Department of Legislative Services
Office of Legislative Audits

Performance Audit

Video Lottery Operations Revenue Small, Minority, and Women-Owned Businesses Account

Report Dated October 23, 2015

Audit Overview

- State Law generally requires that 1.5 percent of video lottery terminal (VLT) proceeds be paid into the Small, Minority, and Women-Owned Businesses Account (the Account).
- The purpose of the Account is to provide investment capital and loans to small, minority, and women-owned businesses in the State. At least 50 percent of such activity must be allocated to eligible businesses in the jurisdictions and communities surrounding a video lottery facility (referred to as 'targeted areas').
- The Board of Public Works (BPW) has authority over the Account and under State law, BPW was to develop criteria to define "fund managers" (managers) to whom BPW would make grants, and who would use the grant funds to provide investment capital and loans to businesses.
- Current State law requires OLA to annually evaluate the use of these funds. This report covers FY 2014.

DBED Responsibility

- On August 22, 2012, BPW entered into a Memorandum of Understanding (MOU) with the Department of Business and Economic Development (DBED), for DBED to serve as BPW's agent to administer the Program (the awarding of the grant funds and subsequent loan activity).

- The MOU delegated certain responsibilities to DBED, including the authority to conduct the procurement of fund managers, recommend approval of managers to BPW, enter into agreements with managers on BPW's behalf and, pursuant to those agreements, disburse grants in amounts approved by BPW to the managers.

- DBED is also responsible for monitoring fund manager reporting and submitting an annual report to BPW that details Program activities, including an itemized list of businesses receiving investment capital or loans.

Fund Managers

- DBED executed similar agreements with 3 fund managers effective May 1, 2013 describing manager services and responsibilities, including loan origination and underwriting, advertising, identifying potential borrowers, and community outreach. Each manager was also to establish (and have custody of) a checking account for all Program activity in the name of the State of Maryland and submit to DBED an annual report detailing its use of the funds during the preceding calendar year, and annual audited financial statements for the funds.
- A manager may request grant funds from available VLT proceeds, which with any repaid loan principal, are available for new investment capital and loans.
- Managers were compensated for their Program costs by origination and transaction fees paid by the businesses, interest earned on loans, and an expense fee paid from the Account (which was not to exceed 8% of their initial first year grant funds).

Businesses Targeted by the Program

- Managers were required to make loans to minority businesses and women-owned businesses certified by the Maryland Department of Transportation, or small businesses as defined by the U.S. Small Business Administration. They were also encouraged to make loans and investments in microenterprises, which are businesses that employ fewer than 10 persons with annual revenue not exceeding $2 million.

- Managers were required to allocate at least 50 percent of their grant funds to businesses in three targeted areas, which generally consisted of a ten mile radius surrounding the facilities operating at that time in Hanover, Berlin, and Perryville, MD.

- There were certain prohibited business types, loan purposes, and investment transactions.

Key Findings

- The appropriate amount of VLT proceeds was distributed to the Account for fiscal year 2014 and the loans issued by managers we tested appeared to be made to eligible businesses. Also, fund managers awarded at least 50 percent of its grants funds as loans to eligible businesses in targeted areas in accordance with State law.
- Although BPW and DBED had established certain protocols and processes for awarding grants, and directing and monitoring manager activities, oversight and controls could be improved by establishing Program goals, objectives, and related measures to direct the lending and investing activities and to measure and evaluate the success of the Program and manager performance.
- DBED oversight of the managers needs to be improved in the areas of financial reporting, contract compliance monitoring, and manager performance.

Summary of Relevant Financial Activity

- During this audit (FY 2014) we determined that the Account has been properly credited with VLT proceeds as specified by law, which totaled $8.4 million. FY 2014 disbursements to the 3 managers totaled $6.8 million, and a $50,000 transfer was made to DBED for administrative costs as provided for in the MOU.

- In FY 2014, managers provided 66 loans to eligible businesses totaling $6.4 million and collected $168,000 in interest and fees on these loans. DBED reimbursed the managers $744,000 for Program administrative costs.

- Subsequent to our audit period, BPW approved 4 new managers and authorized disbursements totaling approximately $9.1 million to the now 7 managers. During fiscal year 2015, 64 loans totaling $8.4 million were made by the 7 managers, and this activity will be subject to review during our next audit of the Account.

Projection of Account Revenue

- As of June 30, 2014, on a cumulative basis (since inception), approximately $21 million had been deposited into the Account from VLT revenues and the Account balance was approximately $12.5 million.

- Based on DBED reports and the Bureau of Revenue Estimates, during the next five years, VLT revenue allocated to the Account is projected to increase annually, with cumulative revenues reaching $92.3 million by fiscal year 2019.

- The most significant increase in annual VLT revenue is expected to occur during fiscal 2017, with the commencement of gaming operations at the MGM National Harbor Casino in Prince George's County.

Program Goals and Objectives

- Formal goals, objectives, and related measures had not been established for directing the lending and investment activities and for evaluating Program and manager performance (**Finding 1**).
  - Neither BPW nor DBED had specified the overall expectations as to what should be achieved by the Program and the managers, beyond meeting the requirements of State law.
  - Managing For Results performance data had been established for a number of DBED programs, but not for the Program.
  - The establishment of goals, objectives and related outcome measures could help ensure DBED and fund managers are working together to achieve the desired results. For example, goals, objectives, and measures could be established that address: 1) desired economic impact, 2) targeted industries (such as manufacturing and new technologies), and 3) geographic distribution (for example, 12 counties were not served in FY 2014).

Monitoring of Fund Managers

- DBED did not establish interim financial reporting requirements and did not ensure managers submitted audited financial statements of grant activity in accordance with the contract requirements (**Finding 2**).
  - Although managers were required annually to submit audited financial statements by March 31 and an annual report detailing the use of Program monies by January 31, no formal interim grant reporting requirement had been established.
  - One of the three managers had not met the audit requirement for calendar year 2013. Specifically, the manager's audited financial statements comingled its Program activity with its other business operations. Additionally, the financial statement reporting period for that manager ended as of September 30, 2013, instead of December 31, 2013, as required.

Monitoring of Fund Managers (continued)

- DBED had not established a formal process to verify manager compliance with key Program contractual requirements (**Finding 3**).
  - A documented process was not in place to review manager activity to ensure that loans and investments were only made to eligible businesses, as defined in the contract.
  - DBED did not sufficiently verify that businesses receiving loans were actually located in the targeted areas. DBED did determine that borrowers' reported zip codes matched the targeted areas, but did not verify the businesses were actually located in those zip codes.
  - Managers' underwriting processes were not reviewed and DBED did not ensure that loans were properly underwritten to reduce the risk of default.
  - DBED did not verify that managers had met the insurance requirements established in the agreements prior to the May 1, 2013 contract award and commencement of the services.

Monitoring of Fund Managers (continued)

- DBED had not established a formal evaluation process to assess the performance of managers, including whether desired results were achieved (Finding 4).
  - Such evaluations could be used by DBED to recommend actions to improve manager performance, and to help make decisions regarding subsequent year grant fund distributions and manager retention.
  - Requirements in manager agreements could be used to evaluate fund manager performance. For example, the managers were required to provide specific plans for assuring geographic and demographic distribution of the funds.
  - Other performance attributes could be evaluated, including operational efficiency (the percentage of grant funding spent on administrative expenses) and lending and collection effectiveness (such as percentage of loan delinquencies, loan loss ratios).

Monitoring of Fund Managers (continued)

- DBED authorized a contract modification for one manager without the necessary BPW approval (Finding 5).
  - The contract modification in question increased the one-time fund establishment fee from 8 percent of the initial grant funds to 12 percent, without BPW approval (this fee represented the amount of grant funds to be used to pay expenses for administrative, actuarial, legal, and technical services). Only BPW is authorized by law to set the maximum amount of grant money that each fund manager may use to pay expenses.
  - DBED approved the increase of $145,000 based on a schedule of budgeted expenses, without any support to justify the need. DBED did not question why this one manager required a greater percentage of grant funds to cover the initial Program start-up costs than what was needed by the other two managers. This reduced the amount of funds available for loans.

State Checking Accounts

- DBED had not established effective oversight of the transactions processed through the State checking accounts maintained by the managers (Finding 6).

    - DBED began transferring grant funds to the managers' accounts in July 2013, but did not establish account monitoring procedures until January 2014 and monthly bank account reconciliations were not required.

    - DBED did not obtain copies of cancelled checks for the managers' accounts directly from the issuing bank to verify the reported payees.

    - One manager paid certain of its expenses from its account totaling $75,611 without DBED's knowledge or required advanced approval.

    - DBED authorized payments for two managers' expenses totaling $130,000 even though the requests were untimely in accordance with the manager agreements.

State Checking Accounts (continued)

- DBED had not established comprehensive policies governing the process for managers to request additional grant funds to replenish their State checking accounts **(Finding 7)**.

  - Managers were not required to provide adequate support to substantiate that they had fulfilled DBED's mandate that 80 percent of the funds previously received had been loaned or committed. Our test of 4 manager requests totaling $2.75 million found that lists of closed and pending loans were included, but not supporting documents, such as loan closing and commitment documents and cancelled checks.

  - DBED had not established a policy stipulating the period of time within which pending loans had to be closed before funds can be requested. Consequently, fund managers could have access to funds well in advance of actual need.

Conclusions

BPW and DBED should

- establish comprehensive Program goals, objectives, and related measures;
- enhance manager financial reporting requirements and enforce compliance;
- verify manager compliance with key contractual requirements;
- establish a formal process to annually evaluate manager performance;
- ensure that all manager contract modifications are submitted to BPW for its review and approval;
- establish effective manager checking account monitoring procedures and controls;
- determine the appropriateness of certain DBED financial transactions with the managers in accordance with the manager agreements; and
- establish comprehensive formal procedures governing manager requests for grant funds.