



Memorandum from the Office of the Inspector General

August 16, 2007

John J. Bradley, OCP 2A-NST

FINAL REPORT – INSPECTION 2007-512I – REVIEW OF TENNESSEE VALLEY
AUTHORITY'S ECONOMIC DEVELOPMENT LOAN PROGRAM

Attached is the subject final report for your review and action. Your staff's informal comments to the draft report have been incorporated. Please advise us of your planned actions in response to our findings within 60 days of the date of this report.

Information contained in this report may be subject to public disclosure. Please advise us of any sensitive information in this report that you recommend be withheld.

If you have any questions, please contact Richard C. Underwood, Project Manager, at (423) 751-3108 or Gregory C. Jaynes, Deputy Assistant Inspector General, Inspections, at (423) 751-7821. We appreciate the courtesy and cooperation received from your staff during this review.

Ben R. Wagner
Deputy Inspector General
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OIG File No. 2007-512I



Tennessee Valley Authority
Office of the Inspector General

Inspection Report

REVIEW OF TVA'S ECONOMIC DEVELOPMENT LOAN PROGRAM

Project Manager
Rick C. Underwood

2007-512I
August 16, 2007

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EXECUTIVE SUMMARY

Economic development (ED), along with energy production and environmental stewardship, is one of the integrated purposes of TVA. TVA's ED goals are to increase capital investment and attract and retain better-paying jobs for the TVA service area.

To aid in achieving these goals, ED currently has four types of loan programs: (1) Special Opportunity County (SOC) - established in 1981 to stimulate economic development and create jobs in the region's poorest, least developed rural areas; (2) Economic Development Loan Fund (EDLF) - established in 1995 to promote economic expansion, encourage job creation, and foster the increased sale of electricity by TVA and its power distributors; (3) Minority Business Development Loan Fund (MBDLF) - established in 1991 as the Valley Investment Fund to promote growth and development of socially and economically disadvantaged businesses in the region; and (4) Business Incubator Tenant Loan Fund (Incubator) - established in 1997 to help young businesses meet their short-term needs for cash flow and operating capital.

Our objectives during this review were to (1) determine if TVA's ED loans are being executed and administered in accordance with TVA policies and procedures and (2) assess loan defaults to identify any actions taken in approving the loans which could have contributed to the defaults. In summary, we found:

- Management has not fully implemented procedures governing the loan administrative process, after closing, as agreed upon in response to Audit 2004-011F.
- Noncompliances with ED loan guidelines were identified in 13 of 42 loan files reviewed.
- Uncollectible ED loans were not written off in a timely manner as required by Generally Accepted Accounting Principles.
- Explanations provided by ED management for 10 of the 13 loan files where noncompliances were noted indicated that the Loan Approval Committee made exceptions and approved loan applications even though they were not in compliance with program guidelines. Of these 10 loans, 5 were identified as being in default status indicating that departure from guidelines could potentially contribute to loan defaults. Other than that, our review noted no specific trends in the loan files that appeared to contribute to loan defaults.

In addition, at ED's request, we reviewed ED's draft Loan Manual and identified improvement opportunities.

We recommended the Executive Vice President, Customer Resources (1) complete development and implementation of loan procedure guidelines; (2) ensure compliance with guidelines or require documentation of deviations including analyses, justifications, and other supporting information; (3) submit uncollectible loans for write-off in a timely manner; and (4) consider our suggestions to improve the draft Loan Manual.

ED management provided informal comments on a draft of this report and generally agreed with our findings. Where appropriate, we clarified the report and/or included management's comments. ED management also generally agreed with our recommendations and noted that since conclusion of our fieldwork, the Loan Manual has been completed and was approved by the Loan Committee on August 13, 2007.

Management deemed that one of the loans reviewed and found to have items of noncompliance should not have been included in our review because it was not considered by the Loan Committee and was not a part of the four loan types evaluated. ED management also disagreed with our identification of another loan as noncompliant. They stated that the guidelines, by which we found the loan to be noncompliant, had been changed in the late 1990s with advice from the Office of the General Counsel.

BACKGROUND

Economic development (ED), along with energy production and environmental stewardship, is one of the integrated purposes of TVA. The goals of ED are to increase capital investment and attract and retain better-paying jobs for the TVA service area. ED's website notes that "TVA Economic Development offers a number of financing services and options to help new and existing companies with the financial resources they need to locate or expand in the Tennessee Valley." ED currently has four types of loan programs to assist in accomplishing their goals: (1) Special Opportunity County (SOC) - established in 1981 to stimulate economic development and create jobs in the region's poorest, least developed rural areas; (2) Economic Development Loan Fund (EDLF) - established in 1995 to promote economic expansion, encourage job creation, and foster the increased sale of electricity by TVA and its power distributors; (3) Minority Business Development Loan Fund (MBDLF) - established in 1991 as the Valley Investment Fund to promote growth and development of socially and economically disadvantaged businesses in the region; and (4) Business Incubator Tenant Loan Fund (Incubator) - established in 1997 to help young businesses meet their short-term needs for cash flow and operating capital.¹

For fiscal years (FY) 1998 through 2006, on average there were 42 loans originated per year totaling about \$15.68 million as follows.

- Twenty-one EDLF loans originated per year totaling \$12.6 million.
- Five MBDLF loans originated per year totaling \$1.3 million.
- Seven SOC loans originated per year totaling \$1.6 million.
- Nine Incubator loans originated per year totaling \$180,000.

As of February 28, 2007, ED documentation showed 223 loans were outstanding with a balance of about \$64.8 million, as shown in Table 1. According to ED management, "since the EDLF program was originated in 1995, Economic Development has originated over 400 loans totaling slightly over \$200 million in loans (EDLF, MBDLF, and SOC). These loans brought significant benefit to the Valley economy, as they resulted in over 59,000 announced jobs and over \$3.9 billion in leveraged capital investment. If loan write-offs during this 12-year period had been in accordance with generally accepted accounting standards from 1995 through 2007, loan losses would total approximately \$8 million. This is an overall loss rate of approximately 4 percent, and that number could decline as recoveries are made."

¹ The Incubator is a revolving fund which was capitalized at \$500,000, and the maximum loan amount that can be made to an Incubator tenant is \$25,000 for a term of one year.

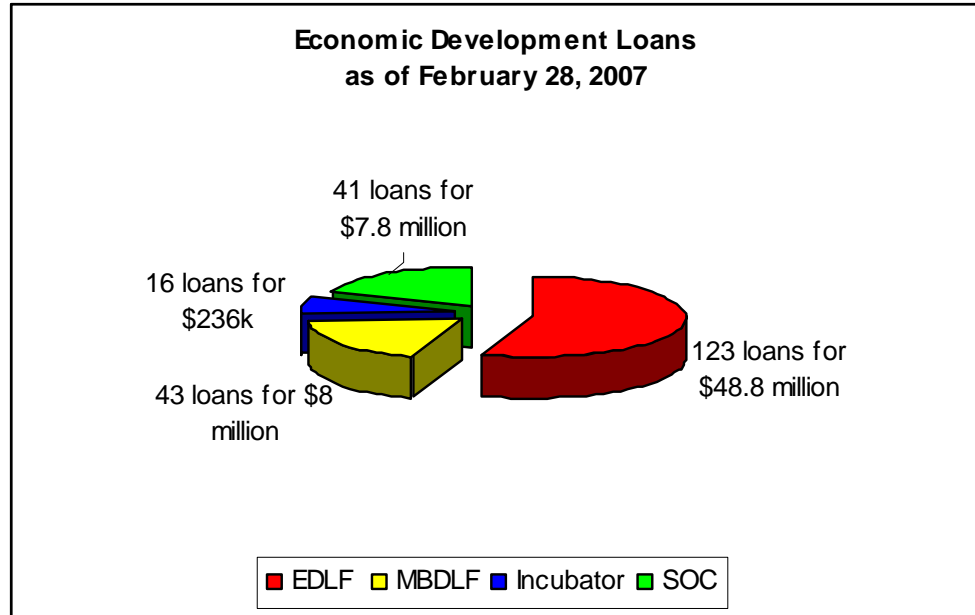


Table 1

In addition, the allowance for doubtful account (AFDA) reserve balance was about \$7 million, while the collection of 21 loans² with balances totaling about \$8.5 million³ has been determined doubtful. Specifically, allocations to the AFDA have totaled about \$9.1 million and loans totaling \$2.1 million have been written off. About \$2.7 million of the \$7 million AFDA reserve represents specific allocations for three doubtful Valley Management, Inc. (VMI) loans.

On November 13, 1991, TVA entered into a cooperative agreement (Contract TV-86208V) with VMI to manage and invest the program funds. In part, the agreement provided for (1) VMI to develop guidelines, subject to TVA's approval, for administering the program and (2) the establishment of an Investment Committee to approve investments. However, when questioned regarding loan files for loans initiated by VMI still shown as receivable on the financial statements or identified as being in default status, ED stated it had limited control over VMI actions during that time period. Effective January 26, 1998, the agreement with VMI was terminated.

² This includes four VMI loans totaling \$3.1 million.

³ According to ED management, loans totaling approximately \$1.4 million are candidates for restructuring.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objectives during this review were to (1) determine if TVA's ED loans are being executed and administered in accordance with TVA policies and procedures and (2) assess loan defaults to identify any actions taken in approving the loans which could have contributed to the defaults. To achieve our objectives, we:

- Interviewed ED personnel to determine the loan process, loan guidelines, and policies and procedures currently in place for approval of loans.
- Reviewed the ED criteria for each loan type to determine the approval guidelines and required qualifications for all loans.
- Reviewed current loans outstanding in each program type to determine (1) the number of loans, (2) the amount approved for each loan, and (3) the current balance outstanding for each loan.
- Reviewed loan defaults, as well as any reasons for default, to identify any actions taken in approving the loans which could have contributed to the default.
- Selected a judgmental sample of 47 loans for testing against identified criteria. These loans had the following characteristics:

Loan Type	Number of Loans	Loan Origination Amounts
EDLF	10	\$9,465,000
MBDLF	4	\$1,206,00
Incubator	2	\$50,000
SOC	8	\$2,145,000
Default	23	\$12,327,010
Totals	47	\$25,193,010

We determined that 5 of the selected default loans, representing about \$3.2 million, were originated by VMI and were addressed in a previous OIG Audit Report 98-008P. Therefore, we excluded these loans from our compliance testing. We reviewed 42 loan files and other supporting documentation to assess compliance with the following investment guidelines.

Criteria Used to Review EDLF Loans
The loan amount did not exceed \$2,000,000.
Loan made for use within TVA power service area.
Loan made to a local government, power distributors, established economic development organizations, or private sector companies with cooperation by a local economic development entity.
Loan used to purchase fixed assets, spec building, industrial park—not to be used for working capital.
Three to one leveraging.
One job created or retained for every \$5,000 invested by TVA.
Loan term not more than seven years for equipment, ten years for real estate.
Loan at below market rate.

Criteria Used to Review MBDLF Loans
The loan amount did not exceed \$500,000.
Loan within TVA region.
Direct loans for fixed assets, other arrangements for working capital, contract financing, loan guarantees, and participatory loans.
At least 51 percent ownership and control by one or more qualified member(s) of a socially and economically disadvantaged group.
One to one leveraging.
One job created or retained for every \$20,000 invested by TVA.
Loan term not more than seven years for equipment, ten years for real estate.
Loan at below market rate.
Loan recipient must demonstrate economic, social, or actual disadvantage.

Criteria Used to Review SOC Loans
The loan amount did not exceed \$500,000.
Loan was made to borrowers located in distressed rural counties, as defined by TVA.
Loans to be used for buildings, plant equipment, infrastructure, or real estate.
The loan was funded by appropriations.
Three to one leveraging.
One job created or retained for every \$10,000 invested by TVA.
Loan term not more than seven years for equipment, ten years for real estate.
Loan at below market rate.
Loan secured with fixed assets.
Recent appraisal of collateral which indicates fair market value.
TVA funding does not exceed 25 percent of project cost (if industrial park or building, not to exceed 50 percent).

Criteria Used to Review Incubator Loans
Loan amount does not exceed \$25,000.
Loan term does not exceed one year.
Loan rate equals prime minus 2 percent.
Loans to be used for fixed assets or working capital.
Loan request supported by purchase orders, invoices, or accounts receivable.
Tenant has no more than one loan outstanding.
Incubator manager recommends tenant for the loan.
Incubator receives \$100 origination fee.
TVA lends to incubator, not tenant.

This inspection was conducted in accordance with the "Quality Standards for Inspections."

FINDINGS AND RECOMMENDATIONS

Our review of selected loans found (1) management has not fully implemented formal procedures, as agreed upon in a previous audit; (2) noncompliances with ED loan guidelines in 13 of 42 loan files reviewed; (3) uncollectible ED loans were not written off in a timely manner as required by Generally Accepted Accounting Principles (GAAP); and (4) explanations provided by ED management for 10 of the 13 loan files where noncompliances were noted indicated that the Loan Approval Committee made exceptions and approved loan applications even though they were not in compliance with program guidelines. Of these 10 loans, 5 were identified as being in default status indicating that departure from guidelines could potentially contribute to loan defaults. Other than that, our review noted no specific trends in the loan files that appeared to contribute to loan defaults. In addition, we reviewed ED's draft Loan Manual and identified improvement opportunities.

ED MANAGEMENT HAS NOT FULLY IMPLEMENTED AGREED-UPON MANAGEMENT ACTIONS AS NOTED IN AUDIT 2004-011F

We recommended in Audit 2004-011F that ED develop procedures governing the loan administrative process after closing. ED management agreed and stated that the procedures governing the loan administration process would be completed within the first six months of FY 2005. In addition, a concise flowchart would be developed to show all parties the documentation and closing process. However, as of April 6, 2007, the process had not been formally documented and approved by senior ED management. ED management did provide us with a draft Loan Manual.

In response to this finding, ED management stated that, “a significant amount of time was invested in dissecting the loan process through ‘lean office’ exercises. Every step of the loan process was diagrammed and analyzed and significant changes resulted from that exercise. The loan manual reflects the results of that exercise but does not show all of the analysis that led to those results. So the loan process has been well documented, though formal adoption has been slower due to significant process improvements and reductions in personnel.” They also stated that the draft loan manual had been approved by the Loan Committee on August 13, 2007.

ITEMS OF NONCOMPLIANCE WERE IDENTIFIED IN LOAN FILES REVIEWED

We found items of noncompliance with identified criteria in 13 of the 42 loan files reviewed. To identify criteria to use in our testing of loan files, we reviewed previous audits and information on the ED website. Through these reviews, we identified guidelines used for approval of loan applications made through the ED loan program. We noted that there are different guidelines for each of the four different types of loans under the program. The criteria used in our analyses were communicated to ED management prior to our testing.

Our review included 10 EDLF, 4 MBDLF, 8 SOC, and 2 Incubator loans that were judgmentally selected. We also reviewed 18 loans ED deemed in default status. The defaulted loans represented 12 EDLF loans and 6 MBDLF loans. Specific results pertaining to our review of the EDLF, MBDLF, and SOC loans are documented in appendices A, B, and C. Some of the noncompliances identified included loans that (1) were used for purposes outside of the loan criteria, (2) did not meet job creation or retention standards, (3) did not meet leveraging or total project cost provisions, and (4) exceeded program amount guidelines. In addition, 10 of the 13 loans were approved even though they did not meet guidelines, as discussed later in this report. Our review of the 2 selected Incubator loans identified no noncompliances.

In response to this finding, ED management noted that:

- One of these 13 was not considered by the Loan Committee and was not a part of any of the four loan types evaluated in this review.
- In the case of one entity, a strong argument can be made that funding plant restart is within the spirit of the EDLF guidelines. ED, in fact, had been communicating that permanent working capital is an allowable use of funds if secured with fixed assets.

- The job creation or retention guideline of one job for every \$5,000 invested by TVA was in effect from March 1995 until December 2005. As a result, 1 of the loans identified as not meeting job creation or retention standards met revised guidelines in effect at time of approval.
- One of the loans was in compliance since ED management decided in the late 1990s, based on advice from the Office of the General Counsel (OGC), to lend directly to companies without requiring a third-party “cooperator.”

In summary, it appears that loan approvals and administration have been based on factors other than approved guidelines. ED management was unable to provide us with any documented or approved changes made to the guidelines we used for our testing. In addition, our review of loan files noted that documentation of reasons decisions are made is lacking.

LOANS ARE NOT WRITTEN OFF IN A TIMELY MANNER AS REQUIRED BY GAAP

While we recommended in Audit 2004-011F that ED write off loans that are uncollectible, we found loans are not being written off in a timely manner as required by GAAP. Specifically, ED management provided documentation indicating that they had made specific reserves for 10 loans in the Allowance for Doubtful Accounts (AFDA) in the amount of about \$4.6 million. Reserves for all 10 of these loans were made in April 1999 or earlier. Of these 10 loans, 3 with combined balances of about \$2.7 million are still included in the balance of Loans & Other Long-Term Receivables on TVA’s financial statements. These 3 loans were all addressed in Audit Report 98-000P.

- One loan for \$1.35 million dollars was identified uncollectible at that time.
- A second with a remaining balance of \$855,306 as of October 31, 1997, was identified as having considerable uncertainty as to the collectibility of the loan if certain negotiations the company was in were unsuccessful. This loan was still shown on TVA’s financial statements as a receivable for \$855,306 as of January 2007.
- The third loan with an outstanding balance of \$498,090 as of October 31, 1997, was identified as being collectible. However, in April 1999 a specific reserve was made for a remaining balance of \$491,830, and that amount still appeared on the financial statements as a receivable as of January 2007.

All three of these loans appear to have been presented to the OGC for write-off. In these cases, the OGC advised the loans could not be viewed as legally uncollectible. Authoritative accounting guidance does not address the legal collectibility of loans, but rather requires that credit losses for loans and trade receivables (which may be for all or part of a particular loan or trade receivable) should be deducted from the allowance. The related loan or trade receivable balance should be charged off in the period in which the loans or trade receivables are deemed uncollectible. Recoveries of loans and trade receivables previously charged off should be recorded when received.⁴

ED loan schedules also showed several other loans which have been deemed as uncollectible and in default status where no payment has been received for several years.

Management generally agreed that loans should be written off in a timelier manner.

LOAN APPROVALS FOR APPLICATIONS NOT IN COMPLIANCE WITH GUIDELINES MAY POTENTIALLY CONTRIBUTE TO DEFAULTS

Of the 13 noncompliant loans identified in the 42 loans we reviewed, we identified 10 where ED management provided explanations indicating that the Loan Committee had made exceptions to program guidelines in these cases. ED management provided the following in their response to our identified instances of noncompliance with the identified loan approval guidelines:

TVA Economic Development's loan program guidelines are intended to provide a common framework for decision-making and are not intended to be absolute measures for deciding loan size. Job creation and leveraging guidelines are intended to ensure that projects have an economic development purpose and are intended to help determine a ballpark loan amount before substantial time and effort are put into a loan request. As a general rule, projects should meet or be relatively close to meeting guidelines, but overriding circumstances may influence the Loan Committee to approve less or more than would be awarded under a strict interpretation of the

⁴ Statement of Position 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, issued by the AICPA's Accounting Standards Executive Committee in December 2001.

guidelines. Examples of overriding circumstances that could influence the Loan Committee might be:

- *The project is a good economic development project and TVA funds are essential to making the project happen.*
- *The project is strong in at least one of the categories of jobs created, capital investment leveraged, or power load added but falls short of the guidelines in other areas.*
- *Either TVA collateral or the loan guarantor is exceptionally strong.*
- *The loan is in a targeted sector or is in a geographic location that badly needs an economic development project.*
- *The borrower may have a procurement contract with TVA.*

Other circumstances could influence the committee's decision, but the reasons listed above are the most common.

For the 10 loans in which the Loan Committee made exceptions, 5 (or 50 percent) were identified as being in default status based on information provided by ED management. While we noted no specific trends in the loan files reviewed for those loans identified as being in default status, the high level of defaults in this group indicates that approving loans not in compliance with program guidelines may potentially contribute to defaults.

With regard to the 13 noncompliant loans we identified, ED management deemed that the number of noncompliant loans should be 12 rather than 13. Specifically, they deemed one loan to be compliant because ED management decided in the late 1990s, based on advice from the OGC, to lend directly to companies without requiring a third-party "cooperator."

OTHER OPPORTUNITIES FOR IMPROVEMENT

After reviewing the draft Loan Manual, ED management requested that we provide them with any suggestions and/or observations. We identified potential areas for improvement which included:

1. For the various types of loans, the Loan Manual states: “Exceptions to the criteria will be determined by the Loan Committee and will be based on positive economic development impact to the local or regional economy.”

ED should require the reasoning and any financial justifications for exceptions to loan guidelines be documented. The Loan Manual could be used to indicate what documentation is required for exceptions and where the documentation is to be maintained.

2. Section IV.F. states: “The present value of the five- and ten-year revenue streams are important considerations in determining the loan interest rate.” However, there does not appear to be any requirement that this analysis be documented.

With regards to our observation, ED management noted that these are documented in the form of an Excel worksheet which is uploaded into DealStream. Various interest rate scenarios may be inserted into the model to see the impact of the interest rate on the projected revenue stream. However, we believe the Loan Manual could be used to indicate what documentation is required and where the documentation is to be maintained.

3. Section V.G. states: “TVA uses Credit Risk Modeling (CRM) contained in *Moody’s Financial Analyst* to aid in determining the credit worthiness of the borrower.” However, there are no documented criteria identifying what risk scores and/or bond equivalent ratings are acceptable. In addition, this section does not require documentation of this evaluation or its results.

With regards to this observation, ED management stated that financial spreads, ratios, risk scores, etc., are uploaded into DealStream. With participations, they also typically receive the bank officer’s analysis, which is also uploaded into DealStream.

We suggest that the Loan Manual document criteria indicating which risk ratings and bond equivalent ratings are acceptable and those that are not. In addition, we believe the loan manual could also indicate where the documentation of the analysis of credit worthiness and reasons for decisions made are to be maintained.

4. Under section XI., Business Incubator Tenant Loan Fund, there is nothing requiring that the incubator manager making the loan decision be independent of tenant businesses prior to making loan decisions.

ED management should modify Incubator program requirements to include that the incubator manager certify that he/she has no financial or other interest in the tenants of the incubator.

ED management agreed with this suggestion.

5. In general, the proposed Loan Manual does not require documentation of loan decisions or approvals be documented or that information used to make decisions be documented. For example, in our review of selected loan files, we noted loan interest rates changed with no documentation of the reason for the change or approval of the change in the loan file.

In response to this observation, ED management noted that decisions and recommendations have always been documented through the Loan Committee minutes, but the Loan Manual did not reflect that so an addition will be made. They also stated that they would add to the Loan Manual that minutes will document reasons for loans approved that vary from guidelines.

We suggest the Loan Manual require documentation of decisions in all other instances not specifically referenced above.

RECOMMENDATIONS

We recommended the Executive Vice President, Customer Resources:

- Complete the development and implementation of ED loan process procedures, as agreed upon in response to a previous audit.
- Ensure compliance with ED loan guidelines, or require that any deviations/ acceptances and supporting documentation, justifications, analyses, and approvals be documented and maintained in the loan files.
- In cooperation with the Controller and OGC, ensure that ED loans identified as uncollectible are submitted for write-off in a timely manner.
- Consider our suggestions for incorporation into the Loan Manual.