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The Headwaters Fund
County of Humboldt
520 E. Street
Eureka, CA 95501

We have performed the procedures enumerated below, which were agreed to by The Headwaters Fund (HWF), County of Humboldt, solely to assist you in connection with a determination as to whether there were differences in the compliance with the terms stipulated in the revolving loan fund lender agreement between the County of Humboldt and Arcata Economic Development Corporation (AEDC) for the year ended June 30, 2009. AEDC is responsible for servicing the Headwaters Revolving Loan Fund. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures we performed and the associated findings are as follows:

- (1) We verified the AEDC's general ledger accounts for The Humboldt Fund outstanding balances and funds disbursed and payments received. This procedure did not reveal any differences. The HWF share of the loans to borrowers as well as funds received, disbursed, and funds returned to HWF is maintained in an excel file which we tied to the reports provided to HWF without exception.
- (2) We have reviewed loans aggregating 83% of the active loans outstanding as of June 30, 2009. Our procedures included reviewing loan agreements, loan proposal memorandums, security agreements, and understanding the evaluation process. Our review did not reveal any deficiencies related to modifications or granting of loans during the year ended June 30, 2009. The borrowers we performed our procedures on and their balances as of June 30, 2009 were as follows:

<u>Borrower</u>	<u>Balance at June 30, 2009</u>
Arcata Theatre Lounge Inc.	\$ 145,745.34
Jessicurl, Inc.	81,284.03
Nocturnum	113,261.21
Fairway Gas and Market	122,641.59
Plaza Design	234,856.02
Humboldt Auto Retailers	86,693.03
Oberon LLC	<u>303,726.02</u>
 Total	 <u>\$1,088,207.24</u>

- (3) We inspected interest and principal payments made by the above mentioned borrowers with bank statements. We verified dates for amounts owed to the Headwaters Fund were paid and if these were paid according to the Revolving Loan Fund Lender Agreement. We also recalculated how much of the principal and interest amounts received from borrowers are owed to the HWF. We noted that amounts owed to the Headwaters Fund are credited to the Headwaters Fund account in the general ledger on the dates the borrower pays. The amounts are held in the unrestricted bank account until these get reimbursed within 15 days of the following month in accordance with the Master Participation Agreement dated September 14, 2004. Our procedure did not reveal any delays in payments made to The Headwaters Fund or any differences in the principal and interest received that are owed to the HWF.
- (4) AEDC has a restricted bank account created to deposit funds received and that are owed to HWF. We inspected bank statements for this restricted bank account for amounts received from HWF for the period July 1, 2008 to December 31, 2009. We noted that AEDC had been depositing amounts owed to HWF in unrestricted bank accounts and not into this restricted account during the period July 1, 2008 to September 30, 2008, as required by the Headwaters Revolving Loan Fund Lender Agreement dated September 14, 2004. AEDC began using this restricted bank account October 2008; however, the amounts deposited in this account during the period October 1, 2008 through April 30, 2009 were generally lower than the amounts owed to HWF, and the balance being deposited in unrestricted bank accounts which was also not in accordance with the Headwaters Revolving Loan Fund Lender Agreement dated September 14, 2004.

We noted that as of May 31, 2009, AEDC had repaid all amounts owed to HWF for past periods. All subsequent payments have been made by AEDC to HWF in a timely manner.

The analysis of the balances that were owed to HWF and balances in the restricted HWF bank account are mentioned below. The "Bank Balance Restricted" represents the balance in the restricted HWF bank account that AEDC maintains. The "Total Funds" column represents HWF funds that are held by AEDC to be disbursed to borrowers either under the line of credit or term loan agreements. The "Bank Balance Unrestricted" column represents balances where the HWF funds with AEDC were deposited in unrestricted bank accounts.

Bank A/C As of	Available Funds				Bank Balance Unrestricted
	Bank Balance Restricted	Line of Credit	Disbursement	Total Funds	
07/31/2008	\$ —	\$ 16,586.67	\$ 267,450.00	\$ 284,036.67	\$ 284,036.67
08/31/2008	—	4,858.38	265,665.36	270,523.74	270,523.74
09/30/2008	—	8,683.00	242,259.21	250,942.21	250,942.21
10/31/2008	152,501.85	14,343.00	446,039.84	460,382.84	307,880.99
11/30/2008	205,381.24	15,843.00	153,462.23	169,305.23	—
12/31/2008	22,295.72	18,885.50	305,688.40	324,573.90	302,278.18
01/31/2009	21,913.94	30,275.50	3,256.52	3,532.02	11,618.08
02/28/2009	29,849.03	30,275.50	7,889.81	38,165.31	8,316.28
03/31/2009	40,031.23	40,430.50	43,482.96	83,913.46	43,882.23
04/30/2009	82,312.78	43,326.95	60,354.29	103,681.24	21,368.46
05/31/2009	34,696.16	—	34,706.23	34,706.23	10.07
06/30/2009	20,105.20	—	—	—	—
07/31/2009	—	—	—	—	—
08/31/2009	—	—	—	—	—
09/30/2009	—	—	—	—	—
10/31/2009	46,013.26	—	—	—	—
11/30/2009	366.00	—	—	—	—
12/31/2009	15,035.30	—	—	—	—



The HWF in its letter dated October 2008 recommended that amounts received from the HWF be credited to a separate account and that amounts not disbursed within 30 days be returned. We noted the following amounts that were returned to HWF after more than 30 days.

Borrower	Repaid to HWF	Amount	Date of Receipt from HWF
Arcata Theater	10/29/2008	152,500.00	7/11/2008
Fraga	12/9/2008	55,825.34	7/11/2008
Gil Miracle		82,772.50	10/28/2008
Sacred Grounds		9,090.47	10/28/2008
Humboldt Auto	6/5/2009	2,489	8/21/2008
		3,750	9/17/2008
		750	10/15/2008
		4,910	10/20/2008
		1,500	12/1/2008
		3,043	12/9/2008
		11,390	2/23/2009
		3,882	3/9/2009
		6,272	3/11/2009
		5,360	4/17/2009
		13,038	5/12/2009

- (5) We reviewed the loan proposal memo for any reasons for the need or gap in funding. This procedure did not reveal any differences.
- (6) AEDC is currently calling borrowers and documenting the number of employees in a memo. AEDC does field inspections of its borrowers frequently during the year. AEDC also calls the borrower to determine the number of new jobs that have been created. We recommend that lender review the payroll records of the borrower as part of its field inspection procedures to validate the number of new employees.
- (7) The tickler file is maintained within the software system used by AEDC to track due dates of UCC filings and insurance. We reviewed the due dates in the tickler files for each of the loans mentioned above to determine if any of the loans had insurance and UCC renewal dates that had expired that need to be reported.
- (8) The lender follows a conflict of interest policy as documented in its Board of Directors manual. We reviewed the conflict of interest policy to validate that such a policy exists. We also reviewed the approvals by the loan committee for loans granted to Jessicurl, Oberon, LLC, Gil Miracle, Arcata Theatre Lounge LLC and Fairway Market. We noted that there were instances where members of the loan committee had abstained.
- (9) The loan balances are reflected in the financial statements for the HWFs and, hence, the allowances for doubtful loans are calculated and accounted for by the HWF. As a result, there is no impact of the observations related to the calculation of allowances for doubtful loans by the auditors for AEDC. During the course of our review of the agreements and loan proposal memorandums, we noted that AEDC obtains a Cal Cap insurance where collateral is not sufficient or there is a loan loss risk. We also noted that AEDC prepares a risk analysis to calculate the allowance for doubtful loans on their



books. We suggest that HWF obtain such information that AEDC prepares to obtain an understanding if there is a risk of a loan loss on the outstanding loans.

- (10) We reviewed the logs and notes maintained for verbal and any written communications for the above mentioned loans and noted that such logs are being maintained within the software application AEDC uses. We noted that there is a separate correspondence file maintained for plaza design and, hence, there are no logs maintained for plaza design in the system.
- (11) We reviewed the appraisals that were obtained for the new loans that were granted during the year ended June 30, 2009. We noted that AEDC does not obtain new appraisals each year. AEDC performs a risk analysis to evaluate the risk associated with the loan for the purpose of calculating its allowance for loans that are doubtful.
- (12) We reviewed payments made by borrowers representing 83% of the loans outstanding at June 30, 2009 and noted that all except for Humboldt Auto were current. AEDC sent Humboldt Auto a letter mentioning this delinquency. All payments of interest and principal were being made by other borrowers in accordance with their current agreements.
- (13) Currently, there are no loans other than Humboldt Auto in default for them to be under a payment plan to bring them current. AEDC is in the process of having Humboldt Auto sell vehicles through auctions at the earliest so that the line of credit can be repaid in full. AEDC has modified loans with its borrowers, mainly Plaza Design and Arcata Theatre Lounge, LLC, which have been approved by the HWF.

We were engaged to conduct agreed upon procedures, the objective of which was to determine deficiencies in the compliance with the terms stipulated in the revolving loan fund agreement between the County of Humboldt and AEDC. We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on the compliance with the revolving loan fund lender agreement between the County of Humboldt and AEDC. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the County of Humboldt, and is not intended to be and should not be used by anyone other than these specified parties.



Hathaway and Ksenzulak, LLP

March 16, 2010



Hathaway & Ksenzulak, LLP