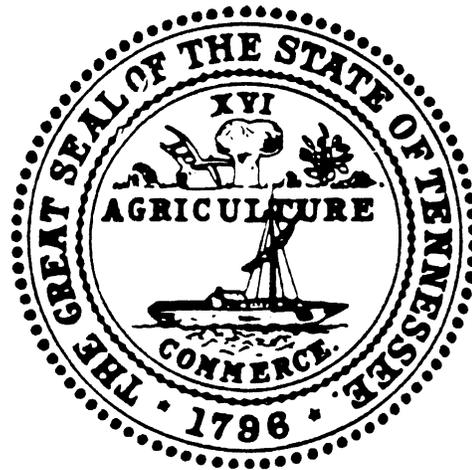


AUDIT REPORT

Department of Economic and Community Development

September 2007



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

State Capitol
Nashville, Tennessee 37243-0260
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John G. Morgan
Comptroller

September 13, 2007

The Honorable Phil Bredesen, Governor
and

Members of the General Assembly
State Capitol
Nashville, Tennessee 37243

and

The Honorable Matthew Kisber, Commissioner
Department of Economic and Community Development
11th Floor, W. R. Snodgrass Tennessee Tower
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of Economic and Community Development for the period June 1, 2005, through May 31, 2007.

The review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements resulted in no audit findings.

Sincerely,

A handwritten signature in black ink that reads "John G. Morgan".

John G. Morgan
Comptroller of the Treasury

JGM/cj
07/083



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COMPTROLLER OF THE TREASURY
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June 19, 2007

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Economic and Community Development for the period June 1, 2005, through May 31, 2007.

We conducted our audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we obtain an understanding of internal control significant to the audit objectives and that we design the audit to provide reasonable assurance of the Department of Economic and Community Development's compliance with laws, regulations, and provisions of contracts or grant agreements significant to the audit objectives. Management of the Department of Economic and Community Development is responsible for establishing and maintaining effective internal control and for complying with applicable laws, regulations, and provisions of contracts and grant agreements.

Our audit resulted in no audit findings.

We have reported other less significant matters involving the department's internal control and instances of noncompliance to the Department of Economic and Community Development's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/cj

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Department of Economic and Community Development
September 2007

AUDIT SCOPE

We have audited the Department of Economic and Community Development for the period June 1, 2005, through May 31, 2007. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements in the areas of the Community Development Block Grant Program; Creative Services; the FastTrack Program; the Tennessee Job Skills Program; expenditures; Department of Finance and Administration Policy 20, "Recording of Federal Grant Expenditures and Revenues"; Department of Finance and Administration Policy 22, "Subrecipient Monitoring"; and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include serving as a member of the Tennessee State Funding Board; approving accounting policies of the state as prepared by the state's Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; and providing support staff to various legislative committees and commissions.

AUDIT FINDINGS

The audit report contains no findings.

**Financial and Compliance Audit
Department of Economic and Community Development**

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Financial and Compliance Audit

Department of Economic and Community Development

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Department of Economic and Community Development. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which requires the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

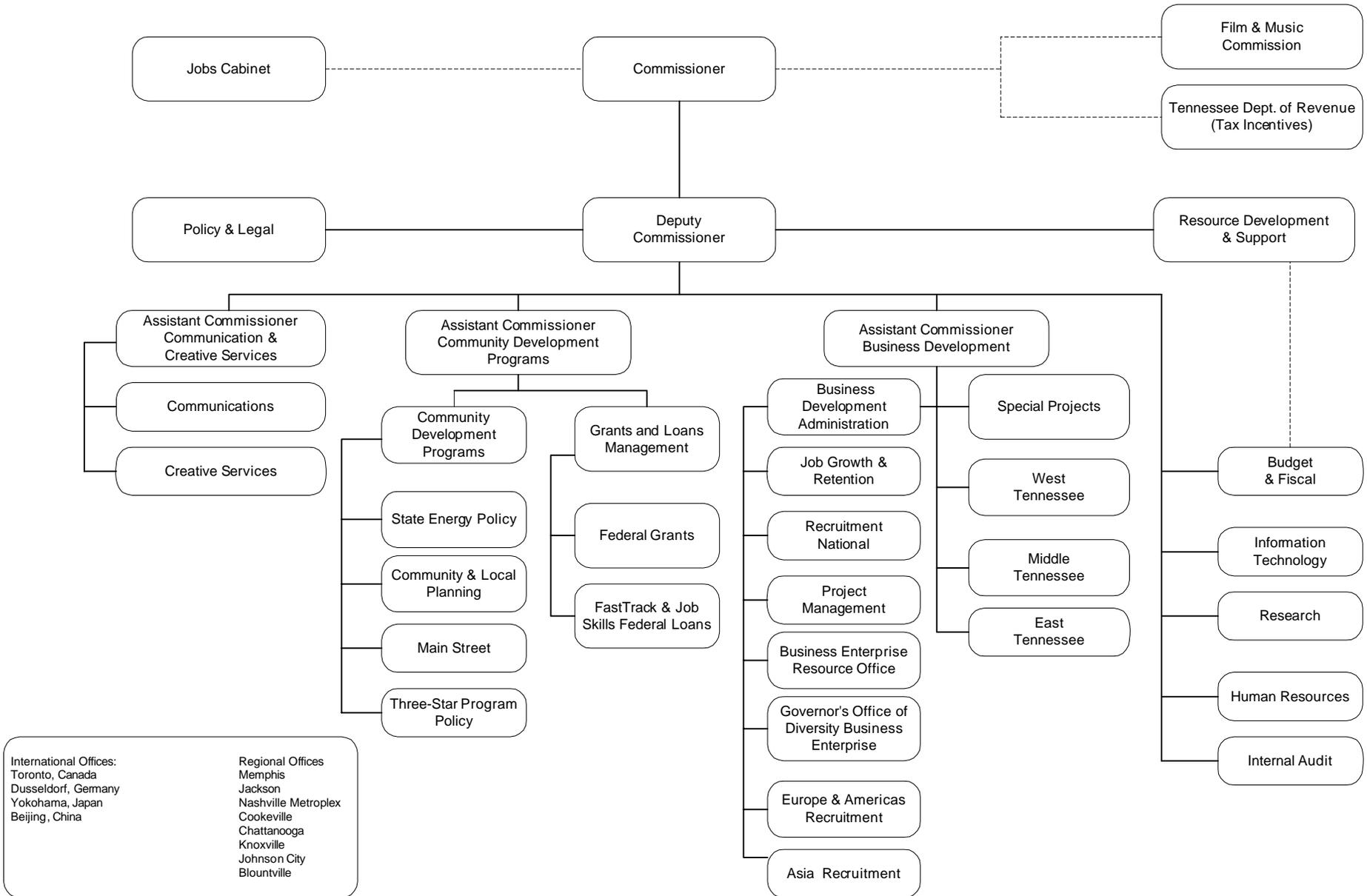
It is the mission of the Department of Economic and Community Development (ECD) to encourage economic growth and maintain a favorable business climate in Tennessee. ECD assists Tennessee communities in preparing and competing for economic development and job creation opportunities. It is also the department’s goal to offer support services for entrepreneurs, existing industries, and new firms, while marketing the state and recruiting new industries domestically and internationally.

An organization chart of the Department of Economic and Community Development is on the following page.

AUDIT SCOPE

We have audited the Department of Economic and Community Development for the period June 1, 2005, through May 31, 2007. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements in the areas of the Community Development Block Grant Program; Creative Services; the FastTrack Program; the Tennessee Job Skills Program; expenditures; Department of Finance and Administration Policy 20, “Recording of

Economic and Community Development Organization Chart



Federal Grant Expenditures and Revenues”; Federal Grant Expenditures and Revenues”; Department of Finance and Administration Policy 22, “Subrecipient Monitoring”; and the Financial Integrity Act.

The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include serving as a member of the Tennessee State Funding Board; approving accounting policies of the state as prepared by the state’s Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; and providing support staff to various legislative committees and commissions.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Department of Economic and Community Development filed its report with the Department of Audit on April 12, 2007. A follow-up of all prior audit findings was conducted as part of the current audit.

RESOLVED AUDIT FINDINGS

The current audit disclosed that the Department of Economic and Community Development has corrected previous audit findings concerning the purchasing practices of the Creative Services Division, Tennessee Job Skills grant procedures, controls over disbursements, and compliance with the Financial Integrity Act.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM

The Community Development Block Grant (CDBG) Program is authorized under Title I of the Housing and Community Development Act of 1974, as amended by Title 42 of the United States Code, Section 5301. One of the primary objectives of the program is the development of viable communities by providing decent housing, a suitable living environment, and expanded economic opportunities, principally for persons of low and moderate income. CDBG provides eligible cities and counties with annual direct grants that they can use to revitalize neighborhoods, expand affordable housing and economic

opportunities, and/or improve community facilities and services, principally to benefit low- and moderate-income persons.

The objectives of our review of the CDBG program were to determine whether

- the department was in compliance with certain laws and regulations concerning this program,
- federal awards were expended for allowable activities,
- federal drawdowns were made in compliance with grant rules and regulations,
- the department monitored contractor classifications and wage rates,
- CDBG funds benefited low- and moderate-income persons,
- CDBG funds used for administrative costs were within the limits,
- the department properly recorded program income generated from the use of CDBG funds,
- required reports included all activity of the reporting period and were supported by accounting records,
- subrecipient activities were monitored to provide reasonable assurance that the subrecipient administered federal awards in compliance with federal requirements,
- the state was ensuring environmental reviews were performed and documented,
- the state's approval of the request for release of funds and environmental certifications was satisfactory, and
- loans and repayments were made in accordance with program requirements and in compliance with applicable grant rules and regulations.

To accomplish our objectives, we reviewed the most recent Office of Management and Budget Circular A-133 Compliance Supplement and other program guidelines to become familiar with program objectives, program procedures, and compliance requirements. We interviewed key departmental employees and evaluated departmental controls for the CDBG program for adequacy. We selected and tested expenditures and related records to determine if expenditures were in compliance with applicable grant rules and regulations and were for allowable activities. We tested CDBG drawdowns and records to ensure that the drawdowns were made in compliance with applicable grant rules and regulations. We reviewed contractor files to determine whether the department monitored job classification and wage rates. We performed testwork to determine if CDBG funds benefited low- and moderate-income persons. We reviewed financial and related records to determine whether the amount of CDBG funds used for administration costs was within the limits. We tested a sample of deposits to determine if the department properly accounted for program income. We reviewed reports filed with the U.S. Department of Housing and Urban Development (HUD)

during the audit period and traced data in the reports to the accounting records to determine if the reports included all activity of the reporting period and were supported by the applicable accounting records. We reviewed subrecipient project files to determine if the subrecipients were monitored and if the state required that environmental reviews were performed and documented. We performed testwork to determine if the state's approval of the request for release of funds and environmental certifications was satisfactory. We tested loans awarded during the audit period and related records to determine if loans were awarded in accordance with program requirements. We tested loan repayments made during the audit period and related records to determine if repayments were made in accordance with program requirements and in compliance with applicable grant rules and regulations.

As a result of our review and testwork, we concluded that

- the department was in compliance with certain laws and regulations concerning the CDBG program,
- federal awards were expended for allowable activities,
- federal drawdowns were made in compliance with grant rules and regulations,
- the department properly monitored contractor classifications and wage rates,
- CDBG funds benefited low- and moderate-income persons,
- CDBG funds used for administration costs were within the limits,
- the department properly recorded program income generated from the use of CDBG funds,
- required reports included all activity of the reporting period and were supported by accounting records,
- subrecipient activities were monitored to provide reasonable assurance that the subrecipient administers federal awards in compliance with federal requirements,
- environmental reviews were performed and documented,
- the state's approval of the request for release of funds and environmental certifications was satisfactory, and
- loans and repayments were made in accordance with program requirements and in compliance with applicable grant rules and regulations.

CREATIVE SERVICES

The Creative Services Division, started in 2003, provides graphic services which were previously provided to the department by external advertising agencies. These services are available to each of the divisions within the department as well as to other state agencies. The objective of our review was to follow up a prior audit finding

regarding violations of purchasing and bidding procedures within the Creative Services Division to determine whether

- the division had complied with its purchasing and bidding procedures and if state purchasing guidelines were followed,
- division staff followed proper bidding procedures and obtained at least three competitive bids, and
- purchase requests were properly prepared and approved.

We interviewed key personnel and reviewed internal controls and other documentation to determine if the division had complied with its purchasing and bidding procedures and if state purchasing guidelines were followed. We specifically reviewed several purchases made by the Creative Services Division after January 1, 2007, to determine if division staff followed proper bidding procedures and obtained at least three competitive bids. The competitive bids obtained were also reviewed for propriety. We reviewed purchase requests for proper preparation and approval.

Based on our inquiries and review of documentation, we found that the division had complied with its purchasing and bidding procedures and state purchasing guidelines were followed. We found the Creative Services Division followed proper bidding procedures and obtained at least three competitive bids. We also found that bids obtained were proper and purchase requests were properly prepared and approved.

FASTTRACK PROGRAM

The FastTrack Program provides funds to local governments for infrastructure improvements and to new or existing businesses and industry for job training assistance. The program is governed by *Tennessee Code Annotated*, Sections 4-3-715 through 4-3-717. Funds may not be used for “speculative” projects but are restricted to situations where there is a commitment by certain private-sector businesses to locate or expand in the state and to create or retain jobs for Tennesseans. The objectives of our review of this area were to determine whether

- grants awarded for infrastructure improvements and job training assistance were in compliance with laws, regulations, and program requirements; and
- grant payments were made in accordance with grant rules and regulations.

To accomplish our objectives, we interviewed key personnel, reviewed appropriate laws, evaluated administrative controls, and reviewed program objectives and procedures. We selected and tested a nonstatistical sample of grants awarded for infrastructure improvements and job training assistance during the audit period to ensure the grants were awarded in compliance with laws, regulations, and program requirements. We selected a nonstatistical sample of grant payments to determine if they were made in accordance with grant rules and regulations.

As a result of our review and testwork, we concluded that grants were awarded in compliance with laws, regulations, and program requirements, and grant payments were made in accordance with grant rules and regulations.

TENNESSEE JOB SKILLS PROGRAM

The Tennessee Job Skills Program is a workforce development incentive program to enhance employment opportunities and to meet the needs of existing and new industries in the state. The program gives priority to the creation and retention of high-wage jobs and focuses on employers in industries that promote high-skill, high-wage jobs in high-technology areas, emerging occupations, or skilled manufacturing jobs.

The objectives of our review of this area were to determine whether

- department staff awarded grants to industries in compliance with laws, regulations, and program requirements; and
- grant payments to industries were made in accordance with grant rules and regulations.

To accomplish our objectives, we interviewed key personnel, reviewed appropriate laws, evaluated administrative controls, and reviewed program objectives and procedures. We tested all new grants awarded during our audit period to ensure that grants were awarded in compliance with laws, regulations, and program requirements. We also tested all Job Skills payments made during our audit period to ensure that they were made in accordance with grant rules and regulations.

As a result of our review, we concluded that the department's staff awarded grants to industries in compliance with laws, regulations, and program requirements, and grant payments to industries were made in accordance with grant rules and regulations.

EXPENDITURES

Our objective in reviewing expenditures was to determine if

- expenditures were properly supported, approved, classified in the accounting records, and paid timely.

We interviewed key personnel to gain an understanding of the department's controls over expenditures. We selected certain expenditures to determine if they were properly supported, approved, classified, and paid timely.

Based on our interviews, reviews of supporting documentation, and the results of our tests, we determined that expenditures were properly supported, approved, and classified in the accounting records, and were paid timely.

**DEPARTMENT OF FINANCE AND ADMINISTRATION POLICY 20,
*RECORDING OF FEDERAL GRANT EXPENDITURES AND REVENUES***

Department of Finance and Administration Policy 20 requires that state departments whose financial records are maintained on the State of Tennessee Accounting and Reporting System (STARS) fully utilize the STARS grant module to record the receipt and expenditure of all federal funds. Our objectives were to determine whether the department staff

- entered appropriate grant information into the STARS Grant Control Table upon notification of the grant award, and related revenue and expenditure transactions were recorded and coded with the proper grant codes;
- made drawdowns timely using the applicable STARS reports; and
- utilized the appropriate STARS reports as bases for preparing the Schedules of Expenditures of Federal Awards and reports submitted to the federal government.

We interviewed key personnel to gain an understanding of the department's procedures and controls concerning Policy 20. Based on our interviews, reviews, and testwork, the department staff complied with Department of Finance and Administration Policy 20. The department staff fully utilized the STARS Grant Module to record and code the receipt and expenditure of all federal funds and made drawdowns timely. The department also used the appropriate STARS reports as the bases for preparing the Schedule of Expenditures of Federal Awards and reports submitted to the federal government.

**DEPARTMENT OF FINANCE AND ADMINISTRATION POLICY 22,
*SUBRECIPIENT MONITORING***

Department of Finance and Administration Policy 22, "Subrecipient Monitoring," establishes guidelines for uniform monitoring of subrecipients that receive state and/or federal funds from state agencies. Our objectives were to determine whether the department

- submitted the required monitoring plans and monitoring reports to the Department of Finance and Administration in a timely manner,
- identified its subrecipients and included them in the monitoring plans, and

- assessed the risk of each subrecipient in accordance with the guidelines established by the Department of Finance and Administration.

We interviewed key personnel to gain an understanding of the department's procedures and controls concerning Policy 22. We reviewed the annual monitoring plan and the Department of Finance and Administration's approval of the plan.

As a result of our review, we determined that the department had submitted the required monitoring plans and reports to the Department of Finance and Administration in a timely manner, the department had identified its subrecipients and included them in the monitoring plan in all material respects, and the department had assessed the risk of each subrecipient in accordance with the guidelines established by the Department of Finance and Administration.

FINANCIAL INTEGRITY ACT

Section 9-18-104, *Tennessee Code Annotated*, requires the head of each executive agency to submit a letter acknowledging responsibility for maintaining the internal control system of the agency to the Commissioner of Finance and Administration and the Comptroller of the Treasury by June 30 each year. In addition, the head of each executive agency is required to conduct an evaluation of the agency's internal accounting and administrative control and submit a report by December 31, 1999, and December 31 of every fourth year thereafter.

Our objective was to determine whether the department's June 30, 2006, and June 30, 2005, responsibility letters were filed in compliance with Section 9-18-104, *Tennessee Code Annotated*.

We reviewed the June 30, 2006, and June 30, 2005, responsibility letters submitted to the Comptroller of the Treasury and the Department of Finance and Administration to determine adherence to the submission deadline. We determined that the Financial Integrity Act responsibility letters were submitted on time.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the entity. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment

by management is the primary method by which the entity is protected from fraud, waste, and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the entity.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the entity. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the control after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff, and to maintain a record of areas that are particularly problematic. The assessment and the controls should be reviewed and approved by the head of the entity.

During the audit period, management of each division met to discuss possible risks and to identify mitigating controls, or additional controls needed for each risk. The Director of Internal Audit has summarized the results into a draft written risk assessment for each division. The Director of Internal Audit is in the process of working with each division to finalize the risk assessments and is assisting in the design of new controls to address unmitigated risks identified during the risk assessment process. According to the Director of Internal Audit, the risk assessment will be revised on an annual basis and controls related to areas of high risk will be tested by internal audit annually.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

TITLE VI OF THE CIVIL RIGHTS ACT OF 1964

Section 4-21-901, *Tennessee Code Annotated*, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by June 30 each year. The Department of Economic and Community Development filed its compliance reports and implementation plans on June 29, 2005, and June 30, 2006.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the grounds of race, color, or origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds. The Tennessee Title VI Compliance Commission is responsible for monitoring and enforcement of Title VI. A summary of the dates state agencies filed their annual Title VI compliance reports and implementation plans is presented in the special report *Submission of Title VI Implementation Plans*, issued annually by the Comptroller of the Treasury.

APPENDIX

ALLOTMENT CODES

330.01	Administrative Services
330.02	Business Development
330.04	Regional Grants Management
330.05	Business Services
330.06	FastTrack Infrastructure Development Program
330.07	Community Development
330.08	Energy Division
330.09	FastTrack Job Training Assistance Program
330.10	Small Business Energy Loan Program
330.11	Local Government Energy Loan Program
330.13	Tennessee Jobs Skills Program
330.15	Economic Development District Grants
330.17	Film and Television Incentive Fund