June 15, 2011

TO: Federal Co-Chair
ARC Executive Director

FROM: Hubert Sparks
ARC Inspector General

SUBJECT: Compliance Audit of Kentucky Highlands Investment Corporation- Meritus Ventures Fund
OIG Report Number, 11-04

GRANTEE: Kentucky Highlands Investment Corporation- Meritus Ventures, Grant 15528-06

The OIG engaged Tichenor & Associates, LLP, Certified Public Accountants, to conduct an audit of a grant made to Kentucky Highlands Investment Corporation which was used to make an investment in the Meritus Ventures Fund. The Fund invests in expansion stage companies.

The grant period covered by the audit was from August 1, 2006 through March 31, 2010. The report had four recommendations for ARC to consider. The recommendations pertained to the following: 1) the grantee appeared to be falling short of meeting two of its grant objectives, which were to invest $600,000 in ARC distressed counties and to create 240 jobs; 2) management fees (and other charges) in relation to the grant funds being invested (management fees, had so far, accounted for 34% of ARC's grant funds invested; 3) the intertwined relationship of the grantee and the Meritus Fund investment management, and the management fees charged against the grant funds; and 4) ARC funds being used as a source of capital to secure USDA program funds in possible violation of their legislation. The recommendation pertaining to investing funds in distressed counties and ARC consideration of the other issues for this type of grant was agreed to by management. All recommendations were considered resolved and were closed by the auditor. However, the recommendation pertaining to the investment of funds in distressed counties will remain open in our records until implemented.

In connection with the audit of Kentucky Highlands Investment Corporation's Meritus Venture Fund activities, conducted by Tichenor & Associates, LLP, the OIG does not express an opinion on Kentucky Highland's Meritus Fund activities, internal controls, or conclusions on compliance with laws and regulations. The OIG had no involvement in the review of Kentucky Highlands Investment Corporation-Meritus Ventures Fund grant. The OIG's involvement was with Tichenor & Associates, who was contracted to audit and report on grant compliance and other matters as outlined in the report's scope section. Tichenor & Associates is responsible for the attached auditor's report and the opinions, conclusions, and recommendations expressed in that report.

Hubert Sparks

Hubert Sparks
Inspector General
Attachment

# COMPLIANCE AUDIT OF
# KENTUCKY HIGHLANDS INVESTMENT CORPORATION
# LONDON, KENTUCKY

## MERITUS VENTURES

**ARC Grant Number: CO-15528-06**

**Grant Period: October 1, 2006 through September 30, 2011**

CAUTION: *Certain information contained herein is subject to disclosure restrictions under the Freedom of Information Act, 5 U.S.C. 552 (b) (4).*

**Report Number: 11-04**

**Date: June 13, 2011**

# COMPLIANCE AUDIT OF
# KENTUCKY HIGHLANDS INVESTMENT CORPORATION
# LONDON, KENTUCKY

## MERITUS VENTURES

**ARC Grant Number: CO-15528-06**

**Grant Period: October 1, 2006 through September 30, 2011**

**Prepared By:**

**Tichenor & Associates, LLP**
**Certified Public Accountants**
**304 Middletown Park Place, Suite C**
**Louisville, Kentucky 40243**

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# TICHENOR & ASSOCIATES, LLP

CERTIFIED PUBLIC ACCOUNTANTS and MANAGEMENT CONSULTANTS

304 MIDDLETOWN PARK PLACE, SUITE C
LOUISVILLE, KENTUCKY 40243

BUSINESS: (502) 245-0775
FAX: (502) 245-0725
E-MAIL: WTICHENOR@TICHENORASSOCIATES.COM


| | |
|---|---|
| TO: | Appalachian Regional Commission (ARC)<br>Office of Inspector General (OIG) |
| FROM: | Tichenor & Associates, LLP<br>Louisville, Kentucky |
| REPORT FOR: | The Federal Co-Chairman<br>ARC Executive Director<br>OIG Report Number: 11-04 |
| SUBJECT: | Compliance Audit Report on Kentucky Highlands Investment Corporation (KHIC), Meritus Ventures, ARC Grant Number: CO-15528-06. |

OBJECTIVE: The objective of our audit was to determine if (a) the total funds provided to KHIC for its Meritus Ventures grant were expended in accordance with the ARC approved grant budget and did not violate any restrictions imposed by the terms and conditions of the grant; (b) the accounting, reporting, and internal control systems were appropriate, operating effectively, and implemented in accordance with generally accepted accounting principles; and (c) that the objectives of the grant were met.

BACKGROUND: ARC awarded Grant Number CO-15528-06 to KHIC for the period October 1, 2006 through September 30, 2011. Total grant funding was for an amount not to exceed $500,000 or 16.7 percent of actual, reasonable, and eligible project costs. ARC required that the grant be matched with $2,500,000 or 88.3 percent in cash, contributed services, or in-kind contributions, as approved by the ARC. Also, $200,000 of ARC funding, and $400,000 in matching funds were to be placed in ARC-designated distressed areas. The grantee receives ARC funds as part of a call for capital and places funds received into an account to be used for investment as needed. The equity for individual investors (including ARC) is determined based upon an allocation percentage. The percentage is computed by dividing each individual investor's funds by the total pool of investors' funds. As of March 31, 2010, ARC has made nine payments totaling $419,740 The purpose of the grant was to provide funding to a venture capital fund, Meritus Ventures, which would use ARC funds (and matching funds) to make investments in rural Appalachia. The fund was licensed by the Small Business Administration (SBA) to do business in designated rural parts of the country. The license was issued under the authority of the U.S. Department of Agriculture's Rural Business Investment Program (RBIP) and the fund became an RBIC (Rural Business Investment Company), the goal of which is to foster business growth by providing funding and expertise to expansion stage companies. The license area comprises the entire states of Arkansas, Kentucky, Tennessee, West Virginia, and eight other states; encompassing all the counties within the Appalachian region for those states, as defined by ARC.

Meritus Ventures was established as a Delaware Limited Partnership with 23 limited partners. The general partner of the fund is Eclipse Management, LLC which includes employees of KHIC, a not-for-profit corporation, and Technology 2020, a not-for-profit public-private partnership. Meritus Ventures' investment committee is comprised of the board of directors of Eclipse Management, LLC, which include the fund managers (one each from KHIC and Technology 2020) and an additional nominee from both KHIC and Technology 2020 for a total of four investment committee members.

Investor capital made available to Meritus Ventures comes from a variety of governmental, private and semi-public sources. In total, $12,147,000 in non SBA funding (investor capital) was committed in support of Meritus Ventures. In addition, SBA agreed to match investor capital at a 2 for 1 level, so another $24,294,000 became available (SBA agreed to provide debenture financing).

To encourage the formation of RBICs, SBA provided various financial incentives. The incentives were direct cash assistance, management fee income, sitting on the board of directors of the portfolio companies (the investee companies) and participating in the returns generated to the fund. Specifically these incentives include: a $1,000,000 operational assistance grant to provide technical assistance to portfolio companies during the fund's first five years of operation; an annual management fee of 2.5 percent, based on the fund amount, both invested and committed/un-invested funds are counted (in this case, the fund balance of $36,441,000 generates an annual management fee of $911,020); and participation by fund managers in the "carried interest" of the fund (5% each for KHIC, Technology 2020, and the two fund managers, for a total of 20%). Carried interest is an interest in the profits of the fund, above and beyond invested capital, and is not distributable until all invested capital has been returned to the limited partners.

The grant application states that Meritus Ventures anticipates making equity investments of $22,500,000, over the life of the fund. The difference between the total fund of $36,441,000 and the anticipated equity investments of $22,500,000 is interest on the SBA debentures and other fees, including management fees, estimated to total $13,941,000.

As of March 31, 2010, $9,426,782 was invested in portfolio companies, representing 42 percent of available funding.[1] Additionally, the fund has paid out (or has that availability) $3,200,000 in management fees over the past 3 ½ years, or approximately 34 percent of the amount invested in portfolio companies (see chart below). The maximum remaining

[1] For the period ended March 31, 2011, Meritus Ventures reported $12,587,745 as invested (55% of the anticipated available financing).

life of the fund is 8 ½ years (6 ½ years, plus two one-year extensions, at the discretion of a majority of the limited partners).

At the time of the grant, ARC anticipated that four investments would be made in Appalachia, resulting in the creation of 240 jobs and the leveraging of over $9 million in additional investment. Additionally, as part of the grant approval process, ARC requested the KHIC revise/amend its grant application to include written commitments that Meritus Ventures would invest at least $900,000 in Appalachian Kentucky and at least $600,000 in ARC-designated distressed counties. These written commitments were provided by KHIC prior to ARC's approval of the grant.

SCOPE: We performed a compliance audit of the grant, as described in the Objective above, for the period of October 1, 2006 through March 31, 2010, at KHIC's office in London, Kentucky on April 12, 2010 through April 23, 2010. Our audit was based on the terms of the grant agreement and on the application of certain agreed-upon procedures previously discussed with the ARC OIG. Specifically, we determined if the accountability over ARC funds was sufficient as required by applicable Office of Management and Budget (OMB) Circulars, if KHIC was in compliance with the requirements of the grant agreement, the ARC Grant Administration Manual, RBIP rules and regulations, the ARC Development Venture Capital Fund Application and Operating Guidelines, and if the objectives of the grant were being met.

METHODOLOGY: We reviewed the grant agreement and KHIC's work plan, ARC Project Guidelines, the ARC Grant Administration Manual, the ARC Development Venture Capital Fund Application and Operating Guidelines (DVC), RBIP rules and regulations, pertinent OMB circulars, and the ARC Code. We interviewed KHIC personnel including the chief financial officer and the controller.

All grant expenditures were tested to determine if the costs were within the approved budget, reasonable, and related to the grant. Matching costs were audited to determine if the costs were allowable, reasonable, and supported by adequate documentation. Receipts were tested to determine whether any program income was used to reduce grant program expenditures or to further the program, and if the use was approved by ARC.

We obtained an understanding of KHIC's accounting system and internal controls to determine if KHIC has the capability to accurately accumulate, record, and report revenues and costs associated with the grant.

We reviewed KHIC's interim progress reports, and supporting documentation to determine if the objectives of the grant were being met.

We conducted this compliance 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.

RESULTS: The following results are based on our audit of ARC Grant Number CO-15528-06 – Meritus Ventures.

## A. Costs Incurred and Program Results

During the course of the audit, we tested the direct and matching costs claimed by the grantee and reviewed program results. The costs incurred for the period from October 1, 2006 through March 31, 2010 were as follows:

| | |
|---|---|
| ARC expenditures | $ 419,740 |
| Matching expenditures | 9,777,410 |
| Total program costs | $10,197,150 |

Our audit indicated that some of the specific objectives identified in the grant were being achieved, while others were not (see table below).

| | Objective | Results as of 3/31/2010 | |
|---|---|---|---|
| Investments made in Appalachia | 4 | 3 | Y1 |
| Jobs created in Appalachia | 240 | 44 | N1 |
| Leveraging of additional (non-Meritus) investments | $ 9,000,000 | $ 15,651,909 | Y |
| Dollars invested in Appalahcian Kentucky | $ 900,000 | $ 2,428,363 | Y |
| Dollars invested in ARC-designated distressed counties | $ 600,000 | $ 0 | N |

Legend:
Y - Objective met
N - Objective not met
Y1 - Progress towards objective being made
N1 - Progress towards objective not being made

As of March 31, 2010, the fund had invested $6,391,140 ($5,971,400 net of ARC's investment of $419,740) in three firms located in Appalachia. Because the period of grant performance has 18 months to run (through September 30, 2011), we believe the grantee can achieve its objective of making four investments in Appalachia. Additionally, the three firms located in Appalachia had attracted additional outside (non-Meritus) investments of $15,651,909.

The grantee has met its commitment of investing $900,000 in Appalachian Kentucky by investing $2,428,363 in an Appalachian Kentucky firm.

1. Grant Objectives Not Met

The grantee has not met its commitment to invest $600,000 ($200,000 in ARC funds and $400,000 in matching funds) in ARC-designated distressed counties. With 84 percent of ARC grant funds expended, no investment has yet been made in any ARC-designated distressed counties. When questioned about the status of this investment commitment, the grantee said that they expected from the balance of funds available to Meritus Ventures (approximately $15,567,650, made up of additional investor capital from limited partners and net proceeds from future SBA debentures) that they would be able to meet their commitment to invest $600,000 in ARC-designated distressed counties.

The grantee, to date, has not met its objective of creating 240 jobs, as the three firms located in Appalachia have only created 44 jobs, as of March 31, 2010. However, we recognize the impact of the economy on the objective, and note the grantee's statement that the jobs created are mostly higher-than-average paying and provide health insurance benefits. In addition, the grantee was confident that the Fund will achieve the objective of investment in ARC designated distressed counties by September 30, 2011.

Recommendation:

We recommend that ARC require that $600,000 be invested in ARC-designated distressed counties by the end of the grant period, September 30, 2011, as agreed to by KHIC prior to approval of the grant or otherwise ARC's portion of the un-invested grant funds should be returned.

ARC's Response:

ARC concurred with our finding and will require that $600,000 be invested in ARC-designated distressed counties by the end of the grant period. ARC also noted that they would respond to a request from the grantee to extend the period of performance by reviewing the request on its merits, as they would with any other grantee (see **Appendix A – ARC's Response**).

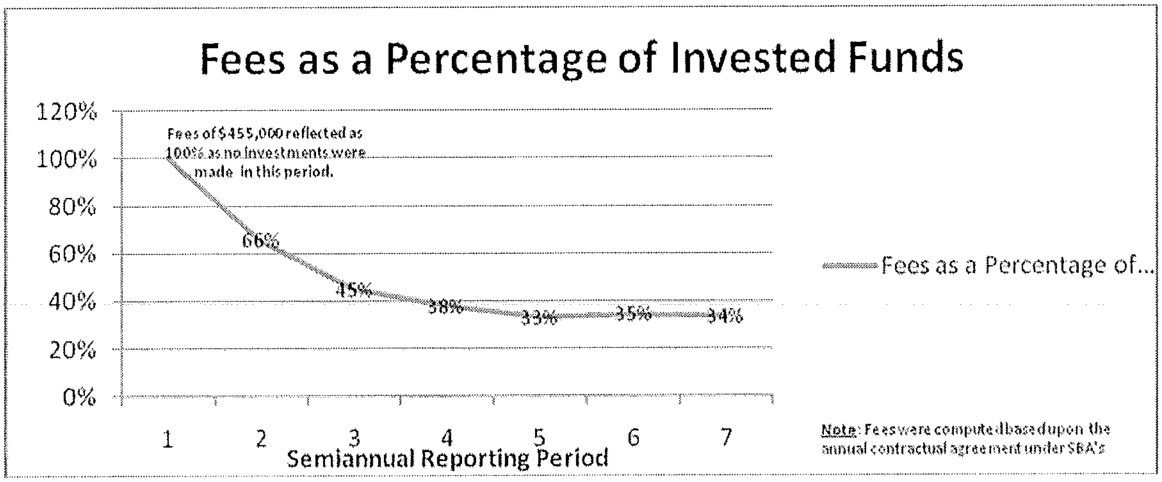
Auditor's Comment:

*ARC concurred with our recommendation and will require that $600,000 be invested in ARC-designated distressed counties by the end of the grant period. As a result, this recommendation is considered closed.*

## B. Other

2. Excessive Management Fees

As noted in the Background section of this report, Meritus Ventures pays annual management fees of 2.5 percent of the total amount of committed funds (both invested and un-invested), which is approximately $911,020 per year or $3,200,000 since the fund's inception in 2006, compared to investments made of $9,426,782, or 34 percent of funds invested in portfolio companies (see chart below). Accordingly, we believe that management fees are high relative to the amount invested and could have a negative impact on the desired grant outcomes by not providing an incentive to invest funds quickly and diminishing the funds available for investment.




The grantee stated that the management expenses must be and were approved by SBA, that the Fund was audited annually to ensure compliance with SBA regulations, and that management fees would be a higher percentage of total invested funds in the initial years. We note, the timeliness of the investment amount is a major determinant of the management fee percentage.

Recommendation:

We recommend that ARC evaluate the impact of high management fees and other grantee program incentives on ARC grant dollars and desired grant outcomes in making future grant determinations.

ARC's Response:

ARC concurred with our recommendation and stated that in their review of future grants involving venture capital funds, they will examine the extent to which ARC investments will be dedicated to program results rather than administrative costs (see **Appendix A – ARC's Response**).

Auditor's Comment:

*ARC concurred with our recommendation and will review future grants involving venture capital funds, examining the extent to which ARC investments will be dedicated to program results rather then administrative costs. As a result, this recommendation is considered closed.*

3. Grant Benefited a For-Profit Entity

Although the ARC grant was made to KHIC, a not-for-profit company, the money was under the control of Eclipse Management, LLC, the fund's general partner and a for-profit entity. Because of the common management of these organizations, the separation between them is questionable.

The ARC Code on Grant Administration, Section 8.1 B. (2) states: "**For-Profit Grants Ineligible.** Except as authorized under Section 207 of the ARDA, no ARC grant may be made directly to a for-profit entity."

Recommendation:

We recommend that ARC consider the eligibility of organizations for grants that include management control by for-profit interests.

ARC's Response:

ARC concurred with our recommendation and stated they will examine the relationships between grantees and for-profit entities in any future requests for grant assistance to venture capital funds (see **Appendix A – ARC's Response**).

Auditor's Comment:

*ARC concurred with our recommendation and stated they will examine the relationships between grantees and for-profit entities in any future requests for grant assistance to venture capital funds. As a result, this recommendation is considered closed.*

4. Federal Funds Used as Source of Capital

KHIC's grant application states the ARC's $500,000 grant would enable Meritus Ventures to obtain an additional $1,000,000 of leveraged financing from SBA's RBIP. However, RBIP rules and regulations do not permit federal funds from other government sources to be used as a source of capital for obtaining SBA financing. 7 CFR, Part 4290.230 (c) (3) states: *"Exclusions from Private Capital.* Private Capital does not include: ...Funds obtained directly or indirectly from the Federal government..."

In response, the grantee indicated SBA had approved the use of ARC funds, but provided documentation shows only approval pertaining to a different program fund, which is not an RBIP Fund. In addition, ARC cites its abilities to increase the federal share under the Appalachian Regional Development Act. Because of the aforementioned legalities, we believe ARC should work with SBA to resolve this issue.

Recommendation:

We recommend that ARC resolve this issue with SBA to determine if ARC funds can be used as a source of capital for the SBA match and accordingly update its records and policy manual concerning RBIP program investments.

ARC's Response:

ARC concurred with our recommendation and stated that in reviewing future grants involving restrictions of the kind contained in the RBIP, they will clarify for the SBA the permissibility of using ARC funds for this purpose (see **Appendix A – ARC's Response**).

Auditor's Comment:

*ARC concurred with our recommendation and in the future will clarify for the SBA the permissibility of using ARC funds in RBIP program investments. As a result, this recommendation is considered closed.*

*Tichenor & Associates, LLP*

Louisville, Kentucky
April 23, 2010

## APPENDIX A

## ARC'S RESPONSE

APPALACHIAN REGIONAL COMMISSION

*A Proud Past, A New Vision*

Date: June 6, 2011

To: Hubert Sparks, ARC Inspector General

From: Charles Howard, ARC General Counsel

Subject: Compliance Audit of KHIC Meritus Ventures (CO-15528)

This memorandum is the agency response to the above-referenced Office of Inspector General Report. In general, we concur with the recommendations contained in the report. Responses to the individual recommendations are set out below.

Recommendation No. 1: ARC will require that $600,000 be invested in an ARC designated distressed county or counties by the end of the grant period. We note, however, that we will respond to a request from the grantee to extend the period of performance by reviewing the request on its merits, as we would with any grantee.

Recommendation No. 2: We agree that the impact of management fees on ARC grant dollars and desired grant outcomes is a legitimate item for review in future grants involving venture capital funds and we will examine the extent to which ARC investments will be dedicated to program results rather than administrative costs in such grants.

Recommendation No. 3: We also agree that the organizational nexus between the ARC grantee and a for-profit entity should be examined carefully in light of the ARC Code restriction on providing grant assistance to a for-profit entity and we will review future request for grant assistance to venture capital funds with this in mind.

Recommendation No. 4: In accordance with the provisions of the Appalachian Regional Development Act (40 U.S.C. 14321(a)(4)), ARC funds are always available to increase the federal involvement in a project notwithstanding any law limiting the federal share. We agree with the auditor's recommendation on this point to the extent that, in reviewing future grants involving restrictions of the kind contained in the Rural Business Investment Program, we will clarify for the Small Business Administration the permissibility of the use of ARC funds for this purpose.

Thank you for the opportunity to provide this response and let me know if you have any questions.

1666 CONNECTICUT AVENUE, NW, SUITE 700 WASHINGTON, DC 20009-1068 (202) 884-7700 FAX (202) 884-7691 www.arc.gov

*Alabama Georgia Kentucky Maryland Mississippi New York North Carolina Ohio Pennsylvania South Carolina Tennessee Virginia West Virginia*