

Department of Economic and Community Development

**For the Year Ended
June 30, 1997**

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May 11, 1998

The Honorable Don Sundquist, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Bill Baxter, Commissioner
Department of Economic and Community Development
Seventh Floor, Rachel Jackson Building
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Economic and Community Development for the year ended June 30, 1997.

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

Our audit disclosed a finding which is detailed in the Objectives, Methodologies, and Conclusions section of this report. The department's administration has responded to the audit finding; we have included the response following the finding. We will follow up the audit to examine the application of the procedures instituted because of the audit finding.

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

Very truly yours,

W. R. Snodgrass
Comptroller of the Treasury

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98/024

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Department of Economic and Community Development
For the Year Ended June 30, 1997

AUDIT SCOPE

We have audited the Department of Economic and Community Development for the period July 1, 1996, through June 30, 1997. Our audit scope included those areas material to the Tennessee Comprehensive Annual Financial Report for the year ended June 30, 1997, and the Tennessee Single Audit Report for the same period. In addition to those areas, our primary focus was on management's controls and compliance with policies, procedures, laws, and regulations in the areas of small business energy loans, deferred revenue, and utilization of the Department of Finance and Administration's STARS grant module to record the receipt and expenditure of federal funds. The audit was conducted in accordance with generally accepted auditing standards and the standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

AUDIT FINDING

Security Interest on Energy Loans Not Protected

The department failed to adequately protect its security interest in collateral for the Small Business Energy Loan Program through the timely filing of financing statements. The financing statements were not filed promptly with the Secretary of State for five of the seven loans tested, or with the register's office for three of the seven loans tested (see page 4).

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit
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Audit Report
Department of Economic and Community Development
For the Year Ended June 30, 1997

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Department of Economic and Community Development For the Year Ended June 30, 1997

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 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 mission of the Department of Economic and Community Development is to increase job opportunities throughout Tennessee.

The department’s goals are to enhance community attractiveness and readiness for creating job opportunities; to create and promote business opportunities to entrepreneurs, existing industries, and new firms; and to increase and improve economic growth opportunities for all new and existing firms.

The department’s priorities are to assist local communities in capitalizing on economic development opportunities, market the state, recruit environmentally responsible new industries, assist existing firms, and increase export trade opportunities for Tennessee businesses and industry. The department hopes to build a business-friendly state.

An organization chart of the department is on the following page.

AUDIT SCOPE

We have audited the Department of Economic and Community Development for the period July 1, 1996, through June 30, 1997. Our audit scope included those areas material to the Tennessee Comprehensive Annual Financial Report for the year ended June 30, 1997, and to the Tennessee Single Audit Report for the same period. In addition to those areas, our primary focus was on management's controls and compliance with policies, procedures, laws, and regulations in the areas of small business energy loans, deferred revenue, and utilization of the Department of Finance and Administration's STARS grant module to record the receipt and expenditure of federal funds. The audit was conducted in accordance with generally accepted auditing standards and the standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

AREAS RELATED TO TENNESSEE'S COMPREHENSIVE ANNUAL FINANCIAL REPORT AND SINGLE AUDIT REPORT

Our audit of the Department of Economic and Community Development is an integral part of our annual audit of the Comprehensive Annual Financial Report (CAFR). The objective of the audit of the CAFR is to render an opinion on the State of Tennessee's general-purpose financial statements. As part of our audit of the CAFR, we are required to gain an understanding of the state's internal control and determine whether the state complied with laws and regulations that have a material effect on the state's general-purpose financial statements.

Our audit of the Department of Economic and Community Development is also an integral part of the Tennessee Single Audit which is conducted in accordance with the Single Audit Act, as amended by the Single Audit Act Amendments of 1996. The Single Audit Act, as amended, requires us to determine whether

- the state complied with rules and regulations that may have a material effect on each major federal financial assistance program, and
- the state has internal control to provide reasonable assurance that it is managing its major federal award programs in compliance with applicable laws and regulations.

We determined that the Community Development Block Grants (CDBG) program within the Department of Economic and Community Development was material to the CAFR and to the Single Audit Report.

To address the objectives of the audit of the CAFR and the Single Audit Report, as they pertain to this major federal award program, we interviewed key department employees, reviewed applicable policies and procedures, and tested representative samples of transactions.

We have issued an unqualified opinion on the general-purpose financial statements of the State of Tennessee in our Independent Auditor's Report dated December 17, 1997, which is included in the CAFR for the year ended June 30, 1997. The Tennessee Single Audit Report for the year ended June 30, 1997, will include our reports on the schedule of expenditures of federal awards and on internal control and compliance with laws and regulations.

We had no findings related to the Community Development Block Grants program.

SMALL BUSINESS ENERGY LOANS

The department maintains the Small Business Energy Loan Program under the Division of Energy. Our objective was to determine whether the department properly protected its security interest in collateral from these small business energy loans through the timely filing of Uniform Commercial Code (UCC) filing statements. Testwork consisted of comparing the loan date with the dates the UCC statements were filed with the Secretary of State and the county Register of Deeds for a sample of loans made during the audit period.

We determined that the UCC statements were not always filed within the required 20 business days, as discussed in the finding.

FINDING AND RECOMMENDATION

The state's security interest on energy loans was not protected timely

Finding

The department failed to timely protect the state's security interest in collateral in the Small Business Energy Loan Program. A security interest in collateral is created when a debtor signs a loan security agreement. Although this agreement allows enforcement against a debtor upon default, the parties with priority claims against the debtor are those who "perfected" their security agreements by filing a financing statement (in the proper state and county offices as outlined in Section 47-9-401 et seq., *Tennessee Code Annotated*). The department did not file these financing statements timely. As a result, the department can lose the state's priority in collateral against defaulted debtors. (*Tennessee Code Annotated*, Section 47-9-101 et seq., incorporates into state law the Uniform Commercial Code as it relates to secured transactions.)

When more than one entity has a security interest in the same collateral, priority is given to the entity which perfected (filed) its interest first even if that entity was not the first to secure a loan agreement. Timely filing with the appropriate office is crucial to protecting the interest of the state. Sections 47-9-301(2) and 47-9-312(4), *Tennessee Code Annotated*, give the department 20 days after a loan agreement is signed to perfect it. Perhaps more importantly, the federal Bankruptcy Code, codified in Title 11, Section 547(e)(2)(A), *United States Code*, provides only ten days to perfect a security interest. Therefore, it would be prudent for the department to perfect the state's interest in collateral within ten days.

Seven loans for the audit period were tested. Security interest was not perfected timely with the Secretary of State in five of the loans (71%). Three of the loans (43%) were not filed timely with the county register (some loans were filed with both). Filings with the Secretary of State ranged from five to 66 days late, and the average was 27 days late. Filing with the county register ranged from one to 40 days late, and the average was 19 days late.

Recommendation

Management should ensure that the department has the necessary procedures in place to protect the state's security interest in collateral from small business energy loans. Uniform Commercial Code financing statements should be filed with the proper state and county offices within 20 days of signing the loan agreement. The department should probably consider procedures to ensure that financing statements are filed within ten days to protect the state's security interests in collateral during both state and federal bankruptcy proceedings.

Management's Comment

We concur. The department has already taken corrective action to ensure that this will not occur in the future.

DEFERRED REVENUE

The objectives of our review of the deferred revenue account that the department maintains for the Petroleum Violation Escrow funds were to determine whether

- the deferred revenue account balance on departmental records reconciled with the STARS account balance at year-end, and
- earned revenue was transferred from the deferred revenue account in a timely manner, and transactions in the deferred revenue account were adequately supported.

We interviewed key personnel to gain an understanding of the department’s procedures and controls, reviewed the documentation supporting all transactions in the deferred revenue account for the audit period, and reconciled the departmental records with the year-end STARS account balance. We had no findings related to deferred revenue; however, a minor weakness came to our attention which has been reported to management in a separate letter.

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 testwork focused on whether

- appropriate grant information was entered into the STARS Grant Control Table upon notification of the grant award, and related revenue and expenditure transactions were coded with the proper grant codes;
- appropriate payroll costs were reallocated to federal award programs within 30 days of each month-end using an authorized redistribution method;
- the department had negotiated an appropriate indirect cost recovery plan, and indirect costs were included in drawdowns; and
- the department utilized the appropriate STARS reports as bases for preparing the schedule 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. We had no findings related to Policy 20; however, a minor weakness came to our attention which has been reported to management in a separate letter.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

OBSERVATIONS AND COMMENTS

TITLE VI OF THE CIVIL RIGHTS ACT OF 1964

Tennessee Code Annotated, Section 4-21-901, 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, 1994, and each June 30 thereafter. For the year ending June 30, 1997, the Department of Economic and Community Development filed its compliance report and implementation plan on June 26, 1997.

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 State Planning Office in the Executive Department was assigned the responsibility of serving as the monitoring agency for Title VI compliance, and copies of the required reports were filed with the State Planning Office for evaluation and comment. However, the State Planning Office has been abolished. The Office of the Governor is currently evaluating which office in the Executive Branch will be the new monitoring agency.

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

DIVISIONS AND ALLOTMENT CODES

Department of Economic and Community Development divisions and allotment codes:

330.01	Division of Administrative and Support Services
330.02	Division of Industrial Development
330.04	Division of Regional Grants Management
330.05	Division of Business Services
330.06	Tennessee Industrial Infrastructure Program
330.07	Division of Community Development
330.08	Division of Energy and Business Technology
330.09	Division of Industrial Training Services
330.10	Small Business Energy Loan Program
330.11	Local Government Energy Loan Program

