AUDIT REPORT

Department of the Treasury

**For the Year Ended
June 30, 2009**

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

Tennessee Comptroller of the Treasury

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September 28, 2010

Members of the General Assembly
and
Members of the Board of Trustees
Baccalaureate Education System Trust
and
Members of the Board of Trustees
Chairs of Excellence Trust
and
Members of the Board of Claims
and
Members of the State Funding Board
and
The Honorable David H. Lillard, Jr., Treasurer
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of the Treasury for the year ended June 30, 2009.

Consideration of internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the Results of the Audit section of this report. The department's management has responded to the audit findings; the responses are included following each finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit findings.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/vdn
09/067

State of Tennessee

Audit Highlights

Comptroller of the Treasury — Division of State Audit

Financial and Compliance Audit
Department of the Treasury
For the Year Ended June 30, 2009

AUDIT OBJECTIVES

The objectives of the audit were to consider the department's internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing an opinion on the financial statements of the Baccalaureate Education System Trust – Educational Services Plan, the Chairs of Excellence Fund, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Risk Management Fund, the Small and Minority-Owned Business Assistance Program Fund, and the State Pooled Investment Fund; to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements; to perform certain limited procedures at the Department of the Treasury as a part of our audit of the *Comprehensive Annual Financial Report* of the State of Tennessee for the year ended June 30, 2009; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDINGS

Controls Over Certain Outgoing Wire Transactions are Inadequate, Increasing the Risk of Unauthorized Withdrawals
Department of the Treasury employees in the Cash Management Division have access in the department's cash management system, referred to as ACME, to initiate and approve electronic wire transfers to be disbursed from the state's bank account for wire activity. While no inappropriate transactions were found, this lack of segregation of duties for certain outgoing wire transactions created an opportunity for fraud (page 12).

Monitoring of Small and Minority-Owned Business Assistance Program Loan Funds Is Inadequate, Increasing the Risk of Defaults
The Small and Minority-Owned Business Assistance Program provides assistance through loans, technical assistance and services, and consulting and educational services. The program loans funds at no cost to qualified organizations who re-loan the funds to qualifying businesses at below-market interest rates. Several of the loans made by one of the qualifying organizations, Southwest Tennessee Development District (SWTDD), were delinquent. Based on our review of SWTDD's loan practices and loan

documents, we determined that SWTDD did not follow prudent lending practices and should not have made two of the loans. Rule 1700-6-1-.09(3)(f) states that "loans made with Program Funds are subject to quality assurance reviews by the persons designated by the Department." However, because quality assurance reviews were not being performed, the department was unaware that SWTDD had made these inappropriate loans until the loans were no longer considered collectible (page 13).

Audit Report
Department of the Treasury
For the Year Ended June 30, 2009

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Department of the Treasury
For the Year Ended June 30, 2009

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Department of the Treasury. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes 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

The State Treasurer is a constitutional officer elected every two years by a joint session of both houses of the General Assembly. The Treasurer is charged with various responsibilities and duties, most relating to the financial operations of state government.

Among the duties of the State Treasurer are accounting for the receipt and disbursement of public funds; investing available cash balances; administering the Tennessee Consolidated Retirement System; investing the pension fund; operating the state's Unclaimed Property Program; administering the State Employees' Deferred Compensation Program; operating the State Employees' Flexible Benefits Plan; administering the Baccalaureate Education System Trust program; administering the Small and Minority-Owned Business Assistance Program; administering the Chairs of Excellence Trust; and directing the staff of the Division of Claims Administration and the Risk Management Division.

The Treasurer is also a member of the following entities:

Baccalaureate Education System Trust Board
Board of Claims
Board of Equalization
Chairs of Excellence Trust
Collateral Pool Board
Commission to Purchase Federal Property
Council on Pensions and Insurance

State Funding Board
Public Records Commission
Sick Leave Bank Board
State Building Commission
State Capitol Commission
State Insurance Committee
State School Bond Authority
State Teacher Insurance Committee
State Trust of Tennessee
Tennessee Consolidated Retirement System Board of Trustees
Tennessee Higher Education Commission
Tennessee Housing Development Agency
Tennessee Local Development Authority
Tennessee Sports Hall of Fame
Tennessee Student Assistance Corporation
Tuition Guaranty Fund Board
Volunteer Public Education Trust
Workers' Compensation Fund Board

ORGANIZATION

The various duties and responsibilities of the Treasurer's office are administered and organized in the following manner:

Administration and Staff Services: This division provides the administrative services necessary to direct and support all operations and functions of the Treasury Department including legal counsel, human resources, legislative, and internal audit. Representation and support to the various boards and commissions on which the Treasurer serves are also provided through this division.

Division of Claims Administration: The division is responsible for handling claims filed with the state including workers' compensation claims, claims against the state for negligent acts, and claims filed under the Criminal Injuries Compensation Program.

Division of Risk Management: The division is responsible for maintaining adequate insurance against damage or loss for all state-owned property through a combination of a self-insurance program and other insurance policies. This division is also responsible for providing a systematic program for the control and prevention of injuries and losses.

Division of Unclaimed Property: Under the Unclaimed Property Program, the state takes custody of abandoned property (bank accounts, insurance policies, utility deposits, etc.) and attempts to locate the rightful owners or their heirs. Until the owners claim the property, it is used for the benefit of all the citizens of the state. Property, or its monetary equivalent, is available to be claimed by owners at any future time.

Baccalaureate Education System Trust: This division is responsible for administration of the state's 529 college prepaid plan.

Small and Minority-Owned Business Assistance Program: This program is responsible for supporting outreach to new, expanding, and existing businesses unable to derive benefit from conventional means of monetary resources and insight provided by traditional lenders and financial advisors.

Division of Retirement: This division administers the Tennessee Consolidated Retirement System, a defined benefit pension plan for teachers, higher education employees, state employees, and local government employees. It serves over 200,000 active members and 107,000 retirees with an annual payroll exceeding $1 billion. The Tennessee Consolidated Retirement System is audited and reported on separately.

Deferred Compensation Division: This division oversees the administration of the State of Tennessee Deferred Compensation Program, which allows state employees to accumulate tax deferred savings to supplement retirement income. In addition, the division oversees the operation of the Optional Retirement Program for higher education employees and the Old Age and Survivors Insurance Program.

Investment Division: This division has two primary functions: investing the $26 billion pension fund to protect the assets of the system and maximize return, and managing and investing $7 billion of state and local government cash balances. These investments help finance, from non-tax sources, the various programs of state and local governments.

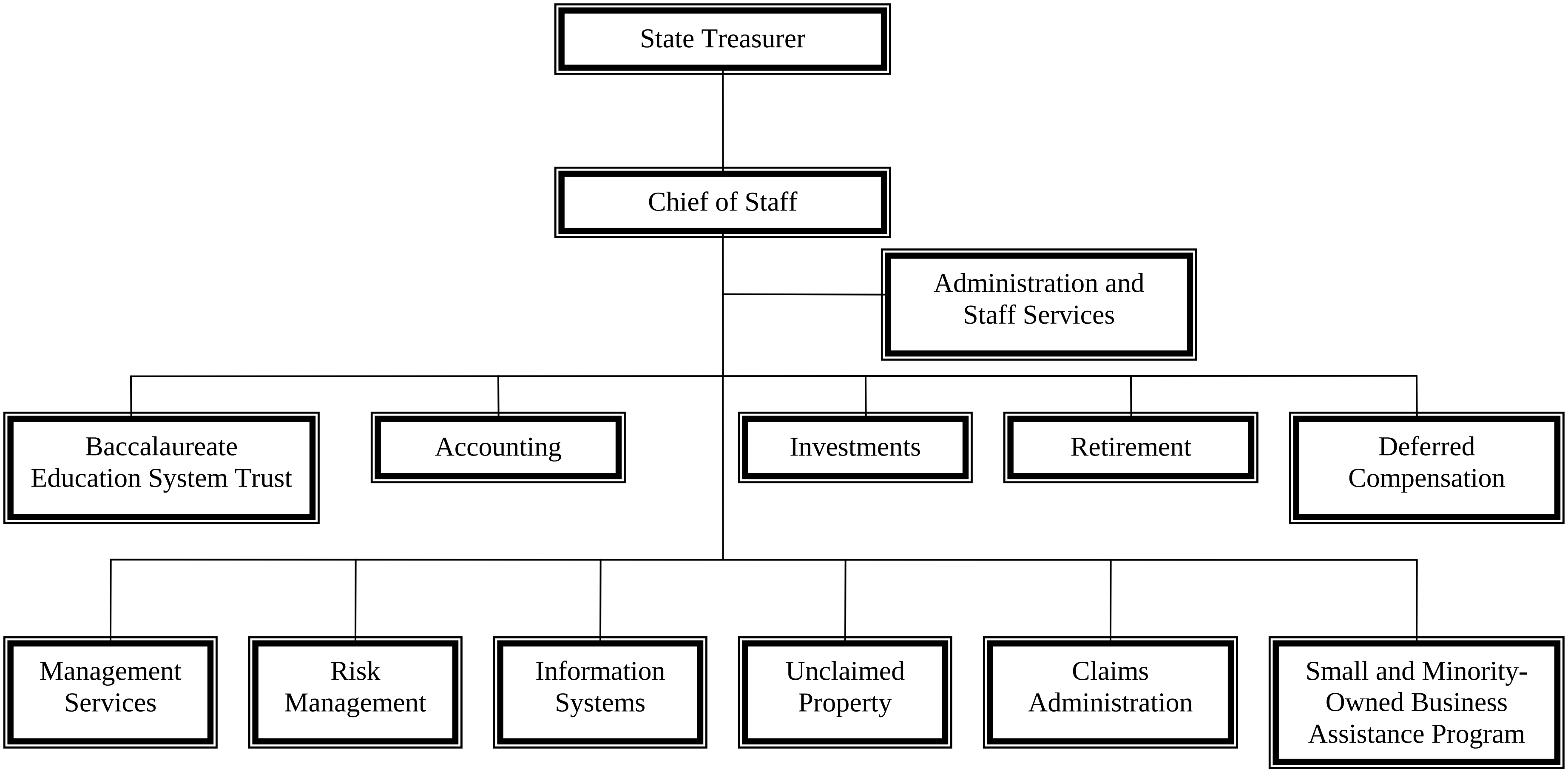
Accounting Division: This division reconciles all state depository bank accounts, provides accounting support, and maintains subsidiary and general ledger accounting for programs administered by the Treasurer's office, including the Tennessee Consolidated Retirement System, the Local Government Investment Pool, the Division of Claims Administration, and the Investments Division.

Management Services Division: This division is responsible for coordinating the department's budget and for performing procurement, payroll, accounts payable, records management, communications, facilities management, remittance processing, funds transfer, and other administrative support functions.

Information Systems Division: This division is composed of an administrative unit that leads the planning, project management, policy recommendations, and security for the department. The operations unit manages the network; supports the servers, desktop hardware, and systems software; and operates the help desk. An additional unit focuses on support of mainframe operations, automation of job execution, file transfer, and back-end processes.

An organization chart for the Department of the Treasury is on the following page.

Department of the Treasury
Organization Chart



AUDIT SCOPE

The audit was limited to the period July 1, 2008, through June 30, 2009, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards.

The operations of the Department of the Treasury are accounted for in the general fund of the State of Tennessee. The department administers the Tennessee Consolidated Retirement System, pension trust funds; the Criminal Injuries Compensation Fund and the Small and Minority-Owned Business Assistance Program Fund, special revenue funds; the Risk Management Fund, an internal service fund; the Chairs of Excellence Fund, a permanent fund; the Baccalaureate Education System Trust – Educational Services Plan, a private-purpose trust fund; the Flexible Benefits Plan, an employee benefit trust fund; and the State Pooled Investment Fund, an external investment pool (which includes the Local Government Investment Pool). This audit included all of the above funds except for the Tennessee Consolidated Retirement System, which is reported on in a separate audit report.

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the Department of the Treasury's internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing an opinion on the financial statements of the Baccalaureate Education System Trust – Educational Services Plan, the Chairs of Excellence Fund, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Risk Management Fund, the Small and Minority-Owned Business Assistance Program Fund, and the State Pooled Investment Fund;

2. to determine compliance with certain provisions of laws, regulations, contracts, and grant agreements;

3. to perform certain limited procedures at the Department of the Treasury as a part of our audit of the *Comprehensive Annual Financial Report* of the State of Tennessee for the year ended June 30, 2009; and

4. to recommend appropriate actions to correct any deficiencies.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

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.

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 October 1 each year. The department filed its compliance report and implementation plan on December 28, 2009.

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.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the financial statements of the Baccalaureate Education System Trust – Educational Services Plan, the Chairs of Excellence Fund, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Risk Management Fund, the Small and Minority-Owned Business Assistance Program Fund, and the State Pooled Investment Fund for the year ended June 30, 2009, we considered internal control over financial reporting as a basis for designing auditing procedures for the purpose of expressing an opinion on the financial statements, as required by auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards. Significant deficiencies, along with recommendations and management's responses, are detailed in the Findings and Recommendations section of this report. Consideration of internal control over financial reporting disclosed a material weakness.

Compliance and Other Matters

The results of our audit tests disclosed no instances of noncompliance or other matters that are required to be reported under generally accepted government auditing standards.

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

July 26, 2010

Members of the General Assembly
and
Members of the Board of Trustees
Baccalaureate Education System Trust
and
Members of the Board of Trustees
Chairs of Excellence Trust
and
Members of the Board of Claims
and
Members of the State Funding Board
and
The Honorable David H. Lillard, Jr., Treasurer
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have audited the financial statements of the Baccalaureate Education System Trust – Educational Services Plan, the Chairs of Excellence Fund, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Risk Management Fund, the Small and Minority-Owned Business Assistance Program Fund, and the State Pooled Investment Fund as of and for the year ended June 30, 2009, and have issued our reports thereon dated July 26, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the department's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the United States of America such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the following deficiencies to be significant deficiencies in internal control over financial reporting:

- Controls over certain outgoing wire transactions are inadequate, increasing the risk of unauthorized withdrawals
- Monitoring of Small and Minority-Owned Business Assistance Program loan funds is inadequate, increasing the risk of defaults

These deficiencies are described in the Findings and Recommendations section of this report.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies described above, we consider the following to be a material weakness:

- Controls over certain outgoing wire transactions are inadequate, increasing the risk of unauthorized withdrawals

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the department's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under generally accepted government auditing standards.

We did, however, note certain other less significant instances of noncompliance, which we have reported to the department's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee, the audit committees, management, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

Arthur A. Hayes, Jr.

Arthur A. Hayes, Jr., CPA
Director

AAH/vdn

FINDINGS AND RECOMMENDATIONS

1. <u>Controls over certain outgoing wire transactions are inadequate, increasing the risk of unauthorized withdrawals</u>

Finding

Department of the Treasury employees in the Cash Management Division have access in the department's cash management system, referred to as ACME, to initiate and approve electronic wire transfers to be disbursed from the state's bank account for wire activity. This lack of segregation of duties for certain outgoing wire transactions has created an opportunity for fraud.

Five employees in the Cash Management Division have the capability to both initiate and approve outgoing wire transactions in the ACME system. After the wire is approved by Cash Management personnel, Wire Room personnel wire the funds to the bank account designated by the individual originating the transaction. For most transactions, a compensating control exists whereby the destination bank account information must be entered by an individual independent of the Cash Management Division. However, for certain outgoing wire transactions, Cash Management personnel enter the destination bank account information from journal vouchers received from the originating agency. These wire transactions are referred to as miscellaneous out (MO) and vendor out (VU) transactions. An employee with the capability to both initiate and approve transactions and enter the destination bank account information could use a miscellaneous out or vendor out to divert funds to an unauthorized bank account.

Wire Room personnel did not have procedures in place to review the transactions in ACME and compare them to a journal voucher approved by the originating agency or other supporting documentation before completing the transaction with the bank.

The Investment Accounting Division had adequately designed controls in place to ensure that errors or fraud associated with these outgoing wires would be caught in a reasonable period of time; however, these controls were not being performed during the audit period. Therefore, the controls were not effective, and there was the potential for a material loss since there is no limit on the amount of funds that can be wired out of the state's bank account as a miscellaneous out or vendor out transaction. Due to the lack of adequate procedures to ensure that all outgoing wires were legitimate transactions, possible detection of a transfer to an unauthorized bank account would not occur until the agency that had been charged with the unauthorized transaction questioned the transaction. This assumes that the agency that was charged with the transaction actively reviews and reconciles its account activity timely.

There were a total of 86 miscellaneous out and 68 vendor out transactions during the year ended June 30, 2009. We tested 38 of these transactions to ensure that they were properly approved, documented, and recorded and that only authorized personnel were involved in the transactions. Two of the 38 transactions tested (5%) were not supported by a journal voucher. However, we were able to determine that the two transactions were legitimate transactions by verifying that the bank account information for the receiving bank matched the approved support for other similar transactions or by verification from the agency charged with the transaction.

Recommendation

The Wire Room Manager should require that Wire Room personnel verify information entered into the ACME system with supporting documentation from the originating agency before completing the wire transaction with the bank. When wire activity is without preset destination bank account information, the Investment Accounting Manager should ensure that Investment Accounting personnel reconcile supporting documentation to wire activity in ACME and ensure that the wire is accurate and went to the proper destination. Ongoing monitoring should also be implemented to ensure compliance after internal controls are in place.

Management's Comment

We concur. Due to implementation of the state's new accounting system EDISON, certain business processes relating to requesting, approving, and initiating wire transfer of funds requests by state agencies were changed from a paper-based process to an electronic workflow process. Once EDISON was implemented, the paper source document (Z-type Journal Voucher) was no longer available to the Wire Room personnel to verify that the transaction's banking destination instructions requested and authorized by the state agency and Finance and Administration Division of Accounts matched the transaction banking destination instructions entered into the cash management system ACME by the Treasury Cash Management Division. The pre-EDISON paper-based process included adequate controls. The Department implemented new compensating control procedures immediately upon being notified by auditors of this matter in November 2009, by providing the Wire Room personnel with inquiry access to the EDISON system's Accounts Payable module so that the wire instructions, including the authorized banking destination, could be verified against the sending agency's instructions prior to the initiation of the wire transfer. Likewise, the Investment Accounting Division personnel were also immediately provided inquiry access to the EDISON Accounts Payable module and resumed procedures to independently verify the executed wire transaction confirmation from the bank to the EDISON system transaction in order to provide additional controls over these transactions.

2. Monitoring of Small and Minority-Owned Business Assistance Program loan funds is inadequate, increasing the risk of defaults

Finding

The Small and Minority-Owned Business Assistance Program (the "program") was created by Chapter 830 of the Public Acts of 2004 within the Department of the Treasury to support the outreach to new, expanding, and existing businesses in Tennessee that do not have reasonable access to capital markets and traditional commercial lending facilities. The program, which replaced the Small and Minority-Owned Telecommunications Business Assistance Program that was administered by the Department of Economic and Community Development, provides assistance through loans, technical assistance and services, and consulting and educational services. The program loans funds at no cost to qualified organizations who re-loan the funds to qualifying businesses at below-market interest rates. In December 2007, the program made its first loan. As of April 30, 2010, the department had contracted with six qualified organizations, and 86 loans totaling $5,982,863 had been made to qualifying businesses.

In October 2009, after reviewing a loan write-off report, the manager of the program discovered that several of the loans made by one of the qualifying organizations, Southwest Tennessee Development District (SWTDD), were delinquent. As of November 30, 2009, 7 of the 12 loans (58%), totaling $528,000, made by SWTDD were either in collection status, which means payment was more than 90 days past due, or were considered uncollectible and were in the process of being written off.

Based on our review of SWTDD's loan practices and loan documents, we determined that SWTDD did not follow prudent lending practices and should not have made two of the loans. The outstanding balances of the two loans were $117,068.36 and $117,049.60. The contract between the department and the SWTDD required that prudent lending practices be followed, and the department requires that all businesses requesting to be lenders of the program include their loan practices in a third-party loan originator/loan servicing proposal submitted to the department.

One of the inappropriate loans made by SWTDD in the amount of $125,000 was made for the purpose of funding an online educational company. A review of the credit report of the borrower reflected an inability to repay the loan. The borrower's and her spouse's total minimum monthly payments per their combined credit report were 76% of their monthly gross income per their 2006 income tax return. The borrower's home, which was pledged as collateral for the business loan, had once before been in the foreclosure process. Also, a certified appraisal of the collateral property was not submitted as required by SWTDD's third-party loan originator/loan servicing proposal. In addition, SWTDD did not require the borrower to provide a signed lease or proof of insurance before the closing to indicate that the borrower had the intent and means to open the business. SWTDD's third-party loan originator/loan servicing proposal states that "recipients must meet the normal credit test of prudent lending practices, good character, sufficient collateral . . ." The proposal goes on to state that "SWTDD staff is responsible for management, monitoring and servicing for the program from loan closing until full repayment from ultimate recipients." These responsibilities, according to the proposal, include making periodic visits to the business to monitor operations and monitoring insurance on collateral. SWTDD did not perform any site visits to monitor this business.

The other loan was for an incorporated hotel. No credit report, as would be required by prudent lending practices, was obtained for the corporation. The loan was approved even though the hotel was facing possible foreclosure at the time of the loan approval and the hotel owner disclosed $122,656.83 in delinquent bills. SWTDD agreed to pay $32,544.55 in delinquent state sales taxes and $8,202.68 in delinquent federal taxes with a portion of the proceeds from the $125,000 loan. According to the *Rules of the Tennessee Department of Treasury,* Chapter 1700-6-1.02(14), "loans will only be made on behalf of Applicants for loans that initially finance a Project. The refinancing of any existing debt shall not be considered eligible for a loan." There was also no evidence that SWTDD received a title insurance statement before the closing of the loan, which is required because the hotel was used for collateral. Additionally, in the Loan Fund Application, the project description is to expand staff, upgrade rooms, and purchase needed items to stay competitive. The Loan Agreement states that the borrower agrees that the number of employees will increase by four full-time employees within two years of the date of the agreement. However, in the pro forma financial statements, forecasted operating expenses for 2008, 2009, and 2010 ($312,188 each year) were nearly $200,000 less than the actual operating expenses for 2005, 2006, and 2007 ($504,526, $499,265, and $486,048, respectively). There is no explanation to support how the borrower expects operating expenses to decrease significantly or the basis for their other projections. The normal credit test of prudent lending practices, as required by SWTDD's third-party loan originator/loan servicing proposal, includes reasonable assurance that the project will generate sufficient cash flows to repay the debt. However, the hotel did not exhibit that it would generate sufficient cash flows with its unrealistic projections of future operating expenses. The property was foreclosed on May 29, 2009, and the borrower has filed for bankruptcy.

Chapter 1700-6-1.03 of the *Rules of the Tennessee Department of Treasury* requires that the program be administered by a program administrator. The department contracted with the Southeast Tennessee Development District to be the program administrator beginning May 1, 2007, and ending April 30, 2012. The program administrator's duties include assisting the department with the selection of qualified organizations, coordinating the selection of entities to provide program services to qualifying businesses, and coordinating the program's marketing efforts.

Rule 1700-6-1-.09(3)(f) states that "loans made with Program Funds are subject to quality assurance reviews by the persons designated by the Department." The program administrator's proposal to the department indicated that it would monitor each qualified organization at least twice per year. According to the manager of the program, these reviews are intended to ensure compliance with the *Rules of the Tennessee Department of Treasury, Tennessee Code Annotated*, and contract requirements. The manager of the program also stated that no quality assurance reviews have been performed to date. Because quality assurance reviews were not being performed, the department was unaware that SWTDD had made these inappropriate loans until the loans were no longer considered collectible, at which time SWTDD requested that it be forgiven of its debt to the department.

As a result of these problems, the Department of the Treasury canceled its contract with SWTDD. The program administrator's monitoring process will also be reviewed as part of the department's internal audit plan.

Recommendation

The manager of the program should develop guidelines and implement a system to ensure that all necessary monitoring, including quality assurance reviews, is being performed. These additional requirements should be added to the contract of the program administrator. The department should also consider whether the failure of SWTDD to comply with its assurances and safeguards, as elaborated in its proposal, renders SWTDD ineligible for loan forgiveness.

Management's Comment

Management concurs. Management has taken the following actions:

- The contract with Southwest Tennessee Development District has been canceled.
- The contracted program administrator has begun onsite quality assurance reviews with the qualified organizations/lenders.
- The Internal Audit Division of the Treasury Department will conduct onsite audit visits to the third-party program administrator to review their quality assurance review process and reports.
- Small and Minority-Owned Business Assistance Program management will also review all future quality assurance reports.
- Enhanced staffing of the Treasury Internal Audit Division, implemented since January 2009, will provide for more oversight to the program including periodic onsite reviews to the qualified lenders in the program.