plant and equipment and to assess its management capabilities because of limited resources.

--Made limited use of ratios, such as current and coverage ratios, to assess a firm's repayment ability and to pinpoint areas needing management attention. The Economic Development Administration's procedures did not require such analysis.

--Generally accepted and used the sales and profit projections supplied by a firm as a basis for determining whether a firm had a reasonable chance to repay the loan, although in many cases the projections were highly optimistic.

--Generally relied only on resumes supplied by firms to assess the abilities of key management personnel.

GAO's analyses also showed that 9 of the 36 firms sampled submitted unaudited financial statements with their loan applications because the Economic Development Administration allowed them to do so. Furthermore, GAO found that the Economic Development Administration's reliance upon letters from private lenders denying a firm a loan did not always satisfy the requirement of evidence needed to demonstrate that private financing was not available. While some letters showed the terms and conditions under which a loan was requested and reason(s) for loan denial, many stated only that a loan request was denied.

The International Trade Administration's October 1981 procedures should correct all but two of these weaknesses. GAO believes that a firm needs to be visited prior to loan approval and private lenders need to provide better information on loan denials. (See pp. 9 to 15.)

WEAKNESSES IN
LOAN SERVICING

The Economic Development Administration recognized the importance of loan servicing for detecting weaknesses early and providing corrective action to prevent a worsening financial position and jeopardizing loan repayment. Nevertheless, very little was done to service the loan portfolio because of insufficient resources. GAO found that the agency rarely made loan servicing field visits and irregularly obtained and analyzed financial statements. To address its delinquencies, the Economic Development Administration has initiated a debt management program and is currently revising its loan servicing procedures.

The International Trade Administration's general terms and conditions for trade loan agreements require a firm to submit financial statements periodically. Also, agency procedures generally require firms to contract for technical assistance in implementing adjustment plans. GAO believes that, in addition to these actions, the International Trade Administration needs to develop and issue loan servicing procedures. (See pp. 15 to 19.)

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ABBREVIATIONS

EDA	Economic Development Administration
GAO	General Accounting Office
ITA	International Trade Administration

CHAPTER 1

INTRODUCTION

The Trade Act of 1974 (19 U.S.C. 2101 et seq.) authorized the President to enter into trade agreements with foreign countries to promote freer international trade. Historically, freer trade has resulted in society-wide benefits--lower prices, greater product availability, and new jobs. The cost of such benefits, however, tends to be borne by the industries and/or firms that cannot compete favorably with imports. Recognizing that foreign competition can injure workers, firms, and communities, the Congress specified in the act various forms of monetary and nonmonetary adjustment assistance. This report deals with the Department of Commerce's program providing adjustment assistance to individual firms. Because the President was proposing to eliminate the Economic Development Administration (EDA), Commerce transferred program responsibility from EDA to the International Trade Administration (ITA) on September 20, 1981. EDA had administered the program from its inception in 1975 and retains responsibility for servicing loans approved prior to the transfer. The President is proposing to eliminate this program in fiscal year 1983 because of its high loan default rate.

ADJUSTMENT ASSISTANCE TO FIRMS

Under the Trade Act of 1974, a firm can be certified as eligible to apply for adjustment assistance (technical and/or financial) if the Secretary of Commerce determines that

(1) a significant number or proportion of the workers in such firms have become totally or partially separated, or are threatened with total or partial separation;

(2) sales or production, or both, of such firms have decreased; and

(3) increases of imports of articles like or directly competitive with articles produced by such firms contributed to such total or partial separation, or threat thereof, and to such decline in sales or production.

Once certified, a firm has 2 years to apply for assistance. If requesting financial assistance, a firm must provide an economic adjustment plan. (See p. 8.) Under Trade Act authority, technical assistance may be provided, either through existing agencies or through private individuals, firms, or institutions, to assist in the development and/or implementation of a firm's economic development proposal. When private sources provide such assistance, the Government may pay up to 75 percent of the cost. In addition, EDA used its authority under the Public Works and Economic Development Act of 1965, as amended (42 U.S.C. 3121 et seq.), to provide a firm up to $10,000 for a diagnostic survey--an assessment of the firm's problems and prospects for recovery. Only apparel firms were required to share in the cost of this work.

Starting in September 1978, EDA also used Public Works Act authority to fund the administrative costs of Trade Adjustment Assistance Centers. Currently, 11 such centers help import-impacted firms requesting such assistance to qualify for and receive trade adjustment assistance through services such as (1) providing guidance in preparing certification petitions, adjustment plans, and loan applications or (2) diagnosing firms' problems and recovery potentials.

Before approving a firm's application for financial assistance, the administering agency must determine that

--the firm does not have the required funds;

--the firm has no reasonable access to financing through the private capital market;

--the firm's adjustment proposal (1) will contribute materially to the firm's economic adjustment, (2) gives adequate consideration to its workers' interests, and (3) demonstrates that the firm will make all reasonable efforts to use its own resources for economic development; and

--the firm has a reasonable chance to repay the loan.

Financial assistance consists of direct and/or guaranteed loans. Such loans can be used to (1) acquire, construct, install, modernize, develop, convert, or expand land, plant, buildings, equipment, facilities, or machinery and/or (2) supply the working capital firms need to implement their adjustment plans. The aggregate amount of loans outstanding to a firm cannot exceed $1 million in direct loans and $3 million in guaranteed loans. The direct loan interest rate is based on the cost of Government borrowings plus an amount to cover administrative costs and probable program losses. The guaranteed loan interest rate can be no higher than the maximum allowed on guaranteed loans made pursuant to section 7(a) of the Small Business Act, as amended (15 U.S.C. 636(a)).

Other loan terms and conditions are (1) the loan maturity date cannot exceed 25 years, (2) priority must be given to small firms, and (3) the Government guarantee cannot exceed 90 percent of the loan amount.

LOANS MADE

From program inception in 1975 through March 1, 1982, 299 firms received 339 direct loans, totaling about $188 million, and 103 guaranteed loans, totaling $141.2 million. Program activity peaked in fiscal year 1979 when 82 firms received 116 direct and guaranteed loans totaling $94.2 million. The following table shows the number of firms receiving those loans by fiscal year.

Fiscal year	Direct loans Number	Direct loans Amount (millions)	Guaranteed loans Number	Guaranteed loans Amount (millions)	Firms receiving loans (note a)
1975	0	$ 0.0	0	$ 0.0	0
1976 (note b)	13	9.2	3	4.2	11
1977	24	12.3	3	5.5	17
1978	88	40.9	22	34.0	69
1979	91	55.5	25	38.7	82
1980	63	42.0	28	30.0	67
1981	59	27.9	18	21.9	49
1982 (note c)	1	.2	4	6.9	4
Total	339	$188.0	103	$141.2	299

a/Double counting is unavoidable because firms may receive assistance in more than 1 year.

b/Includes Transition Quarter (July 1, 1975 - Sept. 30, 1975).

c/As of March 1, 1982.

Source: International Trade Administration.

Although firms from at least 17 major industries have received trade adjustment assistance, the great majority were operating in four industries--non-rubber footwear, apparel, handbag, and textile.

As a rule, EDA assisted relatively small firms in terms of employees, assets, and sales. In our sample of 36 firms (see below), for example, over 80 percent had 200 or fewer employees, and over 70 percent had under $2 million in assets and under $4 million in sales during the fiscal year prior to application for financial assistance.

OBJECTIVES, SCOPE, AND METHODOLOGY

We initiated our review to help the Congress decide whether to reauthorize the firm assistance section of the Trade Act before its September 1982 expiration date. Our original review objectives were (1) to assess the effectiveness of adjustment assistance provided to import-impacted firms as measured by the number of firms that have been able to improve their competitive position and stay current on their financial commitments and (2) to determine what actions may be needed to improve program effectiveness. To accomplish these objectives, we grouped the 169 firms that received direct and/or guaranteed loans from inception of the program in 1975 through September 30, 1979, in the following loan status categories: (1) current in loan payments, (2) delinquent in loan payments, and (3) in liquidation or liquidated. The 169 firms received loans totaling $194.8 million. We established the

September 30, 1979, cutoff date to ensure that assisted firms had had the time and opportunity to implement their adjustment plans and begin to reap any resulting benefits. From each of these groups, we randomly selected one-third of the firms--a total of 58--for detailed review and comparative analysis.

However, we did not follow through on our original scope and objectives because the Congress extended the program's expiration date to September 1983 and, as noted on page 1, Commerce transferred program responsibility from EDA to ITA in September 1981. Also, ITA has taken steps to improve program management, and the impact of this action cannot be measured until many months in the future. ITA released new trade assistance procedures on October 15, 1981, which substantially changed program administration.

In view of the above, we changed our objectives to documenting past program results, evaluating changes in light of observed program weaknesses, and determining whether any additional improvements were needed.

We reviewed documentation supporting 54 loans totaling over $36 million awarded to 36 of our 169-firm universe. While the 36 firms were part of the 58-firm sample, they do not constitute a statistically valid sample and the review results are not projectable. As of December 31, 1981, 9 of these firms were current in loan payments; 9 were delinquent in loan payments; and 18 had loans that were in liquidation or had been liquidated. Even though the program provides for technical assistance, we chose not to evaluate the impact of the technical assistance portion separately from the financial assistance portion. We also reviewed nine loans EDA awarded to seven firms in fiscal year 1981 to observe whether certain weaknesses in the pre-fiscal year 1980 loans were continuing.

To gain further insight, we reviewed the program's legislation and related legislative history, regulations, and policies. We interviewed key officials at EDA and ITA headquarters, Washington, D.C.; EDA's Atlantic Regional Office, Philadelphia, Pennsylvania; and the Mid-Atlantic Area Trade Adjustment Assistance Center, Philadelphia. We selected the Atlantic regional office because EDA made 75 percent of its trade loans to firms in this region. We also examined prior reports and studies by us and others (see app. I) dealing with trade adjustment assistance to firms under the Trade Act and EDA's loan administration.

Because ITA officials were receptive to our findings and agreed to take steps to implement our recommendations, we did not obtain agency comments.

We performed our review in accordance with our "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions," revised February 27, 1981.

CHAPTER 2

MANAGEMENT WEAKNESSES CONTRIBUTE TO LOW SUCCESS

RATE OF FINANCIAL ASSISTANCE PROVIDED TO FIRMS

Relatively few import-impacted firms that received financial assistance under the Trade Act of 1974, as amended, have made the adjustments needed to successfully compete with other foreign and domestic firms. The certification criteria and the conditions for financial assistance required by the act have directed the program toward weaker and more risky firms. However, the program's rate of success has been hindered by weaknesses in

--adjustment plans submitted by firms,

--review and approval of loan applications, and

--loan servicing after approval.

ITA, which assumed responsibility for the program in September 1981, has issued new procedures for program management. This action should correct all but three of the management weaknesses we observed. To address these weaknesses, ITA also needs to require that a firm's physical facilities be visited prior to loan approval, require better information on why banks deny loans to firms, and develop and issue loan servicing procedures. Notwithstanding the improvements made and suggested, the program is designed to assist waning firms and we cannot predict the extent to which such firms can be helped to become more competitive and meet their financial commitments.

MOST ASSISTED FIRMS HAVE NOT ADJUSTED SUCCESSFULLY

The program has helped some firms to increase their sales and profits, but the repayment experiences of assisted firms clearly show that most firms are continuing to struggle. Moreover, a relatively large number of the assisted firms have gone out of business. For example, our analysis as of December 31, 1981, showed that for the 169 firms which received financial assistance before fiscal year 1980, 59 (35 percent) were current in loan payments, 34 (20 percent) were delinquent in loan payments ranging from 1 to 31 months, and the remaining 76 (45 percent) had loans that were in liquidation or had been liquidated.

Further analysis showed that even some firms that are current on loan payments may not be prospering. For example, as of May 31, 1981, 64 of the 169 firms were current in loan payments. Seven months later, on December 31, 1981, only 59 of the firms were current.

A September 1981 report prepared for EDA by Alexander Grant & Company and entitled "EDA Portfolio Financial Viability Study" showed that as of June 30, 1981, 156 (53 percent) of the 293 Trade

Act loans outstanding at that date were either delinquent or in liquidation. Expressed another way, $97 million (54 percent) of the $181 million trade loan portfolio was comprised of delinquent loans or loans in liquidation. The report concluded that the general condition of EDA's portfolio would worsen before it improved. Although this conclusion was applicable to all outstanding EDA loans, the Chief of the Loan Servicing Division of EDA's Office of Business Loans told us that it was particularly applicable to the Trade Act loans.

The following table demonstrates the deteriorating quality of the Trade Act portfolio by comparing the status of our sample universe at the start of our survey in May 1981 and in December 1981.

	Loan status			
	Current	Delinquent	In liquidation or liquidated	Total
Firms:				
Number				
5/31/81	64	46	59	169
12/31/81	59	34	76	169
Percent				
5/31/81	38	27	35	100
12/31/81	35	20	45	100
Loans:				
Number				
5/31/81	91	80	95	266
12/31/81	83	57	126	266
Percent				
5/31/81	34	30	36	100
12/31/81	31	22	47	100

FINANCIALLY WEAK FIRMS RECEIVED LOANS

Firms that have requested and received financial assistance under this program were generally financially weak. For instance, in our sample of 36 firms, 23 reported operating losses ranging from about $500 to $1 million for the year preceeding loan application. Comparable data was not available for three firms. Seven reported a negative net worth ranging from $23,300 to $6.8 million. Examples follow.

In February 1978, EDA approved a $1 million direct fixed-asset loan and guaranteed another $1.5 million working-capital loan to a footwear firm. The firm had a negative net worth of $6.8 million as of July 1977 and had steadily declining sales for the 5 years preceeding loan application. The region's action memorandum 1/ stated that although the collateral position of EDA will be weak, the importance of saving 400 jobs and of saving the firm justified EDA's taking "a greater risk than normal." In May 1979, 15 months after loan approval, the bank demanded full payment of the guaranteed portion of its loan because the firm had defaulted on loan payments. EDA paid the bank over $1.4 million. In March 1980, EDA liquidated the fixed-asset loan with a loss of nearly $400,000. As a result, EDA lost about $1.8 million on these two loans.

In August 1978, EDA approved an $800,000 direct working-capital loan to a handbag firm which had suspended production at the end of 1977. The firm had lost $1 million on its sales in 1977 and, consequently, had also lost its private source of financing. The action memorandum stated that the project involved a high risk factor to EDA and that because of the firm's insolvent position "* * * no bank showed any interest in becoming involved with a new financing arrangement even with an EDA 90 percent guarantee." Nevertheless, the regional office concluded that "* * * Congress intended that applicants for Trade Adjustment Assistance be given special consideration if applicant's adjustment plan is reasonable in the context of the Project and it does not adversely affect repayment ability." The firm ceased operations in December 1979; EDA charged off the loan in March 1980 at a loss of about $740,000.

In September 1978, EDA approved a $135,000 direct working-capital/fixed-asset loan to a firm manufacturing handbags and vests. The firm had three employees and a net worth of $329 according to its last unaudited financial statement dated July 1977. The firm's sales had plummeted from nearly $200,000 in 1973 to less than $17,000 in 1977. According to the action memorandum relating to this loan, "* * * the company has been essentially out of business and filed no Tax Returns for FY 1978 * * *." The loan went into liquidation in April 1980 before the firm repaid any of the loan principal.

In September 1979, EDA approved a $900,000 direct working-capital loan to a handbag manufacturer. The firm's sales had steadily declined over the 4 years preceeding loan application. The action memorandum stated that

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1/A memorandum prepared by a regional office financial analyst for use in reviewing and approving each loan application. Among other things, it contains a brief statement of a firm's background and a summary of its adjustment proposal, including sections on the use of loan proceeds and repayment ability.

"* * * this project involves greater risk of loss to the government than is normally encountered with respect to projects financed under Title II of the Public Works Act. The [regional office] is of the opinion that Congress intended certified companies be given special consideration, if the adjustment proposal is reasonable in the context of the company's proposal to overcome the adverse effects of import [competition], and if it does not adversely effect repayment ability; * * *."

The firm filed for bankruptcy in April 1980--just 7 months after loan approval. EDA is now liquidating the loan. The loan officer in charge of the liquidation told us in February 1982 that EDA had recovered only about $30,000 to date.

WEAKNESSES IN ADJUSTMENT PLANS

An adjustment plan is a document prepared by firms certified as eligible for trade adjustment assistance to explain briefly what the firm intends to do to adjust to the impact of imports and what type of assistance it needs to implement the plan. EDA required the plan to demonstrate that the assistance would be a constructive aid to the firm in establishing a competitive position in the same or a different industry. Also, EDA required the plan to consider the interests of the firm's employees and demonstrate that the firm would make all reasonable efforts to use its own resources.

Our review of adjustment plans submitted by the 36 firms for the 54 loans we sampled showed that the plans usually did not identify the reasons why the firms had not been able to stay competitive and did not identify clearly the difficulties that had to be overcome if the firms were to successfully compete with other firms. In discussing the causes for their problems, firms generally blamed foreign competition. Most plans simply stated that imports had contributed to the decline in sales, production, or employment. We believe that the plans would have been more useful if all firms had been required to specify how their firm's production costs, required selling prices, and product quality compared with costs, prices, and quality of competing foreign and domestic firms.

Moreover, we observed that most plans were directed primarily toward solving immediate problems rather than achieving long-term viability. Most adjustment plans placed heavy emphasis on working capital for such things as paying off existing debt, increasing inventories, or increasing marketing capabilities, rather than modernizing, upgrading, and/or expanding plant and equipment for long-range development. Forty of our 54 sample loans provided funds for working capital; 15 of the 36 firms received only working-capital loans. In terms of dollars, EDA loaned $30.3 million, or 83 percent of the total value of our sample loans, for working capital purposes.

We disclosed similar weaknesses in adjustment plans in a report we issued in December 1978. 1/ For that review, we examined the adjustment plans related to 28 firms that had received Trade Act loans between April 3, 1975, and September 30, 1977, and 16 firms that had received loans under the Trade Expansion Act of 1962 (76 Stat. 872)--the predecessor to the Trade Act of 1974.

To ascertain whether the problems we noted in the pre-fiscal year 1980 loans were continuing, we reviewed the adjustment plans related to nine loans to seven firms that were approved during fiscal year 1981. We observed basically the same weaknesses.

ITA recognized the shortcomings in adjustment plans and addressed them in its October 1981 procedures. Among other things, the procedures require each firm seeking assistance to have a diagnostic survey performed, unless waived by ITA in writing. This survey, which involves a review of a firm's current position, is designed to highlight a firm's strengths, weaknesses, resources, and problems. Also, it is designed to provide a succinct analysis of the difficulties that must be overcome if the firm is to survive.

Although a separate document, the diagnostic survey is closely related to the adjustment plan. The new guidelines require the adjustment plan to cover

--general information about the firm and the industry;

--an analysis of the firm's strengths, weaknesses, and problems;

--a strategy for capitalizing on the firm's strengths, shoring up its weaknesses, and overcoming its problems;

--a list of the specific actions proposed to carry out the strategy; and

--a list of milestones and indicators for checking on progress and achievements.

We believe that these changes should correct observed problems with adjustment plans.

WEAKNESSES IN REVIEW AND APPROVAL OF LOAN APPLICATIONS

EDA based its decisions to approve loans, to a great extent, upon analyses of unverified information supplied by the applicants. Our analysis of 54 sample loan files showed that EDA

1/"Adjustment Assistance to Firms Under the Trade Act of 1974--Income Maintenance or Successful Adjustment?" (ID-78-53, Dec. 21, 1978).

(1) made few pre-loan field visits, (2) accepted unaudited financial statements when submitted, (3) conducted limited ratio analyses, (4) usually accepted applicants' sales and profit projections at face value, (5) performed weak assessments of firms' management capabilities, and (6) required inadequate support that private financing was unavailable. These weaknesses were attributable in part to inadequate resources and procedures.

Pre-loan visits not made

As a rule, EDA did not visit the applicants' business locations to evaluate the physical condition of the firm and assess management capabilities first-hand prior to loan approval. Regional financial analysts agreed with us that such visits would be very beneficial. They said that an initial visit to a firm can tell more about how a business is operated and managed than most of the documents (resumes, financial data and projections, marketing plans) submitted by an applicant. Nevertheless, EDA procedures did not require such visits and regional financial analysts said that they seldom visited a firm before loan approval because of a lack of funds. In our opinion, prudent management would demand that a visit to the firm be made and the impressions from that visit be recorded. In this regard, Small Business Administration procedures require pre-loan visits for all direct loans made by that agency unless specifically waived.

ITA's October 1981 procedures state that it is highly desirable for loan officers to visit project sites at least once while the application is being processed. The procedures, however, do not require such visits because of possible constraints on time and travel funds. We believe, nevertheless, that since decisions are being made to loan up to $1 million and/or provide up to a 90-percent guarantee on as much as $3 million to each firm, ITA needs to require a pre-loan visit to evaluate the physical condition of the firm and observe its management abilities, character, and competence. This visit could be made by ITA analysts or Trade Adjustment Assistance Center personnel and management consultants conducting diagnostic studies. If other than ITA personnel make the visit, ITA needs to require a candid, confidential report on observations and conclusions. In all cases, the results of the visit need to be recorded and retained in the project file.

Unaudited financial
statements accepted

Of the 36 firms we reviewed, 9 firms had submitted unaudited statements with their applications because EDA allowed them to do so. The financial analysts used these statements to approve loans without knowing whether the data was accurate.

Analysis based on inaccurate financial data, such as cash flow analysis, can produce inaccurate and misleading financial conclusions. Also, firms could deliberately misrepresent their financial condition to appear more or less creditworthy. For example, a memorandum prepared by a loan officer before one of our sample loans was placed into liquidation discusses an allegation by the firm's new management that the old management concealed certain debts and overstated certain assets at the time the loan was obtained. The memo states, "the new management feels that the [adjustment] plan cannot succeed and that no application for assistance would have been submitted if all the facts had been known."

The October 1981 procedures require a firm to submit audited current financial statements before the approval of a direct loan or loan guarantee. Before ITA finalized these procedures, we discussed the need for audited financial statements with ITA's Deputy Assistant Secretary for Trade Adjustment Assistance 1/ (hereinafter referred to as the Deputy Assistant Secretary) because draft guidelines we reviewed did not require audited statements. In a November 1981 technical assistance report requested by the Deputy Assistant Secretary, the Office of Inspector General strongly recommended that ITA obtain audited financial statements from borrowers. An Inspector General representative said that his office had also discussed this matter with the ITA official.

In our opinion, this requirement should provide better information for loan approval decisions and should eliminate the potential for program abuse such as that described above.

Limited ratio
analyses conducted

Our review indicated that financial analysts made limited use of ratio analyses because EDA's procedures did not require them to prepare ratio analyses. Ratios developed from a firm's financial data can be used as an important barometer to measure a firm's relative success. Ratios are also useful to internal management to pinpoint areas needing management attention and can be even more important to external lending institutions who are trying to assess a firm's ability to repay a loan.

There are several categories of ratios. Those of interest to external lenders include liquidity, coverage, leverage, and operating. Liquidity ratios measure the quality and adequacy of current assets to meet current obligations. These include the current ratio (total current assets ÷ total current liabilities) and the quick ratio (cash and equivalents + accounts and notes receivable ÷ total current liabilities). Coverage ratios measure a firm's ability to service debt (earnings before interest and taxes ÷ annual interest expense). Leverage ratios help measure the firm's vulnerability to business downturns. One of the most important leverage ratios is the debt to equity ratio which measures the relative amount that each lender and investor had invested in a business. Finally, operating ratios are important

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1/Formerly EDA's Deputy Assistant Secretary for Economic Development.

because they measure management performance. Among the operating ratios are those which measure return on equity or the return on investment.

For 19 of the firms reviewed, we found no documentation that EDA financial analysts had performed any ratio analyses or compared financial data to industry standards. For 17 of the 36 firms reviewed, we noted that analysts had performed some ratio analyses. In 16 of these cases, the analysts used Robert Morris Associates' 1/ data.

ITA's October 1981 procedures state that certain minimum standards for the financial strength of firms seeking financial assistance are required to determine that a reasonable assurance of repayment exists. To make this determination, it must be demonstrated that a firm's current ratio, sales to working-capital ratio, and debt to equity ratio are within the first, second, or third quartiles among firms of similar size in the same industries as reported in the Robert Morris Associates Annual Statement Studies.

We believe that by making ratio analyses and comparisons with industry standards, ITA will have a much stronger basis for determining the creditworthiness of financial assistance applicants.

Sales and profit projections accepted at "face value"

The Trade Act requires a determination to be made that a firm has a reasonable chance to repay before that firm can receive financial assistance. We observed that EDA generally used the sales and profit projections supplied by a firm when making this determination. Moreover, we observed that in most instances, the projections provided appeared highly optimistic.

EDA's procedures required a firm to submit with its loan application pro forma financial statements showing projections for the 3 years after loan approval. The procedures also required EDA financial analysts to complete an action memorandum for use by EDA management in approving or disapproving each loan application. The memorandum's repayment ability section discusses a firm's (1) management capability and commitment, (2) marketing potential, (3) prospects for profitability and debt servicing, and (4) collateral available to secure the loan.

Our review of the files related to the loans made to the 36 sample firms showed that for 27 firms the financial analysts accepted and used projected sales and profit figures provided by

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1/A national association of bank lenders and credit officers which annually publishes an analysis of financial statements of businesses in various industries.

the firms to determine that each firm had a reasonable chance to repay the loan. Apparently, the analysts accepted these projections at face value because a comparison of actual sales and profit figures before the loans were approved with projected figures for future years indicated that many of the projections were highly optimistic. The Atlantic regional office director said that very little was done to analyze financial projections.

We recognize that firms should be expected to increase their sales and profits after the receipt of a loan. However, it may not be realistic to expect highly troubled firms (see pp. 6 to 8) to attain the large increases in sales and profits that many had projected. In one example, a shoe lining manufacturer, which had experienced a drop in sales for the 2 years prior to its application for EDA assistance in September 1977, projected that its sales would increase from $3.9 million to $5.8 million (49 percent) after the first year. It projected that sales would increase to $11.9 million (over 200 percent) after the third year of the loan. Earnings were to increase from a $255,000 loss to an $83,000 profit the first year and a $1.9 million profit by the third year. As it turned out, this firm ceased operations in June 1979, forcing EDA to charge off $615,000 in uncollectable debts.

In another example, a footwear manufacturer, which had declining earnings in the 2 years prior to its application for EDA assistance in September 1978, projected that its sales would increase from $5.4 million to $8.2 million (53 percent) after the first year. It projected that sales would increase to $12.2 million (129 percent) after the third year of the loan. Earnings were to increase from a $427,000 loss to a $104,000 profit the first year and a $781,000 profit by the third year. The bank guaranteeing a loan to the firm declared the firm in default in May 1979. Although the bank received enough during liquidation to satisfy its loan to the firm, EDA had to charge off over $1.1 million on a direct loan to the firm.

ITA's October 1981 procedures provide for a thorough product-by-product analysis of the applicant's sales projections to determine whether they are realistic and attainable in the time foreseen in the adjustment plan. ITA may require applicants to obtain independent market feasibility studies or furnish supplementary market data. In our opinion, these procedures should provide ITA a better basis for determining that applicant firms have a reasonable assurance of repayment.

Weak assessment of management abilities

EDA's procedures stated that if a loan was to have a reasonable chance of repayment, the firm's management team, including the executives and other key personnel, must have the experience and professional management skills necessary to effectively manage the business operations and implement the firm's adjustment plan. For evidencing management capabilities, the procedures enumerated

(1) resumes of the personnel, (2) impressions from negotiations and other meetings, and (3) discussions with creditors, competitors, Trade Adjustment Assistance Center representatives, and other sources.

Our review indicated that EDA's assessment of an applicant's management abilities was weak. As noted earlier, financial analysts seldom had the opportunity to visit a firm's production facilities for a first-hand evaluation of how the business was managed. Although several Atlantic regional office financial analysts said that they normally tried to meet with key managers of each firm applying for a loan, we found no written evidence that firms' management abilities were assessed during those meetings. In this regard, our review of the action memorandums related to our 36 sample firms showed that an EDA analyst's assessment of the management abilities was usually a reiteration of the resumes submitted by the firm with its loan application. We noted documented discussions about a firm's management with creditors, competitors, and/or other sources for only 3 of the 36 firms.

In addition to evidencing management capabilities through resumes, personnel observations, and discussions with others, ITA's October 1981 procedures provide that ITA

--will view the assistance request with special care if it appears poor management contributed to the impact of imports on the firm;

--will require the existing management to provide convincing evidence that previous management problems have been corrected;

--will consider the management team's length of service and the firm's success during that tenure, placing considerable weight on a long record of management success that was interrupted by the impact of imports; and

--could condition the assistance on a change of management and/or the hiring of additional managers.

In our opinion, these procedures, in conjunction with preloan site visits, should substantially strengthen the assessment of the firm's management abilities and should provide for making better loans.

<u>Support for nonavailability of private financing was inadequate</u>

The Trade Act requires that a determination be made that a firm has no reasonable access to financing through the private capital market before its application for financial assistance can be approved. While EDA required loan applicants to provide evidence that financing was not available from private sources, its acceptance of letters from private lenders denying a firm a loan did not always adequately support nonavailability of private financing.

Our review showed that although EDA had obtained the denial letters as required, those letters frequently did not provide insight as to the firms' creditworthiness. While some letters showed the terms and conditions under which the loan was requested or the potential lenders' reason(s) for denying the loan, many only stated that the loan request was denied. A sample denial follows.

> "We have given your application for credit our careful consideration and regret to advise that we are unable to grant your request at this time. We regret that we are not able to assist you either with or without an EDA Guaranty. Perhaps we can be of service to you in the future."

ITA procedures continue the requirement that firms must provide denial letters from at least two eligible lending institutions. In addition, the procedures state that where loan officers believe that the firm's financial condition is sound enough to warrant private financing without a guarantee, they may investigate the availability of such financing on their own initiative and discuss the project with a lending institution, after first securing permission from the applicant.

In our opinion, the new procedures should strengthen the "credit elsewhere" requirement. However, to comply fully with the act's intent, we believe that ITA needs to also require the applicant to provide the terms and conditions under which private financing was requested. Further, ITA needs to require the applicant to obtain from the lending institution and furnish to ITA the reason(s) the lender denied the loan request.

WEAKNESSES IN LOAN SERVICING

Once a loan was approved and the funds disbursed, EDA had done very little to service that loan. As defined by EDA, loan servicing includes activities undertaken by regional officials to assure repayment of a loan. An important objective of loan servicing is the early detection of any weaknesses in a firm's progress so that corrective action could be taken quickly to prevent a worsening financial position and jeopardizing repayment of the Government's investment.

In a 1978 report entitled "Need to Improve Servicing of Direct Business Loans Under the Business Development Assistance Program" (FGMSD-78-34, May 15, 1978), we found the following servicing weaknesses in EDA:

--Borrowers were not promptly contacted concerning late payments.

--Field visits to borrowers were infrequent.

--Borrowers' financial statements were not regularly obtained and analyzed.

During our current review, we found that while EDA recently took action to promptly contact delinquent borrowers (see p. 19), it continued to make very few field visits and did not obtain and analyze borrowers' financial statements because of inadequate resources.

EDA retains responsibility for servicing all Trade Act loans approved before September 20, 1981. ITA is responsible for servicing trade loans approved after that date.

Field visits are rarely made to borrowers' facilities

EDA procedures state that an effective field visit is the most important loan servicing activity and require annual visits on all loans and more frequent visits on non-seasoned and problem loans. Notwithstanding these requirements, we could not determine that EDA had made field visits to any of 36 firms reviewed. Financial analysts from the Atlantic regional office said that they made very few service visits because the region had very limited funds for such visits and the small staff was required to give priority to loan processing efforts. Similarly, EDA's October 1980 loan servicing study (see app. I) disclosed that EDA regional personnel seldom made visits to borrowers. The study concluded that lack of time and insufficient travel funds were the major causes.

Our review indicated that the Atlantic regional office did not have sufficient administrative funds to adequately service its loan portfolio. In 1979 EDA allocated the regional office only $8,975 to administer trade adjustment loans. During 1980 and 1981, the regional office comingled its funds for the regular business development program and the trade adjustment program. The total allocated was $16,085 in 1980 and $12,780 in 1981 even though the regional office was responsible for servicing almost 400 loans to firms scattered throughout the Northeast from Maine to West Virginia, plus Puerto Rico. These funds were available for travel in connection with both loan servicing and loan closing. Since the regional office did not maintain separate accounting of the expenditures, we could not determine how much was spent for servicing.

In addition to the lack of travel funds, limited staff also hampered the Atlantic regional office's servicing efforts. During 1980, for example, each financial analyst assigned to loan servicing in the Atlantic regional office was required to service an average of 100 regular business and trade loans. We believe that this represented an unmanageable workload. In this regard, EDA's standards recommend that one person service 25 to 30 direct loans or 50 to 60 guaranteed loans. The Atlantic regional office director told us in December 1981 that because EDA was not then making business or trade loans, the regional financial analysts were devoting full time to loan servicing.

Financial statements are not used as a servicing tool

Although EDA's procedures state that analyses of borrowers' financial statements are an important part of loan servicing, we found no indication that EDA analysts routinely reviewed and analyzed financial statements. Analyzing financial statements would permit EDA to closely monitor the financial experience of its borrowers, spot trends in a borrower's business, ensure compliance with terms of the loan agreement, and measure a firm's financial progress by comparing performance to projections. Further, such analyses could serve as a trigger for scheduling field visits with borrowers to discuss corrective actions, thus helping firms maintain a stable economic posture.

To perform these analyses, EDA must first receive the financial statements from its borrowers. EDA procedures and each loan agreement require borrowers to furnish quarterly statements and yearend audited statements. Yet, our review indicated that many firms did not regularly provide EDA with their financial statements. Also, we found that EDA did not routinely request statements if the borrowers did not provide them.

For example, 12 of the 19 "active" firms included in our sample 1/ had not supplied EDA with all the required annual financial statements. At our request, the regional office sent a letter to those 12 firms requesting the financial statements that were missing from the loan files. Seven firms responded to the request. One firm went into liquidation about the time the regional office mailed the request and as a result did not respond. For another firm, the request letter was returned with "returned to sender; moved--not forwardable" stamped on the envelope. The regional financial analyst responsible for servicing this firm said that he knew the firm had moved and where it was located. However, he failed to note this in the firm's loan file. The regional office received no responses from the remaining three firms.

Moreover, in our review of the files, we found no evidence that EDA officials had reviewed or analyzed the statements that had been received. One financial analyst said that they generally looked at the statements but rarely did any analysis unless the firm was trying to amend the current loan or get another loan.

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EDA and Commerce have taken steps to improve loan servicing. EDA is currently revising its loan servicing procedures. The draft procedures would require financial analysts to

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1/The 17 other firms in our sample of 36 were in liquidation or had been liquidated at the start of our review.

--make every effort to obtain financial statements in order to compare actual and projected operating results and cash flow;

--analyze financial statements to determine significant trends, compliance with loan covenants, and borrower's existing financial strength and profitability;

--determine whether actual financial results vary significantly from projected results; and

--discuss and resolve as soon as possible all unusual variances or problems identified.

We believe these draft procedures, if finalized and properly implemented, will significantly strengthen EDA's loan servicing efforts.

Another effort which has strengthened loan servicing is Commerce's response to the Office of Management and Budget's April 1981 requirement for aggressive debt collection programs in executive branch departments. Commerce's debt management plan, submitted to the Office Of Management and Budget in October 1981, includes as a key objective a program to deal with delinquencies in the EDA loan portfolio. In October 1981, EDA required its regional offices to advise all borrowers with overdue direct loans to remedy their delinquencies immediately, preferably through payment, otherwise through payment rescheduling. For its guaranteed loans, EDA required that regional officials contact the financial institutions to confirm the status of each loan and to require that quarterly reports be provided to EDA as called for in the loan agreement.

Also, since July 1981, EDA has required certain headquarters officials and regional directors to prepare monthly reports of debt collection efforts, including contacts made, repayment agreements arranged, and referrals to EDA's Chief Counsel. EDA's Office of Business Loans uses the reports to prepare comparative results by time period to monitor the progress of the debt collection effort.

At the same time EDA is pursuing the collection of overdue debts, it is also culling from the portfolio loans that have no chance of repayment. As a result, EDA had 98 trade adjustment assistance loans in liquidation status as of March 1, 1982,--up from 68 as of June 1, 1981.

ITA has not issued loan servicing procedures because it has given priority to developing application review and loan approval procedures. However, the general terms and conditions ITA includes in each trade assistance loan agreement require firms to submit financial statements periodically. The Deputy Assistant Secretary told us that ITA would insist that firms provide financial statements and would generally require firms receiving financial assistance to contract for technical assistance in implementing their adjustment plan with a consultant satisfactory to ITA.

While these actions should assist in loan servicing, ITA needs to develop and issue loan servicing procedures as soon as practicable which will ensure that sufficient oversight is maintained over the life of the loans. ITA plans to issue loan servicing procedures by September 1982.

CONCLUSIONS

Most firms that received financial assistance under the Trade Act of 1974 have not been able to make the adjustments needed to become or stay competitive. Although the program is required to be directed toward weakened firms, the low success rate is partly attributable to weaknesses in (1) adjustment plans, (2) loan application review and approval activities, and (3) loan servicing. Some corrective action has been initiated; more is needed.

EDA and Commerce have taken important steps toward improving the condition of EDA's trade loan portfolio by drafting revised loan servicing procedures and by developing an aggressive debt collection program. Moveover, ITA has taken an important step toward improving the effectiveness of financial assistance to import-impacted firms by issuing new management procedures. These actions, while commendable, do not completely address all the weaknesses we observed. ITA needs to develop the means for obtaining better information on an applicants' physical facilities, its management capabilities, and the nonavailability of private financing. ITA also needs to develop and issue loan servicing procedures.

Heretofore, EDA had not allocated the resources needed to fully evaluate a firm's physical condition and its management capabilities before loan approval and to adequately service a firm's loan(s) after approval. The changes that have been made and are needed will not be free of cost. Unless the dollars made available to administer the program are commensurate with program dollars, their results will be limited.

RECOMMENDATIONS TO THE SECRETARY OF COMMERCE

We recommend that, if the program of trade adjustment assistance to firms is funded beyond September 1982, the Secretary of Commerce direct the Under Secretary for International Trade to

--require that each applicant's production facilities be visited prior to loan approval to evaluate the condition of plant and equipment and to assess management capabilities,

--require each firm to provide with its application the terms and conditions under which private financing was requested and the reason its loan request was denied, and

--develop and issue loan servicing procedures.

The Deputy Assistant Secretary agreed to take steps to implement each of these recommendations.

REPORTS EXAMINED DURING REVIEW OF

TRADE ADJUSTMENT ASSISTANCE TO FIRMS

GAO REPORTS

"Assistance to Non-Rubber Shoe Firms" (CED-77-51, Mar. 4, 1977).

"Need To Improve Servicing of Direct Loans Under the Business Development Assistance Program" (FGMSD-78-34, May 15, 1978).

"Adjustment Assistance to Firms Under the Trade Act of 1974--Income Maintenance or Successful Adjustment?" (ID-78-53, Dec. 21, 1978).

COMMERCE OFFICE OF
INSPECTOR GENERAL REPORT

"Review of Trade Adjustment Assistance Loan Program To Identify Areas for Improvement of Loan Quality" (3AD-134-01-1030-82-1, Nov. 30, 1981).

OTHER REPORTS

"EDA Portfolio Financial Viability Study," Alexander Grant & Company (99-10-00002-01, Sept. 21, 1981).

"Study of Debt Collection Policies and Procedures," Booz, Allen, & Hamilton, Inc. (AA-81-SAC-02108, Dec. 14, 1981).

"Loan Servicing Study," EDA Office of Management and Administration, Management Analysis Division, Oct. 1980.

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