June 15, 2011

TO: Federal Co-Chair
ARC Executive Director

FROM: Hubert Sparks
ARC Inspector General

SUBJECT: Compliance Audit of Kentucky Highlands Investment Corporation- Meritus Ventures Fund
OIG Report Number, 11-04

GRANTEE: Kentucky Highlands Investment Corporation- Meritus Ventures, Grant 15528-06

The OIG engaged Tichenor & Associates, LLP, Certified Public Accountants, to conduct an audit of a grant made to Kentucky Highlands Investment Corporation which was used to make an investment in the Meritus Ventures Fund. The Fund invests in expansion stage companies.

The grant period covered by the audit was from August 1, 2006 through March 31, 2010. The report had four recommendations for ARC to consider. The recommendations pertained to the following:
1) the grantee appeared to be falling short of meeting two of its grant objectives, which were to invest $600,000 in ARC distressed counties and to create 240 jobs; 2) management fees (and other charges) in relation to the grant funds being invested (management fees, had so far, accounted for 34% of ARC's grant funds invested; 3) the intertwined relationship of the grantee and the Meritus Fund investment management, and the management fees charged against the grant funds; and 4) ARC funds being used as a source of capital to secure USDA program funds in possible violation of their legislation. The recommendation pertaining to investing funds in distressed counties and ARC consideration of the other issues for this type of grant was agreed to by management. All recommendations were considered resolved and were closed by the auditor. However, the recommendation pertaining to the investment of funds in distressed counties will remain open in our records until implemented.

In connection with the audit of Kentucky Highlands Investment Corporation's Meritus Venture Fund activities, conducted by Tichenor & Associates, LLP, the OIG does not express an opinion on Kentucky Highland's Meritus Fund activities, internal controls, or conclusions on compliance with laws and regulations. The OIG had no involvement in the review of Kentucky Highlands Investment Corporation-Meritus Ventures Fund grant. The OIG's involvement was with Tichenor & Associates, who was contracted to audit and report on grant compliance and other matters as outlined in the report's scope section. Tichenor & Associates is responsible for the attached auditor's report and the opinions, conclusions, and recommendations expressed in that report.

Hubert Sparks
Inspector General
Attachment