

**AUDIT OF THE ARC REVOLVING LOAN FUND
OPERATED BY
Southwestern North Carolina Planning & Economic Development Commission
Bryson City, North Carolina**

ARC Grant Numbers: NC-10181-88-I-302-0909

October 1, 1988 through June 30, 2005

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.

Report Number: 06-17

Date: May 24, 2006

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October 1, 1988 through June 30, 2005

Prepared By:

**Tichenor & Associates, LLP
Certified Public Accountants
304 Middletown Park Place, Suite C
Louisville, Kentucky 40243**

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TICHENOR & ASSOCIATES, LLP

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To: Appalachian Regional Commission (ARC)
Office of Inspector General (OIG)

Report For: Federal Co-Chair: Anne B. Pope
ARC Executive Director: Thomas M. Hunter
OIG Report Number: 06-17


Independent Auditor's Report

We have audited the ARC RLF grant Schedule of Fund Balance of the Southwestern North Carolina Planning & Economic Development Commission as of June 30, 2005, and the related Statement of Source and Application of Funds for the period of October 1, 1988 through June 30, 2005. These financial statements are the responsibility of the Southwestern North Carolina Planning & Economic Development Commission. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. We also used the ARC, OIG Audit Guide of ARC Revolving Loan Funds (RLF) as a guide. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

In our opinion, the accompanying ARC RLF grant financial statements present fairly in all material respects the financial position of the Southwestern North Carolina Planning & Economic Development Commission's fiduciary activities as of June 30, 2005 and the source and application of funds resulting from fiduciary activities for the period of October 1, 1988 through June 30, 2005 in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated December 8, 2005 on our consideration of the Southwestern North Carolina Planning & Economic Development Commission's internal control over ARC RLF grant financial reporting and on our tests of compliance with certain provisions of laws and regulations, included herein. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.


Tichenor & Associates, LLP
Louisville, Kentucky
December 8, 2005

Southwestern North Carolina Planning & Economic Development Commission

SCHEDULE OF FUND BALANCE

(As of June 30, 2005)

Cash in Bank	<u>\$ 211,765</u>
Loans Outstanding	<u>504,253</u>
Other Investments	<u> </u>
Due from Other Accounts	<u> </u>
Other Assets	<u> </u>
Less: Current Liabilities	<u> </u>
Fund Balance	<u><u>\$ 716,018</u></u>

The accompanying auditor's report should be read with these financial statements.

Southwestern North Carolina Planning & Economic Development Commission

**STATEMENT OF SOURCE AND APPLICATION OF FUNDS
(For The Period of October 1, 1988 through Audit June 30, 2005)**

Source of Funds	
ARC Grant	<u>\$ 656,408</u>
Loan Interest Income	<u>252,905</u>
Investment Interest	<u>101,010</u>
Other Income	<u>10,000</u>
 Total Funds Available	 <u>\$ 1,020,323</u>
 Application of Funds	
Cash in Bank	<u>\$ 211,765</u>
Loans Outstanding	<u>504,253</u>
Grant Funds Returned to ARC	<u>128,867</u>
Loan Losses	<u>0</u>
Administrative Expenses	<u>175,438</u>
 Total Funds Applied	 <u>\$ 1,020,323</u>

The accompanying auditor's report should be read with these financial statements.

TICHENOR & ASSOCIATES, LLP

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Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of the Financial Statements Performed in Accordance with Government Auditing Standards

We have audited the ARC RLF grant financial statements of the Southwestern North Carolina Planning & Economic Development Commission as of June 30, 2005 and for the period of October 1, 1988 through June 30, 2005, and have issued our report thereon dated December 8, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

COMPLIANCE

As part of obtaining reasonable assurance about whether the Southwestern North Carolina Planning & Economic Development Commission ARC RLF grant financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under Government Auditing Standards which are described in the accompanying Schedule of Findings.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audit, we considered the Southwestern North Carolina Planning & Economic Development Commission's internal control over financial reporting for the ARC RLF grant in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we did not note any certain matters involving the internal control over financial reporting and its operation that we consider to be a reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Southwestern North Carolina Planning & Economic Development Commission's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are considered to be material weaknesses.

This report is intended solely for the information and use of the ARC; however, the final report is a matter of public record and its distribution is not limited.

Tichenor & Associates, LLP

Tichenor & Associates, LLP
Louisville, Kentucky
December 8, 2005

EXECUTIVE SUMMARY

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 RLF to make other loans. The program's primary goal is private sector job creation and capital formation.

ARC requires that RLF projects be administered in accordance with the grantee's RLF plan. This plan defines specific objectives and operating procedures, including standards and selection criteria for loans. ARC does not normally approve or review individual RLF loans. Instead, ARC monitors 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 ARC.

Purpose:

The purpose of the audit was to determine if (a) the administration by Southwestern North Carolina Planning & Economic Development Commission for its ARC Revolving Loan Fund Program was managed in accordance with the ARC approved grant and did not violate any restrictions imposed by the terms and conditions of the grant; (b) the accounting, reporting and internal control systems provided for disclosure of pertinent financial and operation information applicable to the revolving loan program; and (c) that the objectives of the grant are being met.

Background:

ARC awarded Grant Number NC-10181-88-I-302-0909 to Southwestern North Carolina Planning & Economic Development Commission (SNCPEDC). Total funding for the original grant was \$250,000 as of October 1, 1988. There were two subsequent amendments totaling \$400,000 to make the total grant obligations of \$650,000. ARC did not require that the grants be matched with any grantee cash, contributed services, or in-kind contributions. However, the Southwestern North Carolina Planning & Economic Development Commission did voluntarily match \$75,000 from their own funds.

Status:

As of June 30, 2005, SNCPEDC had four (4) ARC RLF loans outstanding, with an unpaid principal balance of \$504,253.

Scope:

Tichenor & Associates, LLP, under contract to the Appalachian Regional Commission (ARC), Office of Inspector General (OIG), performed a financial, compliance and internal control audit in accordance with Government Auditing Standards and ARC, OIG Audit Guide of ARC Revolving Loan Funds (RLF) of ARC grant funds administered by Southwestern North Carolina Planning & Economic Development Commission for the period of October 1, 1988 through June 30, 2005.

EXECUTIVE SUMMARY

Audit Results:

The audit resulted in the following:

a. Compliance

1. The grantee's Operating Plan makes no mention of the standardized financial statements that is to be required by all borrowers. We will recommend that this be included in the Operating Plan.
2. Per review of the June 30, 2005 Schedule B-1, the grantee shows a loan write off of \$3,006. Our review shows that this amount is actually accrued interest and therefore, should not be reflected on the Semi-Annual Financial Statement. The grantee had netted the \$3,006 against "Loan Principal Repayments" and included it under "Loan Balances Written Off". We recommend that this entry should be reversed.
3. Per our loan file review of ChemTronix, Inc., there are two loans of \$100,000 each. Key man life insurance was a requirement for both loans. However, the key man life insurance policy in the file is only for \$100,000, and has since lapsed. Grantee management stated that ChemTronix stated that they are in the process of getting a new policy.
4. Our audit determined that excess cash is being held by the grantee. The maximum allowable cash on hand in the SNCPEDC RLF for the period ending June 30, 2005, as prescribed in ARC Guidelines (paragraph VI.D.3, October 1999 edition), is \$126,063. The SNCPED RLF report shows an ending cash balance of \$211,765. The difference in these two amounts is \$85,702 in excess cash that the grantee is required to return to the ARC. We recommend that the \$85,702 in excess cash be returned to ARC.

Refer to the Schedule of Findings for more details on each audit finding.

b. Internal Control

No internal control issues were noted.

Auditee's Response:

In response to our draft report, the grantee officials provided the following responses to the compliance findings.

1. Grantee's Operating Plan has been changed to include the requirement that all borrowers provide standardized financial statements.

EXECUTIVE SUMMARY

2. The appropriate adjusting journal entry has been made concerning the write-off of program income rather than principal.
3. Grantee staff will continue to pursue efforts to get the key man insurance on the principal in ChemTronix, Inc. Additionally, they stated that they believe the collateral provided by the principal will be the only means by which the grantee may recover the balance of its RLF loans.
4. Excess cash has been returned to the ARC by check #1712 in the amount of \$42,684.75.

A copy of the grantee's complete response to the draft report is included in the report as Exhibit – Auditee's Response.

Auditor's Conclusion:

The grantee agreed to our findings and recommendations 1 – 3 included in this report. However, for finding and recommendation 4, the grantee agreed to return only \$42,685 of excess cash to ARC and not the recommended amount of \$85,702 for a difference of \$43,017 that should be returned to ARC or an explanation provided by the grantee to ARC as to why the balance of \$43,017 should not be returned.

We believe that by implementing all of the report recommendations, the grantee will (a) be in compliance with the requirements and responsibilities of its ARC approved grant; and (b) strengthen its systems of internal controls providing for disclosure of pertinent financial and operational information applicable to the revolving loan program. We further believe that the grantee is meeting the objectives of its grant.

Southwestern North Carolina Planning & Economic Development

SCHEDULE OF FINDINGS

SUMMARY OF AUDIT RESULTS

1. The auditor's report expresses an unqualified opinion on the ARC RLF grant financial statements of the Southwestern North Carolina Planning & Economic Development Commission for the period of October 1, 1988 through June 30, 2005.
2. Four (4) instances of noncompliance were disclosed during the audit.
3. No reportable conditions were disclosed during the audit.

FINDINGS AND RECOMMENDATIONS

NONCOMPLIANCES

1. Per ARC RLF Guidelines, all grantees are required to have an RLF Operating Plan. As part of the operating plan, a statement should be included regarding the standardized financial statements to be required of all borrowers.

After review of the SNCPEDC Operating Plan, there is no statement or reference to the standardized financial statements to be required of all borrowers.

This grantee stated that it was unaware of the requirement to reference the standardized financial statements to be required of all borrowers.

The omission of this reference means that the grantee is not in full compliance with ARC RLF guidelines relating to the RLF Operating Plan.

We recommend that the RLF Operating Plan be revised to reference the standardized financial statements to be required of all borrowers.

In response to our draft report, the grantee stated the Grantee's Operating Plan has been changed to include the requirement that all borrowers provide standardized financial statements. (See Exhibit – Auditee's Response.)

2. Per ARC RLF Guidelines, grantee accounting records must be maintained so that the information traces to the Semi-annual Financial Reports.

Per the June 30, 2005 Schedule B-1, the grantee shows a loan write off of \$3,006. Our review shows that this amount is actually accrued interest and therefore, should not be reflected on the Semi-Annual Financial Statement. The grantee had netted the \$3,006 against "Loan Principal Repayments" and included it under "Loan Balances Written Off".

The grantee mistakenly netted the write off of accrued program income against the principal repayments for the General Textiles, Inc. loan.

By doing so, the Loan Principal Repayments balance on the Semi-Annual Financial Status Report is understated and the Loan Balances Written Off is overstated by \$3,006.

We recommend that the grantee make the appropriate adjustment on their general ledger to re-class the \$3,006 back to principal repayments so that the accounting records will be in line with the Semi-Annual Financial Status Reports line with the Semi-annual Financial Reports.

In response to our draft report, the grantee stated that the appropriate adjusting journal entry has been made concerning the write-off of program income rather than principal. (See Exhibit – Auditee's Response.)

3. Per ARC RLF Guidelines, RLF loans to closely held corporations, partnerships or proprietorships dependent for their continuing success on certain individuals ordinarily will be required to provide and assign the RLF, life insurance on these key persons.

Per our loan file review of ChemTronix, Inc., there are two loans of \$100,000 each. Key man life insurance was a requirement for both loans. However, the key man life insurance policy in the file is only for \$100,000, and has since lapsed. Grantee management stated that ChemTronix stated that they are in the process of getting a new policy.

At the time the current policy lapsed, the borrower was experiencing financial difficulty. The borrower did not address the issue regarding life insurance. The grantee has made several attempts to contact the borrower to reapply for key man life insurance. The borrower has made several promises to take care of this situation.

By not having the key man life insurance as collateral, the grantee is left exposed for the amount of the unpaid principal.

We recommend that the SNCPEDC continue to pursue the borrower to obtain key man life insurance for the amount of \$200,000.

In response to our draft report, the grantee stated that the grantee staff will continue to pursue efforts to get the key man insurance on the principal in ChemTronix, Inc. Additionally, they stated that they believe the collateral provided by the principal will be the only means by which the grantee may recover the balance of its RLF loans.

4. Per ARC RLF Guidelines, a grantee is allowed to have a cash balance in their bank account, not to exceed 25% of the gross loan receivable amount.

Our audit determined that excess cash is being held by the grantee. The maximum allowable cash on hand in the SNCPEDC RLF for the period ending June 30, 2005, as prescribed in ARC Guidelines (paragraph VI.D.3, October 1999 edition), is \$126,063. The SNCPED RLF report shows an ending cash balance of \$211,765. The difference in these two amounts is \$85,702 in excess cash that the grantee is required to return to the ARC.

The excess cash is due to the repayment of current/outstanding loans with no loan commitments as of June 30, 2005.

Excess cash held by the SNCPEDC is in violation of the grant agreement. Also, having excess cash may lend itself to be used for non-ARC purposes.

We recommend that the \$85,702 in excess cash be returned to ARC.

In response to our draft report, the grantee stated that excess cash has been returned to the ARC by check #1712 in the amount of \$42,684.75. (See Exhibit – Auditee’s Response.)

REPORTABLE CONDITIONS

No reportable condition issues were noted.

AUDITOR’S CONCLUSION

The grantee agreed to our findings and recommendations 1 – 3 included in this report. However, for finding and recommendation 4, the grantee agreed to return only \$42,685 of excess cash to ARC and not the recommended amount of \$85,702 for a difference of \$43,017 that should be returned to ARC or an explanation provided by the grantee to ARC as to why the balance of \$43,017 should not be returned.

We believe that by implementing all of the report recommendations, the grantee will (a) be in compliance with the requirements and responsibilities of its ARC approved grant; and (b) strengthen its systems of internal controls providing for disclosure of pertinent financial and operational information applicable to the revolving loan program. We further believe that the grantee is meeting the objectives of its grant.

EXHIBIT

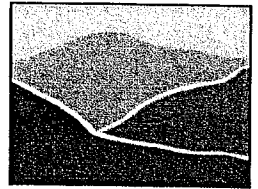
Auditee's Response

SOUTHWESTERN COMMISSION

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Macon County

Franklin
Highlands

Swain County

Bryson City

March 27, 2006

Mr. William R. Tichenor, CPA
Tichenor & Associates, LLP
304 Middletown Park Place, Suite C
Louisville, KY 40243

Dear Mr. Tichenor:

Following are our responses to the draft report for the referenced Appalachian Regional Commission-Revolving Loan Fund Grants:

Grant No. NC-10181-I-302-0909

1. Southwestern Commission's Operating Plan has been changed to include the requirement that all borrowers provide standardized financial statements.
2. The appropriate adjusting journal entry has been made concerning the write-off of program income rather than principal.
3. RLF staff will continue to pursue efforts to get \$200,000 in key man insurance on the principal in ChemTronix, Inc., Mr. James Partridge. We believe that collateral provided by Mr. and Mrs. James Partridge (second deed of trust on their residence and two rental properties) will be the only means by which the Commission may recover the balance of its RLF loans.
4. Excess cash has been returned to the Appalachian Regional Commission by check #1712 in the amount of \$ 42,684.75.

Please let me know if you have any questions or need additional information.

Sincerely,

Bill G. Gibson, Executive Director
Southwestern Commission

Appalachian Development District

Area Agency on Aging

Economic Development District

Rural Planning Organization

Regional Revolving Loan Fund

Workforce Investment Act