



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

Rural Development – Liquidation of a  
Business and Industry Guaranteed Loan  
Washington State



**Report No.  
34601-07-SF  
December 2002**





UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250

DATE: December 4, 2002

REPLY TO  
ATTN OF: 34601-7-SF

SUBJECT: Liquidation of a Business and Industry Guaranteed Loan  
Washington State

TO: John Rosso  
Administrator  
Rural Business-Cooperative Service

THROUGH: Sherie Hinton Henry  
Director  
Financial Management Division

This report presents the results of our audit of the Rural Business-Cooperative Service liquidation of a Business and Industry guaranteed loan in Washington State. Your October 15, 2002, response to the draft report is included as exhibit B in the report. We accept your management decisions on all recommendations.

Department Regulation 1720-1, requires final action to be taken within 1 year of each management decision. Please follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer.

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RICHARD D. LONG  
Assistant Inspector General  
for Audit

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# EXECUTIVE SUMMARY

## RURAL DEVELOPMENT LIQUIDATION OF A BUSINESS AND INDUSTRY GUARANTEED LOAN WASHINGTON STATE

AUDIT REPORT NO. 34601-7-SF

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### RESULTS IN BRIEF

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This report presents the results of our audit of a loan made in Washington State for \$20 million under the Rural Development Business and Industries (B&I) loan program, administered by the Rural Business-Cooperative Service. Rural Development guaranteed payment of the loan at 70 percent, or \$14 million, on September 15, 1999, based on the lender's and Rural Development's analysis of the loan application and congressional and community support. In the Spring of 2000, the borrower defaulted on the loan. Rural Development was left with an unpaid balance of \$12.1 million after the proceeds from the liquidation were applied to the guaranteed portion of the loan. The Rural Development Washington State office asked the Office of Inspector General to review the loan before paying the guarantee.

The objectives of our audit were to determine if (a) collateral had been properly appraised, (b) sufficient collateral existed prior to the disbursement of loan funds, (c) the company's equity equaled at least 10 percent of the assets, and (d) loan funds were used as described in the application.

We concluded that Rural Development did not have sufficient controls in place during the loan making process and during the period in which the agency agreed to negotiate away the ability to rescind the guarantee based on issues identified after the loan note guarantee was issued. As a result, Rural Development management made two critical decisions that were not in the Department's best interest:

- Rural Development guaranteed a loan based on incomplete and improperly prepared analysis. Rural Development approved a \$14 million loan guarantee without ensuring the collateral was sufficient to secure the loan and the company's tangible balance sheet equity was properly calculated. Rural Development was aware that the borrower was rated by the lender as a risk and was in default of existing loans.

*The company lacked sufficient collateral.* Rural Development used the lender's "ongoing concern" appraisal to estimate the value of the company's collateral between \$40 million and \$70 million. This

appraisal assumed the company was a going concern and would have sufficient cash flows for the next several years. In fact, available evidence indicated that the company would not have sufficient cash flow to operate effectively. Prior to loan closing, the lender obtained a liquidation appraisal indicating the company's collateral would be worth as little as \$2 million if it could not continue as an "ongoing concern". This is far below the \$20 million needed to secure the loan. Currently, Rural Development's regulations do not require further analysis during the loanmaking process to determine if the collateral is realistically discounted.

*The company lacked sufficient equity.* The lender and Rural Development relied on financial statements submitted by the borrower to verify that the company's equity in its own assets exceeded the minimum requirement of 10 percent. Our review disclosed that the financial statements were not prepared in accordance with generally accepted accounting principles (GAAP). The statements improperly credited the company with a substantial amount of debt forgiveness that resulted in the company's equity being overstated. If properly stated the company's equity would not have met the 10-percent requirement.

- Rural Development met with the lender and negotiated away some of its rights to rescind the loan note guarantee. In August 2000, representatives from Rural Development and the lender met to discuss the \$14 million loan note guarantee. After the loan had closed, Rural Development became aware of the liquidation appraisal that the lender obtained. The liquidation appraisal disclosed that the collateral for the loan could not secure more than 50 percent of the loan. In addition, Rural Development also became aware of the fact that the company's equity did not meet the agency's minimum requirements. Because of the collateral and equity deficiencies, the agency had possible grounds to rescind the loan note guarantee. In an August 2000 meeting with the lender, the agency agreed not to rescind the guarantee in exchange for having all of the proceeds from the sale of the collateral applied to the guaranteed portion of the loan.

Regulations allow the agency to waive its right to rescind the guarantee only if rescinding it would have an adverse impact on the Department. We found no evidence to show that rescission in this case would have such an impact. Agency officials stated that they agreed to the terms in the negotiated agreement because the agency bore some responsibility for the approval of the loan. The agency was involved in the loanmaking process and was aware the loan was for a borrower rated by the lender as substandard. Agency officials also

stated that the chances of rescinding the guarantee were minimal. However, we found no documentation supporting this decision, nor any analysis showing that this agreement would prevent an adverse impact on the Department.

Nothing in our review indicated the borrower had made inappropriate distributions of loan proceeds or indicated the appraisal was not prepared in accordance with standards. Also, our review did not disclose any other reportable issues.

We concluded that Rural Development needs to institute controls and guidelines to ensure that applicants for B&I loans provide sufficient collateral and equity. The agency also needs to ensure that officials grant exceptions to agency requirements only when it can be demonstrated that applying the requirements would adversely impact USDA.

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**KEY RECOMMENDATIONS**

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We recommend that Rural Development with guidance from the Office of the General Counsel, develop and implement a process to provide a realistic discount of the collateral values of certain industries and specialized equipment, and establish internal controls to ensure that the lender certifies that financial statements used to compute balance sheet equity at loan closing comply with GAAP.

We also recommend that Rural Development establish controls to ensure the agency uses credible and accurate analysis to document the use of the exception authority and ensure that the use of the exception will prevent an adverse impact to the Department.

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**AGENCY RESPONSE**

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In its written response to the draft report, dated October 15, 2002, the RBS National office agreed with the report findings and recommendations. The National office agreed

to (1) revise RD Instruction 4279-B to reflect the implementation of a process that will discount the collateral values of certain industries and specialized equipment and (2) develop an Administrative Notice for all State offices to clarify that the lender is to certify that the calculation of tangible balance sheet equity is based on financial statement that have been prepared in accordance with GAAP.

RBS also agreed to conduct a Management Control Review in which all requests for an Administrator's exception will be reviewed for conformance with regulations.

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**OIG POSITION**

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We have accepted RBS' management decision on each of the recommendations. RBS' written response is included as exhibit B of this report.

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# TABLE OF CONTENTS

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EXECUTIVE SUMMARY.....	i
RESULTS IN BRIEF.....	i
KEY RECOMMENDATIONS.....	iii
AGENCY RESPONSE.....	iv
OIG POSITION.....	iv
TABLE OF CONTENTS.....	v
INTRODUCTION.....	1
BACKGROUND.....	1
OBJECTIVES.....	2
SCOPE.....	2
METHODOLOGY.....	3
FINDINGS AND RECOMMENDATIONS.....	4
CHAPTER 1.....	4
RURAL DEVELOPMENT NEEDS TO STRENGTHEN CONTROLS OVER LOAN NOTE GUARANTEE APPROVALS AND RESCISSIONS.....	4
FINDING NO. 1.....	5
RECOMMENDATION NO. 1.....	11
RECOMMENDATION NO. 2.....	11
FINDING NO. 2.....	13
RECOMMENDATION NO. 3.....	14
RECOMMENDATION NO. 4.....	15
EXHIBIT A – SUMMARY OF MONETARY RESULTS.....	16
EXHIBIT B – AUDITEE RESPONSE TO DRAFT REPORT.....	17

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# INTRODUCTION

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## BACKGROUND

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The Rural Business-Cooperative Service (RBS), an agency within the U.S. Department of Agriculture's Rural Development mission area, operates loan programs intended to finance

sound business projects that create or retain jobs in rural areas and assist in the business development of the Nation's rural communities. To achieve the mission, the agency guarantees B&I loans made by private lenders. A lender would provide the loan to the borrower and Rural Development would guarantee repayment of a portion of the loan in the event the borrower defaulted. The guarantee would allow the lender to have additional capital available for other loans. A guarantee is not intended for marginal or substandard loans, or for the relief of lenders having such loans.

Rural Development guarantees a maximum of 80 percent of loans \$5 million or less, 70 percent of loans between \$5 million and \$10 million, and 60 percent of loans exceeding \$10 million. Loan guarantees exceeding the maximum percentages require concurrence of the Department.

In 1994, a group of investors formed a company to acquire a closed sugar processing plant near Moses Lake, Washington. From 1996 through the summer of 1998, the company, in a developmental stage, focused on securing financing and refitting the plant. In the fall of 1998, the company received its first delivery of sugar beets from growers and began the plant's initial startup phase. The plant experienced significant operational difficulties, and only one-third of the beets were processed. In the spring of 1999, the company recorded significant operating losses, and owed various creditors and the lender \$159 million. The mounting operating losses forced the company to reorganize its debt.

In June 1999, the lender and members from the U.S. congressional delegation from Washington State urged officials from the Department of Agriculture and Rural Development to approve a 70-percent loan guarantee for the sugar processing plant in Washington State. In July 1999, the company applied for a \$20 million loan from the lender (in addition to the \$159 million already owed) to upgrade equipment, pay vendors, and provide additional working capital. Prior to approving the loan, the lender requested that Rural Development approve a 70-percent guarantee on the \$20 million to ensure that they maintained sufficient capital. Rural Development agreed to the lender's request based on their analysis of the loan file. The Department also concurred with Rural Development and approved the



request based on Rural Development's analysis, which included a review of the collateral used to secure the loan and the company's equity position.

To secure the loan the borrower pledged as collateral the land, plant, and equipment of the company that was valued at \$162 million. The lender discounted the appraised value to a range of \$40 million to \$70 million to acknowledge the limited opportunities to dispose of the company assets and the lack of a production history.

In the event the borrower defaulted, the lender also obtained a liquidation appraisal. The liquidation appraisal was designed to inform a lien holder of the value of collateral at the time of liquidation. This appraisal disclosed that the collateral pledged by the borrower had a scrap salvage value of \$2 million and a forced liquidation value of \$10 million. As a basis for the appraisal, the appraiser assumed the plant would no longer be operational and the majority of the specialized equipment would be dismantled and sold to other factories or sold as scrap.

By the spring of 2000, the company's second attempt to establish the viability of the processing plant failed. The failure was attributed to the borrower's poor financial condition and its inability to maintain sufficient resources to survive equipment failure and added production costs. The plant closed and the lender was forced to liquidate the company's assets. In May 2001, the collateral was sold for \$2.1 million. After the company paid liquidation costs, \$1.9 million were applied against the guaranteed loan amount, leaving Rural Development obligated to pay the lender \$12.1 million.

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**OBJECTIVES**

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Our objectives were to determine whether (1) the appraisal (land, plant and equipment) was prepared in accordance with standards, (2) sufficient collateral existed before the disbursement of loan funds, (3) the company's tangible balance sheet equity equaled at least 10 percent, (4) the loan funds were used as described in the application, and (5) any other issues required additional audit work.

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**SCOPE**

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We reviewed the terms and conditions of the B&I loan note guarantee issued by the Rural Development Washington State Office to the lender for a \$20 million loan made to the sugar processing company. The Washington State Office approved the loan note guarantee on September 15, 1999. This review was conducted at the request of the Rural Development Washington State Office.

Audit fieldwork was performed from July 18, 2001, through October 1, 2001,

at the Rural Development Washington State Office in Olympia, Washington; the RBS Washington State Office in Yakima, Washington; the office of the lender, located in Greenwood Village, Colorado; and the accounting firm of the borrower, located in Kennewick, Washington. The audit was conducted in accordance with generally accepted government audit standards.

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**METHODOLOGY**

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

We familiarized ourselves with Rural Development's guarantee loan criteria, GAAP, and Financial Accounting Standards Board Statement 15, Accounting by Debtors and Creditors for Troubled Debt Restructuring.

We interviewed staff and reviewed loan documents at the Rural Development Washington State Office, the lender's offices, and the borrower's accounting firm. We reviewed loan documents that we requested and were provided by the RBS National Office. We also analyzed financial statements provided by the borrower and appraisals provided by the lender.

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## FINDINGS AND RECOMMENDATIONS

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CHAPTER 1	<b>RURAL DEVELOPMENT NEEDS TO STRENGTHEN CONTROLS OVER LOAN NOTE GUARANTEE APPROVALS AND RESCISSIONS</b>
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In September 1999, with strong congressional and public support, a sugar processing company in rural Washington received a \$20 million B&I loan to continue its operations. Six months later, the company defaulted on its financial obligations. By May 2001, it liquidated its assets.

Our review disclosed that in making and liquidating the loan, Rural Development officials made two decisions that were not in the best interest of the Department: 1) the agency guaranteed 70 percent of the \$20 million loan even though the loan was substandard and a considerable risk, and 2) the agency agreed not to rescind the guarantee in exchange for having the proceeds from the sale of the collateral applied to the guaranteed portion of the loan. Rural Development entered into this agreement knowing that the liquidation value of the collateral was at least \$10 million below the loan amount. Neither decision was supported by credible analytical evidence.

During the loanmaking process, the community and members of Congress urged Rural Development to assist the company by giving every consideration to its request for the loan note guarantee. Rural Development encouraged the lender to process the loan application, even though the financial stability of the company was in doubt. B&I loans are intended to provide financial assistance only to companies that can prove they meet the basic financial requirements and have the required collateral to secure the loans.

The company liquidated its assets by May 2001, and the resulting loss to Rural Development totaled \$12.1 million.<sup>1</sup>

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<sup>1</sup> Loan amount of \$20 million x guaranteed portion of the loan of 70 percent = \$14 million less the net proceeds from the sale of collateral of \$1.9 million = \$12.1 million.

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## FINDING NO. 1

### RURAL DEVELOPMENT NEEDS TO ENSURE IT DOES NOT EXTEND GUARANTEE AUTHORITY TO SUBSTANDARD LOANS

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Rural Development guaranteed a \$20 million loan for a company rated as substandard by the lender. Members of Congress, citing the company as a critical opportunity for the financial stability of local sugar beet growers and a significant benefit to the community, urged Rural Development to approve the loan note guarantee. However, Rural Development did not establish guidelines to discount

collateral pledged by a company in an economically depressed industry or with specialized equipment. Nor did the State office establish internal controls to ensure that the calculation of the company's tangible balance sheet equity was accurate. As a result, Rural Development approved a loan note guarantee that had both insufficient collateral and equity. After liquidation, Rural Development incurred a \$12.1 million loss.

Regulations<sup>2</sup> state that:

*The purpose of the B&I Guaranteed Loan Program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities. This purpose is achieved by bolstering the existing private credit structure through the guarantee of quality loans that will provide lasting community benefits. It is not intended that the guarantee authority will be used for marginal or substandard loans or for relief of lenders having such loans. [Emphasis added]*

Our review disclosed that the loan was made to support a venture that was not consistent with the intent of the program.

In June 1999, Rural Development, with strong congressional and public support, encouraged the lender to apply for the loan guarantee. One member of Congress stated, "The application provides a critical opportunity we cannot afford to miss.... Hundreds of jobs and hundreds of millions of dollars will be lost to the community if the loan guarantee is not made." Another member stated that, "with the agriculture economy in the Pacific Northwest struggling, it was imperative that the application be approved in its entirety so that financial stability could be restored for these growers."

During the application process, Rural Development identified weaknesses in the company's financial position. The company lacked the ability to repay its debts and had limited equity. In spite of these perceived weaknesses, Rural Development officials continued to process the application, concluding that the discounted value of the pledged collateral (between \$40 million and \$70

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<sup>2</sup> 7 CFR 4279.101(b)

million) was sufficient to cover the guaranteed portion of the loan (\$14 million). In September 1999, Rural Development approved and issued the loan note guarantee.

Our review disclosed that Rural Development's approval was based on incomplete and inaccurate information. A liquidation appraisal of the company's assets, acquired by the lender prior to loan closing, disclosed that the estimated value of the collateral at the time of liquidation was less than the guaranteed loan amount. In addition, the financial statements used to compute the tangible balance sheet equity did not comply with GAAP and significantly overstated the equity position of the company. Rural Development officials could have identified these weaknesses prior to loan closing by requesting and reviewing documents such as financial statements prepared in accordance with GAAP and by conducting an analysis of the appraisal.

Regulations<sup>3</sup> require that:

*The agency evaluate the application and determine whether (a) the applicant is eligible, (b) the proposed loan is for an eligible purpose, (c) there is reasonable assurance of repayment ability, (d) there is sufficient collateral and equity, and (d) the proposed loan complies with all applicable laws and regulations.*

### **Rural Development Lacked Controls Over the Valuation of Collateral**

In July 1999, the lender submitted an application for a \$14 million loan note guarantee to finance the company's second startup attempt. To secure the loan, the company pledged its land, plant, and equipment as collateral. The lender provided Rural Development with a going concern appraisal valuing the collateral at \$162 million. To be conservative, the lender discounted the value of the collateral to between \$40 million and \$70 million. Rural Development believed this appraisal was sufficient to secure the loan because of the deeply discounted value of the collateral.

Regulation<sup>4</sup> states that:

*Collateral must have documented values sufficient to protect the interests of the lender and the Agency.*

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<sup>3</sup> 7 CFR 4279.165

<sup>4</sup> 7 CFR 4279.131(b)(1)

The collateral values did not adequately reflect the financial situation of the company. The \$40-million-to-\$70-million value assigned to the collateral, even though discounted, was based on the assumption the company would be operating as a going concern at or near capacity for the next 5 years. However, in the company's first year of operation, its equipment failed, and it was unable to process two-thirds of the contracted production. This shortfall in production resulted in significant operating losses and an outstanding debt of \$159 million. Rural Development was aware of this debt at the time the borrower submitted its loan application for \$20 million and had ample reason to question the assumption that the company would be a going concern in the immediate future. Moreover, prior to loan closing, the lender provided the agency with its own analysis of the borrower's startup "disaster," stating that the lender did not expect the company to meet production for another 3 to 5 years.

Regulations<sup>5</sup> state that:

*The lender is primarily responsible for determining credit quality and must address all of the elements of credit quality in a written credit analysis including adequacy of equity, cash flows, collateral, history, management, and the current status of the industry for which credit is to be extended.*

The lender was concerned about the company's mounting debt and its ability to continue processing. To address these concerns the lender ordered a liquidation appraisal of the collateral. The appraisal, obtained by the lender on July 7, 1999, estimated the scrap salvage value of the collateral at \$2 million and the forced liquidation value at \$10 million, far below the guaranteed amount. The State office staff knew of the company's precarious financial position, but they elected to accept the discounted "going concern" collateral valuation of between \$40 million and \$70 million without determining if the specialized nature of the collateral lessened its value on the open market or limited its application to an industry that was depressed.

The "going concern" collateral valuation was based on the company operating at near capacity. However, evidence that was available to both Rural Development and the lender suggested that the company would not be operating at capacity during the next operating cycle. In spite of the evidence, Rural Development elected not to request an appraisal that reflected the actual operation of the company or the liquidation value of the collateral. Even though regulations do not require a liquidation appraisal, the lender elected to obtain a liquidation appraisal to verify the value of the collateral in the event the borrower defaulted. State office staff informed us that if they

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<sup>5</sup> 7 CFR 4279.131

were aware of the valuations in the liquidation appraisal they would not have approved the \$14 million loan note guarantee.

We discussed this issue with State office staff and determined that the agency did not have guidelines to discount collateral that was specialized equipment or was pledged by companies within a depressed industry. Under current procedures, the State office accepts the appraised values provided by the lender, and does not analyze the assumptions underlying those figures.

The value of collateral should be subject to additional analysis and evaluation when the borrower (a) has a history of financial difficulties (b) is working in a depressed industry, or (c) is pledging specialized equipment as collateral. The additional analysis would include realistic discounts of the collateral or consulting knowledgeable staff members within the Department. For example, an agency official was in possession of reports indicating that domestic sugar plants recently closed and a new plant would have difficulty competing. Even though the reports were prepared after loan closing, this type of information was available before the loan closed.

### **Rural Development's Controls Over the Calculation of Tangible Balance Sheet Equity Were Inadequate**

The Rural Development State office calculated the company's tangible balance sheet equity at 14 percent at loan closing. According to financial statements prepared in accordance with generally accepted accounting principles (GAAP), the tangible balance sheet equity was less than 2 percent. This was far below the minimum requirement of 10 percent. The State office had not established internal controls to ensure lenders submitted GAAP financial statements during the loanmaking process, and it misinterpreted documents accompanying the statements to mean that the statements, as a whole, were completed in accordance with GAAP.

Regulations<sup>6</sup> state that:

*...a minimum of 10 percent tangible balance sheet equity will be required for existing businesses at the time the Loan Note Guarantee is issued...Tangible balance sheet equity will be determined in accordance with generally accepted accounting principles.*

Rural Development and the lender are responsible for calculating tangible balance sheet equity using financial statements prepared in accordance with GAAP. State office staff relies on financial information provided by lenders or borrowers as the basis for equity calculations. A solid equity position

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<sup>6</sup> 7 CFR 4279.131(d)

provides an incentive for the borrower to remain committed to successfully operating the business and reducing its debt burdens.

The State office made its determination based on a review of the company's financial statements. One set of the company's financial statements was provided to Rural Development in the loan application packet and another set was provided at loan closing. State office officials believed both sets of financial statements complied with GAAP because one set was prepared by an accounting firm, and the other set, although prepared by the borrower, was accompanied by a letter from an accounting firm. Using these financial statements as the basis for their calculations, State office staff and the lender concluded that the company's tangible balance sheet equity met the Agency's minimum equity requirements, and that the company qualified for the \$14 million loan note guarantee.

We reviewed the two financial statements and determined that neither complied with GAAP, and that the company's tangible balance sheet equity had been significantly overstated.

- Both financial statements reported the company's equity based on the assumption that a \$10 million debt reduction could be recognized as income in a single year. This increase in income led to a corresponding increase in the company's tangible balance sheet equity. However, this treatment of debt relief was incorrect. GAAP does not allow a company to realize an immediate increase in equity from debt forgiveness from a reorganized loan. A borrower must defer the recognition of this benefit over the life of the reorganized debt. Consequently, at the time of loan closing, none of the forgiven debt should have been recognized as income.
- The financial statement provided with the loan application packet, and used by State office staff to evaluate the eligibility of the company, was prepared using projected cash flows. GAAP requires the use of historical transactions. The accounting firm responsible for preparing this statement was directed to use projected amounts to demonstrate the company's ability to repay the loan, provide working capital for future operations, and upgrade equipment. The firm did not express any opinion as to the financial statement's compliance with GAAP.

At loan closing, the company's management provided the second financial statement for the fiscal year ending August 31, 1999. Accompanying the statement was an opinion provided by the company's accounting firm affirming that the treatment of the \$10 million debt forgiveness complied with GAAP requirements. The accounting firm's opinion, although incorrect, referred only to the treatment of the debt forgiveness, and not to the financial statement taken as a whole. State office staff reviewed the letter and



erroneously assumed the company's entire financial statement complied with GAAP. Using this financial statement as the basis for their calculations, they concluded that the company's tangible balance sheet equity was 14.03 percent on the date of closing and the company met the agency's minimum equity requirement.

Approximately 2 months after loan closing, the company received its audited financial statement for the year ending August 31, 1999. These financial statements were prepared by the accounting firm in accordance with GAAP. We reviewed the audited financial statements and determined that the company's tangible balance sheet equity at loan closing was only 1.7 percent. We further determined that even if the improper debt relief was added, the company's calculated equity would have been 8 percent, still below the agency's minimum requirement of 10 percent.

If the financial statements submitted during the loanmaking process had been prepared in accordance with GAAP, it would have been evident that the company lacked sufficient tangible balance sheet equity to qualify for the loan note guarantee. State office staff stated they would not have issued the guarantee if they had known the borrower did not meet the equity requirement. We concluded that the lender should certify that the financial statements used to support the calculation of tangible balance sheet equity comply with GAAP.

The inadequate controls over the analysis of the borrower's collateral and tangible balance sheet equity resulted in the agency's improper approval of the \$14 million loan note guarantee. These collateral and equity deficiencies also led the borrower to default on the loan. The collateral was eventually sold for a salvage value of \$2.1 million. After paying liquidation costs, Rural Development was left with \$1.9 million to offset their loss, leaving the agency obligated to pay the lender \$12.1 million, the balance of the guaranteed amount. If controls over the analysis of the borrower's eligibility had been operating effectively, Rural Development could have put the \$14 million to other program uses.

Agency officials we spoke with agreed that although this loan was an isolated case, similar types of problems have occurred with other loans. Officials also noted that the agency had previously taken into account the economic condition of the industry and the nature of the assets when discounting collateral values. They also stated that if this practice were still available to them, it could help in the loanmaking process. We concluded that the agency should consult with the Office of the General Council to determine whether it may base its discount of collateral values on the type of industry and the nature of the equipment offered as collateral.

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## RECOMMENDATION NO. 1

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With guidance from the Office of the General Counsel, develop and implement a process to provide a realistic discount for the value of collateral for certain industries and specialized equipment.

### **Agency Response**

The Agency agrees with this recommendation and will revise RD Instruction 4279-B in this regard by September 30, 2003.

### **OIG Position**

We accept the RBS' management decision for this recommendation. For final action, please submit to the Department's Office of the Chief Financial Officer the revised RD Instruction (4279-B) that describes the process to discount collateral values for certain industries and specialized equipment.

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## RECOMMENDATION NO. 2

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Establish internal controls to ensure that the lender certifies that the financial statements used to compute tangible balance sheet equity at loan closing comply with GAAP.

### **Agency Response**

The Agency agrees with this recommendation and will develop an Administrative Notice (AN) for all State offices by January 31, 2003. The AN will clarify that the lender is required to certify the calculation of tangible balance sheet equity is based on financial statements that have been prepared in accordance with GAAP. The passage of the FY 2002 Farm Bill contained a provision allowing applicants for B&I Guaranteed Cooperative Stock Purchase Loans to be exempt from the requirement to prepare their financial statements in accordance with GAAP; consequently, this clarification will not apply to these applicants.

### **OIG Position**

We accept the RBS' management decision for this recommendation. For

final action, please submit to the Department's Office of the Chief Financial Officer by January 31, 2003, the AN issued to all State offices clarifying that the lender is required to certify that the calculation of tangible balance sheet equity is based on financial statements that have been prepared in accordance with GAAP. An exception is acceptable for Guaranteed Cooperative Stock Purchase Loans as provided in the FY 2000 Farm Bill.

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## FINDING NO. 2

### NEGOTIATION OF LOAN NOTE GUARANTEE RESCISSIONS NEED IMPROVEMENT

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Rural Development agreed not to rescind a loan note guarantee in exchange for having the first \$14 million from the sale of the collateral applied to the guarantee. Agency officials agreed to the compromise stating that they bore some responsibility for the loan being approved because they were involved in the loanmaking process and were aware that the loan was for a

borrower rated by the lender as substandard. Rural Development justified the negotiated agreement with the lender by using the exception authority, but the basis for the agreement was not supported by credible analysis showing how the decision served the USDA's best interest. As a result, this agreement limited Rural Development's opportunities to rescind the \$14 million loan note guarantee.

Regulations<sup>7</sup> state that:

*The Administrator may, in individual cases, grant an exception to any requirement or Rural Development provision which is not inconsistent with applicable law provided that the Administrator determines that application of the requirement or provision would adversely affect USDA's interest. Requests for exceptions must be in writing by the State Director and must be supported with documentation to explain the adverse effect on USDA's interest.*

By the Spring of 2000, the company defaulted on its loan. Rural Development considered rescinding the loan note guarantee because of the equity and collateral issues, and asked the Office of General Counsel (OGC) to advise them on the legal matter of rescission. On August 7, 2000, OGC informed agency officials that it would be difficult to rescind the loan note guarantee because the lender informed the agency of the low liquidation value of the collateral, albeit in general terms, and the lender acted in good faith with the agency regarding the issue of insufficient equity. In addition, OGC noted that the agency's inaction after learning of the lender's liquidation appraisal would make rescission difficult.

After receiving the OGC opinion, three members of the National Office Executive Loan Committee (NOEL) discussed the issue of rescission.

Two members voted to rescind the loan note guarantee and recorded the decision in the committee's minutes.

On August 9, 2000, representatives for the lender, the Under Secretary, the

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<sup>7</sup> 7 CFR 4279.15

RBS National office, and the Rural Development Washington State Office met to discuss the rescission. During this meeting, the lender offered to apply the first \$14 million from all payments and proceeds from the sale of the company's collateral to the loan note guarantee. In exchange, the agency would agree not to rescind the loan note guarantee because of the identified collateral and equity deficiencies. Agency officials agreed to the compromise stating they bore some responsibility for the issuance of the loan because they were involved in the loanmaking process and were aware that the loan was for a borrower rated by the lender as substandard.

Both Rural Development and the lender entered the compromise agreement having full knowledge, based on the lender's liquidation appraisal, that the additional collateral was significantly devalued. In effect, Rural Development traded away its rights to rescind the \$14 million loan note guarantee in order to receive the proceeds from collateral that had a liquidation value that was far below the guaranteed amount.

Rural Development instructions require that the agency document its use of the "exception authority", its ability to waive any regulatory requirement, with an analysis that will explain the potential adverse impact on USDA and how the adverse impact will be eliminated or reduced by the use of that exception authority. We were unable to determine if the negotiated agreement met the regulatory requirement because the agency did not have documentation supporting the adverse impact to the Department, and the agency representative who signed the agreement on behalf of the Department was no longer with the agency. Nevertheless, lawyers from OGC advised us that the agency representative was fully authorized to sign the agreement and that the agreement is legally enforceable. Rural Development is obligated to pay the outstanding amount of the guarantee.

Subsequent to the completion of the negotiated agreement, Rural Development established new procedures for transactions that are exceptions to the regulations.<sup>8</sup> These procedures require the NOEL committee, OGC, and the Under Secretary to review the circumstances surrounding the use of the exception authority. This requirement will ensure that Rural Development uses the exception authority if the facts support the use of the authority. We recommend that the agency establish controls to ensure the facts are identified and documented.

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### **RECOMMENDATION NO. 3**

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Ensure that agency uses credible and accurate analysis to document the use

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<sup>8</sup> 7 CFR 4279.15 Administrative Procedures dated July 25, 2001

of exception authority.

**Agency Response**

The Agency agrees with the recommendation. In fiscal year 2003, the Agency will conduct a Management Control Review in which all requests for an Administrator's exception will be reviewed for conformance with this recommendation.

**OIG Position**

We accept the RBS' management decision for this recommendation. For final action, please submit to the Department's Office of the Chief Financial Officer the results of the fiscal year 2003 Management Control Reviews.

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**RECOMMENDATION NO. 4**

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Ensure that the agency's use of the exception authority will prevent an adverse impact to the Department.

**Agency Response**

The Agency agrees with the recommendation. In FY 2003, the Agency will conduct a management Control Review in which all requests for an Administrator's exception will be reviewed for conformance with this recommendation.

**OIG Position**

We accept the RBS' management decision for this recommendation. For final action, please submit to the Department's Office of the Chief Financial Officer the results of the fiscal year 2003 Management Control Reviews.

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## EXHIBIT A – SUMMARY OF MONETARY RESULTS

<b>Finding No.</b>	<b>Description</b>	<b>Amount</b>	<b>Category</b>
1	Controls Over the Analysis of Loan Applications Need Strengthening	\$14 million	Management or Operating Improvements/Savings

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## EXHIBIT B – AUDITEE RESPONSE TO DRAFT REPORT



OCT 18 2002

United States  
Department of  
Agriculture

Rural Development

Operations and  
Management

Washington, DC  
20250

SUBJECT: Liquidation of a Business and Industry  
Guaranteed Loan - Washington State  
(Audit Number 34601-007-SF)

TO: Richard D. Long  
Assistant Inspector General  
for Audit  
Office of Inspector General

Attached is a memorandum dated October 15, 2002, from John Rosso, Administrator, Rural Business-Cooperative Service concerning the recommendations in the above subject audit. This response is being submitted for your consideration to reach management decision.

If you have any questions or need additional information, please contact Rochelle Diamond of my staff at 692-0077.

SHERIE HINTON HENRY  
Director  
Financial Management Division

Attachment

Rural Development is an Equal Opportunity Lender. Complaints of  
discrimination should be sent to: Secretary of Agriculture,  
Washington, DC 20250





## EXHIBIT B – AUDITEE RESPONSE TO DRAFT REPORT



United States Department of Agriculture  
Rural Development

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

OCT 15 2002

SUBJECT: Office of the Inspector General  
Report No. 34601-07-SF  
Discussion Draft

TO: Sherie Hinton Henry  
Director  
Financial Management Division

This is in response to the recommendations contained in the above-captioned Office of Inspector General (OIG) audit.

**RECOMMENDATION NO. 1:**

With guidance from the Office of the General Counsel, develop and implement a process to realistically discount the collateral values of certain industries and specialized equipment.

Agency Response

The Agency agrees with this recommendation. RD Instruction 4279-B will be revised in this regard by September 30, 2003. A management decision is requested.

**RECOMMENDATION NO. 2:**

Establish internal controls to ensure that the lender certifies that the financial statements used to compute tangible balance sheet equity at loan closing comply with Generally Accepted Accounting Principles (GAAP).

Agency Response

The Agency agrees with this recommendation and will develop an Administrative Notice (AN) to all State Offices which will clarify that the lender is to certify the calculation of tangible balance sheet equity based on financial statements that have been prepared in accordance with GAAP. The AN will be written and distributed by January 31, 2003. The passage of the FY 2002 Farm Bill contained a provision which allows applicants for Business and Industry (B&I) Guaranteed Cooperative Stock Purchase Loans to be exempt from the requirement to prepare their financial statements in accordance with GAAP; consequently, this clarification will not apply to these applicants. A management decision is requested.

Rural Development is an Equal Opportunity Lender  
Copies of this document should be sent to:  
Secretary of Agriculture, Washington, DC 20250

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## EXHIBIT B – AUDITEE RESPONSE TO DRAFT REPORT

OIG Discussion Draft

2

**RECOMMENDATION NO. 3:**

Ensure that the newly established Agency procedures, which are designed to document the use of exception authority using credible and accurate analysis supporting the exception authority, are consistently used.

Agency Response

The Agency agrees with the recommendation. In fiscal year (FY) 2003, the Agency will conduct a Management Control Review in which all requests for an Administrator's exception will be reviewed for conformance with this recommendation. A management decision is requested.

**RECOMMENDATION NO. 4:**

Ensure that the newly established Agency procedures, which are designed to document that the use of exception authority will prevent an adverse impact to the Department, are consistently used.

Agency Response

The Agency agrees with the recommendation. In FY 2003, the Agency will conduct a Management Control Review in which all requests for an Administrator's exception will be reviewed for conformance with this recommendation. A management decision is requested.

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

  
JOHN ROSSO  
Administrator

Informational copies of this report have been distributed to:

General Accounting Office (2)  
Office of the Chief Financial Officer  
Director, Planning and Accountability Division (1)