

LEGISLATIVE AUDIT COMMISSION



Management Audit
Regulation of Grain Dealers and Warehousemen and
the Administration of the Grain Insurance Fund

December 2003

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RECOMMENDATIONS - 10

NOT ACCEPTED - 2
PARTIALLY ACCEPTED - 1
ACCEPTED - 7

Background

The Department of Agriculture has had the responsibility for licensing and regulating grain dealers and warehouses since the Grain Dealers Act was created in 1967. Warehouses provide facilities to store grain until the producer decides to either sell or use the grain, while grain dealers provide producers with a ready market in which to sell grain. As of February 2003 there were a total of 423 State licensed grain dealers and warehouses with 1,148 locations and a storage capacity of over one billion bushels.

Grain dealers and warehouses may close for many reasons, including voluntarily surrendering their license, selling the facility, merger/consolidation, or forming a new entity. The number of closings in 2000 was 25. In 2002, there were 24 closings. Of these closings, only one or two met the definition of a failure.

In 1983, the Illinois Grain Insurance Act created a pool (Grain Insurance Fund) funded by the licensed participants, to be used to cover claims in the event of a grain dealer or warehouse failure. In August 2001, Ty-Walk Liquid Sales, Inc. failed, leaving approximately \$9 million in claims to be paid by the Grain Insurance Fund (GIF). The Grain Code states that if amounts in the Fund are insufficient to pay all valid claims, the General Assembly shall appropriate amounts sufficient to satisfy the valid claims. \$4 million was transferred from GRF to the GIF to pay these claims.

The Department of Agriculture's system of regulation and oversight includes licensing and examination requirements. State law and the Administrative Code contain specific requirements for licensing and examining grain dealers and grain warehouses. The Grain Code also contains provisions that allow for corrective actions and penalties related to violations of the Code, financial deficiencies, administrative penalties, and suspension and revocation of a license.

The Department's responsibilities regarding the process of liquidation and adjudication of claims in the event of a failure are delineated in the Grain Code and Administrative Code, including specific timelines for submitting claims and determining compensation. The

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Grain Code requires the Department to determine the validity, category, and amount of claims within 120 days after the date of failure. It also requires that the claimant be compensated within approximately 180 days of the failure. It took an average of 227 days for Ty-Walk claimants to be compensated. Ashley Elevator claims took on average 156 days. Department officials noted that the Ty-Walk process was slowed because the licensee was forced into involuntary bankruptcy. As of June 30, 2003, more than \$31.7 million was paid to 281 Ty-Walk claimants. Five claimants—banks and other entities that held collateral warehouse receipts for grain—received 76% of the total payout. Producers received \$7.6 million of the payout.

PA 93-225, effective July 21, 2003, made several changes to the Grain Code that should assist the Department in its regulation and oversight of grain dealers and warehouses. The Act also contained changes for the GIF including two new assessments.

On December 11, 2002, the LAC adopted Resolution #125 which directed the Auditor General to conduct a management audit of the Department of Agriculture and the Grain Insurance Corporation with regard to the regulation of grain dealers and warehousemen and the administration of the Grain Insurance Fund.

Report Conclusions

Audit Commission Resolution #125 asked the Auditor General to determine the following:

- Whether there are sufficient resources in the Grain Insurance Fund, and if shortages exist, the plans to obtain funds needed to pay valid claims;
- Whether the rules established for processing claims filed against grain dealers and warehousemen who choose or become insolvent are adequate; and
- Whether oversight of grain dealers and warehousemen, including the conduct of any audits, site examinations, or other reviews, is sufficient to protect the interests of grain producers, other grain dealers and warehousemen, and the State.

Obviously in the case of the Ty-Walk closing, there were insufficient resources in the Grain Insurance Fund to pay all claims. There was a transfer of \$4 million from GRF, and no funds have been repaid to the GRF as of June 2003. The audit recommends that the Department periodically evaluate the GIF's capacity to pay claims. A new law adds two new assessments (a grain seller initial assessment and a lender assessment), but both assessments require the licensee to notify, collect or remit the assessment to the Department. It may be difficult to ensure the proper amount of assessments is being received since the Department does not receive or keep detailed information regarding grain purchases or person holding collateral warehouse receipts. The Department should implement controls to ensure the correct amount is assessed and collected.

Regarding the second directive concerning the processing of claims, the audit found that the Department lacked specific procedures, other than those in the Grain Code, to determine a valid claim. Additionally, the Department needs to develop procedures to

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ensure that timelines relating to claims are met, even in the case of bankruptcy of the licensee.

Concerning directive three, the Department of Agriculture's system of regulations and oversight includes licensing and examination requirements for grain dealers and grain warehouses. There are administrative rules that allow for corrective actions and penalties related to violations of the Grain Code, financial deficiencies, administrative penalties, and suspension and revocation of a license.

When an application for grain dealer or warehouse license is received, the Department conducts several checks. They calculate the current ratio of assets to liabilities (which must be at least 1:1) and the adjusted debt to equity (no more than 3:1). For license renewals, if the financial ratios are not sufficient, the applicant may post collateral in an amount to meet the financial requirements.

The Department checks to see that the license applicant has insurance and whether the most recent audit of the licensee contained a qualified opinion. The audit found that in 20 of 30 cases reviewed, only one Department employee completed the financial analysis, reviewed the application, and approved the license applications. In all 30 cases, there was no evidence that the Department had conducted background checks of the applicants to determine if the applicant's license (including the officers, directors, partners, or managers) had been terminated or revoked by the Department, the United States, or any other State within the last two years.

The Department is required to conduct an examination and inspect each licensed grain dealer and grain warehouse at least once each calendar year. All licenses received at least one subsequent examination during 2002. The average amount of time between completion of the subsequent exam and when the Department's central office personnel reviewed the exam was 28.5 days. The Ty-Walk review took 79 days, late in 2001. There are no formal written guidelines regarding supervisory review or timelines in which the review should be conducted. Additionally, there are new exam requirements established in PA 93-225.

The Bureau had 23 employees conducting field exams of licensees and one who reviewed the exams. The Department has not established training requirements for new examiners or a formal written training plan. Each examiner files a conflict of interest statement to disclose potential conflicts, but those conflicts were not always taken into account.

The Department has several courses of action it can take to correct violations of the Grain Code including: issuing a memorandum of Adjustment, assessing financial penalties, requiring collateral, increasing reporting requirements, suspending or revoking a license, and criminal prosecution. However, the system of corrective actions and monitoring is inconsistent, and there are no formal written guidelines regarding when a licensee should be placed on an accelerated exam schedule, be required to file an audit within 60 days of the end of the fiscal year, or be required to file additional reports. There were no licenses revoked between 1999 and 2002.

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Recommendations

- 1. Ensure that all license applications and related financial analyses are reviewed and approved by a supervisor; conduct background checks of all license applicants including its officers, directors, partners, and managers; track officers, directors, managers, and partners of former licensees that have had their licenses terminated or revoked or undertaken other improper business practices.**

Findings: The Department's system of regulation and oversight includes licensing and examination requirements. The auditors tested 20 closings in 2001 and 2002 and 10 grain dealers and warehouses with licenses issued in 2002. Of the 30 cases, 11 had collateral posted for a total of \$2.6 million and ranging from a low of \$4,283 to a high of about \$719,000. Requiring licensees to post collateral demonstrates that the Department is determining which licensees are financially weak. The auditors also found the following:

- In 20 of 30 cases, only one Department employee completed the financial analysis, reviewed the application, and approved the license application. In 10 of the cases there was a second review; and
- In all 30 cases, there was no evidence that the Department had conducted background checks of applicants.

Response: Partially accepted. The Department will assure that all license applications and related financial analyses are reviewed and approved by more than one employee of that Bureau and/or the Division of Agriculture Industry Regulation which oversees that Bureau.

The Department of Agriculture is unable to conduct background checks of all licensed applicants including its officers, directors, partners, and managers simply due to the enormity of this recommendation. The Department roughly estimates that we would have to perform background checks on approximately 4,000 individuals to comply with this recommendation. We do not have the resources to devote to this process. However, the Department will perform background checks on managers of newly licensed entities pursuant to the newly enacted statutory authority provided for in the most recent amendment to the Grain Code.

The Department will attempt to formalize and memorialize existing standard operating procedures, which identify persons whose licenses have been terminated, revoked, and have improperly manipulated books and records or undertaken other improper business practices that may arise as part of the business dealings of persons who have been criminally prosecuted.

- 1. Consider the following:**
 - **engaging the services of accounting experts and grain risk management experts; and**

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- **establishing a time limit and guidelines for examinations, and documenting supervisory review of the examinations;**
- **Establishing guidelines for notification of successor agreements and closeout examinations;**
- **requiring at least one board member to be present at exit conferences and sign the examination certification form;**
- **providing copies of examinations to board members, directors, and owners of licenses; and**
- **promulgating rules to implement the new examination process delineated in Public Act 93-225.**

Findings: The Department is required by law to conduct an examination and inspect each licensed grain dealer and grain warehouse at least once each calendar year. All examinations are unannounced. In addition to performing a physical inventory and financial analysis, examiners perform several types of procedures and reviews to verify financial information and check compliance with grain regulations.

Upon completion of an examination, the examiner electronically submits the exam to the Department's central office. An examiner at the central office reviews the examination and completes an exam review form. If the examination has any problems, it is forwarded to one of two supervisors for sign-off. There are no written policies and procedures for the supervisory review process that show how the review should be conducted, the steps taken in the event of a problem or who must review each type of examination.

In the case of the failed grain dealer, Ty-Walk, on July 16, 2001 an auditor hired by one of the banks that held collateral warehouse receipts performed a collateral audit of Ty-Walk's books and records and concluded that the company was short physical grain inventory to cover its total storage obligations. On July 31, 2001, the Department sent an examiner to begin to complete investigation and perform a full examination of all books and records, including physical inventory. The examination required six examiners and was not fully completed by the time of the failure on August 23, 2001.

When a licensee closes or is bought through a successor agreement, a closeout examination is performed. The auditors noted that some closeout exams were not being conducted prior to the company closing or a successor agreement being in effect.

Response: Accepted. The Department will consider engaging the services of accounting experts and/or grain risk management experts when the occasion arises, utilizing funds in the newly created regulatory control fund as provided in the most recent Grain Code changes. The Department has established time limits and guidelines for examinations based on a historical review of each licensee's examination findings and results and will reduce these to formal written procedures. The Department will formalize and memorialize

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Accepted - continued

existing guidelines for the performance of closeout examinations and the execution of successor agreements in the event of a succession from one licensee to another.

The Department engages all licensees' boards of directors or principal officers in both entrance and exit conferences. The Department does provide copies of examinations to board members, directors, and owners of licensees upon attendance at exit conferences. The Department offers the entrance conference document as evidence that we attempt to actively engage all board of directors and principal officers in the examination review process during the exit conference. The Department will change the examination certification form to require signature of the manager and a member of the board of directors or principal officer of the licensed entity.

- 3. Provide training to examiners in grain accounting and fraud detection; track training received by examiners; and identify potential examiner conflicts of interest by requiring examiners to file an annual statement or a statement prior to each engagement.**

Findings: As of July 2003, the Bureau of Warehouses had 24 examiners, 23 who conducted field exams of licensees and one who reviews the exams in the Springfield office. In addition, there were two Public Service Administrators that supervise the work of the examiners.

The Department does not have training requirements for new examiners or a formal written training plan. The Department does not track training examiners receive. Additionally, each examiner files a conflict of interest statement to disclose potential impairments. However those conflicts are not always taken into account, and there were potential conflicts of interest that were not reported. Nine examiners conducted 32 exams of licensees that they listed as having a conflict between 1994 and 2003.

Response: Accepted. The Department will provide additional training to examiners in grain accounting, and we will attempt to identify available fraud detection training to examiners at the earliest possible convenience. The Department will formally track training and memorialize the types of training that we have provided to our examiners on an ongoing basis. The Department will identify conflicts of interest for examiners and track these on an annual basis during the normal performance evaluation process for each employee.

- 4. Establish guidelines for taking and tracking corrective actions.**

Findings: The Department has several courses of action it can take to correct violations of the Grain Code. These actions include issuing a memorandum of adjustment,

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assessing financial penalties, requiring collateral, increasing reporting requirements, suspending or revoking a license, and criminal prosecution.

Over the past four years, few licensees have been assessed penalties. 18 licensees were assessed penalties for \$6,750 in 2002. The most common corrective action is the Memorandum of Adjustment (MOA). Approximately 90% of examinations result in a MOA which requires the licensee to immediately (five days) correct a deficiency found during an examination. The auditors reviewed several MOAs that contained serious violations of the Grain Code. Those violations included exceeding speculation limits, insufficient inventory, having negative liquid position, failure to keep an accurate Daily Position Record, not using State approved forms for price-later contracts, and price-later contracts not being signed within the required 30 days. The auditors noted there were several license suspensions over the past three years, though the Department does not keep an annual total, but no license revocations.

Other actions taken by the Department include requiring collateral, reducing the filing period for an application for renewal of license to 60 days after the fiscal year-end, instead of 90 days, to determine financial deficiencies, and placing a licensee on a monthly, weekly, or bi-weekly reporting schedule. As of May 2003, the Department required \$8 million in collateral from 93 licensees. Sixteen licensees were on the 60-day filing requirement, and 15 licensees were on a monthly, weekly or bi-weekly reporting schedule.

The auditors reviewed several licensees that had violated the Grain Code and other requirements. The auditors reported that it is not clear at what point the license should be suspended, revoked, or no longer renewed. The Department has no formal written guidelines regarding when a licensee should be placed on an accelerated exam schedule, be required to file an audit within 60 days of the end of the fiscal year, or be required to file additional reports.

Response: Accepted. The Department will formalize existing guidelines and standard operating procedures in written form for taking and tracking corrective actions.

5. Consider requiring training of licensees and implementing a licensure test or training certification program for grain managers/merchandisers.

Findings: There are no testing or training requirements to manage a grain dealership or grain warehouse.

Response: Not Accepted. At the present time, the Department of Agriculture does not contemplate implementing a licensure test for grain merchandisers and managers due to lack of resources to devote to this process.

6. Continue to merge computer systems in order to better track licensing, examinations, and corrective action information.

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Accepted - continued

Findings: The Department's computer system does not contain a centralized database with all information on licensees. Licensee data is stored in many areas/data tables and in different software applications making it difficult to access all information on each licensee such as financial histories, examination histories, hearing history and collateral on file. The Department does not track corrective actions taken in each Memorandum of Adjustment, suspensions or other violations of the Grain Code for follow up.

Response: The Department will continue to merge various computer systems from the existing Paradox database to a centralized database to achieve better tracking of licensees, examinations, and corrective actions follow-ups.

7. Develop internal policies and procedures to further define the claims process for failures including;

- **developing procedures to ensure that timeliness relating to claims are met; and**
- **defining specific claims criteria such as what is considered a valid claim.**

Findings: The Department's responsibilities regarding the process of liquidation and adjudication of claims in the event of a failure are delineated in the Grain Code and Administrative Code, including specific timelines for submitting claims and determining compensation. The Grain Code requires the Department to determine the validity, category, and amount of claims within 120 days after the date of failure. It also requires that the claimant be compensated within approximately 180 days of the failure.

The Department lacks specific procedures, other than those in the Grain Code, to determine a valid claim. The auditors reviewed a list of claimants for Ty-Walk and found several instances where multiple claims were filed for the same family under different names of family members. While these may be legitimate claims, there is potential for claimants to spread the claim amounts to different family members in order to maximize recovery of claims and avoid the \$100,000 (now \$250,000) limitation for grain dealer claims under the law.

It took an average of 227 days for Ty-Walk claimants to be compensated. Ashley Elevator claims took on average 156 days. Department officials noted that the Ty-Walk process was slowed because the licensee was forced into involuntary bankruptcy. As of September 2003, more than \$31.7 million was paid to 281 Ty-Walk claimants. Five claimants—banks and other entities that held collateral warehouse receipts for grain—received 76% of the total payout. Producers received \$7.6 million of the payout. During the Ty-Walk failure, the Department did not compensate claimants for claims until all disputes were settled. Under the new law, claimants will be paid the undisputed portion of a claim in accordance with the deadlines of the Code.

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Response: Accepted. The Department will develop and memorialize internal policies and procedures to ensure that timelines relating to claims are met, as has been the case for the twenty-year history of the Grain Insurance Program. The Department will develop internal policies and procedures to further define specific claims criteria such as what is considered a valid claim in the form of rules.

8. Ensure all sub-accounts under the Grain Indemnity Trust Account are used for their designated purpose and their net proceeds are distributed according to the guidelines delineated in the Grain Code.

Findings: The Grain Insurance Fund (GIF) was established to protect producers in the event of a failure of a licensed grain dealer or warehouse. The Grain Code requires all State-licensed grain dealers and warehouses to pay assessments into the GIF. Warehouses licensed by the federal government are not required to participate, but they need a State license to buy grain from producers, who are then protected by State law. As of June 2003, the total assets of the Grain Insurance Fund (GIF) were almost \$1.17 million. However, because \$4 million is owed to the General Revenue Fund, the GIF had a negative fund equity of over \$2.8 million.

All net proceeds from the liquidation of Ty-Walk were not transferred to the GIF as required by law. On December 30, 2002, \$20,000 was transferred by the Ty-Walk sub-account to another failed company's sub-account to pay the former owner's life insurance policy premiums. The Department previously paid the policy using proceeds from the liquidation of that failed company, but the assets in that sub-account were exhausted. The Illinois Grain Insurance Corporation (IGIC) is the beneficiary of the \$250,000 policy. The IGIC refused to approve the transfer from the Ty-Walk sub-account because according to the Code, funds received in trust from the liquidation of a failed licensee should be used only for the costs associated with that entity.

No funds left over in the Ty-Walk sub-account have been returned to the GIF for repayment to GRF.

Response: Not Accepted. The Department believes that they have used the money in the Grain Indemnity Trust Account for its stated purpose as set forth in the Grain Code and will continue to do so. The Department will also continue to distribute net proceeds according to the guidelines delineated in the Grain Code and pursuant to direction from the Illinois Grain Insurance Corporation Board of Directors.

Auditors Comment: To help pay valid claims associated with the Ty-Walk failure, in February 2002 the Grain Insurance Corporation approved the transfer of \$5 million from the Grain Insurance Fund to the Grain Indemnity Trust Account. Another \$4 million was transferred to the Grain Insurance Fund from the General Revenue Fund in March 2002 and subsequently transferred to Grain Indemnity Trust Account. The Grain Code states that such transfers are to be used to pay the balance owed to claimants (240 ILCS 40/25-20(b)).

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Accepted - concluded

The Grain Code requires that if any excess funds remain after all valid claims have been paid, such funds shall be first used to repay the Grain Insurance Fund for moneys transferred to the Trust Account and that the State shall be reimbursed as soon as funds become available for any amounts paid upon replenishment of the Grain Insurance Fund (240 ILCS 40/25-20(d)(1)and(h)).

Further, at its December 2002 meeting, the Grain Insurance Corporation denied the Department of Agriculture's request to use Grain Insurance Fund monies to pay for the premium on the life insurance policy, stating that pertinent provisions in the Grain Code prohibit use of funds for any purpose other than compensating claimants or making refunds. The auditors believe that using Trust Account funds for any purpose other than compensating claimants or making refunds is similarly prohibited. If the Department continues to disagree, we suggest it seek a formal written opinion from the Attorney General's Office as to the appropriateness of its payment of a life insurance policy premium related to one failure from the proceeds of another failure.

9. Periodically evaluate the Grain Insurance Fund's capacity to pay claims. Such evaluation would help ensure there are adequate resources in the Grain Insurance Fund and whether further changes to the Grain Code are needed.

Findings: According to the Grain Code, if the GIF has insufficient resources to pay all valid claims, the General Assembly must appropriate the amount necessary to pay valid claims. The IGIC is required to reimburse the State as soon as funds become available through assessments. In March 2002, the Department received a first ever transfer from the GRF to pay claims. The Department estimated that paying back the GRF would take approximately three years, but four additional failures have slowed that schedule.

There are half as many licensed entities paying into the GIF today than in 1983 when the GIF was established. The potential for higher GIF claims have increased because licensees are larger and there is greater claims coverage. PA 93-225 calls for grain dealer and warehouse subsequent assessment until the GIF exceeds \$6 million.

Response: Accepted. The Department will evaluate the Grain Insurance Fund's capacity to pay claims on an annual basis under the direction of the Board of Directors of the Grain Insurance Corporation. The inability to project maximum foreseeable loss and maximum probable loss, given the dynamic nature of the licensees within the insurance pool, poses a tremendous challenge to meet the Auditor General's recommendation concerning this matter.

10. Implement controls to ensure the correct amount is assessed and collected for the new grain seller assessment and the lender assessment.

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Findings: A new law adds two new assessments (a grain seller initial assessment and a lender assessment), but both assessments require the licensee to notify, collect or remit the assessment to the Department. It may be difficult to ensure the proper amount of assessments is being received since the Department does not receive or keep detailed information regarding grain purchases or persons holding collateral warehouse receipts.

Response: The Department has developed and formalized both a grain seller assessment and lender assessment implementation kit that have been mailed to all licensees as of October 3, 2003. Assessments are due to be collected beginning January 1, 2003 and submitted on a quarterly basis. The Department will utilize existing examiner staff to perform remittance verification audits during the routine course of examinations to ensure the correct amounts are assessed and collected for the new assessments.