

Audit Report

Department of Commerce

September 2019



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DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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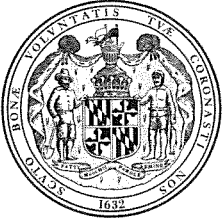
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DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

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September 4, 2019

Senator Craig J. Zucker, Senate Chair, Joint Audit and Evaluation Committee
Delegate Shelly L. Hettleman, House Chair, Joint Audit and Evaluation Committee
Members of Joint Audit and Evaluation Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have conducted a fiscal compliance audit of the Department of Commerce (DOC) for the period beginning July 1, 2014 and ending December 18, 2017. DOC's primary purpose is to stimulate and strengthen the Maryland economy by developing policies and implementing programs to help generate new jobs and retain existing jobs. DOC also develops policies and implements programs to help generate investments by attracting businesses to the State, by facilitating the expansion and retention of existing companies, and by promoting Maryland's strategic assets. DOC uses various financing programs and incentives, such as loans, grants, tax credits, and other financial investments to accomplish its purpose.

Our audit disclosed, for a number of DOC programs, a lack of verification of required information or adequate controls over the issuance of tax credits and grants, and the forgiveness of certain loans. In these cases, DOC failed to monitor recipients of its programs for compliance with State regulations and tax credit, grant, or loan requirements. In many cases, DOC relied on information provided and certified by the recipients, infrequent reviews by its Office of Internal Audits (OIA), or its business acuity to determine adherence to the terms and conditions of the various agreements. However, such informal and infrequent processes are insufficient to ensure compliance with the various program's rules and regulations. Although there was commonality in the deficiencies noted, we presented our results as separate report findings, by program, for the sake of clarity and comprehension.

Specifically, DOC had not established effective procedures to verify that One Maryland Tax Credit applicants accurately reported new positions created, as

required, before issuing a tax credit certificate. For this program, DOC did not receive the necessary payroll records and verify new positions claimed by applicants but, rather, the OIA conducted a limited review of selected applicants' compliance. Although DOC certified 13 applicants for 15 One Maryland Tax Credits totaling \$69.8 million during our audit period, the extent of its verification process was a limited review for 3 tax credit certificates issued that accounted for approximately \$15 million in credits. We also found that DOC certified one tax credit based on ineligible project costs.

In addition, our test of the Biotechnology Investment Tax Credit program, for which DOC issued \$47 million in tax credits associated with 52 biotechnology companies during the audit period, found similar conditions regarding the verification of applicant employment and ownership information. Our review of the credits issued to 67 investors in five biotechnology companies totaling approximately \$8 million, revealed that DOC did not verify reported employment and ownership information prior to issuing tax credit certificates to investors, as required.

In addition, DOC lacked effective processes to verify that loan recipients met employment requirements before forgiving conditional loans issued by the Maryland Economic Development Assistance Authority and Fund. Our audit disclosed that DOC's OIA reviewed payroll data for 4 loans forgiven totaling \$1.3 million; however, 20 loans totaling \$8.3 million were forgiven during our audit period. Furthermore, the verifications were not comprehensive for 2 of these loans. DOC also paid loan guarantees to lenders under the Maryland Small Business Development Financing Authority program without receiving all necessary documentation and reviewing the accuracy and propriety of loan guarantee claims requested by lenders. Instead, DOC relied on the computations and certifications of the lending institutions, and our test of three of four claims paid during our audit period totaling \$1.3 million revealed that each of the claims paid contained errors, such as interest computations and unsupported expenses.

DOC did not have an established process to ensure that non-profit institutions of higher education that received research funds from the Maryland E-Innovation Fund had received required private matching fund donations and that expenditures were for eligible purposes. An annual \$8.5 million appropriation is available for these research funds. Similarly, effective procedures were not in place over the awarding of Maryland State Arts Council grants, which totaled \$13.8 million during fiscal year 2017.

Our audit also disclosed that DOC did not effectively monitor fund managers of the Small, Minority, and Women-Owned Businesses Account, which has

historically been funded by 1.5 percent of video lottery terminal proceeds collected by the State's casinos. Since the program's inception in 2013, fund managers have been awarded \$52.2 million through fiscal year 2017. For example, our review of four of the eight fund manager agreements revealed that three of them lacked critical details of loan underwriting standards and practices, such as the requirement for collateral and a conflict of interest policy. DOC also did not verify fund manager compensation and did not verify reported data regarding their efforts to meet certain program lending goals.

Finally, our audit included a review to determine the status of the 11 findings contained in our preceding audit report. We determined that DOC satisfactorily addressed 9 of these findings, with the remaining 2 findings repeated in this report. We also reviewed the status of the 7 findings in our October 23, 2015 performance audit report on Video Lottery Operations Revenue – Small, Minority, and Women-Owned Businesses Account. We determined that DOC satisfactorily addressed all of these findings.

DOC's response to this audit is included as an appendix to this report. In accordance with State law, we have reviewed the response and identified certain instances in which statements in the response conflict with or disagree with the report findings or related recommendations. In each instance, we reviewed and reassessed our audit documentation, and reaffirmed the validity of our finding. In accordance with generally accepted government auditing standards, we have included five "auditor comments" within DOC's response to explain our position. Through constructive dialogue with DOC, general agreement has been reached regarding the recommendations; however, several specific recommendations will require further clarification. We will advise the Joint Audit and Evaluation Committee of any outstanding issues that we cannot resolve with DOC. Additionally, we have redacted certain vendor names mentioned in DOC's response as allowed by our policy.

We wish to acknowledge the cooperation extended to us during the course of this audit by DOC and its willingness to address the audit issues and implement appropriate corrective actions.

Respectfully submitted,



Gregory A. Hook, CPA
Legislative Auditor

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* Denotes item repeated in full or part from preceding audit report

Background Information

Agency Responsibilities

The Department of Commerce (DOC), formerly known as the Department of Business and Economic Development, is a principal department of State government and operates in accordance with the Economic Development Article of the Annotated Code of Maryland. DOC’s mission is to stimulate and strengthen the Maryland economy by developing policies and implementing programs to help generate new jobs and retain existing jobs. It also develops policies and implements programs to help generate investment by attracting businesses to the State, by facilitating the expansion and retention of existing companies, and by promoting Maryland’s strategic assets. According to the State's records, during fiscal year 2018, DOC’s operating expenditures totaled \$125.6 million, which included grants, loans, and other investments.

DOC uses various financing programs and incentives, such as loans, grants, tax credits, and other financial investments to accomplish its mission. Table 1 reflects the fiscal year 2018 activity of loans, grants, and loan guarantees for which DOC’s financing programs were responsible.

Table 1
DOC Financing Programs and Related Activity – Fiscal Year 2018

Financing Programs	Loans and Grants	Loan Guarantees
Economic Development Assistance Authority and Fund	\$13,350,000	Not Applicable
Industrial Development Financing Authority	\$10,770,000	\$1,350,300
Video Lottery Terminal Fund	\$9,632,225	Not Applicable
E-Innovation Initiative	\$7,020,000	Not Applicable
Small Business Development Financing Authority	\$6,032,050	\$203,600
Sunny Day	\$5,000,000	Not Applicable
Other Programs	\$1,632,652	Not Applicable

Source: DOC Fiscal Year 2018 Consolidated Incentive Performance Report

According to DOC’s records, as of June 30, 2017, its portfolio consists of financial instruments totaling approximately \$434.4 million that were being tracked on DOC’s automated financing programs monitoring system.

In addition to these financing programs, DOC’s Maryland State Arts Council issued grants to arts organizations during fiscal year 2018 totaling \$13.6 million. DOC also issued certain tax credits to accomplish its purpose of attracting and expanding business in Maryland. Table 2 reflects Tax Credit Certificates issued in fiscal year 2018.

Table 2
DOC Tax Credit Programs and Related Activity
Fiscal Year 2018

Tax Credit Programs	Certificates Issued
One Maryland	\$22,947,031
Biotechnology Investment	12,379,430
Research and Development	12,000,000
Aerospace, Electronic, and Defense	7,500,000
Film Production	7,047,304
Job Creation	4,344,464
Employer Security	2,000,000
Other Programs	671,497

Source: DOC Fiscal Year 2018 Consolidated Incentive Performance Report

Organizational Changes

Effective October 1, 2015, in accordance with Chapter 141, Laws of Maryland 2015, the principal economic development entities in the State were restructured. The law renamed the Department of Business and Economic Development (DBED) as the Department of Economic Competitiveness and Commerce (DECC) and created a Secretary of Commerce within the Governor’s Office to be the head of economic development policy and implementation efforts in the State, and to be responsible for the operations of DECC. The Governor’s Executive Order, effective October 1, 2015 changed DECC to the Department of Commerce (DOC).

The Secretary of Commerce is also responsible for monitoring the operations of the Maryland Economic Development Corporation (MEDCO), the Maryland Technology Development Corporation (TEDCO), and the Maryland Public-Private Partnership Marketing Corporation (MPPPMC). MPPPMC was created under the law, in part, to foster public-private partnerships that encourage location and development of new businesses in the State. The law also moved the BioMaryland Center, the Maryland Venture Fund, and the Maryland Venture Fund Authority from DBED to TEDCO.

Effective July 1, 2017, in accordance with Chapter 453, Laws of Maryland 2017, the authority for the administration of the Small, Minority, and Women-Owned Businesses Account (SMWOBA) program was transferred from the Board of Public Works (BPW) to DOC. Prior to this date, a memorandum of understanding between BPW and DOC had established DOC as the responsible entity for the administration of the SMWOBA program.

Status of Findings From Preceding Audit Reports

Our audit included a review to determine the status of the 11 findings contained on our preceding audit report on the Department of Business and Economic Development (now DOC) dated October 9, 2015. As disclosed in Table 3, we determined that DOC satisfactorily addressed 9 of these findings. The remaining 2 findings are repeated in this report.

We also determined the status of the 7 findings in our performance audit report on Video Lottery Operations Revenue – Small, Minority, and Women-Owned Businesses Account dated October 23, 2015. We determined that DOC satisfactorily addressed all 7 of the findings.

**Table 3
Status of Preceding Findings**

Department of Business and Economic Development (DBED)

Preceding Finding	Finding Description	Implementation Status
Finding 1	Comprehensive written procedures were not prepared to ensure consistency and compliance with the law in administering the auction, and tax credit certificates issued to winning bidders included incorrect identifying information.	Not repeated
Finding 2	DBED did not adequately document the selection process and allocation of capital to venture firms, and monitoring efforts over the firms' investment activity were not sufficient.	Not repeated
Finding 3	DBED did not obtain required approval from the Office of the State Treasurer in advance of opening certain investment bank accounts.	Not repeated
Finding 4	DBED's process for verifying that recipients met requirements for forgiveness of conditional loans and grant repayments was not effective.	Not repeated
Finding 5	DBED had not established formal forbearance agreement procedures for its Maryland Small Business Development Financing Authority (MSBDFA) program, and did not have an effective mechanism to track and monitor forbearance agreement activity.	Not repeated
Finding 6	The capabilities of system users on DBED's automated financing programs monitoring system were not adequately restricted.	Not repeated
Finding 7	Cash balances for financing programs were not adequately reconciled with the State's records.	Not repeated
Finding 8	DBED did not sufficiently verify applicants' compliance with job creation and associated cost requirements and did not administer the program in accordance with State regulations.	Repeated (Current Finding 1)
Finding 9	Program regulations were not established as required, and DBED lacked documentation of supervisory reviews of credits issued.	Not repeated
Finding 10	Procedures and controls over the award and disbursement of program grants were not adequate.	Not repeated
Finding 11	Certain purchasing transactions and access to the State's Financial Management Information System (FMIS) were not sufficiently controlled.	Repeated (Current Finding 9)

Findings and Recommendations

One Maryland Tax Credit Program

Background

Businesses that invest in economic development projects in qualified distressed counties and that create at least 25 new full-time jobs may be eligible for up to \$5.5 million in State income tax credits. State law and regulations provide that a qualified business entity may receive the One Maryland Tax Credit after creating at least 25 new jobs within a specified period. The amount of the tax credit is based dollar-for-dollar on the project costs (up to \$5 million) and start-up costs (up to \$500,000) incurred by the business to expand or establish a new facility in the State. Project costs include the acquisition, construction, rehabilitation, and installation of a project, and start-up costs include the cost to furnish and equip a new location. During our audit period, the Department of Commerce (DOC) certified 13 applicants for 15 tax credits totaling approximately \$69.8 million.

Finding 1

DOC had not established effective procedures to ensure that One Maryland Tax Credit applicants accurately reported their compliance with required new job creation numbers, and a tax credit was issued to one applicant based on ineligible project costs.

Analysis

DOC did not have adequate procedures to verify the accuracy of new positions claimed by One Maryland Tax Credit applicants, and a tax credit totaling the maximum of \$5.5 million was issued to one applicant for project costs that were not eligible for the credit according to State regulations.

DOC's Office of Internal Audits (OIA) reviewed payroll records for only a limited number of applicants to verify new positions claimed. Specifically, of the aforementioned 15 tax credits certified during the audit period totaling approximately \$69.8 million, OIA performed payroll record verifications for only 3 tax credits totaling \$15 million. Consequently, the remaining 12 credits were issued based on applicant-supplied data and representations without a verification that these business entities had met the tax credit requirements regarding the number of positions created. A similar condition was commented upon in our preceding audit report.

In addition, our review of two of the three verifications performed disclosed that OIA did not verify that the applicants accurately reported the dates the new positions were created and filled. These dates are critical since State regulations

stipulate a specific period of time within which the new positions must have been created and filled in order to qualify for a tax credit. Additionally, OIA did not verify that the new positions had been filled for at least 12 months as required by the regulations. (The 12 months need not be consecutive.)

DOC finance office personnel performed a determination of the eligibility of the project costs claimed on each application for a tax credit. Nevertheless, we tested 6 tax credit certificates issued totaling \$27.1 million (from the aforementioned 15 tax credits totaling \$69.8 million), and found that DOC certified one tax credit totaling \$5.5 million for project costs that were ineligible for a tax credit according to State regulations. Specifically, the claimed costs were incurred through a sale and purchase transaction between related parties. State regulations stipulate that eligible project costs exclude costs incurred in dealings between related parties. While DOC management did not dispute the ineligibility of the project costs for this tax credit, they advised us that the regulation disallowing inter-company invoices is antiquated in today's economy and does not reflect current business practices. DOC management further advised that it would not rescind the tax credit award; rather, it intends to amend the regulations.

Recommendation 1

We recommend that DOC establish adequate procedures to verify the propriety of One Maryland Tax Credits. Specifically, we recommend that DOC

- a. obtain documentation for and verify the number of new positions created and filled by each applicant, including when they were filled and the duration of time in which they were filled (repeat);**
- b. ensure that project cost eligibility verifications are performed consistent with State regulations; and**
- c. take action to rescind the aforementioned tax credit that was issued based on ineligible project costs.**

Biotechnology Investment Tax Credit

Background

The Biotechnology Investment Tax Credit program was created to support investments in early stage biotechnology companies to promote and grow the biotech industry in Maryland. According to State law, tax credits may be issued under the program to an individual or an entity that invests at least \$25,000 in a certified biotechnology company. The annual certifications require that the company have its headquarters and base of operations in Maryland, and have fewer than 50 full-time employees. Credits are generally limited to 50 percent of

the amount invested, but may not exceed \$250,000 or \$500,000 depending on the jurisdiction, and may not result in the investor owning more than a 25 percent equity interest in the company. During our audit period, according to its records, DOC issued 625 tax credits associated with 52 biotechnology companies totaling \$47 million.

Finding 2

DOC did not have procedures to ensure biotechnology companies accurately reported employment and ownership information prior to being certified and the issuance of tax credits to investors. In addition, DOC did not establish procedures to identify tax credits subject to recapture.

Analysis

DOC did not have effective procedures to verify employment information prior to certifying the biotechnology companies, and to verify ownership information prior to issuing the tax credits to investors. Consequently, DOC lacked assurance that the companies and investors were in compliance with the aforementioned legal requirements regarding the number of company employees and investor ownership, which may not exceed a 25 percent equity interest in the company. In addition, DOC did not establish procedures to identify tax credits subject to recapture.

We reviewed records associated with 86 tax credits, totaling \$8 million, issued to 67 investors in 5 of the aforementioned 52 biotechnology companies. Our review disclosed that DOC did not verify the accuracy of the employment reports provided by the 5 companies when they applied for certification. For example, DOC did not review the company's payroll records. DOC advised us that it obtains a self-certification of the employee count from each company and that, through its current working knowledge of the companies, knows that each qualified company employs fewer than 50 employees. State law limits program participation to companies that have fewer than 50 full-time employees.

In addition, DOC did not verify ownership information prior to issuing the tax credits to investors. For the tax credits reviewed, DOC obtained individual investor ownership information from the biotechnology companies, and advised us that no investor owns more equity than is permitted. However, DOC did not verify the individual investor ownership information provided by the biotechnology companies, and did not obtain complete ownership information for these companies as a whole, which would include other investors not receiving tax credits. As a result, DOC was not in a position to confirm that each investor, after making the proposed investment, did not own or control more than 25

percent of the equity interest in the biotechnology company as specified in State law.

Finally, DOC had not established procedures to identify tax credits subject to recapture. State law specifies that tax credits shall be recaptured if an investor sells its ownership interest within two years of the investment. DOC advised us that, currently, investors have the burden to notify DOC and the Comptroller of Maryland if an event occurs requiring recapture of a tax credit, and that the law does not require DOC to identify tax credits subject to recapture. Regarding subsequent reporting by an investor of such events, we noted that the tax credit certificates make no mention of the investor's responsibility to report changes in circumstance that affect the credit. Because DOC did not obtain complete ownership information of each biotechnology company, it did not have the information necessary to identify tax credits subject to recapture due to premature sale of investments.

Considering the significant value of tax credits issued, DOC should obtain and adequately verify information received from both companies and investors to ensure compliance with the associated State law.

Recommendation 2

We recommend that DOC establish adequate procedures for the Biotechnology Investment Tax Credit program. Specifically, we recommend that DOC

- a. verify the accuracy of employment reports provided by biotechnology companies by periodically reviewing each company's payroll records, to ensure they have fewer than 50 employees;**
- b. obtain and verify complete ownership information for the biotechnology companies to ensure tax credits are not issued to investors who own more than 25 percent equity interest; and**
- c. develop procedures to identify tax credits that require recapture.**

Loans – Conditional and Guaranteed

Background

DOC provides conditional loans and grants, as well as loan guarantees through certain of its financing programs to attract, retain, and support economic development projects, and to assist businesses that are unable to obtain financing on reasonable terms through normal financing channels. Conditional loans, which are made directly to eligible borrowers, generally provide for forgiveness of the loan if the loan recipient hires and maintains a minimum number of qualified

employees. Loan guarantees are provided to lenders for loans to businesses that may not otherwise be able to obtain financing. If the borrower defaults on the loan, the lender is able to recoup from DOC any guaranteed portion of the loan that it is unable to recoup through other means, such as liquidation of collateral.

According to its records, during fiscal years 2015 through 2018, DOC settled 66 conditional loans and grants under the Maryland Economic Development Assistance Authority and Fund, totaling \$33.7 million, and forgave 20 conditional loans totaling \$8.3 million. In addition, DOC paid \$1.6 million for guarantees associated with 4 loans under the Maryland Small Business Development Financing Authority (MSBDFFA). As of September 2018, the MSBDFFA Guaranty Fund had 21 loans with guarantee amounts totaling \$2.9 million.

Finding 3

DOC did not establish a sufficient process to verify loan recipients met employment requirements before forgiving conditional loans. In addition, DOC paid certain loan guarantees without obtaining, reviewing, and verifying adequate documentation to support lender claims.

Analysis

Procedures used by DOC to verify that loan recipients met employment requirements for the forgiveness of conditional loans were not sufficient, and DOC paid certain loan guarantees without obtaining, reviewing, and verifying adequate documentation to support lender claims.

Conditional Loans and Grants

DOC did not establish sufficient procedures to verify employment reports received from loan recipients to support employment requirements for the forgiveness of conditional loans and grants. DOC advised us that it has confidence in the accuracy of the employment reports provided by the recipients because the reports are certified under penalty of perjury. DOC also compares the total employment levels of the recipients to the records of the Maryland Department of Labor (MDL); however, these MDL records do not provide the specificity needed to confirm the number of qualified employees since qualified employees must meet certain requirements as to wages paid, hours working per year, and benefits available to them. Finally, while DOC relies on its OIA to verify the accuracy of the recipient employment reports, the number of verifications performed by the OIA was very limited. According to OIA, it verified the payroll data for 4 of the aforementioned 20 conditional loans for which loans totaling \$1.3 million were forgiven during our audit period.

Furthermore, our review of 2 of the 4 verifications disclosed that OIA's review was not sufficient, as it did not include a review of employment reports for all years of the loan; rather, OIA only reviewed reports associated with the final year of each loan. Loan recipients are required to meet certain employment thresholds for each year of the loan. The loan period was three years for one recipient and eight years for the other recipient. If annual employment thresholds are not met, a portion of the loan must be repaid.

Loan Guarantees

DOC paid certain lender claims on loan guarantees without receiving and reviewing adequate documentation to support the accuracy and propriety of the claims. Rather, DOC relied on the computations of and the certifications by the lending institutions. The guaranty agreements between DOC and lenders require the lender to collect all amounts due from the borrower and personal guarantors to minimize the liability of DOC. We reviewed three of the four loan guarantee claims paid during our audit period totaling \$1.3 million and noted the following errors and discrepancies.

- For all three claims we reviewed, interest claimed by the lenders was improperly calculated, resulting in DOC overpayments. According to each loan guarantee agreement, DOC guarantees the payment of accrued and unpaid loan interest at a rate not to exceed prime plus two percent, for a period not to exceed 120 days. However, in each instance, the 120 days allowed was exceeded and the interest rate used was higher than the interest rate allowed in the loan guarantee agreement. For example, one lender's calculation resulted in a net overpayment of guaranteed interest of approximately \$81,600.
- DOC did not obtain sufficient documentation to verify one lender's efforts to fully liquidate available collateral prior to paying the \$632,000 claim. In this instance, DOC obtained documentation prepared by the lender asserting that there was no equity in two collateralized properties, but did not obtain independent supporting documentation, such as a third-party appraisal of the properties, to verify that assertion.
- For one lender, DOC did not obtain documentation for and may have improperly paid certain claimed costs. DOC paid the lender's claimed costs incurred in liquidating collateral, totaling \$89,000, without obtaining supporting documentation as required in the guarantee agreement. In addition, the lender purchased certain collateralized property and submitted a claim for the remaining loan balance that was not covered by the purchase. DOC rejected the claim since the lender directly purchased the property rather than selling it to a third party. The lender subsequently sold the property to a

third party and re-submitted its claim, which included \$187,600 in settlement costs associated with the lender's initial purchase of the property. DOC paid this claim and advised us that it viewed the \$187,600 to be included in the overall costs to liquidate the collateral even though the costs related to the previously rejected transaction. Under these circumstances, we question DOC's payment of these settlement costs.

Recommendation 3

We recommend that DOC establish a sufficient process for conditional loans and loan guarantee transactions. These processes should include requirements that DOC

- a. verify employment reports received from recipients prior to forgiving conditional loans through the performance of more frequent and comprehensive OIA payroll reviews, including verifications that employment requirements were met for each year of the loan;**
- b. verify the accuracy of interest claimed by lenders for guaranteed loans and seek recovery of past overpayments, as appropriate;**
- c. obtain adequate documentation to support lender claims regarding efforts to liquidate collateral for guaranteed loans; and**
- d. in conjunction with its legal counsel, determine whether payment of the aforementioned \$187,600 in settlement costs was permitted under the related loan guarantee agreement and, if not, take action to recoup those funds.**

Maryland E-Nnovation Initiative Fund

Background

The Maryland E-Nnovation Initiative Fund (MEIF), created by law effective July 1, 2014, provides State matching funds in support of research endowments at Maryland non-profit institutions of higher education (NPIHE). NPIHEs generally include any institution of postsecondary education that receives State funds in its annual operating budget and awards degrees at the associate, baccalaureate, or graduate level. To receive matching funds, the NPIHE must submit an application, including its research endowment plan, and identify qualified donations in the form of cash or cash equivalents to match the amount of MEIF funding requested. State regulations allow NPIHEs to use State funds to establish new positions associated with the research endowment, such as research scientists, and to purchase research infrastructure, such as laboratory equipment. State law requires the Governor to appropriate \$8.5 million annually for MEIF beginning in fiscal year 2016 through fiscal year 2021.

Finding 4

DOC did not have an established process to ensure that MEIF recipients secured and deposited required private funding (donations), and that the related expenditures were made for qualified purposes.

Analysis

DOC did not have an established process to verify that MEIF recipients secured and deposited the required qualified donations, and that the related expenditures were for purposes allowed by State regulations. According to its records, DOC awarded funds to seven NPIHEs totaling approximately \$16.8 million between inception of the Fund in fiscal year 2016 and December 2017.

Our review of 10 awards totaling \$10.8 million made to five of these NPIHEs disclosed that DOC did not verify that three NPIHEs, that received 6 awards totaling approximately \$6.3 million, had obtained qualified donations, as required. Specifically, DOC did not obtain documentation, such as bank deposit tickets or bank statements to support that these NPIHEs deposited matching qualified donations into their research endowments. Although not requested, the other two NPIHEs had provided this documentation for the remaining 4 awards reviewed. State regulations require the NPIHE to deposit qualified donations equal to or greater than the amount of State MEIF funds requested into its research endowment within 90 days of obtaining the State funds.

In addition, DOC did not require NPIHEs to provide documentation, such as invoices and canceled checks, to verify that the State matching funds received were used for the aforementioned permitted purposes, nor did DOC audit NPIHE records for this purpose, as permitted by the grant agreements. In this regard, DOC advised us that it disagrees with the need to obtain additional documentation because it relies on annual reports received from each NPIHE that include a full accounting of the matching funds, as well as a signed self-certification from each NPIHE that the funds were spent in accordance with State regulations. DOC further advised that requiring additional documentation is an unreasonable administrative burden and may discourage institutions from applying for MEIF funds. However, if each NPIHE is already providing a full accounting of the matching funds in an annual report, we believe it is reasonable to require them to provide supporting documentation for those expenditures, at least on a test basis. Alternatively, the DOC OIA could periodically audit, on-site, MEIF related documents at each or a sampled number of NPIHEs.

Recommendation 4

We recommend that DOC establish a process to verify, at least on a test basis, NPIHE compliance with MEIF requirements. In this regard, such verification could include OIA on-site audits or obtaining appropriate documentation from MEIF recipients to ensure that qualified donations were deposited into the designated research endowment, and to verify that State funds were used for purposes allowed by State regulations.

Maryland State Arts Council Grants

Background

The Maryland State Arts Council (MSAC), a unit under DOC's Division of Tourism, Film, and the Arts, administers the Grants for Organizations (GFO) program that provides annual unrestricted general operating funds to nonprofit and tax-exempt organizations and units of government that produce or present ongoing arts programming open to the public. DOC's grant guidelines specify expenses for which the funds may be used, such as for artist salaries, theater sets, and marketing, as well as expenses for which the funds may not be used, such as for purchases of permanent equipment and activities chiefly meant for classroom use. In addition, all grants require the entity to provide matching funds at a three-to-one or one-to-one level, depending on the type of grant awarded. Seventy-five percent of the grant is disbursed to the grantee upon execution of the grant agreement, and the remaining funds are disbursed after the grantee has submitted a satisfactory interim report. According to DOC's records, approximately 285 grants were awarded during fiscal year 2017, with related disbursements totaling approximately \$13.8 million.

Finding 5

DOC had not established effective procedures and controls over the MSAC's GFO program.

Analysis

DOC had not established effective procedures and control over the award and disbursement of GFO program grants. Specifically, our audit disclosed the following conditions.

- DOC did not verify that required matching funds were obtained and that State funds were used for allowable purposes. Our test of 10 grants totaling approximately \$7.5 million, awarded during fiscal year 2017, disclosed that DOC did not obtain documentation from any of the grantees, such as bank statements and invoices, to ensure that State funds were appropriately

matched and were used in accordance with GFO program guidelines. Although each grantee submitted a self-certified final report to show matching funds received and related expenditures, without obtaining and reviewing supporting documents, DOC has no assurance that grantees complied with program guidelines. The grant agreements provide that DOC may inspect the grantee records at any time.

- DOC did not reconcile GFO grant disbursements recorded in the grants management system with the State’s accounting records. Specifically, total grant disbursements from each system were not periodically compared and reconciled to help ensure that only valid transactions had been processed and recorded. During fiscal year 2017, GFO grant payments, according to DOC’s grants management system totaled approximately \$13.8 million, but payments, according to the State’s records totaled \$13.1 million—a difference of approximately \$700,000.

Recommendation 5

We recommend that DOC establish effective procedures and control over the award and disbursement of GFO program grants. Specifically, we recommend that DOC

- a. obtain and review appropriate documentation, such as bank statements and invoices, at least on a test basis, to ensure that each grantee matched the grant funds received as required and that grant funds were used for allowable purposes; and**
- b. periodically reconcile grant disbursements in the grants management system with similar amounts in the State’s accounting records, and investigate and resolve any differences noted.**

Small, Minority, and Women-Owned Businesses Account

Background

Effective July 1, 2017, in accordance with Chapter 453, Laws of Maryland 2017, the authority for the administration of the Small, Minority, and Women-owned Businesses Account (SMWOBA) Program was transferred from the Board of Public Works (BPW) to DOC. Prior to that date, DOC had been designated by BPW, through a memorandum of understanding, to administer the program as BPW’s agent. Historically, the SMWOBA Program has been funded by 1.5 percent of video lottery terminal (VLT) proceeds collected by the State’s six facilities (casinos) with VLTs. In accordance with State law, for fiscal year 2018, VLT proceeds were instead to be used for State grants for education aid and, for fiscal years 2019 and 2020, are to be credited to the Education Trust Fund.

Under the SMWOBA Program, DOC has entered into agreements with fund managers to provide investment capital and loans to small, minority, and women-owned businesses throughout Maryland, with 50 percent of those funds required to be allocated to such businesses in the jurisdictions and communities surrounding video lottery facilities. DOC established various goals for making loans to specific businesses based on ownership, industry sector, and geographic location. DOC, with the approval of BPW, has executed Grant and Fund Management Services Agreements with eight fund managers. The fund manager agreements, which are ongoing, provide descriptions of the services and responsibilities of the fund managers, including making and servicing loans or investing in targeted businesses, and submitting certain reports and audited financial statements to DOC. Each agreement generally contains similar terms and conditions, but differs in terms of the actual grant award amount for each fund manager.

DOC maintains the VLT funds in the SMWOBA, and fund managers request to receive grant funds from the investment account, up to the amount of their award, as funds are needed for investment and loan activity. The managers maintain these funds received in a separate bank account established in trust for the benefit of the State. These funds, plus any repaid loan principal, are made available for new investment capital and loans. With the exception of fund manager compensation, all grants, loan assets, and related records remain the property of the State. Under the agreements, the fund managers are primarily compensated for program costs by origination and transaction fees paid by the businesses, and interest earned on loan assets.

According to DOC records, since the SMWOBA Program's inception in May 2013, through fiscal year 2017, BPW has approved \$52.2 million in awards to the fund managers, of which approximately \$21.2 million remained in the SMWOBA at the end of fiscal year 2017. During our audit period, approximately \$25.7 million was disbursed to fund managers from the investment account.

Finding 6

DOC did not have a process to ensure that fund manager agreements included critical details relating to loan underwriting processes.

Analysis

DOC did not have a process to ensure that fund manager agreements included critical details relating to loan underwriting processes used by fund managers, including standards and practices for evaluating loan applicants for suitability and credit worthiness. During fiscal year 2017, according to DOC records, the eight fund managers settled 93 loans totaling \$10.2 million.

We judgmentally selected four fund manager agreements for review; these four fund managers settled 41 loans totaling approximately \$6.1 million during fiscal year 2017. Our review found that three agreements (related to 37 loans settled totaling \$5.3 million) lacked details relating to the underwriting process, such as procedures to be used for determining borrower eligibility for the loan, minimum borrower requirements, documentation requirements, collateral requirements, and a conflict of interest policy. Conversely, the remaining agreement (related to 4 loans settled totaling \$800,000) included relevant details regarding the process to be used by the fund manager for identifying loan eligibility, determining the applicant's business experience and credit status, and determining the value of collateral. This agreement also included a conflict of interest policy.

Underwriting is the process used to determine if the risk of offering a loan to a particular borrower under certain parameters is acceptable. Lack of appropriate underwriting standards and practices can expose the SWMOBA Program to greater risk of loss and provides fund managers with wide latitude without considering the purpose of the SMWOBA Program.

Recommendation 6

We recommend that DOC establish a process to ensure that fund manager agreements include critical details relating to loan underwriting processes used by fund managers, including standards and practices for evaluating loan applicants for suitability and credit worthiness.

Finding 7

DOC did not establish an effective process to verify fund manager compensation.

Analysis

DOC did not establish an effective process to verify the propriety and accuracy of compensation that fund managers periodically withdrew from their accounts. In addition, our tests disclosed certain discrepancies between the amount of compensation withdrawn for certain fund managers and certain fund activity reported. Compensation to all fund managers since the inception of the program through fiscal year 2017 has totaled approximately \$2.6 million, according to DOC records.

According to their agreements, fund managers are compensated by retaining stated percentages of grant award funds (known as expense fees); loan origination and transaction fees; and interest, capital gains, and dividend earnings. Fund managers withdraw their compensation directly from the bank accounts

established in trust for the State. The agreements require the fund managers to provide a proper invoice which sets out the amount and basis of each compensation component; however, there is no requirement for documentation to be submitted with the invoices.

Although fund managers provided a monthly accounting of fund activity which provided certain details regarding the source of the compensation earned, this accounting was not sufficiently detailed to provide DOC with assurance that the compensation withdrawn was proper and accurate, nor was it supported by independent documentation. Adequate documentation might include, for example, evidence of fees paid by the borrower to the fund manager, and source documentation of interest, capital gains, and dividends earned. Using the monthly accountings, we tested five withdrawals for compensation made by three fund managers during the period between April 2016 and April 2017, totaling approximately \$407,000. Our test disclosed that the amounts withdrawn in three instances exceeded the accountings by an aggregate of \$16,000.

Recommendation 7

We recommend that DOC

- a. establish an effective process to verify fund manager compensation that includes obtaining adequate supporting documentation to verify that compensation claimed by fund managers was proper and accurate in accordance with the fund manager agreements, and**
- b. investigate and resolve the aforementioned difference of \$16,000.**

Finding 8

DOC did not verify data reported by fund managers relating to their efforts to meet certain specific program lending goals.

Analysis

DOC did not have a process in place to verify data reported by fund managers relating to their efforts to meet certain specific program lending goals. Consistent with the SMWOBA Program's purpose, DOC established fund manager goals for making loans to specific businesses based on ownership, industry sector, and geographic location. According to the fund manager agreements, a manager's success in reaching these lending goals is a factor in considering whether additional grant funds should be awarded to the manager.

DOC's established fund manager goals provide more specificity beyond the general SMWOBA Program requirements in State law. Specifically, DOC established annual goals require fund managers to make loans to at least one

veteran-owned business, two women-owned businesses, one disabled-owned business, two businesses in a rural targeted area, one business in the clean energy sector, one business in the manufacturing sector, and one business in the cyber industry sector.

Although fund managers reported to DOC certain data related to these goals, such as the number and value of loans made to specific targeted recipients and recipients in certain locations, documentation was not required to be submitted to support the reported data. Fund managers are required to have certain agreed-upon procedures performed by an independent entity to examine certain program activity, and the results of these examinations are reported to DOC, relieving it of the need to verify such activity. We noted, however, that DOC did not require that these procedures specifically include a determination of whether the aforementioned program goals had been met. If achievement of these program goals is to be used for evaluating fund manager activity, adequate documentation should be obtained through these agreed-upon procedures or by other means to verify each fund manager's reported progress in achieving these goals.

Our review of loan activities for fiscal years 2016 and 2017 reported for three fund managers disclosed that none of the three fund managers met all the stated goals. For example, none of the fund managers reported making loans to a disabled-owned business, and two fund managers did not make loans in a rural targeted area. In addition, there was no evidence that this loan activity reported affected subsequent grant fund allocations, and no explanations had been requested from the respective fund managers for goals not met.

Recommendation 8

We recommend that DOC establish a process to verify data reported by fund managers relating to their efforts to meet DOC's program lending goals, and take appropriate action.

Purchases and Disbursements

Finding 9

Certain purchasing and disbursement transactions and access to the State's Financial Management Information System (FMIS) were not sufficiently controlled.

Analysis

DOC had not established effective controls over its purchasing and disbursement transactions and the assignment of user access capabilities for all disbursements

processed through FMIS. As a result, several employees could process payments without independent approval, and improper access to FMIS could be granted without detection. According to the State's records, DOC processed disbursements totaling \$88.6 million through FMIS during fiscal year 2017 pertaining to its financing programs and general operations.

- DOC had not established adequate online approval requirements in FMIS for disbursements in two departments. Within these two departments, the same employee was able to initiate, approve, and transmit a voucher for payment without independent review and approval. During the period from July through December 2017, this employee initiated and approved \$20,000 in direct vouchers, of which \$3,000 was also transmitted for payment by the user. Our limited testing of transactions processed by this employee did not disclose any improprieties.
- DOC had not established adequate online approval requirements related to purchase orders in FMIS for purchases in one department. Four employees had the capability to initiate and approve purchase orders in one department for dollar amounts as high as \$25,000 without independent review and approval. This differed from other departments within DOC for which the maximum threshold was generally \$5,000. Furthermore, two of the four employees had the ability to add a vendor to the FMIS vendor database. Within this department, we noted that purchase orders totaling approximately \$6.6 million were processed during our audit period by these four employees without independent approval. Our limited testing of purchase orders processed by these four employees did not disclose any improper transactions.
- DOC had not established effective controls to ensure its employees were assigned appropriate access capabilities in FMIS. One employee, who served as the security officer over all levels of access to FMIS, was also responsible for monitoring individual employee security profiles that specified the level of system access provided to employees. This employee would not be in a position to determine what level of system access was appropriate for each employee. The Department of Information Technology's *Internal Control and Security Policy and Procedures Manual* establishes requirements for providing appropriate controls over employee access and states that employee security profiles should be monitored and reviewed by applicable management personnel who are in a position to determine system access required by their subordinates.

Similar conditions regarding purchase order initiation and approval, and the review of access capabilities were commented upon in our preceding audit report.

Recommendation 9

We recommend that DOC

- a. establish adequate online approval requirements so that vouchers for all departments are independently approved,**
- b. establish consistent independent online approval requirements so that purchase orders for all departments exceeding \$5,000 are subject to such approval (repeat), and**
- c. ensure that appropriate supervisory personnel monitor employee security profiles in FMIS for consistency with employee job responsibilities (repeat).**

Audit Scope, Objectives, and Methodology

We have conducted a fiscal compliance audit of the Department of Commerce (DOC), formerly known as the Department of Business and Economic Development, for the period beginning July 1, 2014 and ending December 18, 2017. The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

As prescribed by the State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine DOC's financial transactions, records, and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of significance and risk. The areas addressed by the audit included financing programs, tax incentive programs, grant programs, payroll, and purchases and disbursements. We also determined the status of the findings contained in our preceding audit report of the Department of Business and Economic Development.

To accomplish our audit objectives, our audit procedures included inquiries of appropriate personnel, inspections of documents and records, observations of DOC's operations, and tests of transactions. Generally, transactions were selected for testing based on auditor judgment, which primarily considers risk. Unless otherwise specifically indicated, neither statistical nor non-statistical audit sampling was used to select the transactions tested. Therefore, the results of the tests cannot be used to project those results to the entire population from which the test items were selected.

We also performed various data extracts of pertinent information from the State's Financial Management Information System (such as revenue and expenditure data), and the State's Central Payroll Bureau (payroll data). The extracts are performed as part of ongoing internal processes established by the Office of Legislative Audits and were subject to various tests to determine data reliability. We determined that the data extracted from this source were sufficiently reliable for the purposes the data were used during this audit. We also extracted data from the DOC's automated grants management system and automated financing programs monitoring system for the purpose of testing certain attributes and

functions, such as grant awards, eligibility for financing, and DOC's monitoring efforts. We performed various tests of the relevant data and determined that the data were sufficiently reliable for the purposes the data were used during the audit. Finally, we performed other auditing procedures that we considered necessary to achieve our audit objectives. The reliability of data used in this report for background or informational purposes was not assessed.

DOC's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records; effectiveness and efficiency of operations including safeguarding of assets; and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes findings relating to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect the DOC's ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding significant instances of noncompliance with applicable laws, rules, and regulations. Other less significant findings were communicated to DOC that did not warrant inclusion in this report.

DOC's response to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise DOC regarding the results of our review of its response.

APPENDIX



Larry Hogan | Governor
Boyd Rutherford | Lt. Governor
Kelly M. Schulz | Secretary of Commerce
Benjamin H. Wu | Deputy Secretary of Commerce

August 13, 2019

Mr. Gregory A. Hook, CPA
Legislative Auditor
Office of Legislative Audits
301 W Preston Street
Baltimore, MD 21201

Dear Mr. Hook:

Please find enclosed the Maryland Department of Commerce response to the Legislative Auditor's draft report for our fiscal/compliance audit for the period beginning July 1, 2014 and ending December 18, 2017.

I appreciate the work of your audit team. When I was the Secretary of Labor, I had a cooperative and collaborative relationship with the legislative audit team. I look forward to a similar relationship during my tenure at the Department of Commerce because we both have a mutual desire to make state government run as efficient and effective as possible.

I also appreciate the opportunity last week to have a discussion with your audit team. I found the meeting to be very valuable. As you know, I was not with Commerce during the July 2014-December 2017 audit period or during the department's December 2018 exit meeting with the audit team when Commerce was first made aware of the audit team's initial findings and recommendations.

Since my Commerce tenure began in January 2019, in the intervening eight months from the Commerce December 2018 exit meeting to when we received the draft report a few weeks ago, the department has made strides to adopt and implement many of the audit team's recommendations. We will continue to work with your team to review how we can continue implementing more of the recommendations.

As instructed we are also mailing hard copies of the response by certified mail to your office at the above address. If you should have any questions, please contact Maqsood Khan at 410-767-2292.

Sincerely,

Kelly M. Schulz
Secretary

OFFICE OF THE SECRETARY

World Trade Center | 401 East Pratt Street | Baltimore, MD 21202 | 410-767-6301 | 888-246-6736

commerce.maryland.gov

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One Maryland Tax Credit Program

Finding 1
DOC had not established effective procedures to ensure that One Maryland Tax Credit applicants accurately reported their compliance with required new job creation numbers, and a tax credit was issued to one applicant based on ineligible project costs.

We recommend that DOC establish adequate procedures to verify the propriety of One Maryland Tax Credits. Specifically, we recommend that DOC

- a. obtain documentation for and verify the number of new positions created and filled by each applicant, including when they were filled and the duration of time in which they were filled (repeat);**
- b. ensure that project cost eligibility verifications are performed consistent with State regulations; and**
- c. take action to rescind the aforementioned issued tax credit that was issued based on ineligible project costs.**

Agency Response			
Recommendation 1a	Agree	Estimated Completion Date:	12/31/2019
<i>Please provide details of corrective action or explain disagreement.</i>	<p>Recognizing the auditor’s recommendation for additional compliance verification, a revised process will be adopted for all future applicants.</p> <p>Moving forward for future applicants, a local university will confirm the number of new positions created and verify that they have been filled for a period of 12 months and pay at least 120% of the state minimum wage. Or, the applicant can choose to engage an independent CPA to verify the above information.</p> <p>DOC will rescind any future credits that are not subsequently verified.</p>		
Recommendation 1b	Agree	Estimated Completion Date:	12/31/2019
<i>Please provide details of corrective action or explain disagreement.</i>	<p>There is agreement that project cost eligibility verifications should be performed consistent with State regulations.</p> <p>In the case referenced by the auditors that suggest a tax credit may have been questionably issued based on ineligible project costs, it should be noted that the project costs for which the applicant received the benefit of the tax credit did fall within the One Maryland Tax Credit statute’s definition of eligible project costs.</p>		

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	<p>“Eligible project cost” is defined as “the cost and expense a qualified business entity incurs to acquire, construct, rehabilitate, install or equip an eligible economic development project.” (Economic Development Article § 6-401(d)(1).</p> <p>However, an issue arose because costs from the applicant’s purchase of goods were from a reportedly “related company.” Under the regulations governing the One Maryland Tax Credit Program, “eligible project costs” exclude “[a]ny costs incurred in dealings between related parties.” See COMAR 24.05.24.02B(9)(c)(ii) (the “regulation”).</p> <p>The regulation is intended to prevent a tax credit applicant from possibly claiming costs that may not be justified, or that may be inflated, if purchased from a related entity. The regulation seeks to defeat potential padded profiteering by an applicant.</p> <p>In this case, however, the costs that were incurred by purchasing from a related entity resulted in what was understood to be a net cost savings for the applicant.</p> <p>It is commonly accepted that in administering the tax credits, DOC is authorized to waive regulations for good cause.</p> <p>In the referenced case, a judgment was made that the transaction did not violate the intent of the regulation and that the applicant’s costs were both reasonable and were appropriately considered “eligible” as defined in the One Maryland statute.</p> <p>Further, the transaction was reflective of a common business practice to use related entities to achieve cost savings in procurement.</p> <p>As discussed with the auditors, DOC will propose an amendment to the language of the regulation that clearly allows an exception in these or similar future circumstances so that a waiver is no longer necessary.</p> <p>Specifically, the regulatory amendment would propose that any expenses between related parties will only be acceptable if those expenses are supported by invoices (incurred by the related party to unrelated third-party vendors) that demonstrate a cost savings to the applicant.</p>
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Auditor’s Comment: DOC agrees to ensure project cost eligibility is verified consistent with State regulations; however, DOC disputes that the \$5.5 million tax credit highlighted

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in the finding, which was certified based on claimed costs incurred through a related party transaction, was improperly issued. Throughout the audit, as stated in the audit report, DOC did not dispute the ineligibility of these project costs for this tax credit, but advised that the related party regulation was antiquated and that it intended to amend the regulation.

In its report response, DOC now asserts that the tax credit was consistent with the intent of the regulations even though State regulations specifically exclude related party costs from eligibility. DOC claims that, as authorized by regulations, a judgment was made to waive this regulation in this instance, with the premise that the intent of the regulation was not violated and the costs were appropriately considered “eligible.” However, DOC provided no documentation to support that the Secretary formally waived any elements of the regulations with respect to this tax credit.

Furthermore, while the applicable regulations provide for the Secretary’s waiver under certain specific circumstances, such as when application of the regulation would be inequitable or contrary to the purposes of the related State law, it is unclear how these specific circumstances apply in this tax credit situation. Finally, DOC states it intends to propose regulatory changes to clearly (and formally) allow exceptions in these instances, thereby eliminating the need for a waiver.

Recommendation 1c	Agree	Estimated Completion Date:	12/31/2019
<i>Please provide details of corrective action or explain disagreement.</i>	Respectfully, DOC cannot rescind the tax credit because the applicant submitted costs that were acceptable under the statute. Although there was not an express formal documentation of the waiver, in accepting the expenses, DOC effectively waived the regulation in question. The taxpayer did not engage in fraud or misrepresentation and, therefore, it is the legal determination that there are no legal grounds for rescission of the tax credit.		

Auditor’s Comment: DOC states that it will not rescind the tax credit because the applicant did not engage in fraud or misrepresentation and the regulation was effectively waived. However, as explained in our previous auditor comment, DOC did not provide us with documentation that the regulations were formally waived.

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Biotechnology Investment Tax Credit

Finding 2

DOC did not have procedures to ensure biotechnology companies accurately reported employment and ownership information prior to being certified and the issuance of tax credits to investors. In addition, DOC did not establish procedures to identify tax credits subject to recapture.

We recommend that DOC establish adequate procedures for the Biotechnology Investment Tax Credit program. Specifically, we recommend that DOC

- a. verify the accuracy of employment reports provided by biotechnology companies by periodically reviewing each company’s payroll records, to ensure they have fewer than 50 employees;
- b. obtain and verify complete ownership information for the biotechnology companies to ensure tax credits are not issued to investors who own more than 25 percent equity interest; and
- c. develop procedures to identify tax credits that require recapture.

Agency Response			
Recommendation 2a	Agree		
<i>Please provide details of corrective action or explain disagreement.</i>	<p>Recognizing the auditor’s recommendation for additional compliance verification, a revised process will be adopted for all future applicants.</p> <p>Moving forward for future applicants, DOC will require the two most recent unemployment reports and filing confirmations from the MD Department of Labor. DOC will require the information for two years following the issuance of the tax credit.</p>		
Recommendation 2b	Agree	Estimated Completion Date:	12/31/2019
<i>Please provide details of corrective action or explain disagreement.</i>	For all future applicants, DOC will require the information through two years following the issuance of the tax credit.		
Recommendation 2c	Agree	Estimated Completion Date:	12/31/2019
<i>Please provide details of corrective action or explain disagreement.</i>	For all future applicants, DOC will amend the final tax credit certificate to emphasize the tax credit recapture requirement.		

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Loans – Conditional and Guaranteed

Finding 3

DOC did not establish a sufficient process to verify loan recipients met employment requirements before forgiving conditional loans. In addition, DOC paid certain loan guarantees without obtaining, reviewing, and verifying adequate documentation to support lender claims.

We recommend that DOC establish a sufficient process for conditional loans and loan guarantee transactions. These processes should include requirements that DOC

- a. verify employment reports received from recipients prior to forgiving conditional loans through the performance of more frequent and comprehensive OIA payroll reviews, including verifications that employment requirements were met for each year of the loan;**
- b. verify the accuracy of interest claimed by lenders for guaranteed loans and seek recovery of past overpayments, as appropriate;**
- c. obtain adequate documentation to support lender claims regarding efforts to liquidate collateral for guaranteed loans; and**
- d. in conjunction with its legal counsel, determine whether payment of the aforementioned \$187,600 in settlement costs was permitted under the related loan guarantee agreement and, if not, take action to recoup those funds.**

Agency Response

Please provide additional comments as deemed necessary.

As listed below, we respectfully disagree with the some of the auditor's general conclusions regarding employment and loan guarantee procedures.

Employment:

DOC believes there are well-defined, established procedures to verify employment data submitted by recipients. Companies are required each year to provide documentation to verify compliance with job requirements.

These detailed employment reports include information on wages, hours, benefit eligibility, and a certification executed by an official of the company attesting to the accuracy of the reports. Additionally, recipients of assistance are required to execute consent forms enabling DOC to access employment information maintained by the Department of Labor (DOL).

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	<p>DOC uses the DOL information to verify the employment level. There is confidence in this reporting/verification process based on the following:</p> <ol style="list-style-type: none">(1) a requirement that employment data provided to DOC by a recipient have a certification under penalty of perjury, signed by an official of the recipient, and(2) the recipient's knowledge that the DOL information is used as an independent system of verification. <p>Data reported to DOL by companies is subject to audit and any over-reporting of employees to DOL would increase the company's tax liability to the State. In situations when a company reported a larger number of employees to DOC than what was reported to DOL, the discrepancies are researched and the company as well as DOL are contacted to resolve the discrepancy. Any discrepancies reported are documented on the Employment Validation memo and reviewed by management before any decisions are made to forgive or claw back funds.</p> <p>Furthermore, at the time of forgiveness, DOC enlists its Office of Internal Audits (OIA) to verify the accuracy of these reports. We do agree with the auditor's analysis that OIA did not review and verify all of the loans that were eligible for forgiveness and should perform more frequent reviews of employment records.</p>
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Auditor's Comment: DOC disagreed with the finding that its process for verifying employment data was not sufficient because it uses two sources of documentation to verify such data: certified employment reports from loan recipients and employment information maintained by the Maryland Department of Labor. However, as explained in the analysis, these two data sources do not provide sufficient assurance or specificity that loan recipients have actually met the employment requirements for forgiveness of a conditional loan. However, DOC does agree with the finding that the number of verifications performed by its Office of Internal Audits (OIA) was not effective given the relatively small number of audits conducted. Notwithstanding its concern with its limited resources, DOC does generally agree with OIA's related recommendation (3a) to consider performing more frequent and comprehensive reviews of payroll records at the time of loan forgiveness.

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Loan Guarantee:

DOC acknowledges that it did not obtain certain documentation to support amounts used by a lender in claim computations. DOC acknowledges that it relied upon computations and certifications submitted by a lender.

In August 2018, the DOC established heightened operational procedures and added an additional layer of scrutiny to ensure thorough review of information submitted by lenders prior to approval and payment of a claim.

To avoid this situation in the future and strengthen the claim evaluation process, the Office of Financing Programs (OFP) developed and implemented a Guaranty Fund Claim Checklist Form (GFCC). Use of the GFCC will prevent potential oversights and verify the accuracy of claims prior to issuance.

The lender's complete claim request package and the completed GFCC will be reviewed for sufficiency by the Small Business Unit (SB) and Finance Programs Accounting and Administration Unit (FPAA) before submission to the senior director for approval. Use of the GFCC was implemented in August 2018.

Interest Computation:

DOC disagrees with the auditor's example of an interest overpayment in the amount of approximately \$81,600. After review of information provided by the auditor, we are unable to substantiate this amount. Upon receipt of additional detailed information, DOC will review and respond appropriately. However, we acknowledge an interest overpayment of approximately \$9,000 for the three guaranty fund accounts reviewed. The overpayments are primarily due to an error in the lender's interest calculation.

Liquidating Collateral:

We disagree with the auditor's opinion that DOC did not obtain sufficient documentation to verify one lender's efforts to fully liquidate available collateral prior to paying a claim.

The lender's Line of Credit to the borrower must be renewed every 12 months. The renewal process entails a comprehensive credit and collateral analysis. In addition, the contractor for the program conducts monthly loan Portfolio Review meetings. This process enables DOC to consistently monitor the status of loan accounts, including collateral values. Also, DOC uses Maryland Department of Assessments and

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	<p>Taxation Reports (DAT) and On-Line Real Estate Valuation sites to assess fair market values of real property collateral.</p> <p>In the example cited, the lender provided a liquidation summary of the personal guarantor's assets, which included two residential properties. DOC reviewed and verified the values in the summaries using the methodology referenced above. DOC concluded that there was no material equity in the properties to provide a monetary recovery. As a result, a third-party appraisal was not deemed necessary to complete our evaluation and would be an unnecessary expense.</p>
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Auditor's Comment: DOC disagreed with the finding that it did not obtain sufficient documentation to verify one lender's efforts to fully liquidate available collateral prior to paying the claim. DOC claims that it verified the value of the collateralized properties using State Department of Assessments and Taxation data and online real estate valuation sites and that, consequently, there was no need for an independent appraisal. This process described in the response was not previously disclosed to OLA, and DOC has not documented that these sources provide the same reliable and complete information for this purpose, consistent with independent appraisals as highlighted in the analysis. Nevertheless, DOC does agree with the related recommendation (3c) and has initiated a new operational procedure to ensure the submission of appropriate documentation to support lenders' claims regarding efforts to liquidate collateral.

	<p><u>Lender's Expenses:</u> DOC acknowledges that we did not obtain 100% of the data the auditor considers necessary. However, for the example cited, DOC believed the information provided by the lender was commercially reasonable for evaluation and resolution of the claim request.</p> <p>The lender submitted detailed records of legal and bankruptcy trustee fees. Also, the lender submitted standard US HUD Settlement Statements, which show costs related to foreclosure and subsequent sale to a third party.</p> <p>DOC views the expenses associated with both the foreclosure and third party sale, which includes the \$187,600 cited, to be components of the overall costs to liquidate the collateral.</p>
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	<p>The lender's purchase of the property at the foreclosure sale was deemed to be an unintended outcome of the auction. The auction did not produce third party bids in a sufficient amount to maximize the property's value.</p> <p>This claim request was the subject of substantial review within DOC due to its complexity, including layers of creditors, foreclosure, negotiation and second sale process, and probability of litigation. DOC examined the documentation, and found it to be commercially reasonable to support the claim request. In addition, we conferred with the lender and ultimately arrived at a resolution acceptable to both the lender and DOC.</p>		
Recommendation 3a	Agree	Estimated Completion Date:	12/31/2019
<i>Please provide details of corrective action or explain disagreement.</i>	<p><u>DOC Response:</u> Recognizing the auditor's recommendation for additional compliance verification, DOC will research the practicality, the risks, and the costs associated with performing more frequent and comprehensive reviews of company payroll records including verification that employment requirements were met for each year of the loan.</p> <p>At any given time there are between 50 and 60 companies reporting their employment annually. As of FY19, those companies reported employees totaling 47,659. There is concern that DOC does not have the auditing staff to fully perform this level of activity as recommended by the auditors.</p> <p>Reflecting heightened data security concerns and related potential liability for data breaches, businesses have become increasingly reluctant to provide payroll records in electronic or manual formats. Onsite review of payroll records would carry risk of misuses of data and potential errors inherent in any manual review.</p> <p>DOC has considered requiring independent third party verification (e.g. CPA or legal firm). This approach would add out-of-pocket costs to businesses in the form of related technological processes and vendor fees resulting in a punitive business environment.</p> <p>Nevertheless, subject to staffing capacity, DOC will consider doing a more comprehensive review of payroll records at the time of forgiveness beyond the annual review that is documented each year. This review would include a sampling of the payroll records over the life of the conditional loan or grant if those records are available.</p>		

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	<p>OIA Response:</p> <p>Although we agree with OLA’s recommendation, the DOC Office of Internal Audits (OIA) does not have the current resources to implement this recommendation immediately. OIA has only two employees and is expected to audit 20-25% of the Job Creation Tax Credit (JCTC), One Maryland, and loan/grant forgiveness applications. Also, OIA performs annual reviews of approximately 50 Maryland State Arts Council grant applications that alone take approximately three months to complete.</p> <p>We have also experienced that JCTC, One Maryland, and loan/grant forgiveness applicants are resisting providing payroll data to DOC due to confidentiality and information security concerns.</p> <p>To fully accomplish the auditor’s recommendations, we would therefore need a minimum of four (4) additional staff auditors who can visit applicant’s corporate offices to verify the payroll data as recommended if applicants refuse to send requested payroll information to OIA.</p> <p>At this time, we are unable to provide a specific date to implement this recommendation until resources are provided to OIA or DOC finds an alternative way to receive payroll information in our office.</p>		
Recommendation 3b	Agree	Estimated Completion Date:	08/01/2018
<i>Please provide details of corrective action or explain disagreement.</i>	<p>Recognizing the auditor’s recommendation, implementation steps have already been taken. In August 2018, DOC initiated a new operational procedure, including a Guaranty Fund Claim Checklist Form and an additional layer of scrutiny to ensure thorough review of lenders’ calculations.</p> <p>DOC will evaluate the appropriateness of seeking recovery of a past \$9,000 interest overpayment. However, a request for reimbursement of this amount, while deemed modest in the lender’s view, presents an onerous administrative task for the lender and will be viewed as an unfriendly business practice. This will discourage lenders’ participation with the program, and could potentially result in less capital available for small businesses.</p>		
Recommendation 3c	Agree	Estimated Completion Date:	08/01/2018
<i>Please provide details of corrective action or explain disagreement.</i>	<p>Recognizing the auditor’s recommendation, implementation steps have already been taken. In August 2018, DOC initiated a new operational procedure, including a Guaranty Fund Claim Checklist Form, to ensure the submission of appropriate documentation to support lenders’ claims regarding efforts to liquidate collateral.</p>		

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Recommendation 3d	Agree	Estimated Completion Date:	08/01/2018
<i>Please provide details of corrective action or explain disagreement.</i>	<p>Recognizing the auditor’s recommendation, implementation steps have already been taken. DOC, in consultation with its AAG, has determined that allowing the \$187,600 in settlement costs submitted by the lender as reasonable expenses associated with purchase of the real property collateral at foreclosure was permitted under the related loan guarantee agreement.</p> <p>The lender purchased the real property collateral at foreclosure sale to preserve the collateral. This action was not the “final liquidation” of the collateral, which occurred subsequently when lender sold the real property to a third party.</p> <p>As noted above under “Lender’s Expenses”, DOC received US HUD Settlement Statements detailing the settlement costs associated with both the foreclosure sale and the subsequent sale of the collateral to a third party. DOC determined that the settlement costs for both transactions were commercially reasonable costs and expenses associated with the preservation and final liquidation of the collateral and permitted under the related loan guarantee agreement.</p> <p>It is therefore neither necessary nor appropriate for DOC to take action against the lender for having incurred the \$187,600 in settlement costs.</p>		

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Maryland E-Innovation Initiative Fund

Finding 4
DOC did not have an established process to ensure that MEIF recipients secured and deposited required private funding (donations), and that the related expenditures were made for qualified purposes.

We recommend that DOC establish a process to verify, at least on a test basis, NPIHE compliance with MEIF requirements. In this regard, such verification could include OIA on-site audits or obtaining appropriate documentation from MEIF recipients to ensure that qualified donations were deposited into the designated research endowment, and to verify that State funds were used for purposes allowed by State regulations.

Agency Response			
Recommendation 4	Agree	Estimated Completion Date:	12/31/2019
<i>Please provide details of corrective action or explain disagreement.</i>	<p>Recognizing the auditor’s recommendation, DOC has developed a corrective action plan to:</p> <ul style="list-style-type: none"> (1) inform the applying Non-Profit Institutions of Higher Education (NPIHE) of the required documentation under COMAR; (2) compile checklist of required documents; and (3) create a 90-day tickler to verify receipt of qualified donations. <p>DOC also revamped its Annual Report to include a financial reporting template consistent with the requirements under COMAR 24.05.22.02 for allowable expenditures. Furthermore, DOC will have OIA periodically review MEIF related documents for a sampled number of NPIHEs on a test basis to determine NPIHE compliance with MEIF requirements, and to verify that State funds were used for purposes allowed by State regulations.</p>		

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Maryland State Arts Council Grants

Finding 5
DOC had not established effective procedures and controls over the MSAC’s GFO program.

We recommend that DOC establish effective procedures and control over the award and disbursement of GFO program grants. Specifically, we recommend that DOC

- a. obtain and review appropriate documentation, such as bank statements and invoices, at least on a test basis, to ensure that each grantee matched the grant funds received as required and that grant funds were used for allowable purposes; and
- b. periodically reconcile grant disbursements in the grants management system with similar amounts in the State’s accounting records, and investigate and resolve any differences noted.

Agency Response			
Recommendation 5a	Agree	Estimated Completion Date:	11/15/18
<i>Please provide details of corrective action or explain disagreement.</i>	Recognizing the auditor’s recommendation, implementation steps have already been taken. Under new MSAC leadership and a GFO (Grants for Organizations) overhaul, from June to November 2018, DOC put the following procedures in place: <ol style="list-style-type: none"> (1) The director of Grants and Professional Development will implement a spot check (1 in every 30 applications) for required matching funds; and (2) The Interim and Final Reporting of GFO grants includes a financial and narrative requirement of how the funds were used. Program director approval of reporting, and consequently, compliance, includes the use of funds in alignment with allowable purposes. 		
Recommendation 5b	Agree	Estimated Completion Date:	11/15/18
<i>Please provide details of corrective action or explain disagreement.</i>	Recognizing the auditor’s recommendation, implementation steps have already been taken. The following procedures are now in place: <ol style="list-style-type: none"> (1) Every quarter, the fiscal officer will select randomly a set of twenty (20) grants for review. <ul style="list-style-type: none"> • The fiscal officer will print 20 grant payment requests (both 75% and 25%) from either Pearl or SmartSimple and compare the payment requests to actually what was posted to the general ledger within R-STARS (since these two systems do not interface). 		

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	<p>(2) If any discrepancies are found, the proper corrections will be made.</p> <p>(3) If any discrepancies are found, the fiscal officer will choose an additional twenty (20) payment requests for further review.</p>
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Small, Minority, and Women-Owned Businesses Account

Finding 6

DOC did not have a process to ensure that fund manager agreements included critical details relating to loan underwriting processes.

We recommend that DOC establish a process to ensure that fund manager agreements include critical details relating to loan underwriting processes used by fund managers, including standards and practices for evaluating loan applicants for suitability and credit worthiness.

Agency Response			
Recommendation 6	Agree	Estimated Completion Date:	12/31/2022
<i>Please provide details of corrective action or explain disagreement.</i>	<p>The fund managers have an established record as experienced lenders as required by the statute. DOC is not supposed to play the role of the lender by establishing standardized credit and underwriting policies for the fund managers.</p> <p>Respectfully, that approach defeats the purpose of the program. The program intent is to give small, minority, and women-owned businesses access to capital by lenders who understand the business needs, offer choices and flexible terms that traditionally would not be feasible under other DOC programs.</p> <p>However, DOC will ensure that any new fund manager agreements executed in the future will include critical details relating to loan underwriting processes, including standards and practices for evaluating loan applicants for suitability and credit worthiness.</p>		

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Small, Minority, and Women-Owned Businesses Account

Finding 7
DOC did not establish an effective process to verify fund manager compensation.

We recommend that DOC

- a. establish an effective process to verify fund manager compensation that includes obtaining adequate supporting documentation to verify that compensation claimed by fund managers was proper and accurate in accordance with the fund manager agreements, and
- b. investigate and resolve the aforementioned difference of \$16,000.

Agency Response			
<i>Please provide additional comments as deemed necessary.</i>	<p>Regarding fund manager compensation, it should be noted that DOC did receive and review monthly bank statements and reconciliations, including income withdrawn from the State checking accounts, and was aware of all activity. However, there was not an established, consistent procedure for verifying and approving fund managers' income. Some fund managers took income quarterly, others at the end of the year, and some took no income.</p>		
Recommendation 7a <i>Please provide details of corrective action or explain disagreement.</i>	Agree	Estimated Completion Date:	12/31/2018
	<p>Recognizing the auditor's recommendation, implementation steps have already been taken. DOC has hired a dedicated accountant to review all bank statements, reconciliations, and compensation requests in addition to other activities related to the account.</p> <p>Effective July 20, 2018, DOC implemented a policy that we must approve all fund manager compensation requests before the fund manager may write a check from the State account. Additionally, fund manager income requests will be reviewed monthly along with the bank statements, the reconciliation reports.</p> <p>Fund manager submissions will include evidence of supporting fees, principal, interest, and late fees. The supporting documentation should come directly from the fund managers' loan system and a copy of the check for application and origination fee income.</p>		

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Recommendation 7b	Agree	Estimated Completion Date:	12/31/19
<i>Please provide details of corrective action or explain disagreement.</i>	DOC has completed four out of eight audits on fund manager income and is continuing to audit the remaining four of the fund managers' compensation since the inception of the program. DOC will ensure the applicable adjustments to the account, if any, are discovered from the resulting investigation. At this time, there is no evidence to suggest that any fund manager received more or less income than allowed.		

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Small, Minority, and Women-Owned Businesses Account

Finding 8

DOC did not verify data reported by fund managers relating to their efforts to meet certain specific program lending goals.

We recommend that DOC establish a process to verify data reported by fund managers relating to their efforts to meet DOC’s program lending goals, and take appropriate action.

Agency Response

Please provide additional comments as deemed necessary.

It should be noted that DOC requires fund managers input all of their loan data into a designated database. Data includes, loan detail, minority status, targeted area, purpose of funds, expected outcomes, jobs and project costs.

This data is compiled into a detailed annual report of the fund managers’ activities. DOC also reviews SDAT records annually and reviews company websites to establish the validity of the businesses and where possible, identify the type of ownership.

The fund managers have 400+ loans of which 30% were to women-owned business, 36% to minority-owned and 5% to veteran-owned businesses. Fund managers have loaned funds to a cross section of industry sectors from manufacturing, to cyber, to food services.

DOC examines and analyzes the data to demonstrate the effectiveness of the program. We take the performance and goals of this program seriously and commissioned a local university to examine five primary questions to better manage the program:

- (1) What is the economic impact of the program?
- (2) What gaps does the VLT program fill in the marketplace?
- (3) How does the need for the program vary across the state?
- (4) What types of businesses and industries have been the most successful? and
- (5) Are there underserved businesses or industries that the VLT program should focus on?

DOC established goals in the contract as a basic benchmark for the fund managers. We cannot compel the fund managers to steer funds towards one group over another without a Disparity Study.

Additionally, the purpose of the Agreed Upon Procedures requirement implemented during the previous legislative audit was so that DOC did

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	<p>not need to verify additional supporting documents of applications. Furthermore, fund managers have five years to achieve these goals based on their contract.</p> <p>There has not been a grant award for FY18, FY19 and FY20 to base an evaluation on. If new appropriated grant funds were available in the account, DOC would take steps during the RFP process to evaluate existing fund manager performance when deciding to award additional grant funds.</p>
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Auditor's Comment: DOC's response that fund managers have five years in which to achieve these program lending goals is inconsistent with the fund manager request for proposals, which states that program lending goals are annual. As is the case with several other disagreements with the audit report analysis, DOC has agreed to implement the related recommendation.

Recommendation 8	Agree	Estimated Completion Date:	06/30/2019
<i>Please provide details of corrective action or explain disagreement.</i>	<p>Recognizing the auditor's recommendation, implementation steps have already been taken.</p> <p>DOC has included the following in the updated Agreed Upon Procedures effective June 30, 2019 to verify data reported by fund managers related to their efforts to meet DOC's program lending goals, and take appropriate action.</p> <p>This process verifies the fund manager has made loans to the following groups for the previous fiscal year:</p> <ol style="list-style-type: none"> a. One loan to a veteran-owned business; b. Two loans to women-owned businesses; c. One loan to a disabled-owned business; d. Two loans in a rural target area; e. One loan in the clean energy sector; f. One loan in the manufacturing sector; and g. One loan in the cyber industry sector. 		

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Purchases and Disbursements

Finding 9
Certain purchasing and disbursement transactions and access to the State's Financial Management Information System (FMIS) were not sufficiently controlled.

We recommend that DOC

- a. establish adequate online approval requirements so that vouchers for all departments are independently approved,
- b. establish consistent independent online approval requirements so that purchase orders for all departments exceeding \$5,000 are subject to such approval (repeat), and
- c. ensure that appropriate supervisory personnel monitor employee security profiles in FMIS for consistency with employee job responsibilities (repeat).

Agency Response			
Recommendation 9a	Agree	Estimated Completion Date:	10/31/2019
<i>Please provide details of corrective action or explain disagreement.</i>	<p>Recognizing the auditor's recommendation, implementation steps will be taken. DOC will establish an adequate online approval requirement so that vouchers for all departments are independently approved.</p> <p>FMIS access has been modified so that the same individual cannot initiate and approve a direct voucher. Additionally, the process was reviewed with personnel and the risk associated with the transactions was explained. A written policy will be completed in 90 days.</p>		
Recommendation 9b	Agree	Estimated Completion Date:	10/31/2019
<i>Please provide details of corrective action or explain disagreement.</i>	<p>Recognizing the auditor's recommendation, implementation steps will be taken. DOC has established a consistent independent online approval system.</p> <p>Employees now only have the ability to initiate and not approve purchase orders exceeding \$5,000. The policy has been implemented and the written policy will be completed in 90 days.</p>		
Recommendation 9c	Agree	Estimated Completion Date:	10/31/2019
<i>Please provide details of corrective action or explain disagreement.</i>	<p>Recognizing the auditor's recommendation, implementation steps will be taken. DOC will ensure that the appropriate supervisory personnel will monitor employees' security profiles in FMIS for consistency with employees' job responsibilities.</p>		

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	<p>The appropriate supervisory personnel will continue to be responsible for monitoring FMIS security profiles. The current DOC process will be enhanced by adding electronic signatures to the SharePoint database, where the reports are stored, to confirm that the appropriate supervisor has reviewed and verified the security reports.</p> <p>Additionally, all appropriate supervisory personnel will complete additional security training. Finally, we will formalize the process by creating standard operating procedures outlining the steps mentioned above no later than October 31, 2019.</p>
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