



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

Rural Development  
Lender Servicing of  
Business and Industry  
Guaranteed Loans - State of Arizona  
Lender A



Report No.  
34601-2-SF  
August 2001



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Western Region - Audit

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DATE: August 31, 2001

REPLY TO

ATTN OF: 34601-2-SF

SUBJECT: Rural Development - Lender Servicing of Business and Industry  
Guaranteed Loan – State of Arizona, Lender A

TO: Ernest J. Wetherbee  
Acting State Director  
Arizona State Office  
Rural Development

This report presents the results of our audit of a Lender's Servicing of a Business and Industry Guaranteed Loan – State of Arizona. Your August 2, 2001, response to the draft report is included as Exhibit B of the report.

To accept management decision for the recommendation, we will need a copy of the correspondence notifying the lender of the need to obtain additional collateral from the borrower and the amount of collateral needed to secure the debt.

In accordance with Department Regulation 1720-1, please furnish a reply within 60 days describing the corrective action taken or planned and the timeframe for implementation for the recommendation for which management decision has not yet been reached. Please note that regulations require a management decision to be reached on all recommendations within a maximum of six months from report issuance.

We appreciate the cooperation and assistance provided by your staff during our audit.

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SAM W. CURRIE  
Regional Inspector General  
for Audit

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# EXECUTIVE SUMMARY

## RURAL DEVELOPMENT LENDER SERVICING OF BUSINESS AND INDUSTRY GUARANTEED LOANS-STATE OF ARIZONA LENDER A

AUDIT REPORT NO. 34601-2-SF

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### RESULTS IN BRIEF

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This report presents the results of our audit of a lender's servicing and administration of a Business and Industry (B&I) guaranteed loan active in fiscal years 1999 and 2000. We performed this review as a part of a nationwide review of lender servicing actions. We selected the State of Arizona for review based on the number of guaranteed loans outstanding and the dollar value of those loans. We reviewed the lender servicing of a loan we judgmentally selected from a review of borrower loan files and we identified this lender as lender A.

Our audit disclosed that the lender did not obtain sufficient collateral to secure the loan in case the borrower defaulted. The lender used a valuation method that did not take into account the fair market value of the processing plant to an outside party and/or investor. In addition, the lender did not make any allowance for the depreciation of the machinery and equipment in the years subsequent to the loan being made. The declining value of the machinery and equipment and the valuation methodology used by the appraiser put the lender and Government at risk if the borrower should default on the loan.

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### KEY RECOMMENDATIONS

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In consultation with the National office, determine if the lender can use intangible assets, such as "value in use" to secure a B&I guaranteed loan. If not, require the lender to obtain additional collateral (estimated to be at least \$2.3 million) to secure the outstanding loan balance.

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## **AGENCY RESPONSE**

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In its response dated, August 2, 2001, Arizona Rural Development Office stated they contacted the National Office to determine if “value in use” is an acceptable determinant of value to secure a Business and Industry Guaranteed Loan. According to the National Office, the “value in use” is an acceptable procedure, considered as the Income Approach, as long as the appraisal meets USPAP requirements.

However, the Rural Development Staff Appraiser for Arizona, stated the appraisal in question did not meet USPAP requirements. Accordingly, they will inform the lender by August 17, 2001, of the need to obtain an appraisal of the collateral that meets USPAP requirements in order to establish an acceptable market value of the security for the loan to Fiesta Canning. If the appraisal indicates there is insufficient collateral, the lender will be required to obtain from the borrower the collateral needed to secure the debt.

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## **OIG POSITION**

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To reach management decision, we need a copy of the correspondence notifying the lender of the need to obtain additional collateral from the borrower and the amount of collateral needed to secure the debt.

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## INTRODUCTION

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### BACKGROUND

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The Rural Business-Cooperative Service (RBS), an agency within the U. S. Department of Agriculture (USDA) Rural Development mission area, operates loan programs that are intended to assist in the business development of the Nation's rural areas and the employment of rural residents. To achieve this mission, the agency guarantees B&I loans made by private lenders. Private lenders provide the loans to the borrower as long as Rural Development guarantees a partial repayment of such loans. The private lenders have the responsibility for protecting the collateral while the Rural Development Director is responsible for ensuring loan servicing is properly accomplished by the lender.

The guarantee authority is not intended to be used for marginal or substandard loans or for the relief of lenders having such loans. These loans are made primarily to finance sound business projects that create or retain jobs in rural areas.

Guarantees are provided on loans made by traditional lenders, such as commercial banks, and to a lesser extent, by entities using investment capital for lending. Rural Development provides the following guarantees: a maximum of 80 percent on loans of \$5 million or less, 70 percent on loans between \$5 million and \$10 million, and 60 percent on loans more than \$10 million. However, a guarantee of up to 90 percent can be provided on a loan of \$10 million or less if the RBS' Administrator approves the higher percentage.

Regulations provide that lenders are responsible for servicing the entire loan and for taking all servicing actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. Lenders are responsible for notifying Rural Development officials of any violations of lenders' loan agreements. The guarantee is 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 interest regardless of the time at which the agency acquires knowledge of these deficiencies.

This responsibility of the lender 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 payment of taxes and insurance premiums, and maintaining liens on collateral. All lenders obtaining a B&I loan guarantee are responsible for obtaining valid evidence of debt and collateral in accordance with sound lending practices.

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## **OBJECTIVES**

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Our objectives were to determine if: (1) the lenders properly serviced B&I guaranteed loans by monitoring collateral and submitting required documents to Rural Development timely, and (2) the loan proceeds were used as specified in the loan agreements. Nothing came to our attention to indicate that loan proceeds were not used as specified in the loan agreement.

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## **SCOPE**

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The scope of our review included B&I loan note guarantees issued by the Rural Development Arizona State office during fiscal years 1996 through 1999. We selected the State of Arizona for review based on the number of guaranteed loans outstanding and the dollar value of those loans. As of November 1, 2000, the Rural Development Arizona State office had issued 42 loan note guarantees to 33 different borrowers involving 9 lending institutions. The guarantees cover 60 to 90 percent on loans totaling over \$57 million.<sup>1</sup>

The audit control point (ACP) judgmentally selected for review 7 of the 33 borrowers who received loan note guarantees. We reviewed the 7 borrower loan files considering factors such as (a) loan amount, (b) borrower's location, (c) type of industry, and (d) borrower's fiscal history to select two borrowers. From the two borrowers selected, we reviewed the servicing actions of the lender of record for each borrower. Our review of the lender covered servicing actions from fiscal years 1999 through 2000 for the aforementioned loan. Our fieldwork was conducted from November 2000 through March 2001. This audit presents the results of our review of one lender (lender A).

The audit was conducted in accordance with generally accepted government auditing standards.

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## **METHODOLOGY**

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

At the Rural Development Arizona State office, we (1) interviewed State office personnel to understand the loan note guarantee program, (2)

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<sup>1</sup> A guarantee of up to 90 percent can be provided on a loan of \$10 million or less if RBS' Administrator approves the higher percentage.

reviewed and obtained borrower case files, and (3) selected the lenders and borrowers to be reviewed for this audit.

At Lender A, we (1) interviewed lender personnel to determine their understanding of the loan program and of their responsibilities for servicing, and (2) reviewed the subject borrower's files to ensure compliance with guarantee conditions.

We visited the site and interviewed the selected borrower's employees to (1) verify the existence of collateral pledged to secure the loan and (2) determine if the borrower had any concerns regarding the servicing of the loan.



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## FINDING AND RECOMMENDATION

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|------------------|---|
| <b>CHAPTER 1</b> | <b>INSUFFICIENT COLLATERAL WAS OBTAINED BY LENDER TO SECURE GUARANTEED LOAN</b> |
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### FINDING NO. 1

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The lender did not obtain sufficient collateral to secure the B&I guaranteed loan made to the borrower. This occurred because the lender allowed an intangible asset to be used and pledged as collateral at loan closing. As a result, the \$4.3 million B&I loan is currently undercollateralized by at least \$2.3 million. The lender needs to determine the fair market value of the existing collateral and obtain additional collateral to ensure that the outstanding loan is properly secured.

7 CFR Section 4279.131(b) states that:

*Collateral must have documented value sufficient to protect the interest of the lender and the Agency and...the discounted collateral value will be at least equal to the loan amount. Lenders will discount collateral consistent with sound loan-to-value policy.<sup>2</sup>*

Rural Development Instruction 4279-B, Section 4279.131(b)(4) requires direct lenders to ensure that collateral does not include assets, such as productivity, that are intangible and would have value only to the owner but would be worth nothing during liquidation.

*Make sure that all worthwhile collateral is pledged to the project, but do not require assets with little or no collateral support to be pledged mainly for cosmetic reasons.<sup>3</sup>*

On February 18, 1999, the borrower received a loan from the lender for \$4,325,365 primarily to restructure the company's debt and to improve the cash flow of the business. Prior to disbursing funds, the lender had obtained a conditional commitment from Rural Development to guarantee 70 percent of the loan in case the borrower defaulted on its obligation.

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<sup>2</sup> 7 CFR Ch. XLII (1-1-98 Edition), Section 4279.131(b), Credit Quality.

<sup>3</sup> RD Instruction 4279-B, Section 4279.131(b)(4).

The agreement between Rural Development and the lender requires the lender to service the entire loan and take all servicing actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed.

Specifically, Rural Development Instructions require that:

*All lenders obtaining or requesting a B&I loan guarantee are responsible for...obtaining valid evidence of debt and collateral in accordance with sound lending practices.*<sup>4</sup>

To collateralize the loan, the borrower pledged 488.60 acres, an operating food processing plant situated on 12.55 acres, and the machinery and equipment used to manufacture the borrower's products. On December 24, 1998, the lender received the first of two certified appraisals. The first appraisal contained the market value of the borrower's 407.08-acre farmland, an 81.52-acre vacant desert land (totaling 488.60), and a valuation of the food processing plant situated on the 12.55-acre parcel. The second appraisal, received on February 17, 1999, contained the liquidation values of the machinery and equipment used in the plant operations.

The appraised fair market value of the real estate pledged was \$550,600 and the appraised orderly liquidation value<sup>5</sup> (versus fair market value) of the machinery and equipment was \$1,219,555 (see chart below).

**Table 1: Original appraisal of borrower's assets.**

| Description   | Appraised Value    |
|---|--------------------|
| Agricultural site (farm land)                             | \$350,000          |
| Desert Land   | \$ 32,600          |
| Food Processing Plant (building & land) 12.55 acre-parcel | \$168,000          |
| <b>Total Appraised Value of Real Estate</b>               | <b>\$550,600</b>   |
| Appraised Liquidation Value of Machinery & Equipment      | \$1,219,555        |
| <b>Total Value of Assets Pledged as Collateral</b>        | <b>\$1,770,155</b> |

The lender adjusted the appraised value of the real estate to 80 percent of the current market value, or \$440,480 (\$550,600 times 80 percent). The adjustment by the lender resulted in the borrower pledging assets that had a fair market value of \$1,660,035 to secure a \$4,325,365 loan. As of

<sup>4</sup> RD Instruction 4279-A, Section 4279.30(a)(iv).

<sup>5</sup> Orderly Liquidation Value refers to an estimate of machinery & equipment that could be sold within 6 to 9 months of the appraisal.

February 22, 2001, the current loan balance was \$4,011,000.

In determining the appraised value for the processing plant, the appraiser noted that the food processing plant was located in a rural setting and was not in the most probable place for a food processing plant. The processing plant site would hold value in the marketplace only to a specific user, with very limited marketability to other investors. The lender agreed with the appraiser's assessment and stated that the plant provided significant value to the borrower, but it would be extremely difficult to attract another food processor to the area if the borrower defaulted and liquidation was required.

Therefore, the lender, with Rural Development's approval, instructed the appraiser to reappraise the processing plant using a "value-in-use" method. This valuation method would increase the value of the plant to ensure the lender had adequate collateral to meet Rural Development requirements regarding collateral. Both Rural Development and the lender agreed that this valuation method was acceptable because it met the requirements of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) and the Uniform Standards of Professional Appraisal Practices (USPAP). However, these standards do not address the use of intangible assets as collateral as set forth in RD Instruction 4279-B. The "value in use" method would allow the appraiser to include the plant's productivity in its valuation, even though the plant would not carry this same value during liquidation. The plant's productivity, an intangible asset, would only have value to the owner, not to outside investors. According to the appraisal, "value in use" is:

*...A value concept [that] is based upon the productivity of an economic good to its owner-user.*

The new appraisal increased the value of the food processing plant from \$168,000 to \$3,500,000. The lender added the revised value of the processing plant to the appraised values of the farmland and desert land acres along with the appraised liquidation value of the machinery and equipment to determine the value of the collateral. The revised appraisal provided the lender with sufficient collateral to secure the \$4.3 million loan.

**Table 2: Comparison of fair market value of assets to value-in-use appraisal.**

| <b>Real Estate and Equipment Pledged as Collateral</b> | <b>Fair Market Value of Assets</b> | <b>Value of Assets to Secure Loan (Value-in-Use)</b> |
|--|------------------------------------|--|
| Agricultural site (farm land)                          | \$350,000                          | \$350,000  |
| Desert Land  | \$ 32,600                          | \$ 32,600  |
| Food Processing Plant (land & buildings)               | \$168,000                          | \$3,500,000  |
| <b>Subtotal before Discount</b>                        | <b>\$550,600</b>                   | <b>\$3,882,600</b>                                   |
| Eighty percent margin discount per lender              | 80%                                | 80%  |
| <b>Real Estate Valuation Totals</b>                    | <b>\$440,480</b>                   | <b>\$3,106,080</b>                                   |
| Liquidation Value of Machinery & Equipment             | \$1,219,555                        | \$1,219,555  |
| <b>Value of Collateral Pledged as Security</b>         | <b>\$1,660,035</b>                 | <b>\$4,325,635</b>                                   |

In addition, the appraiser used the liquidation value of the machinery and equipment to collateralize the loan. However, the lender has not re-evaluated the value of these assets since the loan note guarantee was made on February 18, 1999. The lender has not made allowances for the depreciation of the machinery and equipment or attempted to use as collateral additional assets purchased since the date of the loan. Therefore, we believe the lender should re-evaluate<sup>6</sup> the value of the machinery and equipment pledged as collateral to ensure that the current liquidation value is being used.

We informed Rural Development and the lender that using the “value-in-use” method to appraise certain real estate was not in accordance with Rural Development instructions. This method allowed a value to be placed on an intangible asset, which if the borrower defaults, would have potentially zero value to investors. Regulations require lenders to ensure that appraisal values adequately reflect the actual value of the collateral. In this particular case, the valuation method of the collateral pledged did not reflect the actual value. The lender and Rural Development concurred with our analysis and agreed to obtain additional tangible collateral (estimated to be at least \$2.3 million<sup>7</sup>) to secure the loan and value the collateral pledged based on its fair market value.

<sup>6</sup> FmHA Instruction 1980-E, Section 1980.443 (a) states that the lender is responsible for seeing that proper and adequate collateral is obtained and maintained in existence and of record to protect the interest of the lender and the agency.

<sup>7</sup> An additional \$2,350,965 in collateral is needed to secure the balance of the loan (loan balance, as of February 22, 2001, of \$4,011,000 less existing collateral of \$1,660,035).

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## RECOMMENDATION NO. 1

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In consultation with the National office, determine if the lender can use intangible assets, such as “value in use” to secure a B&I guaranteed loan. If not, required the lender to obtain additional collateral (estimated to be at least \$2.3 million) to secure the outstanding loan balance.

### **RD Response**

In its response dated, August 2, 2001, Arizona Rural Development Office stated contacted the National Office to determine if “value in use” is an acceptable determinant of value to secure a Business and Industry Guaranteed Loan. According to the National Office, the “value in use” is an acceptable procedure, considered as the Income Approach, as long as the appraisal meets USPAP requirements.

According to Rural Development Staff Appraiser for Arizona, the appraisal in question did not meet USPAP requirements. Rural Development stated they would inform the lender by August 17, 2001, of the need to obtain an appraisal of the collateral that meets USPAP requirements in order to establish an acceptable market value of the security for the loan to Fiesta Canning. If the appraisal indicates there is insufficient collateral, the lender will be required to obtain from the borrower the collateral needed to secure the debt.

### **OIG Position**

In order to reach management decision, we need a copy of the correspondence notifying the lender of the need to obtain additional collateral from the borrower and the amount of collateral needed to secure the debt.

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## EXHIBIT A – SUMMARY OF MONETARY RESULTS

| RECOMMENDATION NUMBER         | DESCRIPTION   | AMOUNT                   | CATEGORY  |
|-------------------------------|---|--------------------------|---|
| 1                             | Additional collateral needed to secure the remaining balance of the loan. | \$2,350,965 <sup>7</sup> | Unsupported Costs and Loans, Recovery Recommended |
| <b>TOTAL MONETARY RESULTS</b> |   | \$2,350,965              |   |

## EXHIBIT B – AUDITEE RESPONSE TO DRAFT REPORT



UNITED STATES  
DEPARTMENT OF  
AGRICULTURE

RURAL  
DEVELOPMENT

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August 2, 2001

Subject: Audit Response to Draft Report No. 34601-2-SF  
Rural Development-Lender Servicing of Business & Industry  
Guaranteed Loans – State of Arizona, Lender A

To: Sam W. Currie  
Regional Inspector General for Audit

As a result of the June 20, 2001 teleconference with OIG personnel to discuss the above referenced draft report and the key Recommendation section of the Executive Summary, we emailed Fred Kieferle, Branch Chief, Rural Business-Cooperative programs in our National Office concerning the concept of "value in use" and whether or not it is an acceptable determinant of value to secure a Business & Industry Guaranteed Loan. Mr. Kieferle contacted Ken Hennings, the Appraisal Specialist in the Specialty Projects/Program Oversight section for a response. The response is attached. Briefly, Mr. Hennings comments were as follows: "value in use is an acceptable appraisal procedure, considered as the Income Approach. Probably not a true value of the collateral, with the Cost Approach more reliable but can be accepted if the appraisal meets USPAP."

Concerning the appraisal for this loan, it should be noted that Mr. Woody Thomas, Rural Development Staff Appraiser for Arizona, indicated in a previously completed appraisal review that the appraisal completed by Jan Sell, MAI of Sell and Associates Inc. of Tempe, AZ on December 14, 1998 does not meet USPAP requirements. Therefore, we will inform Imperial Bank in writing no later than August 17, 2001 of the need for them to obtain an appraisal of the collateral that meets USPAP requirements in order to establish an acceptable market value (or value in use) of the security for the loan to Fiesta Canning. Should the appraisal indicate that there is insufficient collateral, Imperial Bank will be required to obtain from the borrower the collateral needed to satisfactorily secure the debt.

If you have any questions, contact Gary Mack at (602) 280-8717.

ERNEST WETHERBEE  
Acting State Director

cc: Leonard Gradillas, B&CP Director  
Gary Mack, B&CP Specialist  
Gwen Halls, Management Control Officer

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