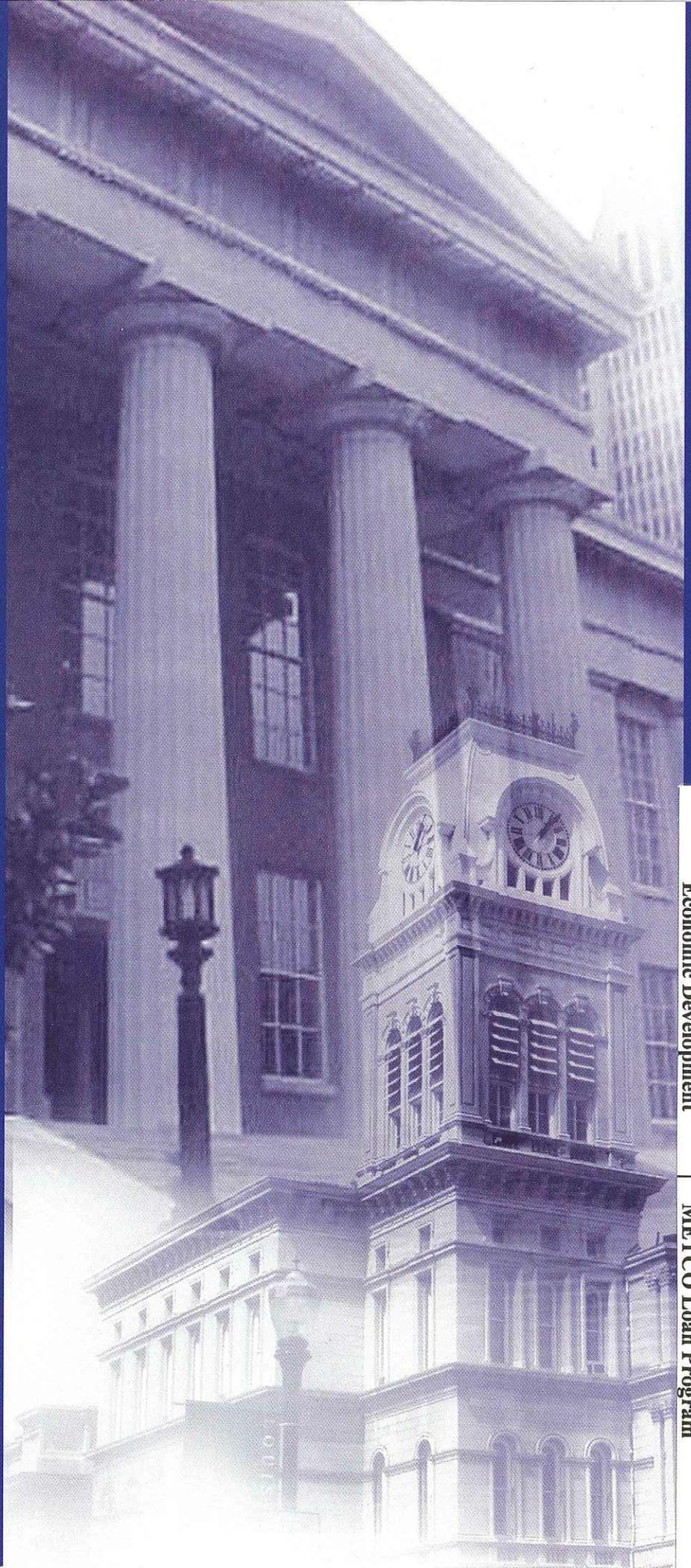




Jerry E. Abramson  
Mayor  
Louisville Metro Council

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# Office of Internal Audit

Economic Development

METCO Loan Program

# Audit Report

Office of Internal Audit

## Economic Development

### Metropolitan Business Development Corporation (METCO) Loan Program

August 2008



Economic Development

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METCO Loan Program

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OFFICE OF INTERNAL AUDIT  
LOUISVILLE, KENTUCKY

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### **Transmittal Letter**

August 11, 2008

The Honorable Jerry E. Abramson  
Mayor of Louisville Metro  
Louisville Metro Hall  
Louisville, KY 40202

### **Subject: Audit of Economic Development's METCO Loan Program**

#### **Introduction**

An audit of Economic Development's Metropolitan Business Development Corporation (METCO) loan program was performed. The primary focus of the audit was the operational and fiscal administration of the loan activity. This included how Economic Development processes, records, and monitors the activity. The objective was to obtain assurance that risks are adequately mitigated through the internal control structure.

The audit was conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States and with the International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.

As a part of the review, the internal control structure was evaluated. The objective of internal control is to provide reasonable, but not absolute, assurance regarding the achievement of objectives in the following categories:

- Achievement of business objectives and goals
- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations
- Safeguarding of assets

There are inherent limitations in any system of internal control. Errors may result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personnel factors. Some controls may be circumvented by collusion. Similarly, management may circumvent control procedures by administrative oversight.

### Scope

The operating policies and procedures for Economic Development's METCO loan program were reviewed through interviews with key personnel. The focus of the review was the operational and fiscal administration of the activity. Tests of sample data were performed for transactions from the period July 1, 2007 to March 31, 2008. Activity reviewed included loan file documentation, activity reports from the loan management system, deposit receipts, and Metro financial system postings. Compliance with Federal funding requirements was excluded from review as they are covered as part of Metro's A-133 annual audit.

The review included assessing whether activity was processed, recorded, and monitored accurately and appropriately. The details of the scope and methodology of the review will be addressed in the Observations and Recommendations section of this report. The audit would not identify all issues because it was based on selective review of data.

### Opinion

It is our opinion that the administration of METCO loan program activity needs improvement. The internal control rating is on page 5 of this report. The rating quantifies the opinion regarding the internal controls, and identifies areas requiring corrective action. Opportunities to strengthen the METCO loan program internal control structure include the following.

- **Loan System.** Economic Development is in need of new loan management software to improve the processing, monitoring, and reconciliations of loan activity. Though efforts have been made over the last few years to replace the current loan software, the purchase and implementation of a new system has not been executed.
  - All users of the loan system share the same login ID and password. Functional access to the system is not restricted, thereby eliminating any segregation of duties and diminishing accountability.
- **General Administration.** The reconciliation of loan payment activity to the Metro financial system is incomplete and not formally documented. This could result in the oversight of errors and inaccurate reporting, which in turn limits the reliability and usefulness of reports as management tools.
- **Loan Payment Processing.** Metro Finance processes METCO loan payment activity. Loan payment transactions are not reconciled to deposit records to ensure completeness of all activity; and in some cases, loan payments were not deposited timely.

The implementation of the recommendations in this report will help strengthen the internal control structure and effectiveness of the administration of METCO loan program activity.

**Corrective Action Plan**

Representatives from Economic Development have reviewed the results and are committed to addressing the issues noted. Corrective action plans are included in this report in the Observations and Recommendations section. We will continue to work with Economic Development to ensure the actions taken are effective to address the issues noted.

Sincerely,

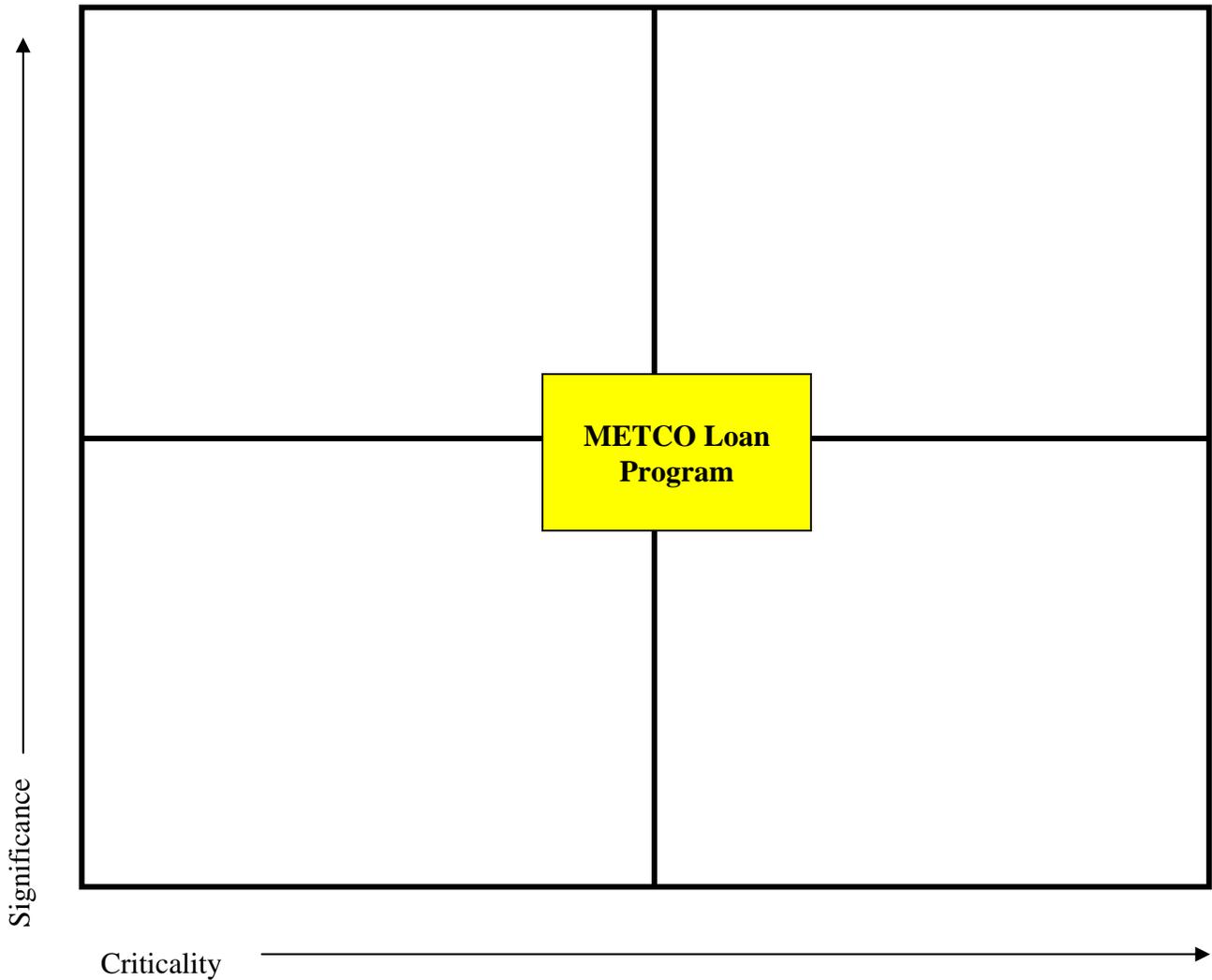


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Michael S. Norman, CIA, CFE, CGAP  
Chief Audit Executive

cc: Louisville Metro Council Government Accountability and Audit Committee  
Director of Economic Development  
Director of Finance  
Louisville Metro External Auditors

**Internal Control Rating**



<u>Legend</u>			
<u>Criteria</u>	<u>Satisfactory</u>	<u>Needs Improvement</u>	<u>Inadequate</u>
<i>Issues</i>	Not likely to impact operations.	Impact on operations likely contained.	Impact on operations likely widespread or compounding.
<i>Controls</i>	Effective.	Opportunity exists to improve effectiveness.	Do not exist or are not reliable.
<i>Policy Compliance</i>	Non-compliance issues are minor.	Non-compliance issues may be systemic.	Non-compliance issues are pervasive, significant, or have severe consequences.
<i>Image</i>	No, or low, level of risk.	Potential for damage.	Severe risk of damage.
<i>Corrective Action</i>	May be necessary.	Prompt.	Immediate.

## **Background**

Louisville Metro's Economic Development department administers a variety of loan programs through the Metropolitan Business Development Corporation (METCO). These loan programs provide affordable financing that can be leveraged with conventional financing for start-up and expanding businesses. METCO establishes loan programs to meet the objectives of the preservation and creation of employment, particularly to low and moderate income families, and the maintenance and expansion of the tax base. In addition, within specially targeted areas or industries, objectives include the promotion of new and expanded businesses, with emphasis on female and minority business enterprises; the improvement in the physical appearance of the city; and the improvement in the goods and services available to residents.

Economic Development manages loan program activity to include the maintenance of loan profile data, transaction records, and report creation. Metro Finance administers the posting of payments to the loan management system and the Metro financial system, as well as the deposit of all payment activity. As of April 1, 2008 there were 262 active loans, representing approximately \$11.6 million in loaned funds.

This was a scheduled audit.

## **Summary of Audit Results**

### **I. Current Audit Results**

See Observations and Recommendations section of this report.

### **II. Prior Audit Issues**

The Office of Internal Audit previously audited the METCO loan program in September 1999. Unless otherwise noted, all prior issues have been satisfactorily addressed.

### **III. Statement of Auditing Standards**

The audit was performed in accordance with Government Auditing Standards issued by the Comptroller General of the United States and with the International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.

### **IV. Statement of Internal Control**

An understanding of the internal control structure was obtained in order to support the final opinion.

### **V. Statement of Irregularities, Illegal Acts, and Other Noncompliance**

The review did not disclose any instances of irregularities, any indications of illegal acts, and nothing was detected during the review that would indicate evidence of

such. Any significant instances of noncompliance with laws and regulations are reported in the Observations and Recommendations section of this report.

## **VI. Views of Responsible Officials / Action Plan**

A draft report was issued to the Louisville Metro Economic Development department and to Metro Finance on July 10, 2008. It was determined that a formal exit conference was not necessary.

The views of Economic Development were received on August 8, 2008 and are included as corrective action plans in the Observations and Recommendations section of the report. The plans indicate a commitment to addressing the issues noted.

LMCO §30.36(B) requires Louisville Metro Agencies to respond to draft audit reports in a timely manner. It specifically states that

*“The response must be forwarded to the Office of Internal Audit within 15 days of the exit conference, or no longer than 30 days of receipt of the draft report.”*

Economic Development’s responses were provided within this required timeframe.

## Observations and Recommendations

### **Scope**

Economic Development's procedures for administering the Metropolitan Business Development Corporation (METCO) loan program activity were reviewed through interviews with key personnel. The primary focus was the operational and fiscal administration of the activity. This included assessing whether activity was processed, recorded, and monitored accurately and appropriately. Compliance with Federal funding requirements was excluded from review as they are covered as part of Metro's A-133 annual review.

Tests of sample data were performed for loan activity from the period July 1, 2007 through March 31, 2008. A sample of 10 loans was judgmentally selected from the population of METCO loans considered active or repaid during the audit period. Activity reviewed included loan file documentation, loan management system reports, deposit receipts, and Metro financial system postings. The review would not reveal all issues because it was based on a selective review of data.

### **Observations**

Some issues were noted with the administration of METCO loan program activity. As a result, the effectiveness of the internal control structure is impaired and needs improvement. Opportunities noted to strengthen the controls are as follows.

#1 – Loan System

#2 – General Administration

#3 – Loan Payment Processing

Details of these begin on the following page.

## #1 – Loan System

Some issues were noted with the system used by Economic Development to maintain METCO loan data. Specifics include the following.

- **Loan Software.** Economic Development consulted with Internal Audit in 2004 regarding the need for new loan software. It was anticipated that the purchase of new software and the implementation of lockbox processing for payments would improve the processing of loan activity, monitoring, and reconciliations. However, neither replacement loan software nor lockbox processing have been implemented.
  - Economic Development purchased new loan software in fiscal year 2006, but due to concerns of Metro Finance and Metro Technology Services the software was never implemented. It should be noted that another loan management software was recently reviewed by the departments and the purchase / implementation is pending fund availability.
- **Access Controls.** Economic Development and Metro Finance personnel access the loan system through a shared login ID and password. With a shared login, functional access to the system is not restricted, thereby eliminating any segregation of duties. Users would have the ability to enter transactions outside their area of responsibility. Also, there is no definitive way to identify the employee processing activity in the system. This increases the risk that information could be manipulated with anonymity and without detection.
- **Partial Payments.** The loan management system does not address or differentiate partial loan payments from full payments. Therefore, when partial payments are keyed they will extend a loan's paid-thru date, and a late fee will not be incurred even though the payment was not full. Ultimately, the treatment of partial payments in this manner will artificially extend the expected repayment period of the loan, which conflicts with the original maturity date and is contrary to the terms of the loan note.
- **Processing Date Field.** The loan system does not have a "processing date" field to track when transactions were keyed into the system. This hampers the reconciliation of daily payment activity and limits the reliability of reports as monitoring tools for management. Though an "activity date" is recorded for transactions, the system uses this field for the application of late fees to payments when applicable. Therefore, processors record the postmark date from the payment envelope in order to give payees credit for paying timely. The postmark date may not be the same as the payment processing date.

## Recommendations

Appropriate personnel should take corrective action to address the issues noted. Specific recommendations include the following.

- ✓ Economic Development, Metro Finance, and Metro Technology Services should continue with their efforts to purchase and implement a new loan management system that will better fit their needs. Prior to the implementation of a new loan system, it

would be beneficial to consult with the Office of Internal Audit to ensure risks and internal controls have been adequately addressed.

- ✓ If resources are not available to purchase a new loan management system, then it is essential that modifications be made to the current system. The modifications should address improved processing and reporting tools to assist with monitoring and reconciliations of loan activity. Manual efforts may be necessary to supplement in areas where system limitations prevent adequate processing and reporting.
- ✓ Each user of the loan management system should have a unique login and password assigned to them. This would provide for a proper audit trail and accountability over transactions performed. System access should be restricted for each individual to only areas deemed necessary to perform job duties and responsibilities associated with their job function.
- ✓ Ultimately, a comprehensive loan management system would be capable of addressing the data entry needs of both payment activity (e.g., partial payments, processing dates) and fee administration within the processing and reporting capabilities. This would promote accountability, efficiency, and support of the loan payment and financial records reconciliation. The purchase of a new loan management system should provide Economic Development with the functionality needed to address all data entry needs.

#### **Economic Development's Corrective Action Plan**

Economic Development concurs with the recommendations; we requested approval to purchase and implement loan software which would fulfill each of these recommendations. The request is pending Metro Finance and Metro Technology Services approval. We have attended an introductory meeting on the Oracle Accounts Receivable module including Housing, Finance and Economic Development.

## #2 – General Administration

Some issues were noted with the general administration of METCO loan activity. Specifics include the following.

- **Activity Reconciliation.** Though a monthly comparison is performed to ensure payment activity in the loan system agrees with revenue postings in the Metro financial system, the reconciliation is not complete or formally documented. Differences in the timing of payment entries in the loan system, the deposit of funds, and postings to the financial system complicate the reconciliation process, inasmuch as an exact dollar match is not achieved with current reconciliations. Differences are not reconciled to verify the accuracy and completeness of activity.
- **Loan Delinquency.** Individual discretion is applied in the method and duration of assistance used to bring a delinquent loan account current. As there are no documented guidelines for these situations, delinquent loans may not be treated in a consistent or efficient manner. This could result in the appearance of preferential treatment.
- **Documentation of Site Visits.** There are no forms completed or records maintained to document on-site visits conducted with loan recipients. According to Economic Development's policies and procedures, on-site visits shall be conducted with all loan applicants within 12 months after the loan close, then annually thereafter. Without documentation of visits performed, there is no means by which to verify loan recipient adherence to agreements and applicable loan requirements.
- **Loan File Storage.** Hardcopy loan files are not kept secured. Loan files contain borrower financial and personal information, including social security numbers, bank accounts and tax returns. Unsecured files increase the risk of unauthorized disclosure, misuse, destruction, or other compromise of such information.

## Recommendations

Appropriate personnel should take corrective action to address the issues noted. Specific recommendations include the following.

- ✓ Economic Development personnel should continue monitoring loan activity reports to ensure payments are properly applied and reported. This should include reviewing loan history and paid-thru reporting, as well as fund and status summary reports, for accuracy and completeness of payment activity. In addition, transactions should be reconciled to the Metro financial statements to ensure the accurate and timely reflection of activity. Any exceptions noted during routine monitoring should be thoroughly investigated and the resolution properly documented.
- ✓ Independent verification and monitoring of activity is an important element of an effective internal control structure. This provides additional oversight, and increases the likelihood of detecting inaccurate or inappropriate activity. An effective monitoring system should include the independent review of supporting documentation and its reconciliation to activity reports. Routine supervisory review

should be performed to ensure that proper reconciliations are performed and variances explained.

- ✓ Policies and procedures that govern loan delinquencies should be created and documented. The procedures should address the documentation necessary to support any variation to the contractual terms of a loan, including those enacted on a temporary basis to assist the borrower in bringing the account current. Documentation should include the reason and basis for the determination, applicable timeframe, recommendation and signature of the loan officer, and a secondary signature of approval. The policy should clearly define allowable actions and those which would require approval by the METCO Board of Directors (e.g., loan restructure). All personnel involved in the administration of loans should be aware of the requirements, and held accountable for adhering to them.
- ✓ Economic Development personnel should document site visits performed of loan recipients. Documentation should include applicable information (e.g., date, time, observations, and follow-up actions) in support of their monitoring of loan recipient adherence to agreements and applicable loan requirements.
- ✓ Care should be taken by Economic Development personnel to ensure loan files are adequately secured at all times. File cabinets should remain locked when not in use and access to files should be limited to only personnel having need based on job function and responsibility. This will help decrease the risk that files and associated information could be used inappropriately.

#### **Economic Development's Corrective Action Plan**

Economic Development is in the process of completing a draft of written policies and procedures to address these recommendations which will be provided to Internal Audit for review. It is estimated a draft will be available within two weeks.

### **#3 – Loan Payment Processing**

METCO loan payments are administered by Metro Government's Finance and Administration department. Some issues were noted with the processing of loan payments. Specifics include the following.

- **Activity Reconciliation.** Finance personnel do not reconcile loan payment activity to ensure all transactions keyed into the loan system agree with bank deposits. There is not a system field to document processing dates, therefore activity can not be queried by date and reconciled to deposit totals.
  
- **Deposit Timeliness.** Loan payments are not always deposited timely with the Treasury division in accordance with Cash Management Policy. For 4 of 10 payments (40%), deposit activity was greater than five business days after receipt by Finance personnel. Deposits ranged from 6 to 15 days. Payments that are not deposited in accordance with policy have a greater risk they could be lost or misplaced.
  
- **Desktop Procedures.** There are no documented desktop procedures for Finance personnel to use in the processing of loan payment activity. Though reference materials were provided to guide in accessing the loan system and processing payments, the materials were obsolete and reflected guidelines used prior to a system upgrade. The lack of documented procedures increases the risk of non-compliance with intended procedures and requirements. This can also lead to inconsistencies and inefficiencies with processing and monitoring of activity.
  - The processing of payments against accrued interest varied. In some instances a carry-over amount of accrued interest was ignored, while in other cases the payment was applied to the accrued interest rather than to principal.

### **Recommendations**

Appropriate personnel should take corrective action to address the issues noted. Specific recommendations include the following.

- ✓ Finance personnel should monitor and reconcile daily loan payment activity to ensure all payments are properly keyed into the loan management system and deposited at the bank. Ideally, a loan management system should have the capabilities to produce daily activity reports to assist with a reconciliation of payment activity. If it is determined that the current loan system can not produce viable activity reports, then Finance should consider taking manual efforts (i.e., printing screens of payment activity) to document and support that activity is appropriate.
  
- ✓ Routine supervisory reviews should be conducted to ensure that proper reconciliations are performed and variances explained. Independent verification and monitoring of activity is an important element of an effective internal control structure. This provides additional oversight of activity, and increases the likelihood of detecting inaccurate or inappropriate activity

- ✓ Care should be taken by Finance personnel to ensure all loan funds are deposited in a timely manner in accordance with Metro's Cash Management policies (weekly or when they reach \$1,000, whichever occurs first). This will help ensure the security of funds and optimize Metro's investment income.
- ✓ Prompt processing of loan payment activity is also crucial to preclude or mitigate payment delinquencies and loan defaults, allowing professional management of the debtor relationship and continued viability of the loan program.
- ✓ Documented procedures for loan payment activity should reflect the most current processes, be updated periodically, and should be distributed to all applicable personnel involved in processing. This will help ensure adherence to applicable guidelines, consistency in processing, and promote efficiency and effectiveness.

### **Economic Development's Corrective Action Plan**

Economic Development works with Finance to manage the loan programs as timely and accurately as possible. We are addressing the reconciliation, timeliness of deposits, and policies and procedures concerns outlined. We will coordinate with Finance to address these issues.



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**Name of Report** Economic Development – METCO Loan Program

<b>How do you rate this report?</b>			
	<b>Beneficial</b>	<b>Somewhat Helpful</b>	<b>Needs Improvement</b>
Background Information	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Details	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Length of Report	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Clarity of Writing	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Potential Impact	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Suggestions, comments, ideas, thoughts: \_\_\_\_\_

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