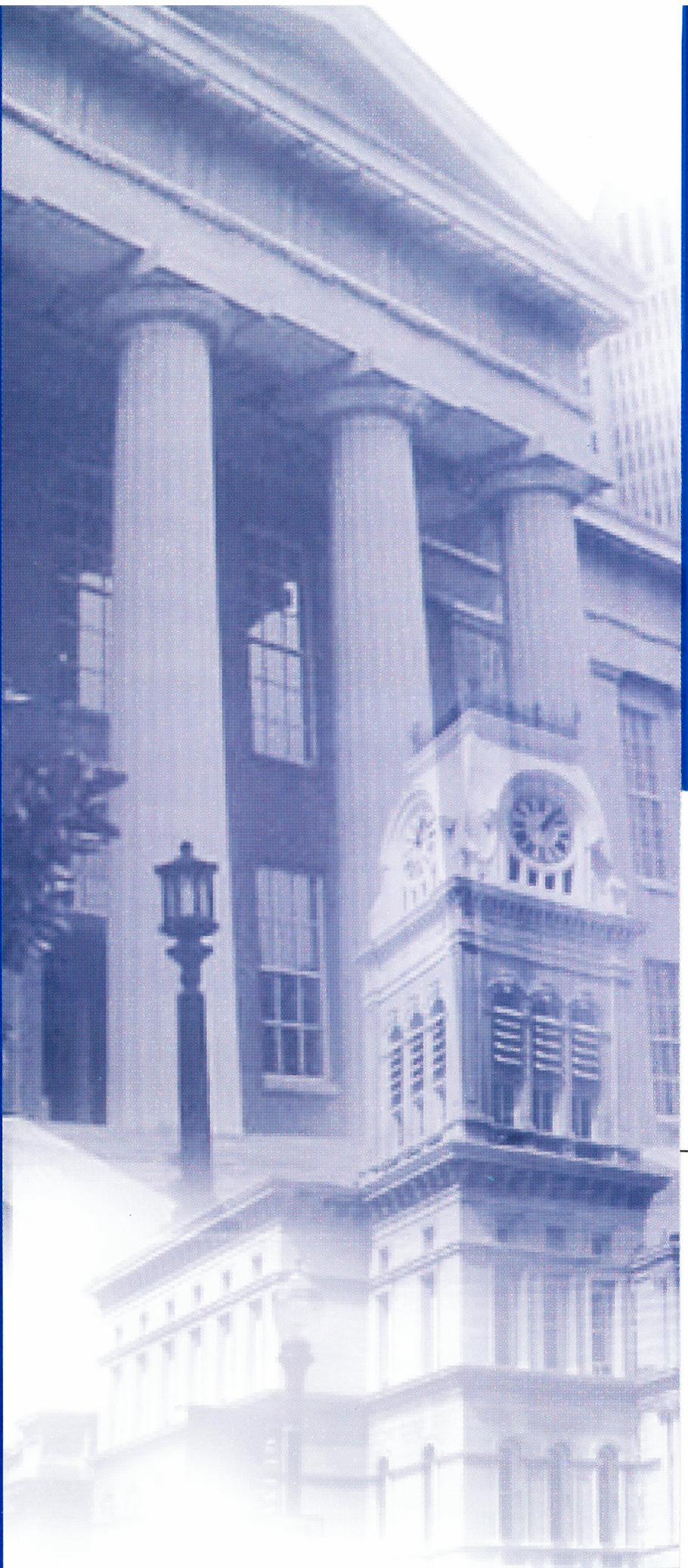




Greg Fischer
Mayor

Louisville Metro Council

The Office of Internal Audit provides independent, objective assurance and consulting services that adds value to and improves Louisville Metro Government.



Office of Internal Audit

**Economic Growth and
Innovation**

METCO Loan Program

Audit Report

Economic Growth and Innovation

METCO Loan Program

September 2014



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Executive Summary

PROJECT TITLE

Economic Growth and Innovation¹ – METCO Loan Program

OBJECTIVE AND SCOPE

The objective was to perform an operational review of the METCO Loan Program. This program is administered by Economic Growth and Innovation. The operating policies, procedures, and records for the loan program were reviewed. The focus was the entire loan process, including application, approval, loan proceeds distribution, loan repayment processing, monitoring of activity, and delinquent collection activity. The objective was to obtain assurance that the risks are adequately mitigated through the internal control structure.

A thorough understanding of the METCO loan process was obtained in order to evaluate the internal control structure. This was achieved through interviews of key personnel and reviews of program documents, applicable departmental policies and procedures, and examination of supporting documentation.

INTERNAL CONTROL ASSESSMENT

Needs Improvement

RESULTS

Opportunities exist for improving the internal control structure for the METCO Loan Program activity. Examples include the following.

- **General Administration.** There were issues noted with the general administration of the METCO Loan Program. Specifics include the following.
 - **Approvals.** There were instances where the appropriate signatures were not on documents signifying approval.
 - **Site Visits.** There are no forms completed or records maintained to serve as documentation regarding on-site visits with loan recipients.
 - **Interest Rate.** There was an instance where the interest rate noted in the loan system was different than the rate noted in the Board Approved Minutes.
 - **Policies and Procedures.** There were issues where the policies and procedures were not updated to reflect current practices.
 - **Payment Activity.** There was an instance where a loan payment was applied incorrectly.
- **Loan System.** There is a lack of clarity with METCO Loan Program activity due to the loan system's inability to modify a loan without creating a new loan entry and marking the existing loan as paid off.

¹During the review period, the METCO Loan Program was within Economic Growth and Innovation's Economic Development. However, due to departmental changes, the METCO Loan Program is now within Louisville Forward's Economic Development.



GREG FISCHER
MAYOR

INGRAM QUICK, CHIEF AUDIT EXECUTIVE

JIM KING
PRESIDENT METRO COUNCIL

OFFICE OF INTERNAL AUDIT
LOUISVILLE, KENTUCKY

Transmittal Letter

September 9, 2014

The Honorable Greg Fischer
Mayor of Louisville Metro
Louisville Metro Hall
Louisville, KY 40202

Subject: Audit of the Economic Growth and Innovation – METCO Loan Program

Introduction

The Office of Internal Audit conducted a review of the Economic Growth and Innovation's (EGI) Metropolitan Business Development Corporation (METCO) Loan Program. The primary focus of the audit was the operational and fiscal administration of the loan activity. This included how EGI 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

A thorough understanding of the METCO loan process was obtained in order to evaluate the internal control structure. This was achieved through interviews of key personnel and reviews of program documents, applicable departmental policies and procedures, and examination of supporting documentation.

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 a 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 6 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.

- **General Administration.** There were issues noted with the general administration of the METCO Loan Program. Specifics include the following.
 - **Approvals.** There were instances where the appropriate signatures were not on documents signifying approval.
 - **Site Visits.** There are no forms completed or records maintained to serve as documentation regarding on-site visits with loan recipients.
 - **Interest Rate.** There was an instance where the interest rate noted in the loan system is different than the rate noted in the Board Approved Minutes.
 - **Policies and Procedures.** There were issues where the policies and procedures were not updated to reflect current practices.
 - **Payment Activity.** There was an instance where a loan payment was applied incorrectly.
- **Loan System.** There is a lack of clarity with METCO Loan Program activity due to the loan system's inability to modify a loan without creating a new loan entry and marking the existing loan as paid off.

Corrective Action Plan

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

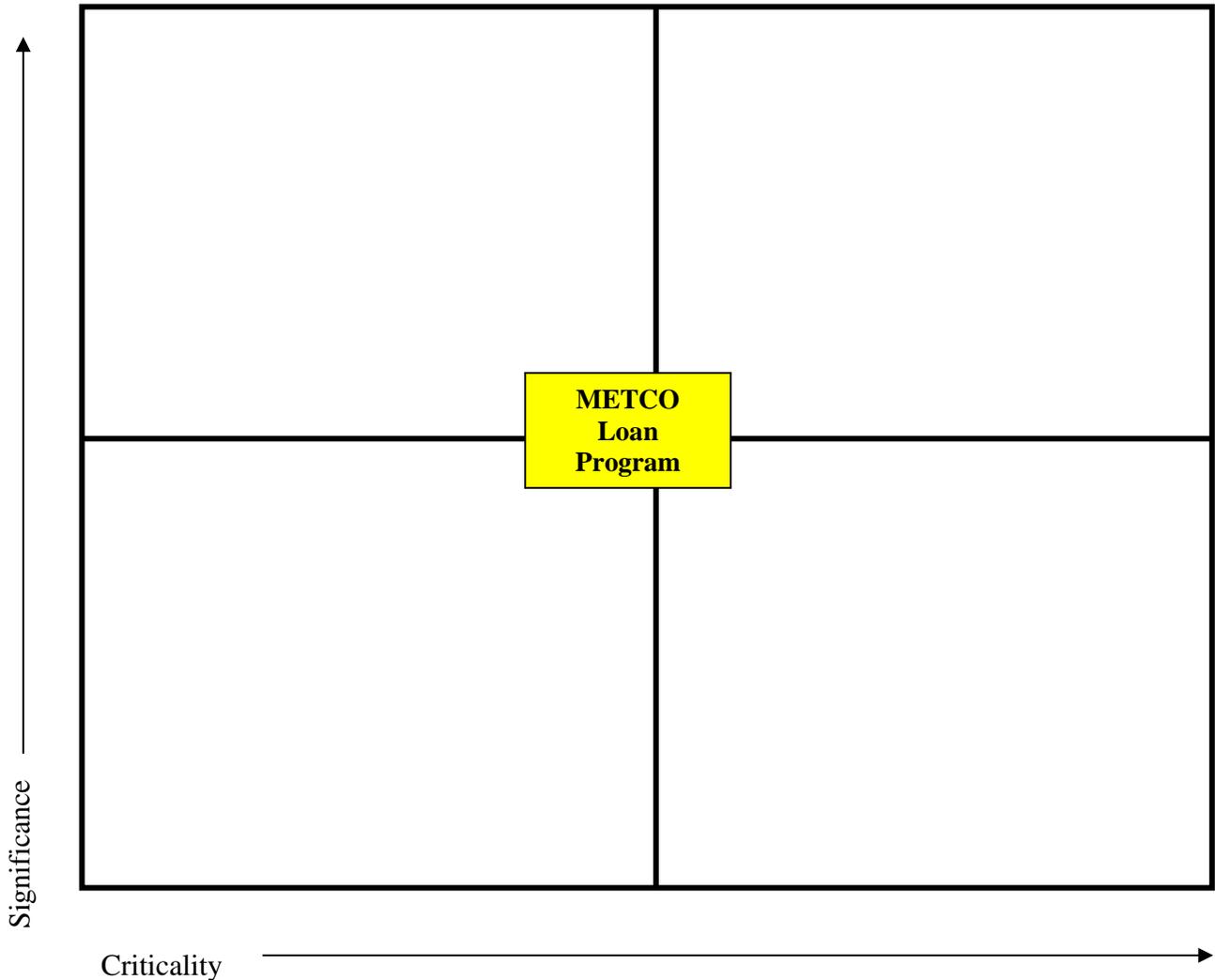
Sincerely,



Ingram Quick, CIA, CFE
Chief Audit Executive

cc: Louisville Metro Council Government Accountability and Ethics Committee
Director of Economic Growth and Innovation
Director of Office of Management and Budget
Louisville Metro External Auditors
Louisville Metro Council President

Internal Control Rating



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

Background

Louisville Metro's Economic Growth and Innovation 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 the residents.

Economic Growth and Innovation manages loan program activity to include the maintenance of loan profile data, transaction records, and report creation. The Office of Management and Budget administers the posting of payments to the loan management system and the Louisville Metro financial system, as well as the deposit of all payment activity. As of June 30, 2013 there were approximately 306 active loans, representing approximately \$20.3 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 August 2008. 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 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.

V. Views of Responsible Officials / Action Plan

The final draft report was issued to Economic Growth and Innovation and the Office of Management and Budget on July, 29, 2014. An exit conference was held with Economic Growth and Innovation at the Metro Development Center (444 S. 5th Street) on August 14, 2014. Attending were Mary Ellen Wiederwohl and Jeff Mosley representing Economic Growth and Innovation and Ingram Quick and Jason Byrd representing Internal Audit. An exit conference was held with the Office of Management and Budget at the City Hall Annex (609 W. Jefferson Street) on August 21, 2014. Attending were Steve Rowland and Matt Yates representing the Office of Management and Budget and Ingram Quick and Jason Byrd representing Internal Audit. Final audit results were discussed.

A joint corrective action plan from Economic Growth and Innovation and the Office of Management and Budget (OMB) officials was received on August 29, 2014 from OMB and is included as the corrective action plan in the Observations and Recommendations section of the report. The plan indicates 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 Growth and Innovation and the Office of Management and Budget’s response was provided within this required timeframe.

Observations and Recommendations

Scope

A review of the METCO Loan Program was performed. The review evaluated the entire loan process, including application, approval, loan proceeds distribution, loan repayment processing, monitoring of activity, and delinquent collection activity. Testing of METCO loans activity was for fiscal year 2013 (July 2012 through June 2013).

An analysis was performed of the complete METCO loans population within the Oracle Loans system to gain an understanding of the characteristics of the loan portfolio. Examinations were performed to determine whether activity processing is complete, accurate, and in compliance with METCO policies and procedures.

A sample of (10) loans were judgmentally selected from the total population of METCO loans considered active or paid off during the testing period, to include a review of documentation. Three payments were selected from each of the loans (30) included in the initial sample to review the payment processing of each loan. A sample of (9) loans which had modifications during the review period were selected for review. A sample of (10) loans were selected to review the delinquency procedures, which included (5) loans where the loan recipient declared bankruptcy were included in the review.

This information was reviewed to ensure that activity was processed accurately and appropriately and monitored effectively. Additionally, an assessment of the internal controls and procedures for the administration of the loan programs was performed. This examination will not reveal all noncompliance issues because it was based on a selective review of data.

Observations

Issues were noted with METCO loan program activity. As a result, the effectiveness of the internal control structure needs improvement. Opportunities to strengthen the controls include the following.

- 1) General Administration
- 2) Loan System

Details of these begin on the following page.

1) General Administration

Issues were noted with the general administration of the METCO loan program. Specifics include the following.

- **Approvals.** Certain steps within the METCO Loan Program process require different levels of approvals and authorization to be completed. Some issues were noted with the approval process.
 - There were three instances (out of 10 loans) in which the form to request the check to disburse the loan was not signed by appropriate personnel. There was no documentation provided that acknowledged the person signing on behalf of the Director had proper signature authorization.
 - There were six instances (out of 10 loans) in which it could not be determined if the check request form was signed by appropriate personnel. The original check request forms could not be located. Only a copy of the form was provided which only included those signatures required for approval prior to being forwarded to the business office.

- **Site visits.** Policies and procedures require an on-site visit be conducted with all loan recipients within twelve months after the closing of the loan, then annually thereafter. Site visits allow for inspection of METCO collateral, verification of employment projections and discussion regarding the status and plans of the business.
 - There are no forms completed or records maintained to serve as documentation regarding on-site visits with loan recipients. Without documentation of visits performed, there is no means by which to verify loan recipient adherence to agreements and applicable loan requirements.

- **Interest Rate.** Appropriate personnel manually enter the interest rate into the loan system based on notes from the Board Approved Minutes. There was an instance where the interest rate noted in the loan system was different from the rate noted in the Board Approved Minutes.

- **Policies and Procedures.** Documented policies and procedures to guide personnel in the day-to-day administration and management of METCO loans activity do not reflect the current practices. This increases the risk of non-compliance with intended policies and procedures and can lead to inconsistencies and inefficiencies in processing loan activity.
 - Policies and procedures related to the fiscal administration of METCO loan activity state that loan invoices are generated twice a month instead of the current practice of generating these invoices daily.
 - Policies and procedures related to the operational administration of METCO loan activity do not include updated form when requesting a check to disburse a loan.

- There was an instance in which a loan funded by a new market tax credit had no formal documentation in METCO's procedures outlining the terms and lending limits for this loan type.
- **Payment Activity.** When applying a loan payment, it is standard operating procedure for payments to be first applied to interest, then principal and finally any fees assessed on the account.
 - There was an instance where a loan payment was not applied to a loan account in compliance with standard operating procedures. The payment was first applied to a previous late fee which resulted in the total invoiced amount being underpaid. Ultimately, this resulted in the borrower being assessed an inappropriate late fee.

Recommendations

Appropriate personnel should take corrective actions to address the issues noted. Specifics include the following.

- ✓ Appropriate personnel should create and maintain the use of a Signature Authorization Form related to METCO loan activity when a signature approval is required. This form would list the names and signatures of appropriate personnel that have signature authority for the respective departments.
- ✓ METCO personnel should log site visits performed. Documentation should include the date, time, activities, and observations in support of their monitoring of loan recipient adherence to the loan agreement and applicable federal loan requirements.
- ✓ An effective monitoring system should include the independent review of Board Approved Minutes and its reconciliation to the loan system. This should be done on a periodic basis and any keying errors or inaccuracies identified should be corrected. This provides additional oversight, and increases the likelihood of detecting inaccurate activity.
- ✓ Revise the METCO Loan Program policies to ensure the policies and procedures reflect the most current guidelines and procedures for the program. The policies and procedures should be updated periodically, distributed to all applicable personnel. This will help ensure adherence to applicable guidelines, consistency in processing, and promote efficiency and effectiveness.
- ✓ Care should be taken to ensure that loan payments are applied in accordance with the standard operating procedures. Appropriate personnel should conduct routine supervisory reviews to ensure that loan payments are appropriately applied to loan accounts. 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 inappropriate fees being applied to loan accounts.

2) Loan System

Scope

An analysis was performed of the complete METCO loans population within the Oracle Loans system to gain an understanding of the characteristics of the loan portfolio. Examinations were performed to determine whether activity processing was complete, accurate, and in compliance with METCO policy and procedures.

The loan analysis is based on a report generated from the loan system for loan activity as of June 30th, 2013. Due to system limitations, this report included duplicate loan entries due to loans being modified. To modify a loan, the loan system user must mark the *active* loan as *paid off* then recreate a new loan entry based on the remaining principal balance. This process resulted in having loans marked as *paid off* in the loan system report that were still *active*, but were recreated in the loan system with the remaining balance as the requested amount and the other modifications that were needed. Any duplicates that were identified from the modification process were reconciled back to the original requested amount with the principal paid to date reflecting the amount as of June 30th 2013. Duplicates were identified using the loan description noted in the report or using a manually maintained listing by Economic Growth and Innovation. This analysis will not include any loans that were paid off in the previous loan system.

<u>LOAN TYPE</u>	<u>REQUESTED AMOUNT</u>	<u>PRINCIPAL PAID TO DATE</u>	<u>PRINCIPAL BALANCE</u>	<u>LOAN STATUS</u>
2002 BOND FORGIVEABLE LOAN	\$ 1,150,000.00	\$ 368,333.38	\$ 781,666.62	ACTIVE
ACCESSIBILITY LOAN	\$ 102,305.00	\$ 49,209.62	\$ 53,095.38	ACTIVE
CDBG	\$ 1,650,000.00	\$ 801,795.20	\$ 848,204.80	ACTIVE
CDBG FORGIVABLE LOAN	\$ 100,000.00	\$ 60,000.78	\$ 39,999.22	ACTIVE
CDBG MINORITY	\$ 388,000.00	\$ 91,365.90	\$ 296,634.10	ACTIVE
DOE EECBG GREEN JOBS	\$ 1,627,300.00	\$ 344,315.66	\$ 1,282,984.34	ACTIVE
EDA TITLE IX	\$ 2,670,500.00	\$ 1,038,044.27	\$ 1,632,455.73	ACTIVE
FAÇADE	\$ 3,862,734.68	\$ 1,633,164.47	\$ 2,229,570.21	ACTIVE
FORGIVABLE LOAN	\$ 330,000.00	\$ 256,655.49	\$ 73,344.51	ACTIVE
KEOZ	\$ 500,065.00	\$ 165,801.63	\$ 334,263.37	ACTIVE
MICRO LOAN PROGRAM	\$ 291,500.00	\$ 134,483.84	\$ 157,016.16	ACTIVE
NEW MARKET TAX CREDIT	\$ 200,000.00	\$ -	\$ 200,000.00	ACTIVE
SMALL AND DISADVANTAGED	\$ 5,948,524.46	\$ 1,576,503.03	\$ 4,372,021.43	ACTIVE
WHISKEY ROW FORGIVABLE LOAN	\$ 1,500,000.00	\$ -	\$ 1,500,000.00	ACTIVE
ACCESSIBILITY LOAN	\$ 50,300.00	\$ 50,300.00	\$ -	PAIDOFF
BUSINESS SOLUTIONS	\$ 30,000.00	\$ 30,000.00	\$ -	PAIDOFF
CDBG	\$ 417,422.53	\$ 417,422.53	\$ -	PAIDOFF
CDBG FORGIVABLE	\$ 530,000.00	\$ 530,000.00	\$ -	PAIDOFF
CDBG MINORITY	\$ 107,034.85	\$ 107,034.85	\$ -	PAIDOFF
CDBG R GROCERY STORE	\$ 3,184,833.00	\$ 3,184,833.00	\$ -	PAIDOFF
EDA TITLE IX	\$ 1,011,097.18	\$ 1,011,097.18	\$ -	PAIDOFF
EPA CLEANUP RLF	\$ 600,000.00	\$ 600,000.00	\$ -	PAIDOFF
FAÇADE	\$ 911,193.00	\$ 911,193.00	\$ -	PAIDOFF
FORGIVABLE LOAN	\$ 220,000.00	\$ 220,000.00	\$ -	PAIDOFF
MICRO LOAN PROGRAM	\$ 265,000.00	\$ 265,000.00	\$ -	PAIDOFF
SMALL AND DISADVANTAGED	\$ 1,030,024.46	\$ 1,030,024.46	\$ -	PAIDOFF
Total	\$28,677,834.16	\$14,876,578.29	\$13,801,255.87	

Observations

- **Loan System.** There is a lack of clarity with METCO Loan Program activity due to the loan system's inability to modify a loan without marking the loan as paid off. Currently, the process in place when modifying an existing loan is to mark the loan as paid off and move the existing balance to create a new loan based on the loan modifications. As a result, the loan system is unable to generate an accurate report of active or paid off loans.

Recommendations

Appropriate personnel should take corrective actions to address the issues noted. Specifics include the following.

- ✓ Economic Growth and Innovation (EGI) and Office of Management and Budget (OMB) should consult with the appropriate persons to address any issues with the loan system that does not adequately meet the needs of the agencies involved in the METCO loan process. The goal is to have a system that can provide accountability and clarity for all METCO loans and perform to the needs of both EGI and OMB.
- ✓ If resources are not available to upgrade/purchase a new loan management system, then it is essential that modifications be made to the current system. The modifications should address improved accountability and clarity. Manual efforts may be necessary to supplement in areas where system limitations prevent adequate reporting.
 - Periodically, compile a report that would accurately track the progress of METCO loans and the respective accounts receivable balances. This report could also list loans that have been paid off and the aging of the loan accounts that are delinquent.

Corrective Action Plan

1. Approvals

This issued was addressed with Economic Development. Economic Development is currently using a revised form that documents the approvals required and we have reviewed with Economic Development who is authorized to sign this form.

2. Site Visits

Standard operating procedure has been that site visits were not required for any loans except for façade loans. Economic Development is currently revising Metco's policies and procedures to reflect this practice. Economic Development will ensure that appropriate documentation is maintained for façade loan site visits.

3. Policies and Procedures

OMB and Economic Development review loan data prior to approval of the loan disbursement. This was a clerical error in the loan input and has subsequently been corrected. OMB and Economic Development have followed up with current staff to review the importance of reviewing loan data prior to disbursement approval.

4. Policies and Procedures

OMB's current operating procedures regarding invoice generation and form usage do not match the loan policies. OMB is reviewing the policy and will make updates to ensure that the current activities and forms are properly reflected in the policy. Economic Development is revising Metco's policies and procedures to ensure that all loan types adopted by the Metco Board are included in the policy and procedure manual.

5. Payment Activity

OMB has reviewed the loan in question and agrees that the payment was applied incorrectly. OMB Management has reviewed the standard payment application with staff and continues to monitor loan activity to ensure payments are accurately recorded.

6. Loan System

We respectfully disagree that there is a lack of clarity with the loan system. Economic Development and OMB have created procedures in order to maintain an audit trail for all loans and implemented a process in which previous loan numbers are documented in the loan system in the description field for all modified loans. OMB currently reviews reports that show all loans associated with a customer as well as querying based on the loan numbers in the description field. OMB completes reconciliations of the accounts receivable balances to review outstanding receivables, delinquent accounts, and paid off loans.



Office of Internal Audit
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Name of Report: Economic Growth and Innovation – METCO Loan Program

How do you rate this report?			
	Beneficial	Somewhat Helpful	Needs Improvement
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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