



**U. S. Department of Agriculture
Office of Inspector General
Audit Report**

**U.S. Department of Agriculture
Alternative Agricultural Research
& Commercialization
Corporation's Financial Statements
for Fiscal Year 1997**



**Audit Report No.
37401-2-FM
January 1999**



UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
Washington D.C. 20250



DATE :

REPLY TO

ATTN OF: 37401-2-FM

SUBJECT: Audit of the Alternative Agricultural Research and
Commercialization Corporation's (AARCC) Financial
Statements for Fiscal Year 1997

TO: Board of Directors
AARCC

THRU: Robert Armstrong
Executive Director
AARCC

This report presents the results of our audit of the U.S. Department of Agriculture's AARCC financial statements for the fiscal year ended September 30, 1997. The report contains our disclaimer of opinion on the fiscal year 1997 financial statements and the results of our assessment of AARCC's internal control structure and compliance with laws and regulations.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective actions taken or planned and the timeframes for implementation. Please note that the regulation requires management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance.

ROGER C. VIADERO
Inspector General

EXECUTIVE SUMMARY

U.S. DEPARTMENT OF AGRICULTURE ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION CORPORATION'S FINANCIAL STATEMENTS FOR FISCAL YEAR 1997 AUDIT REPORT NO. 37401-2-FM

PURPOSE

The purpose of our audit was to determine whether (1) the Alternative Agricultural Research and Commercialization Corporation's (AARCC) financial statements present fairly the financial position, results of operations, and changes in equity in accordance with applicable accounting standards, (2) the internal control structure was adequate to provide reasonable assurance that the internal control objectives were achieved, (3) the AARCC complied with laws and regulations for those transactions and events that could have a material effect on the financial statements, and (4) the information in the Overview of the Reporting Entity was materially consistent with the information in the financial statements.

RESULTS IN BRIEF

We are unable to express, and do not express, an opinion on the AARCC financial statements for the 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. As a result of this disclaimer of opinion, departmental and AARCC officials, Congress and the public do not know how well or poorly AARCC has performed. In addition, departmental officials and the Congress' ability to make informed decisions that are "fact based" is substantially hindered when the underlying information that provides the basis for decisions is called into question or when fundamental information is lacking.

We noted that the financial management system established by AARCC is not sufficiently designed to enable AARCC to either meet current accounting standards or provide reliable financial information for managing its operations. AARCC officials acknowledged that their current financial reporting system is not set up to generate financial statements in accordance with generally accepted Government accounting standards. The greatest impacts are that the Corporation cannot 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, or (3) properly safeguard government funds from loss and/or unauthorized use.

During our audit, we identified the following material internal control weaknesses that impacted the Corporation's operations.

- There is an overall absence of effective procedures to assure that investees used AARCC funds as intended.
- There is an absence of effective procedures to assure the investees contributed required capital, and the contribution was properly valued.
- There are 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 is 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 is a general lack of policies and procedures for performing credit checks, background investigations, and obtaining references about the integrity of the investees. 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.

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

We also noted several instances where AARCC appears to be in noncompliance with the Food, Agriculture, Conservation and Trade Act (FACT) and Federal Agricultural Improvement and Reform Act of 1996 (FAIR). The legislation, among other things, requires that the Board of Directors (Board) review and vote on any financial assistance to be provided, prohibits AARCC from granting monies for commercialization, requires Board members to file annual financial disclosures, requires grants to be competitively bid, and requires the Board to establish a thorough and effective system of auditing and accountability. Our review disclosed that AARCC did not adhere to these requirements and as a result:

- Approved at least \$360,000 in funding to 10 investees without Board vote,
- made grants of over \$575,000 to 11 investees for commercialization of AARCC products,
- did not obtain an annual financial disclosure from a voting Board member,
- did not always competitively bid grant awards, and
- did not establish a system to determine whether AARCC funds were used as intended.

We noted that AARCC has not complied with requirements of the Debt Collection Improvement Act (DCIA) of 1996. AARCC officials have indicated that they believe they have been exempted from the Act because they filed an exemption from the Treasury Offset Program (TOP) and AARCC does not have "debt" because they make equity investments. However, we noted that AARCC has nine loans totaling \$2.7 million. As a result, AARCC has minimum assurance that it is not financing companies that may not be entitled to Government funds because they are delinquent to other Federal agencies, and may have inappropriately written off a \$54,000, including interest, AARCC investment.

AARCC has not published a regulation covering basic policy for operation of its program. A published regulation is needed to provide official policy to the public concerning basic program objectives, the application process, and basic criteria for approving and funding project applications. The regulation should also cover any Board approved policy which has a significant impact on prospective applicants as specified by the Administrative Procedures Act (Public Law 89-554), dated September 6, 1966. AARCC referred to Secretary's Memorandum (SM) 1020-37, dated March 18, 1992, which exempted AARCC from having to follow Departmental Regulations (DR) unless specifically cited. We believe this exemption should be rescinded.

As a result, AARCC and the Department have reduced assurance that taxpayers' monies have been properly expended and investments totaling over \$27 million are properly protected. Since its inception in 1992, AARCC has written off investments totaling about \$1.6 million and there is an additional \$2.8 million in investments where AARCC officials have indicated writeoff is imminent. These

amounts represent about 16 percent of the investments made since the inception of AARCC. Our work, to date, indicates that unless these material control weaknesses are corrected, additional losses will occur.

KEY RECOMMENDATIONS

Because of significant overall internal control and operational weaknesses we identified during our audit of AARCC fiscal year 1997 financial statements, the Board of Directors needs to implement

prompt corrective actions to include the following:

- Contract with a qualified Certified Public Accountant (CPA) firm to assist in the development of the internal control structure.
- Develop and publish procedures that provide guidelines for loan/investment making and rate of return on AARCC investments.
- Immediately notify and require AARCC investees to provide audited financial statements.
- Document a procedure to perform credit checks and background investigations on all potential and existing investees.
- Modify the agreements to provide for additional assertion, audited by a CPA, when investees do business with related parties.
- Modify existing and new agreements to require quarterly financial and performance reports so that AARCC can effectively monitor the projects and provide timely assistance if/when projections are not being accomplished.
- Request that the Secretary rescind SM 1020-37 which granted the exemption of AARCC from following DRs.
- Request that the Office of the Chief Financial Officer (OCFO) revise its accounting operations at the OCFO/National Finance Center (NFC) to properly record AARCC's investments.

AGENCY COMMENTS

AARCC generally agreed with the findings and recommendations.

TABLE OF CONTENTS

EXECUTIVE SUMMARY	i
INTRODUCTION	1
REPORT OF THE OFFICE OF INSPECTOR GENERAL	3
REPORT OF THE OFFICE OF INSPECTOR GENERAL ON INTERNAL CONTROL STRUCTURE	6
FINDINGS AND RECOMMENDATIONS	9
I. ADDITIONAL CONTROLS ARE NEEDED AT AARCC	9
RECOMMENDATIONS	11
II. FMFIA REPORT SUBMITTED BY AARCC WAS INACCURATE AND AARCC IS IN NONCOMPLIANCE WITH FFMIA	12
RECOMMENDATIONS	15
III. IMPROVEMENTS ARE NEEDED IN AARCC'S MONITORING EFFORTS .	16
RECOMMENDATIONS	20

REPORT OF THE OFFICE OF INSPECTOR GENERAL ON COMPLIANCE WITH LAWS AND REGULATIONS	22
FINDINGS AND RECOMMENDATIONS	24
IV. NONCOMPLIANCE WITH FACT AND FAIR ACTS	24
RECOMMENDATIONS	26
V. NONCOMPLIANCE WITH DCIA	26
RECOMMENDATIONS	28
VI. NONCOMPLIANCE WITH THE ADMINISTRATIVE PROCEDURES ACT	28
RECOMMENDATION	29

EXHIBIT A: ABBREVIATIONS	31
---------------------------------	----

AARCC FISCAL YEAR 1997 FINANCIAL STATEMENTS
(Prepared by AARCC)

OVERVIEW OF AARCC	1
STATEMENT OF FINANCIAL POSITION	2
STATEMENT OF OPERATIONS AND STATEMENT OF CHANGES IN NET POSITION	3
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS	4

INTRODUCTION

BACKGROUND

The Alternative Agricultural Research and Commercialization (AARC) Center was established in March 1992 as an independent entity in the U.S. Department of Agriculture (USDA). The program was

authorized by the Food, Agriculture, Conservation and Trade Act of 1990. The Federal Agricultural Improvement and Reform Act of 1996 changed the organization from the AARC Center to the AARC Corporation, a wholly owned government corporation.

AARCC was created to expedite the development and market penetration of nonfood, nonfeed 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. Matching funds equal to the AARCC's investment must be obtained by the small businesses from private sources.

AARCC is exempt from the Freedom of Information Act, thereby protecting the small businesses' innovations and allowing them to retain the proprietary value of their innovations during the application and commercialization process.

An 11 member Board of Directors, 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 of Directors 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.

AARCC publishes an annual notice in the Federal Register requesting proposals for funding. As of September 30, 1997, the Corporation had outstanding investments totaling over \$27 million for 54 investees and had granted about \$2 million to 27 grantees.



UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
Washington D.C. 20250



REPORT OF THE OFFICE OF INSPECTOR GENERAL

TO: Board of Directors
Alternative Agricultural Research and Commercialization Corporation

We were engaged to audit the accompanying Statement of Financial Position of the Alternative Agricultural Research and Commercialization Corporation (AARCC) as of September 30, 1997, and the related Statement of Operations and Changes in Net Position for the fiscal year then ended. These financial statements are the responsibility of AARCC management. We were unable to complete the audit because of the lack of sufficient, competent evidential matter to support numerous material line items on the financial statements and the overall lack of a reliable internal control structure.

The Federal Agriculture Improvement and Reform (FAIR) Act of 1996 established AARCC as a wholly owned corporation of the U.S. Department of Agriculture. Upon obtaining Corporate designation, AARCC was required to produce audited financial statements as required by the Chief Financial Officers (CFO) Act; fiscal year 1997 was the first year that the AARCC's financial statements were audited.

AARCC officials have acknowledged that their current financial reporting system was not set up to generate financial statements in accordance with generally accepted government accounting standards. Therefore, to assist in the preparation of its financial statements, AARCC contracted with a CPA firm. Our audit of the AARCC internal control structure and financial statements disclosed serious administrative and accounting internal control weaknesses.

We noted insufficient and/or ineffective policies and procedures over the loan/investment making process including:

- Financing decisions for new and existing investees,
- determining the rate of return on the investment,
- issuing grants for selected operations, and
- requiring investees to provide a security interest (lien) on the machinery, equipment, etc., obtained with AARCC loan funds, where appropriate.

AARCC uses the Office of the Chief Financial Officer National Finance Center's (OCFO/NFC) Central Accounting System (CAS) as its primary financial management system. This system did not properly account for the types of investments that AARCC enters into. As a result, the CAS has recorded the AARCC investments (assets/equity) as expenses since the inception of the entity. In addition, other control problems discussed in our audit report, where we issued an adverse opinion on the internal control structure of the OCFO/NFC for fiscal year 1997 (see Audit Report No. 11401-3-FM, "Fiscal Year 1997 National Finance Center Review of Internal Control Structure," dated March 1998), had a significant impact on our opinion on AARCC's financial statements.

Our review disclosed a substantial and serious lack of adherence to policies and procedures relating to obtaining audited financial statements from AARCC's investees. This critical internal control procedure was ignored by AARCC officials resulting in serious "information gaps" that caused management to have reduced assurance that:

- The investee uses AARCC funds as intended;
- the investee contributes required capital, or that the contribution is properly valued;
- the investments are properly valued and recorded on AARCC's financial statements;
- AARCC is receiving the return on its investments, repayment of the note, etc., it has earned based on investee operations; and
- related party transactions are appropriate and adequately disclosed.

Because of these conditions, we were unable to obtain sufficient, competent, evidential matter to support whether "Repayable Cooperative Agreements, Net," "Investments, Net," "Notes Receivable, Net," and the related "Allowance for Loss" amounts valued at \$2 million, \$4.6 million, \$.6 million and \$20 million, respectively, were reasonably stated.

We were also unable to obtain reasonable assurance that assets and liabilities at the beginning of the current year and the results of operations during fiscal year 1997 were free of material misstatement. In addition, because we did not perform an audit of AARCC's financial statements for fiscal year 1996, we were unable to determine whether "Net Position, Beginning Balance" totaling over \$5 million was presented fairly.

Since we were not able to apply alternate auditing procedures to satisfy ourselves as to the value of assets, liabilities, equity, and related revenues and expenses of AARCC, the scope of our work was insufficient to enable us to express, and we do not express, an opinion on AARCC's fiscal year 1997 financial statements.

We have also issued a report on internal controls which includes three reportable conditions and a report on compliance with laws and regulations which includes three instances of noncompliance, including material noncompliance with AARCC's enabling legislation.

ROGER C. VIADERO
Inspector General

July 31, 1998



REPORT OF THE OFFICE OF INSPECTOR GENERAL ON INTERNAL CONTROL STRUCTURE

TO: Board of Directors
Alternative Agricultural Research and Commercialization Corporation

We were engaged to audit the accompanying financial statements of Alternative Agricultural Research and Commercialization Corporation (AARCC) for the fiscal year ended September 30, 1997, and have issued our report thereon, dated July 31, 1998. In planning and performing our audit of the financial statements of AARCC for the fiscal year ended September 30, 1997, we considered the internal control structure for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

MANAGEMENT'S RESPONSIBILITY FOR INTERNAL CONTROL STRUCTURE

The management of AARCC is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management reasonable, but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with the agency's prescribed basis of accounting. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In its fiscal year 1997 Federal Managers' Financial Integrity Act (FMFIA) report, AARCC reported to the Secretary of Agriculture that it generally complied with Section 2 (Management Accountability and Control). These standards require agencies to report on whether they can provide reasonable assurance that:

- Obligations and costs are in compliance with applicable laws;
- funds, property and other assets are safeguarded against loss, misappropriation, unauthorized use, and waste; and

- revenues and expenditures are properly recorded and accounted for to maintain accountability over assets, and permit the preparation of accounts and financial reports.

We disagree with AARCC's conclusion. As noted in this report, we determined that AARCC neither has the controls to assure that Government funds are expended as authorized, nor that the Government receives the royalties, to which it is entitled. AARCC acknowledged that its financial management and/or accounting systems did not comply with Section 4 of the FMFIA because it was incapable of preparing financial statements. We concur with that conclusion.

OIG'S EVALUATION OF AARCC'S INTERNAL CONTROL STRUCTURE

For the purpose of this report, we have classified AARCC's significant internal control structure policies and procedures into the following categories.

- Grants - which consists of policies and procedures associated with authorizing and disbursing grants.
- Repayable Cooperative Agreements - which consists of policies and procedures associated with authorizing and disbursing payments, authorizing guarantees, accruing interest and interest income where applicable, collecting repayments including royalties, and determining the allowance for loss on investments.
- Equity Investments - which consists of policies and procedures associated with authorizing and disbursing payments, valuing equity investments on an annual basis, and collecting royalties, where applicable.
- Treasury - which consists of policies and procedures associated with disbursing and collecting cash, reconciling cash balances, and managing debt.
- Financial Reporting - which consists of policies and procedures associated with processing accounting entries and preparing AARCC's annual financial statements.

For each of the internal control structure categories previously listed, we obtained an understanding of the design of significant policies and procedures and whether they have been placed in operation. We assessed control risk and performed tests of AARCC's internal control structure. We also obtained an understanding of relevant internal control structure policies and procedures designed to determine that data supporting reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information. However, our objective was not to provide an opinion on the performance measures. Accordingly, we do not express such an opinion.

In making our risk assessment, we considered AARCC's FMFIA reports as well as our prior and current audit efforts on financial matters and internal accounting control policies and procedures. We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and Office of Management and Budget (OMB) Bulletin 93-06. Reportable

conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to have reasonable assurance that the following objectives are met:

- (1) Transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets;
- (2) funds, property, and other assets are safeguarded against loss from unauthorized use or disposition;
- (3) transactions, including those related to obligations and costs, are executed in compliance with (a) laws and regulations that could have a direct and material effect on the Principal Statements, and (b) any other laws and regulations that OMB, AARCC, or we have identified as being significant for which compliance can be objectively measured and evaluated; and
- (4) data that supports reported performance measures are properly recorded and accounted for to permit the preparation of reliable and complete performance information.

Matters that we consider to be reportable conditions are presented in the "Findings and Recommendations" section of this report.

FINDINGS AND RECOMMENDATIONS

FINDING NO. 1

Additional Controls Are Needed At AARCC

The absence of sound and documented internal control policies and procedures within AARCC has significantly impacted overall operations and reduced the financial strength of the Corporation. We attributed this problem to the need for additional management oversight by the Board of Directors (Board) and the Executive Director. As a result of this and other problems, we were unable to

form an opinion on whether AARCC's fiscal year 1997 financial statements were free of material misstatements. In addition, AARCC and the Department have reduced assurance that taxpayers' monies have been properly expended and investments totaling over \$27 million are properly protected. Since its inception in 1992, AARCC has written off investments totaling about \$1.6 million and there is an additional \$2.8 million in investments where AARCC officials have indicated writeoff is imminent. These amounts represent about 16 percent of the investments made since the inception of AARCC. Our work, to date, indicates that unless numerous and substantial control weaknesses are corrected, additional losses will occur.

During our audit, we identified the following material internal control weaknesses that impacted the Corporation's operations.

- There is an overall absence of effective procedures to assure that investees used AARCC funds as intended.
- There is an absence of effective procedures to assure the investees contributed required capital, and the contribution was properly valued.
- There are inadequate policies or procedures to assure that the Government's investment is protected because AARCC does not require the investee to provide a security interest (lien) on the equipment, machinery, etc., obtained with AARCC loan funds.
- There are 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 is 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 is a general lack of policies and procedures for performing credit checks, background investigations, and obtaining references about the integrity of the investees. 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.
- There is a need for substantial improvements in the monitoring of the investees. For example:
 - Our review of available investee financial information disclosed that many of the companies receiving AARCC funding do business with affiliate companies. (Transactions between affiliated companies constitute related party transactions 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.) However, there is no assurance that these transactions are adequately disclosed to AARCC by investees.
 - We noted that AARCC generally received unaudited financial information about investee operations on an annual basis. We believe that quarterly data should be required in order for AARCC to better monitor the investees' financial operations. This would enable AARCC to provide additional oversight to investees when financial indicators note potential problems such as meeting sales goals, production timeframes, etc.

Overall, AARCC has not adequately documented its internal control objectives and techniques in an integrated framework to ensure that management's overall goals are achieved consistently and uniformly. Additionally, AARCC has no formalized documented accounting procedures. Given the complexity of the agency's operations, documented controls for each activity would assist in providing additional assurance concerning the effectiveness of operations, reliability of financial information, and compliance with laws and regulations.

We noted in an inspection report on Small Business Investment Company (SBIC) Best Practices ¹ that the following characteristics

¹ "Inspection of SBIC Best Practices," dated August 1994, Report No. 94-08-002, Office of Inspector General, U. S. Small Business Administration.

mark financially successful investment firms and were generally lacking in AARCC's operations and/or needed improvement.

- Financially successful SBIC's use a systematic approach to identify, evaluate, and structure deals; closely monitor the financial health of their portfolios through regular reviews of the companies' financial and operational records; and rigorously follow up on late payments.
- SBIC's using loan financing use a rigorous loan approval process to assure creditworthiness.
- The profitable SBIC's have explicit strategies and adhere closely to them to minimize risk.
- Successful SBIC's use a systematic process for evaluating investment opportunities. Detailed analyses focusing on the company's management, business plan, financial records are performed. Potential for growth is the primary consideration in equity financing and ability to repay is foremost in debt financing.
- Reference checks are conducted with suppliers, customers, and industry contacts to assess the integrity and reliability of the company's management. Credit checks are performed to assess payment history and legal reviews are conducted to determine such matters as patent rights.
- Most 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 valuations of the portfolio concerns. 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

- 1a. Contract with a national CPA firm to assist in the development of an internal control structure for AARCC's administrative and accounting operations.
- 1b. Develop procedures to require credit checks and other background investigations on new and existing investees seeking financial assistance, including;
 - reference checks with suppliers, customers, and industry contacts to assess the integrity and reliability of the company's management, and
 - legal reviews to determine the adequacy of such matters as patent rights, trade secrets, etc.

- 1c. Modify the agreements to provide for additional assertion, audited by a CPA, when investees do business with related parties.
- 1d. Modify the investment agreement to require quarterly financial and performance reports so that AARCC can effectively monitor the projects and provide timely assistance if/when projections are not being accomplished.
- 1e. Develop periodic financial management ratios that need to be reported, monitored, and routinely analyzed for investees.
- 1f. Develop a checklist requiring documentation of the analyses performed for recommendation 1e.

FINDING NO. 2

**FMFIA Report Submitted By AARCC
Was Inaccurate And AARCC Is
In Noncompliance With FFMIA**

AARCC reported, for fiscal year 1997, that its system of internal administrative and accounting controls complied with the standards prescribed by the Comptroller General. These standards require that agencies report on whether they can provide reasonable assurance that:

- Obligations and costs are in compliance with applicable laws.
- Funds, property, and other assets are safeguarded against loss, misappropriation, unauthorized use, and waste.
- Revenues and expenditures are properly recorded and accounted for to maintain accountability over assets, and permit the preparation of accounts and financial reports.

We disagree with AARCC's conclusion. We believe that AARCC needs to substantially strengthen its administrative and accounting internal control procedures. Based upon our audit, we concluded that AARCC neither has the controls to assure that Government funds are expended as authorized, nor that the Government received the royalties, repayments, etc., to which it is entitled. Because of a failure to enforce contract agreements that investees provide annual audited financial statements, AARCC does not receive data critical to properly safeguarding the Government's investments. In our opinion, this problem, coupled with substantial and numerous other internal control weaknesses, prevents AARCC officials from providing reasonable assurance that investments made, totaling over \$27 million, are safeguarded from loss, misappropriation, unauthorized use, or waste.

Overall, AARCC (as noted in Finding No. 1) has not established appropriate internal control procedures and regulations to ensure that:

- Funding provided to its investees is used for the purposes agreed upon,

- investees and other investors have contributed the required and properly valued matching funds, and
- investees have accurately represented their financial strength and other key financial interests.

The AARCC investment agreement ² provides that no part of the funds made available shall be expended for the acquisition or construction of a building or facility, the travel of AARCC employees, or for lobbying activities. The agreement also established additional unallowable and allowable costs as outlined in Title 48, Code of Federal Regulations, Part 31.2, "Federal Cost Principles." AARCC also requires a form entitled, "Budget Breakdown by Tasks and Organizations" that breaks out the use and source of funding. The investee is expected to adhere to this schedule and notify AARCC of changes greater than 10 percent. Details follow:

- We noted in a prior audit (Audit Report No. 34099-1-At, "Alternative Agricultural Research and Commercialization - Agro-Fibers, Inc."), that one investee represented that it would provide \$3.2 million as its capital contribution purportedly composed of intellectual property and manufacturing facility assets. We noted that the investees' accounting records did not support any values for intellectual property (e.g., intangible assets, patents, trademarks) and the facility assets were funded entirely with debt. The investees' records only supported \$100 available for its capital contribution. The agreement also provided that over \$355,000 of AARCC funds would be used to purchase equipment. However, other funds were used to purchase that equipment and that lender was provided a security interest in the equipment. The AARCC funds were used for general operations.
- We also noted where investees do substantial business with parent and subsidiary companies and other related parties. However, there are no assurances that these transactions are on an "arm's-length basis." AARCC has not established policies and procedures to address this issue. We have noted in our audits of other USDA programs that effective controls are needed to preclude fraud and abuse in this highly vulnerable area.

Our analysis of AARCC policies and procedures disclosed that it has no policy that requires the investee to provide a security interest (lien) on those assets purchased with AARCC loan funds. We noted that AARCC has entered into nine lending agreements totaling \$2.7 million and had received a security interest in only one of the loans which consisted of preferred stock which had been placed in escrow. We reviewed 11 other USDA lending programs and noted that all 11 require adequate security to be provided to protect the Government's interest.

² Our review noted that the standard AARCC agreement was adopted from the Cooperative State Research Education, & Extension Service (CSREES) and does not directly relate to AARCC financings in many areas. For example, the CSREES cooperative agreement relates to nonreimbursable research grants to primarily nonprofit entities and universities while the AARCC agreement relates to venture capital and repayable cooperative agreements.

AARCC does not enforce its investees to submit audited financial statements as required by the venture capital, cooperative repayable and other agreements signed by AARCC and the investees. AARCC management indicated that requiring audited statements would be "cost prohibitive" to the investee. As a result, investments cannot be recorded to reflect their true value, it is not known whether royalties, repayments, and other returns on the investments are correct, or whether the investees are properly using AARCC funds.

Of the 54 AARCC agreements, in effect as of September 30, 1997, 52 required annual financial statements, one agreement was modified through "negotiation" to only require a "review," and another was modified through "negotiation" to only require a "compilation" of the financial data. Our analysis of AARCC's records showed that most investees ignored the requirement and did not ever submit annual financial statement audits. There were no actions taken by AARCC officials to follow up or take remedial actions to obtain the reports. For example, only six, seven, and three audits were submitted for fiscal years 1995, 1996, and 1997, respectively, for the 52 investments. We believe that this is a serious breach of the Board's and corporate officials' fiduciary responsibilities.

Forty-one of AARCC's agreements provide for repayments or royalty payments to be made based on percentage of sales. Without audited statements, AARCC does not have reasonable assurance that investees are paying according to the terms of the agreement. In addition, in order to properly value its portfolios, reliable data on the financial condition of all the investees is needed.

Our analysis of the investment agreements also disclosed that the investees' audits are not required to be conducted in accordance with generally accepted Government auditing standards (GAGAS). GAGAS audits are required by the Inspector General Act of 1978, as amended, and should be performed by non-Federal auditors when they audit Federal organizations, programs, activities, and functions. A GAGAS audit would provide AARCC officials with reasonable assurance that the investee has properly protected AARCC's interest in the company, properly reported its operations, appropriately calculated and remitted any royalties based on accurate sales or other returns on investments. The GAGAS audit would also provide valuable information to AARCC that the investee has established a reliable internal control structure and has complied with agreements and commitments made to AARCC.

Our review also disclosed that AARCC is in substantial noncompliance with the three requirements of the Federal Financial Management Improvement Act (FFMIA). Under the FFMIA, we are required to report whether AARCC's financial management systems substantially comply with Federal financial management systems requirements, Federal accounting standards and the U.S. Government Standard General Ledger (SGL) at the transaction level.

RECOMMENDATIONS

- 2a. Report that AARCC is unable to provide reasonable assurance that it complies with Sections 2 and 4 of the FMFIA.
- 2b. Establish and publish rules to require investees to provide security interests (liens) on property financed with AARCC loan funds.
- 2c. Notify and enforce requirements that the investees submit audited annual financial statements.
- 2d. Modify the AARCC investment agreement so that it more directly applies to AARCC operations and assures adequate controls are in place to protect the Government's funds.
- 2e. Revise the current agreement to provide appropriate penalties if investees fail to adhere to their agreements.
- 2f. Modify the investment agreements to require that the audits be conducted in accordance with GAGAS.
- 2g. Develop a compliance checklist to standardize the necessary tests that the CPA needs to perform to provide assurance that investees are in compliance with appropriate laws and regulations, including repayments to AARCC and investees contribution requirements.
- 2h. Develop a tracking system to monitor the receipt of audited financial statements.
- 2i. Contract with appropriate financial and industry experts to assist in analyses of the audits, financial and performance reports submitted by investees.
- 2j. Report noncompliance with the FFMI and develop a remediation plan that includes the resources, remedies, and intermediate target dates necessary to bring the agency's financial management systems into substantial compliance.
- 2k. Request that the OCFO revise its accounting operations at the OCFO/NFC to properly record AARCC's investments in accordance with Federal financial management systems requirements, Federal accounting standards, and the SGL.

FINDING NO. 3

Improvements Are Needed in AARCC's Monitoring Efforts

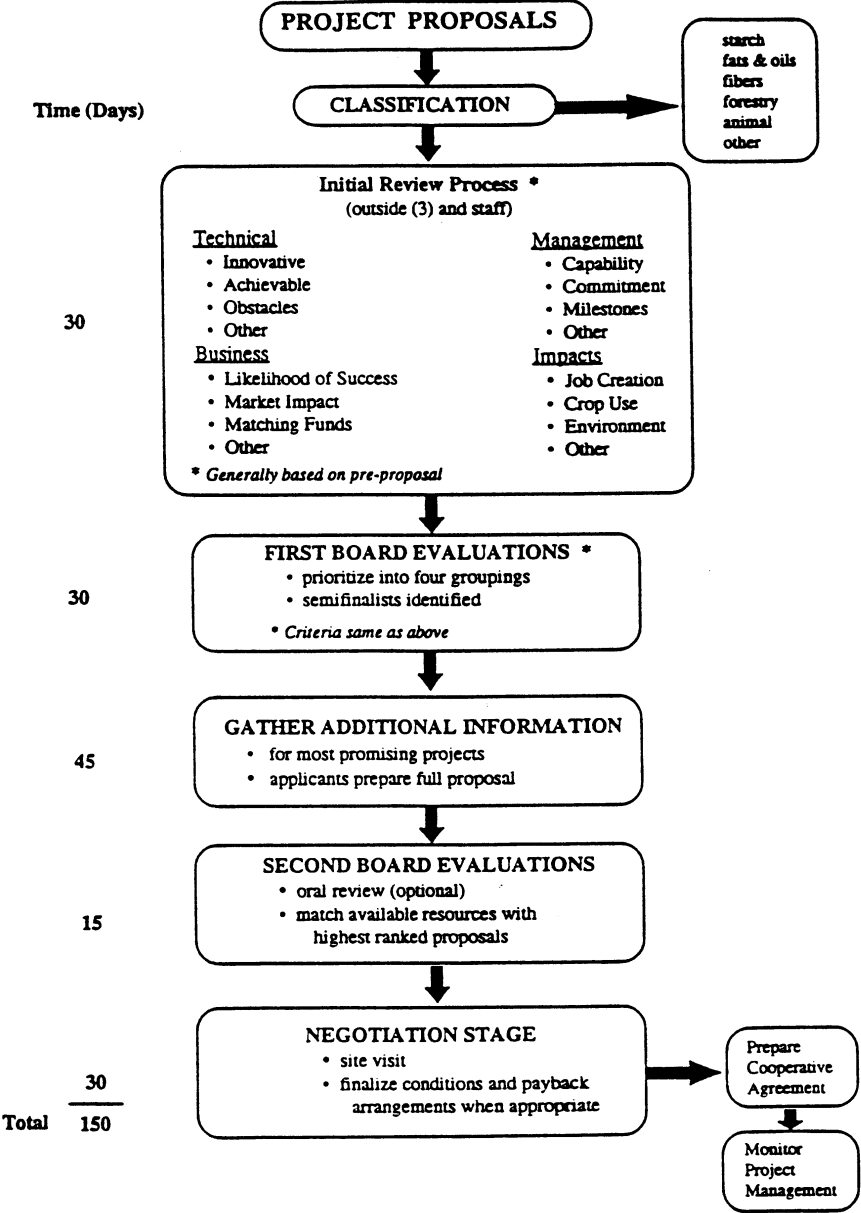
The decisions and processes followed by AARCC in determining whether to make an investment (known as "due diligence"), and what the repayment (rate of return, etc.) will be needs substantial improvements, both in actions taken and documentation of the actions. We attributed this problem to the absence of a documented internal control structure and the need for additional oversight by

the Board and Executive Director. Because of these problems, there is little support for decisions made to provide initial or additional funds to companies, or the processes used to arrive at an appropriate rate of return. For example, in making its selections, the Board is to consider, by law, the following:

- Whether or not the proposed project is likely to succeed?
- What economic activities will be stimulated?
- What type of jobs will result, and the impact of those jobs on the rural community?
- How much "value-added" will accrue to the raw materials?
- What is the potential for the project to develop a new industry?

We noted that while the application process requires that this information be reported, there was a general absence of documentation indicating how AARCC officials used the information during the decision making process. We believe guidelines should be developed to rank the applicants to ensure that the most meritorious projects receive AARCC assistance. This process would also provide documentation supporting AARCC's decisions for rejecting projects.

The following chart, taken from June 1994 draft procedures, illustrates the review process AARCC should follow in selecting projects for funding.



Our review of 35 investments made under these draft procedures disclosed the following:

- There were 10 instances where the results of the site visit were not documented. Documentation is needed to address any concerns, prospects, problems, viability, benefits or "down" aspects of the project, etc.
- There were 11 instances where the Board votes were not documented.
- There were 11 instances where the independent reviewers recommended rejecting the investment and the project was approved for funding. These 11 investments received AARCC funding totaling about \$10.8 million. Some of the reasons for recommending rejection included, insufficient information, lack of sound technology; and the product appeared to have already been "commercialized" and was outside of AARCC's charter.
- There were 10 instances where not all of the three independent reviews were performed. Two of these 10 investments are no longer viable projects and AARCC has recognized losses totaling \$690,000.

AARCC recognized the need to improve its "due diligence" operations and on November 6, 1996, established a separate Due Diligence Committee (Committee). The Committee is made up of four Board members from the private sector and the AARCC Executive Director.

The Committee adopted the following additional procedures for receiving and evaluating applications:

- Within 14 days of receiving a "pre-proposal" application, the Committee will determine whether a full proposal is warranted and/or additional information is needed.
- When received, the full proposal will be forwarded to three independent expert reviewers to analyze the technical, business, and general merits of the project. The technical evaluation addresses whether the technical claims are achievable, defined, and whether there are regulatory obstacles to overcome. The business evaluation looks at the adequacy of the business plan, potential market share that could be expected, and likely competition. These reviewers provide feedback on the project's overall strengths and weaknesses and recommendations on whether to proceed, gather additional information and/or reject the request for funding.
- If the project demonstrates merit, (e.g., obtains approval from the reviewers, demonstrates job creation in rural areas, promotes nonfood, nonfeed use of agricultural products, etc.) the Committee will perform a site visit. During this visit, AARCC representative(s) meet with management, visually inspect facilities, and obtain additional information, if necessary, etc.
- Following the visit, the Committee will present its recommendation to the Board for a vote.

We reviewed the due diligence activities performed on the four investments receiving fiscal year 1997 funding that were submitted after the due diligence committee was established. Our review found continued inconsistent application and documentation of the due diligence process. Details follow:

- There was no documentation to support why 3 of the 4 projects received more funds than requested.
- Independent reviews were not always performed on the full proposals as follows: a technical review was not performed for 3 of the 4; a business review was not performed for 2 of the 4; and a general review was not performed for 3 of the 4 proposals.
- Funding was approved for one of the projects even though the business and general reviewers both recommended that the project should be rejected.
- The results of the site visits were not documented for two of the four projects visited.
- The Board voted to fund one of the projects after the agreement was signed by the Executive Director.

We were advised by AARCC officials that it is not necessary to perform a "due diligence" review for funds provided companies with existing AARCC investments. We disagree with this position. AARCC's portfolio as of September 30, 1997, consisted of about \$18 million in "initial investments," and about \$11 million in additional investments to existing investees (about 39 percent of all funding).

AARCC has broad authority to provide assistance to agricultural research, development and commercialization of nonfood, nonfeed uses of agricultural and forestry products. It can accomplish this through the use of grants, cooperative agreements, contracts, loans, interest subsidy payments and investments in venture capital agreements. As a result, AARCC has entered into a wide range of terms with its clients.

AARCC officials have advised us that it "needs to be able to negotiate without restraint," as long as the agreement is in the best interest of the Government. However, we have noted that these negotiations are frequently not documented, and we were unable to find support for the processes/procedures followed to determine what the rate of return should be, the total return to be obtained or what factors influenced the decision.

For example, we noted where royalty repayments ranged from 10 percent of gross sales for one investment to 1.25 percent of gross sales for another investment. We also noted where the risk investment charge (interest plus a factor for the risk of the investment) ranged from 0 percent for one investment to 15 percent for a different investment. While these repayment terms may be appropriate considering the risk associated with the individual projects, there was inadequate documentation to support the variances. We also noted inadequate documentation for deciding on whether to make equity investments, lending agreements, or grants.

We also noted that many of the repayable cooperative agreements were structured to require repayments based on a contingent future event such as success of the project, threshold of sales, profits, etc. Generally, these agreements do not require that repayment be made if the project is not successful or never goes to market. Given the weaknesses in AARCC's monitoring efforts, we question if this type of agreement is in the best interest of the Government.

We believe that there is a need for substantial and appropriate documentation to support the decisions made by the AARCC, including the analyses of the legislative selection criteria. Without documentation to support why specific royalties, rates of return, etc., are agreed upon (based on risk, size of investment, and other monetary matters) questions can be created regarding these critical decisions.

RECOMMENDATION

- 3a. Supplement existing due diligence by requiring a comprehensive business plan from the investee which requires, at a minimum, current financial condition, proforma income statements for the period of the venture (or not less than 5 years), and validated marketing data (to include identification of prospective clients), as well as other necessary and critical information.

- 3b. Follow established due diligence procedures for all new and existing investees seeking additional funding and document the actions taken.
- 3c. Document reasons and obtain full Board concurrence when independent reviewer's recommendations are not followed.
- 3d. Document reasons and obtain Board approval when increasing amounts awarded to investees from original proposal and obtain additional independent reviews if increases were made subsequent to the last reviews.
- 3e. Develop and publish operational procedures in the Federal Register that provide guidelines for when and what type of investments will be made and for establishing the rate of return on AARCC investments, etc., using quantifiable parameters in relationship to risks and benefits.
- 3f. Develop a "model" (to include such things as risk, potential benefits, number of new jobs created, etc.) to determine which type of investment and rate of return is in the best interest of the Government.
- 3g. Establish criteria to rank each investment against specific legislative and regulatory criteria and among each other prior to approving investments.

A material weakness is a reportable condition in which the design or operation of the specific internal control structure element does not reduce to a relatively low level the risk that errors or irregularities, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are considered to be material weaknesses as defined above. We believe the reportable conditions described in Findings Nos. 1, 2 and 3 are material weaknesses.

ROGER C. VIADERO
Inspector General

July 31, 1998



REPORT OF THE OFFICE OF INSPECTOR GENERAL ON COMPLIANCE WITH LAWS AND REGULATIONS

TO: Board of Directors
Alternative Agricultural Research and Commercialization Corporation

We were engaged to audit the financial statements of AARCC for the fiscal year ended September 30, 1997, and have issued our report thereon, dated July 31, 1998.

The management of the AARCC is responsible for compliance with laws and regulations applicable to the Corporation. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of AARCC's compliance with certain provisions of laws and regulations that may directly affect the financial statements and certain other laws and regulations designated significant by OMB or the Department. We tested compliance with the:

- Antideficiency Act;
- Budget and Accounting Procedures Act;
- Chief Financial Officers (CFO) Act;
- Debt Collection Improvement Act (DCIA);
- Federal Financial Management Improvement Act (FFMIA);
- Federal Managers' Financial Integrity Act (FMFIA);
- Government Performance and Results Act (GPRA);
- Federal Agricultural Improvement and Reform (FAIR) Act; and
- Food, Agriculture, Conservation, and Trade (FACT) Act.

As part of the audit, we reviewed management's process for evaluating and reporting on internal control and accounting systems, as required by the FMFIA, and compared the agency's most recent FMFIA reports with the evaluation we conducted of AARCC's internal control structure. We also reviewed and tested policies, procedures, and systems for documenting and supporting financial, statistical, and other information presented in the overview of the reporting entity and supplemental financial and management information. However, our objective was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Under FFMIA, we are required to report whether AARCC's financial management systems substantially comply with Federal Financial Management Systems Requirements (FFMRS), applicable accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance issued for FFMIA by OMB on September 9, 1997. The results of our tests disclosed instances described in Finding No. 2 of the our Report on Internal Control Structure where the agency's financial management systems, as a whole, did not substantially comply with the three requirements.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in law or regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements, or the sensitivity of the matter would cause it to be perceived as significant by others. Material instances of noncompliance noted during our audit are presented in the "Findings and Recommendations" section of this report.

FINDINGS AND RECOMMENDATIONS

FINDING NO. 4

Noncompliance With FACT and FAIR Acts

We noted several instances where AARCC appears to be in noncompliance with the FACT and FAIR Acts. The legislation, among other things, requires that the Board review and vote on any financial assistance to be provided, prohibits AARCC from providing grants for commercialization, requires Board

members to file annual financial disclosures, requires grants to be competitively bid, and requires the Board to establish a thorough and effective system of auditing and accountability. Our review disclosed that AARCC did not adhere to these requirements and as a result:

- Approved at least \$360,000 in funding to 10 investees without Board vote,
- made grants of over \$575,000 to 11 investees for commercialization of AARCC products,
- did not obtain an annual financial disclosure from a voting Board member,
- did not always competitively bid grant awards, and
- did not establish a system to determine whether AARCC funds were used as intended.

Section 1659 of the FACT and FAIR Acts states that the Board shall review any grant, contract, cooperative agreement and financial assistance to be made or entered into by AARCC and shall make the final decision, by majority vote, on whether and how to provide assistance to an applicant. The Act further states that this approval authority may not be delegated. Section 1659 of the FAIR Act further requires that the Board members submit annual financial disclosure forms to assist in precluding the members from voting on projects where there is a conflict of interest or the appearance thereof.

Section 1660, "Research and Development Grants, Contracts, and Agreements," states that grants made, and contracts and cooperative agreements entered into shall be selected on a competitive basis on the recommendation of a peer review system.

Section 1661, "Commercialization Assistance," states that AARCC may provide financial assistance for commercializing new nonfood, nonfeed products in the form of loans, interest subsidy payments, venture capital investments, and repayable grants.³

Section 1662 states that the Board shall establish a thorough and effective system of auditing and accountability to ensure that funds paid under Sections 1660 and 1661 are used by recipients only for the purposes for which those funds are provided by AARCC.

The conditions noted follow:

- During fiscal year 1993, the AARCC Board improperly gave the AARCC staff authority to invest in small projects without full Board involvement. This authority gives the Executive Director "signature authority" to make grants and/or investments of up to \$50,000 subject to approval of AARCC's Due Diligence Committee. The FAIR Act states, however, that the Board does not have the authority to delegate approval for funding, and the Due Diligence Committee is comprised of four Board members which does not represent a quorum and/or majority vote by Board members. We noted that during the time period June 1997 through April 1998, the Executive Director has approved, under his "signature authority," at least 10 investments totaling \$360,000.
- The FACT and FAIR Acts distinguish between research and development projects which are eligible for grants and nonrepayable cooperative agreements, and commercialization projects which are not eligible for this type of assistance. We noted that AARCC did not distinguish between research and development or commercialization projects as categorized in the Acts prior to making the investment. As a result, we noted that as of September 30, 1997, AARCC has awarded grants for commercialization to at least 11 recipients totaling about \$575,000, where no repayment was required, and appears to be improper.
- AARCC established a policy that Board members, failing to file an annual confidential financial disclosure form, would refrain from voting on Board business. During the audit, we noted that a Board member had not filed a financial disclosure form during fiscal years 1997 and 1998; however, he continued to participate in Board votes. This Board member filed the required form on July 30, 1998, after we brought the matter to the attention of the Executive Director.
- We also noted a general lack of documentation that grants were competitively bid and, as discussed throughout the report on the internal control structure, AARCC has not established a system to ensure its funds are used for only approved purposes.

³ This section does not list grants and/or nonrepayable agreements as an approved type of financing.

RECOMMENDATIONS

- 4a. Rescind the Executive Director's approval authority and develop procedures to ensure that all approval for funding is based on a majority vote of the Board.
- 4b. Discontinue the granting of funds for commercialization projects.
- 4c. Develop procedures to ensure that all funding granted under Section 1660 of the FACT and FAIR Acts are competitively awarded.
- 4d. Enforce the policy for all Board members to have confidential financial disclosure forms on file, annually, prior to voting on Board business.
- 4e. Obtain Comptroller General opinions on the actions that need to be taken if the grants made for commercialization, and without competitive award, are improper, as well as investments made without Board approval.

FINDING NO. 5

Noncompliance With DCIA

that may not be entitled to Government funds because they are delinquent to other Federal agencies, and may have inappropriately written off a \$54,000, including interest, AARCC investment.

The seven purposes of the DCIA include:

- Maximizing collections of delinquent debts owed to the Government.
- Minimizing the costs of debt collection.
- Reducing losses arising from debt management activities by requiring proper screening of potential borrowers, aggressive monitoring of accounts, and sharing of information within and among Federal agencies.
- Ensuring that the public is informed of the Federal Government's debt collection policies and debtors are cognizant of their obligations to repay.

We noted that AARCC has not complied with requirements of the DCIA of 1996. AARCC officials have indicated that they believe they have been exempted from the Act because they filed an exemption from the TOP and AARCC does not have "debt" because they make equity investments. As a result, AARCC has minimum assurance that it is not financing companies

- Ensuring that debtors have all appropriate due process rights.
- Encouraging agencies to sell delinquent debt, when appropriate.
- Relying on the experience and expertise of private sector professionals to provide debt collection services.

The Act further provides that agencies report to the Secretary of Treasury, disclosing amounts of loans and accounts receivable owed the agency and when amounts owed the agency are due to be repaid.

AARCC has not implemented the requirements of the DCIA and has not submitted the following additional information required in the Treasury Financial Management Schedule 9 "Report of Receivables due from the Public:"

- The total amount of receivables and number of claims at least 30 days past due;
- the total amount written off as actually uncollectible and the total amount allowed for uncollectible loans and accounts receivable;
- the rate of interest charged for overdue debts and the amount of interest charged and collected on debts;
- the total number of claims and the total amount collected;
- the total number and total amount of claims referred to the Attorney General for settlement and the number and total amount of claims the Attorney General settles; and
- other information the Secretary considers necessary to decide whether the head of the agency is acting aggressively to collect the claims of the agency.

The DCIA defines "debt" synonymously with "claim" as any amount of funds or property that an appropriate official of the Federal Government has determined is owed to the Government. A debt or receivable is created when a responsible Federal official determines that the amount is owed.

AARCC indicated that it makes equity investments which may not be considered to be debt. Regardless, we noted that AARCC also has nine loans, with a total outstanding balance of approximately \$2.7 million, which are subject to DCIA requirements and reporting.

As of September 30, 1997, AARCC had written off \$1.6 million of its investment portfolio. We believe that AARCC needs to pursue a legal opinion to determine whether the Federal Claim Collection Standards apply to these writeoffs, and if so, pursue appropriate collection of the outstanding amounts. AARCC also needs to establish policies and procedures for determining when its investments constitute debt and become subject to debt collection legislation.

RECOMMENDATIONS

- 5a. Implement procedures to begin compliance with the DCIA, including the preparation of Schedule 9, "Report of Receivables due from the Public," and submit the report to the Secretary of Treasury on an annual basis.
- 5b. Obtain an OGC legal opinion regarding the extent that DCIA and Federal Claim Collection Standards apply to AARCC investments and establish appropriate policies and procedures for implementing the requirements.

FINDING NO. 6

Noncompliance With The Administrative Procedures Act

AARCC has not published a regulation covering basic policy for operation of its program. A published regulation is needed to provide official policy to the public concerning basic program objectives, the application process, and basic criteria for approving and funding project applications. The regulation should also cover any Board approved policy which has a significant impact on

prospective applicants as specified by the Administrative Procedures Act, (Public Law 89-554) dated September 6, 1966.

AARCC has referred to Secretary's Memorandum (SM) 1020-37, dated March 18, 1992, which exempts AARCC from having to follow Departmental Regulations (DR) unless specifically cited. However, this memorandum does not exempt AARCC from compliance with Federal law such as the Administrative Procedures Act of 1966 and other Acts and the United States Code.

We believe this exemption from following DR's should be rescinded because:

- DR's are often implementing guidance for Federal laws and often provide supplemental information on how to appropriately comply with requirements. For example, implementing the following DR's would help AARCC establish corrective action for some of the conditions noted in this report (this list is not all inclusive).

DR No. 1110-2,	"Internal/Management Controls"
DR No. 1512-1,	"USDA Regulatory Decisionmaking Requirements"
DR No. 1720-1,	"Audit Followup, Management Decisions, and Final Actions"

- In addition, other USDA corporations have voluntarily adopted regulations to improve their internal control structure.

RECOMMENDATION

- 6a. Request the Secretary to rescind SM 1020-37 which exempts AARCC from having to follow DRs unless specifically cited.

We considered these material instances of noncompliance when attempting to opine on whether the AARCC's fiscal year 1997 financial statements were presented fairly, in all material respects, in conformity with the applicable accounting standards now in effect for the preparation of financial statements. Because we were unable to extend our auditing procedures to satisfy ourselves regarding the affect these material instances of noncompliance might have on the AARCC's financial statements, as well as other issues discussed in our report, we were unable to, and did not, express an opinion on the financial statements.

ROGER C. VIADERO
Inspector General

July 31, 1998

EXHIBIT A - ABBREVIATIONS

AARCC	Alternative Agricultural Research and Commercialization Corporation
Board	Board of Directors
CAS	Central Accounting System
CFO Act	Chief Financial Officers Act
Committee	Due Diligence Committee
CPA	Certified Public Accountant
DCIA	Debt Collection Improvement Act
DR	Departmental Regulation
FACT Act	Food, Agriculture, Conservation and Trade Act
FAIR Act	Federal Agricultural Improvement and Reform Act
FFMIA	Federal Financial Management Improvement Act
FFMRS	Federal Financial Management Systems Requirements
FMFIA	Federal Managers' Financial Integrity Act
GAGAS	generally accepted Government auditing standards
GPRA	Government Performance and Results Act
OCFO	Office of the Chief Financial Officer
NFC	National Finance Center
OGC	Office of the General Counsel
OMB	Office of Management and Budget
SBIC	Small Business Investment Company
TOP	Treasury Offset Program
USDA	U.S. Department of Agriculture

U.S. DEPARTMENT OF AGRICULTURE
Alternative Agricultural Research and Commercialization Corporation
Overview and Supplemental Information

The Alternative Agricultural Research and Commercialization (AARC) Corporation assists the private sector in closing the gap between research and commercialization of biobased industrial (non-feed, non-food) products from farm and forestry materials and animal by-products by investing in U.S. private sector companies.

The AARC Corporation's goals are to multiply the return on investment (ROI) to the taxpayer; expand rural development or job creation opportunities through the financial support of these new public/private partnerships in mostly rural communities; and increase the use of agricultural materials, not in the traditional sense, but through commercializing new industrial uses, thus providing value-added income to farmers and ranchers while supporting diversity in America's agricultural base. Additionally, AARC Corporation investments also provide significant returns to the U.S. Treasury and state and local governments in the form of new commercial and personal taxes from these new enterprises and their employees.

For fiscal years 1993-97, the AARC Corporation invested \$33 million, matched by \$95 million from private partners, in more than 70 projects located in 33 states, to promote new, innovative and environmentally friendly uses for farm and forestry materials or animal by-products. The Corporation's portfolio includes a mix of long and short term projects providing opportunity for ROI and investment in new projects. To date, the AARC Corporation has received repayments from 11 companies.

Of the agreements, 66 are with small business firms; one is with an agricultural cooperative; three are with other non-profit organizations that sell products; five are with medium-size firms; and one is with a large firm. These projects use nearly two dozen different agricultural materials providing opportunity for biodiversity in agriculture. If all projects were to become successful, the firms project that approximately 5,000 jobs would be created in the near-term.

It is the AARC Corporation's goal to create 10,000 jobs in rural communities by September 2002 in AARC Corporation programs, and accelerate the use of agricultural materials to produce industrial products. To accomplish these goals, AARC Corporation will require financial resources at least as great as those already expended. Some of these funds will come from repayments, but annual appropriations will be necessary in the short term. The AARC Corporation is also aggressively marketing the AARC Corporation client base to attract additional private sector capital through several internet programs such as the Small Business Administration's ACE-Net program and the Industrial Agricultural Clearing House being constructed for AARCC by the Technology Information Transfer Center.

ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION (AARC) CORPORATION
U.S. DEPARTMENT OF AGRICULTURE
STATEMENT OF FINANCIAL POSITION
As of September 30, 1997

	<u>FY 1997</u>
ASSETS	
<u>Entity Assets: Intragovernmental</u>	
Advance with Treasury (Note 2)	\$ 5,348,814
<u>Entity Assets: Governmental</u>	
Risk Investment Charge Receivable, Net (Note 3)	55,389
Monitoring Fees Receivable (Note 4)	25,021
Repayable Cooperative Agreements, Net (Note 6)	2,187,402
Investments, Net (Note 7)	4,650,448
Notes Receivable, Net (Note 5)	<u>630,759</u>
Total Assets	\$ <u>12,897,833</u>
LIABILITIES	
<u>Liabilities Covered by Budgetary Resources:</u>	
Governmental Liabilities:	
Accounts Payable	\$ 45,961
Accrued Payroll and Benefits	<u>22,506</u>
Sub-total	68,467
Non-Governmental Liabilities:	
Accounts Payable	1,158,542
Other Liabilities (Note 13)	<u>137,348</u>
Sub-total	1,295,890
Total Liabilities Covered by Budgetary Resources	<u>1,364,357</u>
<u>Liabilities Not Covered by Budgetary Resources:</u>	
Governmental Liabilities:	
Accrued Annual Leave	26,250
Total Liabilities Not Covered by Budgetary Resources	<u>26,250</u>
Total Liabilities	\$ <u>1,390,607</u>
NET POSITION (Note 8)	
<u>Balances:</u>	
Unexpended Appropriations	\$ 5,142,999
Invested Capital	7,518,609
Cumulative Results of Operations	(1,128,132)
Future Funding Requirements	<u>(26,251)</u>
Total Net Position	<u>11,507,225</u>
Total Liabilities and Net Position	\$ <u>12,897,833</u>

See accompanying notes and accountant's compilation report.

ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION (AARC) CORPORATION
U.S. DEPARTMENT OF AGRICULTURE
STATEMENT OF OPERATIONS AND CHANGES IN NET POSITION
For the Fiscal Year Ended September 30, 1997

FY 1997

REVENUE AND FINANCING SOURCES

Appropriated Capital Used	\$ 21,381,816
Revenues from Services:	
Interest and Penalties	98,222
Other Revenues and Financing Sources (Note 14)	1,037,311
<hr/>	
Total Revenues and Financing Sources	\$ <u>22,517,349</u>

EXPENSES

Bad Debt Expense (Note 12)	\$ 20,440,827
Operating and Program Expenses (Note 11)	1,989,977
Interest Expense	14
Accrued Unfunded Leave Expense	6,121
<hr/>	
Total Expenses	<u>22,436,939</u>
Excess of Revenues and Financial Sources Over Total Expenses	\$ <u>80,410</u>
Net position, Beginning Balance	\$ 5,785,146
Prior Period Adjustments (Note 10)	19,687,660
Beginning Balance, as Restated	<u>25,472,806</u>
Excess of Revenues and Financing Sources Over Total Expenses	80,410
Non Operating Changes (Note 9)	<u>(14,045,991)</u>
Net Position, Ending Balance	\$ <u>11,507,225</u>

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, UNITED STATES DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

NOTE 1: REPORTING ENTITY AND SIGNIFICANT ACCOUNTING POLICIES

The Food, Agriculture, Conservation and Trade Act of 1990 authorized the establishment of the Alternative Agricultural Research and Commercialization (AARC) Center, with a mission to provide equity financing on a competitive basis to companies commercializing industrial and consumer (nonfood, nonfeed) products derived from agricultural and forestry materials and animal by-products. The Federal Agriculture Improvement and Reform Act of 1996 changed the organization from the AARC Center to the AARC Corporation, a wholly owned government corporation. Program policy and oversight for the AARC Corporation is provided by a Board of Directors, composed of Federal and private sector scientists, producers and business experts.

The goals of the AARC Corporation are to: (a) facilitate investments in the private sector; (b) increase economic development in rural areas and create jobs; (c) provide environmentally friendly products; (d) decrease the United States' dependence on imported farm and forestry products; (e) expand markets for farmers; and (f) seek information on suitable technology, markets, and financial capital.

The AARC Corporation's Revolving Fund is available to carry out the authorized programs and activities of the Corporation. The Revolving Fund contains appropriations, fees and royalties, and may receive donations and other funds available to the Corporation.

The AARC's intragovernmental transactions represent inter-agency agreements and other such transactions which involve other federal agencies, while governmental expenses represent those transactions which occur between the federal government and parties outside of the federal government.

A. Basis of Presentation

The statements have been prepared to report the financial position and results of operations of the AARC Corporation, as required by the Chief Financial Officers Act (CFO Act) of 1990. They have been prepared from the books and records of the AARC Corporation in accordance with the form and content of entity financial statements specified by the Office of Management and Budget (OMB), OMB Circular 94-01, and modified by the AARC Corporation's accounting policies which are summarized in these notes. These statements are different from the reports that are used to monitor and control the AARC Corporation's use of budgetary resources.

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, UNITED STATES DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

B. Basis of Accounting

The financial statements have been prepared pursuant to the requirements of the CFO Act of 1990, and in accordance with a comprehensive basis of accounting which is most appropriate for presenting significant assets, liabilities, net position, and results of operations. The financial statements are prepared in accordance with the following hierarchy of accounting principles approved by FASAB:

- (1) Individual standards agreed to and published by the Joint Financial Management Improvement Program (JFMIP), based on the recommendations from FASAB.
- (2) Form and content requirements included in Office of Management and Budget (OMB) Bulletin 94-01 dated November 19, 1993 and subsequent issues.
- (3) Accounting policies published by authoritative standards setting bodies and other authoritative sources (a) in the absence of other guidance in the first two parts of this hierarchy and (b) if the use of such accounting standards improve the meaningfulness of the financial statements.

Transactions are recorded on an accrual accounting basis and a budgetary basis. Under the accrual method, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and control over the use of Federal funds.

C. Revenue and Other Financing Sources

(1) **Appropriations**

The AARC Corporation receives the majority of funding needed to support its programs through appropriations. Appropriations are provided on an annual basis and are used to fund program and other operating expenses. Such expenses include personnel compensation and fringe benefits, rents, communications, utilities, and other administrative expenses. Appropriations are also used to fund projects.

For financial reporting under accrual accounting, appropriations are considered "used" as they finance current year expenses.

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, UNITED STATES DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

(2) Revenues

Revenues are provided by sales of goods and services and from other sources, such as transaction fees and royalties. Revenues are recognized on an accrual basis when the goods have been delivered or the services provided. AARC Corporation uses revenues to support operations and project financing.

D. Funds with U.S. Treasury and Cash

AARC Corporation cash receipts and disbursements are processed by the U.S. Treasury. The funds with U.S. Treasury and Cash are primarily appropriated and are available to pay current liabilities and finance projects. Fund balance with Treasury includes funds that are both obligated, but not yet disbursed, and unobligated.

E. Investments

Investments represent the investment in stock by AARC Corporation in private entities. These investments represent joint ventures 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. Most of these investments do not have readily determinable fair market values.

AARC Corporation policy is to record investments in common stock at initial cost, adjusted for the AARC Corporation's share of the investee's earnings or losses after the date of acquisition and investee's capital transactions.

The investments in preferred stock and common stock where the AARC Corporation owns less than 20 percent are recorded at the lower of cost or market value. No adjustment is made to the investment account for the investee's earnings and dividends. However, preferred and common stocks with readily determinable fair market values are reported at their fair market values with unrealized gains and losses recorded. Income is recognized when cash dividends are declared.

No entry is made for warrants that have no fair market value or are embedded in and not detachable from other financial instruments.

The AARC Corporation's management determines when a series of operating losses indicate

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, UNITED STATES DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

a decrease in the value of an investment which is not temporary; accordingly, a reduction in value of the investment is then recognized. (APB 18)

F. Risk Investment Charge Receivable

Risk investment charge receivable is the risk assessment earned but not received under the promissory notes and charges earned, but not received on debts to the AARC Corporation. A repayable cooperative agreement becomes non-performing when an installment payment is in arrears for more than 90 days. For these non-performing long-term receivables, risk investment charge is not recognized as income, rather it is deferred until the risk investment charge is received or the receivable is returned to performing status.

G. Notes Receivable

Notes receivable represent promissory notes for repayment of funds lent. AARC Corporation policy is to value promissory notes at their present value. The premium or discount resulting from the difference between the face amount of the note and the present value is amortized as interest expense or income over the life of the note. The notes are discounted by the Treasury rate of a similar termed instrument based upon prevailing market yields during the fiscal year, excluding the last five days, on outstanding fixed rate Treasury securities.

H. Repayable Cooperative Agreements

Repayable cooperative agreements represent receivables due from private entities based upon funds lent to them by the AARC Corporation for the joint venture. Proceeds are applied according to the terms of the agreement. If the agreement does not specify how the proceeds are to be applied, the proceeds are applied to the risk assessment charge, principal and income respectively.

If a risk assessment percentage is stated and the agreement provides for a royalty to be paid based upon future events, the proceeds are applied to the risk assessment percentage first, then to the principal then to income. If no risk assessment percentage is stated and the agreement provides for a royalty to be paid to the AARC Corporation based upon future events, the proceeds are applied to principal first, then to income.

I. Allowance for Losses

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, UNITED STATES DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

Allowances are established against notes receivables, repayable cooperative agreements, and investments. These allowances are maintained at a level considered adequate by management and are revised periodically based upon management's assessment of repayment status, future risks and economic conditions.

J. Liabilities

Liabilities represent the amount of monies or other resources that are likely to be paid by the AARC Corporation as a result of transactions or events that have already occurred or are likely to occur; However, no liability can be paid without sufficient budgetary resources. Liabilities which are not covered by budgetary resources are classified as unfunded liabilities.

K. Accounts Payable

Accounts payable represent the amount due under contracts and owed by the AARC Corporation for goods and services received but unpaid. Amounts owed for goods and services received from Federal entities represent intragovernmental transactions and are reported separately from amounts owed to the public which represent governmental transactions. If invoices are not available when financial statements are prepared, the amounts are estimated. Also, accounts payable not covered by budgetary resources are recorded as unfunded liabilities.

L. Accrued Liabilities

Accrued liabilities are unpaid expenses that are accrued for the fiscal year for which financial statements are prepared and are expected to be paid in subsequent years.

M. Future Funding Requirements

Future funding requirements represent expenses incurred by the AARC Corporation for which future appropriations or budgetary resources will provide funding. Future funding requirements are recognized for accrued liabilities for annual leave and FECA expenses.

N. Operating/Program Expenses

Operating and program expenses include personnel services and benefits, travel and

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, UNITED STATES DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

transportation, rent, communication, utilities, printing and reproduction services, contractual services, supplies and materials, and noncapitalized equipment.

O. Interest Expense

The expense incurred by the Corporation from late payment of accounts payable. Also, the differences between the face amount of promissory note or repayable cooperative agreements and the discounted present value are recognized as interest expense.

P. Royalties and Transaction Fees

Under investments or cooperative agreements, the AARC Corporation collects royalties based upon provisions in the project agreements. In accordance with USDA's financial and accounting standards, "royalties are to be used to liquidate the outstanding cooperative agreements' principal and interest. Revenue is to be recognized for royalties earned or collected in addition to the amounts recovered under the cooperative agreements and investments in equity securities".

Transaction fees may be collected to cover the monitoring costs of all projects. It is expected that the monitoring costs incurred during any fiscal year will be equal to or less than the fees collected.

Q. Retirement Benefits

Employees participate in the Civil Service Retirement System (CSRS) or Federal Employees Retirement System (FERS). Under CSRS, the AARC Corporation makes matching contributions equal to 7 percent of employee's pay. On January 1, 1987, FERS went into effect pursuant to Public Law 99-355. Most employees hired after December 31, 1983, are automatically covered by FERS and Social Security. Employees hired prior to January 1, 1984, can elect to either join FERS and Social Security or remain under CSRS. A primary feature of FERS is that it offers a savings plan which automatically contributes one percent of pay and matches any employee's contribution up to an additional four percent of pay.

For most employees hired since December 1983, AARC Corporation contributes the employer's matching share of Social Security.

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, UNITED STATES DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

AARC Corporation does not report CSRS or FERS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees. Reporting such amounts is the responsibility of the Office of Personnel Management and FERS. The AARC Corporation's matchings for contributions for FERS and CSRS participants, including those made to SSA, during FY 1997 are as follows:

FERS	\$40,277
CSRS	5,157
FICA	682
TSP	<u>13,528</u>
	<u>\$59,644</u>

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, U.S. DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

NOTE 2:

FUND BALANCE WITH U.S. TREASURY AND CASH

Cash receipts and disbursements are processed by the U.S. Treasury. The funds with the U.S. Treasury are available to pay current liabilities and finance authorized purchase commitments. There are no cash balances held outside the U.S. Treasury.

The entity's fund balance in the revolving fund with Treasury at September 30, 1997 was \$5,348,814.

Beginning Balance	\$ 6,292,980
Disbursements	(8,444,166)
Current Year Appropriations	7,500,000
TOTAL	<u>\$ 5,348,814</u>

Fund Balance with Treasury:

	Obligated	Unobligated Available	Total
Appropriated Funds	<u>\$5,107,718</u>	<u>\$241,096</u>	<u>\$5,348,814</u>

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, U.S. DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

NOTE 3:

RISK INVESTMENT CHARGE RECEIVABLE

The AARC Corporation's Risk Investment Charge receivable comprises investment charges earned but not received on promissory notes and repayable cooperative agreements from private entities.

Promissory Notes (Non-Federal)	\$ 47,418
Repayable Cooperative Agreements (Non-Federal)	7,971
TOTAL	<u>\$ 55,389</u>

NOTE 4:

MONITORING FEES RECEIVABLE

Monitoring fees receivable of \$25,021 represent fees earned for monitoring investments and cooperative agreements but not received as of September 30, 1997.

NOTE 5:

NOTES RECEIVABLE

The AARC Corporation's notes receivable are with private entities in which the AARC Corporation has invested interest. The following is a summary of notes receivable as of September 30, 1997.

Promissory Notes	\$ 2,523,037
Allowance for Doubtful Accounts	<u>(1,892,278)</u>
TOTAL	<u>\$ 630,759</u>

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, U.S. DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

NOTE 6:

REPAYABLE COOPERATIVE AGREEMENTS

The AARC Corporation's repayable cooperative agreements (RCA) are with private entities in which the AARC Corporation has invested. The following is a summary of RCAs as of September 30, 1997.

Repayable Cooperative Agreements	\$ 8,749,608
Allowance for Losses	(6,562,206)
TOTAL	<u>\$ 2,187,402</u>

NOTE 7:

INVESTMENTS

Investments represent the investment in both preferred and common stock by AARC Cooperation in private entities. These investments represent joint ventures 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. Most of these investments do not have readily determinable fair market values.

Description	Cost of Investment	Unrealized Loss	Investment Disposal	Net Investments
Common Stock:				
Non-Marketable	\$13,112,899		(\$250,000)	\$12,862,899
Marketable	220,530	(183,319)		37,211
Preferred Stock	3,830,000		(515,000)	3,315,000
Sub-total	<u>\$17,163,429</u>	<u>\$(183,319)</u>	<u>\$(765,000)</u>	\$16,215,110
Allowance for Losses				<u>(11,564,662)</u>
Net Investments				<u>\$4,650,448</u>

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, U.S. DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

NOTE 8:

NET POSITION:

Net position is the difference between assets and liabilities recorded for accounting purposes.

	<u>Appropriated Funds</u>
Unexpended Appropriations:	
Unobligated, available	\$ 241,096
Undelivered Orders	4,901,903
Invested Capital	7,518,609
Cumulative Results of Operations	(1,128,132)
Future Funding Requirements	(26,251)
TOTAL	<u>\$11,507,225</u>

NOTE 9:

NON-OPERATING CHANGES

The amount represents any transactions that directly affected the net position during the fiscal year that were not part of the revenues and financing sources, expenses, extraordinary items, or prior period adjustments.

Decrease in Unexpended Appropriation	\$ (643,995)
Decrease in Invested Capital	(13,401,996)
TOTAL	<u>\$ (14,045,991)</u>

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, U.S. DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

NOTE 10:

PRIOR PERIOD ADJUSTMENTS:

Prior period adjustments of \$19,687,660 comprise investments which were erroneously recorded as operating expenses in prior years consistent with the National Finance Center (NFC) system which provides accounting services to AARC Corporation.

NOTE 11:

OPERATING AND PROGRAM EXPENSES

The following are the components of operating and program expenses:

Salaries & Benefits	\$ 656,783
Program/Operating Expenses	884,139
Grants	449,055
TOTAL	<u>\$1,989,977</u>

NOTE 12:

BAD DEBT EXPENSES

Bad debt expense comprises the following items:

Investments	\$11,986,343
-------------	--------------

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, U.S. DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

Repayable Cooperative Agreements	6,562,206
Notes Receivable	<u>1,892,278</u>
TOTAL	<u>\$20,440,827</u>

NOTE 13:

OTHER LIABILITIES

Other Liabilities Covered by Budgetary Resources:

<u>Non-Governmental</u>	<u>Current Liabilities</u>
1. Board Salaries	\$ 11,380
2. Travel	118,051
3. Printing	730
4. Computer Equipment	1,640
5. Postage/Mail	5,007
6. Security	308
7. Supplies	<u>232</u>
Total	<u>\$137,348</u>

NOTE 14:

OTHER REVENUES AND FINANCING SOURCES

Other Revenues and Financing Sources constitute reimbursements due to the AARC Corporation by other Governmental entities.

NOTE 15:

WARRANTS

Warrants acquired by AARC do not have fair market value. The entities issuing the warrants are in the early development stage and their stocks are not available on the securities exchange.

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, U.S. DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

As of September 30, 1998, AARC held the following three warrants:

- (1) Warrant for the purchase of 248 fully paid nonassessable shares of Environmental Composite Products, Inc. Common Stock, \$.01 par value, at the aggregate purchase price of \$2.48.
- (2) Warrant for the purchase of \$250,000 worth of Common Stock for a two and one-half percent (2.5%) equity position in the Phytolife Sciences.
- (3) Warrant for the purchase of \$292,600 shares of Bioenergy Common Stock at \$0.25 per share.

NOTE 16:

CONTINGENCIES

The AARC has a loss contingency which is not otherwise reflected on the financial statements as of September 30, 1997.

As a result of a prior OIG audit, it was determined that the Corporation may not recover its investment in one investee because of the investee's misrepresentations, noncompliance with cooperative agreement terms, weaknesses in project monitoring, and other factors such as poor project sales, and a fire that destroyed the investee's manufacturing facility.

OIG's investigation into this matter is ongoing and, based on advice from OIG, the Corporation has severed all contact with the investee.

Based on the conditions noted above, it is reasonably possible that the full amount of this Repayable Cooperative Agreement will not be collected by the Corporation. The maximum amount of loss the Corporation may sustain as a result of this contingency is \$800,000.

NOTE 17:

ALLOWANCE FOR LOSS

AARC Corporation investments are adjusted by a valuation allowance which reduces investments to approximately fair value. The valuation allowance will be reestimated annually, based on historical

**ALTERNATIVE AGRICULTURAL RESEARCH AND COMMERCIALIZATION
(AARC) CORPORATION, U.S. DEPARTMENT OF AGRICULTURE
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1997**

data, an assessment of future risks, and an analysis of current market conditions.

Since market quotations are not available on most AARC equity investments it is necessary to estimate the fair value of these securities. The objective of the estimating procedure is to state the securities at the amount the Corporation could reasonably expect to receive for them in a current sale, though the Corporation does not intend to sell them.