AUDIT OF THE ARC REVOLVING LOAN FUND
OPERATED BY
Cumberland Valley Area Development
London, Kentucky

ARC Grant Numbers: KY-12036-95-I-302-0411
July 1, 1995 through September 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: 06-20

Date: May 24, 2006

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OPERATED BY
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London, Kentucky

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July 1, 1995 through September 30, 2005

Prepared By:

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

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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: 06-20

Independent Auditor's Report

We have audited the ARC RLF grant Schedule of Fund Balance of the Cumberland Valley Area Development District as of September 30, 2005, and the related Statement of Source and Application of Funds for the period of July 1, 1995 through September 30, 2005. These financial statements are the responsibility of the Cumberland Valley Area Development District. 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 Cumberland Valley Area Development District's fiduciary activities as of September 30, 2005 and the source and application of funds resulting from fiduciary activities for the period of July 1, 1995 through September 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 November 18, 2005 on our consideration of the Cumberland Valley Area Development District'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

Tichenor & Associates, LLP
Louisville, Kentucky
November 18, 2005

Cumberland Valley Area Development District

SCHEDULE OF FUND BALANCE
(As of September 30, 2005)

Cash in Bank	$156,734
Loans Outstanding	121,578
Other Investments	
Due from Other Accounts	
Other Assets	
Less: Current Liabilities	3,148
Fund Balance	$275,164

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

Cumberland Valley Area Development District

STATEMENT OF SOURCE AND APPLICATION OF FUNDS
(For The Period of July 1, 1995 through September 30, 2005)

Source of Funds	
ARC Grant	$365,000
Loan Interest Income	91,453
Fees Charged	5,079
Other Income	12,314
Total Funds Available	$473,846

Application of Funds	
Cash in Bank	$156,734
Loans Outstanding	121,578
Grant Funds Returned	119,126
Match for EDA Fund	0
Loan Losses	15,208
Administrative Expenses	61,200
Total Funds Applied	$473,846

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 Cumberland Valley Area Development District as of and for the period of July 1, 1995 through September 30, 2005, and have issued our report thereon dated November 18, 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 Cumberland Valley Area Development District 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 Cumberland Valley Area Development District'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 noted a certain matter 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 Cumberland Valley Area Development District's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying Schedule of Findings.

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. However, we do not believe the reportable condition described above is a material weakness.

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
November 18, 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 Cumberland Valley Area Development District 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 KY-12036-95-I-302-0411 to Cumberland Valley Area Development District. Total grant funding for the grant was for $300,000. ARC did not require that the grants be matched with any grantee cash, contributed services, or in-kind contributions.

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 Cumberland Valley Area Development District for the period of July 1, 1995 through September 30, 2005.

Status:

As of September 30, 2005, CVADD had two ARC RLF loans outstanding with an unpaid balance of $121,578.

EXECUTIVE SUMMARY

Audit Results:

The audit resulted in the following:

a. Compliance

1. Per CVADD, a deposit error in a prior period has overstated cash by $9166.88. This amount will need to be transferred out of the cash account.

2. The loan to Bluegrass Hosiery had a principal balance of $15,208.58 when it was to be written off. CVADD wrote off $62,081.34 which included past interest. The correct amount of bad debt write off should be $15,208.58.

3. Per RLF Guidelines, once a loan is deemed to be in doubt of collection, all future monies received are to be applied to principal first, until the loan is paid off. Any additional monies can then be applied to Program Income. After the point that Bluegrass Hosiery closed their doors, Program Income of $12,579.25 had been recorded. This amount should be reclassified to principal.

4. Our analysis revealed that excess cash continues to be held. The maximum allowable cash on hand in the CVADD RLF for the period ending September 30, 2005, as prescribed in ARC Guidelines (paragraph VI.D.3, October 1999 edition), is $30,394.47. The CVADD RLF report shows an ending cash balance of $156,733.88. Within this amount is $126,339.41 that you are obligated to return to the ARC.

b. Internal Control

1. The Grantee has one person who performs three key duties related to the payroll function. This person maintains time and attendance records, prepares the paychecks and distributes the paychecks. Proper internal controls dictate that the person responsible for maintaining time and attendance records be separated from the person who prepares and distributes the paychecks. This lack of control leaves a possibility of data manipulation.

2. The Grantee does not require employees in key positions to take vacations. Proper internal control procedures dictate that vacations for employees in key positions should be mandatory.

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

Auditee's Response:

In response to our draft report, the Grantee agreed to each of the report's recommendations. A copy of the Grantee's complete response to the draft report is included in this report as Exhibit – Auditee's Response.

Auditor's Conclusion:

We believe that by implementing 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.

Cumberland Valley Area Development District

SCHEDULE OF FINDINGS

SUMMARY OF AUDIT RESULTS

1. The auditors report expresses an unqualified opinion on the ARC RLF grant financial statements of the Cumberland Valley Area Development District for the period of July 1, 1995 through September 30, 2005.

2. Four (4) instances of noncompliance were disclosed during the audit.

3. Two (2) reportable conditions were disclosed during the audit.

FINDINGS AND RECOMMENDATIONS

NONCOMPLIANCES

1. The CVADD management is required to report current and correct information pertaining to the ARC RLF grant financial statements for the period of October 1, 2004 September 30, 2005.

   The current Cash balance is overstated by $9,166.88. This is due to an erroneous deposit, meant for a different fund, but made to the RLF fund.

   This deposit was made into the wrong bank account which made the accounting records to be misstated. The grantee did not realize this error until our audit was conducted.

   The fact that the RLF cash account balance is overstated is misleading to users of the financial statements. Also, if all monies are used for loan purposes, amounts in excess of the grant dollars available could be used. This would be in violation of the ARC RLF Grant Agreement.

   We recommend that a check be written out of the ARC RLF funds for $9,166.88 to the correct fund. This will correctly state the ARC RLF cash bank account as of September 30, 2005.

   In response to our draft report, the Grantee acknowledged that they have excess funds in the account due to the error and will transfer the funds out per the finding. (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 review of the loan activity and eventual write-off of Bluegrass Hosiery, Inc., CVADD has improperly reported loan principal repayments as interest in the amount of $12,579.25 (See 3 below). Also, while the principal balance of the loan was $27, 787.83, CVADD wrote off $62,081.34.

The Development Specialist stated their outside auditors instructed her to write off the principle, as well as, all past reported interest income.

By doing so, the CVADD accounting records do not agree to the September 30, 2005 Semi-annual Financial Report. The Bad Debt account is overstated by $47,872.76. This is the difference between the amount written off ($62,081.34) and the per audit loan principal balance of $15,208.58.

We recommend that CVADD make the appropriate adjustments to their accounting records to bring them in line with the Semi-annual Financial Reports.

In response to our draft report, the Grantee agreed with the finding and acknowledged the incorrect amount was used in writing-off bad debt. The Grantee stated that the appropriate CVADD accounting books will be adjusted accordingly. (See Exhibit – Auditee's Response.)

3. Per ARC RLF Guidelines, all monies received from a borrower, after the point at which there is a high probability the loan will be in default, should be applied to principal first. After the principal is paid off, any future payments can then be applied to program income (interest income).

   Bluegrass Hosiery, Inc. closed its doors in 1998. At that point, any future payments should have been applied to principal. However, $12,579.25 was applied to interest.

   The Development Specialist stated that this was how their outside auditors instructed them to record the future payments received from Bluegrass Hosiery, Inc.

   By doing so, CVADD is in violation with ARC RLF Guidelines. The program income is overstated and principal repayments are understated by the $12,579.25. The loan dollar pool is then overstated by the same amount.

   We recommend that CVADD reclass $12,579.25 from Interest on Loans to Loan Principal Repayments on their Semi-annual Financial Reports, as well as, accounting records.

   In response to our draft report, the Grantee agreed with the finding and acknowledged the error. The appropriate ACADD accounting books will be adjusted accordingly to reflect the correct classification of the funds. (See Exhibit – Auditee's Response.)

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 analysis revealed that excess cash continues to be held. The maximum allowable cash on hand in the CVADD RLF for the period ending September 30, 2005, as prescribed in ARC Guidelines (paragraph VI.D.3, October 1999 edition), is $30,394.47. The CVADD RLF report shows an ending cash balance of $156,733.88. Within this amount is $126,339.41 that you are obligated to return to the ARC.

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

   Excess cash held by the CVADD 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 CVADD comply with the provisions set forth in the letter of October 14, 2005, from Robert M. Decker, ARC Director of Finance and Administration, which states that CVADD is authorized to hold the $126,339.41 of excess cash until March 31, 2006 while attempting to close additional loans. Should no loans be closed or committed by then, CVADD is obligated to refund up to that amount to ARC by May 1, 2006.

   In response to our draft report, the Grantee that they are aware of the excess cash on hand. Grantee also stated that they do have a potential client that they have been in consultation with recently. (See Exhibit – Auditee's Response.)

REPORTABLE CONDITIONS

1. Proper internal control procedures require a segregation of duties when it comes to the payroll function. The person who is responsible for maintaining time and attendance records should be different from the person who prepares and distributes the payroll checks.

   The detection of keying errors or data manipulation is significantly reduced by this lack of segregation of duties.

   Presently, only one person is performing all three of these 3 key payroll functions (maintaining time and attendance records, preparing and distributing the payroll checks).

   We recommend that the duties be assigned to more than one person.

In response to our draft report, the Grantee provided a partial description of how the time sheets are processed and controlled and that the process has been the "unwritten" traditional policy with the Grantee for many years. (See Exhibit – Auditee's Responses.)

2. Proper internal control procedures require that all employees in key financial positions be required to take annual vacations.

   The detection of misappropriation of funds is made more difficult by not requiring that employees in key financial positions take annual vacations.

   Presently, employees in key financial positions are not required to take annual vacations.

   We recommend that employees in key financial positions be required to take annual vacations.

   The detection of misappropriation of funds is made more difficult by not requiring that employees in key financial positions take annual vacations.

   Presently, employees in key financial positions are not required to take annual vacations.

   We recommend that employees in key financial positions be required to take annual vacations.

   In response to our draft report, the Grantee stated that they would be updating the agency's personnel policy manual and will address the issue relating to mandatory vacations for key positions. (See Exhibit – Auditee's Responses.)

AUDITOR'S CONSLUSION

We believe that by implementing the above recommendations, the Cumberland Valley Area Development District 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 Cumberland Valley Area Development District is meeting the objectives of its grant.

EXHIBIT

Auditee's Response

Chairman
Judge/ Executive
Joseph Grieshop
Harlan County

Vice Chairman
Judge/ Executive
Lawrence Kuhl
Laurel County

2nd Vice Chairman
Gatliff Craig
Rockcastle County

Cumberland Valley Area Development District

CVADD

P.O. Box 1740
342 Old Whitley Road
London, Kentucky
40743-1740

Secretary
Penny Robinson
Clay County

Treasurer
Homer L. Jackson
Knox County

Executive Director
Andrew D. Meadors

March 17, 2006

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

Re: Audit of the ARC Revolving Loan Fund Operated by the Cumberland Valley ADD
Grant No. KY-12036-95-I-302-0411

Dear Mr. Tichenor:

We are in receipt of the draft audit report and wish to provide the following response to the audit results.

Audit Results:

The audit resulted in the following:

a. Compliance

1. Per CVADD, a deposit error in a prior period has overstated cash by $9,166.88. This amount will need to be transferred out of the cash account

Response: We acknowledge that we have excess funds in the account due to the error. We will transfer those funds out per the finding.

2. The loan to Bluegrass Hosiery had a principal balance of $15,208.58 when it was to be written off. CVADD wrote off $62,081.34 which included past interest. The correct amount of bad debt write-off should be $15,208.58.

Response: We agree with the finding and acknowledge the incorrect amount was used in writing-off the bad debt. The appropriate CVADD accounting books will be adjusted accordingly.

3. Per RLF Guidelines, once a loan is deemed to be in doubt of collection, all future monies received are to be applied to principal first, until the loan is paid off. Any additional monies can then be applied to Program Income. After the point that Bluegrass Hosiery closed their doors, Program Income of $12,579.25 had been recorded. This amount should be reclassified to principal.

Response: We agree with the finding and acknowledge the error. The appropriate CVADD accounting books will be adjusted accordingly to reflect the correct classification of the funds.

4. Our analysis revealed that excess cash continues to be held. The maximum allowable cash on hand in the CVADD RLF for the period ending September 30, 2005, as prescribed in ARC Guidelines (paragraph VI.D.3, October 1999 edition), is $30,394.47. The CVADD RLF report shows an ending cash balance of $156,733.88. Within this amount is $126,339.41 that CVADD is required to return to the ARC.

Response: We are aware of the excess cash on hand. However, we do have a potential client that we have been in consultation with recently.

b. Internal Control

1. The Grantee has one person who performs three key duties related to the payroll function. This person maintains time and attendance records, prepares the paychecks and distributes the pay checks. Proper internal controls dictate that the person responsible for maintaining time and attendance records be separated from the person who prepares and distributes paychecks. This lack of control leaves a possibility of data manipulation.

Response: Each employee's supervisor reviews time sheets for approval or disapproval. Additionally, the receptionist maintains a separate daily record on the whereabouts of each employee, including vacation/sick/ holiday status. Prior to submission to the executive director for review, these two checks must balance. Once approved by the executive director, the time sheets are forwarded to the bookkeeper for appropriate use and filing. Also, if an error is discovered on a time sheet, we require that a new time sheet be prepared for review and approval rather than attempting to "correct" an error by marking through it, etc. This has been the "unwritten" traditional policy with the agency for many years.

2. The Grantee does not require employees in key positions to take vacations. Proper internal control procedures dictate that vacations for employees in key positions should be mandatory.

Response: As the new executive director, with the knowledge and final approval of the CVADD Board of Directors, I am updating the agency's personnel policy manual, which includes job descriptions. In the updated policy, I will address the issue relating to mandatory vacation for key positions.

If you need additional information or a more detailed explanation or response to any of the findings or responses, please let me know.

Sincerely,

Andrew D. Meadors

Andrew D. Meadors
Executive Director