



U.S. Department of Agriculture  
Office of Inspector General  
Midwest Region  
Audit Report

LENDER SERVICING OF BUSINESS AND  
INDUSTRY GUARANTEED LOANS  
COLUMBUS, OHIO  
FISCAL YEAR 2001



Report No.  
34004-3-CH  
OCTOBER 2001



UNITED STATES DEPARTMENT OF AGRICULTURE  
OFFICE OF INSPECTOR GENERAL  
Midwest Region  
111 North Canal Street – Suite 1130  
Chicago, IL 60606-7295



DATE: OCT 09 2001

REPLY TO  
ATTN OF: 34004-3-Ch

SUBJECT: Lender Servicing of Business and Industry Guaranteed Loans in Ohio

TO: Randall C. Hunt  
State Executive Director  
Rural Development  
200 North High Street  
Room 507  
Columbus, OH 43215

This report presents the results of our audit of Lender Servicing of Business and Industry Guaranteed Loans in Ohio. Rural Development's response to the official draft report, dated August 9, 2001, is included in its entirety as exhibit A, with excerpts and the Office of Inspector General's position incorporated into the Findings and Recommendations section of the report.

We have not yet reached management decisions on any of the recommendations in the report. Management decisions can be reached when RD provides the additional information outlined in the OIG position sections of the report.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing corrective actions you plan to take and the timeframes to address these recommendations. Please note that the regulation requires a management decision to be reached on all recommendations within 6 months of report issuance.

*Ed Krivus*  
EDWARD R. KRIVUS  
Regional Inspector General

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## EXECUTIVE SUMMARY

### LENDER SERVICING OF BUSINESS AND INDUSTRY GUARANTEED LOANS COLUMBUS, OHIO FISCAL YEAR 2001

REPORT NO. 34004-3-Ch

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#### RESULTS IN BRIEF

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Rural Development (RD) did not obtain required financial documents from lenders participating in its Business and Industry (B&I) Program. Lenders are required to obtain financial statements from borrowers, as specified in loan agreements and program regulations, and submit the statements to RD. The lenders are also required to analyze the borrowers' financial statements and submit a written summary of their analyses and conclusions to RD. The objective of our audit, which was part of a nationwide audit, was to evaluate the lenders' servicing of B&I guaranteed loans. Lenders did not submit the required financial statements and acceptable lenders' analyses for four of the five loans we reviewed. As a result, RD cannot properly evaluate the borrowers' financial status.

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#### KEY RECOMMENDATIONS

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We recommended that RD require lenders/borrowers to submit financial statements that comply with generally accepted accounting principles and loan agreement requirements. Also, classify loans as problems loans in all instances where borrowers are not complying with the loan agreements and program regulations, and notify lenders that noncompliance with loan agreements and program regulations could be considered negligent servicing. In addition, require lenders to submit financial analyses in compliance with RD Instructions and lender agreements.

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#### AGENCY RESPONSE

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RD agreed to revise its language in any new conditional commitments to be more specific as to its requirements regarding financial statements. RD stated that it has improved its monitoring of its portfolio by sending more timely reminder letters but it was vague as to how it intends to require its current lenders/borrowers to submit financial statements that comply with program requirements. RD

agreed to classify loans as problem loans in all instances where noncompliance with loan covenants occur, including inadequate financial statement submissions, and to notify lenders that failure to provide an analysis or providing a poor analysis will be considered negligent servicing. However, RD neither agreed to enforce its AN No. 3572 (4287-B), "Business and Industry Guaranteed Loan Program, Lender Financial Analysis Requirements," nor specified what it intended to do in cases where the lenders do not comply with program requirements. RD did not include the proposed completion dates for implementing corrective actions for any of the recommendations.

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### **OIG POSITION**

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OIG has not reached management decision on any of the four recommendations. We can reach management decision on the four recommendations when RD provides the additional information needed, as outlined in the *OIG Position* section of the report.

We incorporated RD's response, along with our position, in the *Findings and Recommendations* section of the report. The full text of the response is included as exhibit A.

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## INTRODUCTION

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### BACKGROUND

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The Business and Industry (B&I) Guaranteed Loan Program is administered by the Rural Business-Cooperative Service through its Rural Development State offices (hereafter referred to as RD). The purpose of the B&I Guaranteed Loan Program is to "improve, develop, or finance business, industry, and employment; and improve the economic and environmental climate in rural communities." RD guarantees loans made by private lenders (banks, savings and loan associations, etc.) for up to 90 percent of the approved loan amount provided to eligible borrowers.

Lenders are responsible for servicing B&I guaranteed loans and for taking all servicing actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. 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. The loan note guarantee will be unenforceable by the lender to the extent any loss results from the violation of usury laws, use of loan funds for unauthorized purposes, negligent servicing, or failure to obtain the required security.

The loan agreement between the lender and the borrower identifies the type of annual financial statement to be provided. Regulations require borrowers to submit financial statements and lenders to analyze the borrowers' financial statements. RD is responsible for evaluating the lenders' analyses and comparing the borrowers' previous and projected performance.

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### OBJECTIVES

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The objectives of our audit were to (1) evaluate RD's oversight of B&I guaranteed loans and oversight of lender servicing for those loans; (2) determine if lenders were properly servicing B&I guaranteed loans by monitoring collateral and submitting required documents to RD timely; and (3) determine if loan proceeds were used as specified in the loan agreements.

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### SCOPE

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This audit was part of a nationwide audit of B&I guaranteed loans. Our scope was limited to an overall review of five judgmentally selected

loans in Ohio and a more in-depth review of two of the five loans at both the applicable lender and borrower.

We performed our audit in the RD State office in Columbus, Ohio; at one lender in Kentucky; one lender in Ohio; and two borrowers in Ohio. We conducted the audit fieldwork between December 2000 and April 2001.

We performed the audit in accordance with Government Auditing Standards.

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To accomplish the audit objectives we:

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## **METHODOLOGY**

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- Reviewed requirements set forth in the RD Instructions and Administrative Notices issued by the RBS National Office.
- Reviewed prior OIG audits.
- Reviewed loan documentation maintained by the RD Ohio State Office (SO).
- Interviewed RD Ohio SO staff to obtain information regarding the processes and procedures used in the B&I Program.
- Interviewed officials at two lending institutions responsible for servicing the B&I guaranteed loans to determine whether lenders were properly servicing B&I guaranteed loans.
- Visited two lenders to obtain documentation on selected B&I loans.
- Visited two borrowers to determine if they had possession of the collateral pledged for the loans and to determine if the loan proceeds were used for authorized purposes.

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## FINDINGS AND RECOMMENDATIONS

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<b>CHAPTER 1</b>
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<b>LENDERS DID NOT ADEQUATELY MONITOR THE BUSINESS AND INDUSTRY LOANS</b>
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RD has procedures to identify a potential problem borrower before the borrower's financial condition has deteriorated to the point that loan repayment is unlikely. However, these procedures need to be strengthened to ensure that lenders/borrowers submit required financial statements and lenders submit required analyses to RD. The borrower for one of the five loans in our sample defaulted prior to ever submitting its first annual financial statements. (According to RD, the local telephone company forced this borrower, an Internet service provider, out of business for spamming its customers.) Lenders did not provide the required financial statements or the required financial analyses for the remaining four loans.

Lenders are responsible for providing all servicing actions to B&I guaranteed loans that they would perform on their portfolio of non-guaranteed loans. The loan note guarantees are unenforceable by lenders to the extent any loss is occasioned by negligent servicing. This responsibility includes but is not limited to the collection of payments, obtaining compliance with the covenants and provisions in the loan agreements, obtaining and analyzing financial statements, checking on payment of taxes and insurance premiums, and maintaining liens on collateral.<sup>1</sup>

The RD State offices are required to inform lenders, in writing, that failure to obtain the required financial statements, or to document efforts to obtain financial statements, could result in the loan guarantee being unenforceable due to negligent servicing.<sup>2</sup> The lender, with RD's concurrence, establishes the type and frequency of submission of financial statements by the borrower in the loan agreement. RD instructions<sup>3</sup> require that, at a minimum, lenders must submit to RD annual financial statements prepared by an accountant in accordance with generally accepted accounting principles (GAAP).

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<sup>1</sup> 7 CFR 4287, subpart B, paragraph 4287.107, dated January 1, 1998.

<sup>2</sup> RD AN No. 3572 (4287-B), dated September 28, 2000.

<sup>3</sup> RD Instruction 4279-B, paragraph 4279.137(a), dated January 1, 1998.



OIG Audit Report No. 34601-2-Ch, "Business and Industry Guaranteed Loan Program Financial Statement Analysis," issued in January 1999, identified missing and/or untimely financial statements for the 6-year period of review (1991 through 1996). For those guaranteed loans which had financial statements on file, some lenders had not provided any type of analyses and other analyses were incomplete because they did not evaluate loan covenants or did not provide RD with a written summary of the borrowers' financial status. RD did not always pursue the financial statements and financial analyses when this information was not received from lenders. A key recommendation was that RD notify lenders that failure to provide the required financial statements, financial analyses, and adherence to loan covenants could result in the loan guarantee being unenforceable due to negligent servicing. In response to the recommendations in this audit report, RBS agreed to issue an administrative notice (AN). However, the issuance of AN's, including the current RD AN No. 3572 (4287-B), dated September 28, 2000, apparently has not increased lenders' program compliance.

We did not identify any deficiencies related to use of loan proceeds or lenders' monitoring of loan collateral.

Early recognition of potential problems and the pursuit of solutions are keys to ensuring loan repayment ability. When RD does not receive vital financial information, it cannot adequately evaluate borrowers' financial status and monitor corrective actions.

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**FINDING NO. 1**

**LENDERS DID NOT REQUIRE  
BORROWERS TO SUBMIT  
REQUIRED FINANCIAL  
STATEMENTS**

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Lenders did not submit financial statements to RD that complied with terms in loan agreements and program regulations for four of the five loans we reviewed. RD regulations require that lenders submit financial statements that, at a minimum, meet GAAP reporting requirements. Both RD and the lenders generally accepted whatever financial statements the borrowers submitted and did not adequately follow up when those financial statements did not comply with the requirements of RD's Instructions and/or the loan agreements. Although RD provided documentation indicating followup letters were sent and lender visits were made in an attempt to obtain required financial statements, those statements were still not always obtained. Without properly prepared financial statements, neither RD nor the lenders were able to effectively evaluate borrowers' financial status or determine if they were, or if they were likely to become problematic.

Lenders are required to obtain and forward to RD the financial statements specified in loan agreements and program regulations within 120 days of the end of the borrower's fiscal year.<sup>4</sup>

RD prepares a conditional commitment (form 4279-3), which includes its proposed requirements for issuance of the loan note guarantee (form 4279-5). These proposed requirements include the source and use of funds, collateral, required financial statements, and any financial requirements (i.e., minimum financial ratios, account balances, etc.). The proposed requirements in the conditional commitment are negotiable between RD and the lender. Upon agreement in terms, RD issues the loan note guarantee to the lender. The lender uses its own loan agreement to extend these requirements to the borrower.

The lender establishes the type and frequency of submission of financial statements by the borrower in the loan agreement. RD instructions<sup>5</sup> require, at a minimum, annual financial statements prepared by an accountant in accordance with GAAP. Financial statements prepared in accordance with GAAP show financial position at the end of the period, earnings for the period, comprehensive income for the period, cash flows for the period, and investments by and distributions to owners during the period<sup>6</sup>. In addition, disclosure of accounting policies is an integral part of financial statements and required for one or more financial statements<sup>7</sup>. The types of financial statements required by the conditional commitments and loan agreements for the loans we reviewed were:

- Compiled financial statement. The American Institute of Certified Public Accountants (AICPA) defines a compilation as presenting in the form of financial statements, information that is the representation of management without undertaking to express assurance on the statements. Accordingly, an accountant need not be independent to prepare a compilation. Simply stated, a compilation is nothing more than an entity's self-assertion of its financial status.
- Reviewed financial statement. The AICPA defines a reviewed financial statement as one on which an accountant has performed inquiries and performed analytical procedures on that form that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that

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<sup>4</sup> 7 CFR 4287, subpart B, paragraph 4287.107(d), dated January 1, 1998.

<sup>5</sup> RD Instruction 4279-B, paragraph 4279.137(a), dated January 1, 1998.

<sup>6</sup> Statement of Financial Accounting Standards 5 (SFAC 5) issued by Financial Accounting Standards Board (FASB)

<sup>7</sup> Accounting Principles Board (APB) Opinion No. 22

should be made to the statements in order for them to be in conformance with GAAP. Accordingly, the accountant must be independent.

- Audited financial statement. This is defined as an examination of historical financial statements performed in accordance with generally accepted auditing standards. As stated in the standard auditor's report, the auditor's objective is to obtain reasonable assurance about whether the financial statements are free of material misstatement.

We reviewed RD loan files for the five judgmentally selected guaranteed loans to identify the type of annual financial statements that were required by the conditional commitments and the loan agreements. We then determined whether RD's files contained the annual financial statements in accordance with the lender agreements and program regulations for the five loans reviewed. Our review of the RD loan files disclosed the following information.

<b>Borrower &amp; Loan Amount</b>	<b>Conditional Commitment Requires</b>	<b>Loan Agreement Requires</b>	<b>RD Files Contain</b>
Borrower A, \$1.14 million loan	Reviewed financial statements	Audited financial statements	Compiled financial statements for calendar year 1999
Borrower B, \$1.8 million loan	Quarterly financial statements prepared according to GAAP; annual income tax returns (not specified for whom) prepared by an outside firm; and annual financial statements of personal and corporate guarantors	Quarterly internally prepared financial statements; annual income tax returns prepared by an outside CPA for the borrower and corporate guarantors; and annual personal financial statements of personal and corporate guarantors	Quarterly and annual balance sheets and income statements for calendar year 1999; income tax returns prepared by an outside CPA for both personal guarantors for 1997 (but no income tax returns for the three corporate guarantors); personal financial statements for both personal and corporate guarantors as of 12/31/99

Borrower C, \$3.4 million loan	Reviewed financial statements	Reviewed financial statements	Compiled financial statements
Borrower D, \$4.35 million loan	Compiled financial statements	Compiled financial statements, including statement of cash flows (not normally a part of a compilation)	Financial statements not prepared in accordance with GAAP. Only the balance sheet and income statement was submitted; not the statement of cash flows, the statement of earnings and comprehensive income, the statement of changes in owner's equity, or the disclosures of accounting policies
Borrower E, \$3 million loan	Reviewed financial statements	Audited financial statements	No financial statements were due because this borrower was forced out of business before its first annual financial statements were due

Borrower A's \$1.14 million loan was for the construction of a restaurant. The financial statements on file for this borrower did not comply with the loan agreement, which required audited financial statements. The borrower submitted compiled financial statements; not audited financial statements, as required. The lending official stated that there was a mistake in the loan agreement that went unnoticed; the loan agreement should have called for reviewed financial statements. Not only did the financial statements submitted not comply with the terms of the loan agreement, they did not meet the lender's intended requirements for the borrower to submit reviewed financial statements.

Borrower B's \$1.8 million loan was for the construction of a motel. The financial statements were not prepared in accordance with GAAP, as required by RD regulations, because only the balance sheet and income statement were provided. The borrower did not submit the statement of cash flows, the statement of changes in owner's equity/capital, or the disclosures of accounting policies, which are all required by GAAP.

Borrower C's \$3.4 million loan was for the construction of a retirement center. The borrower submitted compiled financial statements, not the reviewed statements required by the loan agreement, and the lender

accepted them because the lender official's understanding of reviewed and compiled financial statements was erroneous. The financial statements submitted were not in compliance with the loan agreement.

Borrower D's \$4.35 million loan was for construction of a nursing home. RD had originally requested that this borrower provide reviewed financial statements, but decided to accept compilations and a cash flow statement. An excerpt from RD's running record for this borrower revealed that the borrower was unwilling to provide reviewed statements and the lender referred to this as a "deal breaker." This borrower has experienced financial problems and cost overruns since the loan was made, and has since obtained additional nonguaranteed loans from the lender with RD's permission. We concluded that the financial statements submitted (balance sheet and income statement) were not in compliance with RD regulations that required financial statements to be prepared in accordance with GAAP. The borrower did not submit the statement of cash flows, the statement of changes in owner's equity/capital, or the disclosures of accounting policies, which are all required by GAAP.

Borrower E was an Internet service provider who was forced out of business about 4 months after the \$3 million loan was closed; therefore no financial statements were due. The long distance provider for this borrower cut off their service due to alleged spamming activities. Spamming occurs when an Internet service provider allows excessive amounts of advertising to be sent to subscribers via electronic mail. This loan is currently in liquidation.

The lenders told us that the reasons they did not submit the required financial statements were either that nobody at the lending institution paid attention to what the loan agreement and/or the RD Instructions required and just accepted what was received or that RD had not informed them that the statements submitted were inadequate. RD's practice was to accept whatever financial statements lenders submitted because they did not want to reject any available financial information. RD's documentation indicated followup letters were sent and lender visits were made in an attempt to obtain the required financial statements; however, those financial statements were not always obtained.

The regulations do not provide guidance on procedures RD should follow to obtain the required financial information, but RD can make the loan guarantee unenforceable due to negligent servicing actions by the lender. We believe that RD needs to document attempts to obtain the required information and inform the lenders of the potential effects of negligent servicing actions. Accurate and timely financial statements are vital for proper loan servicing.

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## RECOMMENDATION NO. 1

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Require lenders/borrowers to submit financial statements that comply with GAAP requirements and the requirements of loan agreements.

### **Agency Response**

RD agreed to revise its language in any new conditional commitments to be more specific as to its requirements. However, RD was vague as to how it intends to require its current lenders/borrowers to submit financial statements that comply with GAAP requirements and the requirements of the loan agreements. Also, RD did not give its proposed completion dates for implementing corrective actions.

### **OIG Position**

We cannot accept RD's management decision. Management decision can be reached when RD: (1) Details how it intends to require current lenders/borrowers to submit financial statements that comply with GAAP requirements and the requirements of loan agreements and (2) provides its proposed completion dates for implementing corrective actions.

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## RECOMMENDATION NO. 2

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Notify lenders in writing that failure to obtain the required financial statements from borrowers or to notify USDA in writing of any loan agreement violations could be considered negligent servicing.

### **Agency Response**

RD stated that it has improved the monitoring of its portfolio by sending more timely reminder letters to the lenders and following up with phone calls and visits when needed to accomplish the desired results until the proper financial statements are eventually received. RD also has developed a standard letter for the most serious cases that contains language referencing the possibility of a negligent servicing determination and the risks that would cause the lender. That letter would apply to missing financial statements as well as failure to notify RD of loan agreement violations.

**OIG Position**

We cannot accept RD's management decision. Management decision can be reached when RD notifies all lenders, in writing, that failure to obtain the required financial statements from borrowers and failure to notify USDA, in writing, of any loan agreement violations could be considered negligent servicing. RD also needs to provide its proposed completion dates for implementing its corrective actions.

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**RECOMMENDATION NO. 3**

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Classify loans as problem loans in all instances where noncompliance with loan covenants occur, including inadequate financial statement submissions.

**Agency Response**

RD stated that it agreed with this recommendation and plans to comply. However, RD continued by suggesting development of a special category in its Rural Community Facilities Tracking System (RCFTS) for nondelinquent problem loans due to financial statement or covenant violations only. RD stated that this would keep the minor problem loans separate from the major problem loans and provide a count as to how widely spread the delinquent financial statement problem is throughout RD's entire portfolio.

**OIG Position**

We cannot accept RD's management decision until RD advises us as to the date it plans to implement the corrective action. Suggestions regarding the development of additional categories in RCFTS to account for nondelinquent problem loans should be addressed to RD's Headquarters, not OIG.

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**FINDING NO. 2**  
**LENDERS FAILED TO PROVIDE**  
**FINANCIAL ANALYSES OR**  
**ANALYSES PROVIDED WERE**  
**INCOMPLETE**

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Lenders were not providing RD financial analyses as required by lender agreements and RD instructions or were providing incomplete analyses; RD did not follow up when lenders submitted incomplete financial analyses or did not submit any at all. This occurred because RD's Ohio SO procedures were to accept any financial analyses that showed lenders were reviewing the borrowers'

financial condition. RD's ability to identify borrowers' financial status and implement appropriate servicing actions is adversely affected when lenders fail to provide required financial analyses.

Lenders are required to analyze borrowers' financial statements and provide RD with written summaries of the lenders' analyses and conclusions, including trends, strengths, weaknesses, extraordinary transactions, and other indications of the financial condition of borrowers. RD is responsible for evaluating the lenders' analyses and following up with lenders on required servicing actions<sup>8</sup>.

We reviewed the most recent annual financial analyses lenders had submitted to RD for three of the five judgmentally selected B&I guaranteed loans. The business started with one of the five loans we reviewed did not operate long enough for the lender to perform an annual analysis. One lender did not submit any analyses for the borrower's 1999 financial statements. Lenders for the remaining three loans did not provide adequate analyses. They provided analyses of 1999 financial statements, but did not address all of the factors required by RD instructions and the loan agreements.

Officials at the RD SO stated that lenders should submit their analyses with the annual financial statements. They stated that the analyses provided depended on the lender, and acknowledged that the four loans in our review did not have required analyses. The RD officials further stated that they generally accept ratio calculations without written explanations and, as long as there is evidence of lenders checking borrowers' financial status, they do not ask for additional information. Lenders told us that they were aware that analyses were required. However, RD had not informed the lenders that the analyses submitted were incomplete or did not comply with program regulations.

Since the regulations do not specify followup efforts, we believe that RD needs to document attempts to obtain the required financial information and inform the lenders of the potential effects of negligent servicing

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<sup>8</sup> 7CFR 4287, subpart B, paragraph 4287.107, dated January 1, 1998



actions. Since the required financial statements were also not available, reliable analyses of the borrowers' financial position could not be performed. Without lenders communicating their conclusions as to the borrowers' financial condition, RD cannot properly evaluate the lenders' analyses or address servicing actions that are required.

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#### **RECOMMENDATION NO. 4**

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Require lenders to submit complete financial analyses in compliance with RD instructions and lender agreements, and notify lenders that failure to submit proper analyses will be considered negligent servicing.

##### **Agency Response**

RD agreed to comply for those lenders doing no analyses or poor analyses. However, RD did not agree to enforce its AN No. 3572 (4287-B), "Business and Industry Guaranteed Loan Program, Lender Financial Analysis Requirements," because that announcement required specific ratios that the RD Ohio State office does not believe are necessary or should be required.

##### **OIG Position**

We cannot accept RD's management decision. Management decision can be reached when RD: (1) Agrees to comply with AN No. 3572 (4287-B) and future RD instructions and announcements regarding lenders analyses; (2) agrees to notify lenders that failure to submit proper analyses will be considered negligent servicing; and (3) provides its proposed completion dates for implementing corrective actions.

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## EXHIBIT A – RDS' RESPONSE TO THE DRAFT REPORT



United States  
Department of  
Agriculture

Rural  
Development

Federal Building, Room 507  
200 North High Street  
(614) 255-2500  
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September 6, 2001

ATTN: 34004-3-Ch  
SUBJECT: Lender Servicing of Business and Industry Guaranteed Loans in Ohio  
TO: Edward R. Krivus  
Regional Inspector General  
United States Department of Agriculture  
Office of Inspector General  
111 N. Canal Street, Suite 1130  
Chicago, IL 60606-7295

We have reviewed the Official Draft of the subject Audit Report and have the following comments. We have responded to each audit recommendation individually and completely.

Finding No. 1

Recommendation No. 1

**Require lenders/borrowers to submit financial statements that comply with GAAP requirements and the requirements of loan agreements.**

Agency Response:

We will revise our language in any new conditional commitments to be more specific as to our requirements. Where in the past we may have simply required a year-end compilation/review/audit, we will clarify in the future by requiring a compilation/review/audit prepared by an accountant in accordance with GAAP.

It is our intent to always require the borrowers to submit financial statements that comply with GAAP and our regulatory requirements. We appreciate the definition contained in the audit indicating that a statement prepared in accordance with GAAP must show financial position at the end of the period, earnings for the period, comprehensive income for the period, cash flows for the period, and investments for and distributions to owners during the period. In addition, disclosure of accounting policies is an integral part of financial statements.

We may have mistakenly accepted compilation statements in the past believing that all compilations complied with our requirements. We appreciate the accounting lessons learned in the audit and will educate our lenders and borrowers as necessary.

**RURAL DEVELOPMENT** USDA Rural Development is an Equal Opportunity Lender, Provider, and Employer. Complaints of discrimination should be sent to:  
USDA, Director, Office of Civil Rights, Washington, D.C. 20250-9410.

Recommendation No. 2

**Notify lenders in writing that failure to obtain the required financial statements from borrowers could be considered negligent servicing. Additionally, notify lenders in writing that failure to notify USDA in writing of any loan agreement violations will be considered negligent servicing.**

Agency Response:

We have improved monitoring of our portfolio to send more timely reminder letters to the lenders when statements are missing or not completed in compliance with requirements. When letters fail to accomplish the desired results we will follow-up with phone calls and personal visits until the proper statements are eventually received. We have developed a standard letter for the most serious cases containing language referencing the possibility of a negligent servicing determination and the risks that would cause the lender. This will apply to missing financial statements as well as failure to notify us of loan agreement violations.

Our National Office issued RD AN No. 3572 (4287-B) on September 28, 2000 entitled "Business and Industry Guaranteed Loan Program Lender Financial Analysis Requirements". This AN states "The State Offices are requested to notify all lenders that failure to obtain or analyze financial statements or to properly service loans could be considered negligent serving and that the Loan Note Guarantee may be rendered unenforceable".

We have a standard operating procedure for follow-up letters to lenders to remind the lender of missing statement and or financial analysis. We also cover this during our annual lender visits. We do not believe the auditors fully recognized our attempts to get the lenders and borrowers to comply with these requirements. We pointed out numerous letters and references to resolving these problems in the files reviewed, but our efforts were not adequately recognized.

All four of the active borrowers reviewed submitted financial statements after the OIG auditors had completed their field review and left our offices. Our regulations call for submission of statements and analysis within 120 days from the end of the company's fiscal year. However, compliance with this time schedule is a constant problem as evidenced by the statements received on these four accounts after the auditor's review. Consideration should be given to relaxing the deadline for year-end information and analysis back to 150 days. This is especially true for businesses with a fiscal year end in December because of the competition for accountant's time during the regular tax season.

We feel there is a huge difference between notifying the lender they may or could be accused of negligent servicing versus "will be considered negligent" as suggested by OIG. We have to be aware of the continued integrity of the program. We believe it is potentially very dangerous to the continuation of the value of our program to be threatening the lender with such strong action as nullifying the guarantee for something like a failure to notify us of a loan agreement violation. Unfortunately, OIG failed to make any attempt to study action taken by prudent lenders on nonguaranteed commercial loans so that we have a measure to compare performance against. We should be saving threats of negligent servicing for the most serious problems and not be throwing this threat out lightly. If a senior bank official receives such threats for such minor infractions, they are likely to refuse to use the program again. We also have to consider our

chances for success in court if we should ever try to nullify a guarantee for a fairly minor infraction of our rules. We assume the court would require the government to prove the government had been harmed by such action before allowing such a drastic step to be taken. We couldn't begin to determine this without first suffering a loss and then prove how much of that loss could be attributed to the lack of notice.

Recommendation No. 3

**Classify loans as problem loans in all instances where noncompliance with loan covenants occur, including inadequate financial statement submissions.**

Agency Response:

We agree and plan to comply. However, in the future we strongly suggest that a special category of problem loans be developed for loans where noncompliance with financial statements is the only problem. Currently we report problem loans in our Rural Community Facilities Tracking System (RCFTS). We have the following choices for reporting a problem loan:

- 501 Nondelinquent Problem Loan
- 502 Nondelinquent Problem in Liquidation
- 504 Nondelinquent Problem in Chapter 11. Liquidation
- 506 Nondelinquent Problem in Chapter 11. Reorganization
- 507 Nondelinquent Problem in Chapter 7
- 509 Nondelinquent Problem in Chapter 13

Currently we have to report the loan with delinquent financial statements as a 501, Nondelinquent Problem Loan, right in with the borrower with slumping sales, cash shortages, and imminent delinquency right around the corner.

We recommend creation of a new problem loan category, such as a 500 or 503, that is called "Nondelinquent Problem Loan, Statement or Covenant Violation Only". This would keep the minor problems loans separate from the major problems and also provide a count to our agency as to how widely spread the delinquent financial statement problem is throughout our entire portfolio. Currently there is a hesitation to classify a loan as a 501 Nondelinquent Problem simply for a late statement or internal statement not meeting GAAP, especially if the company is doing well financially. Also, if we report every financial statement problem in with the real problem loans, the real problems may get lost within the higher numbers.

Finding No. 2

Recommendation No. 4

**Require lenders to submit complete financial analysis in compliance with RD instructions and lender agreements, and notify lenders that failure to submit proper analysis will be considered negligent servicing.**

Agency Response:

We will comply with the above recommendation for those lenders doing no analysis or poor analysis.

The governments claim of negligent servicing will not stand up in court if a lender provides analysis for our loans that are similar to that done for the balance of their portfolio. Most lenders use Baker-Hill or some other standard software that measures the four major categories; liquidity, coverage, leverage, and operating. Our requirements should be in line with industry standards and not be so specific as to require specific ratios, such as are required by RD AN No. 3572 (4287-B), "Business and Industry Guaranteed Loan Program, Lender Financial Analysis Requirements". This finite definition of a proper financial analysis simply invites problems and opens the lender and the agency up for criticism from future audits to find supposed deficiencies on an analysis that conforms with industry standards and the lenders treatment of the balance of their portfolio. Threatening negligent servicing accusations should be reserved for major problems and deficiencies, not for some ratio being missing from a list arbitrarily put together by our agency. Future AN's on this subject should simply require the lender to complete an analysis that thoroughly covers all four categories of ratios; liquidity, coverage, leverage, and operating.

We hope the above responses will be considered adequate response to this audit. We would like to add some general comments about the audit in general. The cases to be reviewed were "judgmentally selected" and not a random representation of our portfolio or our lender's response to their servicing requirements. The cases selected were all somewhat unusual and had all suffered through some type of problem during the life of their loan. As noted in the audit, one case was not even around long enough to provide financial statements. What is the value of an audit where cases are judgmentally selected for review? No attempt was made to review loans that have a long history of success to see if the lender servicing was any different in those cases. The auditors refused to ask the lenders what the lenders considered prudent servicing for the balance of their nonguaranteed commercial loan portfolio. Without knowing how the average lender services a loan, how can we be expected to accuse the lender of negligent servicing? We have no way of knowing if all this attention to receiving and analyzing financial statements has any effect upon our delinquency and loss rates because every time OIG chooses to complete one of these audits, you preselect the loans to review and only review loans with some problems in their past.

Thank you for the opportunity to respond to your audit findings. If you have any questions, feel free to contact James T. Cogan, Business Program Director at 614-255-2420.



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