United States Department of Agriculture
Office of Inspector General

American Recovery and Reinvestment Act—Business and Industry Guaranteed Loans—Phase 3



Audit Report 34703-0001-32
March 2013

American Recovery and Reinvestment Act—Business and Industry Guaranteed Loans—Phase 3

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What Were OIG's Objectives

Our audit objectives were to assess the servicing of Recovery Act-funded B&I guaranteed loans, whether Recovery Act funds were used properly, and whether the program was effective in terms of its performance measures.

What OIG Reviewed

Of the 374 loans obligated through the B&I Guaranteed Loan Program with Recovery Act funds—totaling $1.1 billion—OIG statistically selected a sample of 53 loans from 26 States—totaling $200 million—for review.

What OIG Recommends

Rural Development should develop and implement guidance, regulations, and comprehensive training related to servicing actions, documentation, small business determinations, and job reporting. The agency should also take specified actions to monitor and verify lender servicing and conduct any borrower visits that have not yet been performed.

OIG assessed Recovery Act-funded Business and Industry loans that Rural Development guarantees to determine whether loans were properly serviced, funds were used properly, and the program met performance goals.

What OIG Found

The Office of the Inspector General (OIG) determined that the controls Rural Development has in place should be strengthened to ensure that lenders receiving American Recovery and Reinvestment Act of 2009 (Recovery Act) funded Business and Industry (B&I) loan guarantees complete all servicing actions and correctly report data used to determine program performance. Specifically, lenders are not properly servicing Recovery Act-funded B&I guaranteed loans, and Rural Development State office personnel are not adequately monitoring the loan servicing. Based on issues identified with 37 of 53 loans in our statistical sample, we estimate that lenders did not correctly service 72 percent of the loans in the audit universe. In addition, Rural Development did not adequately monitor the lenders of 33 of the 53 loans, or 64 percent of the loans in the audit universe. As a consequence, there is a greater risk that problem loans are going undetected. In addition, the use of loan proceeds could not always be verified to ensure the funds were used for authorized purposes or in accordance with program requirements and Loan Agreements.

Furthermore, the agency does not have a well-defined process in place to ensure that data on jobs created and saved are collected in a consistent manner and the percentage of small business participation is accurately determined. Because of issues with the agency's guidance regarding these processes, the agency's success in meeting its established performance goals may be overstated.

Rural Development generally agreed with our recommendations and we accepted management decision for most of the recommendations.

United States Department of Agriculture
Office of Inspector General
Washington, D.C. 20250

DATE: March 29, 2013

AUDIT NUMBER: 34703-0001-32

TO: Dallas Tonsager
Under Secretary
Rural Development

Lillian E. Salerno
Acting Administrator
Rural Business-Cooperative Service

ATTN: John Dunsmuir
Acting Director
Financial Management Division

FROM: Gil H. Harden
Assistant Inspector General for Audit

Gil H. Harden

SUBJECT: American Recovery and Reinvestment Act—Business and Industry Guaranteed Loans—Phase 3

This report presents the results of the subject audit. The agency's March 19, 2013, written response to the official draft is included in the report, with excerpts and the Office of the Inspector General's (OIG) position incorporated into the relevant Findings and Recommendations sections of the report. Based on your response, we accept management decision on Recommendations 2, 3, 4, 5, 6, and 7 in the report. Management decision has not been achieved for Recommendation 1. To reach management decision on this recommendation, please see the relevant OIG Position section in the audit report.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective actions taken or planned, and timeframes for implementing the recommendation for which management decision has not been reached. Please note that the regulation requires management decision to be reached on all recommendations within 6 months from report issuance, and final action to be taken within 1 year of each management decision to prevent being listed in the Department's annual Agency Financial Report. Please follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer.

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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Background and Objectives

Background

The Department of Agriculture's (USDA) component agency, Rural Development, supports rural America through programs such as the Business and Industry (B&I) Guaranteed Loan Program. Rural Development operates the B&I Guaranteed Loan Program through its Rural Business – Cooperative Service. Through the program, Rural Development provides loan guarantees to banks or other approved lenders to improve, develop, or finance businesses located in rural areas. The program is not intended for marginal or substandard loans, or as relief for lenders having such loans.

The American Recovery and Reinvestment Act of 2009 (Recovery Act) provided $126 million in budgetary authority for use under the B&I Guaranteed Loan Program, affording a program lending level of approximately $1.6 billion.[1] The Recovery Act required the heads of Federal departments and agencies to commence expenditures and activities as quickly as possible, consistent with prudent management. Rural Development did not propose changes to the requirements currently reflected in its B&I program regulations. As such, the agency did not develop new performance goals specific to the Recovery Act-funded program. In July 2009, Rural Development announced the availability of the B&I Recovery Act assistance. Rural Development generally operated the program under its normal procedures. In the announcement, it outlined 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.

The B&I Guaranteed Loan Program requires approved 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. After receiving the applications, the State offices evaluate the applications according to the agency's standards. If the requested loan amount exceeds the State office's approval authority, the application is sent to the national office for review and concurrence.

Prior to the issuance of the Loan Note Guarantee,[2] the lender must certify to multiple provisions outlined in the Conditional Commitment,[3] including that loan proceeds have been or will be

[1] Budget authority is the actual cost of a program to the Government; it is funding that the Government does not recover. When the subsidy rate multiplier is applied to the $126 million authorized for this program, Rural Development is able to fund B&I guaranteed loans of approximately $1.6 billion. In fiscal year 2010, the subsidy rate created $12.30 in loans for every $1 budget authority to determine program level funding. Of the $1.6 billion, OIG's audit universe consisted of approximately $1.1 billion obligated.

[2] A Loan Note Guarantee is a legally binding agreement, containing the terms and conditions of the guarantee, under which the guarantor agrees to pay any or the entire amount due on a loan instrument in the event of nonpayment by the borrower.

[3] 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.

disbursed as delineated in the Conditional Commitment. Along with the certification, the lender attaches a copy of the detailed loan settlement. State office personnel are to review the loan settlement to verify that funds were used for authorized purposes before they issue the Loan Note Guarantee.

The lenders, however, retain responsibility for making, servicing, and collecting the loans. These duties include, but are not limited to, processing applications, maintaining loan documents, obtaining evidence of collateral, supervising construction, distributing loan funds, and obtaining agency approvals or concurrence, as needed. The lender is also responsible for collecting payments, ensuring compliance with the Loan Agreement, obtaining and analyzing financial statements, ensuring taxes and insurance premiums are current, and maintaining liens on collateral. If compliance with the Loan Agreement is not maintained, the lender is also responsible for notifying Rural Development officials. If it is found that the lender violated usury laws, loan funds were used for unauthorized purposes, negligent servicing occurred, or the lender failed to secure the collateral, the Loan Note Guarantee will be unenforceable to the extent any loss occurs.

The State Director has the primary responsibility for ensuring that the lender is servicing the loan in a prudent manner as required by the Lender's Agreement, the regulations governing the program, and loan documents. Since the program is lender driven, the agency has a minimal role in servicing, with the exception of delinquencies and liquidations. State office personnel are required to meet with the lender at least once a year to discuss the lender's responsibilities, as well as review the latest financial analysis, loan classification, and application of loan payments. The State office staff are also obligated to visit the borrower's business within the first year of operation, after the Loan Note Guarantee is issued, and every 3 years thereafter, with the exception of problem loans, in which case the State office staff may exercise their discretion as to the frequency of the visits. During the borrower visit, State office personnel are expected to observe the condition of the business' premises, collateral, and the maintenance and utilization of equipment along with potential hazardous contamination. State office personnel are to document and present their findings in writing to the lender. Additional agency actions include approvals or concurrences with specified servicing actions, such as interest rate changes; disposition of collateral; and additional loans. The lender should be immediately notified in writing when the agency suspects noncompliance with the legal instruments governing the loan.

The primary goals of the Recovery Act were to preserve and create jobs and promote economic recovery; assist those most impacted by the recession; provide investments needed to increase economic efficiency by spurring technological advances in science and health; invest in transportation, environmental protection, and other infrastructure that will provide long-term economic benefits; and stabilize State and local government budgets, in order to minimize and avoid reductions in essential services and counterproductive State and local tax increases. To evaluate the success of the Recovery Act-funded B&I program, the agency used the same performance measures it uses for the regular program. The performance measures are:

- Rural jobs created or saved;
- The percentage of loan guarantee recipients that are small business owners;
- Businesses remaining in existence 5 years after loan closing; and
- The percentage of small businesses remaining in existence 5 years after loan closing.

The results of the performance measures were provided to Congress and the general public through various means, including websites and implementation status reports.

To assist Rural Development in achieving its Recovery Act objectives and to minimize the risks of inefficient or improper actions that could put Government funds at risk, the Office of the Inspector General (OIG) initiated a multiphase program of oversight related to Recovery Act funding.[4] Audit work in the first phase[5] 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[6] to mitigate the issues previously noted. Audit work in the second phase[7] identified weaknesses in the loan approval process. Again, the agency generally agreed, issuing Administrative Notices and proposing regulation enhancements and training to mitigate the issues noted. This report presents our final phase of work.

Objectives

This audit assessed whether (1) lenders are properly servicing B&I guaranteed loans, (2) funds were spent as intended and in accordance with Recovery Act requirements, and (3) the Recovery Act-funded B&I Guaranteed Loan Program was effective in meeting the program's goals, based on the performance measures in place.

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[4] The Recovery Act mandates that OIG provide oversight of programs, grants, and activities funded by the Recovery Act and administered by USDA.
[5] *American Recovery and Reinvestment Act–Business and Industry Guaranteed Loan Program –Phase 1* (34703-0001-Te, March 2010).
[6] Administrative Notices are used to issue additional guidance or clarification to agency officials.
[7] *American Recovery and Reinvestment Act–Business and Industry Guaranteed Loans – Phase 2* (34703-0002-Te, February 2012).

Section 1: B&I Guaranteed Loan Servicing

Finding 1: Rural Development Needs to Ensure That Lenders Are Servicing Loans According to Regulation

Based on our review of 53 loans, we determined that, for 37 loans, lenders did not fulfill their responsibilities to perform required loan servicing actions, such as obtaining required documents from borrowers, supplying such documents to State offices, and obtaining agency approval before taking certain actions on the loan. This occurred because Rural Development State offices did not perform the required monitoring steps or document their attempts to follow up with lenders when the lenders did not service loans properly. Based on our statistical sample, we estimate that lenders did not service 72 percent of the loans in our universe correctly, and Rural Development did not monitor the lenders correctly for 64 percent of the loans.[8] We also identified two guaranteed loans, totaling $2.45 million, for which the use of loan proceeds could not be verified. As a consequence, the agency faces elevated risks that problem loans are not detected to mitigate any potential loss.

While the Government guarantees up to 90 percent of Recovery Act-funded loans, the lender maintains primary responsibility for servicing the entire loan and for taking all servicing actions that a prudent lender would perform in servicing its own loan portfolio. Loan servicing actions include, but are not restricted to, ensuring compliance with the covenants and provisions of the Loan Agreement,[9] obtaining and analyzing financial statements before providing a summary to the agency, and verifying payments of taxes and insurance premiums.[10]

Lenders Did Not Perform All Prudent Servicing Actions

Regulations make clear the prudent servicing actions that lenders must take as part of the guarantee agreement. Lenders must obtain and forward to the agency the financial statements required by the Loan Agreement; analyze the financial statements; and provide the agency with a written summary of the lender's analysis and conclusions, along with spreadsheets of the new financial statements. Regulations further state that the lender is not to take certain servicing actions without first obtaining prior written approval from the agency.[11]

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[8] We identified that 37 of 53 statistically sampled loans were not properly serviced by the lenders, and are 95 percent confident that the number of loans in the universe is between 226 and 314 loans (or 60 to 84 percent of the universe). The estimate is 270 loans, or 72 percent of the universe, were not properly serviced by lenders. In addition, we identified that State offices did not adequately monitor lender servicing of 33 of 53 statistically sampled loans, and are 95 percent confident that the number of exceptions is between 194 and 288 loans (or 52 to 77 percent of the universe). The estimate is 241 loans or 64 percent of the universe for State offices that did not adequately monitor lender servicing.

[9] A Loan Agreement is the agreement between the borrower and lender containing the terms and conditions of the loan and the responsibilities of the borrower and lender.

[10] Title 7, Code of Federal Regulations (CFR), part 4287, subpart B, Business and Industry Guaranteed Loans, 4287.107, Routine servicing, January 1, 2009.

[11] Such servicing actions include charging a default interest rate, releasing collateral valued at over 20 percent of the original loan amount, making additional loans to the borrower, and liquidating without agency concurrence.

Despite agreeing to perform these loan servicing actions, lenders did not take all required actions for 37 of the 53 loans in our sample, or 72 percent of the Recovery Act guaranteed B&I loans in the universe.[12] Specifically, we identified that:

- For 14 loans, lenders did not ensure the borrowers were in compliance with financial covenants, such as required financial ratios. Based on this result, we estimate that lenders did not ensure 102 Recovery Act guaranteed B&I loans (27 percent) complied with financial covenants;[13]
- For 15 loans, lenders did not obtain required financial statements. Based on this result, we estimate that lenders did not obtain required financial statements for 109 Recovery Act guaranteed B&I loans (29 percent);[14]
- For 8 loans, lenders did not document their analysis of the borrower's financial statements and provide a summary to Rural Development within required timeframes. Based on this result, we estimate that lenders did not document their analysis and provide a summary timely for 58 Recovery Act guaranteed B&I loans (16 percent);[15]
- For 14 loans, lenders did not ensure the borrowers paid all taxes and assessments on collateral. Based on this result, we estimate that lenders did not monitor taxes and assessments on collateral for 102 Recovery Act guaranteed B&I loans (27 percent);[16] and
- For 9 loans, lenders did not obtain the agency's written concurrence prior to taking servicing actions. Based on this result, we estimate that lenders did not obtain written concurrence before taking servicing actions on 66 Recovery Act guaranteed B&I loans (18 percent).[17]

When we spoke to Rural Development National office personnel about why the lenders are not doing a better job of following these requirements, they stated that, in recent years, they have noticed an increase in lender turnover, which may be contributing to the

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[12] During the audit period, the universe of loans consisted of 374 Recovery Act-funded B&I guaranteed loans. See exhibit C for information about our statistical plan, sampling methodology, and analysis results.

[13] We are 95 percent confident that lenders did not ensure between 58 and 146 loans (or 16 to 39 percent of the universe) complied with financial covenants. The estimate is 102 loans (27 percent of the universe) that lenders did not ensure complied with financial covenants.

[14] We are 95 percent confident that lenders did not obtain required financial statements for between 65 and 154 loans (or 17 to 41 percent of the universe). The estimate is 109 loans (29 percent of the universe) that lenders did not obtain required financial statements.

[15] Sampled loans did not have documentation that the lender's written analysis was submitted to the State office within 120 days after the borrower's fiscal yearend. We are 95 percent confident that between 23 and 94 loans (or 6 to 25 percent of the universe) lacked the documents. The estimate is 58 loans (16 percent of the universe) that the lenders did not document their analysis of the borrower's financial statements and provide to the State office within 120 days after the borrower's fiscal year-end.

[16] We are 95 percent confident that lenders did not monitor taxes and assessments on collateral for between 58 and 146 loans (or 16 to 39 percent of the universe). The estimate is 102 loans (27 percent of the universe) that lenders did not monitor taxes and assessments on collateral.

[17] Servicing actions taken included charging a default interest rate, releasing collateral valued at over 20 percent of the original loan amount, making additional loans to the borrower, and liquidating without agency concurrence. We are 95 percent confident that lenders took servicing actions on between 28 and 103 loans (or 8 to 28 percent of the universe) without prior agency concurrence. The estimate is 66 loans (18 percent of the universe) that lenders took servicing actions without prior agency concurrence.

quality of lender servicing. They also stated that lender underwriting and servicing policies vary between lenders. Nonetheless, Rural Development requires lenders to follow regulations.

Rural Development State Offices Did Not Ensure That Lenders Fulfilled Their Obligations

While lenders are directly responsible for servicing these loans, Rural Development State office personnel are responsible for ensuring that the lenders are fulfilling their obligations. However, we found that for 33 of the 53 loans, or 64 percent of the Recovery Act guaranteed B&I loans in the universe, the agency was not always proactive in monitoring a range of lender servicing actions. Specifically, we identified that:

- For 15 loans, State offices did not have required financial statements from the lender on file. Based on this result, we estimate that States did not obtain the statements for 109 Recovery Act guaranteed B&I loans (29 percent).[18]
- For 12 loans, State offices did not obtain written analysis from the lender that included loan-related trends, strengths, weaknesses, extraordinary transactions, and other indications of the borrower's financial condition. Based on this result, we estimate that States did not obtain the analysis for 88 Recovery Act guaranteed B&I loans (23 percent).[19]
- For 10 loans, neither the State office nor the lender maintained documentation to support that the borrower met the tangible balance sheet equity at loan closing.[20] Based on this result, we estimate the supporting documents were not maintained for 73 Recovery Act guaranteed B&I loans (20 percent).[21]
- For 12 loans, State offices did not hold or document annual lender meetings. Based on this result, we estimate that State offices did not hold or document annual lender meetings for 88 Recovery Act guaranteed B&I loans (23 percent).[22]

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[18] We are 95 percent confident that States did not obtain the required financial statements for between 65 and 154 loans (or 17 to 41 percent of the universe). The estimate is 109 loans (29 percent of the universe) that the States did not obtain the required financial statements.

[19] We are 95 percent confident that the total number of exceptions in the universe is between 46 and 129 loans (or 12 to 35 percent of the universe). The estimate is 88 loans (23 percent of the universe) that the States did not obtain the written analysis from the lender.

[20] A balance sheet is the financial statement used to verify equity at loan closing. A minimum percentage of tangible balance sheet equity is required for each borrower. Tangible balance sheet equity is total equity, less the value of intangible assets, as determined from balance sheets, prepared in accordance with generally accepted accounting principles. In processing the loan guarantee, the lender must certify that the equity requirement has been met and provide financial statements, executed not more than 60 days before the time of certification.

[21] Regulation states that the lender must certify to the agency that it used financial statements, presented in accordance with generally accepted accounting principles, to calculate tangible balance sheet equity, and must support the certification by attaching a copy of the balance sheet on which the certification is based. We are 95 percent confident that certifications were not supported for between 34 and 112 loans (or 9 to 30 percent of the universe). The estimate is 73 loans (20 percent of the universe) that the tangible balance sheet equity certifications were not supported.

[22] Rural Development's instructions require State offices to document annual lender meetings with Form RD 4279-15. We are 95 percent confident that the total number of exceptions in the universe is between 46 and 129 loans (or 12 to 35 percent of the universe). The estimate is 88 loans (23 percent of the universe) that the State office did not hold or document lender meetings.

- For 13 loans, State offices did not conduct and document a borrower visit within the first year of operation. Based on this result, we estimate that Rural Development did not conduct and document borrower visits for 95 Recovery Act guaranteed B&I loans (25 percent) within the required timeframe.[23]

When we contacted Rural Development national office staff about why State offices had not more closely monitored the lenders to obtain the required financial statements and analysis, they explained that some lenders are more responsive than others, but that State office personnel should make every effort to obtain information, follow up with the lenders on servicing deficiencies, and document in the case files their attempts to obtain information. Rural Development officials stated that it is the lender's responsibility to obtain financial statements at least on an annual basis. Officials further stated that lenders are notified of required analysis that they must provide, and are instructed that failing to fulfill their responsibilities could be classified as negligent servicing. If a loss occurs due to negligent servicing, the agency can reduce the proposed loss claim accordingly.

Rural Development's current guidance instructs State offices to notify lenders in writing when it suspects noncompliance with loan documents. However, OIG noted that current guidance does not instruct State office personnel to document their attempts to secure required documentation from the lender.[24] In addition to the letter, to demonstrate proper monitoring of lender noncompliance, the case files should include a record of all verbal contacts and email documentation of the State office's attempts to obtain documentation, along with the results of the request. Since the Government has agreed to guarantee up to 90 percent of the total outstanding balance for each of these loans if borrowers default, it is vital that State offices adequately document all noncompliance issues.

Before the Government agrees to provide the guarantees, lenders are to use balance sheets to certify that borrowers have enough tangible equity to meet requirements at loan closing. However, we found that lenders were not always obtaining balance sheets, as of the loan closing date, to support tangible balance sheet equity, and, in several instances, were instead utilizing *pro forma* statements.[25] Whereas *pro forma* statements base estimates on potential transactions, financial statements present actual financial results as of a specified date. OIG noted that current regulations and instructions do not allow the use of *pro forma* statements to support tangible balance sheet equity at loan closing or explain that *pro forma* statements are not, by definition, financial statements. During our audit, the agency stated that there is a general lack of understanding regarding the differences between the *pro forma* balance sheet, which is submitted with the application

[23] We are 95 percent confident that Rural Development did not conduct and document borrower visits for between 52 and 138 loans (or 14 to 37 percent of the universe). The estimate is 95 loans (25 percent of the universe) that Rural Development did not conduct and document borrower visits.
[24] RD Instruction 4287-B, *Servicing Business and Industry Guaranteed Loans*, 4287.107, Routine servicing, dated December 23, 1996.
[25] Due to the timing of the fieldwork, the lender certification for the minimum tangible balance sheet equity requirement was reviewed during this audit on loan servicing in which field visits to lenders were performed. The remaining audit work related to the approval process was reviewed in the previous report, *American Recovery and Reinvestment Act—Business and Industry Guaranteed Loans—Phase 2* (34703-0002-Te, February 2012).

to demonstrate projections for loan closing, and the actual balance sheet that demonstrates that the tangible balance sheet equity requirement was met, as of loan closing. Rural Development should clarify the requirement in its regulations to verify that sufficient tangible balance sheet equity actually exists at loan closing and that State office personnel must obtain a balance sheet. Further, to ensure accurate and consistent application of the procedures, Rural Development should provide additional training to its State office personnel regarding any newly revised regulations. Rural Development is currently working on a proposed rule that will clarify this issue.

So that the Government can ascertain how a guaranteed loan is being serviced and that the conditions and covenants of the Loan Agreement are being enforced, procedures require Rural Development officials to meet with lenders at least once per year. The agency is to remind the lender of its servicing responsibilities and review the lender's latest financial analysis during the meeting. A required agency form is available that provides a format in which the annual lender meetings can be documented.[26] When we questioned the agency about why State officials did not always hold and document lender meetings, the agency stated that it has recently issued guidance concerning annual lender meetings, stating that conferences may be face-to-face or by other means of communication (i.e., teleconference). Additionally, State office personnel have been encouraged to document files accordingly.

Finally, in the first year after the Government guarantees a loan, Rural Development is required to schedule borrower visits and document them.[27] Although the borrower visit is the primary opportunity for Rural Development to review collateral for loans for which Rural Development has provided up to a 90 percent guarantee, Rural Development does not always conduct and document borrower visits. When we asked officials about the 13 borrower visits that were not conducted and documented, the national office stated that all visits should be conducted and documented, and strongly encouraged State officials to invite lenders to attend. When we asked State officials about why borrower visits were not always conducted and documented, officials in some States said that the borrower visits were conducted, but not documented. Officials in other States said that Recovery Act borrower visits were not scheduled, due to oversights. To verify the collateral for the loans that the Government guarantees and other information, the agency needs to schedule and conduct borrower visits, as required, in the first year and should encourage lenders to attend.

It is important that B&I guaranteed loans are properly serviced and monitored because these actions verify collateral for the loans and could identify other deficiencies. During our audit, OIG found that use of loan proceeds related to two loan guarantees, totaling $2.45 million, could not be verified. In the first case, a $2 million guaranteed loan's stated purpose was to refinance debt, purchase machinery and equipment, and remodel facilities. However, we were unable to verify that the purchases and improvements were made because supporting documentation was

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[26] Form RD 4279-15, *Business & Industry and Section 9006 Program Visit Review Report* (Field Visit Review), Part 1: Lender Visit.
[27] The agency is to use Form RD 4279-15*, Business & Industry and Section 9006 Program Visit Review Report* (Field Visit Review), Part 2: Borrower Visit.

not available from the lender or borrower.[28] Regulations state it is the lender's responsibility to monitor construction. When we asked the agency about the loan, the agency stated that the lender admitted that monitoring of construction to remodel facilities was not performed. National Rural Development officials have requested the relevant State office to place the lender on written notice that if losses are incurred, the agency may reduce its claim because of negligent servicing. In the second case, a $450,000 loan guarantee's purpose was to equip and install a food storage and distribution facility in a rural community. However, we found that about 1 year after loan closing, the project was not operational and we were unable to verify whether all funds had been used as approved. During our review (May 2012), the Office of the General Counsel and Rural Development's national office approved the withdrawal of the Loan Note Guarantee for the $450,000 loan and the lender was notified.

In addition, of the 37 sample loans identified with lender servicing deficiencies and inadequate monitoring by the State office staff, 3 were delinquent. Of those three loans, one has entered the liquidation process, as the lender has initiated the foreclosure process on a $600,000 guaranteed loan.[29] It is essential that the State office staff follow up on lender servicing deficiencies, so that potential problems such as these are identified and addressed in a timely manner.

Operating the B&I program effectively requires lenders and State office personnel to work together to make sure loans are serviced properly in order to minimize the potential losses to the Government. Agency officials have stated that it is the lender's responsibility to service the guaranteed loans and that Rural Development State office personnel should make every effort to obtain information when following up with the lenders on servicing deficiencies, and document in the case files their attempts. By clarifying its regulations, requiring State office personnel to document communications with lenders consistently, and notifying lenders of possible negligence and its consequences, Rural Development can better ensure that its loans are serviced in a more preventive manner, strengthening its program overall.

Recommendation 1

Develop and implement procedures that require State offices to record actions taken to obtain required documents from lenders to facilitate mitigation of any potential losses to the Government.

Agency Response

In its March 19, 2013, response, Rural Development stated that the agency currently has regulations and policies to address and mitigate potential loss. When a borrower becomes delinquent, Rural Development Instruction addresses curative actions that may be taken in an attempt to resolve the delinquent account.

In the past the agency has conducted regional training sessions. In addition, the agency conducts on a regular basis webinars, teleconferences, and cluster meetings to ensure that State/national office staff members are informed on regulatory procedures. The agency will conduct a series of

[28] See exhibit A.
[29] See exhibit A.

webinars prior to the end of fiscal year (FY) 2013 to emphasize the agency's need to obtain information to be documented.

OIG Position

We are unable to accept management decision at this time. The Rural Business-Cooperative Service's response does not adequately address the high error rate noted in the report with lenders not obtaining required documents from borrowers, supplying the documents to the State office, and obtaining agency approval before taking certain actions on the loan. The agency responded during the audit that State offices should document their case files of attempts to obtain required information from the lenders when such information has not been received. As noted in the report, the current guidance does not require personnel to document their attempts to secure required documentation from the lender. Due to the high error rate, procedures should be implemented that require all of the State actions regarding attempts to obtain information to be documented in the case files in case any losses occur in the future.

To achieve management decision, Rural Development needs to develop and implement procedures that require State office personnel to record actions taken to obtain required documents from lenders.

Recommendation 2

Revise existing procedures to clarify that lenders are responsible to verify and certify that sufficient tangible balance sheet equity exists at loan closing.

Agency Response

Rural Development stated that a Procedural Notice discussing tangible balance sheet equity is in clearance. This notice clarifies tangible balance sheet equity requirements. The agency has also created the Lender Education and Awareness Program which also provides a tangible balance sheet equity calculator for lenders. Also, the agency is promulgating an enhanced B&I regulation which includes a proposal that a debt-to-tangible net worth ratio be used as an alternative to tangible balance sheet equity. A debt-to-tangible net worth ratio is more commonly recognized by lenders, but the lender may use either measure. The final rule is anticipated to be published by September 30, 2014.

OIG Position

We accept management decision for this recommendation.

Recommendation 3

Develop comprehensive training for Rural Development's State office personnel that covers the procedures discussed in Recommendations 1 and 2 and deficiencies identified with the State office monitoring of lender servicing.

Agency Response

Rural Development stated that the agency held 10 regional training meetings that covered the calculation of tangible balance sheet equity. Future training will be conducted when new regulations are published as a final rule. Calculation of tangible balance sheet equity and debt-to-tangible net worth ratio will be included as part of that training. It is anticipated that the training will be conducted sometime in FY 2015.

The agency is planning to conduct at least four training webinars in FY 2013 and provide additional training to State office personnel on loan processing and servicing issues. The proposed dates of these webinars are April 18, May 15, June 19, and July 10, 2013. Agenda items will emphasize documentation required from lenders and tangible balance sheet equity.

OIG Position

We accept management decision for this recommendation.

Recommendation 4

Verify that all Recovery Act-funded borrower visits have been performed. For any borrower visits that have not yet been performed, expedite scheduling and inform lenders of the schedule. Conduct and document the borrower visits, as required.

Agency Response

Rural Development stated instructions provide that borrower visits should be scheduled during the first year of operation after issuance of the Loan Note Guarantee. For all current borrowers, a field visit should be done at least once every 3 years. RD provided evidence that most initial borrower visits were performed as of March 12, 2013. The State offices have been contacted concerning completing borrower visits in accordance with the regulations. It will be emphasized at the upcoming proposed training dates of April 18, 2013; May 15, 2013; June 19, 2013; and July 10, 2013, and during monthly Rural Business-Cooperative Service teleconferences, etc.

OIG Position

We accept management decision on the recommendation.

Recommendation 5

Review the two loans with guarantees (of $2 million and $600,000) to verify that all proper servicing actions have been taken, and take additional servicing actions if needed.

Agency Response

Rural Development stated that, on February 21, 2012, the State office contacted the borrower of the $2 million loan to follow up regarding OIG's findings. On April 30, 2012, the Rural Development State office put the lender on notice that failure to comply with the Lender's Agreement could be considered negligent servicing and the Loan Note Guarantee may be reduced as a result. In addition, the borrower is current and performing in accordance with its signed Loan Agreement and agency regulations.

On February 28, 2013, the Rural Development State office received the lender's liquidation plan and has reviewed it. On March 12, 2013, the State Office Loan Committee approved the lender's liquidation plan. Thus far, the servicing actions taken by the State office appear to be in accordance with agency regulations.

OIG Position

We accept management decision for this recommendation.

Section 2: Program Performance Results

Finding 2: Rural Development Incorrectly Reported Small Business Participation

Although providing support to small business owners through loan guarantees is not an explicit goal of the Recovery Act, one way in which the agency measured performance[30] of the Recovery Act-funded B&I Guaranteed Loan Program was the percentage of loan guarantee recipients that were small business owners.[31] The agency provided monthly reports to various program stakeholders, stating that 100 percent of its loan guarantees went to small businesses.[32] However, we determined that 28 percent of the loan guarantee recipients did not meet the criteria to be considered a small business.[33] Further, 19 of the 26 State offices contacted did not make a small business determination for each business by reviewing each borrower's employee numbers or annual receipts. This occurred because the national office did not provide guidance concerning the need to identify those recipients that were small businesses. It was mistakenly believed that there was a place to designate assistance to small businesses in the Guaranteed Loan System (GLS).[34] As a result, the agency has overstated its success in meeting its established performance goal.

State office personnel are to identify loan guarantee recipients that are small business owners during the application review process. B&I application forms require lenders to provide a North American Industry Classification System (NAICS) code that Rural Development's State office personnel are to use to determine if applicants are small businesses. NAICS codes place a business within a certain industry class. The Small Business Administration established size standards that define the largest size that a business can be within each industry classification and still qualify as a small business.

OIG analyzed the 53 loan guarantee recipients included in our statistical sample and found that, although Rural Development stated that 100 percent of guarantees went to small businesses, 15 of the guarantees were provided to borrowers that did not meet the small business criteria. For example, three of the borrowers were nonprofit entities, although the small business size standards only apply to for-profit entities. Also, one borrower stated that it employed 800 people when the small business size standard for its industry is 500 employees. Further, we noted another borrower was identified by Rural Development with the NAICS code for hunting and

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[30] The agency used the same performance measures for the B&I guaranteed loans related to the Recovery Act as the B&I loans guaranteed through the regular program because the B&I program regulations did not change.

[31] There is a size standard for each business industry class that is expressed in number of employees or annual receipts in millions of dollars for a business and all of its domestic and foreign affiliates. Size standards define the largest size that a business can be within each industry class to qualify as a small business.

[32] The agency provided monthly implementation status reports to program leadership, the Office of the Under Secretary, and the Office of the Secretary stating that it used the Small Business Administration's definition of small businesses.

[33] We identified that 15 of 53 statistically sampled loans did not meet the Small Business Administration's criteria, and are 95 percent confident that the total number of exceptions in the universe is between 59 and 147 loans (or 16 to 39 percent of the universe). The estimate is 103 loans or 28 percent of the universe that did not meet the Small Business Administration's criteria.

[34] An information system where B&I Guaranteed Loan Program data are stored.

trapping, rather than the correct code for a nursery and tree production business. Characterized accurately, the borrower would not be considered a small business.

Our audit work disclosed that State office personnel did not conduct reviews during the loan approval process to identify those recipients who met the small business criteria. Specifically, when we requested documentation to support that all loan guarantees were provided to small businesses, the agency was unable to provide this support. Rural Development stated that it would have State office personnel re-verify that the assistance provided was to small businesses, based on small business size standards. Subsequently, the agency concluded that, out of 493 B&I Recovery Act-funded loans, 51 (or 10.3 percent) were not provided to small businesses. However, our review of the agency's analysis of the 493 loans noted several discrepancies with the data the agency used. Specifically, we identified 49 NAICS codes were used that are not in the small business size standard table and 43 size standards that are not accurate, based on the NAICS code used. Therefore, OIG concluded that the agency's small business determinations could not be relied upon.

Rural Development State office personnel stated that the national office did not provide guidance concerning small business determinations. National office representatives further stated that they mistakenly believed that, historically, all B&I guaranteed loans were provided to small businesses, and it was an oversight, on their part, not to instruct State office personnel to track this information.

Given the errors we found in the agency's small business determinations, the agency needs to develop guidance for State office personnel to make the determinations. To accurately determine the size of an applicant's business, the agency must obtain current employment figures and financial statements for the business. However, the agency has not issued State offices guidance that details the small business review process.

By issuing guidance regarding small business determinations, the agency can improve the accuracy of its reporting on the program's performance. In the current budget climate, a more accurate presentation of the program's performance could have a significant impact as decisions are made on future programs and funding.

Recommendation 6

Develop and implement instructions to guide staff when conducting the small business review process to enhance the accuracy of the agency's reporting on small business participation.

Agency Response

Rural Development stated that it issued an unnumbered letter on January 18, 2013, addressing this issue and will include the following guidance in the FY 2014 performance measures:

> To determine if your borrower is a small business, it must meet the Small Business Administration (SBA) definition of a small business. SBA defines a small business concern as one that is independently owned and operated, is organized for profit, and is not dominant in its field. Depending on the industry, size standard eligibility is based on the average number of employees for the preceding 12 months or on sales volume

averaged over a 3-year period. Please review the North American Industrial Classification System code provided by the borrower to ensure that it is correct before making the determination. The following link will connect you to the SBA webpage. http://www.sba.gov/content/what-sbas-definition-small-business-concern.

OIG Position

We accept management decision for this recommendation.

Finding 3: Rural Development Reported Recovery Act-Created or Retained Jobs Inconsistently

Reporting of program performance regarding jobs created and saved differed among the State offices and was not always verifiable. This occurred because the agency's guidance to State office personnel or lenders did not define whether jobs data should include indirect jobs, state a maximum timeframe in which jobs must be created, require supporting documentation for job estimates, or provide policies and procedures for obtaining supporting documents to ensure that personnel verify that jobs data are reasonable and accurate. Of the 5,000 total jobs reported in relation to the 53 loans in our sample, we verified that 4,650 jobs were created or retained. Without a well-defined methodology for measuring program outcomes related to jobs, performance results may overstate the agency's success in meeting its established performance goal for jobs created and saved.

Goals for both the Recovery Act and the regular B&I Guaranteed Loan Program include creating and preserving jobs. Regulation requires the borrower to submit an application for loan guarantee that includes the number of jobs created and saved.[35] Agency instructions direct its personnel to enter all appropriate information about the borrower, lender, and loan guarantee request into GLS.[36]

With job creation and preservation as a goal of the B&I program, the agency provides monthly status reports, which include the number of jobs created and saved, to various program stakeholders. The national office uses the total number of jobs recorded in GLS to report the results of the program's performance. Through our assessments of the different State offices' methodologies for collecting and recording these figures in GLS, we determined that personnel within the agency do not have a consistent definition of reportable jobs. Although State offices are to report verifiable jobs, i.e., reasonable estimates of direct jobs within a specified timeframe, some offices reported job numbers that were overstated, some offices reported indirect jobs, and another included jobs projected to exist 5 years in the future.

For example, we identified four borrowers that reported jobs data that included indirect jobs. For instance, one State office recorded in GLS that one borrower estimated it would create and save

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[35] 7 CFR 4279B, *Business and Industry Guaranteed Loans*, 4279.161(b)(1), Filing preapplications and applications, dated January 1, 2009.

[36] RD Instruction 4279-B, *Business and Industry Guaranteed Loans*, 4279.165(a)(7), Evaluation of application, dated December 23, 1996. GLS is an information system where B&I Guaranteed Loan Program data are stored.

400 jobs; however, during our visit with the borrower, we determined that the borrower saved 2 jobs as a direct result of the Recovery Act B&I guaranteed loan. The remaining reported jobs would be created or saved indirectly, as the loan proceeds were used to refinance residential lots that contractors would develop.

In another case, the State office recorded the number of jobs that the borrower projected to create over several years. The borrower estimated 22 jobs would be created and saved; however, we found that the borrower had 8 employees. When asked about the difference, the borrower stated that the jobs creation figure was a 5-year projection.

We also identified errors in the number of estimated jobs recorded in GLS and used to report on the B&I program's performance. For example, one borrower estimated 144 jobs would be created and saved; however, we determined that the borrower created and saved 55 jobs. The borrower stated it included jobs for the entire company, both retail and manufacturing. However, the project funded by the B&I guaranteed loan related only to its manufacturing operations.

Rural Development agreed that indirect jobs should not be included and that, typically, jobs created are based on the length of time the effects of loan proceeds are felt by the business. In most cases, 5 years may be too long a period for the jobs to be created, but it will vary from project to project. Further, the agency stated that new guidance being drafted will address these issues.

The Recovery Act provided additional funding levels to the B&I program and emphasized the preservation and creation of jobs and the promotion of economic recovery. Since creating economic opportunity is also a B&I program goal, Rural Development measures the program's performance in terms of estimated jobs created and saved as a result of the guaranteed loans. The Recovery Act's emphasis on accountability and transparency has shown that the agency's reporting of its performance in relation to jobs can be improved. By clearly defining reportable jobs, the agency can strengthen its reporting.

Recommendation 7

Develop and implement instructions that specify only reasonable and verifiable direct jobs created or retained within a specified timeframe are to be entered into GLS and used for reporting.

Agency Response

Rural Development stated that an unnumbered letter dated January 18, 2013, titled "Rural Business and Cooperative Programs Performance and Accountability Report Performance Measures," contains detailed guidance on how to count and verify jobs created and saved. Guidance on performance measures is issued annually.

OIG Position

We accept management decision for this recommendation.

Scope and Methodology

Our audit examined 53 statistically selected Recovery Act-funded B&I guaranteed loans that were obligated as of September 29, 2011, and closed by the time of our fieldwork, which we conducted from August 2011 through September 2012. We conducted our audit by contacting Rural Development's national office in Washington, D.C., and visiting 24 Rural Development State offices, as well as lender and borrower project sites (see exhibit B for a list of locations).[37] During the audit period, the universe of loans consisted of 374 Recovery Act-funded B&I guaranteed loans, totaling $1,099,358,407 in obligations.

Rural Development provided us with Recovery Act-funded B&I guaranteed loan data generated from GLS. 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 is not used extensively in the verification of use of funds, servicing process, or small business-related performance measure under review. We did conduct a limited review of the performance measure data related to the number of jobs created and saved, which is documented in GLS and supported by the loan applications. However, since the number of jobs created and saved as a direct result of the B&I guaranteed loans could be adequately supported by the loan applications and other manual documentation obtained from the States, lenders, or borrowers, we did not rely upon the information system to obtain sufficient, appropriate evidence to support the findings presented in this report.

We identified the listing from GLS 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 two 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 53 loans. The 53 loans in the sample were spread among 26 States.

In order to accomplish our objectives, we interviewed officials to determine the controls established to ensure lenders are properly servicing B&I guaranteed loans, whether funds were used as intended and complied with Recovery Act requirements, and whether the Recovery Act-funded B&I Guaranteed Loan Program was effective in meeting the program's goals, based on its performance measures. We reviewed controls related to lender servicing; monitoring use of funds; compliance with Loan Agreements and Conditional Commitments; collecting, assessing, and reporting performance results related to the number of jobs created and saved; as well as the percentage of loan guarantees provided to small businesses. To assess these controls over lender servicing and use of funds compliance with regulations and policies, we visited the State offices, lenders, and borrowers listed in exhibit B.

[37] Loans were spread among 26 States, including Alaska and Hawaii. We did not visit these two States as alternate procedures were performed instead of physical inspections.

Additionally, we obtained and reviewed:[38]

- Loan servicing files for the 53 loans included in our statistical sample;
- Documents maintained by lenders, including financial statements, written credit analyses, and other documents to assess proper servicing and authorized use of funds; and
- Documents maintained by State offices, including loan settlement statements; status reports; lender and borrower visit forms; Davis-Bacon support, when applicable; and other documents to assess adequate monitoring of lender servicing.

In order to review Rural Development's performance measures, we:

- Conducted interviews with national and State office personnel;
- Reviewed documents maintained by State offices, including loan application forms and Project Summary: Part C of Form 4279-1, and financial statements submitted at the time of application;
- Reviewed Small Business Administration regulations;
- Compared the Small Business Administration Table of Small Business Size Standards to the NAICS codes identified for each loan included in our statistical sample;
- Obtained employee listings from borrowers; and
- Reviewed program participation data, such as jobs and NAICS codes, maintained in GLS.

In addition, we obtained and reviewed the following:

- American Recovery and Reinvestment Act of 2009;
- Administrative Notices, unnumbered letters, and any other policies and procedures applicable to the Recovery Act-funded B&I Guaranteed Loan Program;
- Business and Cooperative Program Assessment Review reports; and
- Farm Credit Administration's Review of Loans Guaranteed Under the American Recovery and Reinvestment Act report.

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.

[38] A *pro forma* working paper and questionnaire were developed to allow us to document our analysis of each statistically sampled loan.

Abbreviations

B&I ....Business and Industry
CFR.............................Code of Federal Regulations
FY ....fiscal year
GLS ....Guaranteed Loan System
NAICS.........................North American Industry Classification System
OIG ....Office of Inspector General
Recovery Act ....American Recovery and Reinvestment Act of 2009
SBA.............................Small Business Administration
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	5	Delinquent or Unverified Use of Funds	$2,600,000[39]	Questioned Costs/Loans, No Recovery
TOTAL			**$2,600,000**	

[39] $2,000,000 unverified use of funds and $600,000 loan in liquidation process.

Exhibit B – Statistically Sampled Loans and Locations Visited

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

State Office Location	Sample Counter	Obligation Amount	Lender Location	Borrower Location
Amherst, MA	17	$450,000	Worcester, MA	Boston, MA
Athens, GA	18	$8,310,000	Lakeland, GA	Homerville, GA
	33	$2,480,000	Brookfield, WI	Roberta, GA
	6	$2,879,000	Cumming, GA	Cumming, GA
	14	$3,800,000	Dalton, GA	Tennga, GA
Boise, ID	36	$500,000	Boise, ID	Meridian, ID
Bozeman, MT	1	$4,000,000	Butte, MT	Butte, MT
	43	$1,600,000	Bozeman, MT	Belgrade, MT
	13	$1,177,750	Kalispell, MT	Kalispell, MT
Carson City, NV	41	$1,700,000	Reno, NV	Palomino Valley, NV
	4	$7,125,000	Houston, TX	Boulder City, NV
Champaign, IL	29	$1,755,000	Taylorville, IL	Assumption, IL*
	37	$3,800,032	Pontiac, IL	Streator, IL
Columbia, MO	5	$1,600,000	St Joseph, MO	Platte City, MO
	39	$205,000	Kirksville, MO	Kirksville, MO
Columbia, SC	50	$2,700,000	Greer, SC	Greer, SC
	23	$2,600,000	Myrtle Beach, SC	Myrtle Beach, SC
	45	$1,496,855	Georgetown, SC	Georgetown, SC
Columbus, OH	46	$500,000	Oak Harbor, OH	Fremont, OH
Concord, NH	34	$6,000,000	Boston, MA	Middleton, NH
	38	$6,377,920	Concord, NH	Keene, NH
East Lansing, MI	2 (replacement)	$2,900,000	Farmington Hills, MI	Romulus, MI
	3 (replacement)	$2,000,000	Kent City, MI	Kent City, MI
	26	$4,895,000	Farmington Hills, MI	Farmington Hills, MI
	15	$2,100,000	Ludington, MI	Ludington, MI
	28	$360,000	Flint, MI	Dowagiac, MI
Gainesville, FL	16	$5,000,000	Bradenton, FL	Ocala, FL
Hilo, HI*	47	$500,000	Hagatna, GU*	Hagatna, GU*
Jackson, MS	44	$600,000	Abbeville, MS	Oxford, MS

Lexington, KY	11	$9,580,000	Bowling Green, KY	Bowling Green, KY
	7	$9,850,000	London, KY	Stanford, KY
	22	$5,505,000	Glasgow, KY	Glasgow, KY*
Lincoln, NE	2	$3,967,262	Omaha, NE	O'Neill, NE
	3 (strata 1)	$22,000,000	Iselin, NJ*	Genoa, NE*
Nashville, TN	3	$3,100,000	Franklin, TN	Franklin, TN
	42	$3,800,000	Brookfield, WI	Tiptonville, TN
Newton, KS	24	$2,200,000	McPherson, KS	Wichita, KS
Palmer, AK*	1 (replacement)	$1,100,000	Juneau, AK*	Santa Ana, CA*
Phoenix, AZ	32	$2,000,000	Flagstaff, AZ	Flagstaff, AZ
Portland, OR	40	$5,100,000	New York, NY*	Hermiston, OR*
	35	$750,000	Long Beach, CA*	Dayton, OR
Raleigh, NC	30	$450,000	Tabor City, NC	Tabor City, NC
	27	$576,000	Southern Pines, NC	Southern Pines, NC
	25	$900,000	Whiteville, NC	Whiteville, NC*
	48	$700,000	Hillsborough, NC	Hillsborough, NC
	49	$5,000,000	Biscoe, NC	Troy, NC
Richmond, VA	19	$400,000	Marion, VA	Marion, VA
	31	$1,360,000	Christiansburg, VA	Christiansburg, VA
Stevens Point, WI	9	$1,900,000	Wausau, WI	Wausau, WI
	21	$7,855,000	Brookfield, WI	West Bend, WI
Stillwater, OK	8	$1,650,000	Weatherford, OK	Thomas, OK
Temple, TX	51	$6,532,950	Enid, OK*	New Braunfels, TX*
	1 (strata 1)	$25,000,000	Tyler, TX	Corpus Christi, TX

*Location was not visited.

Exhibit C – Statistical Plan - Sampling Methodology and Analysis Results

Objective:

OIG statisticians designed a sample to support the Phase 3 audit of the Recovery Act B&I Guaranteed Loan Program. The sampling objective was to quantify the noncompliance rates and funding at risk for specific criteria associated with each of the audit objectives.

Audit Universe:

The original universe consisted of 415 loans approved for B&I guarantees under the Recovery Act as of May 3, 2010. However, 40 of those were withdrawn, as of September 29, 2011, and 1 had not closed during the fieldwork for this audit. Therefore, we used a final audit universe of 374 guaranteed loans. The total loan value for the loans in this universe was approximately $1.1 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 two loans in the first stratum and a simple random sample of loans in the second stratum.

Stratum I: Two loans exceeded $10 million. The audit team had a specific interest in reviewing the highest dollar amount loans. Therefore, we placed those two loans into a census stratum, i.e., 100 percent review. The total loan value for this stratum was $47 million.

Stratum II: The second stratum included the remaining 372 loans. The total loan value for the loans in this stratum was about $1.05 billion.

We used a "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 $153.7 million.

In summary, 53 loans, which were spread among 26 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 with State and lender servicing criteria. 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:

- Improper servicing by lenders.
    - Based on our sample results, at a 95 percent confidence level, we project that between 226 and 314 of the loans (60 to 84 percent) were not properly serviced. Our estimate is that 270 of the loans in the audit universe (72 percent) were improperly serviced by lenders. The achieved precision is +/- 12 percent.

- Required financial statements maintained by lenders.
    - Based on the sample results, at a 95 percent confidence level, we project that between 65 and 154 of the loans (17 to 41 percent) were noncompliant in this category. Our estimate is that 109 of the loans in the audit universe (29 percent) had an exception in this criterion. The achieved absolute precision is +/- 12 percent.

- Lender's written analysis submitted to the State office.
    - Based on the sample results, at a 95 percent confidence level, we project that between 23 and 94 of the loans (6 to 25 percent) were noncompliant with this aspect of servicing. Our estimate is that 58 of the loans in the audit universe (16 percent) had an exception in this criterion. The achieved absolute precision is +/- 10 percent.

- Borrowers in compliance with required financial ratios.
    - Based on the sample results, at a 95 percent confidence level, we project that between 58 and 146 of the loans (16 to 39 percent) were noncompliant with this criterion. Our estimate is that 102 of the loans in the audit universe (27 percent) had an exception in this criterion. The achieved absolute precision is +/- 12 percent.

- Taxes and assessment payments monitored by lenders.
    - Based on the sample results, at a 95 percent confidence level, we project that between 58 and 146 of the loans (16 to 39 percent) were noncompliant with this criterion. Our estimate is that 102 of the loans in the audit universe (27 percent) had an exception in this criterion. The achieved absolute precision is +/- 12 percent.

- Lenders received written concurrence from the agency for servicing actions taken.
    - Based on the sample results, at a 95 percent confidence level, we project that between 28 and 103 of the loans (8 to 28 percent) were noncompliant with this criterion. Our estimate is that 66 of the loans in the audit universe (18 percent) had an exception in this criterion. The achieved absolute precision is +/- 10 percent.

- State offices adequately monitor lender servicing.
    - Based on the sample results, at a 95 percent confidence level, we project that between 194 and 288 of the loans (52 to 77 percent) were noncompliant with this

criterion. Our estimate is that 241 of the loans in the audit universe (64 percent) had an exception in this criterion. The achieved absolute precision is +/- 13 percent.

- Required financial statements maintained at State office.
    - Based on the sample results, at a 95 percent confidence level, we project that between 65 and 154 of the loans (17 to 41 percent) were noncompliant with this criterion. Our estimate is that 109 of the loans in the audit universe (29 percent) had an exception in this criterion. The achieved absolute precision is +/- 12 percent.

- Written lender's analysis maintained at State office.
    - Based on the sample results, at a 95 percent confidence level, we project that between 46 and 129 of the loans (12 to 35 percent) were noncompliant with this criterion. Our estimate is that 88 of the loans in the audit universe (23 percent) had an exception in this criterion. The achieved absolute precision is +/- 11 percent.

- Support indicating the borrower met the tangible balance sheet equity at loan closing.
    - Based on the sample results, at a 95 percent confidence level, we project that between 34 and 112 of the loans (9 to 30 percent) were noncompliant with this criterion. Our estimate is that 73 of the loans in the audit universe (20 percent) had an exception in this criterion. The achieved absolute precision is +/- 10 percent.

- Documentation of annual lender meetings.
    - Based on the sample results, at a 95 percent confidence level, we project that between 46 and 129 of the loans (12 to 35 percent) were noncompliant with this criterion. Our estimate is that 88 of the loans in the audit universe (23 percent) had an exception in this criterion. The achieved absolute precision is +/- 11 percent.

- Documentation of visit to borrower or verification of jobs.
    - Based on the sample results, at a 95 percent confidence level, we project that between 52 and 138 of the loans (14 to 37 percent) were noncompliant with this criterion. Our estimate is that 95 of the loans in the audit universe (25 percent) had an exception in this criterion. The achieved absolute precision is +/- 11 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	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		
Improper servicing by lenders	Proportion of loans with exception	72.2%	60.4%	83.9%	+/- 12%	37
	Number of loans with exception	270	226	314	+/- 44	
Required financial statements maintained by lenders	Proportion of loans with exception	29.3%	17.3%	41.2%	+/- 12%	15
	Number of loans with exception	109	65	154	+/- 45	
Lender's written analysis submitted to State office	Proportion of loans with exception	15.6%	6.1%	25.1%	+/- 10%	8
	Number of loans with exception	58	23	94	+/- 36	
Borrowers in compliance with required financial ratios	Proportion of loans with exception	27.3%	15.6%	39.0%	+/- 12%	14
	Number of loans with exception	102	58	146	+/- 44	
Taxes and assessment payments monitored by lenders	Proportion of loans with exception	27.3%	15.6%	39.0%	+/- 12%	14
	Number of loans with exception	102	58	146	+/- 44	
Lenders received written concurrence from the agency for servicing actions taken	Proportion of loans with exception	17.6%	7.5%	27.6%	+/- 10%	9
	Number of loans with exception	66	28	103	+/- 37	
State offices adequately monitor lender servicing	Proportion of loans with exception	64%	51.8%	76.9%	+/- 13%	33
	Number of loans with exception	241	194	288	+/- 47	

Required financial statements maintained at State office	Proportion of loans with exception	29.3%	17.3%	41.2%	+/- 12%	15
	Number of loans with exception	109	65	154	+/- 45	
Written lender's analysis maintained at State office	Proportion of loans with exception	23.4%	12.3%	34.5%	+/- 11%	12
	Number of loans with exception	88	46	129	+/- 42	
Support indicating borrower met tangible balance sheet equity at loan closing	Proportion of loans with exception	19.5%	9.1%	29.9%	+/- 10%	10
	Number of loans with exception	73	34	112	+/- 39	
Documentation of annual lender meetings	Proportion of loans with exception	23.4%	12.3%	34.5%	+/- 11%	12
	Number of loans with exception	88	46	129	+/- 42	
Documentation of visit to borrower or verification of jobs	Proportion of loans with exception	25.4%	13.9%	36.8%	+/- 11%	13
	Number of loans with exception	95	52	138	+/- 43	

* 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) = (83.9% - 72.2%) = 12% and (lower bound proportion – projected proportion) = (60.4% - 72.2%) = -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 estimate (for example, 314 - 270 = 44).

Criteria and results associated with Finding 2:

- Borrowers are small business owners.
  - Based on the sample results, at a 95 percent confidence level, we project that between 59 and 147 of the loans (16 to 39 percent) were noncompliant in this category. Our estimate is that 103 of the loans in the audit universe had an exception (28 percent) in this criterion. The achieved absolute precision is +/-12 percent.

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

Summary of Results for Finding 2

Criterion	Measure	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		
Borrowers are small business owners	Proportion of loans with exception	27.6%	15.9%	39.3%	+/- 12%	15
	Number of loans with exception	103	59	147	+/- 44	

* 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) = (39.3% - 27.6%) = 12% and (lower bound proportion – projected proportion) = (15.9% - 27.6%) = -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 estimate (for example, (147 - 103 = 44).

USDA’S
RURAL DEVELOPMENT’S
RESPONSE TO AUDIT REPORT

March 19, 2013

TO: Gil H. Harden
Assistant Inspector General for Audit
Office of Inspector General

FROM: John Dunsmuir /s/ Cynthia M. Buck-Thompson for
Acting Director
Financial Management Division

SUBJECT: Audit Number 34703-001-32
American Recovery and Reinvestment Act – Business and Industry
Guaranteed Loans – Phase 3

Attached, please find Rural Business-Cooperative Service's response to the subject official draft report. If you have any questions, pleases contact Debby Shore of my staff at (202) 692-0191.

Attachments

TO: Gil Hardin
Assistant Inspector General for Audit

FROM: Lillian E. Salerno /s/ Lillian Salerno
Acting Administrator
Rural Business-Cooperative Service

THROUGH: John Dunsmir
Acting Director
Financial Management Division

SUBJECT: Audit Number 34703-0001-32
American Recovery and Reinvestment Act – Business and Industry
Guaranteed Loans – Phase 3

We have reviewed the official draft report on the subject audit. We appreciate the opportunity to provide responses on the findings and the suggested recommendations. We have included the proposed corrective actions to be implemented, including timeframes for completion.

Finding 1: Rural Development Needs to Ensure That Lenders Are Servicing Loans According to Regulation

Recommendation 1:
Develop and implement procedures that require State offices to record actions taken to obtain required documents from lenders to facilitate mitigation of any potential losses to the Government.

Agency Response:

The Agency currently has regulations, RD Instruction 4287-B, section 4287.107 and policies in place to address and attempt to mitigate any potential loss, e.g. Annual Lender Visits, borrower visits, financial reporting requirements, etc. When a borrower becomes delinquent, RD Instruction 4287-B, section 4287.145 addresses curative actions that may be taken in an attempt to satisfactorily resolve the delinquent account.

In the past the Agency has conducted Regional Training sessions. In addition, the Agency conducts on a regular basis Webinars, Teleconferences, Cluster meetings to ensure that State/National Office staff members are informed on regulatory procedures. The Agency will conduct a series of webinars prior to the end of fiscal year (FY) 2013 (September 30, 2013) to emphasize the Agency's need to obtain information to be documented in case files. The dates are identified in recommendation number 4.

Recommendation 2:
Revise existing procedures to clarify that lenders are responsible to verify and certify that sufficient tangible balance sheet equity exists at loan closing.

Agency Response:

A Procedural Notice containing the following administrative guidance is in clearance. RD Instruction 4279-B, section 4279.131(d)(3), "Prepared in accordance with GAAP simply means that the financial statements are presented in line with GAAP standards. Tangible balance sheet equity is derived from GAAP-based financial statements. The lender must provide a certification to the Agency that tangible balance sheet equity was calculated from financial statements presented in accordance with GAAP and supported by attaching a copy of the balance sheet on which the certification is based. This balance sheet must demonstrate actual tangible balance sheet equity as of the date of loan closing." The Agency created the Lender Education and Awareness Program, which is available at the following webpage; http://www.rurdev.usda.gov/BCP_BI_LEAP.html. Contained therein is a tangible balance sheet equity calculator for lenders' convenience. Additionally, the Agency is promulgating an enhanced B&I regulation. It is proposed that a debt-to-tangible net worth ratio be used as an alternative to tangible balance sheet equity. The lender may use either measure. Tangible balance sheet equity is defined as tangible equity divided by tangible assets. Formula: ((Assets - intangible assets) – liabilities)/(Assets - intangible assets). A debt-to-tangible net worth ratio is more commonly recognized by lenders. Formula: total liabilities divided by tangible net worth (total assets minus intangible assets minus total liabilities). The final rule is anticipated to be published by September 30, 2014.

Recommendation 3:
Develop comprehensive training for Rural Development's State office personnel that covers the procedures discussed in Recommendations 1 and 2 and deficiencies identified with the State office monitoring of lender servicing.

Agency Response:

During FY 2012, ten regional training meetings were held. The calculation of tangible balance sheet equity was thoroughly covered during each of these meetings. The dates of these training meetings were:

March 13-15, 2012 - Indianapolis, IN

April 10-12, 2012 - Syracuse, NY

April 17-19, 2012 - Topeka, KS

April 24-26, 2012 - Knoxville, TN

May 1-3, 2012 - Davis, CA

May 8-10, 2012	-	Olympia, WA
May 17-18, 2012	-	Atlanta, GA
May 22-24, 2012	-	Sioux Falls, SD
June 5-7, 2012	-	Salt Lake City, UT
June 12-14, 2012	-	Little Rock, AR

Future training when the enhanced Business and Industry (B&I) regulations are published as a final rule will be conducted on the enhanced regulation. Calculation of tangible balance sheet equity and debt-to-tangible net worth ratio will be included as part of that training. It is anticipated that the training will be conducted sometime in FY 15, after the publication of the final rule.

The Agency is revising its regulations and forms to provide improved delivery of the program. Agency personnel currently has available to them SharePoint which provides the Agency with the ability to share a wealth of information including success stories, best practices, newsletters, reports, etc. In recent months the Agency has ceased the renewal of Administrative Notices and Unnumbered Letters and will focus on making this information available through its regulation enhancement which is in circulation for approval and final publication.

In January 2013, the Agency conducted planning meetings as it relates to processing and servicing training needs for its personnel for this fiscal year. The Agency is planning to conduct at a minimum four training webinars for the fiscal year and provide additional training to State Office personnel on loan processing and servicing issues. The proposed dates of these webinars are April 18, 2013, May 15, 2013, June 19, 2013, and July 10, 2013. Agenda items will emphasize documentation required from lenders and tangible balance sheet.

Recommendation 4:
Verify that all Recovery Act-funded borrower visits have been performed. For any borrower visits that have not yet been performed, expedite scheduling and inform lenders of the schedule. Conduct and document the borrower visits, as required.

Agency Response:

RD Instruction 4287-B, section 4287.107(f) states in part that all borrower visits should be scheduled during the first year of operation after issuance of the Loan Note Guarantee. For all current borrowers, a field visit should be done at least once every 3 years. Based on the Guaranteed Loan System (GLS) dated March 12, 2013, GLS074 borrower visit indicates that 99 percent of all the annual borrower visits have been made in the first year in accordance with the regulations. The State Offices have been contacted concerning completing borrower visits in accordance with the regulations. It will be emphasized at the upcoming proposed training dates of April 18, 2013, May 15, 2013, June 19, 2013, and July 10, 2013, monthly Rural Business-Cooperative Service (RBS) teleconferences etc.

Recommendation 5:

Review the two loans with guarantees (of $2 million and $600,000) to verify that all proper servicing actions have been taken, and take additional servicing actions if needed.

Agency Response:

On February 21, 2012, the Arizona RD State Office contacted the borrower of the $2 million B&I guaranteed loan as a means to a follow-up regarding the Office of Inspector General's (OIG) findings after their review of the ARRA funded guaranteed loan. On April 30, 2012, the Arizona RD State Office put the lender of record on notice that failure to comply with the requirements outlined in the Lender's Agreement could be considered negligent servicing and the Loan Note Guaranteed may be commensurately reduced as a result. On March 8, 2013, the National Office contacted the Arizona RD State Office concerning this loan and has been informed that, OIG has been provided all of the requested information concerning this guaranteed borrower. In addition, the borrower is current and performing in accordance with its signed Loan Agreement and Agency regulations.

On February 28, 2013, the Mississippi RD State Office was in receipt of the lender's liquidation plan as it related to the $600,000 guaranteed loan. The Mississippi RD State Office has reviewed the liquidation plan as in accordance with RD Instruction 4287-B, section 4287.157(d). On March 12, 2013, the State Office Loan Committee met to approve the lender's liquidation plan as presented. Thus far, the servicing actions taken by the State Office appear to be in accordance with Agency regulations.

Finding 2: Rural Development Incorrectly Reported Small Business Participation

Recommendation 6:
Develop and implement instructions to guide staff when conducting the small business review process to enhance the accuracy of the agency's reporting on small business participation.

Agency Response:

The unnumbered letter dated January 18, 2013, "Rural Business and Cooperative Programs Performance and Accountability Report Performance Measures," states, in part: "Previous guidance stated that an applicant shall be identified in GLS in one of the categories listed in GLS (farmers/ranchers, businesses, small businesses, individuals, etc.) This previous guidance is hereby rescinded. The term "businesses" will be considered a primary measure and will be used as a common term to describe all sizes and types of business entities, enterprises, organizations, and individual entrepreneurs. This general definition of the term "businesses" will be applied consistently across all RBS programs. . . . For B&I loans, the borrower's business and other businesses directly assisted . . . will be entered in GLS in the "businesses" data field (primary measure) on the BP Facility/Project Information screen and further described as farmers/ranchers, small businesses, individuals, or cooperatives, (secondary measure)." Guidance on performance measures is issued annually. We will include the following guidance in the FY 2014 performance measures: To determine if your borrower is a small business, it must meet the Small Business Administration (SBA) definition of a small business. SBA defines a small business concern as one that is independently owned and operated, is organized for profit, and is not dominant in its field. Depending on the industry, size standard eligibility is based on the average number of employees for the preceding 12 months or on sales volume averaged over a 3-year period. Please review the North American Industrial Classification System code provided by the borrower to ensure that it is correct before making the determination. The following link will connect you to the SBA webpage. http://www.sba.gov/content/what-sbas-definition-small-business-concern

Anticipated issuance of the FY 14 performance measures unnumbered letter is January 31, 2014.

Recommendation 7:
Develop and implement instructions that specify only reasonable and verifiable direct jobs created or retained within a specified timeframe are to be entered into GLS and used for reporting.

Agency Response:

The unnumbered letter dated January 18, 2013, “Rural Business and Cooperative Programs Performance and Accountability Report Performance Measures,” contains detailed guidance on how to count and verify jobs created and saved. The guidance begins on page 3 and continues through page 5. Guidance on recording these jobs in GLS is on pages 6 and 7. We did not paste the guidance here due to its length. Guidance on performance measures is issued annually.

If you have any questions, please contact Pandor H. Hadjy, Deputy Administrator Business Programs, at (202) 720-7287.

Informational copies of this report have been distributed to:

Acting Administrator, Rural Business-Cooperative Service
Attn: Agency Liaison Officer

Government Accountability Office

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

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