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Report to the Acting Chairman, Subcommittee on Merchant Marine, Committee on Merchant Marine and Fisheries, House of Representatives

August 1987

MARITIME ADMINISTRATION

Efforts to Improve Data on the Federal Ship Financing Program

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

Resources, Community, and
Economic Development Division

B-226298

August 28, 1987

The Honorable Glenn M. Anderson
Acting Chairman, Subcommittee on
Merchant Marine
Committee on Merchant Marine
and Fisheries
House of Representatives

Dear Mr. Chairman:

This report, prepared in response to the former chairman's December 20, 1985, request, discusses the Maritime Administration's efforts to improve data on its Federal Ship Financing Program and Fund. The report identifies the portion of the program's portfolio that is considered to be at risk of default, the financial condition of the fund, and internal control weaknesses in program data. It also covers whether the fund's financial statements properly recognize potential future default payoffs on the outstanding portion of the program's portfolio and whether the estimates of potential future default payoffs are reasonable. Program officials generally have taken or plan to take action to address the problems we noted.

We are sending copies of this report to the Secretary of Transportation and the Administrator, Maritime Administration. We will also make copies available to others upon request.

This work was performed under the direction of Mr. Kenneth M. Mead, Associate Director. Other major contributors are listed in appendix II.

Sincerely yours,

J. Dexter Peach

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

In a letter expressing concern about the mounting default payments in the Maritime Administration's (Marad) federal ship financing program, the Chairman, Subcommittee on Merchant Marine, House Committee on Merchant Marine and Fisheries, asked GAO to answer five questions about the program and its approximately $5 billion portfolio of loan guarantees as of September 1986: (1) What portion of companies with loan guarantees is considered to be at risk of default? (2) What is the financial condition of the fund that finances the program? (3) Does Marad maintain reliable data on the program's loan guarantees and companies at risk of default? (4) Do the fund's financial statements properly recognize potential defaults on outstanding loan guarantees? (5) How accurate are Marad's estimates of expected defaults?

Background

The loan guarantee portion of the program was established in 1972 to encourage the construction of vessels in the United States. With Marad's approval, a U.S. citizen shipowner obtains a loan guaranteed by the United States from a bank or other private sector lender.

The fund that underwrites the program receives income primarily from statutory fees set by Marad and paid by shipowners whose loans are guaranteed and pays the program's expenses, including defaults. Marad has authority to borrow from the Treasury when the fund's resources are insufficient to pay expenses. This money is to be repaid with interest.

Economic conditions in key industries—oil and agricultural products—contributed to the rapid expansion and subsequent record default payments in the program. The program's portfolio rose from less than $2 billion at the end of fiscal year 1973 to more than $8 billion by the end of fiscal year 1982. However, in the 1980s the price of oil declined sharply and agricultural exports decreased, leading to depressed operating conditions for certain vessels guaranteed under the program and to an upsurge in defaults starting in 1985. Marad expects depressed conditions in several maritime segments to continue throughout this decade.

Results in Brief

Of the fund's approximately $5 billion in outstanding loan guarantees as of September 30, 1986, about $1 billion, or 20 percent, was considered by Marad to be at risk of default.

By the end of fiscal year 1985, the fund was not self-supporting, and the condition worsened in fiscal year 1986 when default payments exceeded

$1.2 billion, the highest level in the program's 15 years. The fund was not self-supporting because it was unable to generate revenues sufficient to cover its expenses without the aid of Treasury borrowings. Marad is required to repay these borrowings but was able to do so only with a supplemental appropriation of nearly $1.4 billion. Treasury borrowings are covering the bulk of program expenses in fiscal year 1987.

GAO identified several problems relating to Marad's program, financial, and budget data, including reporting inconsistent data on the total value of outstanding loan guarantees and commitments for fiscal year 1985, not having a complete list of troubled companies, not establishing a required liability for future losses on loans, and significantly underestimating fiscal year 1986 default payments.

Department of Transportation and Marad officials have taken or plan to take corrective action in nearly all of the above areas. However, Marad needs to state clearly in its annual reports that the fund is not self-supporting when projected fund revenues are not sufficient to cover expenses and pay back Treasury borrowings without the aid of supplemental appropriations. This will permit the Congress to make more-informed decisions.

Principal Findings

Fund Is No Longer Self-Supporting

The fund had a deficit of $250 million for fiscal year 1985 and borrowed over $1.2 billion from the Treasury to cover expenses for fiscal year 1986. The Secretary of Transportation received a supplemental appropriation to repay the debt and interest incurred through fiscal year 1986. Furthermore, Marad projects a deficit of more than $500 million for fiscal year 1987.

Neither Marad's 1985 nor 1986 annual reports stated that the fund is no longer self-supporting. Such a statement is important because (1) Marad is no longer able to repay its expenses, including Treasury borrowings, without a supplemental appropriation and (2) it would make more useful and complete information available to support the Congress's policy-making and oversight responsibilities especially with respect to approving supplemental appropriation requests.

Program Data Have Been Improved

In several documents as of September 1985, Marad reported inconsistent data on the total value of its portfolio that differed by up to $400 million. In addition, Marad does not have a complete list of companies at risk of default and their loan balances. In one document Marad omitted over $700 million in troubled loans. However, Marad has provided consistent data in internal and external reports of its total portfolio as of September 30, 1986. In addition, Marad officials are preparing a complete list of companies at risk of default. (See ch. 3.)

Financial Statements Are More Complete

GAO pointed out in June 1985 and December 1986 that Marad's fiscal year 1985 annual report did not include a liability for expected yearly losses on its outstanding loan guarantees as required by Comptroller General criteria. Marad established such a liability in its fiscal year 1986 annual report. (See ch. 4.)

Default Estimates Are Being Prepared

Marad originally stated that it was not possible to prepare a realistic estimate of loans in its portfolio at risk of default. GAO disagreed and, for illustrative purposes, used the fund's recent experience to prepare an estimate—$524 million for fiscal year 1987. Marad officials later agreed that they could prepare yearly default estimates and have estimated defaults at $600 million for fiscal year 1987. Marad officials said the estimate is based on an analysis of company and market conditions and trends. (See ch. 4.)

Documentation of Processes Is Needed

Marad officials stated and GAO agreed that they had made the improvements in program, financial, and budget data that were discussed earlier in this summary, including developing a list of companies at risk of default and estimating future default payments. However, GAO was unable to review Marad's process for developing these data because Marad did not document the process. Such documentation is important to ensure that the data were properly compiled. Documentation will also enable Marad's processes to be independently reviewed. (See chs. 3 and 4.)

Recommendations

GAO recommends that the Secretary of Transportation require Marad's Administrator to (1) state in its annual report and elsewhere, as appropriate, that the fund is no longer self-supporting and (2) document the processes used to compile data on companies at risk of default and the estimates of default payments used in financial and budget documents. (See chs. 2, 3, and 4.)

GAO also recommends that Marad's Administrator report at the end of this calendar year to the Secretary of Transportation on those financial reporting areas identified in this report where corrective action has not been taken, including any areas of nonconformance in Marad's accounting system with the Comptroller General's principles, standards, and related requirements. (See ch. 4.)

Agency Comments

In commenting on a draft of this report, the Department of Transportation noted improvements in program, financial, and budget data to address the problems GAO identified. Although its comments do not address the need for documentation of the processes for compiling such data, the Deputy Associate Administrator for Maritime Aids generally agreed that documentation is important and plans to consider ways of preparing such documentation. These actions, if properly implemented, should resolve the problems.

However, the Department noted that its annual reports show that expenses exceed revenues and thereby disclose that the fund is not self-supporting. GAO agrees that one can determine from reading the reports that expenses exceeded revenues but believes the annual reports would be more useful and complete if they clearly stated that the fund is no longer self-supporting because the fund will not generate revenues to repay Treasury borrowings without the aid of supplemental appropriations. This would make clear that without the aid of appropriations, expenses will continue to exceed revenues.

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Abbreviations

DOT	Department of Transportation
GAO	General Accounting Office
Marad	Maritime Administration
RCED	Resources, Community, and Economic Development Division

Introduction

The Federal Ship Financing Program (commonly called title XI) was established by title XI of the Merchant Marine Act of 1936 primarily to encourage the construction of vessels in the United States. The act was amended in 1972 to, among other things, attract more private capital fo vessel construction. Under the 1972 amendments, guarantees backed by the full faith and credit of the United States are issued to U.S. citizen shipowners. Prompt payment in full of the interest and the unpaid principal of any loan guarantee is provided for under this program by the U.S. government in the event a shipowner defaults in the payment of any principal and interest on the loan guarantee when due. The vessels usually form the security for the government's guarantee of the loans.

Funds for vessel construction are obtained by the shipowner's issuance of corporate bonds to private sector investors, such as banks, pension trusts, life insurance companies, and the general public. The bonds have a maximum maturity of 25 years. The program is administered by the Department of Transportation's (DOT) Maritime Administration (Marad).

By law, the total outstanding amount in loan guarantees for vessels cannot exceed $9.5 billion at any given time. According to Marad's records, its portfolio (outstanding loan guarantees and commitments) amounted to about $5 billion in September 1986. Thus, Marad could have guaranteed an additional $4.5 billion. However, in fiscal years 1980 through 1986, the Congress specified a limit on the value of new commitments in each year's appropriation. For example, Marad was limited to $67 million in fiscal year 1986. No limit for fiscal year 1987 has been enacted.

Marad's fiscal year 1988 budget request has proposed that new loan guarantee commitments and the authority to issue loan guarantee commitments be terminated. However, even if Marad does not guarantee any new loans or loses its authority to issue new commitments, it will still be custodian over the existing portfolio.

The Federal Ship Financing Fund underwrites the program. The fund receives income from (1) fees (determined by Marad in accordance with statutory limits) paid by shipowners whose loans are guaranteed, (2) interest on investments in Treasury securities, (3) proceeds from the repayment of loans or the sale of vessels acquired by Marad after it makes default payments, and (4) repayment of federal loans. Expenses, including those to pay loan defaults and maintain vessels acquired through default, are paid from the fund.

When a vessel owner does not make loan repayments, investors or their agents may call the loan into default, thus requiring Marad to pay from the fund the outstanding principal plus accrued interest. If the fund's resources are not sufficient to cover these costs, Marad is authorized to borrow the money from the Treasury. The fund is required to repay this money, with interest. To help recoup the costs of a default, Marad will foreclose on and attempt to obtain title and sell the vessel that is security for the loan guarantee. Proceeds from the sale are credited to the fund.

Objectives, Scope, and Methodology

In a letter dated December 20, 1985, the former Chairman, Subcommittee on Merchant Marine, House Committee on Merchant Marine and Fisheries, asked us to provide information on certain aspects of Marad's Federal Ship Financing Program and Fund. As agreed with his office, we compiled and analyzed information to answer the following questions:

- What portion of companies with loan guarantees is considered to be at risk of default?
- What is the financial condition of the fund that finances the program?
- Does Marad maintain reliable data on the program's loan guarantees and companies at risk of default?
- Do the fund's financial statements properly recognize potential defaults on outstanding loan guarantees?
- How accurate are Marad's estimates of expected defaults?

We performed our review at Marad headquarters in Washington, D.C. We interviewed Marad officials to obtain information on the companies that Marad considered to be at risk of default ("troubled"). We also obtained and analyzed reports and other documents that contained data on troubled companies to determine what portion of Marad's loan guarantee portfolio was troubled. In addition, we tracked the progress of selected troubled companies to determine whether these companies ultimately repaid their loans or defaulted on them.

To determine the financial condition of the fund, we reviewed financial statements and other budget documents. We interviewed Marad officials to determine the reasons for the fund's financial condition and to find out what information is available on the portfolio.

To determine the reliability of the data on the portfolio, we reviewed reports and other documents, including files on companies with loan guarantees. We did not attempt to assess the adequacy of Marad's management information system for the program. We focused instead on two basic measures on which we had been asked to compile data: (1) loan guarantees and commitments and (2) the number of troubled companies.

We did not review Marad's entire accounting system to determine whether it conformed to the Comptroller General's principles, standards, and related requirements. Instead, to answer the Chairman's questions on how default payments and future default estimates were shown, we concentrated on the portion of the system dealing with the financial statements that Marad had prepared. We reviewed the financial statements and other budget documents to determine whether the financial condition of the fund had been properly disclosed. In addition, we assessed whether Marad's estimates of expected defaults were reasonable.

Our review was conducted in accordance with generally accepted government auditing standards except that we did not independently verify all of the data Marad provided. We performed our review primarily between December 1985 and July 1986, but in certain instances, we performed additional audit work beyond July 1986 in order to update data that Marad had provided. This additional work was completed in July 1987.

In order to simplify our discussion of Marad's loan guarantee portfolio, we use the term "loan guarantee amounts" to refer to that portion of Marad's portfolio represented by companies that have loan guarantees with outstanding principal balances. Unless specifically stated, interest Marad paid for defaulted loan guarantee amounts has not been added.

DOT's Office of the Inspector General also evaluated the effectiveness of Marad's policies and practices in managing selected areas of the title XI program.[1] The objectives of the audit were to evaluate (1) the fund's financial management practices, (2) the adequacy of decisions to provide assistance to troubled companies, and (3) actions to maintain and dispose of vessels obtained through defaults.

Our report and the Inspector General's report generally cover different aspects of the title XI program and fund. For example, we concentrated our efforts on information developed and disseminated by Marad to

[1] Report on Audit of the Management of the Federal Ship Financing Guarantee Program, AV-MA-6-040 (Sept. 4, 1986)

answer questions on the program's and fund's status with respect to troubled companies and loan guarantees and increasing default payments. The Inspector General report also addressed the fund's financial situation but evaluated Marad's financial decisions to approve financial aid for several troubled companies and Marad's vessel disposal practices after default payments had been made. In addition, the Inspector General Office's audit work was performed, in some cases, at various locations outside Washington, D.C. The report identified weaknesses in these areas and recommended corrective actions. Its findings are summarized and discussed in our report where appropriate.

Agency Comments

On December 24, 1986, we provided DOT with copies of our proposed report for its official review and comment. DOT provided comments on April 7, 1987. Its comments, along with our evaluation of them, are summarized in the remaining chapters of this report. The text of DOT's comments with our supplemental views is included as appendix I.

Marad Should Report That the Fund Is No Longer Self-Supporting

The fund's expenses have exceeded its revenues, and expenses are now covered primarily by borrowing funds from the Treasury. The fund wa not self-supporting in 1985, and this condition worsened in 1986 becau of an unprecedented number of defaults, which were largely due to eco nomic conditions.[1] However, Marad did not state that the fund is no longer self-supporting in its 1985 and 1986 annual reports. On the basis of Marad's own projections, the fund will not be self-supporting throug fiscal year 1987. The Congress would have more useful and complete information on which to base policy decisions if the fund's complete financial condition were clearly presented. In addition, a portion of the portfolio is still at risk of default.

In its comments, DOT said that the fund's financial statements and other documents disclosed that expenses exceeded revenues. However, we believe that the statements would be more useful, clear, and complete i they also state that the fund is no longer self-supporting—a condition the fund had not experienced in prior years. This statement should be included because Marad is not in a position to repay Treasury borrowings, thus necessitating requests for future congressional appropriation to pay its expenses.

Fund Expenses Exceed Its Revenues

Fiscal year 1984 was the last year the fund's revenues exceeded its expenses—by about $27 million. The fund's expenses surpassed its rev enues in fiscal years 1985 and 1986; to cover default payments, it borrowed from the Treasury about $130 million for fiscal year 1985 and over $1.2 billion for fiscal year 1986.

Between 1972, when the program started to guarantee loans, and 1986, about $1.9 billion in default payments were made, with 82 percent of the total being paid in fiscal years 1985 and 1986. Cumulative payment of about $5 million were made before fiscal year 1977; over $336 millio was paid between fiscal years 1978 and 1984. However, such payments increased to about $321 million in fiscal year 1985 alone and to over $1.2 billion in fiscal year 1986. (See fig. 2.1.)

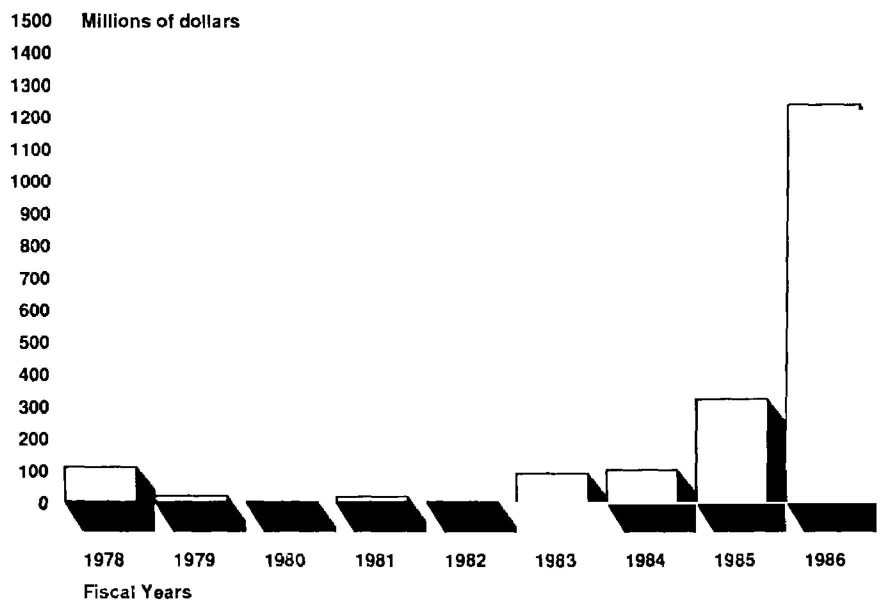
When the fund's revenues and surplus are not sufficient to meet expenses, Marad borrows from its unlimited line of credit with the Trea sury to cover expenses, including defaults. Prior to fiscal year 1985,

[1] As used in this report, self-supporting means the ability of the Federal Ship Financing Fund during the fiscal year to draw upon the fund's balance and or to generate revenues in amounts sufficient to pay all expenses, including default payments and Treasury borrowings, without congressional appropriations.

Marad borrowed four times from the Treasury to cover default payments and in each case repaid the borrowings without seeking an appropriation. However, Marad has not received sufficient revenues to repay the borrowings that started in fiscal year 1985. Marad had borrowed almost $1.4 billion by the end of fiscal year 1986 and reported paying about $74 million in fiscal year 1986 to cover interest on its debt to the Treasury. In fiscal year 1987 (July 11, 1987), DOT received a supplemental appropriation for $1.375 billion to cover Marad's expenses from fiscal years 1985 and 1986.

Marad projects that borrowings will continue through fiscal year 1987. Through June 22, 1987, Marad made payments of over $312 million to cover defaults—more than the $94 million of revenue it projects for the entire year. Marad projects that for fiscal year 1987 it will make default payments of $600 million and borrow over $547 million to cover these payments. We believe DOT will request another supplemental appropriation in fiscal year 1988 to repay the Treasury debt incurred in fiscal year 1987.

Figure 2.1: Default Payments From the Federal Ship Financing Fund, Fiscal Years 1978-86



The Fund's Statement of Operations Did Not State That It Was Not Self-Supporting

Although the fund was established with the intention of being maintained from revenues generated primarily from companies seeking gua anteed loans, by the end of fiscal year 1985, the fund was not self-supporting. Marad's fiscal year 1985 annual report's statement of oper tions (dated July 1986) showed that expenses were greater than revenues, and the statement of financial condition indicated borrowings from the Treasury.[2] We believe that the statement of operations in the 1985 annual report would have been more useful and complete if it hac clearly stated that the fund is no longer self-supporting. That is, we believe Marad will request another supplemental appropriation to repa Treasury borrowings that will occur in fiscal year 1987.

The Accounting and Auditing Act of 1950 vests in federal agency head the primary responsibility for establishing and maintaining adequate systems of accounting and internal control. These systems must confor to the Comptroller General's principles, standards, and related requirements. One of the Comptroller General's accounting standards prescribes the financial reporting that agencies follow in preparing and issuing financial statements. This standard, in part, requires financial statements to contain useful and complete data.

The Merchant Marine Act of 1936 (section 208), as amended, requires Marad to prepare an annual report covering, in part, its activities in administering federal maritime programs, including the title XI program. The report also contains financial statements and is sent to the President and the Congress and is available to the public.

Marad's 1985 statement of operations did not—in a footnote or otherwise—state that the fund was no longer self-supporting. Such a recogni tion is important because, for the first time, Marad received a supplemental appropriation for nearly $1.4 billion in fiscal year 1987 to cover expenses in fiscal years 1985 and 1986.

Further, Marad's 1986 annual report also does not state that the fund is not self-supporting.[3] It does indicate that expenses exceeded revenues by about $755 million and that Marad continued to borrow from the Treasury to cover default payments totaling over $1.2 billion. Marad's

[2] MARAD '85: The Annual Report of the Maritime Administration for Fiscal Year 1985, U.S. Department of Transportation, Maritime Administration (July 1986).

[3] MARAD '86: The Annual Report of the Maritime Administration for Fiscal Year 1986, U.S. Department of Transportation, Maritime Administration (June 1987).

1986 year-end financial statements to the Treasury Department showed similar amounts.

Moreover, Marad's budget documents for fiscal year 1987 and 1988 did not state that the fund is no longer self-supporting. (Budget documents are used to justify an agency's request for appropriations to perform its activities and operations.) Since the fund's expenses for fiscal year 1987 have already exceeded its projected revenues, Marad has continued its Treasury borrowings to pay off defaults. Marad estimates that it will borrow over $547 million in fiscal year 1987. We believe Marad will seek another supplemental appropriation to repay these borrowings.

The 1986 annual report and other documents should have stated that the fund is no longer self-supporting at least through fiscal year 1987. If this had been done, the Congress and other decisionmakers would have more useful and complete information on which to base policy decisions.

Economic Changes Affected Title XI Default Payments

The program's rapid expansion in the 1970s and its troubles in the 1980s were due largely to the shifting fortunes of two key industries—energy and agriculture.[4] The program's portfolio was less than $2 billion at the end of fiscal year 1973. It rose to a peak of more than $8 billion by the end of fiscal year 1982 and declined to about $5 billion by the end of fiscal year 1986.

Dramatic increases in oil prices in 1973-74 and 1978-79 led to a national effort to decrease U.S. dependence on imported energy sources. Part of this effort was program assistance for energy-related vessels, including domestic tankers and drill rigs. During the same period, a significant increase in agricultural product exports occurred that led to more requests for assistance to construct inland tugs and barges.

However, a sharp decline in oil prices in the 1980s has reduced the demand for drill rigs and other energy-related vessels. Similarly, agricultural exports have not been sustained at expected levels. Lower demand for vessels in both markets resulted in lower freight prices, reduced economic viability, and increased defaults. Marad reports project that several maritime segments will probably continue to experience depressed economic conditions through the remainder of this decade.

[4]This section is based primarily on the remarks of Garrett E. Brown, Jr., Acting Deputy Maritime Administrator, before the Subcommittee on Merchant Marine, House Committee on Merchant Marine and Fisheries, on June 25, 1985

Most Companies Judged at Risk Defaulted

We tracked the progress of 58 companies that Marad categorized as troubled as of November 1985.[5] These companies had a combined loan guarantee amount of over $1.6 billion. By January 1987, 39 of them (about 67 percent) had defaulted; their loan guarantee amounts were about $927 million. Marad paid these 39 companies' creditors an additional $61 million to cover interest, bringing the total payments to over $988 million.

A Portion of the Program's Portfolio Is Still Troubled

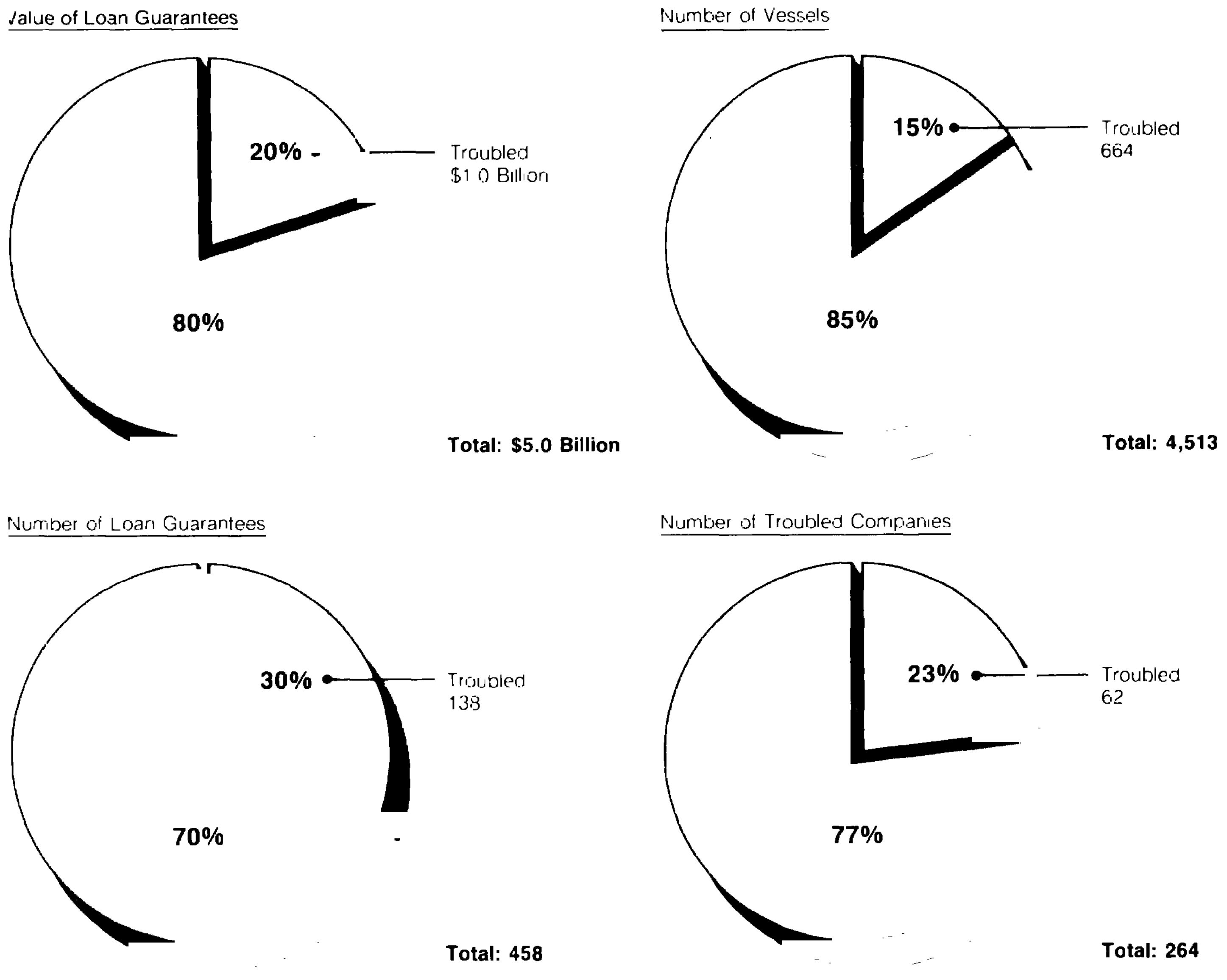
The increase in defaults in the last 2 fiscal years did not cleanse the program's portfolio of all troubled loans. Instead, 20 percent of the total loan guarantee amount of about $5 billion as of September 1986 (the end of fiscal year 1986) was still in danger of default, according to our analysis of Marad data. Our analysis also showed that the troubled portion included 30 percent of the loan guarantees, 15 percent of the vessels, and 23 percent of the companies. (See fig. 2.2.)

Despite the defaults in the 12 months after November 1985, the number of troubled companies as of December 1986 remained stable while the value of troubled loans declined. Of the 58 troubled companies as of November 1985, 39 defaulted and were removed from the list. However, 36 new companies were added during that period, yielding a list of 55 companies as of December 1986. The November 1985 list included 58 companies, with loan guarantee amounts totaling $1.6 billion; the December 1986 list included 55 companies, with loan guarantee amounts totaling over $954 million.

Marad officials said they had reviewed the entire portfolio to identify the complete troubled portion for November 1985 and December 1986. We did not verify the completeness of these lists because Marad officials said they had not documented the process they used that would allow us to independently verify the thoroughness of Marad's process and the reliability of its results. (Ch. 3 provides a more complete discussion of Marad's process for identifying and listing troubled companies.)

[5] When we began our review in December 1985, Marad provided an initial list of 44 companies troubled as of November 1985. The list was the latest available information on troubled companies, at the time we began our audit work, that was comparable to information on the total loan guarantee portfolio. This list was later expanded to 58 companies by adding 14 companies that should have been included on the initial list.

Figure 2.2: Troubled Loan Guarantees as a Portion of the Total, as of September 30, 1986



Conclusion

The Federal Ship Financing Fund is no longer self-supporting, a condition caused primarily by economic factors. Marad has not stated this in its annual reports' financial statements or other budget documents. Prior to fiscal year 1985, it paid expenses and repaid borrowed funds by generating its own revenues. The statement that the fund is no longer self-supporting is needed because in the past, Marad never repaid expenses of the fund with a congressional appropriation. Marad's financial documents will be more informative to the Congress and other decisionmakers when they are clearer and more complete.

Recommendation to the Secretary of Transportation

We recommend that the Secretary of Transportation direct Marad's Administrator to improve the financial information in Marad's annual report and budget documents by clearly stating that the fund is no longer self-supporting. This statement should continue to appear in future annual reports and budget documents until the fund's own revenues are sufficient to pay all expenses, including default payments, within the same fiscal year, and Treasury borrowings within the next fiscal year, without the aid of supplemental appropriations.

Agency Comments

In a draft of this report, we proposed that the condition of the fund be clearly and prominently displayed to decisionmakers. DOT responded that Marad's financial statements did disclose that the fund's fiscal year 1985 expenses exceeded revenues by over $250 million. Although we do not dispute this, we believe that Marad should state explicitly that the fund is no longer self-supporting in its annual report's financial statements and budget documents for two reasons. First, in previous years, Marad had borrowed from the Treasury to cover shortfalls in the fund when expenses exceeded revenues and had repaid these borrowings as required. However, unlike the previous borrowings, Marad was able to repay fiscal years 1985 and 1986 borrowings only with a supplemental appropriation because the fund did not generate income sufficient to pay expenses.

Second, we believe that Marad's statements and documents will be more informative if they state—in a footnote or otherwise—that the fund is no longer self-supporting. Simply disclosing that expenses have exceeded revenues and that Treasury borrowings have occurred does not inform the Congress and other users of Marad's financial statements that the fund is no longer a revolving fund (self-supporting) and will not be able to pay its expenses, including default payments, without borrowing from the Treasury. This condition was not stated in the fiscal year 1985 and 1986 annual reports, or in Marad's fiscal year 1987 or 1988 budget submissions.

As stated earlier in this chapter, Marad's own projections indicate that Treasury borrowings will continue through fiscal year 1987. The fund has unlimited borrowing authority with the Treasury; however, we believe revolving funds are intended to be generally self-supporting and should not be maintained with Treasury borrowings. Therefore, we have not withdrawn our recommendation.

Management Data Have Been Improved

The Federal Managers' Financial Integrity Act of 1982 requires federal agency managers to establish adequate internal control systems. These systems must conform to the Comptroller General's criteria. One criterion states that an agency must document its significant activities.

We found that Marad reported inconsistent data on the total value of outstanding loan guarantees and commitments[1] for fiscal year 1985. We also found that Marad has no complete list of companies at risk of default that includes statistical and profile data on each company. However, Marad has made improvements in these areas, and when it documents the process for deciding which companies are at risk of default and which loan guarantees it is likely to pay, we believe that the data will be more useful and complete.

Why Management Controls Are Needed

In 1983 the Comptroller General issued Standards for Internal Controls in the Federal Government to implement the Federal Managers' Financial Integrity Act. That issuance contains internal control standards to be followed by executive agency managers in establishing and maintaining systems of internal control. Internal controls are the plan of organization and methods and procedures adopted by managers of executive agencies to ensure that resource use is consistent with laws, regulations, and policies. Managers must also ensure that resources are safeguarded against waste, loss, and misuse and that useful and complete data are obtained, maintained, and fairly disclosed in reports.

One of the internal control standards is documentation, which requires, among other things, written evidence of all pertinent aspects of agency transactions and other significant activities. Federal agency managers must document transactions and other significant activities completely and accurately in order to facilitate tracing the transaction or event and related information from before it occurs until after it is completed.

[1] After initially approving an application for a loan guarantee, Marad issues a "commitment" to the applicant, which guarantees the obligation and states the requirements necessary for final approval Marad's commitment is generally based on the estimated cost of the vessel, while a loan guarantee is generally based on the actual cost of the vessel after final approval. A single commitment or guarantee can cover more than one vessel

Data on the Total Value of Loan Guarantees and Commitments Have Improved

In fiscal year 1985 Marad reported inconsistent data—sometimes containing significant disparities—in several documents on the number and value of outstanding loan guarantees and commitments and on other basic program data. These data are basic to program management and oversight.

The loan guarantee principal balances for the companies in Marad's portfolio are updated on the basis of information obtained from the companies and their investors. Commitments are then added to arrive at the total value of outstanding loan guarantees and commitments. The Office of Ship Financing publishes the updated information semiannually, at the end of March and September.

Useful and complete data on the portfolio are needed to provide managers with a basic framework for making decisions about program management and to provide assurances to the Congress and the public that managers know the magnitude of the program resources for which they are responsible and to help ensure that the agency's data are credible. Lack of consistency in program totals raises questions—first, about the accuracy of the company-specific figures that are summed up to yield totals and second, about the general credibility of the program's management and data.

We also identified other disparities in Marad's data on individual companies' outstanding loan guarantee amounts and in the number of vessels for which a guarantee had been made. However, the examples below relate only to disparities in the figures represented as the program's total outstanding loan guarantee and commitment amounts in September 1985.

A financial statement, as of September 30, 1985, was prepared by Marad's accounting office and sent to the Treasury Department. This statement contained a schedule that represented the program's total outstanding loan guarantee and commitment amounts as $6.7 billion; a report for the same date prepared by Marad program officials for internal use represented these amounts as $6.5 billion. Another report, prepared by Marad program officials for the Marad Administrator in September 1985, reflected a balance of $6.9 billion for the program's total outstanding loan guarantees and commitments. This figure was identical to one that was represented as current in June 1985 and appeared in Marad's testimony before the House Subcommittee on Merchant Marine. Marad officials told us in June 1986 that the $6.9-billion balance was actually current as of the end of March 1985.

We asked Marad officials in June 1986 to account for these differences. They attributed them to such factors as omitting qualifying explanations or footnotes from financial statements and incorrectly reporting how current the information was. In April 1987 Marad officials said that all future reports and presentations will include qualifying explanations and footnotes as appropriate. We reviewed Marad's fiscal year 1986 documents and testimonies and noted that the total value of outstanding loan guarantees and commitments is consistent throughout.

Marad Is Developing a Complete List of Troubled Companies

Marad now is compiling a current, complete list of troubled companies. Such data are basic to program management and oversight. However, in order to ensure that the list is credible and complete, Marad needs to document the process used to decide which companies are troubled.

According to Marad officials, they periodically review the financial situation of every company with a loan guarantee to determine whether the company is likely to have difficulty making its loan repayments. Loan examiners have been told to consider such factors as whether a company's financial statements reflect a negative cash flow, whether a downturn has occurred in the market in which the company's vessel operates, and whether the company has had problems in the past making loan repayments.

When the loan examiners determine that a company is likely to have difficulty making its payments because of these factors, Marad classifies the company as troubled and places it on a "credit watch" report.[2] Marad established this report in 1983 because of an increase in defaults; and according to officials, it is usually prepared monthly as a management information and tracking tool to monitor the troubled companies and their progress in overcoming their financial difficulties.

When we began our work, we obtained from Marad the November 1985 credit watch report, which listed 44 companies with aggregate loan guarantee principal balances of over $939 million for 756 vessels. We were told initially that this was a complete listing of troubled companies. However, we later learned that the report omitted certain companies.

[2]We did not review the adequacy of Marad's criteria for identifying a troubled company or the procedures by which the list of troubled companies was compiled

At our request, the Marad program office identified another 14 companies that met Marad's criteria as being troubled. Through a review of other Marad documents, we found that these additional companies had loan guarantee principal balances totaling about $700 million for 1,631 vessels. The 14 companies, according to Marad officials, had not been included in the report because their identity and financial distress were assumed to be "common knowledge" within Marad.

Thus, the initial November 1985 list was not complete as of that date and the omissions were significant. Relative to the updated list that was prepared at our request, the companies that were not initially listed represented

- 24 percent (14) of the 58 companies identified as troubled,
- 68 percent (1,631) of the 2,387 vessels associated with troubled companies, and
- 43 percent ($700 million) of $1.6 billion in loan guarantee principal balances considered troubled.

When we asked Marad officials why they did not routinely compile complete data on troubled companies, they told us they were satisfied to rely on their staff to provide data as needed. They also said that program managers were aware that no complete list of troubled companies existed, and therefore this would not hinder Marad in managing the program.

The Deputy Associate Administrator for Maritime Aids, in January 1987, agreed that a complete listing of troubled companies had not been prepared but said that Marad would prepare the list. We asked him to prepare a listing of troubled companies as of September 30, 1986, for us to compare the troubled portion to the total value of Marad's loan guarantee portfolio for the same date. We also asked for the troubled portion as of December 31, 1986, which was the date of the latest credit watch report.

He provided these lists and stated that in preparing them, Marad officials had reviewed the status of every company and its loan guarantees to assess whether they could potentially become troubled. In addition, he said the officials discussed the current status of each company with loan examiners and other Marad officials. However, he told us that Marad had not documented how the lists had been prepared. Consequently, we were unable to verify whether and how the entire portfolio had been reviewed.

In our opinion, Marad will have better assurance that the list is credible and complete once loan examiners document the process for deciding which companies are troubled. Documentation is important for several reasons. It helps managers control their operations by providing assurance that processes were properly followed and that the processes and their results are recorded. Documentation also helps assure interested parties outside the organization that agency decisions were soundly based and agency data are useful and complete. In addition, documentation provides internal and external auditors with a basis for independent verification of the agency's processes and results. (We also used this criteria in ch. 4 when we discuss the need for Marad to document its process for estimating potential default payments.)

The list of troubled companies should include not only the names of the troubled companies but also the principal balances, loan guarantees that are in danger of default, number of vessels, and other pertinent data needed to present a clear picture of the companies' circumstances.

Conclusion

Federal managers must ensure that useful and complete data are obtained, maintained, and fairly disclosed in reports in accordance with the Comptroller General's criteria for internal controls. Marad now has prepared and disseminated consistent figures on the total value of loan guarantees and commitments for fiscal year 1986. In addition, Marad is preparing a complete list of companies at risk of default. However, Marad has not documented the process it used to prepare the list. Without this documentation, Marad has no assurance that the list is credible and complete. The documentation should include the names of each troubled company, its circumstances, and other pertinent information.

Recommendation to the Secretary of Transportation

We recommend that the Secretary of Transportation direct Marad's Administrator to document Marad's process for compiling a list of companies that are considered to be at risk of default to ensure that each company's circumstances are reviewed thoroughly and consistently.

Agency Comments

In a draft of this report, we proposed that the Secretary of Transportation direct Marad's Administrator to compile useful and complete data on the total value of outstanding loan guarantees and commitments. We also proposed that the Administrator compile useful and complete data on the portion of the loan guarantee portfolio that is considered to be at risk of default.

In its comments, DOT said that Marad does have accurate information on its loan portfolio. DOT also said that the two documents we discussed, covering the total value of outstanding loan guarantees and commitments for the same period, had been prepared for different purposes and therefore did not display the same information. We disagree that this explains the difference in data. The 1985 financial statement we obtained from Marad's accounting office contained a schedule that had a total figure for outstanding loan guarantees and commitments without an explanation or footnote on the schedule as to what composed the total. This figure differed by $200 million from a report showing the total value of outstanding loan guarantees and commitments for the same date used by the program office handling title XI loan guarantees.

Further, the figures Marad prepared for these documents as well as others dated September 1985 for the total value of its loan portfolio differed by as much as $400 million. Regardless of the purpose of the reports or presentations, Marad officials should either report consistent data or properly characterize the data to avoid the confusion that may result if different figures are reported for the total amount of the portfolio. In its comments, DOT conceded that the presentations made for the Administrator and the congressional committee should have indicated the correct reporting period.

With regard to accuracy, 14 of the 44 companies whose loan guarantee principal balances, which are part of the total portfolio, varied in amounts ranging from $35,000 to over $6 million in the reviewed program reports for the September 1985 period. Variances also occurred in the number of vessels for several companies. We did not compare all of the over 300 companies' loan balances and the number of vessels that comprised the portfolio at that time, so we could not determine the amount of variance in the entire portfolio that may exist when different reports are used.

We believe that DOT and Marad have recognized the need for consistency because DOT also stated in its comments that although Marad presentations in general do contain adequate explanations, all future reports and presentations will include qualifying explanations and footnotes as appropriate. We reviewed Marad's fiscal year 1986 year-end documents and certain other related documents and noted that the total value of outstanding loan guarantees and commitments is consistent throughout.

(We did not review the loan balances and number of vessels for individual companies.)

DOT also commented that although a single list of troubled companies does not exist, Marad program officials had updated information on all troubled companies. We believe that a single complete list of troubled companies, with pertinent statistical information on each company's circumstances as described earlier in this chapter, would be more useful to Marad and DOT managers than several reports and documents in presenting a complete picture of the number and value of such companies.

Again, DOT and Marad officials said they recognize this need. DOT stated that a single report specifically addressing all troubled companies may be a useful mechanism for consolidating information for management and that Marad is in the process of reestablishing procedures to produce a single complete list of troubled companies. We believe that when Marad has established this list with appropriate statistical information on each troubled company, our proposal will be properly implemented. Because of DOT's active commitment to improve this area, we are not making a recommendation at this time.

However, because Marad did not document its process for compiling the lists of troubled companies, we could not verify the process for compiling them. Therefore, we have included a recommendation to address this. We discussed this recommendation with the Deputy Associate Administrator for Maritime Aids, who generally agreed with it.

ımprovements in the Fund's Financial Reports

Good financial management is dependent on strong systems, including accounting systems that contain useful financial information. Financial information is useful when, among other things, it is timely, relevant, reliable, cost beneficial, comparable, and consistent. Heads of executive agencies are required by the Federal Managers' Financial Integrity Act of 1982 to maintain adequate systems of accounting and internal control suited to the needs of their agencies and conforming to principles, standards, and related requirements prescribed by the Comptroller General. They are also required to report annually to the President and the Congress on their accounting systems' conformance or nonconformance with the Comptroller General's criteria. The report should include areas of nonconformance and the agencies' plans to correct the nonconformance.

The Federal Ship Financing Fund's fiscal year 1985 statement of financial condition in Marad's 1985 annual report of operations did not recognize future potential losses on outstanding loan guarantees and therefore is not in compliance with a Comptroller General standard. Marad also substantially underestimated default payments for fiscal year 1986. In addition, the problems discussed in the previous chapters—such as Marad's financial statements' not stating that the fund is no longer self-supporting, reporting inconsistent totals for the value of the loan portfolio, and not having a complete list of troubled companies—resulted in Marad's financial reports being less useful and complete than they could have been.

Marad has taken or planned corrective action for nearly all of the problems we identified. Marad's Administrator should report to the Secretary of Transportation any areas uncorrected at the end of this calendar year together with planned corrective actions. In this way, the Secretary will be better able to determine whether the remaining problems stem from internal control or accounting system weaknesses and, as appropriate, report them to the President and the Congress as required by law and ensure that necessary corrective actions are taken.

Marad Has Taken Steps to Improve Its Financial and Budget Data

Marad compiles various financial and budgetary data on the title XI program and disseminates them in different formats to several organizations and the public. The data include some similar elements relating to the program's current and expected financial situation. Of particular interest to us were the data, in both financial statements and budget documents, on possible default payments.

Marad prepares two types of financial statements at the end of each fiscal year. One type is required by the Treasury Department and the other is for Marad's annual report on its operations. Although we reviewed both types of statements, we concentrated our efforts on the annual report statement because it has a wider distribution, including the President and the Congress. The statement of financial condition in Marad's 1985 annual report did not include a liability to pay off expected defaults on loan guarantees. If Marad had established such a liability, it would have been in a better position to prepare realistic budget estimates. A report by the Inspector General also identified a weakness in Marad's financial reports.

In addition, Marad substantially underestimated the outlays needed to pay off defaulted loan guarantees in fiscal year 1986. Because of these underestimates, congressional and administration decisionmakers were not provided with useful and complete budget data for fiscal year 1986. Marad has taken steps to resolve this problem in fiscal year 1987.

Marad Established a Liability for Potential Loan Losses in 1987

Prior to fiscal year 1987, Marad officials did not establish a liability for yearly losses similar to that of other private financial institutions and government activities, as discussed earlier in this chapter. Instead, they compiled a quarterly figure for the amount they expected to pay off in defaults for companies whose investors notified Marad that defaults had already occurred.

Marad published in the budgets of the U.S. government the following default payment estimates for fiscal year 1986:

- in February 1985 (fiscal year 1986 federal budget) the estimate was $92 million and
- in February 1986 (fiscal year 1987 federal budget) the revised estimate was $500 million.

Actual default payments for fiscal year 1986 were over $1.2 billion.

The Accounting and Auditing Act of 1950 states that agency accounting systems must conform to the principles, standards, and related requirements prescribed by the Comptroller General. These are specified in the General Accounting Office's Policy and Procedures Manual for Guidance of Federal Agencies. Two of the main objectives of accounting standards are to (1) provide useful information to decide among alternative uses of resources and (2) determine whether resource allocation decisions implemented by agency management are proper and congressional intent has been met.

Among the standards is the requirement that probable losses on guarantees, loans, and other assets be recognized in accounting statements if the amount can be reasonably estimated. This principle is well established for private financial institutions and applies equally to government activities such as the fund. We have noted the omission of a liability for future loan losses in connection with other organizations, including the Export-Import Bank and the Federal Savings and Loan Insurance Corporation.[1]

We testified in June 1985 that, in reviewing the fund's financial statements, a liability and related expense had not been recognized for estimable and probable losses on outstanding loan guarantees.[2] The liability was not included in Marad's 1985 annual report on its operations dated July 1986. We discussed this with officials in Marad's Office of Accounting in July 1986, who told us that Marad could not reasonably estimate a liability for potential future yearly losses on outstanding loan guarantees. Therefore, they said, in accordance with generally accepted accounting standards, the liability need not be included in the annual report's statement of financial condition.

We disagreed that such a liability could not be reasonably estimated and prepared an estimate for the fund, which was included in our September 1986 report on the fiscal year 1987 budget reductions.[3] We developed this estimate for illustrative purposes only, to demonstrate that an estimate could be reasonably determined. Our approach for making this

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[1] With respect to the Export-Import Bank, see The Export-Import Bank of the U.S. Financial Condition and Budget Issues (GAO, T-AFMD-87-15, May 21, 1987) statement of Frederick D. Wolf, Director, Accounting and Financial Management Division, before the Subcommittee on International Finance, Trade and Monetary Policy, House Committee on Banking, Finance and Urban Affairs. With respect to the Federal Savings and Loan Insurance Corporation, see Financial Audit: Federal Savings and Loan Insurance Corporation's 1985 and 1984 Financial Statements (GAO, AFMD-86-65, July 2, 1986). In 1985, for the first time, the Corporation began estimating potential losses attributable to troubled savings and loan institutions.

[2] Financial Aspects of the Maritime Administration's Title XI Federal Ship Financing Fund, statement of Dennis J. Duquette, GAO, before the Subcommittee on Merchant Marine, House Committee on Merchant Marine and Fisheries, June 25, 1985. We performed a limited review of the fund's financial aspects in preparation for the hearing. We did not audit the fund's financial statements for either the testimony or this report.

[3] Budget Reductions for FY 87: Review of Initial OMB/CBO Report Under the Deficit Control Act (GAO, OCG-86-4, Sept. 4, 1986), p. 17. This report reviewed the estimates to reduce the federal deficit prepared by the Office of Management and Budget and the Congressional Budget Office to implement requirements of the Balanced Budget and Emergency Deficit Control Act of 1985.

estimate involved judgment, just as determining a liability for loan guarantees, a common practice of financial institutions, is rarely subject to precise measurement. Whenever practical, estimates of future defaults should consider the wide range of developments affecting both individual vessels and the markets in which they operate. A measure that compresses all these factors into one value is the default rate.

Before preparing our illustrative estimate, we asked Marad officials if they expected the default rate to change in fiscal year 1987. They stated that they expected the default rate to be somewhat lower than it was in 1986, but not dramatically lower. However, they did not explain why the default rate would be lower except to state that the 1986 default payments had removed most of the weaker companies, such as those that had had to operate in depressed markets with newer, high-cost equipment.

Using Marad's overall expectations of what would occur in fiscal year 1987, we arrived at a default rate of nearly 67 percent. This was approximately the rate at which companies classified as troubled defaulted in 1986. This default rate was then applied to the number of companies classified as troubled at the beginning of fiscal year 1987. The value of outstanding loan guarantees held by all of these companies was approximately $777 million. We estimated that nearly $524 million of these loans would default by the end of fiscal year 1987.

Later, in January 1987, Marad officials said they agreed that an estimate could be prepared, and they developed a liability for potential default payments for fiscal year 1987—$600 million. This estimate appears in the fiscal year 1988 budget of the U.S. government. A liability for fiscal year 1987 also appears in a footnote to the statement of financial condition in Marad's 1986 annual report, which was issued in June 1987.

Marad officials said that to prepare their estimate, they analyzed different companies and segments of the maritime industry and considered a wide range of variables. We agree that this approach should yield a more realistic estimate of potential default payments than simply projecting 1 year's experience into the future. We believe Marad has taken positive steps to prepare more realistic estimates starting in fiscal year 1987. However, we did not evaluate its methodology because Marad officials said that the process for preparing the liability had not been documented.

As discussed in chapter 3, documentation is important for several reasons, including helping managers control their operations, assuring interested parties outside the organization that agency decisions were soundly based, and providing internal and external auditors with a basis for independent verification of the agency's processes and results.

An Inspector General Report Found a Weakness in Marad's Financial Reporting

In its September 1986 report, the Inspector General's office also identified a weakness in Marad's financial reporting. The report found that Marad carried all of its $106 million in loans (advances) to troubled companies as assets when only 50 percent of the advances were likely to be collected.[4] The report also stated that since the fund will probably never repay the Treasury, Marad should not continue to list all of the advances as collectible because such a decision could affect budgetary decisions.

The report recommended that Marad annually project fund revenues and expenses and request appropriations for any anticipated shortfalls. In commenting on the final report, Marad said it would work "with the appropriate budget officials in the Department of Transportation to resolve this situation in a manner that is in the best interest of the Department."

Conclusion

Marad has taken or is in the process of taking action to correct nearly all of the financial and accounting reporting problems identified in this report. For example, Marad has established an estimate of $600 million for a liability for potential future losses on outstanding loan guarantees. It also is planning to make more realistic forecasts of anticipated default activity. Marad still needs to document the process it uses for establishing the liability estimate as well as for estimating potential future default activity. As noted in chapter 2, Marad also should ensure that its financial reports disclose that the fund is no longer self-supporting.

The actions taken or planned by Marad should result in its financial reports being more useful and complete than they have been in recent years. To the extent problem areas identified in this report remain uncorrected at the end of this calendar year, Marad should report these

[4] Marad can help financially troubled companies by making loans for such things as debt service payments. Marad makes loans to shipowners in financial trouble to help overcome a temporary negative cash flow. These loans are usually scheduled to be repaid within 2 years.

areas to the Secretary of Transportation to help facilitate DOT's compliance with the Federal Managers' Financial Integrity Act of 1982.

Recommendation to the Secretary of Transportation

We recommend that the Secretary of Transportation direct Marad's Administrator to document the process used to estimate Marad's liability for potential future losses on outstanding loan guarantees. Documentation should include a description of how each company's circumstances and market segment were considered in preparing the estimate.

Recommendation to the Maritime Administrator

We recommend that the Maritime Administrator report at the end of this calendar year to the Secretary of Transportation on those financial reporting areas identified in this report where corrective action has not been taken, including any areas in Marad's accounting system that do not conform with the Comptroller General's principles, standards, and related requirements.

Agency Comments

In our draft, we proposed that the Secretary of Transportation direct Marad's Administrator to establish a liability for potential future losses on outstanding loan guarantees. We also proposed that the Secretary of Transportation direct Marad's Administrator to prepare yearly estimates of potential future default payments.

In its comments, DOT said that it had established a liability for fiscal year 1987 and footnoted the amount of the liability in Marad's fiscal year 1986 financial statements, as we had proposed. We believe that with this action, Marad has been responsive to our proposal. Marad officials told us they had prepared this estimate by reviewing the entire portfolio and discussing each company with loan examiners and other Marad officials, but they had not documented the process they used. Since the process was not documented, it was not feasible to evaluate the soundness of the estimate. In addition, Marad could not ensure that the process had been followed in all instances. We therefore recommend that Marad document the process used for making its estimates. Marad officials told us they will take steps to ensure that the process is adequately documented in the future.

Our draft report used Marad's recent default experience and overall expectations of whether the fiscal year 1986 default rate would carry over into fiscal year 1987 to illustrate one technique for forecasting potential defaults. DOT may have misunderstood our intentions for including this in our draft report. We did not intend to imply that this was the only technique for making such estimates or even that it was preferable to a range of other available approaches. Our points were that Marad could and should develop potential future default estimates and that techniques were available for doing so. In fact, it is a common practice in the commercial and private sector.

Although they initially contended that a reasonable estimate of future defaults could not be made, in January 1987 Marad officials agreed that a reasonable estimate could be prepared and said they had developed a methodology (described earlier in this chapter) for analyzing different companies and segments of the maritime industry. We believe DOT's description of how estimates are now being prepared is both reasonable and responsive to our recommendation. However, to ensure that Marad's methodology for making estimates of potential future defaults is adhered to and can be monitored by management, we recommend that the estimating process be documented

Our draft report also contained a chapter discussing the Federal Managers' Financial Integrity Act of 1982 and how it appeared to relate to the various financial reporting and accounting information problems identified in the report. The chapter proposed that the problems be classified as material weaknesses and reported in the Secretary's annual statement on internal controls to the President and the Congress. After considering DOT's comments and its response to our report, we determined that the chapter and proposal are unnecessary and have deleted them for the following reasons.

First, after reviewing our draft report, Marad has initiated or completed the following actions:

- Marad officials plan to include qualifying explanations and footnotes as appropriate when depicting the total value of outstanding loan guarantees and commitments in all future reports and presentations.
- In its comments, DOT stated that a single report specifically addressing all companies at risk of default may be a useful mechanism for consolidating information for management and that Marad is in the process of establishing procedures to produce a single complete list of companies at risk of default.
- Marad has established a liability for potential future losses on outstanding loan guarantees.

- Marad officials described a methodology they developed that considers factors necessary to prepare estimates of potential future default payments.

As our conclusions in this chapter indicate, Marad still needs to document its estimating process and include a statement in its financial reports clearly noting that the fund is no longer self-supporting. These actions, together with those already taken or planned, will result in Marad's financial and related reports being more useful and complete than they have been in recent years.

Second, several of the problems we identified, such as Marad's not establishing a liability for potential future defaults, relate to the conformance or nonconformance of Marad's accounting system with the Comptroller General's criteria for such systems. Problems of this type should be reported as part of the Secretary's annual report on DOT's accounting systems, regardless of whether the problems can also be cor sidered internal control weaknesses. To the extent the areas of nonconformance are corrected—as is the case with the liability for potential future defaults—they need not be reported.

And, finally, DOT correctly pointed out that most of the problems identified by our review involve financial or accounting reporting problems and that these problems did not cause the financial difficulties currentl facing the fund or the adverse publicity the fund has experienced. Nevertheless, we consider the reporting problems significant in that they have a direct bearing on the financial information available to provide necessary oversight and management of the fund. The reporting problems also may themselves be manifestations of systemic internal contro or accounting system weaknesses. Although it was not within the scope of our review to examine the overall adequacy of Marad's process for annually identifying internal control and accounting system weaknesse and strengths, Marad's annual evaluations' inability to identify these financial information and reporting problems is cause for concern.

In view of the significant progress Marad has made in taking corrective action, Marad's most constructive approach would be to report to the Secretary, at the end of this calendar year, the remaining uncorrected areas with a plan for correcting each area. In this way, the Secretary will be in a position to determine whether the remaining problems stem from internal control or accounting systems weaknesses and, as appropriate, report them to the President and the Congress as required by law. In addition, Marad may find it beneficial to examine the adequacy of the processes it has in place for identifying problems with its internal control, accounting, and related systems.

Comments From the Department of Transportation

Note. GAO comments supplementing those in the report text appear at the end of this appendix

U.S. Department of Transportation

Assistant Secretary for Administration

400 Seventh St. S.W. Washington, D.C. 20590

APR 7 1987

Mr. J. Dexter Peach
Assistant Comptroller General
Resources, Community and Economic
Development Division
U.S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Peach:

Enclosed are two copies of the Department of Transportation's comments concerning the U.S. General Accounting Office draft report entitled, "The Federal Ship Financing Fund Is Insolvent."

Thank you for the opportunity to review this report. If you have any questions concerning our reply, please call Bill Wood on 366-5145.

Sincerely,

Jon H. Seymour

Jon H. Seymour

Enclosures

Enclosure

DEPARTMENT OF TRANSPORTATION REPLY

TO

GAO DRAFT REPORT

I. TITLE: Maritime Administration: The Federal Ship Financing Fund is Insolvent. Report No. GAO/RCED-87-58.

II. SUMMARY OF GAO FINDINGS AND RECOMMENDATIONS:

A. Loan Portfolio and Status of Federal Ship Financing Fund

See comment 1

GAO found that about one-quarter of the value of the loan portfolio as of March 1986 was troubled, 28 percent of loan guarantees were troubled, 37 percent of the vessels covered were troubled, and 22 percent of the companies with a loan guarantee were troubled.

See comment 2

GAO also found that the Fund's expenses exceeded its revenues. The Fund had a surplus of about $63 million in FY 1982, but had a deficit of $250 million by the end of FY 1985. In FY 1986, default payments reached $1.2 billion by July 1986.

B. Program Data

GAO concluded that MARAD could not readily provide accurate data on the total value of outstanding loan guarantees and commitments, and that MARAD did not have a complete list of troubled companies. GAO found that the data provided to them by MARAD on outstanding loan guarantees and commitments were inconsistent. Also, GAO initially reviewed data provided by MARAD on 44 troubled companies as of November 1985, but subsequently found that 14 additional companies were also troubled at that time and should have been on the original list.

GAO recommended that the Secretary of Transportation direct the Maritime Administrator to compile reliable data on the total value of outstanding loan guarantees and commitments and the portion of the loan guarantee portfolio that is considered to be troubled.

C. Accounting Documents/Financial Statements and Default Estimates

See comment 3

GAO found that MARAD's financial statements and other documents did not disclose that for FY 1985 the Fund's expenses exceeded revenues and, therefore, that the Fund was not self-sufficient. GAO also concluded that MARAD violated a Comptroller General accounting standard to establish a liability for expected payments for defaults on its outstanding loan guarantees.

GAO considered that MARAD's estimates of FY 1986 defaults, as shown in the proposed federal budgets for FY 1986 and FY 1987, were significantly underestimated. MARAD estimated in February 1985 that FY 1986 defaults would be $92 million; in February 1986, MARAD estimated that FY 1986 defaults would be $500 million. However, FY 1986 default payoffs were about $1.2 billion through July 1986, with MARAD estimating another $200 million during the balance of the fiscal year.

See comment 4.

GAO believes that MARAD's original estimate of $100 million in default payoffs for FY 1987 is significantly low. GAO concluded that a more realistic estimate, based upon the Fund's recent experience, would have predicted defaults in FY 1987 more than five times MARAD's estimate.

See comment 5.

GAO recommended that the Secretary of Transportation direct the Maritime Administrator to improve MARAD's financial and budget data by (1) clearly and prominently displaying the Fund's financial condition to decision-makers, (2) establishing a liability for potential future yearly losses on outstanding loan guarantees, and (3) preparing budget estimates that are based on MARAD's most recent experience with default payoffs.

See comment 6.

D. <u>Administrative and Accounting Systems</u>

See comment 7.

GAO found that the internal control weaknesses discussed in their draft report are material and warrant their inclusion in the Secretary of Transportation's 1986 annual statement under the requirements of the Federal Manager's Financial Integrity Act of 1982.

GAO recommended that the Secretary of Transportation include the material weaknesses identified in MARAD's Federal Ship Financing Guarantee Program in her 1986 annual statement on internal controls to the President and the Congress. The weaknesses should be reported in future years until the Secretary determines that the corrective actions taken are sufficient to preclude further inclusion.

III. SUMMARY OF DEPARTMENT OF TRANSPORTATION POSITION:

A. Loan Portfolio and Status of Federal Ship Financing Fund

The Department agrees that a significant proportion of the Federal Ship Financing Guarantee (Title XI) program loan portfolio is troubled. We also agree with the fact that revenues to the Federal Ship Financing Fund are currently not sufficient to cover all expenses including defaults. These specific problems, as well as others, are currently being addressed by an Office of Management and Budget, Department of the Treasury, Office of the Secretary, and MARAD Task Force. This Task Force is analyzing the problems and determining alternative solutions.

See comment 8

B. Program Data

The Department disagrees with GAO's conclusions for the following reasons:

1. Two different financial reports covering the same period were prepared for different purposes, and therefore did not display the same information.

2. Although a single list of troubled companies did not exist, program officials had updated information on all troubled companies.

C. Accounting Documents/Financial Statements and Default Estimates

The Department does not agree with some of the GAO conclusions for the following reasons:

See comment 3

1. MARAD's FY 1985 financial statements for the Title XI program reported that expenses exceeded revenues by $250,826,636.

See comment 7

2. MARAD received and implemented GAO guidance to disclose the contingent liability with a footnote to the FY 1986 financial statements.

See comment 9

3. The Inspector General's report was not critical of MARAD's accounting for receivables or Allowance for Losses.

See comment 10

The Department agrees with GAO that our budget submissions underestimated likely defaults, but the report should reflect that these estimates were made 8-20 months before completion of the period during which the defaults occurred. The Department does not agree

See comment 7.

with GAO's proposed method for estimating future defaults, for it relies solely on historical data and does not consider future economic conditions.

See comment 7

D. Administrative and Accounting Systems

The Department does not agree with GAO's conclusions that material weaknesses exist in MARAD's administrative and accounting systems for the following reasons:

1. As earlier noted, GAO compared two different financial reports for the same period that were prepared for different reporting purposes.

2. Program officials had information on all troubled companies, even though one single listing did not exist.

3. As noted earlier, the Fund's financial statements clearly disclosed that expenses exceeded revenues.

4. MARAD followed GAO's guidance by disclosing the contingent liability with a footnote to the FY 1986 financial statements.

IV. DEPARTMENT OF TRANSPORTATION POSITION STATEMENT:

A. Loan Portfolio and Status of Federal Ship Financing Fund

1. GAO found that about one-quarter of the value of the loan portfolio as of March 1986 was troubled, 28 percent of loan guarantees were troubled, 37 percent of the vessels covered were troubled, and 22 percent of the companies with a loan guarantee were troubled.

GAO also found that the Fund's expenses exceeded its revenues. The Fund had a surplus of about $63 million in FY 1982, but had a deficit of $250 million by the end of FY 1985. In FY 1986, default payments reached $1.2 billion by July 1986.

2. The Department agrees that there are problems. These specific problems, as well as others, are currently being addressed by an Office of Management and Budget, Department of the Treasury, Office of the Secretary, and MARAD Task Force. This Task Force is analyzing the problems and determining alternative solutions.

The Department does not dispute that a significant proportion of the Federal Ship Financing Guarantee program portfolio is troubled, no matter what measure is used. As the GAO draft report states, defaults have increased over the past three years, largely because of economic conditions, including (1) a worldwide shipping recession, (2) a reduced demand in domestic waterborne shipping reflecting significant shifts in international trade, and (3) a downturn in the energy industry (not just the offshore drilling industry, as stated on page 16 of the draft report).

See comment 11

The Department also does not dispute the statement that revenues to the Federal Ship Financing Fund are not presently sufficient to cover defaults. The statement does reflect the status of program cash flow. However, revenues to the Fund are sufficient to cover administrative and custodial expenses. Revenues are not sufficient to cover default payments, and as authorized by statute, MARAD has borrowed from the U.S. Treasury to fund default payoffs. MARAD has made all required payments on the Treasury borrowings. Therefore, rather than use the words insolvent or insolvency throughout the draft report, we suggest more accurate wording such as "presently operating at a deficit." It should also be pointed out that the current problem facing the Fund may well prove to be temporary. The proposed supplemental appropriation and recoveries from sales of defaulted vessels could eliminate the problem.

See comment 12

In order to clarify program history in the report, we believe the several references to the 15-year history of guaranteeing loans should be revised to make it clear that the Title XI program has been in operation for close to 40 years. The program was authorized in 1938, with the first transactions made in the 1950's. Under the Federal Ship Financing Act of 1972, the program was amended so that, rather than insuring a loan or mortgage agreement, the United States now directly guarantees the payment of principal and interest on obligations.

B. Program Data

1. GAO concluded that MARAD could not readily provide accurate data on the total value of outstanding loan guarantees and commitments, and that MARAD did not have a complete list of troubled companies. GAO found that the data provided to them by MARAD on outstanding loan guarantees and commitments were inconsistent. Also, GAO initially reviewed data provided by MARAD on 44 troubled companies as of November 1985, but subsequently found that 14 additional companies were also troubled at that time and should have been on the original list.

   GAO recommended that the Secretary of Transportation direct the Maritime Administrator to compile reliable data on the total value of outstanding loan guarantees and commitments and the portion of the loan guarantee portfolio that is considered to be troubled.

See comment 8

Now on p. 21

2. The Department does not agree that MARAD could not readily provide accurate data on the total value of outstanding loan guarantees and commitments. MARAD does have accurate information on its loan portfolio. Reports are prepared monthly identifying the amount of the outstanding loan balance and commitments. The updating of this monthly report is not as stated in the first full paragraph on page 24, and should be reworded as follows: "The outstanding loan balance for each contract is updated as information is received by MARAD's Office of Accounting from Indenture Trustees. This Office then compiles monthly reports of loan balances and commitments. The Office of Ship Financing used these monthly reports

to prepare semiannual reports at the end of March and September on the total value of outstanding loan guarantees and commitments."

The evidence used by GAO to support its contention that MARAD could not readily provide accurate data on the total value of outstanding loan guarantees and commitments is based on information contained in MARAD financial statements, reports, and

ɔw on p 21

testimony prepared for the period between March and September of 1985. On page 24, lines 19-22, the $0.2 billion difference between the two reports of September 30, 1985, is essentially the estimated amount of accrued interest (approximately $186 million) that was clearly included as a separate entry in the report to Treasury (as required by GAO accounting principles and standards, and Treasury reporting requirements) but not included in the semiannual program report (where accruals are not required) of outstanding principal balances for

low on p 21

contracts in force. The presentations of September 20, 1985, and June 25, 1985, discussed on pages 24-25, clearly should have indicated that the $6.9 billion represented the total of guarantees and commitments as of March 31, 1985, as it appeared in the most recent semiannual report. In general, MARAD presentations do contain adequate explanations. However, to avoid any possible confusion, all future reports and presentations will include qualifying explanations and footnotes as appropriate.

See comment 13

While MARAD did not provide a single complete list of troubled companies, information on all companies considered to be troubled is readily available. MARAD prepares a complete risk analysis of its portfolio periodically, with a three-part numerical ranking system based on whether the risk of default is considered minimal, moderate, or high. Additionally, MARAD prepares a monthly Credit Watch report for senior Agency officials. Copies of this report are/have been provided to the Office of the Secretary of Transportation. The list of troubled companies in the monthly Credit Watch report, a copy of which was provided to GAO, was never intended to be a comprehensive listing of all troubled companies. This report is limited to detailed information and status reports on troubled companies with payments currently due. Liner companies are generally excluded from the Credit Watch report, as are other companies which do not have payments due but which show signs of problems. Information on these latter companies is available from special reports prepared separately by MARAD as developments warrant. A single report specifically addressing all troubled companies may be a useful mechanism for consolidating information for management. However, the risk analysis, the detailed individual company analyses and the Credit Watch report do make information on all troubled companies available to senior management officials. Nevertheless, MARAD is in the process of reestablishing procedures to produce a single complete list of troubled companies to address GAO's concern.

In specific reference to the November 1985 period cited in the GAO draft report, MARAD considered 58 companies to be troubled. Of these companies, 44 were included in the Credit Watch report with information on the remaining 14 being provided to senior officials in separate reports and analyses prepared by MARAD staff.

See comment 14

Now on p. 23

The statement in the last sentence on page 21 of the draft report that MARAD had not analyzed the entire loan guarantee portfolio to determine whether the lists of troubled companies contained all the troubled companies as of the dates in question is not correct. MARAD did and currently does analyze the entire portfolio in determining which companies are troubled.

See comment 8

The Department believes the GAO recommendation concerning compilation of reliable data is unwarranted. MARAD has always and will continue to compile reliable data on the individual and total value of outstanding loan guarantees and commitments and the portion of the loan guarantee portfolio that is considered to be troubled. MARAD is eliminating duplication in reports that contain data regarding the total value of guarantees and commitments. As noted above, MARAD also is reestablishing procedures to produce a single complete list of troubled companies. An automated system previously developed by MARAD is being modified and will have the capability to produce such a single list. These measures should insure that complete information is clearly presented in external and internal reports and in testimony and should mitigate potential misunderstandings.

C. Accounting Documents/Financial Statements and Default Estimates

e comment 3

1. Financial Statements Did Not Disclose Insolvency.

a. GAO found two problems with the fund's fiscal year 1985 annual statement of financial condition, one related to the fund's revenues and expenses, the other related to the fund's assets and liabilities. Specifically, GAO states that it was not shown that expenses exceeded revenues, and that this was not reflected in the statement of financial condition.

b. It is not known if GAO is criticizing MARAD in this section for (1) not establishing a liability, but instead using footnote disclosure, or (2) not showing that expenses (including defaults) exceeded revenues. If GAO believes an accrual is necessary, please see response 2b below. If GAO believes that the financial statements did not show that expenses (including defaults) exceeded revenues, we do not agree.

It should be understood that MARAD '85, the Annual Report of the Maritime Administration for Fiscal Year 1985, is a consolidated financial statement for all MARAD programs. Although it does not contain only Federal Ship Financing Fund financial information, it did disclose that the Fund's FY 1985 expenses exceeded revenues by $250,826,636 in the Statement of Operations on page 52.

The MARAD '85 also reported on page 51 that during FY 1985 MARAD borrowed $130 million from the U.S. Treasury to meet demands for payments due on defaults, another clear indication that the program is operating at a deficit.

The FY 1985 operating deficit also was reflected in the Statement of Income and Retained Earnings (Standard Form 221) included as part of the Statement of Financial Condition submitted to Treasury. The titles of the financial statements submitted to Treasury were changed for Fiscal Year 1986 reports. However, the Report on Operations (Schedule 221), included as part of the Report on Financial Position, clearly shows an operating deficit of $754,963,674 for FY 1986.

Copies of this FY 1986 financial report have been provided to GAO. The FY 1986 deficit also will be reported in MARAD '86.

See comment 7.

2. Failure To Accrue Contingent Liability.

a. GAO states that the Department failed to accrue a contingent liability for potential future guaranteed loan losses. GAO cites the accounting standard "that reasonable and probable losses on guarantees, loans, and other assets be recognized in accounting statements if the amount can be reasonably estimated."

b. In July 1986, MARAD accounting officials met with the GAO Director of Accounting and Financial Management, and agreed that although losses were "probable" they could not be "reasonably" estimated. Therefore, footnote disclosure would be adequate. It was acknowledged at this meeting that using the "best guess," should it be significantly in error, would unacceptably distort the Statement of Operations. As a result of this meeting, MARAD included a footnote in the FY 86 financial statements that estimated defaults on guaranteed loans to be $250,000,000. This estimate was changed to approximately $600 million in January 1987 when new information became available.

See comments 9 and 15

3. Inspector General Report on Similar Weakness

a. GAO stated that the Inspector General (IG) report found that:

1. MARAD carried all of its $106 million in loans (advances) to troubled companies as assets when only 50 percent of the advances were likely to be collected.

2. MARAD should not continue to list all of the advances as collectible because such a decision could affect budgetary decisions.

b. It appears that GAO is stating that our IG recommended that we write off receivables in which there has not been default. In discussions with our IG auditors, they stated that:

1. The IG audit report does not refer to receivables on MARAD's books, but rather those of the U.S. Treasury. It states on page 14 that..."Showing a receivable on the books of the Treasury indicates that the FSFF will eventually recover and repay the loan to Treasury. However, since the fund will unlikely ever repay the Treasury, continuing to carry a receivable could affect budgetary management decisions."

2. The IG's audit report does not address "Allowance for Losses."

4. <u>MARAD's Budget Underestimated Likely Defaults</u>

a. GAO stated that MARAD's budget underestimated likely defaults.

b. The Department concurs that MARAD's budget submissions have underestimated actual defaults in the past. Part of the problem, as discussed in more detail below, has been that economic projections did not accurately reflect what happened in the oil market in late 1985 and 1986. However, we also agree with GAO that the methodology used to estimate the defaults has tended to result in underestimating actual defaults. An interagency Task Force is currently analyzing the methodology to determine what improvements can be made.

Although the Department concurs that MARAD's budget submissions underestimated actual defaults, we would appreciate the report reflecting that MARAD officials apprised the Congress in June 1985 testimony that the projected number of defaults had increased after the February 1985 budget submission. It should also be reflected in the report that at the time the estimates were made many of the actual defaults were not considered probable. To reach the conclusion that the budget submissions were underestimated, GAO compared the levels included in the proposed budgets dated February of 1985 and 1986 with actual results for FY 1986. In developing the estimates, MARAD used information from respected economic sources which forecasted stabilization in the oil market. Contrary to these forecasts, depression in oil prices continued and ultimately contributed directly to the higher than predicted level of actual defaults. It is not unusual, especially in today's rapidly changing maritime economic environment, for forecasts to vary significantly from actual results. This especially is true for estimates presented in the President's budget which are prepared 8-20 months ahead of the relevant time period. The difficulty in forecasting is also recognized by GAO, as evidenced in the statement on page 35 of the report, "...we recognize that such estimates are imprecise because of the difficulties of anticipating future economic conditions and industry developments."

Now on pp 29-30

See comment 7

While the methodology for projecting defaults could be improved, the Department disagrees that the GAO technique, which uses only the rate of default among troubled companies in a given year to predict defaults in the subsequent year, is a more realistic approach to developing budget estimates. Rather, we believe it is more realistic to develop estimates by analyzing several factors, including historical data, for each element of the portfolio. In proposing its method, even GAO recognizes that estimates using historical defaults are imprecise. Given this caveat, the argument for selecting a method different than that used by MARAD is not convincing. The GAO approach certainly would not have predicted the large increase in defaults between 1985 and 1986.

See comment 7

D. <u>Administrative and Accounting Systems</u>

1. Material internal control weaknesses not included in Annual Statement.

    a. GAO states that the following four material internal control weaknesses existed and were not reported.

        1. Program did not have routinely accurate data on the value of the portfolio.

        2. Program did not have a complete list of troubled companies.

        3. Fund's financial statements and other documents did not clearly disclose the fund's insolvency.

4. MARAD did not establish a liability for potential future losses on loan guarantees.

b. The Department has the following comments on the purported weaknesses:

1. No weakness existed. See Program Data, B, 2.

2. We do not believe that not having one single list of troubled companies constitutes a material weakness. See Program Data, B, 2.

3. No material weakness existed. Informal GAO guidance was followed. See Accounting Documents/Financial Statements and Default Estimates, C, 1 and 2.

4. See 3 above.

Even if we did determine that there were internal control weaknesses when GAO provided the draft report on December 24, 1986, it is unrealistic for GAO to expect that the weaknesses would be included in the Secretary's 1986 letter. This letter is prepared much earlier than December 24 so that it can be properly coordinated throughout the Department in order to assure that the report is accurate. If changes were made to the report after the coordination process, there would be a breakdown of the internal control procedures we have in place to assure the report's accuracy.

2. Program Meets Factors of Materiality

a. GAO states that the program meets the following four materiality factors:

1. The program mission has been impaired.

2. The program reputation has been diminished.

3. Secretary needs to be involved in the issue.

4. MARAD violated a Comptroller General standard which possibly hampered Congress from fulfilling their oversight and budget responsibilities.

b. The Department has the following comments regarding the four materiality factors:

1. We do not agree that the mission of the program has been impaired. The mission of the program as indicated in the Merchant Marine Act, 1936, as amended, states in part, "It is necessary for the national defense and development of its foreign and domestic commerce that the United States shall have a merchant marine...." Authority to borrow from the Treasury to cover the difference between revenues and expenses was built into the enabling legislation, and borrowings have occurred several times in the history of the Title XI program. There were borrowings from the Treasury in the late 1950's and early 1960's, albeit for smaller amounts than the current debt. These earlier borrowings were fully repaid by the end of 1968. Although the level of current Treasury borrowing is unprecedented, there is no indication that the program mission has been technically impaired. Consistent with the program's mission, MARAD issued $47 million in new loan guarantees for construction projects during FY 1986. All of the new loan guarantees met all program requirements, despite the problems being encountered by the industry, and despite the current indebtedness of the Fund.

2. The recent history of defaults has generated an appropriate level of attention in the press. In virtually every case, published articles have reported the extreme world overtonnaging situation which continues to jeopardize the industry and which has resulted in the abnormally high level of defaults of all types of maritime loans. Although the program's reputation undoubtedly has been tarnished in the eyes of the general public and some government decisionmakers, we disagree with the implied judgement that press articles have diminished the credibility of the Title XI program or its reputation among potential program users. Ship owners

have continued to seek Title XI guarantees, and bond purchasers have continued to participate in the program.

3. We believe the assertion regarding the lack of personal attention or awareness of the agency head or higher management has been seriously misconstrued in its application to the Title XI program. The Secretary of Transportation has regularly been provided briefings by the current and former Administrator on the Fund and industry status. The Secretary, in recognition of the difficulties faced in bankruptcy situations, was personally involved in successful efforts to amend bankruptcy laws and hasten the Government's ability to move against defaulted assets. In addition to those instances cited above, the Secretary actively advocated a supplemental appropriation to pay off the principal and interest on Treasury borrowing in discussions with OMB on the FY 1988 budget. We believe these efforts reflect that the Secretary has appropriately focused her attention on major programmatic issues and the consequences of those conditions relative to the status of the Fund and other government operations. However, the internal control weaknesses cited by GAO, and summarized on pages 41 and 42 of the draft report, involve administrative matters and accounting reports. We fail to see how the GAO concludes that the program meets this materiality factor "because of these weaknesses." In the discussion of this materiality factor, the GAO draft report makes no reference to these "weaknesses." Instead, the report notes that the large number of defaults, the inability to cover default payoffs from the Fund balance, and the debt to the Treasury, warrant involvement by the Secretary. We certainly agree that these are problems which require personal attention by the Secretary, but these are not the internal control weaknesses that were cited by GAO.

To reiterate, we are particularly concerned with statements which imply that the Secretary of Transportation has not been aware of or involved in the problems resulting from the large number of default payoffs and the inability to generate sufficient revenues to cover the default payoffs and repay debt to the Treasury. The Secretary has been fully aware of changes in the condition of the Fund and the industry.

4. Comptroller General Standard not violated. See response to Accounting Documents/Financial Statements and Default Estimates, C, 2, b.

We also are concerned with the implication that MARAD and the Department have been misleading Congress as to the status of the Title XI program and its present default problems. MARAD has responded to Congressional inquiries with data that accurately portray the program's status. As discussed earlier, MARAD financial statements clearly did disclose that the program was operating at a deficit and did identify the indebtedness of the Fund. Estimates of defaults were included in budgets submitted to Congress, although these estimates ultimately proved to be low.

3. The Inspector General Found Internal Control Weaknesses

a. GAO states that the Inspector General found the following internal control weaknesses:

1. MARAD carried all of its $106 in loans to troubled companies as assets when only 50 percent of the loans were likely to be collected.

2. MARAD used revenue from insurance proceeds to convert two defective vessels rather than selling or scrapping them.

3. MARAD lacked documented pertinent information concerning available alternatives and their related costs in 21 instances where companies were allowed to revise the terms of their loans to facilitate repayment. It also stated that 11 of these companies have defaulted, and 8 more probably will in the next 3 years.

b. Although the IG report never mentioned the term "internal control weaknesses," the Department has the following comments on GAO's interpretation of the information provided in the report:

1. Considering that there was an Allowance for Losses of $61.4 million for these loans on September 30, 1985, we are unable to determine what internal control weakness GAO is citing.

2. Since top management was aware of the risks being assumed when deciding to proceed with the project, and the use of the funds in this manner was permissable, it is the Department's opinion that no internal control weakness existed.

3. GAO appears to be drawing the conclusion that because there were 21 workouts, and it appears that 19 will result in defaults, there was an internal control weakness. There is no presentation in the draft report which demonstrates that the actions taken were more costly to the Government than other alternatives. The primary consideration in approving a workout is that the Government would be no worse off, considering all relevant costs, than if the workout was not approved. In addition, in these circumstances, the agency is fulfilling its program role by allowing the debtor an opportunity to rehabilitate itself during economic distress. The IG report recommended that the cost analyses of alternatives be better documented.

It should also be noted in the report that the IG reviewed MARAD's response to that audit report and concluded on December 10, 1986, that the actions taken or planned by MARAD are considered responsive to the recommendations in the report. The IG considers the audit report closed.

See comment 16

E. We would appreciate it if the following editorial corrections were made in the report.

Page	Correction
2	In "Background," the fees are set by MARAD in accordance with statutory limitations.

Now on p. 8.	2	The limitation is on "the principal amount of guaranteed loans and commitments in force," not on "loans."
Now on p. 8	3	The annual limits on new guarantees (not "loans") have only occurred in recent years.
See comment 17. Deleted from final report	5	The September 30, 1986, financial statements included a contingent liability footnote for potential defaults, so the contingent liability had been established in December 1986.
	10	In the second paragraph, the first sentence should read: "Funds for vessel construction are obtained by the ship owner through the issuance of corporate bonds which are sold to private sector investors, such as banks, pension trusts, and life insurance companies, as well as to the general public."
	11	In the first paragraph, in (1) add "in accordance with statutory limitations" after "MARAD," and at the end of the first sentence, add "and (4) repayment of Federal loans."
See comment 18 Now on p. 8	11	In the second paragraph, in the first sentence replace "private sector lender" with "Indenture Trustee on behalf of the bondholder or the bondholders themselves."
See comment 11 Now on p. 9. Now on p. 12 only.	16	In the first paragraph, the expenses covered by Treasury borrowings are those related directly to default payoffs. Fund revenues are sufficient to cover other expenses. The same comment pertains to the final paragraph on page 17, and the first paragraph on page 43.
Now on p. 20.	22	In the footnote, delete the second sentence in view of the fact that both commitments and guarantees may be based on either estimated or actual costs.
Now on p. 30.	35	In the third paragraph, second sentence, add ", generally companies with newer high cost equipment in depressed industries," after "the weaker companies."

The following are GAO's comments on the Department of Transportation's letter dated April 7, 1987.

GAO Comments

1. We have provided updated information on the troubled portion of the portfolio as of September 30, 1986.

2. We noted that fiscal year 1984 was the last year the fund's revenues exceeded expenses. We also updated fiscal year default payments through September 30, 1986.

3. Discussed in the agency comments section of chapter 2.

4. We updated fiscal year 1986 default payments through September 30, 1986, and deleted Marad's estimate of default payments for the remainder of the fiscal year ($200 million).

5. Marad's original estimate of $100 million is not included in our final report.

6. Discussed in the agency comments sections of chapters 2 and 4.

7. Discussed in the agency comments section of chapter 4.

8. Discussed in the agency comments section of chapter 3.

9. Our report did not address allowance for losses.

As stated in our report, the Office of Inspector General report recommended that Marad make annual projections of fund revenues and expenses and request appropriations for any anticipated shortfalls.

10. Discussed in agency comments section of chapter 4. Marad's year-end financial statements to the Treasury were not transmitted until December 30, 1986. We believe sufficient time was available to include the $600 million estimate since the Deputy Associate Administrator for Maritime Aids told us that both estimates were prepared during the same period. The fiscal year 1986 annual report was issued in June 1987.

11. Discussed in the agency comments section of chapter 2. The Federal Ship Financing Fund is a public enterprise revolving fund. This type of

fund is an expenditure account that is credited with collections, prima ily from the public, generated and earmarked to finance a continuing cycle of business-type operations. That is, this fund receives fees primarily from shipowners to pay for expenses related to the continuing operation of the Federal Ship Financing Program. Default payments a included as an expense of operating the program. We believe this type fund should not rely on Treasury borrowings to finance portions of its expense payments.

Our position is that public enterprise revolving funds may be appropr ate when

- a continuing cycle of operations exists that generates receipts, principally from the public,
- the fund is or will likely be substantially self-sustaining, and
- a substantial need for flexibility exists to meet unforeseen requiremen

12. Prior to fiscal year 1973, Marad made default payments totaling about $37 million (or almost 2 percent) of the nearly $1.9 billion in default payments since the program's inception in 1936. Although default payments for insured loans or mortgages may have been made for vessels after fiscal year 1973, the vast majority of default paymen were for guaranteed loans. These loan guarantees were approved afte fiscal year 1972.

13. Discussed in agency comments section of chapter 3. Additionally, Marad officials told us in January 1987 that the automated system th produces the ranking for each company in its portfolio was not fully operational and that information on the financial status of companies updated every 6 months. They said that reliable and useful reports wi be available in February 1987. We met with the Deputy Associate Administrator for Maritime Aids on February 27, 1987, who said that the system was still not fully operational, but that he would provide a copy of the report when it was. The system was not operational in Jul 1987 and, consequently, we were not provided a copy of the report.

Marad officials told us that they did not prepare credit watch reports for January 1986, August 1986, and April 1987. They also were unabl to provide copies of the report for the 10-month period between Janua 1985 and November 1985. Further, the March 1987 credit watch repor listed the liner companies' names only with little additional informatio on their title XI loan guarantees.

14. When we stated that neither Marad nor GAO analyzed the entire loan portfolio to determine whether the November 1985 and June 1986 lists were complete, we meant that Marad officials said they did not document the process for preparing a complete list of troubled companies. Therefore, we could not verify that the entire portfolio had been reviewed, and Marad program managers could not verify that all companies' circumstances had been reviewed thoroughly and consistently.

15. The Office of Inspector General report stated on page 5 that "Marad recorded receivables of $106 million in its accounting records as of December 31, 1985."

The report also states on page 14 that "Title XI advances are recorded [on the Treasury Department books] as an interdepartmental receivable."

16. Except where otherwise noted, we have made changes to incorporate DOT's editorial comments

17. The financial statements were officially approved and transmitted to the Treasury Department on December 30, 1986.

18. "Private sector investors" is the generic phrase we used in this report.

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