



Commonwealth of Massachusetts
Office of the State Auditor
Suzanne M. Bump

Making government work better

Official Audit Report – Issued February 6, 2015

Massachusetts Growth Capital Corporation

For the period July 1, 2011 through September 30, 2013





Commonwealth of Massachusetts
Office of the State Auditor
Suzanne M. Bump

Making government work better

February 6, 2015

Mr. Lawrence D. Andrews, President
Massachusetts Growth Capital Corporation
529 Main Street
Schrafft Center, Suite 1M10
Charlestown, MA 02129

Dear Mr. Andrews:

I am pleased to provide this performance audit of Massachusetts Growth Capital Corporation. This report details the audit objectives, scope, methodology, findings, and recommendations for the audit period, July 1, 2011 through September 30, 2013. My audit staff discussed the contents of this report with management of the agency, and their comments are reflected in this report.

I would also like to express my appreciation to Massachusetts Growth Capital Corporation for the cooperation and assistance provided to my staff during the audit.

Sincerely,

A handwritten signature in blue ink, appearing to read 'SMBump'.

Suzanne M. Bump
Auditor of the Commonwealth

TABLE OF CONTENTS

EXECUTIVE SUMMARY 1

OVERVIEW OF AUDITED AGENCY 3

AUDIT OBJECTIVES, SCOPE, AND METHODOLOGY 5

DETAILED AUDIT RESULTS AND FINDINGS WITH AUDITEE’S RESPONSE 7

- 1. Massachusetts Growth Capital Corporation does not consistently follow its documented criteria for evaluating prospective loans. 7**
- 2. MGCC is not following its existing policies and procedures for control over property and equipment..... 8**
- 3. MGCC’s internal control documentation does not include a formal risk assessment. 10**

EXECUTIVE SUMMARY

Massachusetts Growth Capital Corporation (MGCC) was established on October 1, 2010 as a quasi-public agency formed by the combination of two preexisting entities, the Massachusetts Community Development Finance Corporation and the Economic Stabilization Trust. According to its website, MGCC's mission is "to create and preserve jobs at small businesses, women and minority owned businesses, and to promote economic development in underserved, gateway municipalities and low and moderate income communities." To accomplish this, MGCC works with various financial institutions, community development corporations, and other nonprofits to provide financing for job-producing projects, loan guarantees, and grants. MGCC also makes loans to organizations that for various reasons are not able to obtain financing from traditional sources.

In accordance with Chapter 11, Section 12, of the Massachusetts General Laws, the Office of the State Auditor has conducted a performance audit of certain activities of MGCC for the period July 1, 2011 through September 30, 2013.

The objectives of our audit were to review and examine various aspects of MGCC's operations to determine whether (1) MGCC was properly administering loans and grants; (2) MGCC was appropriately tracking job creation by its grant and loan recipients; and (3) MGCC's administrative expenses were reasonable and applicable to its operations.

Summary of Findings

- MGCC's loan policy says that loan applicants need to meet certain financial ratios in order to qualify for a loan. However, in practice, MGCC does not always follow this policy. This inconsistency in policy application could result in MGCC granting higher-risk loans because of the absence of certain ratios prescribed by existing loan policy.
- MGCC does not maintain a current list, and has never taken a physical inventory, of its property and equipment and does not currently tag or record the serial numbers of property and equipment. Further, MGCC only capitalizes tangible assets costing more than \$10,000 and does not record the acquisition or disposal of assets that cost less than that amount. By not adhering to existing policy or recording tangible assets, MGCC risks loss, theft, or misuse of its assets.
- MGCC's internal control process does not require it to perform a formal risk assessment of its activities. The absence of a detailed departmental risk assessment could hinder or prevent MGCC from ensuring the integrity and effectiveness of its internal control system.

Recommendations

- In order to ensure that loans are being provided fairly and equitably, MGCC should comply with the requirements of its loan policy regarding the required ratios. If MGCC believes that other factors should be considered in the evaluation of loan applications, it should amend its loan policy to specifically identify what other ratios/factors can be considered and under what circumstances that should happen.
- MGCC should perform an inventory of its current property, equipment, and other tangible assets with remaining useful lives of more than one year. It should continue to perform this inventory each year to determine whether it still has the listed items.
- For control purposes and in compliance with its existing policies, MGCC should tag and numerically control all such assets to track eventual disposal. It should inventory and tag tangible assets that are particularly susceptible to loss, theft, and abuse, such as portable computers, regardless of whether they are capitalized under existing parameters.
- MGCC should adjust its capitalization threshold to ensure that all assets that should be capitalized are identified.
- MGCC should, in combination with its process of documenting internal controls through its policies and procedures, perform detailed assessments of risks and related controls in effect to mitigate risks.

OVERVIEW OF AUDITED AGENCY

Background

Massachusetts Growth Capital Corporation (MGCC), located at 529 Main Street in Charlestown, was formed in 2010 by the consolidation of the Massachusetts Community Development Finance Corporation and the Economic Stabilization Trust. Both prior agencies were quasi-public financing agencies devoted to making nontraditional¹ business loans to foster economic growth in the Commonwealth. MGCC has a similar purpose and is a resource for small businesses seeking growth capital.

According to its website, MGCC's mission is "to create and preserve jobs at small businesses, women and minority owned businesses, and to promote economic development in underserved, gateway municipalities and low and moderate income communities." To accomplish this, MGCC works with traditional financial institutions, non-bank lenders, community development corporations, and other nonprofits to provide financing for job-producing projects. Additionally, MGCC makes loans to firms that, for various reasons, are not able to obtain traditional financing. Finally, MGCC manages competitive grant programs that provide training and technical assistance to small businesses, including small contractors.

During the fiscal years ended June 30, 2013 and June 30, 2012, MGCC's financial position, revenue, and expenses, as reported by its independent accounting firm, included the following selected data:

	Fiscal Year Ended	
	June 30, 2013	June 30, 2012
Total Assets	\$51,310,617	\$47,645,370
Total Liabilities	\$ 1,707,854	\$ 2,096,606

Total assets include loans receivable as of June 30, 2013 and June 30, 2012, respectively, of \$21,634,453 and \$20,475,430 net of allowances for uncollectible amounts of \$5,160,793 and \$5,942,248 for the fiscal years ended June 30, 2013 and June 30, 2012, respectively. There were approximately 128 loans outstanding as of June 30, 2013 and approximately 120 loans outstanding as of June 30, 2012. Outstanding loan balances during the two-year period ended June 30, 2013 ranged from \$4,292 to \$1,000,000, with an average outstanding balance of approximately \$215,000.

¹ Nontraditional loans are loans that exhibit characteristics that may result in higher risk than typical loan products.

MGCC awarded grants of approximately \$700,000 and \$600,000, respectively, in fiscal years 2013 and 2012, representing 14 awards in each year.

Operating revenue and expenses during the fiscal years ended June 30, 2013 and June 30, 2012 were as follows:

	Fiscal Year Ended	
	June 30, 2013	June 30, 2012
Operating Revenue	\$3,002,262	\$2,936,448
Operating Expenses	\$2,868,728	\$2,518,940

AUDIT OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Chapter 11, Section 12, of the Massachusetts General Laws, the Office of the State Auditor has conducted a performance audit of certain activities of Massachusetts Growth Capital Corporation (MGCC) for the period July 1, 2011 through September 30, 2013.

We conducted this performance audit 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.

The objectives of our audit were to review and examine various aspects of MGCC's operations to determine whether (1) MGCC was properly administering loans and grants; (2) MGCC was appropriately tracking job creation by its grant and loan recipients; and (3) MGCC's administrative expenses were reasonable and applicable to its operations.

To achieve our audit objectives, we interviewed MGCC senior management and reviewed laws, regulations, policies, and procedures applicable to our audit objectives. We obtained and reviewed relevant documentation including, but not limited to, invoices and consulting contracts. We also reviewed MGCC loan records and supporting source documents, reports issued during our audit period by MGCC's independent auditors, and the report of an independent consultant engaged to review the adequacy of MGCC's loan loss reserves. We reviewed internal controls we deemed significant to our audit objectives and evaluated the design and effectiveness of those controls.

For the purposes of this audit, we relied on certain electronic data files that contained loan and other information. To assess the reliability of the data, we reviewed related documentation; interviewed MGCC personnel compiling the data; and performed checks by tracing source documents to general ledger postings, trial balances, and audited financial statements where applicable. We determined that the data were sufficiently reliable for the purposes of this report.

Further, we conducted audit testing in the following areas:

- We reviewed MGCC's policies and procedures to determine whether they were adequate and applicable to the agency's business operations.

- We judgmentally selected 19 out of 103 loans issued by MGCC during our audit period and reviewed the related loan documentation for compliance with required criteria, including financial ratios; proper approvals; and evidence of ongoing monitoring, including appropriate performance reviews.
- We judgmentally selected 12 loans mentioned in the minutes of meetings of MGCC's Credit Committee. The minutes we reviewed documented agreed-upon loan values and terms. We traced this loan information to loan records.
- We reviewed the grant award process through inquiry, examination of documents, and personal observation of the actual process.
- We judgmentally selected 22 out of 28 proposals for grants awarded during our audit period for testing.
- We reviewed and analyzed MGCC's policies and procedures for employee benefits and compared them to employee benefits offered by other Commonwealth agencies.
- We judgmentally selected 15 administrative expenditures from a stratified population of 11 administrative expense accounts that were being maintained by MGCC during our audit period and reviewed them for reasonableness and applicability to MGCC's operations.
- We reviewed the adequacy of MGCC's controls over capitalized and non-capitalized assets.
- We reviewed the measurement process for tracking job creation.
- We reviewed the job performance information MGCC submitted to the Commonwealth's Office of Performance Management and Oversight as required by law and traced the data used by MGCC to source documents to confirm the accuracy of this information.

Whenever sampling was used, we applied a non-statistical approach, and as a result, we were not able to project our results to the population.

Based on our audit, we have concluded that, except as discussed in the Detailed Audit Results and Findings section of this report, during the audit period, MGCC was appropriately tracking job creation by its grant and loan recipients and its administrative expenses were reasonable and applicable to its operations. However, we found that MGCC did not consistently follow its documented criteria for evaluating prospective loans or follow its existing policies and procedures for control over property and equipment. Further, its internal control documentation did not include a formal risk assessment. These issues are discussed in the Detailed Audit Results and Findings section of this report.

DETAILED AUDIT RESULTS AND FINDINGS WITH AUDITEE'S RESPONSE

1. Massachusetts Growth Capital Corporation does not consistently follow its documented criteria for evaluating prospective loans.

In order to ensure that it is not taking on too much risk in its loan portfolio, Massachusetts Growth Capital Corporation (MGCC) has established a policy that says that loan applicants need to meet certain financial ratios in order to qualify for a loan. However, in practice, MGCC does not always follow this policy: some of these ratio requirements are informally waived or substituted by different requirements, even though MGCC's loan policy does not identify what other factors can be considered as substitutes for the established ratios. This inconsistency in policy application could result in MGCC granting higher-risk loans because of the absence of certain ratios prescribed by existing loan policy.

In our testing, we examined 19 out of 103 loans granted for compliance with established underwriting ratio requirements. In 9 instances, not all of the three required ratios were met, but the loans were granted. The most common issue, occurring in all 9 cases, was that the entity requesting the loans did not meet the requirement that its debt be less than five times the value of its equity. Each of these loans was eventually granted on the basis of other mitigating factors. In 3 instances, loans were granted based on very strong cash flow. Other reasons for granting loans included anticipated new business, available collateral, and the expectation of grants or contributions.

Authoritative Guidance

MGCC's loan policy establishes the following underwriting ratio requirements for applicants:

- *Debt service coverage² must be at least 1.1X*
- *Leverage³ must not exceed 5X*
- *Cash flow⁴ must be trending positive*

The policy also states that one of the purposes of the loan is to ensure that "MGCC operates within acceptable risk tolerances" and that "the primary eligibility measure is an ability to repay the loan or

² A measurement of an entity's ability to generate sufficient revenue to cover the cost of its mortgage payments, calculated by dividing net operating income by total debt service.

³ The amount of debt used to finance an entity's assets. Entities with significantly more debt than equity are considered to be highly leveraged.

⁴ Amounts received and expended by an entity. Amounts received in excess of expenditures are referred to as "positive cash flow."

redeem the investment.” This policy says that any exceptions to policy requirements must be identified for MGCC’s Credit Committee at the time the loan is presented for approval. All of the loans we examined received the appropriate credit approvals.

Reasons for Noncompliance with Established Policy

MGCC officials told us that they believed that enforcing strict compliance with the ratios established in the agency’s loan policy might prevent MGCC from providing loans to applicants who can satisfy other criteria more applicable to their unique situations.

Recommendation

In order to ensure that loans are being provided fairly and equitably, MGCC should comply with the requirements of its loan policy regarding the required ratios. If MGCC believes that other factors should be considered in the evaluation of loan applications, it should amend its loan policy to specifically identify what other ratios/factors can be considered and under what circumstances that should happen.

Auditee’s Response

If MGCC were an asset based lender and could rely on hard collateral to secure its loans, identifying a comprehensive universe of acceptable ratios, as banks do, would be possible. Our enabling legislation directs us “to provide flexible, high risk financing. . . .” By definition we do not have consistent variables in the underwriting process. The Loan Policy ratios are therefore a guide, not fixed rules. We do not believe it would be possible to pre-determine every exception and every acceptable metric change.

To ensure informed decision making we prominently display ratios so that they can be easily grasped by the Credit Committee members, along with stating exceptions to Loan Policy in the loan approval process.

In summary, we do not view it as feasible or realistic to define all potentially acceptable ratios in advance, however we will amend the MGCC Credit Policy to designate ratios as broad guidelines.

Auditor’s Reply

We agree with MGCC’s decision to amend its credit policy to reflect current practices.

2. MGCC is not following its existing policies and procedures for control over property and equipment.

MGCC is not following its existing policies and procedures for control over property and equipment. Specifically, it does not maintain a current list, and has never taken a physical inventory,

of its property and equipment. The last recorded addition to MGCC's property and equipment list was in November 2011. In addition, MGCC is not currently tagging or recording the serial numbers of property and equipment. Further, MGCC only capitalizes tangible assets costing more than \$10,000 and does not record the acquisition or disposal of assets that cost less than that amount. By not adhering to existing policy or recording tangible assets, MGCC risks loss, theft, or misuse of its assets.

Authoritative Guidance

According to generally accepted accounting principles (GAAP), entities such as MGCC should establish and implement an adequate internal control system within the organization to ensure that goals and objectives are met; resources are used in compliance with laws, regulations, and policies; assets are safeguarded against waste, loss, and misuse; and financial data are maintained, reported, and fairly disclosed in reports. Further, conducting an inventory count is essential in keeping an entity's inventory compliant with GAAP because the actual value of inventory at the end of the year has to be reported. Not identifying and reflecting changes in inventory, such as disposal or theft of assets that would be detected by an inventory count, would undermine the reliability and accuracy of an entity's financial statements. In addition, Section 700 of MGCC's Accounting Policies and Procedures Guide provides for an annual inventory of property and equipment, including tagging and sequentially numbering assets.

Reasons for Incomplete Inventory of Property and Equipment

When MGCC was formed, it created a list of the property and equipment it had inherited from the entities from which it was formed. At that time, MGCC did not believe that the economic value of the inherited property and equipment was sufficiently significant to require specific monitoring. In September 2013, MGCC revised its accounting policies and procedures to provide for an annual inventory of property and equipment. As part of that policy revision, MGCC changed its capitalization threshold from purchases of \$1,000 or greater to purchases of \$10,000 or greater.

Time constraints have prevented MGCC from performing a physical inventory since its formation.

Recommendations

- MGCC should perform an inventory of its current property, equipment, and other tangible assets with remaining useful lives of more than one year. It should continue to perform this inventory each year to determine whether it still has the listed items.
- For control purposes and in compliance with its existing policies, MGCC should tag and numerically control all such assets to track eventual disposal. It should inventory and tag tangible assets that are particularly susceptible to loss, theft, and abuse, such as portable computers, regardless of whether they are capitalized under existing parameters.
- MGCC should adjust its capitalization threshold to ensure that all assets that should be capitalized are identified.

Auditee's Response

The recommendations regarding inventorying and tagging of equipment are useful and will be completed in the very near future. . . .

The recommendation regarding capitalization of equipment purchases under \$10,000 we believe concerns a judgment regarding income statement credibility.

MGCC is not a capital intensive operation nor are our equipment purchases substantial and with long useful life. We view the most important factor to be accurately reporting the true annual cost of operating the loan fund. . . . Expensing our equipment costs ensures transparency and does not inflate assets. MGCC therefore is persuaded that its current practice of expensing equipment under \$10,000 is the appropriate one.

We've reviewed this approach with our outside audit firm . . . who has concurred with this approach, given our relatively small size and mission.

Auditor's Reply

MGCC's intent to begin inventorying and tagging equipment is appropriate. We agree that the threshold for capitalization of purchased property is judgment-based. However, we recommend that MGCC implement a policy to track purchased personal property under \$10,000 that is especially susceptible to loss or theft, such as personal computers.

3. MGCC's internal control documentation does not include a formal risk assessment.

Contrary to sound business practices, MGCC's internal control process does not require it to perform a formal risk assessment of its activities. When MGCC was formed, it generally adopted the policies and procedures of the agencies that merged to create it. MGCC combined and modified these policies and procedures in their September 17, 2013 revision to better represent the agency's activities. This process improved documentation of internal controls but did not include a formal risk assessment of MGCC's control activities. The absence of a detailed departmental risk

assessment could hinder or prevent MGCC from ensuring the integrity and effectiveness of its internal control system.

Authoritative Guidance

The most widely used framework for internal controls in the United States was developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO document *Internal Control—Integrated Framework* adopted the concept of enterprise risk management, a key element of which is an organization's identification and assessment of the risks inherent in its operations that could prevent the accomplishment of its mission and goals and the controls in effect to mitigate those risks.

The Commonwealth's Office of the State Comptroller requires state agencies to develop internal control systems, as directed by Chapter 647 of the Acts of 1989. In Section A.03 of the document *Government Auditing Standards*, the U.S. Government Accountability Office (GAO) specifically refers to COSO as providing guidance on internal control, noting risk assessment as one of five interrelated components providing "reasonable assurance that the unauthorized acquisition, use, or disposition of assets will be prevented or timely detected and corrected." GAO requires adherence to *Government Auditing Standards* in the performance of federal A-133 audits, to which MGCC is subject because it receives federal funds.

Reasons for Absence of Risk Assessment

MGCC is in the process of performing a formal risk assessment, but it has not been completed because of time constraints.

Recommendation

MGCC should, in combination with its process of documenting internal controls through its policies and procedures, perform detailed assessments of risks and related controls in effect to mitigate risks.

Auditee's Response

We agree this is an important task to complete. While we have a useful beginning, it may require 3rd party assistance to complete.