



September 8, 2004

Memorandum for: The Federal Co-Chair
ARC Executive Director

Subject: OIG Report 04-16
Review of Revolving Loan Fund (RLF) Grants for the
Southern Tier Enterprise Development Fund

Attached are copies of the subject report dealing with the RLF grants to the Southern Tier Enterprise Development Fund (STEDO). STEDO received its initial RLF grant in 1995. As of March 31, 2004, STEDO has received \$450,000 in ARC RLF grants, and has six loans outstanding, with unpaid balances totaling approximately \$275,000.

The report contains four 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.

A handwritten signature in black ink, appearing to read "C. H. Jennings", written over a horizontal line.

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: September 3, 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 Snead, President

SUBJECT: Final Audit Reports

Leon Snead & Company is submitting to ARC and Grantee Officials five copies of the audit reports for the following assignments.

Buckeye Hills – Hocking Valley Regional District
Buckeye Hills – Hocking Valley Regional District (Distressed)
Southern Tier Enterprise Development Organization
Regional Economic Development and Energy Corporation

Enclosure

**APPALACHIAN REGIONAL COMMISSION
OFFICE OF INSPECTOR GENERAL
AUDIT OF REVOLVING LOAN FUND
Southern Tier Enterprise Development Organization**

**Report No. 04-16
September 2004**

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



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September 1, 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 Southern Tier Enterprise Development Organization (STEDO) 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 STEDO: (1) operated the RLF in compliance with ARC regulations and guidelines, the grant agreement, and operating plan; (2) implemented sufficient internal controls to assure semiannual reports to ARC were completed accurately and timely; However, we noted that STEDO needed to ; (1) ensure the RLF Operating Plan fully meets ARC requirements; and (2) loan agreements and loan applications are properly completed; and (3) requests for release of loan funds are provided to ARC.

A draft report was provided to ARC and RLF officials for comment on June 6, 2004. The Executive Director, ARC agreed with the findings and recommendations. The comments of the Executive Director are included in their entirety in Appendix A.

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

Sincerely,

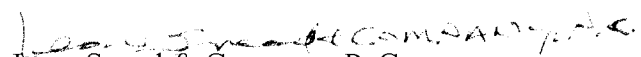

Leon Snead & Company, P. C.

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Introduction

Leon Snead & Company, P.C. has completed an audit of the Revolving Loan Fund (RLF) grant awarded by the Appalachian Regional Commission (ARC) to Southern Tier Enterprise Development Organization. The audit was performed at the request of ARC's Office of the Inspector General (OIG) to assist it in carrying out its oversight of ARC grant activities.

STEDO was incorporated on February 14, 1984, under Section 402 of the Not-for-Profit Law of the State of New York. The corporation was formed to promote general business and economic development within the counties of Allegany, Cattaraugus and Chautauqua. STEDO's primary objectives are to: (1) encourage the development and retention of industry, tourism, manufacturing, small businesses and agricultural businesses; (2) study and promote economic growth and business prosperity; (3) construct, acquire, re-habilitate and improve industrial and manufacturing plants; and (4) relieve and reduce unemployment.

STEDO received its initial RFL grant in 1995. As of March 31, 2004, STEDO had received \$450,000 in ARC grant funds, and had 6 loans outstanding, with unpaid balances totaling approximately \$275,000.

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 borrowers repay loans, 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 provide capital which otherwise would not be available for economic development.

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 applicable laws, 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 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 ARC on its semiannual reports, (3) administrative costs reported on 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 STEDO activities during the period October 1, 2002 to March 31, 2004. Audit fieldwork was completed at STEDO on June 11, 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 STEDO to assure RLF operations adhered to applicable ARC Guidelines, OMB regulations, and STEDO's grant agreement and operating plan. The audit included tests of STEDO's subsidiary and detailed loan records to assure the financial information submitted to ARC was supported. We verified that loans made by the grantee complied with ARC Guidelines and the RLF operating plan. We performed tests of selected administrative costs claimed by STEDO to validate that the costs were allowable, reasonable and supported. We also reviewed STEDO's most recent single audits, 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 STEDO: (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. However, we identified several matters that require actions to strengthen STEDO's procedures and controls for managing loans. These matters concern the need to ensure: (1) the RLF Operating Plan fully meets ARC requirements; (2) loan agreements and loan applications are properly completed for all loans; and (3) requests for release of loan funds are provided to ARC. These areas are discussed in the Findings and Recommendations section of this report.

FINDINGS AND RECOMMENDATIONS

1. RLF Operating Plan

The current STEDO RLF Operating Plan did not include the anticipated loan term, and a certification or statement of assurance that the RLF will be managed and operated in accordance with ARC requirements and regulations. Consequently, the Operating Plan did not fully comply with ARC regulations.

ARC RLF Guidelines, Section III.C.1.b require that the grantee Operating Plan include the anticipated term of each type of loan. Section III.C.2 of the Guidelines also requires that the Plan include an affirmation that the grantee understands and agrees to operate the RLF in accordance with the ARC policies contained in the Guidelines. ARC relies on this affirmation as a basis for releasing loan funds.

We reviewed STEDO's current RLF Operating Plan to determine whether the plan included the requirements specified in the ARC RLF Guidelines. We determined that the Plan did not address the anticipated loan term, and it did not include assurances or certifications that the RLF will be managed and operated in accordance with ARC policies and guidelines. We discussed this matter with STEDO officials. They agreed that the current Plan did not include these two requirements, and the Plan needed to be revised accordingly.

Recommendation

ARC should require STEDO to revise its RLF Operating Plan to include the anticipated loan term, and assurances that the RLF will be operated in accordance with the ARC RLF Guidelines.

Management Response

The ARC Executive Director concurred with the finding and recommendation. The Executive Director stated that: (1) STEDO has revised its operating plan to include an anticipated loan term for all the types of loans STEDO anticipates approving, and (2) the STEDO Project Director has provided ARC his statement of assurance that STEDO will adhere to the policies contained in the ARC RLF Guidelines.

Auditor's Comments

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

2. Loan Agreements

STEDO did not require borrowers to sign an ARC loan agreement. This condition occurred because STEDO officials believed a loan agreement was not necessary. As a result, loans were not made in accordance with ARC RLF Guidelines, and loan funds were not adequately protected.

ARC RLF Guidelines, Section V.5.7 states that a loan agreement is required, and it must include language that permits the immediate recovery of the loan principal, or an increase in the interest rate to commercial levels if: (1) a loan is not used for the purpose represented in the loan application; or (2) it becomes apparent that the number of jobs created or saved in the project will not meet the grantee's Operating Plan criteria.

As part of our detailed review of STEDO loans and the associated loan files, we determined that STEDO was not using the required ARC loan agreement. For the loans reviewed, we found that the loan files contained a properly executed Promissory Note, Security Agreement and a Guaranty. However, the loan files did not include an ARC loan agreement.

The STEDO Assistant Director informed us that several years ago, STEDO's legal advisor had reviewed this matter, and at that time, concluded that the Promissory Note, Security Agreement and Guaranty was sufficient to meet ARC requirements. Therefore, a loan agreement has not been used. However, based a recent assessment of this matter, the Assistant Director stated that he had obtained the required ARC loan agreement, and it will be used for further loans.

Recommendation

ARC should ensure STEDO obtains a properly completed and signed loan agreement for all RLF loans.

Management Response

The ARC Executive Director concurred with the finding and recommendation. The Executive Director stated that STEDO has provided ARC copies of loan agreements that have been presented to the borrowers of all loans closed since July 21, 2003, and STEDO has advised ARC that once the agreements are completed copies will be forwarded to ARC. The Executive Director further stated that STEDO has informed ARC that loan agreements will be part of the closing process for all loans closed by STEDO.

Auditor's Comments

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

3. Loan Applications

STEDO provided a loan to a borrower that had not completed a loan application. The borrower signed a loan applicant, but the application was not completed. The application form was blank. This condition occurred because STEDO officials believed the urgency of the borrower's need for funds required that the loan be processed as soon as possible, and a completed loan application was not necessary due to the unique circumstances associated with this loan.

ARC RLF Guidelines, Section V.5 state that a formal written loan application is required for each potential borrower. As a minimum, the application should include: (1) general information identifying the borrower, a schedule of proposed financing, number of employees, and proposed job impact of the project; and (2) the applicant's certification that it will comply with the legal requirements described in Appendix C of the ARC RLF Guidelines.

Our review of STEDO loan files revealed that a loan was made to a borrower that had not completed a loan application. The loan file contained sufficient information and documents, such as a credit report, job saving analysis, financial statements, income tax returns, etc. necessary for STEDO to evaluate the loan. Nevertheless, STEDO the borrower did not complete a loan application.

The STEDO Assistant Director told us the borrower needed working capital immediately to continue business, and the borrower provided the information required to adequately evaluate the loan. Consequently, the loan was reviewed and approved although a loan application was not completed. The Assistant Director also stated that STEDO's objective in making the loan was to save jobs, and it was imperative to complete the loan approval process as soon as possible.

Recommendation

ARC should ensure STEDO obtains a properly completed loan application for all RLF loans.

Management Response

STEDO stated that the application provided was from a local development agency participating in the loan, and it included all required information as outlined in the ARC RLF Guidelines. STEDO further stated that the borrower signed the STEDO application with the understanding they were agreeing with the legal requirements specified in the application, and that they had previously provided the local development agency the information necessary to make an informed decision on loan approval or denial.

Auditor's Comments

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

4. Requests for Release of Loan Funds

At STEDO's request, ARC approved the release of funds for a loan for a certain borrower. STEDO, however, used these funds to make a loan to another borrower, and did not submit a request for release of funds for the "substituted" loan. As a result, STEDO did not comply with RLF loan reporting requirements, and loan funds were used for unauthorized purposes.

ARC RLF Guidelines, Section VI.E state that grantees must report each loan on "RLF Form for Reporting Loans Disbursed/Requesting a Release of Grant Funds." The Guidelines further state that this form must be submitted to support requests for grant payments.

On September 2, 2003, ARC approved the release of funds for a loan to a specific borrower. We determined, however, that these funds were actually used to make a loan to a different borrower. Furthermore, STEDO did not report this "substitute" loan to ARC, and the required RLF Form for this loan was not provided to ARC.

According to the STEDO Assistant Director, the initial loan was not made because the borrower could not meet the loan guarantee requirements. Consequently, another loan was substituted for the initial loan, but STEDO did not provide ARC the RLF Form for this loan. The Assistant Director agreed that STEDO should have notified ARC of the substituted loan, and the required documentation and information for the loan should have been provided to ARC.

Recommendation

ARC should ensure STEDO fully complies with RLF loan reporting requirements, and loan funds are only used for authorized purposes.

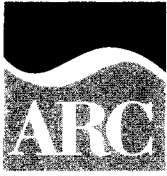
Management Response

The ARC Executive Director concurred with the finding and recommendation. STEDO responded that each loan approved by the STEDO Board will be forwarded to ARC on the appropriate form, and a written request for draw down will follow when a loan closing date has been established.

Auditor's Comments

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

APPENDIX A
MANAGEMENT RESPONSE



AFRICAN AMERICAN
REGIONAL
CORPORATION

*A Proud Past,
A New Vision*

August 30, 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 Southern Tier Enterprise Development Organization, Inc. performed by Leon Snead & Company, P.C.

Dear Mr. Snead:

Thank you for your thorough examination of the Southern Tier Enterprise Development Organization, Inc. (STEDO) ARC RLF grant. The assistance provided by this examination will aid ARC in monitoring STEDO's loan operations and compliance with ARC RLF Guidelines. Please correct the typographical error on the first line (RFL) of the third paragraph on page 1 of the draft report and change the word "agreement" to "application" in the 3rd recommendation (Loan Application).

RLF Operating Plan.

STEDO has revised its operating plan to include an anticipated loan term for all the types of loans STEDO anticipates approving. ARC had the required signed assurance, signed by the Executive Director of the Southern Tier West Regional Planning & Development Board. The Grantee's Project Director has now provided ARC with his statement of assurance that STEDO will adhere to ARC RLF loan policies contained in ARC BDRLF Guidelines.

Loan Agreements.

STEDO has furnished ARC copies of Loan Agreements that have been presented to the borrowers of all loans closed since July 21, 2003. STEDO has advised ARC that once the agreements are completed copies will be forwarded to ARC. STEDO further advises that loan agreements will be a part of the closing process for all loans closed by STEDO.

Loan Applications.

STEDO has responded to this finding with the following information:

“The application provided was from a local development agency participating in the loan. The application provided supplied all the required information as outlined in the ARC RLF Guidelines. The applicant then reviewed and signed the STEDO application with the understanding that by doing so they were agreeing to the legal requirements outlined within the application. They also did so with the understanding that the application that they had previously supplied with the local development agency would provide the information necessary for the board to make an informed decision concerning the loan approval/denial.” ARC accepts a Grantees use of information from partnering agencies loan applications as long the assurances required by ARC are signed by the borrower.


Requests for Release of Loan Funds.

STEDO has responded to this finding with the following information:

“In the future STEDO will comply with RLF loan reporting requirements as dictated by the ARC BDRLF Guidelines. Each loan approved by the STEDO board will be forwarded to ARC on the appropriate form, after which the written request for draw down will follow when a loan closing date has been established.”

ARC’s position is that STEDO’s response is the correct one. STEDO has not had loan activity requiring a grant payment since the incident identified by the auditor.

Sincerely,


Thomas M. Hunter
Executive Director