

USDA



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Office of Inspector General
Southeast Region
Audit Report

RURAL DEVELOPMENT
LENDER SERVICING OF BUSINESS AND
INDUSTRY GUARANTEED LOANS IN
GEORGIA



Report No.
34601-5-At
AUGUST 2003



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



DATE: **August 27, 2003**

REPLY TO
ATTN OF: 34601-5-At

SUBJECT: Rural Development Lender Servicing of Business and Industry
Guaranteed Loans in Georgia

TO: John Rosso
Administrator
Rural Business-Cooperative Service

THROUGH: John Purcell
Director
Financial Management Division

This report presents the results of the subject audit. Rural Development's July 30, 2003, response to the official draft report is included as exhibit D with excerpts and the Office of Inspector General's (OIG) position incorporated in the Findings and Recommendations sections of the report.

We can reach management decision on the recommendations once we have been provided the information as outlined in the report's "OIG Position" sections.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days. Please note that the regulation requires a management decision to be reached on all recommendations within 6 months of report issuance.

for
RICHARD D. LONG
Assistant Inspector General
for Audit

EXECUTIVE SUMMARY

RURAL DEVELOPMENT LENDER SERVICING OF BUSINESS AND INDUSTRY GUARANTEED LOANS IN GEORGIA

AUDIT REPORT NO. 34601-5-At

RESULTS IN BRIEF

The primary audit objective was to determine if the lender complied with program regulations for loanmaking and servicing. Specific objectives were to determine whether

the lender ensured (1) terms of the conditional commitment were met, (2) loan funds were used for authorized purposes, (3) collateral was sufficient to protect the interest of the Government, and (4) proper servicing of the loan.

As of January 11, 2001, there were 67 borrowers with 73 Business and Industry (B&I) guaranteed loans totaling \$214.2 million in Georgia. These loans were made from 1991 through 2000. Eleven of the borrowers with loans totaling \$28.1 million were delinquent. We performed a detailed review of one defaulted loan of \$5 million.

On September 15, 1995, the Alternative Agricultural Research and Commercialization Corporation (AARCC) entered into a venture capital agreement with the borrower to invest \$800,000 in the proposed business. The agreement's overall purpose was to assist the borrower in developing, producing, and marketing high-grade activated carbon from agricultural biomass, primarily peanut shells.

On October 23, 1997, the borrower received a \$5 million B&I loan guaranteed at 90 percent to construct a manufacturing facility to produce activated carbon. The company had performed research indicating that peanut shells could be made into activated carbon, which is used as a component in air and water filtration systems. However, the production process to convert agricultural biomass into activated carbon was experimental and untested on a commercial scale.

Our review disclosed that the lender did not (1) adequately monitor the borrower's use of loan funds, (2) ensure the facility was properly engineered and designed, and (3) obtain sufficient collateral to reasonably ensure repayment of the loan. As a result, Rural Development (RD) faces a \$5 million loss on the loan. These conditions occurred because the lender did not (1) obtain sufficient professional evaluation of the project

before loan approval and during construction and (2) provide oversight at critical points during facility construction. RD staff stated that program regulations place almost total reliance and responsibility upon the lender to properly evaluate loan applications and perform and execute loanmaking and servicing duties. Specifically, we found the following.

- The lender did not adequately monitor the borrower's use of loan funds resulting in the questioned use of \$1,170,910 (RD is liable for the \$1,053,819 guaranteed at 90 percent). The lender disbursed the funds for (1) questioned salaries, fees, and other compensation paid to borrower officials, stockholders, and their family members; (2) profits and other questionable payments to identity-of-interest businesses owned by borrower officials, stockholders, and family members; and (3) cost that was either unsupported or did not qualify for loan purposes.
- The lender did not ensure requirements for construction of the production facility were met including that it be designed utilizing accepted architectural and engineering practices and, when completed, produce the quantity and quality of carbon called for in the application. Due to design problems, cost overruns, and substantial delays, the facility was not completed after project funds were exhausted. The facility could not produce the quantity and quality of carbon called for in the loan application and, therefore, never started full-scale commercial production. The lender did not require that the borrower obtain the services of a professional engineer to design the facility including detailed machinery and equipment specifications. Instead, the lender allowed the owner, who did not have experience in architectural and engineering design and construction to design the facility and serve as general contractor.
- The lender did not ensure that the value of collateral was sufficient to repay the loan. The loan collateral that was originally appraised for \$7.4 million sold for only \$148,500. As of August 2002, a loss of about \$5.8 million was expected for which RD could be liable for 90 percent. The loan was under-secured primarily because the (1) \$3.7 million discounted value-of-purposed collateral was less than the loan amount, (2) purposed collateral with a discounted value of \$1.6 million was not constructed and/or purchased, and (3) primary collateral was specialized machinery and equipment that had to be fabricated and was not adaptable to other activities.

The above conditions each contributed to the expected \$5.8 million loss of which RD guaranteed 90 percent (\$5.2 million).

The borrower spent \$224,951 of AARCC investment funds for ineligible and questionable purposes. Of the \$224,951, we found that \$213,325 was spent on project construction, which was prohibited by the venture capital agreement, and \$11,626 was used to pay off credit lines of the borrower's chief executive officer and general manager that were spent on undocumented items. This misuse of funds occurred because the borrower did not maintain an adequate accounting for the use of the invested funds or comply with the venture capital agreement requirements to obtain annual financial audits and submit periodic financial and performance reports to AARCC.

KEY RECOMMENDATIONS

We made a series of recommendations for corrective actions. Key among those recommendations were that RD, in consultation with the Office of the General Counsel, rescind the loan note guarantee or substantially reduce the \$5.2 million estimated loss payment (see exhibit A) and debar the borrower from further participation in Government activities.

AGENCY RESPONSE

In its July 30, 2003, written response to the draft report, RD National Office stated that (1) it has delegated responsibility for acting on the recommendations to the Georgia RD State Office (SO) and (2) the SO was to complete its determinations by October 31, 2003.

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INTRODUCTION

BACKGROUND

Program Background – Rural Development (RD) operates a variety of loan programs including the Business and Industry (B&I) Guaranteed Loan Program. The program

assists business development in the Nation's rural areas and the employment of rural residents. B&I guaranteed loans achieve this purpose by bolstering the existing private credit structure through the guarantee of quality loans, which provide lasting community benefits. The guarantee authority is not intended to be used for marginal or substandard loans or for the relief of lenders having such loans. RD administers the program through its State offices (SO). Private lending institutions make the loans with RD guaranteeing payment of up to 90 percent, including interest, in the event of a loss.

Guarantees are provided on loans made by traditional lenders, such as commercial banks, and to a lesser extent, on loans made by other non-traditional lenders, such as entities using investment capital and which are authorized by State law to engage in lending. The loans are made to most types of legal entities, including for-profit and nonprofit cooperatives, corporations, partnerships, individuals, public bodies, and Indian tribes. RD can guarantee up to 90 percent of private lending institutions' (banks, savings and loans, etc.) loans made to eligible borrowers. RD SO's can approve loans up to \$5 million and generally offer a guarantee of 80 percent. The RD National office must approve loans over \$5 million and generally offers a 70-percent guarantee for loans between \$5 and \$10 million, and 60 percent for loans exceeding \$10 million. The maximum loan amount is \$25 million.

Lenders are responsible for servicing the B&I guaranteed loans and for taking all actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. Lenders are responsible for notifying RD officials of any violations of loan agreements. The loan note guarantee will be unenforceable by the lender to the extent any loss is occasioned by violation of usury laws, use of loan funds for unauthorized purposes, negligent servicing, or failure to obtain the required security regardless of the time at which the agency acquires knowledge of the foregoing. This responsibility includes but is not limited to the collection of payments, obtaining compliance with the covenants and provisions in the loan agreement, obtaining and analyzing financial statements, checking on payments of taxes and insurance premiums, and maintaining liens on collateral.

As of January 11, 2001, there were 67 borrowers with 73 loans totaling \$214.2 million in Georgia. Eleven of the borrowers with 12 loans totaling \$28.1 million were delinquent.

Borrower/Lender Loan Background – On May 1, 1995, the borrower was organized as a limited liability company with the goal of constructing a manufacturing facility to produce activated carbon from agricultural related biomass by-products (primarily peanut shells). The company had performed research indicating that peanut shells could be made into activated carbon, which is used as a component in air and water filtration systems. The production process to convert agricultural biomass into activated carbon was experimental and untested on a commercial scale.

On September 15, 1995, the Alternative Agricultural Research and Commercialization Corporation (AARCC) entered into a venture capital agreement with the borrower to invest \$300,000 in the proposed business in return for 300 shares of common stock in the company. At the time AARCC was the venture capital-making arm of the U.S. Department of Agriculture (USDA). Its mission was to support the efforts of small rural businesses to commercialize new, non-food, non-feed industrial products derived from crops or agricultural waste material. Prior to elimination of its budget by Congress, AARCC was authorized by 7 United States Code 5905 to assist business concerns in their commercialization efforts.

On April 17, 1997, AARCC amended the venture capital agreement and invested an additional \$500,000 in the company. In return for the investments, the agreement was amended to provide that the borrower pay AARCC the following royalties from product sales beginning on January 1, 1998. (See table 1.)

Table 1

Year	Royalty
1998	1½ %
1999	2 %
2000	2½ %
2001-2002	3 %

The agreement provided that none of AARCC's investment funds were to be expended for acquisition or construction of a building or facility.

On June 14, 1996, the borrower company entered into a contract with the borrower's general manager to construct the plant facilities. The general manager's construction experience was ownership and management of a small pavement company. The general manager established a separate company to construct the borrower's facilities.

On September 6, 1996, the borrower filed an application with RD for a \$5 million loan guarantee to construct the facilities. The approved use of loan proceeds was to finance the construction of facilities and improvements (\$1.3 million), buy and install machinery and equipment (\$3.2 million), and working capital (\$500,000).

On August 15, 1996, the applicant obtained preliminary drawings and a cost estimate of \$4,230,920 to develop the facility from an engineering firm. An August 30, 1996, appraisal of the proposed development, estimated its value at \$7.4 million. Added to the engineering estimates was \$2,035,000 for a laboratory and second smaller production building, and an estimated entrepreneurial profit of \$1,202,684.

On June 26, 1997, RD issued a conditional commitment to the lender to guarantee 90 percent of the \$5 million loan made to the borrower. The loan was guaranteed at 90 percent because RD and AARCC had a memorandum of understanding that provided for a 90-percent guarantee for loans of up to \$10 million for companies funded by AARCC who could also qualify for a B&I loan.

Table 2 shows amounts and sources of borrower funding from 1995 through 1999.

Table 2

Source	Amount
Guaranteed Loan	\$5,000,000
AARCC Investment	800,000
Private Equity Investment	1,239,557
Outside Lender Loan	150,000
Total	\$7,189,557

On September 11, 1997, at the request of the lender, RD approved a change in the original conditional commitment to permit reimbursement to one of the owners for direct costs (material/labor/equipment rental) incurred for loan purposes. The intent of the change was to allow one of the owners to continue construction of the facility, which he had started in 1996 and be reimbursed for the costs. In addition to being an owner, the contractor was also the general manager of the borrower's company and related to the principal owner.

On October 23, 1997, the \$5 million guaranteed loan was closed. At that time, \$1,509,103 was disbursed to reimburse the borrower and the contractor for previously incurred construction cost and fees. The remaining \$3,490,898 was placed in escrow and periodically disbursed through March 30, 1999.

The business was projected to start generating income for loan repayment between October 1998 and February 1999. Testing and installing of equipment experienced significant problems. The borrower continued attempts to debug the production process until January 2000. The quantity and quality of production never met expectations resulting in the facility never effectively starting full-scale production.

As of August 1, 2002, the loan principal, interest, and liquidation costs totaled \$5,903,172. On August 1, 2002, the loan collateral that originally appraised for \$7.4 million was sold for \$112,895 (net proceeds). Therefore, loan losses will total \$5,790,277, of which RD is potentially liable for \$5,211,250 (90 percent).

OBJECTIVES

The primary audit objective was to determine if the lender complied with program regulations for loanmaking and servicing. Specific objectives were to determine whether the lender ensured that (1) terms of conditional commitments were met, (2) loan funds were used for authorized purposes, (3) collateral was sufficient to protect the interest of the Government, and (4) loan servicing was proper. After selection of the loan for review, an objective was added to review the borrower's compliance with terms of the AARCC venture capital agreement.

SCOPE

The audit, conducted in accordance with generally accepted government auditing standards, covered B&I guaranteed loan operations in Georgia for fiscal years 1998 through 2000. Other periods were reviewed as necessary. The audit was part of a nationwide audit of the B&I guaranteed loan program. The USDA, Office of Inspector General's (OIG) Southwest Regional office located in Temple, Texas, was the audit control point with overall responsibility for the audit.

We reviewed one of the delinquent borrowers. The selection was based on the large dollar value and payment status of the loan. (See table 3.)

Table 3

Loan Date	Amount	Percent Guarantee	Loan Status	Estimated Loss	Guaranteed Amount
10/23/97	\$5,000,000	90	Liquidated	\$5,790,277	\$5,211,250

Preliminary audit fieldwork was initiated in April 2001 and suspended shortly thereafter. Fieldwork resumed in May 2002 and was performed primarily from May 2002 through November 2002. Work was performed at the RD SO in Athens, Georgia; RD District office in Tifton, Georgia;

lender's office in Bainbridge, Georgia; and the borrower's place of business in [], Georgia.

METHODOLOGY

To accomplish the audit objectives, we performed the following procedures:

- Interviewed RD officials and reviewed policies and procedures governing the B&I guaranteed loan program.
- Reviewed records at the RD State and District offices for the loan selected for review, and performed a detailed review of lender and borrower business and financial records related to the loan.
- Interviewed lender and borrower officials responsible for the loan and project.
- Inspected the business site of the project.

CHAPTER 1**LENDER WAS DEFICIENT IN ITS RESPONSIBILITY TO ENSURE PROPER USE OF LOAN FUNDS**

The lender disbursed loan funds of \$1,170,910 for (1) questioned salaries, fees, and other compensation paid to borrower officials, stockholders, and their family members; (2) profits and other questionable payments to identity-of-interest businesses owned by borrower officials, stockholders, and family members; and (3) costs that were either unsupported or did not qualify for loan purposes. These conditions occurred because the lender did not adequately monitor the borrower's use of loan funds resulting in the questioned use of the \$1,170,910 (\$1,053,819 guaranteed at 90 percent).

RD Instructions¹ places responsibility on the lender to ensure that loan proceeds have been disbursed for purposes and in amounts consistent with the conditional commitment.

Construction of the facility began in July 1996. Prior to loan closing on October 23, 1997, construction of the facility was funded through the sale of shares of stock in the borrower's business, AARCC investment funds, and interim financing loans. At loan closing about \$1.5 million was disbursed which included \$1.3 million to the interim lenders, the borrower, and identity-of-interest construction companies as reimbursement for the prior work. The remaining loan funds of about \$3.5 million were placed in an escrow account and disbursed to the borrower for expenses incurred between loan closing and March 30, 1999.

FINDING NO. 1**INELIGIBLE PAYMENTS TO BORROWER OFFICIALS AND FAMILY MEMBERS**

The borrower used \$346,081 of loan funds to pay salaries, fees, and other compensation to corporate officers, stockholders, and family members. Payment of loan funds to owners, stockholders, and family members was ineligible and did not represent arm's-length transactions. The improper payments

occurred because the lender did not adequately monitor the borrower's use of loan funds. As a result, the lender's loss claim will be overstated \$311,473 (90 percent).

RD Instructions² state that loan funds are ineligible for payment to a stockholder (owner) of the borrower or a stockholder's close relative. On September 11, 1997, the RD SO established a clarification to these restrictions. The clarification, incorporated into the conditional

¹ RD Instructions 4279.30 (a) and 4279.181 (l), dated December 23, 1996.

² RD Instruction 4279.114, dated December 23, 1996.

commitment, was intended to permit an identity-of-interest company owned by a borrower official (who was also a stockholder and close relative) to continue construction of the project facility and be paid from loan funds for its work. The identity-of-interest company had begun construction of the facility in 1996. The conditional commitment, as revised, follows.

*The lender is prohibited from disbursing any of the loan funds under this guarantee to the owner(s), stockholders or * * * members of their families * * * **Notwithstanding the foregoing, the lender shall be permitted to reimburse direct costs (material/labor/equipment rental) incurred by an owner which are included in the loan purposes. No reimbursement for profit will be disbursed to any owner from loan proceeds [emphasis added].** The lender will utilize and maintain appropriate documents (appraisals, invoices, audits, etc.) in the disbursement of loan proceeds. The lender will ensure that all transactions meet the criteria of an arms length transaction.*

RD Instructions³ define an arm's-length transaction as, "The * * * release * * * of assets * * * to a ready, willing, and able disinterested third party that is not affiliated with or related to and has no security, monetary, or stockholder interest in the borrower * * * at the time of the transaction."

From borrower records, including check registers, account statements, and canceled checks, we identified a total of \$922,134 in salaries, fees, and other compensation paid from project funds to five company officers, stockholders, owners, and family members. Of the \$922,134, we determined that at least \$346,081 was paid with guaranteed loan funds. The remaining payments came from private and AARCC investments.

We traced the disbursement of loan funds from the lender through the borrower and identity-of-interest company accounts to the five recipients (see table 4).

³ RD Instruction 4279.2, dated December 23, 1996.

Table 4

Title/Period	TOTAL				LOAN FUNDS			
	Salary	Fees	Other	Total	Salary	Fees	Other	Total
Chief Executive Officer (Officer A) 1/1/95-4/7/00	\$222,487		\$62,170	\$284,657	\$132,509		\$4,172	\$136,681
General Manager (Officer B) 1/28/95-6/9/00	152,303		93,563	245,866	74,613		52,043	126,656
Chief Financial Officer (Officer C) 7/5/96-10/14/00	44,858	\$52,968	6,872	104,698		\$9,341		9,341
Operations Manager (Officer D) 11/1/95-12/1/00	129,376		12,464	141,840	42,266		4,200	46,466
Family Member A 6/13/95-6/9/00	56,286	36,387	52,400	145,073	26,445		492	26,937
Total	\$605,310	\$89,355	\$227,469	\$922,134	\$275,833	\$9,341	\$60,907	\$346,081

We first applied any available outside investment fund balances against the payments to determine that the questioned amounts came from guaranteed loan funds.

The payments were made to the individuals even though the company never started full-scale commercial operations (see Finding No. 4). They occurred primarily during the development and construction phases.

Chief Executive Officer - The chief executive officer (CEO), who was the principal owner, was paid a weekly salary of \$2,308 as of December 1997. He received total payments of \$284,657. We were able to trace at least \$136,681 to loan funds. The remaining payments came from private and AARCC investments. The payments did not meet the conditional commitment requirement that reimbursement be for direct cost incurred by an owner and represent an arm's-length transaction.

The approved purpose of loan funds was to finance construction of the facility including purchasing and installing machinery and equipment and working capital. The CEO was not responsible for construction of the facility. The identity-of-interest company owned and managed by the borrower's general manager was responsible for construction of the facility. A June 14, 1996, construction contract stated the following:

** * * has assumed 100% responsibility for the Project.*

*The Contractor shall design, furnish all the materials, and perform all the Work * * * The Contractor shall be solely responsible for and have control over construction means, methods, techniques, sequences and procedures [for] coordinating all portions of the Work under the Contract. * * **

*The Contractor shall be responsible for the design, coordination, completeness, accuracy and all plans, drawings, specifications and other documents necessary for the construction * * * and for their compliance with all applicable codes, ordinances, regulations and laws.*

The CEO received a fixed salary as opposed to wages. His time and personal services as an owner were not a direct incurred cost of construction. Further, the CEO told us that he set the salary rates for himself and other officers and employees in the company. The payment to the CEO did not meet the criteria of an arm's-length transaction.

General Manager (Construction Contractor) - The general manager, who also owned the identity-of-interest construction company (business D), was paid a salary and other compensation totaling \$245,866. We identified that at least \$126,656 came from loan proceeds. The lender disbursed funds to the borrower who subsequently transferred them to business D to pay bills for the construction of the facilities. The general manager was paid from the loan funds transferred to business D.

In addition to owning the construction company, the general manager owned stock in the borrower company, was the borrower's general manager, and the [] of the CEO and operations manager. His primary responsibility was construction of the project. The general manager's compensation for personal services was not a direct incurred cost and payment of the salary with loan funds did not represent an arm's-length transaction.

Chief Financial Officer and Accountant - The chief financial officer (CFO) and accountant employed by the borrower were paid \$249,771 in salaries, fees, and other compensation. We identified that at least \$36,278 was paid from loan proceeds. (See table 5.)

Table 5

Payee	Total	Loan Funds
CFO	\$104,698	\$9,341
Accountant	145,073	26,937
Total	\$249,771	\$36,278

The CFO was responsible for the borrower's and the identity-of-interest companies' accounting and financial management functions. He was also a [] of the CEO and a stockholder. The accountant was the [] of the general manager (owner of the identity-of-interest construction company), [] of the CEO and the operations manager, and a stockholder. Their personal services did not qualify as direct incurred costs and the

payments did not represent arm's-length transactions with the borrower.

An identity-of-interest accounting business owned by the CFO was also paid \$232,493 from project funds for accounting services of which \$60,682 came from loan funds (see Finding No. 2). Therefore, accounting related costs charged to the \$7.2 million project totaled \$482,264.

Operations Manager - The borrower's operations manager was paid \$141,840, primarily as a salary. We identified that at least \$46,466 came from loan proceeds. The operations manager was a stockholder, [] zof the CEO, [] of the general manager (owner of the identify-of-interest construction company).

RECOMMENDATION NO. 1

To the extent the loss claim is not denied by other recommendations in this report, reduce any loss payments to the lender by \$311,473 for the questioned salaries, fees, and other compensation.

Agency Response

In its July 30, 2003, response, RD stated,

The Rural Business-Cooperative Service (RBS) National Office will advise the Georgia [RD SO] to consult with the Atlanta Regional Office of the General Counsel (OGC) in the development of a notification to the lender of the audit finding and, if legally permissible, to reduce the loss payment to the lender by an amount of \$311,473. Notification to the lender on action regarding this recommendation will be completed not later than October 31, 2003. A management decision is requested.

OIG Position

To achieve management decision, we will need the results of the SO and OGC determinations and a copy of the notification to the lender showing the amount of the loss claim reduction.

FINDING NO. 2

PAYMENTS TO IDENTITY-OF-INTEREST BUSINESSES

The borrower used \$478,217 of loan funds to make questionable payments to four businesses owned by borrower officials, stockholders, and []. The payments to these businesses were questioned because they were not direct costs of construction, represented unauthorized profits, and did not represent arm's-length

transactions. The questioned payments occurred because the lender did not adequately monitor the borrower's use of loan funds to ensure that payments to the businesses occurred at arm's-length and excluded profits. As a result, the loss claim could be overstated \$430,395 (90 percent) due to improper use of loan funds.

From borrower records including check registers, account statements, canceled checks, tax returns, and financial statements, we determined that \$6,511,095 of project funds were disbursed to four identity-of-interest businesses owned by company officers, stockholders, [

] over the life of the project. We traced the disbursement of loan funds from the lender through the borrower and to the identity-of-interest companies' accounts and questioned \$478,217 disbursed for unsupported fees and profits (see table 6).

Table 6

Business	Owner	Payments	Questioned/ Unsupported Payments
Business A (accounting)	CFO	\$232,493	\$60,682
Business B (leasing)	General Manager	140,189	93,334
Business C (engineering)	CEO	174,900	26,025
Business D (construction)	General Manager	5,963,513	298,176
Total		\$6,511,095	\$478,217

We first applied any available outside investment fund balances against the payments to determine that the questioned amounts came from guaranteed loan funds.

Business A (Accounting) - The borrower's CFO was a certified public accountant (C.P.A.) who also owned a public accounting business that provided services to identity-of-interest businesses B, C, D, and E as well as other non-affiliated clients. The CFO was a stockholder and [to the CEO. Over the life of the project, payments to business A totaled \$232,493 of which \$60,682 was paid from loan funds.

There were no written service agreements between the accounting business and the borrower and the other identity-of-interest companies. Generally there were no monthly billings submitted by business A. However, the borrower's files contained canceled checks showing payments of about \$6,000 per month to business A. The CFO told us that his accounting business was responsible for the payrolls, depository

accounts, tax filings, and preparation of financial statements for the related companies.

We requested that the CFO provide documentation showing whether his accounting business earned a profit on services provided to the borrower and other identity-of-interest companies. The CFO told us that his business provided public accounting services for profit but did not maintain records on whether a profit was earned from the borrower and the identity-of-interest companies. He refused to provide any information showing profits from his accounting business.

The fees paid to business A did not meet the definition of an arm's-length transaction and without documentation of direct cost incurred by business A, we questioned the \$60,682 of loan funds.

Business B (Equipment Leasing) - The general manager established a company (business B) to rent equipment to his construction company (business D). The owner received \$93,334 of questioned loan funds from the project because he used loan funds to purchase the equipment that was rented back to business D.

Documentation showed 13 equipment items totaling \$94,824 were purchased by business B from unrelated parties. The equipment was rented to business D for use during the project's construction. From December 15, 1997, through November 30, 1998, rental payments totaled \$45,076, which came from loan funds. The rental rates were established based on the cost of the equipment amortized over a 24-month period at 12-percent interest. There was no documentation showing if the rental rates charged were comparable to fair market rates for similar equipment (see table 7).

Table 7

Item No	Equipment	Date Purchased	Cost	Monthly Rental Rate
1	1989 Dodge Pick Up	12/17/1997	\$4,198	\$198
2	HP 450C Plotter	12/19/1997	5,315	250
3	Pearson Squaring Shear	12/2/1997	13,500	635
4	Qysong & Miles Press Brake	12/2/1997	16,500	777
5	(2) 8' Dies	12/3/1997	622	29
6	1974 International Loader	12/11/1997	11,800	555
7	Vermeer M-37 Trencher	12/17/1997	4,926	232
8	Atlas Copco Air Compressor	12/29/1997	13,213	622
9	1983 GMC Brigadier Truck	11/14/1997	4,400	207
10	Lo-Boy Trailer	12/17/1997	4,000	188
11	Lathe	4/15/1998	1,200	56
12	Buffalo Ironworker	4/23/1998	4,300	234
13	Forklift	7/29/1998	10,850	511
	Total		\$94,824	\$4,494

We were not provided bank statements or financial statements for business B. The CFO provided us copies of the 1997 and 1998 Federal income tax returns for business B. The returns reported no profit during 1997 and a profit of \$1,498 in 1998 (see table 8).

Table 8

Year	1997	1998	Total
Income:			
Interest	\$501	\$848	\$1,349
Rents	3,901	45,829	49,730
Total Income	\$4,402	\$46,677	\$51,079
Deductions:			
Depreciation Expenses	\$4,216	\$42,350	\$46,566
Other Expenses	186	2,829	3,015
Total Deductions	\$4,402	\$45,179	\$49,581
Net Income	\$0	\$1,498	\$1,498

Our review of bank statements for businesses A and D showed that loan funds were used to purchase the equipment items. Business D was established for the sole purpose of constructing the plant and all of its resources were to be devoted to the construction of the plant. Cost incurred by business D was to be considered cost incurred by the borrower. On October 29, 1997, business D issued a check for \$95,113 to business B. Business B then purchased the equipment that was rented back to business D on a monthly basis (see table 7). Therefore, the \$45,076 rental payments were ineligible because the items were purchased with loan funds. In addition, because the equipment items

purchased with loan funds were in the name of business B, they were not included as collateral for the loan or in those items that were liquidated. Therefore, the residual value of \$48,258 (\$94,824 purchase price - \$46,566 depreciation) was an ineligible benefit to the owner. As a result, we questioned \$93,334 of loan funds paid to business B (\$45,076 + 48,258), which appears to represent an unauthorized conversion of loan funds/collateral.

The lender informed us that they were unaware of the existence of business B, and had no information concerning it.

Business C (Engineering Firm) - The borrower's CEO established an engineering firm (business C) to provide engineering advisory services to the borrower during project construction. The CEO stated that the firm was established to pay the engineer and his assistant and that there should not have been any profits made by the firm.

Our review showed that a total of \$174,900 was disbursed to the engineering firm during the period December 4, 1997, through September 15, 1999, of which \$109,793 was disbursed from loan funds. (See table 9.)

Table 9

Source of Funds	1997	1998	1999	Total
Loan Funds	\$6,000	\$103,794	0	\$109,794
Private/AARC Funds	0	0	65,107	65,107
Total	\$6,000	\$103,794	\$65,107	\$174,901
Payroll Amount	\$0	\$83,769	\$0	\$83,769
Difference	\$6,000	\$20,025	\$65,107	\$91,132

The firm employed a professional engineer during the period December 15, 1997, through August 3, 1998, who provided the engineering services for the project. The services included certifying completion of construction on written draw requests submitted to the lender. Prior to his departure, the engineer certified five draw requests totaling \$701,918.

The lender was aware of the engineering firm and its relationship with the borrower, but did not determine whether the firm made a profit. The CFO stated that he did not have any financial statements on the business. From the financial records provided by the CEO, we found W-2 forms prepared for three employees totaling \$83,769 for 1998. We found no W-2 forms for 1997 or 1999.

We questioned the use of \$26,025 of loan funds paid to company C in 1997 and 1998, due to the lack of supporting expenditure records (see table 9).

Businesses D and E (Construction Companies) - Business E was owned by the borrower's general manager and was under contract to construct the project. On June 14, 1996, the borrower signed a contract to construct the facility. The general manager then established business D, an incorporated business, to assume responsibility from business E for the construction work already in process. Business D was established for the sole purpose of constructing the facility and agreed to devote all its resources to the project. Any cost incurred by business D was considered cost incurred on the project.

Loan funds were transferred from the borrower's account to business D's account whenever additional funds were needed to replenish the construction account.

Although we requested financial statements for business D, the CFO did not provide any. The CFO provided Federal income tax returns for the years 1997, 1998, and 1999. The returns showed that business D earned no profit in 1997 and 1998 and \$268 profit in 1999. Financial statements found in the borrower's records, provided to us by the CEO, showed that business D had a net income totaling \$298,176 for the combined period ended December 31, 1996; December 31, 1997; and October 31, 1998 (see table 10).

Table 10

	12/31/96	12/31/97	10/31/98	Total
Revenue	\$758,463	\$2,110,703	\$3,094,347	\$5,963,513
Job Cost	635,343	1,782,398	2,512,510	4,930,251
Gross Profit	\$123,120	\$328,305	\$581,837	\$1,033,262
Total Operating Expense	85,197	222,770	427,119	735,086
Net Income	\$37,923	\$105,535	\$154,718	\$298,176

Disparities also existed between revenues reported on the tax returns and financial statements (see table 11).

Table 11

Year	Revenue		Net Income	
	Tax Return	Financial Statements	Tax Return	Financial Statement
1996	Not Provided	\$758,463	Not Provided	\$37,923
1997	\$941,234	2,110,703	\$0	105,535
1998 ¹	2,613,642	3,094,347	0	154,718
1999	757,456	Not Provided	268	Not Provided
Total	\$4,312,332	\$5,963,513	\$268	\$298,176

¹Through October 31, 1998

The tax returns did not show an explanation of the differences between the income per the financial statements and tax returns. Internal Revenue Service (IRS) Regulations⁴ require a reconciliation between income/loss per accounting records with income/loss per tax returns and that the reasons for the differences be disclosed.

We were unable to reconcile the differences between the tax returns and the financial statements.

The lender stated that business D was established to provide a reliable accounting control over project costs to ensure that a profit did not result from construction of the facilities. Any cost incurred by business D would be considered cost incurred for the project. Although the intent of this control is sound, the lender did not have required documentation such as financial statements, audits, etc., for business D to support that a profit was not earned.

RECOMMENDATION NO. 2

To the extent the loss claim is not denied by other recommendations in this report, reduce any loss payments to the lender by \$430,395 (90 percent) unless the lender can provide documentation that the payments did not represent profits and represented arm's-length transactions.

Agency Response

In its July 30, 2003, response, RD stated,

The RBS National Office will advise the Georgia [RD SO] to consult with the Atlanta Regional OGC in development of a notification to the lender of the audit finding. If the lender cannot demonstrate that the payments did not represent profits and represented arm's length transactions, if legally

⁴ IRS Instructions for Form 1120S U.S. Income Tax Return for an S corporation.

permissible, reduce the loss payment to the lender by an amount of \$430,395. Notification to the lender on action regarding this recommendation will be completed not later than October 31, 2003. A management decision is requested.

OIG Position

To achieve management decision, we will need the results of the SO's and OGC's findings and determinations, and a copy of the notification to the lender showing the amount of the loss claim reduction.

FINDING NO. 3

LENDER DISBURSED FUNDS FOR INELIGIBLE AND UNSUPPORTED COSTS

The lender did not ensure that \$346,612 of costs were eligible for reimbursement from loan funds. Borrower records such as invoices and canceled checks did not support that the questioned reimbursement was for eligible loan purposes, (constructing and equipping the project's facility). The lender did

not sufficiently evaluate whether the reimbursement was for purposes authorized by the conditional commitment. As a result, the lender's loss claim could be overstated \$311,951 (90 percent).

RD Instructions⁵ state that distribution of loan funds is the responsibility of the lender and requires the lender to certify that disbursements have been made for purposes consistent with the conditional commitment. The conditional commitment states that loan funds will be used for constructing and equipping the project's facilities. The conditional commitment requires evidence of proper disbursement. It states, "The lender will utilize and maintain appropriate documents (appraisals, invoices, audits, etc.) in the disbursement of loan proceeds."

The loan disbursement statement (see exhibit B) showed that \$1,509,103 was disbursed at loan closing. The statement itemized \$204,625 as typical closing expenses paid to third parties. The remaining \$1,304,477 was supposed to be reimbursement for prior costs incurred by the borrower and an identity-of-interest company (business E) for constructing and equipping the facility.

To determine whether the \$1,304,477 was for eligible loan purposes, we examined all documents the borrower (CEO, CFO, and identity-of-interest companies) provided to us including property appraisals, paid invoices, bank statements, canceled checks, accounting transaction registers, and itemized transaction registers for the two construction companies. We found documentation supporting \$957,865 of

⁵ RD Instructions 4279.30(a) and 4279.181(1), dated December 23, 1996.

facility construction and equipment related costs. Therefore, we questioned \$346,612 (\$1,304,477 - \$957,865) because its documentation (e.g., checks and invoices) was for purposes other than facility construction and equipment such as the early research and development cost.

An October 13, 1997, independent C.P.A. attestation report was the lender's support for the \$1,304,477 disbursed for prior cost. The report stated that a capitalized balance of \$1,804,910 recorded in the borrower's account for property, plant, and equipment was supported by paid invoices and canceled checks.

Borrower officials told us they provided us with all financial records and documentation applicable to the project including those for the identity-of-interest companies. Our review of the borrower's records identified several primary sources that funded these project costs prior to loan closing. (See table 12.)

Table 12

Source of Funds	Amount
AARCC	\$ 600,000
Private Investors	\$ 490,046
Interim Financing	\$ 652,880
Total	\$1,742,926

The C.P.A.'s review did not assess whether the \$1,804,910 met the eligible use criteria (constructing and equipping the facility) for reimbursement from loan funds. The \$1,804,910 capitalized balance included expenses incurred since inception of the company including the research and development phases for the new technological process. These type costs were not eligible for reimbursement from loan proceeds. The AARCC funding was to assist the venture in the research and development phase and determine if the concept had commercial applications.

Included in the questioned \$346,612 was \$26,940 paid to the borrower's general manager and owner of the construction companies. At loan closing \$88,340 was disbursed to the general manager to pay for 6.14 acres of land he sold to the borrower and on which the facility was constructed. The land's appraisal value of \$61,400 (\$10,000 per acre) was \$26,940 less than the purchase price. The CEO stated land improvements made since the August 1996 appraisal justified the higher value but he provided no specifics. Site preparation had been underway since April 1996 and was financed with interim loans and other sources. An RD Headquarters official stated the lender should have made the disbursement based on the appraisal value.

RECOMMENDATION NO. 3

To the extent the loss claim is not denied by other recommendations in this report, reduce any loss payments to the lender by \$311,951 (90 percent) unless the lender can provide documentation that the payments were for eligible loan purposes.

Agency Response

In its July 30, 2003, response, RD stated,

The RBS National Office will advise the Georgia [RD SO] to consult with the Atlanta Regional OGC in development of a notification to the lender of the audit finding. If the lender cannot demonstrate that the payments were for an eligible purpose, the loss payment to the lender will be reduced, if legally permissible, by \$311,951. Notification to the lender on action regarding this recommendation will be completed not later than October 31, 2003. A management decision is requested.

OIG Position

To achieve management decision, we will need the results of the SO's and OGC's findings and determinations, and a copy of the notification to the lender showing the amount of the loss claim reduction.

CHAPTER 2**LENDER WAS DEFICIENT IN ITS RESPONSIBILITY FOR LOANMAKING AND SERVICING**

The lender did not ensure that the facility was designed and constructed to produce the quantity and quality of product needed for successful operations and collateral was adequate for repayment of the loan. Loanmaking and servicing requirements that were not met included (1) obtaining architectural and engineering specifications and analyses for the design of the project's facilities and equipment, (2) ensuring the facility was constructed and equipped as plans called for and on the basis which the proposed collateral was appraised, and (3) obtaining sufficient loan collateral. The business never started up because the facility could not produce the quantity and quality of product after available funds were spent. Proceeds from liquidation of collateral in August 2002 were insufficient to repay the loan principal and accrued interest, resulting in a deficiency of \$5.8 million. We concluded that these conditions occurred because the lender was deficient in its responsibility for loanmaking and servicing.

RD Instructions⁶ state that the lender is responsible for ensuring that all program requirements for loanmaking and servicing are met including those concerning sufficiency of engineering and architectural design of facilities to produce the planned quantity and quality of product when completed, supervision of construction, and collateral.⁷ RD staff stated that program regulations place almost total reliance and responsibility on the lender to properly evaluate loan applications and perform and execute loanmaking and servicing responsibilities.

FINDING NO. 4**ENGINEERING DESIGNS, PLANS,
AND SPECIFICATIONS NOT
OBTAINED**

The lender did not ensure requirements for construction of the production facility were met including that it be designed utilizing accepted architectural and engineering practices and when completed produce the quantity and quality of carbon called for in the application. Due to design problems, cost overruns, and

substantial delays, the facility was not completed after project funds were exhausted. The facility could not produce the quantity and quality of carbon called for in the loan application and, therefore, never started full-scale commercial production. The conditions occurred because the lender did not require that the borrower obtain the services of a professional engineer to design the facility including detailed machinery and equipment specifications. Instead, the lender allowed the owner, who did not have

⁶ RD Instruction 4279.1(b), dated December 23, 1996.

⁷ Code of Federal Regulations (CFR) Ch. XLII sec. 4279.156(a) and (b).

experience in architectural and engineering design and construction to design the facility and serve as general contractor. Therefore, RD is potentially liable for \$5,211,250 (90 percent) of the losses on the loan.

Regulations⁸ state that the lender is responsible for ensuring that all program requirements for loanmaking and servicing are met including adequate supervision of construction of a facility that will become loan collateral. The lender must also ensure that the facility is designed using accepted architectural and engineering practices.⁹ These requirements were incorporated into the conditional commitment for the loan.

Project Not Designed Using Accepted Architectural and Engineering Analyses

The requirements that the project be designed using accepted architectural and engineering practices to ensure timely functionality of the plant and equipment were not met. The lender allowed the borrower's general manager, who was not an architect or engineer, to design and construct the project (see Findings Nos. 1 and 2). The June 14, 1996, construction contracts, made the general manager responsible for preparation of competent plans and specifications. The contract stated, in part, the following.

** * * has assumed 100% responsibility for the Project.*

*The Contractor shall design, furnish all the materials, and perform all the Work * * * The Contractor shall be solely responsible for and have control over construction means, methods, techniques, sequences and procedures [for] coordinating all portions of the Work under the Contract. * * **

*The Contractor shall be responsible for the design, coordination, completeness, accuracy and all plans, drawings, specifications and other documents necessary for the construction * * * and for their compliance with all applicable codes, ordinances, regulations and laws.*

The general manager's work experience included ownership and management of [

] According to RD officials, the program regulations neither prohibit nor permit the borrower from serving as the design engineer and general contractor. Therefore, it is up to the lender to approve or disapprove an applicant's request to perform these functions.

⁸ 7 CFR Ch. XLII sec. 7279.1(b) and 4279.30(a).

⁹ 7 CFR Ch. XLII sec. 4279.156(a).

The design plans were general drawings prepared by an engineering firm of building sizes and processing equipment locations in relation to each other. These plans served as the basis for the appraisal (see Finding No. 4). The borrower's CEO stated detailed design plans and analyses with complete specifications for the fabricated specialized equipment were not obtained due to cost. The general manager told us that construction and installation procedures were determined by trial and error and borrower documentation stated employees fabricated 85 percent of the equipment installed in the plant.

According to an October 26, 2001, letter from the lender, "Problems developed early in the construction of the manufacturing process. Obtaining, installing, and testing each piece of machinery and equipment took far longer than anyone projected and the physical plant was more than a year behind when completed."

The business was projected to start generating income for loan repayment between October 1998 and February 1999. The facility was to be designed to produce 395 pounds per hour or 144 tons per month. Actual production never reached more than 200 pounds per hour and could not be sustained without deterioration in the quality of product. During the period March to July 1999, only nine tons of activated carbon had been produced but could not be crushed and sold because the plant's grinder room was not yet built.

Examples of the production problems were described in a status report dated October 22, 1999, prepared by the borrower's CFO.

*As of July 15, [] was not in continuous production. The pyrolysis system made a very good char when it was running, but typically after 2-4 days the system would shut down due to tar build up * * * I made a decision after a thorough review of the status of all systems to shut the plant down* * *I had no idea how long the pyrolysis system would take to be corrected.*

*By early September * * * we began construction of a pyrolysis unit made from stainless steel. The carbon steel unit was not strong enough to withstand the temperatures in pyrolysis.*

The production process never generated sufficient quantity and quality of product to start commercial production.

The lender did not require the borrower to obtain the expertise of a professional engineer to identify constraints or limitations in facility

construction or design-related factors that would adversely affect the success of the project. The production process to convert peanut shells to activated carbon was experimental and untested on a commercial scale. There were no engineering analyses of the technological processes and what equipment and its capacity would be needed in order to achieve the desired production levels or engineering designs and specifications to show the proper equipment needed to support a production process that would be generating 144 tons of carbon per month. Adequate design and engineering specifications should have been obtained to anticipate the equipment capabilities and interfaces needed in order to achieve the desired production level and ensure timely functionality of the loan collateral.

The lender told us that the planned manufacturing facility to produce activated carbon would be part of continuing research and development. A June 30, 1999, borrower financial projection, disclosed that the company had produced only laboratory quantities of final product, and novel designs were still being incorporated into the manufacturing process. The lender did not respond to our inquiry concerning why design and engineering analyses were not required.

We concluded that the lender did not sufficiently evaluate the technical feasibility of the carbon manufacturing process.

Lender Did Not Adequately Inspect and Monitor Construction Progress

The lender did not perform progress inspections to determine if the amounts of loan fund draws were justified and consistent with the construction plans. RD Instructions¹⁰ provide that the lender would normally have inspections made by a qualified individual prior to making progress payments for completed construction and equipment installations.

In an April 18, 1997, letter to RD, the lender stated it would employ a professional engineer to verify construction draws on loan funds and changes in plans. The lender told us that the services of an engineer were not obtained as agreed because the borrower's CEO established an engineering firm (see Finding No. 2) to provide inspections prior to the lender making disbursements on draws.

At loan closing, \$1.3 million of loan funds were disbursed as reimbursement for previously incurred construction costs. However, we found no engineer analysis to support the value of construction or compliance with plans to that point. After loan closing, an engineer employed by the CEO's firm certified construction draws for several

¹⁰ RD Instruction 4279.156, dated December 23, 1996.

months. Prior to his termination, the engineer certified five draw requests totaling \$701,918. The lender continued to disburse funds for an additional 11 months totaling \$2,788,980 in the absence of certified progress inspections performed by an engineer.

RECOMMENDATION NO. 4

In consultation with the Office of the General Counsel, and to the extent the loss claim is not reduced by other recommendations in this report, deny or substantially reduce the lender's loss claim (\$5,211,250) due to its failure to exercise due diligence in ensuring that the construction of the facility was properly planned, designed, and equipped with available funding to produce the quantity and quality of carbon called for in the application package.

Agency Response

In its July 30, 2003, response, RD stated,

The RBS National Office will advise the Georgia [RD SO] to consult with the Atlanta Regional OGC to determine to what extent the loss payment can be reduced, based on the lender's failure to exercise due diligence as described in the audit finding. Upon such determination, the [SO] is to notify the lender of the finding and proceed to reduce/recover the amount of the loss, if any, occasioned by the lender's failure to exercise due diligence in this matter. Notification to the lender in regard to this recommendation will be diligence in this matter. Notification to the lender in regard to this recommendation will be completed not later than October 31, 2003. A management decision is requested.

OIG Position

To achieve management decision, we will need the results of the SO's and OGC's findings and determinations, and a copy of the notification to the lender showing the amount of the loss claim reduction.

FINDING NO. 5
LOAN SECURITY WAS
INADAQUATE

The lender did not ensure that the value of collateral was sufficient to repay the loan. The loan collateral that originally appraised for \$7.4 million sold for only \$148,500. As of August 2002, a loss of about \$5.8 million was expected for which RD could be liable for

90 percent. The loan was under-secured primarily because (1) the \$3.7 million discounted value-of-purposed collateral was less than the loan amount, (2) some purposed collateral with a discount value of \$1.6 million was not constructed and/or purchased, and (3) the primary collateral was specialized machinery and equipment that had to be fabricated and was not adaptable to other activities.

RD Instructions¹¹ provide that lenders only recommend loan proposals that are supported by evidence of sufficient collateral. RD Instructions¹² also state that the lender is responsible for obtaining sufficient collateral to reasonably assure repayment of the loan and that appraisal values adequately reflect the actual value of the collateral.¹³ These requirements are important because sufficient collateral minimizes the risk of loss to the Government in the event a loan cannot be repaid. In the case of this loan, the risk was elevated due to the specialized machinery and equipment which had to be fabricated and the business being a startup venture for an untested technology and commercial process.

Insufficient Collateral

A significant disparity existed between the August 1996 appraised value of the loan security (primarily facilities to be constructed including the purchase, fabrication, and installation of machinery and equipment) and the August 2002 liquidation value. In August 1996 the borrower obtained an appraisal from an independent professional firm that valued the proposed, fully-equipped facility at \$7.4 million based on estimated construction cost. The lender's records showed that it discounted the collateral down to \$3.7 million. Therefore, the lender knowingly under-collateralized the \$5 million loan at inception by at least \$1,315,976. RD Instructions¹⁴ require that the discounted collateral value at least cover the loan unless the lender can document that a borrower's cashflow history and profitability are strong. In this case, this was not possible because the business was a startup venture without an income or production history.

¹¹ RD Instruction 4279.30(a), dated December 23, 1996.

¹² RD Instruction 4279.131(b), dated December 23, 1996.

¹³ RD Instruction 4279.144, dated December 23, 1996.

¹⁴ RD Instruction 4279.131(b), dated December 23, 1996.

Total proceeds received from liquidation of collateral were \$148,500. Therefore, losses in excess of \$5.7 million were expected for which RD could be liable for 90 percent.

The proposed facility and its machinery and equipment were appraised on a cost estimate basis. To identify planned collateral and determine values, the appraiser relied on general drawings of buildings and an equipment list dated August 15, 1996, that were prepared for the borrower by an engineering firm. The plans included a 50,000 square foot building, kilns, and gas generators. The design plans were general drawings of the building and processing equipment locations in relation to each other. The August 15, 1996, engineering plans, estimated cost at \$4.2 million, which included \$1,533,585 for the building; \$2,573,700 for equipment; and \$99,500 for engineering. The appraisal report included the engineer's estimate for equipment and engineering costs, but utilized construction cost factors to estimate the cost of the building. The building cost estimate increased from \$1,533,585 to \$1,795,500.

The appraiser told us that borrower officials subsequently provided additional information for planned construction not reflected in the engineering drawings. Added to the appraisal was a second 9,084 square foot production building and a laboratory estimated at \$349,882, equipment for \$1,279,400, and land and engineering costs of \$79,000. The appraiser then added \$1,202,684 to the total estimated cost for entrepreneurial profit.

The borrower's loan application showed a discounted collateral value of \$5.3 million. The discounted value removed the entrepreneurial profit and engineering costs (i.e., soft costs). The agency reviewed the appraisal, which was based on the cost approach, and determined it was acceptable. Since entrepreneurial profit and engineering costs are allowable with the cost appraisal approach, RD accepted the \$5.3 million discounted valuation provided on the application.

The lender's credit analysis showed the appraised value of planned loan collateral was actually discounted from \$7.4 million to \$3,684,024 (see table 12).

Table 12

	Appraised Value	Discount Percent	Lender Discounted Value
Entrepreneurial profit	\$1,202,684	100	\$0
Engineering costs	149,500	100	0
Real estate	2,196,842	20	1,757,474
Equipment	3,853,100	50	1,926,550
Total	\$7,402,126		\$3,684,024

The lender's credit analysis also concluded that the collateral would be insufficient in the event of failure of the business. The lender's analysis stated, "Pertaining [to] an exit strategy the most likely alternative would be a reliance on the Government guarantee if the business venture does not prove to be viable. In this scenario, given the value and specialized nature of the collateral, it is likely that the Bank would experience a deficiency."

The only other collateral the lender obtained was the personal guaranty of the borrower's CEO who was also the principal owner. A personal financial statement of the CEO showed his net worth was \$482,525 at loan inception. The majority of his net worth was comprised of stock ownership valued at \$447,742 in the borrower company. Therefore, the personal guarantee duplicated the lender's security interest in the assets of the business. After failure of the business, the stock was worthless.

Collateral Constructed and Installed Did Not Match Items on Appraisal

The lender did not monitor construction to ensure compliance with plans, installation of required equipment, and submission of modification change orders. Planned real estate improvements and purchases and installation of machinery and equipment shown on the appraisal were either not constructed or installed in the facility. Based on values in the August 1996 appraisal report, items not constructed or purchased and installed totaled \$2,573,515. The discounted value was \$1,634,612. (See table 13.)

Table 13

	Collateral Not Constructed or Purchased	Discount	
		Percent	Value
Real Estate			
50,000 SF [square feet] Building	\$1,149,515		
Asphalt Paving (5,000 SF @ \$2.00/SF)	10,000		
Subtotal	\$1,159,515	20	\$927,612
Machinery/Equipment			
stainless high temp. processing kilns	\$500,000		
2 – 20" 10 hp stainless oil/gas separator condensing units	7,000		
6' continuous recharge activated charcoal gas filter system	9,000		
30" x 24" gas impinging filter	2,500		
2 - 20" x 20" high flow fiberglass gas filter system	500		
3 – 150 KW Caterpillar natural gas powered generators	225,000		
20' x 48" off gas combustion system	15,000		
36" Williams ring roller mill	120,000		
stainless steel cyclonic oil/gas separator condensing units	15,000		
continuous recharge activated charcoal gas filter system	16,000		
gas impinging filters	6,000		
High flow fiberglass gas filters	3,000		
natural gas powered generators	420,000		
off gas combustors	75,000		
Subtotal	\$1,414,000	50	\$707,000
Totals	\$2,573,515		\$1,634,612

The same appraiser who performed the August 1996 appraisal also performed the November 2000 foreclosure appraisal. The foreclosure appraisal reported various discrepancies and stated, "The subject property was not built according to project's plans and specifications and the projected quality of construction was considerably less than what was expected."

The largest differences occurred due to (1) substantially reducing the size of the buildings, (2) installing only one of several kilns, and (3) not installing all generators and associated equipment listed on the appraisal.

- As described in the August 1996 appraisal report, plans called for two heavy-duty buildings of 50,000 and 8,100 square feet; and a laboratory of 984 square feet (59,084 total square feet). Instead, a complex of low-quality style buildings was constructed including production, office, and warehouse facilities. (See Table 14.)

Table 14

Use	Size (Square Feet)
Office Area	1,265.5
Shop Area	3,299.5
Superstructure	3,600.0
Production Area	2,700.0
Laboratory	813.0
Annex	395.0
Warehouse/Storage	15,000.0
Total Square Feet	27,073.0

We computed a value for the 32,011 square footage that was not constructed. Based on a construction cost of \$35.91 per square foot used in the appraisal, the building value was \$1,149,515 less than planned.

- The August 1996 appraisal valued the cost of two high-temperature processing kilns at \$350,000 and \$500,000, respectively. The November 2000 liquidation appraisal listed one kiln as present in the facility and our inspection of the facility found only one present. Borrower documentation described the installed kiln as proprietary equipment fabricated by plant employees, which the appraisal had valued at \$350,000.
- The appraisal reported that natural gas generators valued at \$645,000 were to be installed in the facility. The November 2000 liquidation appraisal included an inventory of equipment present at the plant, but did not specifically identify whether generators were present. It listed a boiler for steam generating purposes. Our inspection of the facility found that natural gas generators had not been installed. The CEO and general manager told us that after construction started, plans changed and only steam generators were installed.

The loan agreement stipulated that disbursements will be made only after receipt by the lender of all change orders showing modifications to construction plans. Neither the lender nor borrower had modification change orders on file to document approval for changes to planned construction and equipment items listed in the August 1996 appraisal.

In summary, the discounted value of the collateral at loan inception was \$1,315,976 less than the \$5 million loan and planned buildings and machinery and equipment with a discounted value of \$1,634,612 was either not constructed or installed. RD is potentially liable for \$2,655,529 (90 percent) of the total \$2,950,588 shortfall.

RECOMMENDATION NO. 5

To the extent that the loss claim is not denied by other recommendations in this report and in consultation with OGC, disallow \$2,655,529 due to the lender's failure to

obtain sufficient security.

Agency Response

In its July 30, 2003, response, RD stated,

The RBS National Office will advise the Georgia [RD SO] to consult with the Atlanta Regional OGC to determine to what extent the loss payment can be reduced based on the lender's failure to acquire sufficient collateral as described in the audit finding. Upon such determination, the [SO] is to notify the lender of the finding and proceed to reduce/recover the amount of the loss, if any, occasioned by the lender's failure to obtain sufficient collateral. Notification to the lender in regard to this recommendation will be completed not later than October 31, 2003. A management decision is requested.

OIG Position

To achieve management decision, we will need the results of the SO's and OGC's findings and determinations, and a copy of the notification to the lender showing the amount of the loss claim reduction.

FINDING NO. 6

The borrower spent \$224,951 of AARCC investment funds for ineligible and questionable purposes. Of the \$224,951, we found that (1) \$213,325 was spent on project construction, which was prohibited by the venture capital agreement and (2) \$11,626 was used to pay off credit lines of the borrower's CEO and general manager that were spent on undocumented items. The misuse of funds occurred because the borrower did not maintain an adequate accounting for the use of the invested funds or comply with the venture capital agreement requirements to obtain annual financial audits and submit periodic financial and performance reports to AARCC.

On September 15, 1995, AARCC entered into a venture capital agreement with the borrower. The agreement's overall purpose was to assist the borrower in developing, producing, and marketing high-grade activated carbon from agricultural biomass, primarily peanut shells. In return, AARCC would receive royalties on future product sales and could redeem its stock investment. An April 17, 1997, amendment, increased the investment by \$500,000, resulting in a total investment of \$800,000. (See table 15.)

Table 15

Date	Amount
10/18/95	\$100,000
1/9/96	50,000
2/14/96	150,000
5/13/97	300,000
1/12/99	200,000
Totals	\$800,000

Because the borrower's enterprise did not succeed, AARCC never received royalties and a return of invested funds.

The venture capital agreement states, "The Company agrees that no part of the funds made available by the AARC Center to the Company shall be expended for the acquisition or construction of a building or facility, for travel of AARC Center employees, or for lobbying activities."

Because the borrower records lacked a detailed accounting for the use of the AARCC funds, we reviewed the borrower's bank records to determine source and application of funds. Bank statements were available that showed the disposition of \$500,000 of the investment funds received from AARCC (May 1997 for \$300,000 and January 1999 for \$200,000) and canceled checks identifying payees. We identified that \$224,951 of the AARCC funds were used for ineligible and questioned purposes. (See table 16.)

Table 16

Payee	Funds Amount
CEO - line of credit	\$6,632
General Manager - line of credit (construction contractor)	4,994
Engineering Firm (Business C)	4,000
Construction company (Business D)	196,500
Construction Company (Business E)	12,825
Total	\$224,951

We were unable to make a similar analysis for the AARCC funds totaling \$300,000 made in December 1995 and January and February 1996.

Businesses C, D, and E existed to provide construction-related services to the borrower. Therefore, the AARCC funds disbursed to these businesses were for project construction, a violation of the venture capital agreement. The borrower's records did not show what the CEO's and general manager's credit lines were used to purchase. Therefore, we questioned the amounts.

We could find no evidence that the borrower complied with provisions of the venture agreement that required financial and performance reporting. The agreement required the company to submit (1) semiannual Financial Status Reports (Standard Form (SF) 269) and a final report after expiration of the agreement, (2) semiannual performance reports and a final report after expiration of the agreements, and (3) annual financial audits.

The borrower's records did not contain copies of financial reports (SF 269) and performance reports. SF 269 provides information on the status of invested funds; and performance reports compare project output to established goals and explain cost overruns. Our review of AARCC files obtained from RD Headquarters also found that the required reports were not present. In addition, the borrower failed to obtain annual audits of its financial statements as required by both the loan and AARCC

agreement for calendar year's 1998, 1999, and 2000. We concluded that the borrower did not prepare and submit financial and performance reports to AARCC.

The venture capital agreement stated that it is governed by the USDA Regulation¹⁵ on debarment. Due to the improper use of invested funds and the failure to obtain financial audits and file required financial and performance reports, an assessment should be made as to whether responsible borrower officials should be debarred.

On September 17, 2002, the AARCC Investment Review Committee wrote off the investment. The committee found that the borrower's company, with no revenue and its assets having been sold at auction by the RD guaranteed lender, was worthless and represented a total loss to the AARCC portfolio.

RECOMMENDATION NO. 6

In consultation with OGC determine whether borrower officials should be debarred from participation in Government programs.

Agency Response

In its July 30, 2003, response, RD stated,

The RBS National Office will advise the Georgia [RD SO] to consult with the Atlanta Regional OGC to determine if actions of the borrower officials, as described in the audit finding, constitute grounds for debarment. If such a determination is made, the State is to make a recommendation to the National Office to institute debarment proceedings. The [SO] response in regard to this recommendation will be completed not later than October 31, 2003.

OIG Position

To achieve management decision, we will need the results of the SO's and OGC's findings and determinations.

¹⁵ CFR, chapter 7, part 3017, dated January 2003.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

Recommendation No.	Description	Amount	Category
1 and 2	Questioned payments to owners, stockholders, [] and their identity-of-interest companies.	\$741,868	Questioned costs/loan - Recovery Recommended
3	Unsupported cost incurred prior to loan closing that were reimbursed with loan funds.	311,951	Unsupported costs/loan - Recovery Recommended
4	Loan collateral was insufficient and construction was not completed and equipment not purchased/installed as planned.	2,655,529	Questioned costs/loan - Recovery Recommended
5	Facility was not designed using accepted architectural and engineering practices and would not produce the quantity and quality of carbon as planned.	5,211,250	Questioned costs/loan - Recovery Recommended
Unduplicated Total¹		\$5,211,250	
6	Borrower used AARCC funds for ineligible purposes.	224,951	Questioned costs/loan - Recovery Recommended
Grand Total		\$5,436,201	

¹ Total loan loss estimated at \$5,790,277 guaranteed at 90 percent (\$5,211,250). Therefore, the total monetary results associated with Recommendations Nos. 1 through 5 cannot exceed \$5,211,250.

EXHIBIT B - LOAN DISBURSEMENT STATEMENT

Item Description	Conditional Commitment	Loan Disclosure Settlement Statement
Real Estate:		
Pay off construction contractor's loan		\$408,168 ²
Refinance interim loan made to borrower		204,951
Reimburse borrower for fees (appraisal, survey, environmental report, accounting), construction period interest, and other construction-related costs		50,037
Reimburse borrower for accounting fees related to loan closing		3,338
Purchase land for building site		88,340
Pay construction contractor for work completed on building		278,543
Pay various fees (packaging, guaranty, attorney, origination, audit), insurance, taxes		57,271
Subtotal Real Estate	\$1,300,000	\$1,090,648
Machinery & Equipment:		
Reimburse borrower for fees (appraisal, environmental report, design), construction period interest, and costs		211,407
Reimburse borrower for accounting fees related to loan closing		8,218
Pay various fees (packaging, guaranty, attorney, origination, audit), insurance, taxes		126,144
Refinance interim loan made to borrower		50,192
Subtotal Machinery & Equipment	\$3,200,000	\$395,961
Working Capital:		
Pay various fees (packaging, guaranty, attorney, origination, audit), insurance, taxes		21,210
Reimburse borrower for accounting fees related to loan closing		1,284
Subtotal Working Capital	\$500,000	\$22,494
Total Disbursements at Loan Closing¹		\$1,509,103¹
Balance of Funds Placed in a Certificate of Deposit for Future Use		\$3,490,897
Totals	\$5,000,000	\$5,000,000

¹ Funds disbursed at loan closing, October 23, 1997.

² Check issued to an outside lender to pay off 3 loans made prior to issuance of the conditional commitment.

EXHIBIT C – DISBURSEMENTS TO OFFICERS, STOCKHOLDERS, FAMILY MEMBERS, AND CLOSELY HELD BUSINESSES

Payee	[]
Chief Executive Officer (Officer A)	[] of officer B and [] A, [] of officer C, and [] of officer D
General Manager (Officer B)	[] of officers A and C, [] A
Operations Manager (Officer C)	[] of officer A and [] of officer B and [] A and General Contractor
Chief Financial Officer (Officer D)	[] of officer A and C
Accountant [] A	[] of officers A and C and [] of officer B
Business A (accounting)	Owned by Officer D
Business B (leasing)	Owned by Officer B
Business C (engineering)	Owned by Officer A
Business D (construction)	Owned by Officer B
Business E (construction)	Owned by Officer B

EXHIBIT D – RD RESPONSE TO THE DRAFT REPORT

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United States Department of Agriculture
Rural Development

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

SUBJECT: Rural Development Lender Servicing of Business and Industry
Guaranteed Loans in Georgia
Audit Report No. 34601-005-AT

TO: John M. Purcell
Director
Financial Management Division

JUL 30 2003

This is in response to the official draft findings and recommendations of the above-captioned Office of Inspector General (OIG) audit.

Recommendation No. 1:

To the extent the loss claim is not denied by other recommendations in this report, reduce any loss payment to the lender by \$311,473 for the questioned salaries, fees and other compensation.

Agency Response

The Rural Business-Cooperative Service (RBS) National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional Office of the General Counsel (OGC) in the development of a notification to the lender of the audit finding and, if legally permissible, to reduce the loss payment to the lender by an amount of \$311,473. Notification to the lender on action regarding this recommendation will be completed not later than October 31, 2003. A management decision is requested.

Recommendation No. 2:

To the extent the loss claim is not denied by other recommendations in this report, reduce any loss payment to the lender by \$430,395 (90 percent) unless the lender can provide documentation that the payments did not represent profits and represented arm's length transactions.

Agency Response

The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC in development of a notification to the lender of the audit finding. If the lender cannot demonstrate that the payments did not represent profits and represented arm's length transactions, if legally permissible, reduce the loss payment to the lender by an amount of \$430,395. Notification to the lender on action regarding this

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Secretary of Agriculture, Washington, DC 20250



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recommendation will be completed not later than October 31, 2003. A management decision is requested.

Recommendation No. 3:

To the extent the loss claim is not denied by other recommendations in this report, reduce any loss payments to the lender by \$311,951 (90 percent) unless the lender can provide documentation that the payments were for an eligible loan purpose.

Agency Response

The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC in development of a notification to the lender of the audit finding. If the lender cannot demonstrate the payments were for an eligible purpose, the loss payment to the lender will be reduced, if legally permissible, by \$311,951. Notification to the lender on action regarding this recommendation will be completed not later than October 31, 2003. A management decision is requested.

Recommendation No. 4:

In consultation with the Office of the General Counsel (OGC), and to the extent the loss claim is not reduced by other recommendations in this report, deny or substantially reduce the lender's loss claim (\$5,211,250) due to its failure to exercise due diligence in ensuring that the construction of the facility was properly planned, designed, and equipped with available funding to produce the quantity and quality of carbon called for in the application package.

Agency Response

The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC to determine to what extent the loss payment can be reduced, based on the lender's failure to exercise due diligence as described in the audit finding. Upon such determination, the State Office is to notify the lender of the finding and proceed to reduce/recover the amount of the loss, if any, occasioned by the lender's failure to exercise due diligence in this matter. Notification to the lender in regard to this recommendation will be completed not later than October 31, 2003. A management decision is requested.

Recommendation No. 5:

To the extent the loss claim is not denied by other recommendations in this report and in consultation with OGC, disallow \$2,655,529 due to the lender's failure to obtain sufficient security.

Agency Response

The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC to determine to what extent the loss payment can be reduced

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based on the lender's failure to acquire sufficient collateral as described in the audit finding. Upon such determination, the State Office is to notify the lender of the finding and proceed to reduce/recover the amount of the loss, if any, occasioned by the lender's failure to obtain sufficient collateral. Notification to the lender in regard to this recommendation will be completed not later than October 31, 2003. A management decision is requested.

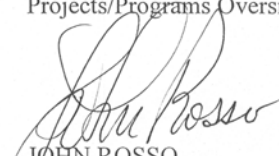
Recommendation No. 6:

In consultation with OGC determine whether borrower officials should be debarred from participation in Government programs.

Agency Response

The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC to determine if actions of the borrower officials, as described in the audit finding, constitute grounds for debarment. If such a determination is made, the State is to make a recommendation to the National Office to institute debarment proceedings. The State Office response in regard to this recommendation will be completed not later than October 31, 2003.

If you have any questions or concerns, please contact Dwight Carmon, Director, Special Projects/Programs Oversight Division, (202) 690-4100.



JOHN ROSSO
Administrator

ABBREVIATIONS

AARCC	
Alternative Agricultural Research and Commercialization Corporation.....	2
B&I	
Business and Industry	1
C.P.A.	
Certified Public Accountant.....	11
CEO	
Chief Executive Officer	8
CFO	
Chief Financial Officer	9
CFR	
Code of Federal Regulations	21
IRS	
Internal Revenue Service	17
OGC	
Office of the General Counsel	10
OIG	
Office of Inspector General.....	4
RD	
Rural Development.....	1
SF	
Standard Form.....	33
SO	
State Office	1
USDA	
U.S. Department of Agriculture	2