APPALACHIAN REGIONAL COMMISSION
A Proud Past, A New Vision

Office of Inspector General

March 16, 2006

Memorandum for: The Federal Co-Chair
ARC Executive Director

Subject: OIG Report 06-09
Review of Revolving Loan Fund (RLF)
Operated by the Regional Planning Commission
of Greater Birmingham
Birmingham, Alabama

Attached is the subject report dealing with the RLF grant to the Regional Planning Commission of Greater Birmingham. Currently, the Regional Planning Commission of Greater Birmingham RLF grant has a zero balance as no funds have been drawn down. The Regional Planning Commission of Greater Birmingham received its initial RLF grant in 2004 with a grant of $ 200,000. As of August 31, 2005, the Regional Planning Commission of Greater Birmingham had no ARC loans outstanding, with an unpaid balance for its non-ARC loans totaling $ 1,054,832.

The report includes two recommendations. The auditee responses to the recommendations are considered responsive and the report will be closed. Implementation of the recommendations should be verified at the next possible opportunity. However, we further recommend that ARC review the need for the grantee to either utilize the funds or return them to be put to better use.

Clifford H. Jennings
Inspector General

Attachment

cc: Director for Program Operations
Director for Finance and Administration
Mary Moran

AUDIT SURVEY OF THE ARC REVOLVING LOAN FUND OPERATED BY THE REGIONAL PLANNING COMMISSION OF GREATER BIRMINGHAM BIRMINGHAM, ALABAMA

ARC GRANT NUMBER: (AL-14730-04)

July 1, 2004 through May 31, 2005

ARC OIG Report Number: 06-09
Date: March 7, 2006

CAUTION: Certain information contained herein is subject to disclosure restrictions under the Freedom of Information Act, 5 U.S.C. 522 (b) (4). Distribution of this report should be limited to Appalachian Regional Commission and other pertinent parties.

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SUMMARY REPORT

INTRODUCTION

The Appalachian Regional Commission (ARC) makes grants to grantees. The grantee uses the grant funds to make loans to achieve economic benefits for a designated project area. As the loans are repaid, the principal funds and interest in excess of expenses are returned to the Revolving Loan Fund (RLF) to make other loans. The program's primary goal is private sector job creation and capital formation, specifically in the Appalachian region.

ARC requires that RLF projects be administered in accordance with the grantee's RLF plan. This plan explicitly defines the specific objectives and operating procedures, including the standards and selection criteria that are used to grant funds through the RLF for loans. ARC does not approve or review the RLF loans on an individual basis. ARC monitors the RLF project grantee objectives for conformance with guidelines, the RLF plan and other grant agreement conditions. The grantee is required to submit financial and progress reports to the ARC on a bi-yearly basis.

OBJECTIVES OF THE AUDIT

The objectives of the audit were (1) to determine whether the Regional Planning Commission of Greater Birmingham (RPCGB) is administering its ARC RLF in accordance with the ARC approved grant and did not violate any restrictions imposed by the terms and conditions of the RLF grant, (2) to determine whether the accounting, reporting and internal control structure of the RPCGB provides for the disclosure of pertinent financial and operation information applicable to the revolving loan program, and (3) to determine whether the objectives of the grant are being met.

BACKGROUND

In June 2004, ARC granted the RPCGB $200,000 in accordance with Grant Number AL-14730-04. The RPCGB has been an active lender through the RLF program since 2000. Currently, the RPCGB grant with ARC has a balance of zero. Since the inception of the original grant to RPCGB, the grant program has been unable to process a loan. However, recent efforts by management officials may result in two to three loans being processed in the next four months. They plan to create assistance loans for capital investments for the creation and/or retention of jobs in the Birmingham region of the State of Alabama.

SCOPE OF AUDIT SURVEY

Allmond & Company, a certified public accounting firm, was contracted by the ARC's Office of Inspector General (OIG) to perform a financial, compliance, and internal controls audit in accordance with <u>Government Auditing Standards</u> and ARC, OIG Audit

Guide for Revolving Loan Funds of the ARC grants administered by the RPCGB for the period July 1, 2004 through May 31, 2005.

As of August 31, 2005, the RPCGB had no ARC RLF loans outstanding and six (6) non-ARC RLF loans outstanding, with an unpaid balance of $1,054,832. Since RPCGB had no loans issued at the time of review, an audit survey of its current loans from its non-ARC RLF was performed considering the same objectives of an ARC RLF.

AUDIT SURVEY RESULTS

As a result of the audit survey performed, we concluded that (1) RPCGB was administering its non-ARC RLF in accordance with the ARC approved grant and nothing came to our attention that they were violating restrictions imposed by the terms and conditions of the RLF grant, (2) RPCGB's accounting, reporting, and internal control structure provided for the disclosure of pertinent financial and operation information applicable to the revolving loan program, and (3) RPCGB was meeting the objectives of the grant program. We found no material weaknesses and reportable conditions. However, we observed certain procedures and processes that could be strengthen when processing, administrating, and collecting loans from the ARC RLF program.

OBSERVATIONS AND RECOMMENDATIONS

Observation 1: Information Requested during Loan Application is Incomplete

Historical financial information requested from loan applicants is not complete enough to answer questions by loan review committee members to draw conclusions on an entity's quality of business and its current need for expansion. RPCGB's policy is to request three years of historical financial statements (balance sheet, profit and loss statement, and statement of changes in financial position). Using this information, a financial analysis of a project is made by answering the following questions:

1. Does the company collect its receivables?
2. Is the company paying its bills?
3. Does the company control inventory?
4. What is the officer's level of commitment to the company?
5. Does the company have a successful history of increasing retained earnings and net worth?
6. Does the company provide for contingent liabilities such as taxes, lawsuits and fringe benefits in the financial statements?

We believe that Questions 5 and 6 are the only questions that can be answered with any degree of certainty from information on the three financial statements. Accounts receivable turnover may provide some information; however an aging of receivable report may be a better document to obtain an answer to Question 1. An aging of payables report may be a better document to obtain an answer to Question 2. When answering Question 4, the financial statements may provide information on notes to officers, but one would not be able to determine whether the notes were collateralized and/or subordinated or in writing with a schedule of repayment terms. Additionally, the financial statements would not provide information on whether the company carries insurance payable to the company on the life of its officers or owners. We concluded that additional historical information needs to be obtained from loan applicants if the above questions are to be answered effectively.

Recommendation:

We recommend that RPCGB officials request more relevant information from its loan applicants if they wish to obtain more responsive answers to its questions geared to access the quality of the business and its current need for expansion.

Auditee's Response:

The auditee concurred with our observation. The RLF Manager stated that he will meet with the Loan Review Committee to determine what historical information is needed to answer key questions about the loan applicant's quality of business and his/her current need for expansion.

Observation 2: Periodic Visits to Borrower's Site Need to be Documented

RPCGB did not always document its periodic visits to borrower's site. The loan agreement terms call for periodic visits to borrower's sites. Our review of two of its six RLF loan files disclosed that there was no indication that RPCGB officials made periodic visits to the borrower's sites. Management assured us that the visits were made; however, no notes were maintained on the observations during these visits.

Recommendation:

We recommend that RPCGB officials document observations made during visits to borrower's site. Potential problem areas should be identified, documented, and addressed by responsible officials.

Observation 3: Documentation of Commercial Participation in Total Loan was not Included in Loan File

RPCGB did not always document the final commercial participation in a loan project. Our review of one of RPCGB's active RLF loan files disclosed that there was not clear evidence of the commercial participation in a project in which the borrower represented the amount invested as the commercial participation. Records revealed that over $50,000 were disbursed from the RLF loan proceeds to the owner. RPCGB's RLF Manager stated that the payment represented a reimbursement of funds advanced by the borrower. Even though the project was for the purchase and renovation of real property, a settlement statement of the transfer was not a part of the loan file. Evidence of the true commercial participation should be made a part of the loan file when RLF proceeds are disbursed directly to the borrower.

Recommendation:

We recommend that RPCGB establish and implement procedures to ensure that the actual commercial participation is documented in the loan files.

February 17, 2006

Mr. Marvin C. Allmond, CPA, CFE
Managing Partner
8181 Professional Place, Suite 250
Landover, MD. 20785

Dear Mr. Allmond:

RE: Draft ARC/RLF Audit Report

Listed below are the responses to the comments contained in your report and the alterations that will be made to our RLF procedures also made in response to your comments.

Observation 1:

1. **Does the company collect its receivables?** All future RLF loan applications will contain a Days Receivable Formula that will indicate if the company is collecting receivables in a timely manner.
2. **Is the company paying it bills?** All future RLF loan applications will contain a copy of the company's credit report. We normally check with the company's bank to account to obtain a credit report and sometimes this credit information is not listed in the firm's RLF application. In addition, all future RLF loan applications will contain a Days Payable Formula that will provide an indicator that reveals whether the firm is paying its bills in timely fashion.
3. **Does the company control inventory?** All future RLF applications will contain a Days Inventory Formula that will indicate the number of days of inventory that the firm has on hand.
4. **What is the officer's level of commitment to the company?** All future RLF applications will contain a listing of stockholder equity for the firm's major stockholders having a 20% or greater ownership interest in the business.
5. **Does the company have a successful history of increasing retained earnings and net worth?** All future RLF applications will contain a three year history of retained earnings and an indication of whether the firm's debt to equity ratio is consistent with industry averages.
6. **Does the company provide for contingent liabilities such as taxes, lawsuits and fringe benefits in the financial statements?** Please note that our RLF marketing activities have focused on the area's smaller companies having loan needs of less than $1 million. Most of these firms are just too small to set aside much money for anything other than for their tax obligations. However, we will

make note of the availability of these contingent liabilities in all future RLF applications.

Observation 2

We will provide written documentation of our annual site visits made to our RLF borrowers in an effort to verify that the firm is continuing to meet its job creation goals and to assess the company's current financial condition.

Observation 3

All future RLF loans made for construction and/or renovation activities will be required to obtain a construction loan. RLF loan funds will only be applied to payment of the borrower's construction loan. This will enable us to make RLF payments based upon the construction lender's assurance that all construction payments were correctly made and that the construction conformed to the requirements contained in all local construction codes. In addition, copies of the primary lender's settlement statement will be included in all future RLF applications.

We appreciate your comments on our RLF Program. These changes will substantially improve our loan procedures.

Sincerely,

Jack Wright, Director
Community Development

JRW/jw

Cc: Larry Watts