Audit Report

Maryland Economic Development Corporation

August 2007

OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

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Bruce A. Myers, CPA
Legislative Auditor

August 28, 2007

Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Senator Nathaniel J. McFadden, 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 November 5, 2003 and ending December 4, 2006.

MEDCO's outstanding non-recourse debt increased significantly during the audit period, and totaled $1.9 billion as of June 30, 2006. The debt represents non-recourse obligations of MEDCO; 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, State Department of Business and Economic Development).

Our audit disclosed that MEDCO, in conjunction with the Department of Natural Resources and Department of Business and Economic Development, needs to develop a long-term comprehensive plan to address the troubled financial condition of one facility that is owned by MEDCO. Also, MEDCO did not seek approval from the Board of Public Works for a contract totaling $1.25 million.

Our audit also disclosed that a troubled project was not included in a disclosure of troubled projects in MEDCO's annual report. A plan has not been adopted to address the project's deficiencies and formal guidelines for identifying troubled projects and related follow-up have not been established. In addition, controls over cash were inadequate and several of MEDCO's cash accounts were not adequately collateralized.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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Background Information

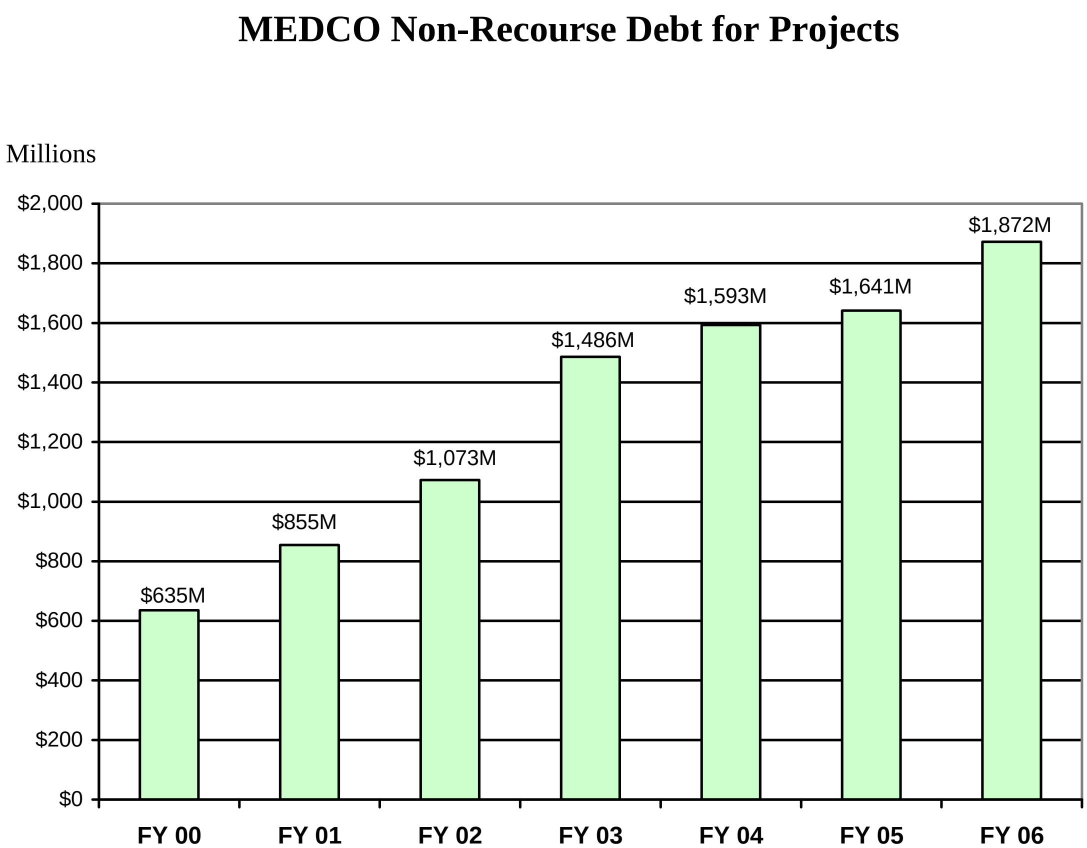
Agency Responsibilities and Financial Activity

The Maryland Economic Development Corporation (MEDCO), which functions under the provisions of Article 83A, Sections 5-201 through 5-217 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 assists, upon request, local jurisdiction projects and 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.

MEDCO has experienced increased growth in recent years. Specifically, MEDCO was created in 1984 and, as of June 30, 1996, had provided assistance to 43 projects in a span of 12 years. The cumulative number of projects undertaken by MEDCO has increased each year, to a total of 187 through June 30, 2006 (an additional 144 projects in 10 years). At the end of fiscal year 2006, MEDCO's non-recourse debt totaled $1.87 billion (see Figure 1 on next page). The debt represents non-recourse obligations of MEDCO; 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, State Department of Business and Economic Development).

Based on a review of MEDCO's project records and discussions with management personnel, we noted that there were four financially troubled projects during the audit period. Two nursing homes, with outstanding debt of approximately $17 million as of June 30, 2006, defaulted on payments to bondholders, resulting in a temporary forbearance by the bondholders to prevent default. One other project, with outstanding debt of approximately $30 million entered into a forbearance agreement with the bondholders to avoid default. The fourth project, owned by MEDCO and with a deficit of approximately $1.3 million, has not been able to pay its operating costs without the help of MEDCO. MEDCO has no further obligations to continue to pay for this project's operating deficits.

In addition, two other projects that were mentioned in our prior report had also defaulted on payments to bondholders. One of these projects is expected to emerge from bankruptcy through a reorganization of its debt. The other project was sold after entering into receivership.



Source: Financial statements audited by and independent accounting firm

Figure 1. MEDCO's debt increased almost 200 percent during the period from fiscal year 2000 through fiscal year 2006. As of June 30, 2006, MEDCO projects had outstanding debt totaling $1.87 billion.

Financial Statement Audits

MEDCO engaged an independent accounting firm to perform audits of its financial statements for the fiscal years ended June 30, 2004, 2005, and 2006. 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.

Current Status of Finding From Preceding Audit Report

Our audit included a review to determine the current status of the finding contained in our preceding audit report dated May 13, 2004. We determined that MEDCO satisfactorily resolved this finding.

Findings and Recommendations

Long-Term Plan

Finding 1 (Policy Issue)
In view of the growing project deficit totaling $26.9 million as of June 30, 2006, MEDCO, in conjunction with the Department of Natural Resources (DNR) and the Department of Business and Economic Development (DBED), should develop a plan to address the financial condition of one of its operating facilities.

Analysis
In view of a growing project deficit, MEDCO, in conjunction with DNR and DBED, should develop a long-term comprehensive plan 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.

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) and local governments. As of June 30, 2006, the facility's deficit had grown to $26.9 million, bonds payable totaled $29.8 million, notes payable to DBED totaled $8.5 million, accrued ground rents owed to DNR totaled $3.1 million and deferred fees owed to MEDCO totaled $1.6 million. Interest on outstanding debt is accruing at the rate of approximately $2 million a year.

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 is owed. Included in the agreement with the bondholders and the State, MEDCO is only obligated to pay the bondholders and the State a total of $50,000 per month, if funds are available. As of March 2007, MEDCO had set aside project funds totaling $315,000 for the bondholders and $35,000 for the State.

In March 2007, the bondholders agreed to allow MEDCO to set aside more funds for repairs and maintenance and agreed to extend to the facility a seasonal line of credit. However, MEDCO, DNR, and DBED do not presently have a comprehensive plan to improve the financial stability of the facility. 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 July 2007 no decisions had been finalized

Recommendation 1
We recommend that MEDCO, in conjunction with DNR and DBED, continue their efforts to establish a long-term comprehensive plan to address the financial condition of the facility.

Contract Approval

Finding 2
MEDCO did not seek approval from the Board of Public Works for a contract totaling $1.25 million, as required.

Analysis
Approval was not requested from the Board of Public Works (BPW) for a management contract with a new operator originally entered into on April 14, 2002 for a 5-year term totaling $1.25 million, as required. The contract required the contractor to manage and operate one of MEDCO's owned operating facilities. This contract was subsequently modified in April 2004 to extend the term to April 2008 for as additional $300,000. The ground lease for this facility from DNR, dated April 1, 1998, states that any changes in the contractor are subject to prior written consent of the BPW and that any new operating and/or management contracts or material amendments or modifications must have prior written approval by DNR and BPW. DNR was advised of the change and did not object; therefore, it was considered approved in accordance with the lease. However, neither MEDCO nor DNR sought to obtain approval from BPW as required.

Recommendation 2
We recommend that MEDCO, in conjunction with DNR, seek approval from BPW for the aforementioned management contract as required.

Annual Report

Finding 3
Although MEDCO's annual report included a disclosure on troubled projects, one such project was not included in the disclosure, and a plan had not been adopted to address the project deficiencies. In addition, formal guidelines for identifying troubled projects and related follow-up had not been established.

Analysis
Although MEDCO's annual report included a section on troubled projects, MEDCO did not have formal guidelines to define troubled projects or to establish procedures that should be followed to address project deficiencies identified. In this regard, MEDCO's 2006 annual report identified certain troubled projects; however, MEDCO did not disclose that one of its other operating facilities had also been experiencing financial difficulties. In addition, we noted that MEDCO had not established a formal plan to address the project's deficiencies.

In relation to this project (Chesapeake Hills Golf Course), the notes to the project's audited financial statements for 2006 stated that the project is incurring operating losses and further stated that, "in the past, the County and MEDCO have periodically advanced funds to support the Project's working capital needs. However, the County and MEDCO have no future obligations to continue to fund working capital shortfalls." The project's net deficit at June 30, 2006 totaled approximately $1.3 million and it incurred an operating loss for that year of $201,888. The project owes MEDCO $250,633 and Calvert County $934,000 for funds advanced. Although the financial statements stated that "management believes recent capital improvements to the golf course and facilities will result in improvements in the operating results and cash flow of the Project", we were advised by MEDCO's management that the project is expected to continue to experience operating deficits. Accordingly, we believe that the project should have been included in the annual report and a plan should be developed to address the project's deficiencies.

State law requires that MEDCO prepare and submit to the General Assembly, the Governor and other State Officials, an annual report that includes its financial statements for the preceding fiscal year and also summarizes MEDCO's activities.

Recommendation 3
We recommend that MEDCO establish formal guidelines that define a troubled project and the appropriate follow-up actions to be taken. We also recommend that all such troubled projects be identified in its annual report.

In addition, we recommend that MEDCO establish a plan to address the aforementioned project's deficiencies.

Cash Receipts

Finding 4
Controls over collections were inadequate to ensure that all receipts were deposited.

Analysis
Adequate internal controls were not established over cash receipts. Specifically we noted the following conditions:

- MEDCO headquarters' cash receipts, which totaled $29.6 million during calendar year 2006, were not recorded immediately upon receipt. Instead, receipts were recorded on the day that the collections were prepared to be deposited. We were advised by MEDCO personnel that checks were occasionally deposited up to a week after receipt.

- The management letter issued by the independent auditors during their audit of MEDCO's fiscal year 2006 financial statements stated that controls over collections at all of MEDCO's housing facilities were inadequate. For example, rent collected at seven out of eight of the housing facilities were recorded by employees who also had the ability to update accounts receivable on the accounting system and three housing facilities did not maintain adequate collection logs to record the collections upon receipt. As of July 2007, MEDCO management had not established a corrective action plan to address these deficiencies. According to the fiscal year 2006 financial statements, rent revenue for the housing facilities totaled approximately $31.1 million.

Recommendation 4
We recommend that all cash receipts be recorded immediately upon receipt and deposited within one business day after receipt. We also recommend that MEDCO ensure that adequate controls are in place at its housing facilities, including a separation of duties between cash and accounts receivable responsibilities.

Collateral

Finding 5
MEDCO did not ensure that its cash accounts were adequately collateralized as required by State law and did not disclose the lack of collateral in its June 30, 2006 financial statements as required.

Analysis
MEDCO did not ensure that all of its bank accounts were adequately collateralized as required by State law and did not disclose the lack of collateral in its June 30, 2006 financial statements as required by generally accepted accounting principles. Specifically, our test of 45 bank accounts, with deposits on November 30, 2006 totaling approximately $23 million, disclosed that MEDCO's main operating account, which had a balance of $5.7 million on November 7, was not collateralized. In addition, there were several other MEDCO accounts which were not collateralized and there were a number of accounts at various financial institutions for MEDCO's operating facilities for which MEDCO did not know whether the accounts were collateralized.

In addition, our review of MEDCO's financial statements disclosed that the lack of collateral was disclosed in its June 30, 2005 combined financial statements but not in its June 30, 2006 combined financial statements.

State law requires that MEDCO collateralize deposits in financial institutions in excess of federal deposit insurance. Additionally, in accordance with recommendations of the Government Finance Officers Association, the collateral for these accounts should be evidenced by a written agreement, held by an independent third-party institution, and controlled by MEDCO.

In addition, generally accepted accounting principles, as established by Governmental Accounting Standards Board Statement No. 40, require disclosure of cash deposits that are exposed to custodial credit risk (uncollateralized or inadequately collateralized deposits) in the financial statements. Several of the individual operating project financial statements disclosed that deposits were not adequately collateralized; however, the lack of collateral over its accounts was not disclosed in MEDCO's June 30, 2006 combined financial statements. MEDCO management represented that it was their understanding that the law did not require MEDCO to ensure funds were collateralized. However, our discussions with legal counsel to the General Assembly indicated that the State law requiring collateralization of funds on deposit is applicable to MEDCO.

Recommendation 5
We recommend that MEDCO establish a policy and require that all bank accounts be adequately collateralized in accordance with State law. We also recommend that MEDCO disclose the exposure of cash deposits to custodial credit risk in its financial statements as required by generally accepted accounting principles.

Audit Scope, Objectives, and Methodology

We have audited the Maryland Economic Development Corporation (MEDCO) for the period beginning November 5, 2003 and ending December 4, 2006. The audit was conducted in accordance with generally accepted government auditing standards.

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.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. 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/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding 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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BALTIMORE, MD 21201
PHONE: (410) 625-0051; FAX (410) 625-1848

August 24, 2007

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 November 5, 2003 through December 4, 2006. The Corporation finds the draft audit acceptable with few exceptions and appreciates the manner in which the audit was conducted. The Corporation's responses to the Finding are as follows:

1. **Finding # 1: In view of the growing projected deficit totaling $26.9 million as of June 30, 2006, MEDCO, in conjunction with the Department of Natural Resources (DNR) and the Department of Business and Economic Development (DBED) should develop a long term comprehensive plan to address the financial condition of one of MEDCO's operating facilities.**

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

   Response to Finding #1: The Corporation agrees to the recommendation. The Corporation proposed a restructuring in 2006 and the investors choose to continue with the forbearance as they did not want to set a new loan structure based on the current cash flow levels. It was the investor's prerogative to defer a restructuring to a point in time when the cash flows would be viewed to be representative of a stabilized operation. As part of the current forbearance, restructuring discussions are underway and the final approval is to be completed before the end of December 2007. While the Corporation agrees with the recommendation the implementation of a plan requires the consent of the investors and the Corporation does not control their decision making process.

MEDCO recognizes the value to restructuring the transaction and has worked diligently to sustain the operations with limited financial resources over the past several years. The investors have been extremely cooperative and have made decisions which have allowed for funds that would have otherwise been used to pay interest, to be used to maintain and improve the facility. Some of the improvements have included replacing all of the mattresses with pillow top mattresses along with the necessary soft goods. This past spring the entire exterior of the building was cleaned, repaired and re-stained. All of these investments have allowed the facility to maintain its AAA four Diamond rating.

The Rocky Gap project has been a very successful economic development project for Allegany County and the region. The facility employs up to 300 associates at its peak and over 150 year round. MEDCO estimates the project generates over $20,000,000 in economic activity for the region on an annual basis.

2. Finding #2: MEDCO did not seek approval from the Board of Public Works for a contract totaling in excess of $1.25 million, as required.

   Recommendation: We recommend that MEDCO, in conjunction with DNR, seek approval from the BPW for the aforementioned management contract as required.

   Response to Finding # 2: The Corporation acknowledges the approval of the BPW was not acquired to install the new manager. This omission was noted in 2006 and a formal request was made to DNR to approve the manager. At this time the Corporation intends to again seek approval but in connection with an overall restructuring which is being negotiated at this time. The Corporation has met with the Secretary's of DBED and DNR to brief them on the history and current status of the project. The requirement of the BPW to approve the manager was discussed and will be included as part of the restructuring that is currently being negotiated.

3. Finding #3: Although MEDCO's annual report included a disclosure on troubled projects, one such project was not included in the disclosure, and a plan had not been adopted to address the project deficiencies. In addition, formal guidelines for identifying troubled projects and related follow-up had not been established

   Recommendation: We recommend that MEDCO establish formal guidelines that define a troubled project and the appropriate follow-up actions to be taken. We also recommend that all such troubled projects be identified in its annual report.

   In addition, we recommend that MEDCO establish a plan to address the aforementioned project's deficiencies.

Responses to Finding #3: The Corporation will establish formal guidelines that identify troubled projects.

MEDCO is working in a collaborative manner to resolve the problem project and the final outcome with be with the input of the MEDCO, the investors and the County. At this time, MEDCO expects for either the County to acquire the project or the investors will exercise their rights to foreclose. In any case a final decision will be made before the end of 2007.

4. Finding # 4: Controls over collections were not adequate to ensure that all receipts were deposited.

   Recommendation: We recommend that all cash receipts be recorded immediately upon receipt and deposited within one business day after receipt. We also recommend that MEDCO ensure that adequate controls are in place at its housing facilities, including a separation of duties between cash and accounts receivable responsibilities.

   Response to Finding #4: The Corporation agrees with the finding as it pertains to the deposits under the Corporation's direct control and the Corporation has installed enhanced procedures to assure all deposits are recorded. The new procedure includes having the receptionist record checks into a check log, the checks are then forward to the office manager who endorsees the check with a stamp and includes the depository account number. The Assistant Controller has access to the check log and reconciles the check log to the bank statement on a monthly basis. Since mail is received by the Corporation after 3PM, the deposit may not be ready on the day of receipt. The Corporation will ensure all deposits are made no later than the next business day from receipt.

   The Corporation does not have direct control over deposits made at the outside projects. Each project location has its own local depository account. The Corporation has reviewed the OLA recommendation with the onsite management companies and each is of the opinion the recommendation would require the hiring of an additional staff person which would not be cost effective. Moreover, the Corporation believes the monthly collection and tracking of lease payments provides a level of control to track and follow up for past due payments on a current basis and as such any misapplied or unapplied payment would be readily discovered. Attached are the Cash Handling Procedures used by Capstone the manager at five of the eight projects[1]. The Corporation believes the systems maintained by the managers are adequate.

[1] **Document received, but excluded for printing purposes.**

5. **Finding # 5: MEDCO did not ensure that its cash accounts were adequately collateralized as required by State law and did not disclose the lack of collateral in its June 30, 2006 financial statement.**

   Recommendation: We recommend that MEDCO establish a policy and require that all bank accounts be adequately collateralized in accordance with State law. We also recommend that MEDCO disclose the exposure of cash deposits to custodial credit risk in its financial statements as required by generally accepted accounting principals.

   Responses to Finding #5: The Corporation's agrees with the finding and has recently adopted an investment policy which requires depository account to be collateralized. The Corporation will comply with the recommendation; in fact the Corporation has obtained collateral for all of its accounts.

   MEDCO will also assure the financial statements include a disclosure regarding the custodial risk.

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 Auditors as the findings made in the recent audit will be incorporated in our on going self improvement process.

Sincerely,

Robert C. Brennan
Executive Director

Cc: H. Lee Boatwright, III, Chairman
Randy Shields, Controller

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