Assessment of the Alternative Agricultural Research and Commercialization Corporation - Management Lacking Over High Risk Investments

Audit Report No.
37099-1-FM
November 1999

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250

DATE: November 30, 1999

REPLY TO
ATTN OF: 37099-1-FM

SUBJECT: Assessment of the Alternative Agricultural Research and Commercialization Corporation
Management Lacking Over High Risk Investments

TO: Jeffrey W. Gain
Chairman, Board of Directors
Alternative Agricultural Research and Commercialization Corporation (AARCC)

This report presents the results of our audit of the Alternative Agricultural Research and Commercialization Corporation's (AARCC) management of its program. Our review disclosed that AARCC provided federal assistance to program participants with little or no assurance that benefits would be derived. In addition, AARCC did not monitor the actions of investees who had received funding to protect the Government's interest; as a result, the majority of its investments have been, or are in jeopardy of being, lost. These significant weaknesses stemmed, in part, from the absence of internal controls prescribed by management to safeguard assets and efficiently fulfill the legislated mission. Our review also disclosed, however, other instances in which investees violated stated AARCC requirements with AARCC's knowledge or at least tacit approval.

The discussion draft of this report was forwarded to you and AARCC management on October 18, 1999. Subsequently, we became aware that Congress did not fund AARCC operations for fiscal year 2000. In addition, Dr. Armstrong has indicated orally to us that he has no interest in discussing this report because of the cessation of the corporation's activities. Due to these unique circumstances, we are issuing this report in final to you.

Several of the recommendations in this report remain viable in that they deal with managing ongoing investment activity. The implementation of these recommendations, however, is contingent upon the Department's decision regarding the dissolution of the portfolio (i.e., retained and managed by another USDA agency or sold to private parties).

Please advise us by December 15, 1999, of the Department's plans regarding the AARCC investments. If you would like to discuss this matter, please call me at 720-6945.

ROGER C. VIADERO
Inspector General

Attachment

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Assessment of the Alternative Agricultural Research and Commercialization Corporation - Management Lacking Over High Risk Investments
AUDIT REPORT NO. 37099-1-FM

PURPOSE

Our assessment of the Alternative Agricultural Research and Commercialization Corporation's (AARCC) investments was performed because of severe internal administrative and accounting control deficiencies identified during our audit of AARCC's financial statements for fiscal year 1997.[1] During our review of investment files maintained by AARCC at its Washington, D.C. office, we noted evidence of potential significant noncompliance with AARCC investment agreements and possible misuse of Government funds. We concluded that the deficiencies noted left AARCC highly susceptible to fraud, waste and abuse.

RESULTS IN BRIEF

Our site visits at 11 investees and one grantee that had received, in total, over $8 million in AARCC funding disclosed significant problems. We found general noncompliance with the investment agreements and evidence that most of the projects visited did not result in any substantive job creation in rural areas or expansion of agricultural markets. Even more significant was that we found potentially fraudulent activities for a number of investees. For example, two of the 11 companies appear to be in violation of the Securities Acts of 1933 and 1934 because of the significance of their misrepresentations (e.g., substantial overstatement of sales expectations, etc.).

We believe these serious problems are attributed to the absence of effective internal administrative and accounting control policies and procedures within the Corporation, poor investment decisions and

1 Audit Report No. 37401-2-FM, "U.S. Department of Agriculture Alternative Agricultural Research & Commercialization Corporation's Financial Statements for Fiscal Year 1997," dated January 1999.

ineffective monitoring actions by AARCC. During our previous audit of AARCC’s fiscal year 1997 financial statements, we estimated that about 75 percent of AARCC’s approximate $27 million portfolio was nonperforming, representing over $20 million in potential losses. Based on the results of this audit, we believe that AARCC’s financial position may have deteriorated even further.

To illustrate the decline in investment value for AARCC, we believe that AARCC will not recoup about $6.8 million (about 85 percent) of its $8 million investment in the 11 investees visited. This is because four of the companies have ceased operations, and five of the companies are experiencing significant financial difficulties, including significant losses, and limited sales/production, to such a degree that we question their ability to continue as going concerns.

In addition, while the two remaining investees are still operating, they are primarily producing non-AARCC products even though they used AARCC funds to assist in the production of these products.

We referred several of the investees to the Office of Inspector General, Investigations.

Misuse of AARCC Funds

We noted that 9 of the 11 investees visited (one with AARCC’s approval) had improperly used AARCC funding. Examples of the problems noted follow.

- We noted where three companies used AARCC funding, which was provided for advertising, business planning, marketing and/or research expenses, to pay off an existing owner’s debt and/or other private investors, (a decision that had significant impact on these investees). For example, a company used about $344,000 of AARCC’s approximate $450,000 investment to pay off the existing debt to a company owned by one of its partners. AARCC approved this transaction indicating that "it was just bookkeeping." The company is now out of business and, in effect, this transaction allowed the partner to recoup his prior investment, with Government funds, before shutting down operations.

- We also noted where a company used $715,000 of AARCC funding to establish a system and production line for the commercialization of oil absorbents from a low grade wool. However, during our onsite audit work we found that, for the past several years, the production line was being used 98 percent of the time to produce non-AARCC products. AARCC receives no return on its investment when these non-AARCC products are produced.

- Another company claimed to have used $90,000 to pay management consulting fees to a private firm to market its products. This was an approved use of the AARCC funding. However, when we attempted to validate this payment we were advised by the consulting firm that they had not received the $90,000.

Questionable Related Party Transactions

We noted in 7 of the 11 investees visited that there were instances of highly questionable and potentially fraudulent related party transactions.[2] This potentially fraudulent activity would have been identified and reported to AARCC had AARCC obtained audited financial statements, as required in its investment agreements, and as we recommended in our previous financial statement audit. AARCC however, has indicated that it is not willing to enforce this legal requirement.

To illustrate the significance of the problem, at one company, we were provided bank statements and/or cancelled checks relating to seven companies to support the expenditures of AARCC funds. The seven companies are subsidiaries of their "parent," a Canadian holding corporation. We noted that funds were frequently transferred between the companies' accounts with no explanation or support for the transfers. The last two drawdowns of AARCC funds, totaling over $50,000, were deposited directly into the bank account of one of the related companies and we were unable to determine what the funds were used for.

Failure To Contribute Required Matching Funds Negatively Impacts Investee Operations

We noted where 8 of the 11 investees visited failed to contribute matching funds totaling about $3 million. We found that AARCC had no effective process to assure that, as legally required, matching funds were contributed. In some instances, AARCC was aware of this serious breach of the agreement, and took no actions to enforce this critical requirement. As noted by venture capital experts, it is critical that principals invest personal funds into the companies to assure they have a vested interest in the success of the projects. In addition, this lack of funds had a substantial negative impact on the investee operations.

2 Related party transactions represent transactions between affiliated companies and appropriate disclosure should be made. This would include the nature of the relationship, a description of the transactions including dollar amounts, amounts due to and from related parties and terms and manner of settlement.

Grants Awarded Non-Competitively Did Not Benefit The Government

Two grants, totaling $100,000 for one grantee, were not awarded competitively, as required by the Food, Agriculture, Conservation and Trade (FACT) Act of 1990 and the Federal Agricultural Improvement and Reform (FAIR) Act of 1996. In addition, our onsite review disclosed that the company did not maintain required records to support work performed for AARCC. In addition, the first grant for $50,000, was not awarded until after the "services" had been performed. These grants also have resulted in no tangible benefits to the Government or AARCC investees. In addition, AARCC awarded funding to two other AARCC investees so that those companies could retain this grantee's "services." One company declined to use the services of this company and the other investee noted "severe disappointment" with the services provided.

Results Indicate AARCC Has Not Accomplished Its Mission

Our review of these 11 investees disclosed no substantive evidence that the AARCC funded activity resulted in job creation in rural areas, or material expansion of agricultural markets.

- AARCC identified job creation in rural areas as one of its priority goals under the Government Performance and Results Act. In the overview of its fiscal year 1997 financial statements, AARCC claimed that one of its goals is to create 10,000 jobs by the year 2002.

  However, there were no jobs created at 5 locations; a decrease of 19 jobs at 3 locations; and only 1 job was created at 1 location[3]. The jobs created at the 2 remaining locations were not as a result of the AARCC products, and the companies are in serious breach of the AARCC agreement. We concluded that overall, AARCC's $8 million investment in these 11 companies (which represents about 20 percent of all AARCC investments) resulted in fewer jobs than before AARCC's involvement.

- We also noted little to no usage of agricultural products, another critical component of AARCC's mission. For example, one company estimated usage of 30 million pounds of raw wool annually; the company actually has used an annual average of about 15,000 pounds.

AARCC Could Benefit By Employing Best Practices

Venture capital investments are inherently speculative in nature with the high risk of total loss. In discussions with the National

3 The AARCC sponsored product only represents about 20 percent of this company's operations.

Venture Capital Association, the Director of Small Business Administration's (SBA) Small Business Investment Companies (SBIC), an associate professor of Business Administration from Harvard University, and numerous other State and private venture capital managers, we determined that AARCC's operating and investing policies and procedures were significantly less than the "Best Practices" employed by these entities.

In summary, based upon our prior audit work and detail analysis of the 11 investees we visited, we concluded that AARCC's investments have not met the intent of the enabling legislation. Based upon initial investment decisions, and/or subsequent ineffective monitoring of these investments, Government funds have been expended on companies, with little to no chance of success. Unless actions are taken to immediately reverse these trends, we see additional losses in the future.

KEY RECOMMENDATIONS

We recommend that no further investments be made until actions are taken to (1) resolve all material internal accounting and administrative controls weaknesses that we have reported, and (2) contract with financial and venture capital experts to assist in management of the Corporation and assess the value of each investment. We recommend that no action be taken on these investees until disposition of the referrals are known or the investigations are completed.

INTRODUCTION

BACKGROUND

The AARCC was established in March 1992, as an independent entity within the U.S. Department of Agriculture (USDA). The program was authorized by the Food, Agriculture, Conservation and Trade (FACT) Act of 1990. The Federal Agricultural Improvement and Reform (FAIR) Act of 1996 established AARCC as a "corporation" within USDA, subject to the general supervision and direction of the Secretary of Agriculture.

AARCC was created to expedite the development and market penetration of non-food, non-feed value added industrial products from agricultural and forestry materials and animal by-products. It provides funds to companies and individuals for projects that, if successful, create jobs, increase demand for agricultural commodities, and enhance economic development in rural areas. Applicants are required to show that they have invested significant resources in the proposed projects and must obtain matching funds at least equal to AARCC's investment.

An 11 member Board, appointed by the Secretary of Agriculture, establishes policy, evaluates and approves applications for AARCC financial assistance, and oversees operations of the Corporation. Eight members are non-Federal, representing commercial, financial, producer, and scientific interests. The Board appoints an Executive Director, subject to the approval of the Secretary. The Executive Director is the chief executive officer of the Corporation and is responsible for the overall management and implementation of general policies with respect to the management and operation of the programs and activities of the Corporation.

According to June 1994 draft procedures, project proposals should undergo a review process prior to funding. The process begins when an applicant submits a pre-proposal to AARCC. The pre-proposal is subject to reviews by three outside reviewers as well as AARCC staff. The independent reviews consist of business, technical and general (management) reviews. AARCC's Board then evaluates the findings of the reviewers and determines which projects merit further consideration. For the most promising projects, additional information is gathered. The applicant is asked to complete a full proposal which is reviewed by the Board. AARCC will also conduct a site visit to assess operations and negotiate the terms of the agreement. The AARCC Board will then formally vote to ratify or reject the investment. Once a project is ratified, AARCC is responsible for monitoring the progress of the project. At AARCC's discretion, this monitoring may take the form of telephones calls, site visits, meetings at AARCC headquarters or other locations, and/or review of the documents submitted by the investees.

We recently completed the first audit of the AARCC financial statements. During the audit, we noted significant weaknesses in AARCC operations. We were unable to express an opinion on the AARCC financial statements for the fiscal year ended September 30, 1997. This disclaimer of opinion was significantly impacted by the absence of an effective internal control structure, and compounded by the lack of reliable financial information on AARCC's investees.

Our disclaimer of opinion means that AARCC could not provide reasonable assurance that it can (1) properly record and account for transactions which permit the preparation of reliable financial statements, (2) maintain appropriate accountability over assets, and (3) properly safeguard Government funds from loss and/or unauthorized use.

We identified, in the above cited report, the following material internal control weaknesses that impacted the Corporation's operations.

- There was an overall absence of effective procedures to assure that investees used AARCC funds as intended.

- There was an absence of effective procedures to assure the investees contributed required capital, and the contribution was properly valued.

- There were inadequate policies or procedures to assure that the Government's investment was protected because AARCC does not require investees to provide a security interest (lien) on the equipment, machinery, etc., obtained with AARCC loan funds. As a result, the Corporation is unnecessarily at risk in the event of a default.

- There were insufficient and/or ineffective policies and procedures over the loan/investment making process, including inadequate documentation over:

    - lending/investing decisions for new and existing investees,

    - determining the rate of return on the investment, note, etc., and

    - decisions to issue grants for selected operations.

- There was substantial lack of adherence to existing critical policies and procedures (e.g., obtaining audited financial statements from the investees). As a result, AARCC does not have reasonable assurance about the financial strengths of its investees, whether repayments, etc., are made in compliance with terms of each agreement, or whether AARCC funds were used as intended.

- There was a general lack of policies and procedures for performing credit checks, background investigations, and obtaining references about the integrity of the investees.[4]

- There was a substantial need for improvements in the monitoring of the investees.

We concluded that AARCC and the Department had minimal assurance that taxpayers' monies have been properly expended and investments totaling over $27 million were properly protected (we estimated that about 75 percent of AARCC's portfolio was nonperforming to the extent that it had no value). While venture capital is inherently high risk, the risk of loss associated with AARCC's portfolio is substantially greater because of its lack of an effective internal control structure and poor investment and monitoring actions. Since its inception in 1992 through July 1998 (the date we completed the fiscal year 1997 financial statement fieldwork), AARCC had written off investments totaling about $1.6 million and there was an additional $2.8 million in investments where AARCC officials had indicated writeoff is imminent. These amounts represented about 16 percent of the investments made since the inception of AARCC. Our work indicated that unless these material control weaknesses were corrected, additional losses will occur.

OBJECTIVES

The objectives of this audit were (1) to determine whether AARCC investees were complying with all material provisions of the investment agreement (i.e., determine whether each investee contributed matching funds, used AARCC funding as agreed upon, were repaying in accordance with the terms of the agreement, producing the product as agreed upon, and submitting reliable, accurate financial reports), (2) to determine whether AARCC had adequately managed its operations (i.e., issued and enforced program provisions which would protect the Government's financial interests while fulfilling its mission), and (3) to assess whether overall program objectives of increased demand for farm commodities, increased farm income, and increased

4 During fiscal year 1997, AARCC began performing credit checks on new investees; however, a documented procedure is needed to ensure that credit checks and other background investigations are performed on all new and additional lending/investing to existing investees.

rural community development had been achieved (e.g., amount of agricultural products used to date and number of jobs created).

SCOPE AND METHODOLOGY

We reviewed a judgmentally selected sample of 11 AARCC investees and 2 grants awarded to 1 grantee. The companies were selected on the basis of size, location, and certain risk factors identified during the financial statement audit. AARCC's management agreed that the sample represented a cross section of its investments. Funding provided for the 12 projects totaled over $8 million which represented about 20 percent of AARCC investments made since its inception through April 6, 1999.

To accomplish the audit objectives, we performed site visits at the selected companies' offices. We performed the following audit work, as appropriate.

- Reviewed the company's accounting records, general ledger, bank statements, financial reports, tax returns and supporting invoices, checks, etc.
- Interviewed the company's owners, accountants, lawyers, and other appropriate management officials.
- Confirmed sales and purchases with the company's vendors and customers.
- Analyzed the impact of material related party transactions.
- Compared actual with the budgeted use of funds.
- Determined whether the company had obtained an audit of its annual financial statements.

We also assessed the extent that the project accomplished the following:

- Developed technologies that could make it possible to use or modify existing agricultural commodities to provide an economically viable quantity of new non-food, non-feed products;
- increased the potential market size of new non-food, non-feed products;
- increased the potential for job creation;
- involved State or local participation;
- involved financial participation of private investors;

- reduced Federal crop subsidies and other Federal agricultural assistance program costs;

- had a positive impact on resource conservation and the environment; and

- involved a likely positive effect of helping family-sized farmers and rural communities.

We reviewed investee files maintained by AARCC prior to our site visits.

We also obtained and reviewed (1) the policies and procedures the Small Business Administration (SBA) follows in its monitoring of the Small Business Investments Companies (SBIC) that it licenses, (2) SBIC best practices as reported by the Office of Inspector General (OIG)-SBA, and (3) interviewed auditors and officials from National, State and private venture capital firms.

We conducted our audit during the time period January through June 1999. The audit was performed in accordance with generally accepted Government auditing standards.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1 - MANAGEMENT OF AARCC HAS BEEN INEFFECTIVE -- GOVERNMENT'S FINANCIAL INTERESTS HAVE NOT BEEN PROTECTED AND ITS LEGISLATIVE MISSION HAS NOT BEEN FULFILLED

Our site visits at 12 entities that had received AARCC funding disclosed significant noncompliance with the investment agreement, evidence that the projects did not result in substantive job creation in rural areas or expansion of agricultural markets, and a significant number of possible fraudulent or abusive practices. We believe this problem is attributed to the absence of effective internal administrative and accounting control policies and procedures within the Corporation and poor investment and monitoring actions by AARCC.

We noted several instances of apparent fraudulent activity, misuse of AARCC funding, and extensive and significant misrepresentations by many of the companies. We concluded that AARCC was aware of many of these problems, or should have been aware of these instances through its monitoring efforts. As a result, AARCC and the Department have reduced assurance that taxpayers' monies have been properly expended and investments are properly protected. Additionally, because of these internal control weaknesses, we believe AARCC has incurred unnecessary losses and will continue to do so until significant corrective actions are taken. We estimated that 75 percent of AARCC's portfolio was nonperforming to the extent that it has no value.

FINDING NO. 1

GOVERNMENT'S FINANCIAL INTERESTS HAVE NOT BEEN PROTECTED

When investing in a project, AARCC enters into an investment agreement requiring the investee to comply with certain conditions. While these agreements are tailored to meet the specific needs of the project and AARCC, the investment agreement generally provides the following, at a minimum.

- Details what the company and AARCC agree to do.
- An agreement that all projects/activities will be jointly planned and conducted.
- Details conditions, repayments and equity holdings in exchange for monies.

- Requires that the company must obtain prior written approval for changes in budget of more than 10 percent.

- Requires that the company shall arrange for an annual financial statement audit.

- Requires that the company retains ownership in patents, inventions, and copyrights.

- Stipulates that if noncompliance has occurred, the programmatic contact will notify the company in writing of noncompliance and corrective action necessary.

During audit work at the 12 projects, we noted substantial noncompliance with many of the above requirements. Noncompliance was not precluded by AARCC, in part, because its internal controls were not adequate to identify such actions but also because AARCC management opted not to enforce critical provisions designed to protect the Government. Due to the extensive nature of the disclosures, specific details of noncompliances relating to each site visited will be provided in separate correspondence. We also referred several of the investees to the Office of Inspector General, Investigations. For example, we noted:

- potentially fraudulent use of Government funds,

- potential violations of anti-fraud provisions of the Securities Acts of 1933 and 1934,

- overall noncompliance with the AARCC investment agreement for many of the investments reviewed, and

- a conflict of interest involving a current member of the AARCC Board.

Misuse of AARCC Funds

We noted that 9 of the 11 companies visited (one with AARCC’s approval) had inappropriately used AARCC funding as stipulated in the signed agreement. Two of these companies may be in violation of the Securities Acts of 1933 and 1934 because of the significance of their misrepresentations. The anti-fraud provisions of these Acts apply to all companies whether an offering is exempt or registered. Various provisions in the securities statutes make it illegal to make a misstatement or omission of a material fact in connection with an offering. We believe these misrepresentations were intentional because of the magnitude of the misstatements. Some examples of the problems noted follow.

- Company A, has received over $2.6 million in AARCC financing, since August 1993, to develop a state-of-the-art system to commercialize new structural panels made from kenaf[5] and other agricultural and forestry materials. To date, sales have been insufficient to allow a return to AARCC. Company A has ceased production.

  Our review disclosed that the company consistently misrepresented its use of AARCC funds. It paid excessive compensation and fringe benefits to its officers, and failed to meet its cost and production projections. For example, the company projected it would take about 9 months and cost about $1.7 million to enter into production; it actually took 18 months and cost about $4 million. For the second year of production, the company projected Net Income Before Tax of over $7.4 million; the company actually experienced Net Loss Before Tax in excess of $2.4 million. We also noted that actual expenses consistently exceeded budgeted expenses as shown in the following table:

Fiscal Year	Budgeted Expenses	Actual Expenses [6]
1994	$1.5 million	$2.0 million
1995	$1.6 million	$5.4 million
1996	$2.7 million	$5.7 million
1997	$3.3 million	$7.2 million

  We attributed the differences, in part, to the following:

  - Excessive salaries, rents, fringe benefits and travel costs were found. For example, we noted where the company paid salaries to its management approximately 3 times higher than was provided in the budget submitted to AARCC. During the period 1994 through 1997, the company budgeted salaries for its officers totaling over $1.6 million; actual salaries paid totaled over $5.8 million (a difference of over $4.2 million).

5 Kenaf is a biodegradable, environmentally friendly alternative fibre crop that has been researched by USDA for over 50 years. It can replace or augment the traditional uses of trees and fossil fuels in many instances.

6 Up until April 1996, Company A was required to obtain written consent from AARCC when actual expenses exceeded budgeted by more than 10 percent.

- During our site visit, we found that the controller had embezzled funds, including AARCC funding, in excess of $70,000. The incident is under police investigation.

- We noted where $510,000 of AARCC funding was to be used to purchase equipment. Although the equipment was purchased, the company immediately sold the equipment and entered into an agreement to lease back the equipment. The company is currently in default on the lease payments.

- The company obtained the technology for its AARCC project from the Agricultural Research Service (ARS) through an Intellectual Property License. The license provides that, "This license shall not be transferred or assigned by Licensee to any party other than a successor or assignee of the entire business interest of the Licensee relating to the invention." During the period 1993 through 1998, the company has made at least $112,000 in royalty payments to USDA. We found, however, that the company had sublicensed these rights, for a fee, to three of its shareholders to market the product in foreign countries. For example, a private investor paid $1.1 million plus an equity investment of $700,000 for the Japanese rights. The agreement requires that sublicenses be subject to prior approval by the licensor. We found no documentation that this approval had been obtained and the royalty rights of USDA protected.

We attributed these problems to insufficient and ineffective monitoring efforts by AARCC. According to company officials AARCC has had a representative at Board meetings for the last year and a half, but only as an observer. AARCC visits to the company did not include reviews of company records, or other detailed analyses.

- In August 1995, Company B entered into a venture capital agreement with AARCC for $450,000 to develop, manufacture, and market headbands. In return, AARCC received a 10 percent equity interest in the company as well as royalty rights on sales of the AARCC sponsored product (headbands).

The agreement was made with the expectation that the company had the commercial processing technology to manufacture headbands. Also, the company represented that there were buyers interested in purchasing headbands, and that a full scale commercial manufacturing and marketing business could be realized. However, immediately after receiving AARCC funding, the company concluded that no market for the headbands existed. It decided to produce incontinence pads in lieu of the headbands and began commercial operations for the pads about October 1996. Since the incontinence pads were not part of the signed agreement, their sales have not been subject to royalty payments for the last 3 years.

Misrepresentations made to AARCC during the proposal phase may also violate anti-fraud provisions of the Securities Acts of 1933 and 1934. Misrepresentations of a product's likelihood of success is one example of a material misstatement of fact which applies to the company. The company's proposal for funding included proforma financial statements which estimated headband sales at $2.4 million in 1995, $6.8 million in 1996, $10.0 million in 1997, and $11.4 million in 1998. As stated above, the company never attempted to produce headbands for sale.

Company B also represented that it intended to develop, manufacture, and market sweatbands using starch/plastic/combed with fibers, starch absorbents and rayon/cotton. We noted that the raw material used in the production of the incontinence pads was primarily wood pulp. <u>In addition, about 70 percent of the raw material used was from Canadian sources</u>.

We found that AARCC's monitoring efforts for this investee were insufficient. AARCC performed only one monitoring visit between August 1995 and April 1999. During that visit, which occurred in 1997, AARCC first learned that the company had abandoned the production of headbands. Since that time, AARCC has attempted to renegotiate the agreement with the company without success.

Had AARCC been more vigilant in its monitoring efforts, the Corporation would have been aware of the company's nonperformance as well as their usage of Canadian agricultural materials in production. In addition, AARCC took no legal action to assure the Government's financial position was protected after it became aware of this improper activity. Our review disclosed that the company sales of incontinent pads are approximately $80,000 per month, using AARCC financed equipment. Almost 4 years after the inception of the agreement, AARCC has received no return on its investment.

- During October 1993, AARCC entered into a repayable cooperative agreement for $715,000 with Company C to commercialize oil absorbents from low grade wool. AARCC's money was used to finance 50 percent of the cost of production equipment. During our audit, we found that the Government financed production line was being used almost solely to manufacture non-AARCC sponsored products. If AARCC were to receive its royalty repayment based on the sales of all products from that line, instead of the production of the wool based product, it would have earned in excess of $1 million during the time period 1995 through 1998. Instead, AARCC has received just over $5,000.

AARCC's ineffective monitoring and enforcement procedures allowed this condition to exist for the past 6 years. Our audit disclosed that AARCC was aware of the misuse of Government funded equipment as early as December 1996. At that time, AARCC and the company renegotiated the agreement to allow for royalty payments for sales of wool-based items manufactured on Company C's other production lines. The amended agreement has provided only a nominal return on investment to AARCC. AARCC has taken no legal actions to ensure compliance with the AARCC agreement.

AARCC's investment in this company was made over the objections of an independent business reviewer who noted that the pre-proposal was based on limited research and that there was a limited market for environmental use of this product.[7] We believe that the independent reviewer's concerns have been validated. AARCC files contain no explanation as to why the warnings of the independent business reviewer were not heeded.

- In March 1997, Company D and AARCC entered into a venture capital agreement for $400,000. In January 1998, AARCC also agreed to guarantee a $500,000 line of credit. In September 1998, AARCC paid the bank the $500,000 guarantee because the company was unable to maintain an adequate debt to equity ratio, thereby defaulting on the terms of the line of credit. The company received the funding to develop a market for oil absorbents derived from cotton. However, the company failed to use a large portion of AARCC venture capital funds for the purposes outlined in the agreement. Instead, the company used AARCC funds to repay debts incurred prior to the inception of the venture capital agreement. As a result, over $258,000 was not used to contribute to the manufacturing and marketing of oil absorbent product, as required by AARCC. We also determined that AARCC did not require the company to match the $500,000 follow-on investment.

  Given the current financial position of this company, we seriously question the ability of this company to function as a going concern.

7 The pre-proposal is subject to reviews by three outside independent reviewers and AARCC staff. The independent reviews consist of business, technical and general (management) reviews. The AARCC Board then evaluates the findings of the reviewers and determines which project merit further consideration.

- We noted two other investees, Companies G and K that used AARCC funding to pay down existing debt of their owners. Company G used $586,000 of AARCC's approximate $1 million investment to pay off bank loans incurred prior to receiving AARCC funds. The AARCC agreement prohibited this because it was structured to advance funds for future expenses and not to provide for the reimbursement of prior debts. This company is in serious financial difficulty, and has ceased plans for the production of the product.

  Company K used about $344,000 of AARCC's approximate $450,000 investment to pay down existing debt to a related company that was owned by one of the partners of Company K. Correspondence between AARCC and the company indicated that AARCC approved of the company's use of funds to satisfy prior debts because "it was just bookkeeping." This company is now out of business and, in effect, this transaction allowed the company to use AARCC funding to repay the partner for his prior investment before shutting down operations.

- During September 1994, AARCC entered into a repayable cooperative agreement with Company E for $235,000 to be used to market biodiesel, a fuel produced from vegetable oils or animal fat and other products made from esterified oils. These funds were deposited into three different bank accounts. Only limited sales of the biodiesel product were realized. In March 1997, the original agreement was amended to change all references from Company E to its parent company, a wholly-owned Canadian corporation. In effect, AARCC's investment was in a wholly-owned foreign corporation.

  The budget submitted to AARCC required Company E to use the funds, including $235,000 in matching funds, for expenditures related to trade shows, direct marketing, advertising, shipping, demonstrations and testing. At our request, the company provided a spreadsheet detailing the use of the $470,000 in AARCC and matching funds. We noted significant discrepancies. For example, a consulting firm was listed as an expense on the spreadsheet for about $90,000. Company E claimed that $45,000 of AARCC funds and $45,000 of matching funds were used to pay consulting fees. The company provided "invoices" from the firm. However, we contacted the consulting firm who advised they have never received payment. Therefore, we believe the reported usage of the $45,000 of AARCC funds is incorrect.

  Another error noted in the reported use of funds was salary. Per the company, $182,000 of the AARCC and matching funds were used for salaries. Our review disclosed, however, that only $90,000 was actually paid during this time period. According to the president’s W-2, he only received about $1,000 in salary during this time period. However, we noted checks totaling about $106,000 that had been written to him. He later claimed that these were for salary and consulting services. However, these payments were not supported and had not been reported to the Internal Revenue Service. This company is experiencing severe financial difficulties and we question its ability to continue to function as a going concern.

Questionable Related Party Transactions

We noted numerous instances of highly questionable and potentially fraudulent related party transactions. We noted that seven companies used AARCC funds to pay administrative and other expenses to non-AARCC affiliated companies. This activity would have been identified and reported had AARCC obtained audited financial statements as required in its investment agreements. We recommended in our previous financial statement audit that AARCC enforce this requirement. However, AARCC has not indicated that it is willing to do so. Details follow.

- At Company F, about two thirds of AARCC’s approximate $606,000 investment, was used to pay consulting fees to a company operated by Company F’s president. In effect, the company president paid himself for consulting services using AARCC funds. The company is currently indebted to AARCC for more than $1 million. The company does not have sufficient funds to pay AARCC and is currently attempting to relocate its operations to Iceland and South Africa. In effect, the company is out of business.

- For Company B, there were numerous transactions between the company and a related company. The related company is owned by the Chief Executive Officer of the AARCC funded company and is co-located on the same premises. Company B rents the building where manufacturing operations are conducted from the related company for $6,000 per month for about 60 percent of the building. The related company, in turn, pays about half that amount to the Company B’s owner for rent of the entire building.

- For Company E, we were provided bank statements and/or cancelled checks relating to seven companies to support expenditures. The seven companies are subsidiaries of their "parent," a Canadian holding corporation. We noted that funds were frequently transferred between the companies’ accounts with no explanation or support for the expenses. The last two draw downs of AARCC funds, totaling over $50,000, were deposited directly into the bank account of one of the related companies and we were unable to verify if the use of these funds was appropriate.

Investees Failed To Contribute Matching Funds

We noted where eight companies failed to invest matching funds totaling close to $3 million, as required by legislation. We found that AARCC had no effective process to assure that matching funds were contributed by companies, and that, in some instances, AARCC was aware of this serious breach of the agreement. We also noted that AARCC awarded additional funding without requiring the company to complete its previous matching requirements. The matching requirement is set by law in the FAIR Act of 1990 and the FACT Act of 1996 and is a critical requirement which helps to ensure that AARCC investees have a vested interest in the success of the company.

Venture capital investment firms contacted during this audit also emphasized the critical need for companies to match investments. They noted that this requirement is one of the single most critical aspects of assuring success of a venture capital company. Examples of the problems noted follow.

- The AARCC agreement required that Company B invest at least $350,000 cash and over $1 million of in-kind contributions (building, laboratory, support services, etc.) to the project. We found that the company did not contribute the $350,000 to the project or make the $1 million in-kind contributions.

- Company G attempted to match the initial $500,000 AARCC funding by not drawing its owner’s $160,000 annual salary. However, the salary was merely deferred and reported as a payable due to the company official. Since the president will be paid for his services in the future, this deferred salary cannot be counted towards the matching requirement. The second $500,000 in AARCC funding provided in November 1997 was to be matched through an $11 million bond issue. However, the bond issue was not obtained and matching was again not provided.

ARCC took no action to enforce this critical requirement when it noted that matching had not taken place.

Companies Are Not Submitting Annual Audited Financial Statements

Nine of the companies did not submit annual audited financial statements to AARCC, a breach of their agreement with AARCC. Without audited statements, AARCC does not have reasonable assurance as to the financial position and results of operations of its investee companies. Enforcement of the audited financial statement requirement is critical to allow AARCC to effectively monitor its investments. Generally accepted Government auditing standards audits which are required by legislation, would provide substantiated reporting on the appropriate use of Government funds. AARCC would also be made aware of budget overruns, matching violations, royalties in arrears, related party transactions and investees on the verge of failure if annual financial statement audits were performed, submitted to AARCC, and properly analyzed by AARCC. As noted above, AARCC is not willing to enforce this requirement.

Grants Awarded Non-Competitively

The grants we reviewed for Company H were not awarded competitively, a violation of the FACT and FAIR Acts. We found that grant requirements were also not followed by the grantee. The company did not maintain sufficient records to show what work was actually performed for AARCC. These grants also have resulted in no tangible benefit to AARCC or its investees. In addition, AARCC awarded funding to two other AARCC investees so that those companies could retain the services of Company H. One company declined to use the grantee's service and the other company reported its "severe disappointment with the lack of results" from using Company H.

Violations of Departmental Regulation 1700-2

As shown above, AARCC knew that some investees may have improperly used AARCC funds. However, none of these instances were referred by AARCC staff to the Inspector General for possible investigation. This violates Departmental Regulation 1700-2 which requires USDA employees to "promptly report to OIG or proper officials any instances of known or suspected violations or irregularities in USDA programs...". Examples follow:

- AARCC files contained a letter dated April 22, 1998, from a director of Company A alerting shareholders to the "disastrous stewardship of this company" by the company's president. AARCC did not refer this matter to OIG.

- AARCC received two electronic mails, dated June 30, 1998, and July 7, 1998, detailing concerns about Company G's use of Government funding. Our review confirmed the validity of the communicated concerns. The matter was not referred to OIG.

- AARCC's Due Diligence Committee minutes, dated January 30, 1998, discussed potential improprieties committed by the former AARCC Executive Director. The minutes documented potential infractions because the former employee was contracting with AARCC investees for consulting services within 1 year of resigning his position. AARCC's actions were limited to contacting the company and advising it to cease its dealing with the former employee. AARCC failed to report the matter to OIG.

RECOMMENDATIONS

1. Discontinue making further investments until the material weaknesses noted in this report and OIG Audit Report No. 37401-2-FM are substantially corrected.

2. Take immediate actions, including all necessary civil legal action, to force investees to abide by their investment agreement.

3. Take immediate actions to protect the Government's interest and remedy the specific problems noted in this report and subsequent correspondence.

4. Coordinate all planned actions with OIG to assure no planned actions impact potential OIG investigative activity.

5. Contract with financial and venture capital experts to assist in resolving the management problems within the Corporation and to obtain the market value of each of AARCC's investments.

6. Develop a comprehensive and targeted investee monitoring process and checklist based upon analysis of our recommendations, and require onsite monitors to comprehensively document their visits, conclusions, and recommendations.

7. Assure that AARCC officials are members of the investees' Board of Directors including positions on the audit and compensation committees.

8. Develop an exit strategy for the companies identified in this report who have ceased production or are in serious financial trouble to assure the Government's funds are adequately protected.

9. Develop controls to assure that DR 1700-2 is adhered to by AARCC personnel. Provide periodic training to AARCC personnel to assure adherence to this regulation, including the referral to OIG for any condition noted that requires additional audit and/or investigation.

10. Monitor compliance with investees’ adherence to project’s objectives.

11. Contract with appropriate experts to perform both file and on-site reviews to ascertain whether serious problems exist with all other AARCC investments.

12. Collect royalties and other monies due from the companies identified in this report.

13. Disallow and collect back from the investees any budget changes in excess of 10 percent that were not approved by AARCC.

14. Coordinate with ARS on the actions necessary to enforce the licensing agreement requirements for the investee cited in this report.

15. Advise all investees, in writing, of the requirement to obtain AARCC approval of the 10 percent variance of budgeted with actual requirement and the potential penalties if not adhered to.

FINDING NO. 2

RESULTS INDICATE AARCC HAS FAILED TO ACCOMPLISH ITS MISSION

Our review of the operations at 11 judgmentally selected AARCC investees and 1 grantee disclosed no substantive evidence that the AARCC funded activity resulted in job creation in rural areas or expansion of agricultural markets on any material basis. There were no jobs created at 5 locations; a decrease of 19 jobs at 3 locations; and only 1 job was created at 1 company. However, the AARCC sponsored product only represents about 20 percent of this company's operations. The jobs created at the 2 remaining locations were not as a result of the AARCC project.

In addition, of the 11 companies visited, 4 have ceased operations and 5 are experiencing serious financial difficulties, and the remaining 2 are, in effect, not producing the AARCC sponsored product.

According to the FACT Act of 1990, AARCC's Board of Directors may select a research, development, or demonstration project to receive a grant, contract, or cooperative agreement based on the likelihood that the project will result in creating or improving economically viable commercial non-food, non-feed products, applications, processes, or technologies that involve the use of raw or processed agricultural commodities. According to the law, the criteria to be considered include the following:

(1) developing technologies that make it possible to use agricultural commodities to provide a viable quantity of new non-food, non-feed products,

(2) the potential market size of the new non-food, non-feed product and the potential for job creation in an economically distressed rural area,

(3) the anticipated State or local private participation,

(4) the likely impact on reducing Federal crop subsidies,

(5) the likely positive impact on resource conservation and the environment, and

(6) the likely positive effect of helping family-sized farmers and rural communities.

For the 11 investments reviewed, (we excluded the grant from this analyses since its purpose was to expand markets), we determined whether the investment met the criteria included in the legislation.

The chart below details the data obtained during our audit of the companies.

Company	Did the Project Help Develop Technologies To Provide New Non-food, Non-feed Products [8]	Were New Jobs Created in Rural Areas	Was State or Local Private Funding Provided	Was There A Reduction In Federal Crop Subsidies	Was There A Positive Impact on Conservation Resources	Was There A Positive Effect on Farmers or Rural Areas
A	NO	NO	YES	NO	NO	NO
B	NO	NO[9]	YES[12]	NO	NO	NO
C	YES[10]	NO[9]	YES	NO	NO	NO
D	YES[11]	NO	YES[12]	NO	NO	NO
E	YES[11]	NO	NO	NO	NO	NO
F	YES[11]	NO	YES[12]	NO	NO	NO
G	YES[11]	NO	NO[12]	NO	NO	NO
I	NO	NO	YES[12]	NO	NO	NO
J	NO	NO[9]	NO[12]	NO	NO	NO
K	NO	NO	NO[12]	NO	NO	NO
L	YES[11]	TBD[13]	YES[12]	NO	TBD[13]	TBD[13]

Job Creation Goal Not Met

AARCC identified job creation in rural areas as one of its performance measures under the Government Performance and Results Act. In the overview of its fiscal year 1997 financial statements, AARCC claimed that one of its goals is to create 10,000 jobs by the

---

[8] These headings correspond to the criteria to be considered when selecting investments.

[9] Some job growth occurred, but not as a result of AARCC sponsored project.

[10] Less than 2 percent of sales activity was attributed to AARCC sponsored project.

[11] Technology was developed but has yet to be successfully marketed.

[12] Company failed to meet matching requirements.

[13] TBD - Results are uncertain at this time.

year 2002. As part of our audit, we reviewed the 11 investees' operations to determine the number of jobs that had been created as a result of the AARCC's involvement in the projects.

In order to determine whether AARCC was making progress in attaining this critical goal, we obtained evidence from the investees as to employment levels prior to AARCC's investment and current employment levels. We also compared current employment levels to the job creation data provided by the companies in their pre-proposals to obtain AARCC funding. The following table summarizes the results of our tests:

COMPANY	NO. OF JOBS PRIOR TO AARCC FUNDING	NO. OF JOBS AS OF 1999	NO. OF JOBS CREATED	ESTIMATED JOBS BY 1999 AS REPORTED TO AARCC
A	7	7	0	222
B	6	13	7	41
C	233	293	60	100
D	18	12	(6)	13
E	9	1	(8)	2050
F	0	0	0	49
G	2	2	0	83
I	0	0	0	11
J	2	3	1	7
K	5	0	(5)	NO DATA
L	4	4	0	17

The only three companies which showed any positive job creation are Companies B, C and J. Both Companies B and C are in serious breach of the AARCC agreement by producing primarily non-AARCC products. Company J resulted in the creation of one job; however, the AARCC product only represents about 20 percent of its operations. Therefore, for these investees, we concluded that the AARCC program was not responsible for any meaningful job creation. Overall, AARCC's $8 million investment (which represents more than 21 percent of all AARCC investments) in these 11 companies, over a 6-year period, resulted in fewer jobs than before AARCC's involvement.

Increased Usage of Agricultural Products Insignificant

We noted deminimis usage of agricultural products. As noted above, of the 11 companies visited, 4 have ceased operations, 5 are experiencing serious financial difficulties with limited production, and the remaining 2 are, in effect, not producing the AARCC sponsored product. None of the companies have approached estimated usage of agricultural materials provided to AARCC in their proposals. For example, Company C estimated usage of 30 million pounds of raw wool annually; the company actually has used an average of about 15,000 pounds. Company I estimated annual usage of 2.4 million pounds of corn husks annually. However, production has ceased at the company. Company G estimated that it would use 24 million board feet of low grade hardwood; however, no production occurred.

Although Company B received $452,000 in Government funds, we noted that its purchases are benefiting foreign agricultural markets more than U.S. agricultural markets. The company has obtained about 70 percent of its raw agricultural materials from Canada for use in production. Review of the investment file maintained by AARCC gives no indication that AARCC was aware of this condition. Company A represented to AARCC that it would use kenaf in its product. Instead, the company has used recycled cardboard. Furthermore, AARCC was aware of this fact, yet continued to invest heavily in Company A.

RECOMMENDATIONS

16. Require investees, as part of their audited financial statements, to report on the benefits derived, as noted in the FAIR Act, on the AARCC investment.

17. Analyze each AARCC investment to determine the benefits derived from AARCC funding. Develop investee specific plans to assure the maximum benefit from Government invested funds are achieved.

18. Revise AARCC’s Overview and Supplemental Information and Budgetary Notes to accurately disclose the benefits identified in Recommendation No. 16.

CHAPTER 2 - AARCC'S OPERATIONS WOULD BENEFIT BY EMPLOYING BEST PRACTICES

FINDING NO. 3

AARCC's investing and monitoring processes are ineffective and frequently result in the investment of Government funds in a company with little chance of success. Additionally, subsequent actions by the company frequently placed the Government's investment at risk. We noted where AARCC could benefit by employing "best practices" for researching and monitoring investments, as implemented by other National, State and private venture capital investment firms. As noted in our financial statement audit report, we believe that at least 75 percent of AARCC's investments totaling over $27 million are at risk. Although all venture capital companies have high risk, much of AARCC's high risk occurs simply because its procedures fall significantly short of the procedures implemented by other venture capital companies.

We compared the oversight procedures implemented by other Federal, State, and private venture capital investment firms to the procedures implemented by AARCC. We interviewed individuals from the National Venture Capital Association, the Director of SBA's SBIC Operations, an associate professor of Business Administration from Harvard University, and numerous other State and private venture capital managers and informed personnel.

We also obtained a report from the Legislative Division of Post Audit of the State of Kansas entitled, "Reviewing the State's Investment in Venture Capital." The State auditors completed a performance audit on the Kansas Technical Enterprise Corporation and issued the report in January 1998. The auditors surveyed publicly funded venture capital firms from nine other States. In addition, we surveyed four publicly financed venture capital companies in order to compare their internal control structure with the internal control structure at AARCC. The companies provided information on operating procedures regarding due diligence, monitoring, and repayment structures. The significant disparities noted between these companies and AARCC operations include:

- The due diligence process performed prior to approval of the investment was much more intensive than AARCC's. Background investigations were more extensive and included a thorough assessment of management's capabilities.

- Annual audited financial statements were usually required.

- Timely financial reports were required and obtained (quarterly and/or monthly) and thorough reviews of the entity’s budgets were performed.

- Stronger controls over a breach of contract were enforced. Breaches of contract were not tolerated, and legal action was taken when necessary.

One typical response was received from a State sponsored venture capital corporation which shows the substantial differences in the operating procedures employed by it and AARCC. The State corporation performs the following due diligence prior to making an investment:

- An investment analyst assigned to a venture prepares an extensive investment report covering the product, market, management, and financial aspects of the investment. The report with appendices will often run 40-50 pages. The investment analyst will normally spend between 60-100 hours in researching and preparing the report. AARCC uses independent experts; however, ignored their recommendation to reject the proposal for 2 of the 11 investees reviewed.

- Credit checks, background investigations and references are obtained for potential investees. The investment analyst pursues not only direct references but also indirect business and personal references identified in the due diligence process. AARCC has only recently started to perform credit checks and we noted insufficient background investigations and reference checks.

- Prior to the board meeting at which the staff plans to recommend an investment, an officer of the Corporation and a member of the Board will visit the company. This visit is designed to resolve any questions or concerns raised in the investment analyst’s report. We noted that AARCC approved investments without performing due diligence and site visits, or approved investments in conflict with independent expert recommendations.

- Investment analysts have full access to company records which enables the analyst to have a clear understanding of how the funds are being utilized and what modifications to the use of funds might be necessary. We noted no similar analyses in the AARCC files we reviewed.

- Investments are made conditional upon the contemporaneous closing of coinvestment including capital from the principles of the company. AARCC takes no actions to ensure coinvestments are made. We noted that 8 of the 11 companies visited did not contribute the required matching capital.

- Annual audited financial statements are generally required from investees. The AARCC agreement requires annual audited financial statements, but AARCC does not enforce the requirement.

- Investees are required to provide unaudited monthly financial statements and annual budgets. AARCC requires semiannual reports but, does not enforce the requirement.

- When material breaches of contract occur, the venture capital firm will attempt to negotiate a mutually acceptable modification. If that fails, it will take legal action against the company. We noted that AARCC has not initiated legal action against companies where there have been serious breaches of contract.

The Office of Inspector General for SBA, published an Inspection Report on SBA's Small Business Investment Companies' (SBIC) Best Practices in August 1994.[14] Our review of the report disclosed the following characteristics, that marked a financially successful SBIC, which were lacking or needed improvement in AARCC's operations.

- SBA SBIC's use a systematic approach to identify, evaluate, and structure deals; closely monitor the financial health of their investment portfolios through regular reviews of their investees' financial and operational records; and rigorously follow up on late payments.

- SBA SBIC's use a rigorous loan approval process to assure creditworthiness before authorizing funding.

- Profitable SBIC's have explicit strategies and adhere closely to them to minimize risk.

- SBA SBIC's use a systematic process for evaluating investment opportunities. Detailed analyses focusing on the company's management, business plan, and financial records are performed.

[14] "Inspection of SBIC Best Practices," dated August 1994, Report No. 94-08-002, Office of Inspector General, U.S. Small Business Administration

- SBA SBIC’s perform reference checks with suppliers, customers, and industry contacts to assess the integrity and reliability of the investees’ management. Credit checks are performed to assess payment history and legal reviews are conducted to determine such matters as patent rights.

- For most investees, SBA SBIC’s perform at least one of the following: (1) Conduct site visits and meet regularly with management, (2) review monthly financial statements, annual business plans, and annual audits, and (3) perform quarterly analyses of the composition of their portfolios. In addition, when a company experiences problems, the monitoring efforts are accelerated by (1) requiring weekly reports and/or meetings, (2) encouraging more frequent meetings of the company’s board of directors, and (3) in some cases, requiring daily meetings.

RECOMMENDATIONS

19. Develop a "Best Practices" model and modify current procedures to incorporate those practices.