



**APPALACHIAN
REGIONAL
COMMISSION**

*A Proud Past,
A New Vision*

Office of Inspector General

August 10, 2004

Memorandum for The Federal Co-Chair
 ARC Executive Director

Subject: OIG Report 04-10
 Review of Revolving Loan Fund (RLF) Grants for the
 Ohio Mid-Eastern Governments Association (OMEGA)

Attached are copies of the subject reports dealing with the RLF grants to OMEGA Local Development District. OMEGA received its initial RLF grant in 1992. As of May 5, 2004, OMEGA has received \$775,000 in ARC RLF grants, and has 15 loans outstanding, with unpaid balances totaling approximately \$605,309.

The report contains 4 recommendations. The responses by the grantee and ARC are considered responsive to the recommendation. They have agreed to take the necessary steps outlined in the recommendations.

This report is considered closed. However, ARC staff should verify that the promised actions have indeed taken place. Please contact me if you have any questions on this issue.

Clifford H. Jennings
Inspector General

Attachment

cc: Director for Program Operations
 Director for Finance and Administration



**LEON SNEAD
& COMPANY, P.C.**

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& Management Consultants*

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MEMORANDUM

DATE: August 4, 2004

TO: Clifford Jennings, Inspector General
Appalachian Regional Commission
Office of Inspector General
1666 Connecticut Avenue, N.W. Room 215
Washington, DC 20009-1068

FROM: Leon Sneed, President

SUBJECT: Final Audit Report
Ohio Mid-Eastern Governments Association (OMEGA)

Enclosed for distribution to ARC and Grantee Officials are five copies of the subject audit report. If you have any questions, please call me at 301-738-8190.

Enclosure

**APPALACHIAN REGIONAL COMMISSION
OFFICE OF INSPECTOR GENERAL
AUDIT OF REVOLVING LOAN FUND
Ohio Mid-Eastern Governments Association**

**Report No. 04-10
August 2004**

**Prepared by
Leon Snead & Company, P.C.**



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August 3, 2004

Appalachian Regional Commission
Office of the Inspector General
1666 Connecticut Avenue, N.W.
Washington, D.C. 20009

Leon Snead & Company, P.C. has completed an audit of the to Ohio Mid-Eastern Governments Association (OMEGA) Revolving Loan Fund (RLF). The audit was performed at the request of the Appalachian Regional Commission's (ARC), Office of the Inspector General (OIG) to assist in carrying out its oversight of ARC activities.

The audit objectives were to determine if: (1) the grantee complied with the requirements of applicable laws, OMB Circulars, ARC Guidelines and its grant agreement and operating plan (2) the grantee's internal control policies and procedures were adequate to assure that RLF transactions were properly recorded, and accurately and timely reported to the ARC on its semiannual reports, (3) administrative costs reported on the semiannual reports were allowable, supported and reasonable, and (4) appropriate actions have been taken to resolve or correct deficiencies identified in prior audits and reviews.

The audit determined that, overall, the OMEGA generally operated the RLF in compliance with ARC regulations and guidelines, the grant agreement, and operating plan; and implemented sufficient internal control policies and procedures to assure semiannual reports to ARC were completed accurately and timely. However, we did note that OMEGA needed: (1) to strengthen actions to ensure that appropriate documentation is obtained to support that the RLF loan could not made through the private sector; (2) to develop and document procedures for charging administrative costs to ARC that more closely approximate the work effort associated to the program; and (3) to obtain guidance from ARC on two loans that did not meet OMEGA's RLF operating plan lending requirements.

A draft report was provided to ARC program officials and RLF officials for comment on May 25, 2004. The Executive Director, ARC, in a response dated July 22, 2004, advised that: (1) OMEGA had provided sufficient documentation to support that the RLF loans cited in the audit had not displaced local commercial lenders, (2) OMEGA will monitor the loan that was not supported by required equity, as long as the loan is active, and (3) OMEGA had completed actions to address the recommendations on cost allocation procedures. The comments of the Executive Director are included in their entirety in Appendix A.

Leon Snead & Company appreciates the cooperation and assistance received from OMEGA and ARC personnel during the audit.

Sincerely,

Leon Snead & Company, P.C.
Leon Snead & Company, P. C.

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Introduction

Leon Snead & Company, P.C. has completed an audit of Revolving Loan Fund (RLF) grant awarded by the Appalachian Regional Commission (ARC) to Ohio Mid-Eastern Governments Association (OMEGA). The audit was performed at the request of ARC Office of the Inspector General (OIG) to assist it in carrying out its oversight of ARC grant activities.

OMEGA is a state certified Regional Planning and Development Organization representing local governments in ten counties. OMEGA was designated as a Local Development District (LDD) for ARC in 1968. OMEGA assists local officials in preparing plans and projects to improve living conditions, reverse trend of out migration of people, and to spur economic development. OMEGA's membership is comprised of a minimum of three members per county, or one representative for each 10,000 county residents.

OMEGA received its initial RFL grant in 1992. As of May 5, 2004, OMEGA has received \$775,000 in ARC RLF grants, and has 15 loans outstanding, with unpaid balances totaling approximately \$605,309.

A RLF is a business development revolving loan fund that is used by eligible grantees to make loans to create and/or save jobs. As loans are repaid by the borrowers, the money is returned to the RLF to make other loans. RLF loans are not intended to match or replace the capacity of lending institutions, rather, RLF's fill gaps in local lending, and to provide capital which otherwise would not be available for economic development. The primary goals of OMEGA's RLF were to: (1) encourage increased employment opportunities, particularly for low/moderate income residents, (2) stimulate private sector capital formation, (3) encourage redevelopment of blighted or vacant areas for productive uses, (4) provide employers with needed capital for start-up, expansion, or retention of businesses, and (5) coordinate with other economic development organizations.

The grantee is required to administer the RLF in accordance with its grant agreement and operating plan. The operating plan, developed by the grantee as part of the grant agreement, defines specific objectives and operating procedures, including standards and selection criteria for loans in the portfolio. ARC does not review and approve individual loans made by the RLF. Instead, ARC monitors RLF activities for conformance with the ARC code, RLF Guidelines, operating plan, and other conditions of the grant agreement.

Objectives, Scope, and Methodology

The audit objectives were to determine if: (1) the grantee complied with the requirements of applicable laws, OMB Circulars, ARC Guidelines, its grant agreement and operating plan, (2) the grantee's internal control policies and procedures were adequate to assure that RLF transactions were properly recorded, and accurately and timely reported to the ARC on its semiannual reports, (3) administrative costs reported on the semiannual reports were allowable, supported and reasonable, and (4) appropriate actions have been

taken to resolve or correct deficiencies identified in prior audits and reviews. The audit covered OMEGA activities during the period October 1, 2002 to March 31, 2004. Audit fieldwork was completed at OMEGA on May 8, 2004.

We reviewed grantee policies and operating procedures to gain an understanding of the grantee's system of administrative and accounting controls. In addition, we accessed the accounting and administrative controls established by OMEGA to assure RLF operations adhered to applicable ARC Guidelines, OMB regulations, and OMEGA's grant agreement and operating plan. The audit included tests of OMEGA's subsidiary and detailed loan records to assure the financial information submitted to ARC was supported. We verified that the loans made by the grantee complied with ARC Guidelines and the RLF operating plan. We performed tests of selected administrative costs claimed by OMEGA to validate that the costs were allowable, reasonable and supported. We also reviewed OMEGA's most recent single audit, and ARC internal reviews to ensure that corrective actions were taken on any reportable or material weaknesses identified in the reports.

The audit was performed in accordance *Government Auditing Standards*, and included appropriate tests necessary to achieve the audit objectives.

Summary of Audit

The audit determined that, overall, OMEGA: (1) generally operated the RLF in compliance with ARC guidelines, the grant agreement, and operating plan; and (2) implemented sufficient internal control policies and procedures to assure semiannual reports to ARC were completed accurately and timely. ARC's latest internal reviews of OMEGA's operations did not disclose any deficiencies in operations.

We noted two conditions where OMEGA needed to strengthen its controls over loan making. For the two loans made since September 2002, we did not find documentation supporting that the applicant was unable to obtain private sector financing, as required by ARC guidelines and OMEGA's operating plan. In addition, we noted that for one loan that the applicant did not contribute the \$25,000 equity to the project, as required by the borrower's loan agreement.

While we found that administrative costs charged to ARC RLF appeared reasonable, OMEGA's unwritten policy for allocating salary costs, if followed, would not have resulted in a reasonable and supportable allocation of salary costs. However, OMEGA personnel modified, for each quarter tested, the allocation procedure to more accurately reflect the proper costs of the program. OMEGA's policy was to allocate salary costs based upon the prior month's cash balance of the four programs administered by OMEGA's loan administrator.

FINDINGS AND RECOMMENDATIONS

Loan Documentation

1. The two loans closed since October 2002 did not contain sufficient documentation to support that the loans met ARC RLF guidelines, OMEGA's operating plan, and/or loan agreements concerning private sector financing and required borrower equity contributions. This condition was attributed to the need for a loan-closing checklist that more clearly addresses the requirements for equity contribution and private sector financing. As a result, without additional documentation to support the loans, the loans do not meet ARC RLF lending requirements.

ARC guidelines require grantees to establish internal controls over Federal programs to ensure they are managing the RLF in accordance with provisions of the grant. OMEGA's operating plan requires that in order for a loan to be approved, typically 10 percent borrower equity must be contributed, and that other lending sources cannot be able to provide the lending supplied by ARC RLF.

We reviewed the two loans closed since October 1, 2002, to determine if the loans followed ARC guidelines, OMEGA's RLF operating plan, as well as, the specific closing requirements for each loan. We found the following items that need corrective action:

- A borrower received an ARC RLF loan for \$30,000 on January 16, 2003, to finance the purchase of a manufacturing enterprise. Our review showed that the loan file contained sufficient documentation to support that all loan requirements had been met, except for two key requirements. The file did not contain sufficient documentation to support that the applicant was unable to obtain credit from other private sources, or that the borrower made the required \$25,000 equity contribution, as required by the loan agreement

The file contained information on a line of credit provided by a local lending institution, and a personal financial statement that showed the applicant with a net worth of about \$1 million. There was no other documentation in the file that would support that the applicant was unable to obtain other private financing.

The loan agreement required the applicant to make an equity contribution of \$25,000 to the project. However, documentation in the file showed that instead of providing equity, the applicant made a loan to company, and was receiving 8.25 percent interest on the loan. The file also showed that a large portion of the loan has been repaid.

- A borrower received a \$100,000 loan on November 4, 2003, to expand the applicant's existing business. Our review showed that the loan file contained sufficient documentation to support that all loan requirements had been met,

except for documentation supporting that the applicant was unable to obtain credit from other sources.

Recommendations

ARC should require OMEGA to:

1. Obtain guidance on the actions to be taken concerning the absence of required equity contribution and missing documentation that supports the need for ARC RLF financing for the loans cited in this report.
2. Strengthen documentation requirements to ensure that more detailed information is obtained to support the determination that applicants are unable to obtain credit from other sources, and required borrower equity contributions are made.
3. Document, for the two loans cited, the details supporting that the applicants were unable to obtain credit from other sources.

Management Response

The Executive Director, ARC advised that the RLF had provided sufficient documentation to address the issues cited in this finding.

Auditors Comments

The comments received from the grantee and ARC are considered responsive to the findings and recommendations.

Administrative Cost Allocation Procedures

2. OMEGA needs to modify and document its policies on the allocation of salary costs to the ARC RLF. While we found that administrative costs charged to ARC RLF appeared reasonable, OMEGA's unwritten policy for allocating salary costs, if followed, would not have resulted in a reasonable and supportable allocation of salary costs to ARC RLF programs. However, no actual overcharges were incurred because OMEGA personnel had modified, for each quarter tested, the allocation procedure to more accurately reflect the proper costs that should be charged to the ARC RLF program.

ARC guidelines require grantees to establish internal controls over Federal programs to ensure they are managing the RLF in accordance with provisions of the grant. ARC guidelines require grantees to keep complete records to document those administrative costs charged to the program. In addition, OMB Circulars contain specific requirements concerning documentation needed to support administrative costs charged to a program.

Review of administrative costs charged to the ARC RLF program showed that all direct costs charged to the program were fully supported. However, for those costs related to the salary expenses charged to the ARC RLF, no written documentation was available to support the allocation of these costs. Although an unwritten policy existed regarding the process followed to allocate salary costs, this policy was not always followed. The policy was to allocate salary costs based upon the ratio of each of four loan funds cash balance for the prior month. However, for the periods tested during the audit, the loan administrator modified this allocation process, because the workload for the month indicated a different allocation was necessary. Had these modifications not been made, the costs charged to the ARC RLF program would not have been supported.

We do not believe that the cash balance of a loan fund provides a reasonable method of allocating salary costs. For example, if a particular loan fund has a low balance because of recent lending activity, it would be charged a small percentage of salary costs, even though the costs associated with this loan program may have been high that month.

OMEGA's payroll system did not track time charges by program; therefore, we were unable to determine if the administrative costs charged to ARC RLF were supported by time sheets. However, based upon review of the various loan activity and outstanding loan balances, and discussions with OMEGA officials, the administrative charges to ARC RLF did not appear to be materially out of line with the administrative requirements of the program.

Recommendation

ARC should require OMEGA to:

1. Document the procedures for allocating salary costs to the ARC RLF. Perform periodic studies of actual time charges to support the allocation of salary costs to the program.

Management Response

The Executive Director, ARC advised that the RLF had completed a study to document the proper allocation of salary costs to the ARC RLF program.

Auditors Comments

The comments received from the grantee and ARC are considered responsive to the finding and recommendation.

APPENDIX A
MANAGEMENT RESPONSE



**APPALACHIAN
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Office of the Executive Director

July 22, 2004

Leon Snead, President
Leon Snead & Company, P.C.
416 Hungerford Drive, Suite 400
Rockville, Maryland 20850

Subject: Management Response to ARC Inspector General Audit of the ARC Funded Revolving Loan Fund at the Ohio Mid-Eastern Governments Association performed by Leon Snead & Company, P.C.

Dear Mr. Snead:

Thank you for your thorough examination of the Ohio Mid-Eastern Governments Association (OMEGA) ARC RLF grant. The assistance provided by this examination will aid OMEGA in justifying the costs of the lending program charged against program income from ARC RLF lending activities. The draft report notes on page one (Introduction) that OMEGA was designated as a Local Development District (LDD) for ARC in 1992. Please change this reference in the final report to 1968.

Loan Documentation

A loan to Stitches USA, LLC was closed January 16, 2003. OMEGA has provided documentation, dated December 5, 2002 that complies with the ARC requirement that RLF lending not displace local commercial lenders. (see paragraph IV.A.3.a., ARC RBDRLF Guidelines)

A loan to Superb Industries, Inc. was closed November 4, 2003. OMEGA has provided documentation, dated September 3, 2003 that complies with the ARC requirement that RLF lending not displace local commercial lenders. (see paragraph IV.A.3.a., ARC RBDRLF Guidelines)

The RLF loan to Stitches USA was part of a \$130,000 project to enable the startup of a company specializing in the production of American Flags. The RLF loan of \$30,000 was used for equipment purchases. Financial statement information, for Stitches USA, indicates that all project funds were consumed in the project by July 2003 but \$3,300 of the Peoples Bank line of credit. Stitches USA is the borrower thus it was the obligation of the company to inject \$25,000 into this startup not one of the LLC partners. ARC has no problem with the fact the company has incurred debt to provide this injection as they are a startup. OMEGA will monitor this project as long as the ARC loan is active. Their monitor focuses on the ability of the company to service their debt as well as job creation.

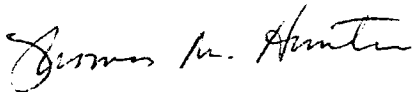
Administrative Cost Allocation Procedures

ARC agrees with the finding and recommendation regarding Administrative Cost Allocation Procedures. OMEGA was asked to respond to the audit recommendation. Their response follows:

OMEGA has completed a current time study on the Loan Administrator that covered the time period of May 10, 2004 through May 21, 2004 to determine the proper allocation of salary costs to the ARC RLF program. Salary costs will be charged to the RLF program based on this study for the period July 1, 2004 through December 31, 2004. OMEGA will perform a similar time study starting November 1, 2004 through November 14, 2004. In the future OMEGA will do two time studies per year, at six-month intervals, during the months of May and November of each year and revise its cost allocation as necessary. Our procedure for allocating costs to the ARC RLF program will be properly documented.

OMEGA has added an addendum to this response acknowledging that 50% of the loan administrators salary is being charged to a separate administrative fund grant provided by ARC. ARC considers the OMEGA response to be appropriate.

Sincerely,

A handwritten signature in cursive script, appearing to read "Thomas M. Hunter".

Thomas M. Hunter
Executive Director