United States Department of Agriculture
Office of Inspector General

Rural Development, American Recovery and Reinvestment Act - Business and Industry Guaranteed Loans - Phase 2



Audit Report 34703-0002-Te

February 2012

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Office of Inspector General
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TO: Dallas Tonsager
Under Secretary
Rural Development

Judith Canales
Administrator
Rural Business-Cooperative Service

ATTN: John Purcell
Director
Financial Management Division

FROM: Gil H. Harden
Assistant Inspector General
for Audit

SUBJECT: American Recovery and Reinvestment Act – Business & Industry Guaranteed Loans – Phase 2

This report presents the results of the subject audit. Your written response to the findings presented in an official draft on December 5, 2011, is included as an attachment. Excerpts of your response and the Office of Inspector General's position are incorporated into the Findings and Recommendations section of the report. Based on your response, we were able to accept management decision all recommendations in the report. Please follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer, Director, Planning and Accountability Division.

In accordance with Departmental Regulation 1720-1, final action is required to be taken within 1 year of each management decision to prevent being listed in the Department's annual Performance and Accountability Report. For agencies other than OCFO, please follow your internal agency procedures in forwarding final action correspondence to OCFO.

We appreciate the courtesies and cooperation extended to us by members of your staff during our audit fieldwork and subsequent discussions.

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American Recovery and Reinvestment Act – Business and Industry Guaranteed Loans – Phase 2

Executive Summary

The American Recovery and Reinvestment Act of 2009 (Recovery Act) provided Rural Development $130 million in budget authority for its Business and Industry (B&I) Guaranteed Loan Program, resulting in a lending level of approximately $1.6 billion. Rural Development operates the program in order to improve, develop, or finance business and industry in rural communities by guaranteeing quality loans to bolster the existing credit structure in these communities and to provide lasting community benefits. With this authority, the agency guaranteed a total of 515 loans across 47 States, and obligated more than $1.5 billion in Recovery Act funds by September 30, 2010. The Office of Inspector General (OIG) has provided Recovery Act-mandated oversight to Rural Development throughout the lifecycle of Recovery Act-funded program operations. We initiated this audit to assess the effectiveness of Rural Development's internal controls over B&I guaranteed loan approvals. More specifically, we assessed controls over loan prioritization, financial reviews, and eligibility, and whether the agency's outreach program was effective to ensure that Recovery Act funds were obligated.

Overall, we concluded that Rural Development implemented an effective outreach program, which ensured that all available funds were obligated. In addition, the agency's outreach activities resulted in over 10 percent of the available funds being awarded to businesses in persistent poverty counties, as mandated by the Recovery Act. We determined that all 27 States in our sample had documented outreach plans or conducted different outreach activities (such as lender visits and workshops or published newsletters and other informative documents) in order to receive and approve Recovery Act-funded B&I guaranteed loans. Nationwide, we noted that only three States (Delaware, Maryland, and New Mexico) did not obligate any Recovery Act-funded B&I guaranteed loans.[1] However, these States did obligate loans through the regular B&I Guaranteed Loan Program.

However, through our analysis of 55 statistically sampled loans[2] spread across 27 States, we determined that 68 percent of applications were awarded priority points not merited in various categories, and that 65 percent of requests for Recovery Act-funded B&I loan guarantees were reviewed inadequately because key financial data went undocumented.[3] We attributed these issues to deficiencies in the instructions Rural Development provides to its personnel so that the agency can prioritize among loans, and also to the instructions that it provides so that personnel can conduct reviews of applications to ensure that it guarantees only quality loans. As a result of awarding higher priority to some loans erroneously and impairing its ability to identify

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[1] Delaware and Maryland did not receive loan requests that met the additional Recovery Act requirements and restrictions. Although New Mexico received one loan request, which it concluded to be eligible for Recovery Act funds, it did not qualify for enough priority points to compete with the other projects submitted at that time.
[2] The universe of loans in our sample included all loans obligated as of May 3, 2010, a total of 415 loans valued at more than $1.2 billion.
[3] We are 95 percent confident that the number of loans that received more priority points than warranted is between 231 and 333 loans (or 56 to 80 percent of the universe), and we are 95 percent confident that the number of loans with inadequately documented reviews is between 217 and 321 loans (or 52 to 76 percent of the universe).

potentially marginal or substandard loans before approval, the agency faces higher financial obligations if the borrowers default. Rural Development and OIG cannot at this point assess the extent of this increased risk.[4] Since the Government has agreed to pay back 90 percent of the total outstanding balance for each of these loans if borrowers default, Rural Development exposed at least an additional $41 million to risk.[5] We also identified that as a result of inadequate reviews, Rural Development awarded guarantees to at least two loans that do not fully comply with eligibility regulations. Due to approving at least two ineligible loans in the program, Rural Development obligated at least $6.2 million that should not have been approved. We discuss the issues related to priority scoring in our first finding, and the issues related to inadequate reviews in our second finding.

Recommendation Summary

Rural Development needs to improve instructions and provide training in support of those instructions so that it can operate the B&I Guaranteed Loan Program more effectively. Specifically, we recommend the agency improve its priority point score sheets by clarifying terms and ensuring that instructions are consistent with regulations, and improve instructions related to its evaluation of applications by providing personnel more detailed instructions and procedures for assessing collateral, repayment ability, and loan purposes during reviews.

Agency Response

In its response dated December 30, 2011, Rural Development generally agreed with our findings and recommendations as presented in the report. It issued additional guidance and proposed regulation enhancements and training, which should improve its prioritization process and evaluation of loan applications. Rural Development's response to the official draft report is included in its entirety at the end of this report.

OIG Position

We agreed with Rural Development's proposed corrective actions and accepted management decision on the report's four recommendations.

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[4] The full extent of a loan's credit quality may not be realized for several years. For instance, two of Rural Development's performance measures cannot be measured until 5 years after the loan is made.

[5] We estimate that an additional $82 million is at risk. However, we are reporting a more conservative estimate of $41 million based on the lower bound of our statistical analysis. This number is based on our sample results and is a one-sided lower limit for a 95 percent confidence level. See exhibit E for details. The projection is based upon an additional $10,219,810 at risk.

Background and Objectives

Background

Rural Development, an agency within the Department of Agriculture (USDA), operates the B&I Guaranteed Loan Program through its Rural Business-Cooperative Service. Through the lender-driven program, Rural Development provides loan guarantees to banks or other approved lenders that finance private businesses located in rural areas. Loan guarantees are legally binding agreements under which the guarantor agrees to pay a percentage of any outstanding loan balance if the borrower defaults on the loan.

The B&I Guaranteed Loan Program requires commercial lenders to apply to Rural Development for loan guarantees by submitting complete applications. To propose a loan, the lender must analyze all credit factors associated with the loan, apply professional judgment to determine whether there is reasonable assurance that the borrower will repay the loan, and develop a written analysis for the agency. Lenders remain responsible for making, servicing, and collecting loans that receive B&I guarantees.

Rural Development's State offices receive applications from lenders and then evaluate applications according to the agency's standards. State offices have authority to sign what is known as Conditional Commitments[6] and, ultimately, issue Loan Note Guarantees.[7] If the requested loan amount exceeds the State office's approval authority, it must be sent to the national office for review and concurrence.

When Rural Development received the supplemental funding provided by the Recovery Act, it determined that the most effective use of the funds was to target expenditures in rural areas in greatest need, most difficult to reach, and hardest hit by the current economic crisis. It offered to extend credit to encourage businesses and industries to create or retain quality jobs in these areas. Rural Development generally operated the program under its normal procedures, aside from some specific revisions. Specifically, the agency required States to add two Recovery Act-related provisions to the Conditional Commitments, and to prohibit additional ineligible purposes, such as pools, golf courses, and casinos.[8] It also reduced the program's regular initial fees from 2 percent to 1 percent of loans, eliminated the regular annual renewal fee, allowed the award of 90 percent guarantees to loans that merited enough priority points, and revised instructions that pertained to one of six point categories.

A Notice of Funding Availability[9] announcing that Rural Development would operate the B&I Guaranteed Loan Program with Recovery Act funds was published July 24, 2009. It outlined the

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[6] A Conditional Commitment is the agency's notice to the lender that the loan guarantee it has requested is approved subject to the completion of all conditions and requirements set forth by the agency.
[7] A Loan Note Guarantee is a legally binding agreement under which the guarantor agrees to pay any or all of the amount due on a loan instrument in the event of nonpayment by the borrower.
[8] Rural Development (RD) Administrative Notice (AN) 4471, Business and Industry Guaranteed Loan Program: The American Recovery and Reinvestment Act of 2009, dated August 20, 2009. These purposes were specifically prohibited by the Recovery Act.
[9] Rural Development announces the availability of money for many of its programs in the *Federal Register*, through a Notice of Funds Availability. Each notice lists the application deadlines, eligibility requirements, and places where one can get more help in applying for program dollars.

additional provisions and ineligible purposes specific to the program's Recovery Act-related operations, stated that 10 percent of the funds would be allocated for businesses located in persistent poverty counties, and announced that Rural Development would distribute funds on a first-come, first-served basis.

Requests from 47 out of the 50 States were approved for Recovery Act-funded guarantees. Delaware, Maryland, and New Mexico did not approve any Recovery Act-funded B&I guaranteed loans because the requests they received either did not meet Recovery Act requirements, or because other requests merited greater priority. These three States, like other States, approved requests for non-Recovery Act-funded guarantees during the period. Rural Development operated the B&I Guaranteed Loan Program both with Recovery Act and non-Recovery Act funds simultaneously.

To assist Rural Development in achieving its Recovery Act objectives and to minimize the risks of inefficient or improper actions that could put taxpayers' money at risk, OIG initiated a multiphase program of oversight related to Recovery Act funding.[10] Audit work in the first phase identified that several recommendations from prior audits were left unresolved and that this would introduce a significant risk of inefficient or improper use of Recovery Act funding. Rural Development generally agreed with our conclusions and issued Administrative Notices[11] to mitigate the issues previously noted. This report presents our second phase of work. OIG has initiated a third audit phase to assess the effectiveness of the program through analysis of agency performance measures, lender servicing, and the borrower's use of funds.

Objectives

This audit assessed Rural Development's internal controls over B&I guaranteed loan approvals. More specifically, we determined if (1) program participants and project purposes met eligibility requirements, (2) Rural Development effectively reviewed and accurately scored applications to determine priority, and (3) Rural Development implemented an effective outreach program in order to ensure that the goals of the Recovery Act were met.

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[10] The Recovery Act also mandates that OIG provide oversight of programs, grants, and activities funded by the Recovery Act and administered by USDA.
[11] Administrative Notices are used to issue additional guidance or clarification to agency officials.

Section 1: Review of Applications Needs Improvement

Finding 1: Rural Development Awarded Priority Scores Inaccurately

We found that Rural Development State offices scored 68 percent of applications for Recovery Act-funded B&I loans inaccurately.[12] This occurred because Rural Development's priority point scoring criteria and verbal instructions were not always clear to State officials and in some instances were inaccurate. As a result of erroneously inflated priority scores, 33 percent of Recovery Act-funded B&I guaranteed loans were awarded higher loan guarantees than they should have received.[13] Since the Government has agreed to pay back 90 percent of the total outstanding balance for each of these loans if borrowers default, Rural Development exposed an additional $41 million to risk.[14]

Rural Development uses a point system to award higher priority and loan benefits to projects that meet certain criteria outlined in its B&I Guaranteed Loan Program regulations.[15] Point categories include "high impact investment priorities," "loan features," "community priority," "Empowerment Zone/Enterprise Community," and "administrative points." Because the Recovery Act was concerned with job creation and assistance to those hardest hit by the current economic crisis, Rural Development instructed State Directors and the National Administrator to award administrative points only to projects that create "quality jobs" and that meet at least one demographic criterion.[16] However, beyond these additional restrictions to the administrative category, Rural Development did not otherwise change its existing priority point scoring criteria or instructions when it operated the B&I Guaranteed Loan Program with Recovery Act funds. Projects that accrued enough priority points received guarantees that Rural Development would pay back 90 percent of the outstanding balance if the borrower defaults. Projects that did not receive enough priority points to be awarded a 90 percent guarantee were approved with a lower percent guarantee, and still received the other Recovery Act benefits of a lower guarantee fee and waived annual fee.

Through our review of score sheets and loan file documents, we determined that many States awarded priority points to loans that did not merit points in the given category. The errors we

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[12] We identified that 35 of 55 statistically sampled loans received more priority points than regulations allowed, and are 95 percent confident that the number of loans in error is between 231 and 333 loans (or 56 to 80 percent of the universe of approved loans), or, in effect, about 282 out of 415 loans.

[13] We identified that 17 of the 35 loans erroneously received the higher guarantee benefit (see exhibit C for a list of errors), and are 95 percent confident that the number of loans in error is between 85 and 189 loans (or 21 to 45 percent of the universe of approved loans), or, in effect, about 137 out of 415 loans.

[14] We estimate that an additional $82 million is at risk. However, we are reporting a more conservative estimate of $41 million based on the lower bound of our statistical analysis. This number is based on our sample results and is a one-sided lower limit for a 95 percent confidence level. See exhibit E for details. The projection is based upon an additional $10,219,810 at risk.

[15] Title 7, *Code of Federal Regulations* (CFR), part 4279, subpart B, Business and Industry Loans, 4279.155, Loan Priorities, dated January 1, 2009.

[16] "Quality jobs" pay wages that average at least 125 percent of the Federal minimum wage, or qualify under the Work Opportunity Tax Credit Program, or offer a healthcare package to all employees with at least 50 percent of the premium paid by the employer. Demographic criteria include outmigration, high unemployment, location in under-served/under-represented areas and groups, or location in persistent poverty counties.

observed ranged across point categories, but occurred most frequently in four categories. Specifically, we determined that:

- 21 of 55 loan applications received "high impact business investment" priority points for creating jobs with certain wages, but either did not propose to create jobs or did not have adequate documents to support the specified wages.
- 15 of 55 loan applications received "loan features" priority points for being financed at certain interest rates, but were not actually financed at these rates because of a clause in the variable rate loans that set a minimum rate "floor" that was in excess of the prioritized rate when the points were awarded.
- 5 of 55 loan applications received "Empowerment Zone/Enterprise Community" priority points for being in certain types of communities with strategic plans, but were not in areas that had developed the specified strategic plans.
- 7 of 55 loan applications received "community" priority points for being in demographic areas with certain unemployment rates, but were not in areas that had the specified unemployment rates.

We project that errors in some categories repeated at relatively high rates across the universe of loans. For instance, we project that 41 percent of loan applications received priority points for creating jobs with certain wages, even though they did not propose to create jobs.[17]

We attributed these repeated errors either to inaccurate verbal instructions given to State officials at regional meetings, or to State officials misinterpreting how to award points in certain categories. When we asked Rural Development's personnel about these errors, they attributed some errors to instructions given at regional meetings Rural Development held in order to clarify how to operate the B&I program with Recovery Act funds. During meetings held in March 2010, national office personnel provided verbal instructions to States as a supplement to the regular instructions. Unfortunately, these verbal instructions, as reported, were not always in agreement with regulations. Since some errors ceased to occur after the meetings and some occurred both before and after the meetings, we conclude that the meetings addressed some issues, but provided inaccurate verbal instructions in some instances. We observed that the majority of the errors occurring in the "high impact business investment category" during our audit period resulted from the national office providing inaccurate instructions. Based on statements made by national office personnel, we determined that during the meetings, national office personnel told State personnel to award points to projects that either created or saved jobs with certain wages. However, regulations state that projects that create jobs should receive points, and are silent on awarding points to projects that saved jobs.[18] These 21 projects proposed to save jobs, but either did not propose to create jobs or did not have adequate documents to support the specified wages.

Subsequent to our audit of guaranteed loans obligated as of May 3, 2010, Rural Development issued an Administrative Notice to address the B&I Guaranteed Loan Program's priority point scoring issues to further clarify the process. The Administrative Notice, issued in July 2011, will

[17] We are 95 percent confident that the number of loans in error is between 115 and 223 loans (or 28 to 54 percent of the universe).
[18] 7 CFR 4279B, Business and Industry Loans, 4279.155(b)(5)(iii), Occupations, dated January 1, 2009.

expire July 31, 2012.[19] Rural Development needs to ensure that it addresses these issues in its instructions before the Administrative Notice expires.

The 15 errors in the "loan features" category can also be attributed to misstatements at the regional meetings. Essentially, national office personnel told States to disregard whether variable rate loans contained a clause that set a certain interest rate "floor," or minimum below which the interest rate would not vary. Loan applications were to receive points if they had interest rates within a certain range of a published figure called the Wall Street Journal Prime Rate.[20] However, the prime rate was so low at the time that interest rate floors took effect for the loans, that the loans' current rates were in excess of the range that merited priority points. The verbal instruction to disregard interest rate floors contributed to the 15 loans receiving priority points they did not merit.

In other instances, States awarded priority points to loan applications because terms on the score sheets were not clear to State officials prior to the meetings. We noted that five loan applications received "Empowerment Zone/Enterprise Community" priority points, but did not have the required designation. We observed that the score sheet states that projects "located in a non-designated EZ/EC applicant community" can receive points. States interpreted this as referring to any community other than the communities that participated in the Empowerment Zone/Enterprise Community Grant Program. However, Rural Development intended to prioritize projects located in communities that applied for the grant program, but which were not approved. Rural Development has designated these communities "Champion Communities" because they developed strategic plans when they applied for the grant program, but were not approved to participate in the program. The five loan applications that erroneously received points in this category were located in communities that never applied for the Empowerment Zone/Enterprise Community program. National office personnel stated that these five errors were overlooked and not corrected before Rural Development approved the loans. None of these errors occurred after Rural Development clarified its instructions related to this issue at the regional meetings.

The last type of scoring error relates more closely to the unique funding opportunity of the Recovery Act. We noted that seven loan applications received "community priority" points for being located in areas with certain unemployment rates, which the score sheet specified as 125 percent of the Statewide rate or greater. However, States were not always clear about whether to use nationwide or statewide unemployment rates to determine if the project merited "community priority" points due to a misunderstanding. For the "administrative" point category, the agency revised its usual instructions for Recovery Act purposes, and defined "high unemployment" in relation to nationwide rates. It was not clear to all States that this revision pertained only to that section, rather than all sections. Some States extended the change from the "administrative" category to the "community priority" category, and used nationwide rates to determine whether projects received points in this category. We determined that if these States had used the proper, statewide rates as their basis, the seven loan applications would not have

[19] RD AN 4591, Business and Industry Guaranteed Loan Program: Priority Point Scoring Issues, dated July 15, 2011.

[20] The *Wall Street Journal* surveys the 30 largest banks and publishes the consensus prime rate. The prime rate is an important index used by banks to set loan rates.

received points in the “community priority” category. Only one of these errors occurred after Rural Development provided clarity on this issue at regional meetings.

Rural Development’s priority point scoring system has not always had a substantial impact on the program’s operations because the agency has typically received appropriations that allow it to guarantee loans regardless of priority scores. However, without clear and accurate instructions, Rural Development personnel can award points that are not merited. Priority point scoring errors such as these can have a significant impact when the stakes of receiving priority are significant. When Congress provided the supplemental appropriation of Recovery Act funds, Rural Development’s program was amply funded, and was able to provide additional benefits to some applicants. In a budget climate of reduced appropriations, Rural Development’s ability to provide benefits to all applicants may become restricted, and Rural Development may need to prioritize the loans it approves to participate in the program.

Recommendation 1

Revise the B&I Application Priority Points Scoring Sheet to include specific instructions and definitions of key terms to be used when determining if a project qualifies for points in each category. Provide sources of information to be used by State and Area Office personnel in making these determinations.

Agency Response

Rural Development’s written response, dated December 30, 2011, stated that it issued AN 4591 (4279-B) dated July 15, 2011, regarding priority point scoring. Staff was provided links to sources of information in the AN and reminded that adequate documentation needs to be provided to support points awarded. Additionally, the priority point scoring system is currently being revised, and more guidance will be provided as part of the regulation enhancement project. Estimated publication date of the proposed rule is June 2012.

OIG Position

We accept management decision on the recommendation.

Recommendation 2

Provide additional training to State and Area Office personnel specifically related to the new instructions to ensure clear understanding and consistent application.

Agency Response

Rural Develpment’s written response, dated December 30, 2011, stated that it discussed this topic at the new Program Directors’ training held in November 2011 and will conduct additional training in conjunction with publication of the new regulations. Estimated completion date of the training, following publication of the final rule, is April 2013.

OIG Position

We accept management decision on the recommendation.

Finding 2: Rural Development Did Not Adequately Review Loans

We found that Rural Development did not adequately review and document key financial and eligibility-related information for 65 percent of the B&I guaranteed loans in our sample before approving them.[21] This occurred because Rural Development does not have sufficient instructions in place to ensure that State personnel complete adequate reviews to evaluate credit quality and eligible loan purposes.[22] As a result, Rural Development faces an increased risk of approving under-collateralized, unprofitable, or ineligible loans for B&I guarantees. Rural Development and OIG cannot at this point fully assess the effects of this increased risk.[23] However, because it approved at least two ineligible loans in the program, Rural Development obligated at least $6.2 million that should not have been approved.

Rural Development directs its State officials to conduct reviews of loan applications to determine whether there is reasonable assurance that applicants will be able to repay the loan, whether loans have sufficient collateral, and whether the proposed loan is for an eligible purpose before they approve loans for the program.[24] The agency also evaluates applications to determine whether proposed loans comply with all applicable statutes and regulations. For Recovery Act-funded loans, applicable statutes and regulations include Recovery Act provisions. For these reviews to be effective, personnel need enough information and instructions to determine, for instance, whether the loan application answers all financial concerns, and whether the application and loan are in compliance with all relevant statutes and instructions.

We found that State-conducted reviews did not always identify inconsistencies related to key areas of financial concern or eligibility-related issues. For instance, the agency's financial analysis of 27 out of 55 loans was inadequate or incomplete, and for 15 out of 55 loans deviations from collateralization policies were inadequately documented. We estimate that these issues occurred with 49 percent and 26 percent of loans, respectively.[25] Further, we identified that two loans were, in fact, ineligible. Specifically, we found that one reviewed loan was not eligible for the program because Rural Development did not have enough information to calculate a financial value that was crucial for demonstrating its eligibility for the program, and that the other reviewed loan involved an ineligible purpose specifically restricted by the

[21] We are 95 percent confident that the number of loans with inadequately documented reviews is between 217 and 321 loans (or 52 to 76 percent of the universe).
[22] The agency is responsible for determining whether there is reasonable assurance of repayment ability and sufficient collateral and equity, which are elements of credit quality.
[23] The full extent of a loan's credit quality may not be realized for several years. For instance, two of Rural Development's performance measures cannot be measured until 5 years after the loan is made.
[24] 7 CFR 4279B, Business and Industry Loans, 4279.165(a), Evaluation of Application, dated January 1, 2009.
[25] We are 95 percent confident that the number of loans with incomplete financial analysis is between 149 and 258 loans (or 36 to 62 percent of the universe), and we are 95 percent confident that the number of loans with inadequate documentation of collateral calculations is between 59 and 154 loans (or 14 to 37 percent of the universe).

Recovery Act. These matters should have been identified during Rural Development's review process, specifically when personnel were evaluating applications in order to determine whether they provide reasonable assurance of repayment ability, have sufficient collateral, and are for eligible purposes.

Financial Analysis Not Adequately Documented

Rural Development lacks adequate documentation of reviews, which indicates that Rural Development's personnel did not always analyze loans completely to satisfy all financial concerns before approving them for guarantees. For instance, States did not always complete key sections of the Project Summary forms that the agency uses to document analysis of a loan during the review process; therefore, the financial analysis for 27 cases was incomplete. Similarly, Rural Development's reviews did not always identify concerns with loan collateral. Although reviewers are to evaluate whether loans have sufficient collateral to secure repayment if the borrower defaults, we found 15 instances where Rural Development personnel did not calculate and document collateral values in accordance with agency policy.

We found that Rural Development personnel did not record a range of information on the Project Summary forms (see exhibit D for a summary of missing components). For instance, a measure of the applicants' ability to repay their debts (their "debt service coverage ratios") was incomplete for 49 percent of the approved loans.[26] Similarly, we noted that:

- 11 did not include a complete analysis of historical balance sheets;
- 11 did not compare the applicant's historical balance sheet data to industry standards;
- 10 did not address industry trends;
- 7 did not address the market;[27]
- 15 did not compare the applicant's income statement data to industry standards;
- 5 did not discuss the basis for the applicant's projections; and
- 5 others did not discuss the applicant's repayment ability.

We determined that, since personnel are to use this form to document their financial analysis of loans, State offices did not always demonstrate that there was reasonable assurance that applicants will be able to repay the loans.

Each section on the Project Summary form is relevant to the overall level of financial risk that Rural Development faces when it agrees to guarantee a loan, and each section of the form contains information that has the potential to alter the overall financial picture. Taken together, these sections also provide a crucial overall profile of the borrower's

[26] We identified that 27 of 55 statistically sampled loans were missing either a calculation of the applicant's historical, current, and/or projected debt service coverage ratio, and are 95 percent confident that the number of loans missing this information is between 149 and 258 loans (or 36 to 62 percent of the total universe of approved loans).
[27] Market includes supply and demand, competition, location factors, and demographics.

ability to repay the loan. For example, if a company's debt service coverage ratio indicates that it is unable to repay existing debts, the risk that the borrower will be unable to repay the B&I guaranteed loan may be unacceptably high. However, if Rural Development does not calculate this ratio, it impairs its ability to discern whether the borrower will be able to repay the debt, and its ability to survey the overall financial picture of the loan.

When we asked officials at Rural Development's national office about deficiencies in the analysis of these loans, they attributed the inconsistent and incomplete evaluations, in part, to the fact that a number of these loans were handled by small banks that were unfamiliar with the financial ratios. Indeed, when we examined the financial statements and written analyses that lenders provided to Rural Development, we found the analyses provided by lenders were typically weak. For instance, in 30 cases, lender-provided analyses did not address all the minimum elements needed to adequately assess credit quality.[28] We estimate that 55 percent of lender analyses were incomplete.[29] Rural Development acknowledged that the State offices need to work closely with these lenders to ensure that all requirements are met. Rural Development officials state that the agency needs to continue to provide training to the State office staff and to lenders so they can perform and document their loan analyses. However, Rural Development's officials were unaware that State personnel did not always correctly provide all required information in their financial analysis of loans.

OIG shares Rural Development's perspective on the need to work with lenders and to provide training, but emphasizes that such training should be coupled with improvements to Rural Development's instructions to its personnel. Rural Development needs to complete its own detailed review of the lenders' financial analysis according to its standards.

Rural Development has a strong need for a complete view of a loan's financial profile. The agency's financial risk is often comparatively substantive because it often takes on more risk than the lender that services the loan. For instance, if the agency guarantees 90 percent of a loan, the agency bears nine times more risk than the lender. Therefore, it is important for the agency to secure as much financial information as possible about a loan up front, before the agency commits to guaranteeing the loan.

It is also crucial for State officials to determine whether borrowers have pledged adequate security for loans and to document their analysis during reviews. We determined that in 15 cases, State officials discounted collateral using a discount factor higher than the standard factor stated in the policy without documenting why they deviated from policy. Because collateral loses value over time, collateral value is projected by a process known as "discounting." Rural Development requires some types of collateral to be discounted

[28] Rural Development requires lenders to submit information related to seven elements of the applications' credit quality. These elements include the adequacy of equity, cash flow (repayment ability), collateral, history (of credit and debt repayment), borrower's management, the current status of the industry for which credit is to be extended, as well as the necessity of any debt refinancing.
[29] We are 95 percent confident that the number of loans in error is between 173 and 282 loans (or 42 to 68 percent of the loan universe).

to specific percentages of market value (such as 50 to 70 percent), but allows personnel to use different values if the reason for doing so is documented.

Using higher discount factors results in higher collateral values. For example, using a discount factor of 80 percent to calculate the discounted collateral value of machinery and equipment (M&E), as State officials did when they analyzed a $4,895,000 loan, results in a discounted collateral value of $4,900,000.[30] However, using a discount factor of 70 percent (a factor within the range stated in Rural Development's policy) results in a discounted collateral value of $4,287,500, a value that falls more than $600,000 short of the sufficient collateral value for this loan.[31] In short, using the undocumented discount factor raises the collateral value, and may mask an under-collateralized loan. Without documents to support the use of a higher-than-standard discount factor, it appears as if the discount factor used in this calculation was selected because it resulted in collateral value that was marginally higher than the loan, rather than because using it would result in an impartial value.

When we asked about collateral valuations, State officials generally indicated that they relied on the discount factors established by the lenders, as they were in the best position to evaluate the condition and value of the collateral. However, lenders do not necessarily use the same discount factors that Rural Development's policy requires its personnel to use.

When we recalculated collateral valuations for the 15 loans in our sample according to the rates specified in Rural Development's policy, we concluded that 4 applicants did not have sufficient collateral according to Rural Development's standards.[32] While the under-collateralization alone is not sufficient to render these loans ineligible for the program, under-collateralization is a risk factor that should be of concern to officials when they evaluate whether Rural Development is able to guarantee the loans and what guarantee percentage they may offer.

We attribute the inadequate reviews to deficiencies in Rural Development's instructions. We noted that Rural Development's current instructions do not provide States with procedures for assessing applicants' repayment ability, nor has the agency explained how to perform detailed financial analysis of loans beyond instructions to "complete the form carefully." While Rural Development has a policy in place that personnel are to obtain this information, personnel who do not know how to perform and document a thorough analysis of applications without detailed instructions are not necessarily aware of the pressing need to obtain it. Thus, personnel did not always document financial analyses thoroughly enough to establish reasonable assurance that the borrower could repay the loan.[33] Rural Development needs to enhance its instructions and provide its staff detailed instructions for documenting thorough financial analyses during reviews.

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[30] $6,125,000 (M&E value) x 80% = $4,900,000 (discounted value).

[31] $6,125,000 (M&E value) x 70% = $4,287,500 (discounted value). $4,900,000 - $4,287,500 = $612,500 (over-valued); $4,895,000 – 4,287,500 = $607,500 (under-collateralized).

[32] We determined that each of these four applicants had adequate equity and assurance of repayment ability.

[33] Form RD 4279-1, part C: Project Summary. RD Instruction 4279-B, Business and Industry Loans, 4279.165(a)(3), Evaluation of Application, dated December 12, 1996.

Reviews Did Not Identify Ineligible Loans

We identified two cases in which reviews failed to identify that loans were ineligible for B&I guarantees. We determined that deficiencies with the review instructions led the agency to guarantee each of these loans erroneously.

To be eligible to refinance outstanding debts, borrowers must demonstrate that the guaranteed loan will improve cash flow and also create or save jobs. To be eligible for the B&I Guaranteed Loan Program, proposed loans need to be for eligible purposes and in compliance with all applicable statutes and regulations. In addition to Rural Development's regular instructions, the Recovery Act restricted the use of funds in certain other ways. For instance, to be eligible for Recovery Act financing, none of the funds may be used for a swimming pool.

In the case of the first of the two ineligible loans we identified, the borrower was applying to refinance outstanding debt. However, we found that the loan lacked adequate documents to support its eligibility for the program. Rural Development requires borrowers intending to refinance outstanding debt to demonstrate that the guaranteed loan will improve cash flow. To determine whether a loan improves cash flow, personnel need to calculate the difference between the "debt service" before and after the loan. However, personnel left this area of the Project Summary form blank, and left other areas of the form blank as well. Without this information, it is a challenge for personnel to determine whether the borrower is eligible for the program during reviews.

When we examined the documents included in the loan file, we found no evidence of the existing debt to use to determine the debt service before the guaranteed loan refinance was approved. When we requested the State office personnel to provide us with evidence of the existing debt or evidence of their cash flow analysis, they responded by stating that paying off a construction loan, as this loan proposed to do, would normally improve cash flow. The State office did not provide documents to support the assertion that the refinance would improve this borrower's cash flow. Without documents to support the existing debt or the improvement to cash flow, there is not enough evidence to determine whether the B&I loan guarantee improved cash flow. We therefore determined that this $4 million loan refinance does not meet the eligibility requirements for Rural Development's guarantee.

While the issue with the first ineligible loan stemmed from inadequacies in the instructions Rural Development provides to States so that they can conduct the program's regular operations, the second relates to a lack of instructions about the additional requirements associated with Recovery Act funds.

In the case of the second of the two ineligible loans, the borrower was constructing a swimming pool as part of a community development project. The Recovery Act prohibited the use of funds for swimming pools, but Rural Development did not develop its instructions so that all States would confirm that no Recovery Act funds were used to finance projects that involved swimming pools. Subsequently, the State office interpreted the instructions as allowing Recovery Act funds to be split off from the component of the project that included the swimming pool. However, the national office later determined that costs related to the swimming pool could not be split off from Recovery Act B&I loan funds. We concur with Rural Development's Administrator that funds should not be split off.

Thus, through our audit, we discerned that the instructions Rural Development provides for performing reviews were not always adequate for Recovery Act purposes, and led to Rural Development agreeing to guarantee the $2 million loan that was ineligible due to the swimming pool. However, since revoking the guarantee would penalize the borrower unfairly, we are not making a recommendation on this Recovery Act-specific issue.

Overall, we discovered that State personnel are currently conducting reviews of B&I guaranteed loan applications inconsistently and inadequately. Inadequately reviewed loans passed through Rural Development's review process with incomplete financial analyses and also with unsupported discount factors. Further, some States are depending on lenders to provide information about key financial concerns related to loans. Others are allowing lenders not to provide information about loans on the grounds that the lenders are not experienced with program requirements, and are not themselves proactively seeking out information about those loans that is critical for evaluating them and for making determinations that the loans are for eligible purposes. We conclude that Rural Development's instructions for conducting reviews of applications are not always adequately detailed to support the need to capture and document financial information related to loans, and to provide personnel with detailed procedures for completing necessary calculations and analyses of applications for Rural Development's purposes.

Together, these issues highlight deficiencies in the way that Rural Development performs and documents its analyses during reviews intended to ensure that it does not extend its guarantee authority to ineligible, marginal, or substandard loans, or to relieve lenders of such loans. In addition to training its staff and lenders to perform in-depth assessments of loan quality, developing detailed instructions for assessing loan quality will strengthen Rural Development's ability to assess loans. Overall, taking steps to develop its instructions to better serve the needs of its personnel will help Rural Development identify the risks of guaranteeing loans more clearly, and to identify loans that should not be provided B&I guarantees.

Recommendation 3

Develop and implement detailed instructions, directed to the State offices, for assessing loan quality and loan purposes during the review process.

Agency Response

Rural Development's written response, dated December 30, 2011, stated RD AN 4471 (4279-B) dated August 20, 2009, implemented detailed instructions for use during the Recovery Act program, which clearly indicated what loan purposes were ineligible and directed staff to include those ineligible loan purposes in Conditional Commitments. The agency also published credit evaluation guidance as an Appendix to the regulations. This credit evaluation guidance is being updated as part of the regulation enhancement project. Additionally, RD AN 4509 (4279-A and

4279-B), dated April 5, 2010, provided guidance to field staff on the required due diligence of the agency and the lender. This AN will be updated and reissued by March 2012. Estimated publication date of the final rule is December 2012.

OIG Position

We accept management decision on the recommendation.

Recommendation 4

Provide training to State and Area Office personnel specifically related to these new instructions to ensure clear understanding and consistent application.

Agency Response

Rural Development's written response, dated December 30, 2011, stated it will conduct training in conjunction with publication of the new regulations. Training in this area is planned for the spring of 2012. Estimated completion date of subsequent training, following publication of the final rule, is April 2013.

OIG Position

We accept management decision on the recommendation.

Scope and Methodology

We conducted our audit of the B&I Guaranteed Loan Program at the Rural Development National Office in Washington, D.C., and at Rural Development offices in 27 States (see exhibit B for a list of States). From March 2010 through July 2011, we conducted fieldwork related to 55 statistically selected Recovery Act-funded B&I guaranteed loans that Rural Development obligated by May 3, 2010. During the audit period, the universe of loans consisted of 415 Recovery Act-funded B&I guaranteed loans totaling $1,240,508,786 in obligations, or approximately 79 percent of the program's total fund level available to Rural Development.

To conduct this review, we were provided Recovery Act-funded B&I guaranteed loan data by a Rural Development official that were generated from the Guaranteed Loan System (an information system where B&I Guaranteed Loan Program data are stored). These data included the State, borrower name and address, lender name and address, obligation date and amount, loan amount, date loan closed, loan note guarantee issue date, project type, and other relevant information for each loan. We did not evaluate the effectiveness of the information system or its controls, as it was not used extensively throughout the B&I guaranteed loan approval process which was under review. The information system was not relied upon to obtain sufficient, appropriate evidence to support the findings presented in this report.

We identified this listing, from the Guaranteed Loan System, as the universe and used it as a basis for the statistical sample. For this audit, we used a stratified sample design with a census of four loans that exceeded $10 million dollars in the first stratum and a simple random sample of loans in the second stratum. We had no historical information on which to base the sample-size calculation. Therefore, for sample-sizing purposes, we assumed an error rate of about 35 percent, a desired confidence level of 95 percent, and a desired precision of about +/-12 percent. These criteria led to a sample size of 55 loans. After allocating 4 to the first census stratum, we selected a simple random sample of 51 loans for review in the second stratum. The 55 loans in the sample were spread among 27 States.

In order to accomplish our objectives, we interviewed officials to determine controls in place over participant eligibility, loan eligibility, and compliance with regulations and policies. We reviewed controls related to lender credit quality analysis, lender certifications, State office analysis of loans, loan committee reviews, loan agreements, and Conditional Commitments, as well as national office and Office of the Secretary review and concurrence. To assess these controls over eligibility and compliance with regulations and policies regarding loan approvals, we visited the 27 State offices listed in exhibit B. Additionally, we obtained and reviewed:

- loan files for the 55 loans included in our statistical sample;[34]
- documents submitted by lenders, including application forms, written credit analyses, financial statements, and other support to confirm eligibility of borrowers and project purposes;
- documents of the analyses performed by the State offices, including the priority scoring sheet, Project Summary: Part C of Form 4279-1, loan committee minutes, and the Conditional Commitment issued to verify compliance; and

[34] A pro forma working paper was developed, which allowed us to document our analysis of each statistically sampled loan.

- books containing listings of multiple individual projects from the national office that include summaries of the proposed projects, the priority scoring sheets submitted by the State offices, and spreadsheets identifying the projects, loan amounts, and priority scores.[35]

In order to assess the effectiveness of Rural Development's outreach, we:

- conducted interviews with national and State office personnel;
- obtained and reviewed copies of flyers and pamphlets created to promote the Recovery Act-funded B&I Guaranteed Loan Program;
- obtained and reviewed any available outreach or marketing plans for each of the 27 State offices visited;
- contacted the three State offices (Delaware, Maryland, and New Mexico) that did not approve any B&I guaranteed loans funded by the Recovery Act to discuss their outreach plans and activities; and
- obtained and analyzed program participation data.

In addition, we obtained and reviewed the following:

- American Recovery and Reinvestment Act of 2009;
- Notice of Funding Availability;
- Fiscal Year 2008 Management Control Review;
- Administrative Notices, unnumbered letters, and any other policies and procedures applicable to the Recovery Act-funded B&I Guaranteed Loan Program;[36] and
- Recovery Act-funded B&I loan reviews performed by the Farm Credit Administration.

We conducted this performance audit in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[35] The agency referred to listings of multiple individual proposed projects as "books." "Books" were submitted to the Office of the Secretary and the Office of Management and Budget for concurrence with the agency's recommended approval.
[36] 7 CFR 4279B, Business and Industry Loans, dated January 1, 2009.

Abbreviations

AN	Administrative Notice
B&I	Business and Industry
CFR	Code of Federal Regulations
M&E	Machinery and Equipment
OIG	Office of Inspector General
RD	Rural Development
Recovery Act	The American Recovery and Reinvestment Act of 2009
RMA	Risk Management Association
USDA	Department of Agriculture

Exhibit A: Summary of Monetary Results

Exhibit A summarizes the monetary results for our audit report by finding number.

Finding	Recommendation	Description	Amount	Category
1	1 and 2	Additional Dollars at Risk	$10,219,810	Questioned Costs/Loans, No Recovery
2	3 and 4	Ineligible Loan Purposes	$6,200,000	Questioned Costs/Loans, No Recovery
Total			**$16,419,810**	

Exhibit B: Statistically Sampled Loans and State Offices

Exhibit B presents a list of State offices (identified by location), and loan amounts included in our statistical sample (identified by counter numbers OIG assigned to each loan in our statistical sample). We note the four loans in our first stratum census as well.

State Office	Location	Counter	Obligation Amount
Arizona	Phoenix, AZ	32	$2,000,000
Florida	Gainesville, FL	16	$5,000,000
Georgia	Athens, GA	6	$2,879,000
Georgia	Athens, GA	14	$3,800,000
Georgia	Athens, GA	18	$8,310,000
Georgia	Athens, GA	33	$2,480,000
Hawaii/Western Pacific	Hilo, HI	4 (Strata 1)	$16,672,000
Hawaii/Western Pacific	Hilo, HI	47	$500,000
Idaho	Boise, ID	36	$500,000
Illinois	Champaign, IL	29	$1,755,000
Illinois	Champaign, IL	37	$3,800,032
Kansas	Topeka, KS	24	$2,200,000
Kentucky	Lexington, KY	7	$9,850,000
Kentucky	Lexington, KY	11	$9,580,000
Kentucky	Lexington, KY	22	$5,505,000
Massachusetts	Amherst, MA	17	$450,000
Michigan	East Lansing, MI	15	$2,100,000
Michigan	East Lansing, MI	26	$4,895,000
Michigan	East Lansing, MI	28	$360,000
Mississippi	Jackson, MS	44	$600,000
Missouri	Columbia, MO	5	$1,600,000
Missouri	Columbia, MO	39	$205,000
Montana	Bozeman, MT	1	$4,000,000
Montana	Bozeman, MT	13	$1,177,750
Montana	Bozeman, MT	43	$1,600,000

Nebraska	Lincoln, NE	3 (Strata 1)	$22,000,000
Nebraska	Lincoln, NE	2	$3,967,262
Nevada	Carson City, NV	4	$7,125,000
Nevada	Carson City, NV	41	$1,700,000
New Hampshire	Montpelier, VT	34	$6,000,000
New Hampshire	Montpelier, VT	38	$6,377,920
North Carolina	Raleigh, NC	25	$900,000
North Carolina	Raleigh, NC	27	$576,000
North Carolina	Raleigh, NC	30	$450,000
North Carolina	Raleigh, NC	48	$700,000
North Carolina	Raleigh, NC	49	$5,000,000
North Dakota	Bismarck, ND	20	$650,000
Ohio	Columbus, OH	10	$1,896,000
Ohio	Columbus, OH	46	$500,000
Oklahoma	Stillwater, OK	8	$1,650,000
Oregon	Portland, OR	35	$750,000
Oregon	Portland, OR	40	$5,100,000
South Carolina	Walterboro, SC	23	$2,600,000
South Carolina	Walterboro, SC	45	$1,496,855
South Carolina	Walterboro, SC	50	$2,700,000
Tennessee	Nashville, TN	3	$3,100,000
Tennessee	Nashville, TN	42	$3,800,000
Texas	Temple, TX	1 (Strata 1)	$25,000,000
Texas	Temple, TX	51	$6,532,950
Utah	Salt Lake City, UT	12	$2,920,000
Virginia	Richmond, VA	19	$400,000
Virginia	Richmond, VA	31	$1,360,000
Wisconsin	Stevens Point, WI	2 (Strata 1)	$25,000,000
Wisconsin	Stevens Point, WI	9	$1,900,000
Wisconsin	Stevens Point, WI	21	$7,855,000

Exhibit C: Priority Points Questioned and Additional Dollars at Risk

Exhibit C presents a list of the loans, priority points in question, and the additional dollars at risk. We identify loans by the counter number assigned to each loan included in our statistical sample, and obligation amount. The table identifies the total priority points awarded to each loan according to the scoring sheet maintained in the loan file and scoring sheets included in the books, and also lists the total priority points that we concluded should have been awarded to each loan.

The table also identifies the percentage of guarantee given to each loan, according to the Guaranteed Loan System, and the percentage of guarantee that we concluded should have been given to each loan. Finally, the table also lists the additional dollars at risk, as a result of these loans receiving higher guarantees, for each loan and in total.

Counter	Obligation Amount (a)	Total Points per Loan File	Total Points per Book	OIG Total Points	Percentage of Guarantee per GLS[37] (b)	OIG's Percentage of Guarantee (c)	Additional Dollars at Risk (a*b) - (a*c)
1 (Strata 1)	$ 4,000,000	50	55	45	80%	80%	$0
2 (Strata 1)	$ 3,967,262	58	52	53	90%	80%	$396,726
3 (Strata 1)	$ 3,100,000	65	75	65	70%	70%	$0
5	$ 1,600,000	36	36	21	80%	80%	$0
7	$ 9,850,000	55	55	50	90%	70%	$1,970,000
8	$ 1,650,000	20	20	15	80%	80%	$0
10	$ 1,896,000	58	58	38	70%	70%	$0
11	$ 9,580,000	56	61	51	90%	70%	$1,916,000
12	$ 2,920,000	60	60	50	90%	80%	$292,000
13	$ 1,177,750	60	70	60	90%	90%	$0
14	$ 3,800,000	58	58	53	90%	80%	$380,000
16	$ 5,000,000	21	21	6	80%	80%	$0
18	$ 8,310,000	60	60	55	90%	90%	$0
19	$ 400,000	68	68	38	90%	80%	$40,000
22	$ 5,505,000	55	55	45	90%	70%	$1,101,000
23	$ 2,600,000	46	56	46	80%	80%	$0
25	$ 900,000	60	65	60	90%	90%	$0
28	$ 360,000	23	23	18	80%	80%	$0
29	$ 1,755,000	61	61	41	90%	80%	$175,500

[37] Guaranteed Loan System.

30	$ 450,000	58	53	48	80%	80%	$0
33	$ 2,480,000	58	58	40	90%	80%	$248,000
34	$ 6,000,000	63	63	43	90%	70%	$1,200,000
35	$ 750,000	55	45	25	90%	80%	$75,000
38	$ 6,377,920	61	61	41	90%	70%	$1,275,584
40	$ 5,100,000	70	70	60	90%	90%	$0
41	$ 1,700,000	33	28	28	80%	80%	$0
42	$ 3,800,000	55	65	40	90%	80%	$380,000
43	$ 1,600,000	58	58	48	90%	80%	$160,000
44	$ 600,000	58	58	38	90%	80%	$60,000
45	$ 1,496,855	63	63	58	90%	90%	$0
46	$ 500,000	50	60	45	90%	80%	$50,000
48	$ 700,000	33	33	28	75%	75%	$0
49	$ 5,000,000	58	68	53	90%	80%	$500,000
50	$ 2,700,000	63	63	58	90%	90%	$0
51	$ 6,532,950	13	13	3	70%	70%	$0
Total Questioned						**17**	**$10,219,810**

Exhibit D: Loans with Incomplete Project Summaries

Exhibit D presents a list of loans found to have incomplete Project Summaries broken down by components of Project Summary form sections. Rural Development personnel are required to analyze, for instance, aspects of feasibility and repayment ability through discussion of industry trends, the market, income statements and debt service coverage ratios, comparisons of the income statements to industry standards, the basis for any projections, and the applicant's repayment ability.

Designations of "Y" (for "yes") indicate that information was present and complete for each category of analysis. Designations of "I" (for "incomplete") indicate that information was present but not complete. Designations of "N" (for "no") indicate a lack of information. A designation of "D" (for "does not apply") indicates that information in that category was not required for the loan.

Counter	Obligation Amount	Financial Position		Feasibility and Repayment Ability					
		Historical Balance Sheets	Comparison to RMA Industry Standards[38]	Industry Trends	Market	Income Statements & DSCR[39]	Comparison to RMA Industry Standards[40]	Basis for Projections	Repayment Ability
1	$ 25,000,000	Y	Y	Y	Y	I	I	Y	Y
3	$ 22,000,000	N	Y	Y	Y	I	N	Y	Y
1	$ 4,000,000	I	N	N	Y	I	I	Y	N
2	$ 3,967,262	Y	N	N	Y	I	N	Y	Y
5	$ 1,600,000	I	N	Y	Y	I	N	Y	Y
8	$ 1,650,000	N	N	N	N	I	N	N	Y
12	$ 2,920,000	Y	Y	Y	Y	I	Y	Y	Y
13	$ 1,177,750	I	N	Y	Y	I	Y	Y	Y
15	$ 2,100,000	N	N	Y	Y	I	I	Y	Y
17	$ 450,000	D	Y	Y	Y	I	Y	Y	Y
19	$ 400,000	I	Y	N	N	N	N	N	N
22	$ 5,505,000	I	Y	Y	Y	I	Y	Y	Y
23	$ 2,600,000	Y	Y	Y	Y	I	Y	Y	Y
24	$ 2,200,000	Y	Y	Y	Y	I	Y	Y	Y
27	$ 576,000	N	N	N	Y	I	N	Y	Y
30	$ 450,000	Y	Y	Y	Y	I	Y	Y	Y
32	$ 2,000,000	Y	N	Y	N	I	N	Y	Y
33	$ 2,480,000	Y	N	N	N	I	N	N	N
35	$ 750,000	Y	Y	Y	Y	I	Y	Y	Y

[38] Historical balance sheets compared to Risk Management Association (RMA).
[39] Debt Service Coverage Ratio.
[40] Historical and projected income statements compared to industrial standards such as RMA.

36	$ 500,000	I	Y	Y	Y	I	Y	Y	Y
38	$ 6,377,920	Y	Y	N	Y	I	Y	Y	Y
40	$ 5,100,000	Y	Y	N	N	I	N	Y	Y
43	$ 1,600,000	Y	N	N	N	I	N	N	N
44	$ 600,000	N	N	N	N	I	N	Y	Y
45	$ 1,496,855	Y	Y	Y	Y	I	Y	Y	Y
48	$ 700,000	Y	Y	Y	Y	I	N	N	Y
49	$ 5,000,000	Y	Y	Y	Y	I	Y	Y	N
No		5	11	10	7	1	12	5	5
Incomplete		6	0	0	0	26	3	0	0
Total Exceptions		**11**	**11**	**10**	**7**	**27**	**15**	**5**	**5**

Exhibit E: Statistical Plan - Sampling Methodology and Analysis Results

Objective:

OIG statisticians designed a sample to support the audit of Rural Development's B&I Guaranteed Loan Program (Audit Report 34703-2-Te). The objective of the audit was to test Rural Development's internal controls over B&I guaranteed loan approvals. Specifically, the audit was to determine whether (1) program participants and project purposes met eligibility requirements, (2) Rural Development effectively reviewed and accurately scored applications to determine priority, and (3) Rural Development implemented an effective outreach program in order to ensure that the goals of the Recovery Act are met. The sampling objective was, therefore, to quantify the noncompliance rates and funding at risk for specific criteria associated with the first two audit objectives.

Audit Universe:

Our universe consisted of 415 loans approved for B&I guarantees under the Recovery Act as of May 3, 2010. The total loan value for the loans in this stratum was approximately $1.2 billion. The audit team obtained the universe list from the Processing Branch Chief of Rural Development's B&I Division.

Sample Design:

For this audit, we used a stratified sample design with a census of four loans in the first stratum and a simple random sample of loans in the second stratum.

Stratum I: Four loans exceeded $10 million. The audit team had a specific interest in reviewing the highest dollar amount loans. Therefore, we placed those four loans into a census stratum, i.e., 100 percent review. The total loan value for this stratum was $88.7 million.

Stratum II: The second stratum included the remaining 411 loans. The total loan value for the loans in this stratum was about $1.1 billion.

We used the Excel "randbetween" function to draw a random number for each loan and selected a simple random sample of 51 loans for review. For the 51 loans in the Stratum II sample, the total value was $153.2 million.

In summary, 55 loans, which were spread among 27 States, were reviewed for this audit. We had no historical information on which to base the sample-size calculation. Therefore, for sample-sizing purposes, we assumed an error rate of about 35 percent, a desired confidence level of 95 percent, and a desired precision of about +/-12 percent.

Results:

To support the audit objectives, the audit team reviewed the sample of loans and measured compliance and performance criteria associated with two audit findings: (1) Rural Development awarded priority scores inaccurately and (2) Rural Development did not adequately review loans. All projected proportions relate to the audit universe of 415 loans. In situations where a criterion did not apply to a loan reviewed, the loan was considered to be compliant.

Criteria and results associated with Finding 1:

- Assignment of priority points.
    - Based on our sample results, we project that 282 of the loans in the universe (68 percent) were scored inaccurately, receiving more priority points than allowed by regulations. At a 95 percent confidence level, we estimate that this occurred in 231 to 333 of the loans in the audit universe (56 to 80 percent) with an achieved absolute precision of +/- 12 percent.
- Borrower's eligibility to receive a 90 percent loan guarantee.
    - Based on the sample results, we project that 137 of the loans in the universe (33 percent) incorrectly received a higher guarantee than the one established by Recovery Act loan application regulations. At a 95 percent confidence level, we estimate that the proportion of loans receiving this higher guarantee erroneously is between 85 and 189 of the loans in the audit universe (21 to 45 percent). The achieved absolute precision is +/- 12 percent.
    - Based on the sample results, we project that approximately $82 million of additional risk is associated with the higher guarantees. At a 95 percent confidence level, we project that the additional risk is at least $41 million.
- Job creation.
    - Based on the sample results, at a 95 percent confidence level, we project that between 115 and 223 of the loans (28 to 54 percent) were noncompliant in this category. Our point estimate is that 169 of the loans in the audit universe (41 percent) had an exception in the job creation criterion. The achieved absolute precision is +/- 13 percent.
- Priority points for certain interest rates.
    - Based on the sample results, at a 95 percent confidence level, we project that between 71 and 171 of the loans (17 to 41 percent) were noncompliant with this aspect of priority points determination. Our point estimate is that 121 of the loans in the audit universe (29 percent) had an exception in this criterion. The achieved absolute precision is +/- 12 percent.

The Finding 1 results described above are tabulated in the table below, which also includes, for each criterion, the number of exceptions observed in the sample.

Summary of Results for Finding 1

Criterion	Measure	Point Estimate: Projected Proportion or Number with Exceptions	Confidence Interval, 95% Confidence Level		Achieved Precision (Absolute)*	Raw Data: Exceptions Observed in Sample
			Lower Bound	Upper bound		
Assignment of priority points	Proportion of loans with exception	68%	56%	80%	+/- 12%	35
	Number of loans with exception	282	231	333	+/- 51	
Borrower's eligibility to receive a 90 percent loan guarantee	Proportion of loans with exception	33%	21%	45%	+/- 12%	17
	Number of loans with exception	137	85	189	+/- 51	
	Value of loans with exception	$82 million	$41 million	Not applicable	- $41 million	$10.2 million
Job creation	Proportion of loans with exception	41%	28%	54%	+/- 13%	21
	Number of loans with exception	169	115	223	+/- 53	
Priority points for certain interest rates	Proportion of loans with exception	29%	17%	41%	+/- 12%	15
	Number of loans with exception	121	71	171	+/- 50	

* For proportions, achieved absolute precision is calculated by comparing the upper and lower proportions to the projected proportion. For example, for the first criterion: (upper bound proportion – projected proportion) = (80% - 68%) = 12% and (lower bound proportion – projected proportion) = (56% - 68%) = -12%. Values shown are rounded. For the number of loans, the achieved absolute precision shown in the table is the difference between the bound and the point estimate. This number can be divided by the total in the universe for precision relative to the universe (for example, (333-282)/415 = 51/415 = 12.3%) or divided by the point estimate for precision relative to the point estimate (for example, (333-282)/282 = 51/282 = 18%).

Criteria and results associated with Finding 2:

- Review of financial and eligibility information.
  - Based on the sample results, at a 95 percent confidence level, we project that between 217 and 321 of the loans (52 to 77 percent) were noncompliant in this category. Our point estimate is that 269 of the loans in the audit universe had an exception (65 percent) in at least one aspect of this criterion. The achieved absolute precision is +/- 12.5 percent.
- Financial analysis adequacy and completeness.
  - Based on the sample results, at a 95 percent confidence level, we project that between 149 and 258 of the loans (36 to 62 percent) were noncompliant in this category. Our point estimate is that 203 of the loans in the audit universe (49 percent) had an exception in the State's Analysis of debt service coverage ratio criterion. The achieved absolute precision is +/- 13 percent.
- State offices' use of acceptable discount factors in determining collateral value.
  - Based on the sample results, at a 95 percent confidence level, we project that between 59 and 154 of the loans (14 to 37 percent) were noncompliant in this category. Our point estimate is that, for 107 of the loans in the audit universe (26 percent), the State office used unacceptable discount factors when determining collateral value. The achieved absolute precision is +/- 11.5 percent.
- Lender's analysis to assess credit quality.
  - Based on the sample results, at a 95 percent confidence level, we project that between 173 and 282 of the loans (42 to 68 percent) were noncompliant in this category. Our point estimate is that 228 of the loans in the audit universe (55 percent) had an exception in the lender's analysis to assess credit quality criterion. The achieved absolute precision is +/- 13 percent.

The Finding 2 results described above are tabulated in the table on the next page. The table also includes, for each criterion, the number of exceptions observed in the sample.

Summary of Results for Finding 2

Criterion	Measure	Point Estimate: Projected Proportion or Number with Exceptions	Two-sided Interval, 95% Confidence Level		Achieved Precision (Absolute)*	Raw Data: Exceptions Observed in Sample
			Lower Bound	Upper bound		
Review of financial and eligibility information	Proportion of loans with exception	65%	52%	77%	+/- 12.5%	36
	Number of loans with exception	269	217	321	+/- 52	
Financial analysis adequacy and completeness	Proportion of loans with exception	49%	36%	62%	+/- 13%	27
	Number of loans with exception	203	149	258	+/- 54	
State offices' use of acceptable discount factors in determining collateral value	Proportion of loans with exception	26%	14%	37%	+/- 11.5%	15
	Number of loans with exception	107	59	154	+/- 48	
Lender's analysis to assess credit quality	Proportion of loans with exception	55%	42%	68%	+/- 13%	30
	Number of loans with exception	228	173	282	+/- 55	

* For proportions, achieved absolute precision is calculated by comparing the upper and lower proportions to the projected proportion. For example, for the first criterion: (upper bound proportion – projected proportion) = (77% - 65%) = 12% and (lower bound proportion – projected proportion) = (52% - 65%) = -12%. Values shown are rounded. For the number of loans, the achieved absolute precision shown in the table is the difference between the bound and the point estimate. This number can be divided by the total in the universe for precision relative to the universe (for example, (321-269)/415 = 52/415 = 12.5%) or divided by the point estimate for precision relative to the point estimate (for example, (321-269)/269 = 52/269 = 19%).

USDA'S
RURAL DEVELOPMENT
RESPONSE TO AUDIT REPORT

United States Department of Agriculture
Rural Development

December 30, 2011

TO: Gil Hardin
Assistant Inspector General
for Audit

FROM: Judith A. Canales /s/ Judith A. Canales
Administrator
Rural Business-Cooperative Service

SUBJECT: American Recovery and Reinvestment Act
Business and Industry Guaranteed Loans Phase 2
Request for Management Decision
Audit Number 34703-002-TE,

Attached please find Rural Business-Cooperative Service's request for management decision on all recommendations of the subject audit.

If you have any questions, please contact Rick Bonnet in the Oversight Coordination Staff at 202-720-1804 or rick.bonnet@wdc.usda.gov.

Attachment

Finding 1: Rural Development Awarded Priority Scores Inaccurately

Recommendation 1

Revise the B&I Application Priority Points Scoring Sheet to include specific instructions and definitions of key terms to be used when determining if a project qualifies for points in each category. Also provide sources of information to be used by State and Area Office personnel in making these determinations.

Response:

The Agency issued RD AN No. 4591 (4279-B) dated July 15, 2011, regarding priority point scoring and discussed this topic at the new Program Directors training held in November 2011. Staff was provided links to sources of information in the AN and reminded that adequate documentation needs to be provided to support points awarded. Additionally, the priority point scoring system is currently being revised and more guidance will be provided as part of the regulation enhancement project. Training of staff will be conducted in conjunction with publication of the new regulations. Estimated publication date of the proposed rule is June 2012. Estimated completion date of the training, following publication of the final rule, is April 2013.

Recommendation 2

Provide additional training to State and Area Office personnel specifically related to the new instructions to ensure clear understanding and consistent application.

Response:

As stated in the response to recommendation number 1, the Agency discussed this topic at the new Program Director's training held in November 2011 and will conduct additional training in conjunction with publication of the new regulations. Estimated completion date of the training, following publication of the final rule, is April 2013.

Finding 2: Rural Development Did Not Adequately Review Loans

Recommendation 3

Develop and implement detailed instructions, directed to the State Offices, for assessing loan quality and ineligible loan purposes during the review process.

Response:

RD AN No. 4471 (4279-B) dated August 20, 2009, implemented detailed instructions for use during the ARRA program, which clearly indicated what loan purposes were ineligible and directed staff to include those ineligible loan purposes in Conditional Commitments. The Agency also published credit evaluation guidance as an Appendix to the regulations. This credit evaluation guidance is being updated as part of the regulation enhancement project. Additionally, RD AN No. 4509 (4279-A and 4279-B), dated April 5, 2010, provided guidance to field staff on the required due diligence of the Agency and the lender. This AN will be updated and reissued by March 2012. Estimated publication of the final rule is December 2012.

Recommendation 4

Provide training to State and Area Office personnel specifically related to these new instructions to ensure clear understanding and consistent application.

Response:

As stated in responses to recommendation numbers 1 and 2, the Agency will conduct training in conjunction with publication of the new regulations. Training in this area is planned for the spring of 2012. Estimated completion date of subsequent training, following publication of the final rule, is April 2013.

Informational copies of this report have been distributed to:

Administrator, Rural Business-Cooperative Service
Attn: Agency Liaison Officer (3)

Government Accountability Office (1)

Office of Management and Budget (1)

Office of the Chief Financial Officer
Attn: Director, Planning and Accountability Division (1)

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