

Audit Report

Maryland Economic Development Corporation

March 2010



OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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Karl S. Aro
Executive Director

DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

Bruce A. Myers, CPA
Legislative Auditor

March 31, 2010

Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Delegate Steven J. DeBoy Sr., Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Maryland Economic Development Corporation (MEDCO) for the period beginning December 5, 2006 and ending September 15, 2009. MEDCO's purpose is to assist in the expansion, modernization, and retention of existing Maryland businesses and to attract new businesses to the State.

Our audit disclosed that MEDCO, in conjunction with other State agencies, needs to continue its efforts to address the troubled financial condition of one facility owned by MEDCO, which had a cumulative operating deficit of \$42.4 million as of June 30, 2009. Additionally, there were an excessive number of authorized signers on certain of MEDCO's bank accounts.

MEDCO's response to this audit is included as an appendix to this report. We wish to acknowledge the cooperation extended to us during the course of this audit by MEDCO.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

Background Information

Agency Responsibilities and Financial Activity

The Maryland Economic Development Corporation (MEDCO), which functions under the provisions of Title 10, Subtitle 1 of the Economic Development Article of the Annotated Code of Maryland, is constituted as a public instrumentality of the State of Maryland.

MEDCO's goal is to assist in the expansion, modernization, and retention of existing Maryland businesses and to attract new businesses to the State. MEDCO also owns and leases certain properties and, upon request, assists local jurisdiction projects, borrows money and issues bonds for the purpose of financing this assistance. MEDCO is managed by a 12-member Board of Directors appointed by the Governor. The administrative affairs and technical activities of MEDCO are directed and supervised by an executive director who is appointed by the Board, subject to the approval of the Governor.

The Corporation was created in 1984 and, as of March 2009, had undertaken 208 projects. At the end of fiscal years 2008 and 2009, MEDCO's non-recourse debt, according to its audited financial statements, totaled \$2.1 billion and \$1.1 billion, respectively. (See Figure 1 on next page.) The significant decrease in debt as of June 30, 2009 was primarily the result of a change in MEDCO's accounting method for certain debt obligations. In accordance with generally accepted accounting principles, debt incurred by MEDCO as a conduit for specific third parties is no longer reported in MEDCO's financial statements. The debt that is recorded in the financial statements represents obligations related to operating facilities of MEDCO, and such debt is to be retired solely from the operating revenues of the respective facilities. MEDCO is not liable to bondholders and lenders in the event of project/borrower default. The debt consists primarily of revenue bonds issued by MEDCO (which are not obligations of the State of Maryland) and loans from government agencies (for example, the State Department of Business and Economic Development).

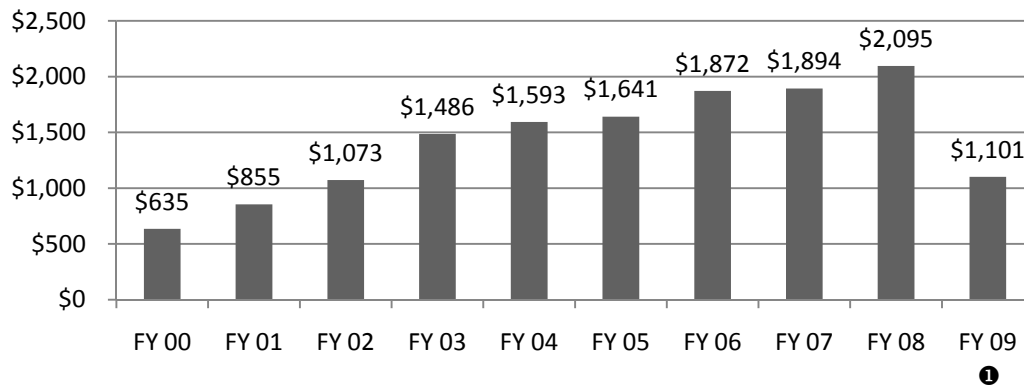
Based on a review of MEDCO's annual activities reports and discussions with management personnel, we noted the following five financially troubled projects as of June 30, 2009:

- Three student residential building projects and one conference center project, with outstanding bond debt as of June 30, 2009 of approximately \$89.2 million and \$176.8 million, respectively, did not achieve the required cash flow coverage ratio (that is, the ratio of cash flow to debt service

requirements). As a result, MEDCO engaged management consultants for these projects who recommended various improvement strategies that are in the process of being implemented.

- For one golf course and hotel project, with outstanding bond debt of approximately \$50 million as of June 30, 2009, MEDCO restructured the debt to avoid default. For further details on this project, refer to Finding 1.

Figure 1
MEDCO Non-Recourse Debt for Projects
(in millions)



❶ - The significant decrease in the amount of debt in fiscal year 2009 (as compared to fiscal year 2008) is due to a change in the accounting method for reporting certain debt obligations for which MEDCO is not ultimately liable. This change is permissible under generally accepted accounting principles.

Source: Audited financial statements

Financial Statement Audits

MEDCO engaged an independent accounting firm to perform audits of its financial statements for the fiscal years ended June 30, 2007, 2008, and 2009. In the related audit reports, the firm stated that MEDCO's financial statements were presented fairly in conformity with accounting principles generally accepted in the United States of America.

Status of Findings From Preceding Audit Report

Our audit included a review to determine the status of the five findings contained in our preceding audit report dated August 28, 2007. We determined that MEDCO satisfactorily addressed four of these findings. The remaining finding is repeated in this report.

Findings and Recommendations

Project Long-Term Plan

Finding 1 (Policy Issue)

In view of the growing project operating deficit, totaling \$42.4 million as of June 30, 2009, MEDCO, in conjunction with the Department of Natural Resources (DNR) and the Department of Business and Economic Development (DBED), should continue its efforts to address the financial condition of one of its operating facilities.

Analysis

In view of a growing project operating deficit, MEDCO, in conjunction with DNR and DBED, needs to continue its efforts to address the financial condition of one of its operating facilities (Rocky Gap). This facility is owned by MEDCO and its operations are managed by a contractor hired by MEDCO. MEDCO completed an expansion of the facility in September 2004, which has enabled the facility to increase its revenue and fund its operating costs and a limited amount of its capital needs. However, the project has been unable to pay the debt owed to its bondholders and the State. Amounts owed have continued to accrue and the future of the project is unclear.

Figure 2

Financial Results and Obligations (Rocky Gap)

	Balance as of	
	June 30, 2009	June 30, 2006
Cumulative Operating Deficit	\$42.4 million	\$26.9 million
Bonds Payable	45.2 million	29.8 million
Notes Payable to DBED	4.5 million	8.5 million
Accrued Ground Rents Owed to DNR	11.8 million	3.1 million
Deferred Fees Owed MEDCO	2.6 million	1.6 million

Source: Project Financial Statements

In 1996, MEDCO issued non-recourse revenue bonds to finance the building of the facility. DNR owns the ground upon which the facility is located and leases the land to MEDCO. Since that time, additional grants and loans have been made to the project by the State (through DBED).

Because the project was unable to pay the interest owed to the primary bondholders, MEDCO entered into a forbearance agreement with the bondholders and the State to delay the payments to the bondholders until October 2007 for most of what was owed. Included in the agreement with the bondholders and the State, MEDCO was only obligated to pay the bondholders and the State a total of \$50,000 per month, if funds were available. This agreement was not renewed and the project did not have sufficient funds to pay the bond. Consequently, the bondholders refinanced the debt, effective December 1, 2008, which restricts the ability of the bondholders to take action in the event principal or interest payments are not made.

According to MEDCO management, the strategy used by MEDCO, DNR, and DBED has been to keep the facility operations alive while the State proceeds with implementing its efforts to bring slot parlors to Rocky Gap. If the slots initiative does not materialize, MEDCO believes the bondholders will bring a buyer to the project and, at that time, the use of all the facilities will become the responsibility of the new owner. We were advised by MEDCO's senior management that meetings with DNR, DBED and the bondholders are taking place to address this issue; however, as of December 9, 2009, no comprehensive

plan had been developed to improve the financial stability of the facility. The lack of an established long-term comprehensive plan to address the financial condition of the facility was commented upon in our preceding audit report.

Recommendation 1

We recommend that MEDCO, in conjunction with DNR and DBED, continue its efforts to establish a long-term comprehensive plan to address the financial condition of the facility (repeat).

Bank Accounts

Finding 2

The number of authorized signers on certain bank accounts was excessive.

Analysis

The number of authorized signers on certain of MEDCO's bank accounts was excessive. Our review of 28 bank accounts disclosed that 9 bank accounts, with balances totaling approximately \$4 million as of August 2009, had an excessive number of authorized signers on the accounts. Specifically, the number of authorized check signers on each of these accounts ranged from 5 to 12. MEDCO management personnel could not readily explain the authorized signers on these accounts.

Recommendation 2

We recommend that MEDCO review the number of authorized signers on its bank accounts and limit the number of signers on the accounts to the minimum number needed.

Audit Scope, Objectives, and Methodology

We have audited the Maryland Economic Development Corporation (MEDCO) for the period beginning December 5, 2006 and ending September 15, 2009. 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 MEDCO's financial transactions, records and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations. We also determined the status of the findings contained in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. The areas addressed by the audit included cash receipts, cash disbursements, and project monitoring. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of MEDCO's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

MEDCO'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 MEDCO's ability to maintain reliable financial records, operate effectively and efficiently, and comply with applicable laws, rules, and regulations. Our audit did not disclose any significant instances of noncompliance with applicable laws, rules, or regulations. Other less significant findings were communicated to MEDCO that did not warrant inclusion in this report.

MEDCO'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 MEDCO regarding the results of our review of its response.

APPENDIX



MARYLAND ECONOMIC DEVELOPMENT CORPORATION

MEDCO

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March 26, 2010

Mr. Bruce A. Myers, CPA
Legislative Auditor
State of Maryland
Office of Legislative Audits
State Office Building, Room 1202
301 West Preston Street
Baltimore, Maryland 21201

Dear Mr. Myers:

We are responding the draft audit on the Maryland Economic Development Corporation (the "Corporation") for the period December 5, 2006 through September 15, 2009. The Corporation finds the draft audit acceptable and appreciates the professionalism of the Legislative Audit representatives and the manner in which the audit was conducted. The Corporation's responses to the Findings and Recommendations are as follows:

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- 1. Finding #1 Policy issue: In view of the growing project operating deficit, totaling \$42.4 million as of June 30, 2009, MEDCO, in conjunction with the Department of Natural Resources (DNR) and the Department of Business and Economic Development (DBED), should continue its efforts to address the financial condition of one of its operating facilities.**

Recommendation: We recommend that MEDCO, in conjunction with DNR and DBED, continue its efforts to establish a long-term comprehensive plan to address the financial condition of the facility (repeat).

Response to Finding #1: MEDCO has been working with DNR and DBED to address the financial challenges at the Rocky Gap Lodge and Golf Resort as demonstrated by the debt restructuring that closed in December of 2008. The agencies have not developed a long-term plan for the facility as it has been determined that the facility is not viable under its existing business model for the long term. Moreover, the agencies' collective thoughts have been focused on causing a change in the ownership by selling the facility to a private party in conjunction with a successful bid and award of slots licenses. While certain interest was expressed by private parties to establish slots at

the facility in 2009, the offer was not accepted as it failed to conform to the bid requirements.

In the current 2010 legislative session, there is legislation being considered that would allow slots in the resort facility and clarify certain adjacency issues for a slots facility. MEDCO believes that the original slots solicitation was undertaken at a time when the financial markets were in an upheaval and that the resulting uncertainty kept slots operators from bidding or even considering the site. With the legislative changes and slightly improved financial environment MEDCO believes a buyer will come forth.

The agencies are continuing to explore the change in ownership strategy and expect the slot commission to conduct another RFP for Rocky Gap in late spring or early summer of 2010. If a qualified bidder does not come forth and the prospects for gaming at the facility diminish then MEDCO would expect the bond investors to take action and cause a sale of the facility.

While the 2008 debt restructuring provided significant debt relief, the operating conditions of the facility have been impaired by the national recession that has severely depressed the hospitality industry. It is imperative for the agencies to work to cause a sale or be faced with sourcing funds to provide long-term capital and working capital support at the facility.

MEDCO is working with DNR to arrange a meeting with DBED to discuss the near-term prospects and potential outcomes under various scenarios.

2. **Finding #2:** The number of authorized signers on certain bank accounts was excessive.

Recommendation: We recommend that MEDCO review the number of authorized signers on its bank accounts and limit the number of signers on the accounts to the minimum number needed.

Response to Finding #2: MEDCO agrees with the recommendation and will undertake to review all bank accounts to ensure that each account has an appropriate number of authorized signers. This task should be completed by April 30, 2010.

The Corporation is always seeking to improve its management controls and recognizes with its significant growth, improvements to its processes and practices are necessary to allow the Corporation to grow in a responsible manner. To that

end we appreciate the recommendations made by the Office of Legislative Audits as the findings made in the recent audit will be incorporated in our ongoing self improvement process.

Sincerely,

A handwritten signature in black ink, appearing to read "Rob Brennan", written in a cursive style.

Robert C. Brennan
Executive Director

Cc: Leonard R. Sachs, Chairman
Randy Shields, Controller

AUDIT TEAM

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