PERFORMANCE AUDIT

DEPARTMENT OF COMMERCE

Report to the Arizona Legislature
By the Auditor General
April 1993
93-3

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

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April 27, 1993

Members of the Arizona Legislature

The Honorable Fife Symington, Governor

Mr. James E. Marsh, Director
Department of Commerce

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Commerce. This report is in response to a December 13, 1991, resolution of the Joint Legislative Oversight Committee.

We found the Department's efforts to assist businesses in relocating to Arizona are rated favorably by the vast majority of those businesses contacting the Department. However, we found the Department needs to better monitor its efforts to determine the actual impact of its assistance on relocation decisions. We also found the Department can make several changes to improve its other operations. It can ensure greater long-term economic benefit to the State by awarding more of the Commerce and Economic Development Funds to existing small Arizona businesses. It can improve the Small Business Administration loan program by privatizing the function. Finally, it can help avoid controversy by developing more specific policies governing entertainment and promotion expenditures.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on April 28.

Sincerely,

Douglas R. Norton
Auditor General

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SUMMARY

The Office of the Auditor General has conducted a performance audit and Sunset Review of the Department of Commerce, pursuant to a December 13, 1991, resolution of the Joint Legislative Oversight Committee. The audit was conducted as part of the Sunset Review set forth in Arizona Revised Statutes §§41-2951 through 41-2957.

The Department of Commerce, formerly the Office of Economic Planning and Development, was established in July 1985. The Department is charged with promoting and enhancing the economic growth and development of the State. The Department's responsibilities and activities range from attracting new business to the State and assisting communities in their economic development efforts to promoting energy conservation and technology development.

The Commerce And Economic Development Commission Needs To Improve The Controls Governing Its Award Decisions (see pages 7 through 16)

The Commerce and Economic Development Commission (CEDC) needs to improve the controls governing its decisions to award State economic development funds. In 1989, the Legislature created the CEDC to oversee the Department of Commerce in administering the Commerce and Economic Development Fund (which receives between $3 million and $5 million annually from the State Lottery scratch games). The fund was established to expand economic activities in Arizona by providing financial assistance for business expansion, retention, and location in the State.

CEDC has inconsistently applied its loan criteria, which at a minimum gives the appearance of unfairness. For example, some applicants have been denied funds for reasons such as not having 50 percent bank participation or for having less than two years of operating history (considered a start-up business), while other businesses were approved when they did not meet those same criteria. Further, although Commission guidelines indicate that 64 percent of Fund receipts will be targeted for existing small- to medium-sized Arizona businesses, less than 21 percent of the funds committed as of February 1993 had gone to such businesses. The Commission should develop Administrative Rules that clearly state its application and decision-making process, and award criteria.

State-Run Loan Program
Should Be Privatized (see pages 17 through 23)

The State is paying too much for a program that issues too few small business loans. The U.S. Small Business Administration (SBA) authorizes local Certified Development Companies (CDCs) to administer its 504 loan program, which provides low interest loans to small businesses. The statewide SBA 504 program is overseen by the Arizona Enterprise Development Corporation, a CDC which is a private nonprofit corporation. However, the program is housed in and staffed by the Department of Commerce; thus, the operating expenses of this nonprofit corporation are primarily State funded. Historically, this CDC has been extremely unproductive, issuing a total of two loans in 1990-91. Although it increased its loans to 11 in 1991-92, a similar-sized private CDC to which we compared it issued 38 loans per year. Because the volume of loans has been low, Arizona has not been getting its fair share of SBA 504 loans - leaving Arizona businesses underserved. Further, Commerce's cost per loan is nearly $13,000, or over twice the $4,000 to $5,500 cost per loan experienced by three private CDCs we reviewed. For the benefit of both taxpayers and small businesses in Arizona, the State should privatize the function.

The Department Of Commerce Should Identify And Pursue Changes That Positively Influence Businesses' Decisions To Locate In Arizona (see pages 25 through 29)

The Department of Commerce should continue to identify and pursue changes that would convince businesses to move to or expand into Arizona. In recent months, the Department has seen an increase in the number of businesses that have announced moves to Arizona. Because so many factors and players impact businesses' location decisions, it is difficult to pinpoint the Department's impact on these decisions. However, by surveying clients, the Department would be better able to monitor changes needed to improve its service, as well as being able to identify changes needed to improve Arizona's overall business climate.

Policies Are Needed To Govern Entertainment And Promotional Expenditures (see pages 31 through 35)

The Department of Commerce lacks well-defined policies for handling unique expenditures. Because the Department is charged with promoting and enhancing the economic environment of Arizona, it has traditionally been allowed to expend State funds in areas (such as entertainment and promotion) that are generally prohibited in other State agencies. However, we found that these expenditures frequently do not include a business client, but instead involve board or commission members, and economic development or utility officials. Other states also expend monies for entertainment and promotion, but often restrict these expenditures to instances wherein a prospective business client is included. The Department should develop specific policies to govern these unique expenditures.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit and Sunset Review of the Department of Commerce, pursuant to a December 13, 1991, resolution of the Joint Legislative Oversight Committee. The audit was conducted as part of the Sunset Review set forth in Arizona Revised Statutes §§41-2951 through 41-2957.

The Department of Commerce, formerly the Governor's Office of Economic Planning and Development, was established in July 1985. The Department is charged with promoting and enhancing the State's economic growth and development. Its responsibilities and activities range from attracting new business to the State and assisting communities in their economic development efforts to promoting energy conservation and technology development.

Organization

To perform its responsibilities, the Department is organized as follows:

- **BUSINESS DEVELOPMENT** - This division's efforts focus on attracting new business and industry, and supporting the retention and expansion of existing businesses.

- **FINANCIAL SERVICES AND HOUSING DEVELOPMENT** - This division's function is to advocate improved infrastructure and housing throughout the State and coordinate the availability of Federal and State financing programs available for businesses.

- **COMMUNITY ASSISTANCE SERVICES** - This division provides technical assistance, direct hands-on assistance, and training to communities in a variety of areas.

- **COMMUNICATIONS AND RESEARCH** - This division provides research, information, and marketing services for the Department of Commerce.

- **ENERGY OFFICE** - This office consists of four units, whose activities include energy conservation and education programs and technical assistance to the State and businesses for developing energy-efficient technologies. It also oversees grants and the use of millions of Federal and oil overcharge monies.

- **INTERNATIONAL TRADE AND INVESTMENT** - This division's objective is to facilitate job growth in Arizona by assisting in developing exports and promoting reverse investment from outside the United States.

- **MOTION PICTURE DEVELOPMENT OFFICE** - This division was created to encourage the motion picture and television industry to film in Arizona. The Motion Picture Development Office provides a wide range of services and information to production companies who are filming or considering filming in Arizona.

- **OFFICE OF SPORTS DEVELOPMENT** - This office works to attract and retain professional sports teams and sporting events making Arizona a major site for sporting activities.

- **ADMINISTRATION AND FINANCE** - The division supports the department's planning and operational needs. It includes the director's office and administrative support services such as personnel, management information systems, and fiscal services.

In addition to the Department's internal organization, there are several advisory groups assisting the Department. Some of these groups include the Commerce and Economic Development Commission (CEDC), the Solar Energy Advisory Council, and the Governor's Motion Picture and Television Board and Advisory Committee. The CEDC has oversight authority for the CEDC loan program and the Solar Energy Advisory Council assists the Department in establishing and implementing solar energy policy for the State. The Governor's Motion Picture and Television Board and Advisory Commission assists in developing policy and promoting and expanding the film industry in Arizona.

Budget and Personnel

The Department's operating budget consists of both appropriated and nonappropriated funds. The Department expended approximately $5 million in appropriated funds and $17.5 million in nonappropriated funds in Fiscal Year 1991-92. Of the appropriated monies, approximately $3.6 million was from General Fund monies and $1.1 million from lottery revenues, with the remaining coming from specific funds such as bond and housing trust monies.

TABLE 1

DEPARTMENT OF COMMERCE
Actual and Estimated Expenditures
Appropriated Funds
Fiscal Years 1990-91, 1991-92, and 1992-93
(unaudited)

	1990-91 (Actual)	1991-92 (Actual)	1992-93 (Estimated)
FTE Positions	72.0	69.0	67.0
Personal Services	$2,088,000	$1,816,500	$1,877,700
Employee-Related Expenses	438,600	377,800	398,800
Professional & Outside Services	188,700	196,300	206,400
Travel, In-State	68,400	67,000	62,900
Travel, Out-of-State	96,500	44,200	91,800
Other Operating	597,900	663,400	684,500
Capitalized Equipment	167,000	105,700	9,700
Below-the-Line Expenses(a)	1,661,200	1,753,700	2,262,600
Total	$5,306,300	$5,024,600	$5,594,400

(a) These "Below-the-Line" expenses include salaries, grants and matching funds, consultant costs and promotional expenses for more than a dozen special programs ranging from the Asian Pacific Trade Office to solar energy projects.

Source: Department of Commerce Executive Budget Request for Fiscal Year 1992-93 and Fiscal Year 1993-94

In Fiscal Year 1991-92 the nonappropriated funds accounted for 78 percent of expenditures. (See Table 2, page 4.) Approximately one-half of the FTE positions are budgeted from the nonappropriated funds. The three largest sources of these monies were Federal funds ($8.5 million), the Oil Overcharge Fund ($4.4 million), and the State Housing Trust Fund ($3.3 million). These funds generally have designated purposes outlined in statute, by grant, or in the settlement stipulations. More than one-half (approximately $9 million) of the expenditures were pass-through monies going largely to non-State entities, such as grants to local communities and private organizations.

TABLE 2

DEPARTMENT OF COMMERCE
Actual and Estimated Expenditures
Nonappropriated Funds
Fiscal Years 1990-91, 1991-92, and 1992-93
(unaudited)

	1990-91 (Actual)	1991-92 (Actual)	1992-93 (Estimated)
FTE	73.7	61.7	62.0
Personal Services	$ 1,486,600	$ 1,679,500	$ 1,771,700
Employee-Related Expenses	316,600	364,400	426,100
Professional & Outside Services	866,900	980,800	3,403,300
Travel, In-State	36,100	35,800	50,400
Travel, Out-of-State	75,400	57,700	82,400
Other Operating	694,300	935,400	1,177,900
Capitalized Equipment	193,700	37,400	48,700
Below-the-Line(a)	3,393,400	3,958,200	13,604,000
Indirect Costs	174,000	140,000	166,400
Transfer & Refunds	35,000	400	0
Pass-Throughs(b)	3,595,100	138,600	200,000
Pass-Throughs(c)	9,147,800	8,993,200	14,938,400
Land & Capital Projects	0	171,500	1,200,000
Other	525,100	0	0
Total	$20,540,000	$17,492,900	$37,069,300

(a) These "Below-the-Line" expenditures include CEDC loans and Housing Trust Fund awards.
(b) To other State Agencies
(c) To non-State agencies.

Source: Department of Commerce Executive Budget Request for Fiscal Years 1992-93 and 1993-94.

Audit Scope

Our audit report of the Department presents findings and recommendations in four areas.

- The need for improvement in the CEDC loan program
- The need for improvement in the Small Business Administration loan program
- The need to strengthen the business recruitment program

- The need for policy and better documentation for entertainment and promotional expenditures

In addition to these audit areas, we present a section of other pertinent information that includes information on the Energy Office and needed changes with the depletion of the oil overcharge monies (see pages 37-39). In addition, the report contains a response to the 12 Sunset Review Factors for the Department (see pages 41-45), and also Sunset Factors for the Economic Planning and Development Advisory Board (see pages 47-49) and the Solar Energy Advisory Council (see pages 51-53).

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Director and staff of the Department of Commerce for their cooperation and assistance throughout the audit.

FINDING I

THE COMMERCE AND ECONOMIC DEVELOPMENT COMMISSION NEEDS TO IMPROVE THE CONTROLS GOVERNING ITS AWARD DECISIONS

The Commission needs to improve the controls governing its decisions to award State economic development funds. The Commission has inconsistently applied its loan criteria and is not awarding sufficient funds to the small Arizona businesses for which it is intended. Additionally, the Commission should become more actively involved in the program it is charged to oversee. To ensure that applicants are guaranteed a fair review and that funds are reaching the appropriate businesses, administrative rules should be developed.

Background

In 1989, the Legislature created the Commerce and Economic Development Commission (CEDC) to oversee the Department of Commerce in administering the Commerce and Economic Development Commission Fund.[1] The Fund is to expand economic activities in Arizona by providing financial assistance for business expansion, retention, and location in the State. According to CEDC guidelines, the majority of funds are intended to provide low-interest loans to for-profit businesses. However, statutes additionally allow loans, grants, and other types of assistance to nonprofit economic development groups, political subdivisions, the State, tribal governments, and the universities. According to Commission reports, from the Fund's inception through February 1993, the Commission has had $9,189,909 available for financial assistance, of which they have committed $6,046,030 to 26 organizations.[2] Approximately $5 million is expected from Lottery revenues in Fiscal Year 1992-93 (of which $1.4 million was appropriated to the Commerce operating budget). Although Lottery revenues are not certain, the Fund is expected to receive between $4 million and $5 million annually. Return of the principal and interest also adds to the Fund balance.

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1 The Commission consists of four members appointed by the Governor, as well as the director of the securities division of the Corporation Commission, and the director of the Commerce Department, who, by statute, is the CEDC chairman.

2 In addition to the funds available for business assistance, over $2.7 million in CEDC funds were appropriated to the Department of Commerce budget and another $850,000 of the funds went to one-time mandated economic development activities.

Arizona statutes are very broad with regard to the use of the CEDC Fund, giving the Commission almost total discretion in its decisions. However, the Commission has adopted program guidelines designed by a consultant from the National Development Council in Washington D.C. The guidelines, based on input from economic development experts around the State, provide an overall structure for the award decisions, defining the categories of businesses the funds should go to, and general criteria the businesses must meet. However, the guidelines are not binding and do not restrict the commission from making selected awards which may not fit the loan criteria.

Broad Guidelines May Result In Inconsistent Loan Award Decisions

Operating with broad guidelines leads to inconsistencies in CEDC loan decisions that at a minimum, give the appearance that some award recipients receive special consideration. Because Arizona statutes mandate that all information in the CEDC loan application files is confidential, specific references to individual companies or an analysis of each award is not presented. However, the similar characteristics of businesses denied and receiving loans, and the violation of CEDC guidelines in some cases, gives the appearance of unfairness in award decisions.

Commission loan awards appear inconsistent - The Commission lacks written criteria as to what criteria must be met to receive a CEDC award. However, through our review of applicant files and loan denial correspondence as well as interviews with Commerce loan staff and applicants, we found the following criteria are commonly used as the basis to deny or disqualify applicants:

- The company must not be a start-up operation;
- CEDC funds must be leveraged by 50 percent private sector participation;
- Funds are not for working capital but must be used for and collateralized with fixed assets;
- The company must show that it has adequate cash flow and profitable operations; and
- Funds are to provide capital to businesses that cannot get funding from other sources.

During our review of loans, however, we identified businesses approved for loans who did not meet the criteria applied to other applicants who were denied loans.

For example, in our review of eight companies receiving CEDC awards, we found one or more of the following characteristics:

- The company was being newly created;
- The company did not have 50 percent private sector financing;
- The company's debt was not collateralized with land, building or equipment;
- The company had a history of operating losses; or
- The company had existing available credit and as such did not need the loan.

In addition to appearing inconsistent, in a few cases the process followed produced an appearance of special treatment, as illustrated in the following examples.

- One applicant, who appeared to be a viable candidate for a loan, told us that he had decided to drop the process, in part because of the amount of effort it would take to complete the tax revenue calculation required in the application. (Applicants are asked to project the increase in tax revenues to the State and local jurisdictions if their loan is awarded.) However, we identified loan recipients who did not complete this section of the application, and it appeared Commerce calculated it for them.

- An internal memo suggested discussing a loan with the Commission prior to the applicant submitting an application to determine whether the CEDC members *"supports the idea in concept, and if so, have the staff begin the credit review."*

- An applicant approved for a loan was taken at his word that other funding sources had been exhausted, while other applicants provided documentation (such as letters from banks) as required by the application.

Any appearance of favoritism or special treatment may reduce the program's effectiveness by discouraging existing small Arizona businesses from applying for the very funds created to assist them.

CEDC Funds Are Not Getting To The Businesses That Most Benefit The State

CEDC 's guidelines were designed to direct monies to those businesses that would most benefit the State. CEDC's guidelines, based on input from economic development experts throughout Arizona, suggest that most funds should be directed to existing small- to medium-sized Arizona businesses. However, our analysis shows that less than 21 percent of the $6.04 million committed has gone to these businesses.

Guidelines designate the majority of funds for existing Arizona small businesses - Prior to the development of the Commission's guidelines, a consultant with the National Development Council interviewed businesses, lenders, and economic development experts across the State to assess Arizona's needs. According to the consultant, the majority of the CEDC funds should be made available to the companies that are going to benefit the State the most in the long run, which are the small, expanding Arizona businesses. The guidelines state that over 80 percent of all new jobs come from firms employing less than 100 people, and the cost of creating these jobs in Arizona is 10 percent the cost of creating a job in a large corporation. The guidelines suggest that approximately two-thirds of the CEDC funds be dedicated to existing Arizona small- and medium-sized businesses. Specifically, the Commission's guidelines state:

> *...The greatest part of the fund, then, is designed to provide expansion capital for existing Arizona small businesses who need affordable financing to invest in plant and equipment. These firms will have the greatest impact on Arizona's tax base, and they will produce the greatest number of permanent private sector jobs.*

In addition to funding existing small- and medium-sized businesses, the guidelines also provide goals for other loan types. These loan types include:

- Business location assistance to provide financial assistance for out-of-state firms wanting to locate or expand in Arizona;

- Venture capital for Arizona businesses; and

- Project monies for disadvantaged areas of the State, or for taking defensive action to keep a company from moving out of Arizona.

However, the guidelines intentionally emphasize aid to existing small- and medium-sized businesses over funding for these other loan types.

Less than 21 percent of funding getting to existing Arizona small businesses - The Commission's goal is that approximately 64 percent of CEDC funds will go to healthy Arizona small- and medium-sized businesses needing money for expansion.[1] However, as shown in Table 3 (see page 12), our review of CEDC loans shows that less than one-fourth of the $6.04 million in Fund commitments have been made to these businesses. Instead the majority of the CEDC Fund dollars have gone to large businesses (24.4 percent) or businesses expanding or relocating to Arizona from other states (42.8 percent).

Commerce has increased efforts to market CEDC loans - According to Commerce officials, efforts are being made to market the CEDC program throughout Arizona. The Commerce Director stated that he and other Department officials tout the program in speeches made throughout the State. In addition, the Department has hired a marketing representative to identify appropriate businesses for CEDC funds, and to encourage these business owners to apply for such funds. The Commerce Director indicated, however, that few Arizona small businesses are applying for these loans.

Because the Department does not track the number of inquiries, applications, or denial reasons, we were unable to determine whether the volume of small businesses applying was indeed low. However, because most of the Statewide visibility of the program has occurred when the Department made loans to major large corporations, small business may perceive the program as being oriented to large businesses. Therefore, more action may be needed to enhance the program's

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1 The goal of 64 percent includes the goal of 55 percent in the Retention category and 9 percent in the Production Financing category, another type of loan designed to assist existing small businesses in Arizona.

TABLE 3
CEDC Loans and Grants Awarded
November 1989 through February 1993

Assistance to Existing Small Arizona Businesses:

Ferrell Secakuku	$ 42,000
K-Tronics	70,000
Project PPEP	157,500
Smith and Bell	85,000
Urban Coalition West	80,000
Yavapai Block	300,000
Signature Industries	76,000
Navi-Hopi Tours	25,530
Riotech, Inc.	100,000
Barnjo, Inc.	50,000
Jack of All Trades	25,000
Lakeside Entertainment Group, Inc.	150,000
Crossroads Automart	105,000
TOTAL	$1,266,030

Percentage of Awards to Category: 20.9 Percent

Assistance to Existing Large Arizona Businesses:

Evergreen Air Center	$ 230,000
Capin Mercantile	250,000
America West Airlines	1,000,000
TOTAL	$1,480,000

Percentage of Awards to Category: 24.5 Percent

Assistance to Businesses Relocating From Other States:

Eurofresh, Inc.	$ 400,000
AACCO Foundry	140,000
Muscular Dystrophy Association	1,000,000
Atlas Headware	100,000
Monsey Products	250,000
McDonnell Douglas Travel	700,000
TOTAL	$2,590,000

Percentage of Awards to Category: 42.8 Percent

Other:

Arizona Economic Council	$ 60,000
Arizona Technology Incubator	300,000
Coronado Venture Fund	200,000
First Commerce and Loan	150,000
TOTAL	$ 710,000

Percentage of Awards to Category: 11.7 Percent

Source: Auditor General Analysis of loan information provided by the Department of Commerce.

credibility. One national expert cautions that unless the program is perceived as a program which is truly open and supportive of small businesses, most small business owners will not bother to apply. Thus, the Department needs to continue, and expand, its efforts to deliver CEDC loans to small businesses.

More Commission Involvement Needed in Decision Making

The Commission should have a more active role in the award decisions. In the current process, the Commission may not see important information that could affect its decisions. Additionally, Commerce staff appear to be taking actions that should be reserved for the Commission.

Commission may not see important information - The Commission may not be aware of important information in the applications of the businesses it approves for loans. Our review of loan files revealed the following instances where information that may have affected the Commission's decision to approve a loan was not brought forward.

- **Example 1** - Between the time of Commission approval and the disbursement of funds, a loan applicant was required to notify the Commission of any changes affecting the status of another funding source. Although a major change did occur with regard to capital requirements, it was not reported by the applicant, and the Commerce loan officer had documentation that the applicant had been informed of the change. The loan officer advised Commerce management, recommending that it be brought to the Commission. Commerce management chose not to bring the matter to the Commission and the funds were disbursed the next day.

- **Example 2** - In another loan, in which the applicant had a three-year history of operating losses, internal Commerce documentation differed from that presented to the Commission. There were three different versions of the credit analysis prepared (all on the same day) by Commerce business finance staff. The first stated as an unfavorable factor that there was *"insufficient cash flow to service existing or proposed debt."* The final version presented to the Commission on that same day stated, *"There is adequate projected cash flow to repay existing and proposed CEDC obligations."*

In addition, Commerce staff sometimes act as the decision maker in place of the Commission. For example, Commerce staff amended the terms and conditions of a CEDC loan without Commission approval. The Commission awarded a loan to a business which operated a small-business loan program. The second distribution of funds to the loan recipient was contingent upon satisfactory performance in the first phase of its small business loan program. The terms of the CEDC loan document specified the definition to be used by the loan recipient to qualify loans from its program as delinquent and specified the maximum percentage of delinquent loans allowed in order to receive the second CEDC distribution. Commerce staff amended these conditions, making them more lenient to the loan recipient. We asked if the amended document had been brought to the Commission and were told that the changes were not of sufficient materiality to require them to go to the Commission. However, there are no written policies that define what parts of a loan agreement are considered material.

Finally, Commerce staff have significant control in determining who will get CEDC funds. Commerce staff select the applications to be presented to the Commission and have the authority to disqualify and deny CEDC applicants. Since there is no scoring of applications and the guidelines are flexible, the staff have a great deal of discretion in which loans will be presented to the Commission. Further, there are no standard record-keeping mechanisms documenting these decisions and no required reports to the Commission that summarize the number of and reasons for the denials.

The Commission Needs To Adopt Administrative Rules

Administrative rules are needed to provide structure and direction for the State's multi-million-dollar economic development fund. The Commission currently has no written policies or rules that govern the decision-making process other than general guidelines that the Commission is not bound to adhere to. Rules will help ensure that award decisions are based on objective criteria and protect the Commission from criticism and potential lawsuits.

Rules are needed for CEDC program administration - The agency's Attorney General representative made a written recommendation to the Commission in July 1992 that administrative rules were necessary to establish the procedures and criteria governing the award decisions. The attorney advised the Commission to suspend additional awards until the rules were adopted. After discussions with Commerce and the Commission, the Attorney General representative withdrew the recommendation that the Commission cease making awards, but advised: 1) that they begin developing rules and 2) in the meantime, adhere as closely as possible to the National Development Council guidelines. As of December 1992, little work has been done in the drafting of rules.

Not only would rules improve the perception of fairness, they would reduce the likelihood that the Commission could be successfully sued for discrimination or other legal violations. Already a group of taxpayers who question the appropriateness of a CEDC loan decision has hired an attorney and filed a Taxpayer

Request questioning the constitutionality of the CEDC Fund and the Commission's operations. One of the contentions of the affidavit is that Administrative Rules are required.

Rules should define the award process and the criteria - Much of the content of administrative rules can reflect and give teeth to the guidelines currently in place. However, some program aspects will need to be more clearly defined. Rules should address the following program areas:

- **APPLICATION AND DECISION-MAKING PROCESS** - Rules should define the process through which an application is evaluated and reviewed by the Commission. If Commerce staff have authority to pre-screen and disqualify unsuitable applicants, the criteria must be clearly specified and auditable records should be kept of pre-screening decisions. Rules should outline procedures for processing applications for Commission review, specifying the decision points and the authority for such decisions. Record-keeping requirements should be delineated.

- **AWARD CRITERIA** - The evaluation criteria should be specified for each program category. The Commission should consider which of the current criteria they will require, versus those which are less important and, although preferred, may be waived under specified circumstances (such circumstances should be outlined in written policy). Key terms used to describe the criteria should be defined, such as: small business, start-up, profitable operations, acceptable collateral, etc.

- **DEFINITION OF THE DISTINCT PROGRAM CATEGORIES AND FUNDING GOALS** - Using the current guidelines as a framework, the program categories and funding goals for each should be clearly defined. The Commission should consider measures to force stronger adherence to its funding goals for program categories.

RECOMMENDATIONS

1. The Commission should immediately begin to draft administrative rules governing the application and decision-making processes used to award CEDC funds. The rules should include (but not be limited to) the following:

   - Definition of the authorities of the Commerce staff and the authorities of the Commission, i.e., what decisions can be made by Commerce and what decisions must come to the Commission.

   - Definition of the award criteria for each category of business eligible to receive awards. The criteria should be sufficiently objective that minimal discretion is needed to determine if a business is qualified to apply. If some criteria may be waived, for example, the requirement of 50 percent bank participation, the rules should specify under what conditions the criterion may be waived.

2. The Commission should be more involved in denial decisions. At a minimum, the Commission should be informed of those businesses denied funding, and the reasons for denials.

3. The Commission should begin to emphasize loans for the smaller Arizona businesses for which the funds are intended.

FINDING II

STATE-RUN SBA LOAN PROGRAM SHOULD BE PRIVATIZED

The State is paying too high a price for administration of Arizona's SBA 504 small business loan program. Additionally, small businesses in Arizona are underserved due to the low volume of loans produced by the Commerce-staffed organization. For the benefit of both taxpayers and small businesses in Arizona, the State should privatize the function.

Background

The U.S. Small Business Administration (SBA) authorizes local Certified Development Companies (CDCs) to administer its 504 loan program that is an important source of capital for small businesses. The 504 program provides low-interest loans to small businesses for purchases of buildings, land, or equipment up to $2 million.[1]

The Department of Commerce houses and staffs the statewide SBA 504 loan program. Although no State funds are used for the loans, the majority of the program's operating expenses, including salaries of more than four staff positions, are State funded. The entity authorized by SBA as the statewide CDC, however, is not Commerce but the Arizona Enterprise Development Corporation (AEDC), a private, nonprofit corporation. While the activities of the statewide 504 loan function are carried out under the auspices of AEDC, AEDC is essentially a small board with no operations or revenue outside the Commerce-staffed program.[2] The current president and executive director of AEDC are Commerce employees.

Arizona has two other CDCs. Both at one time received government support but are now self-supporting. The Business Development Finance Corporation (BDFC), headquartered in Tucson, has concurrent jurisdiction with Commerce for areas east and south of Phoenix. The Phoenix Local Development Corporation (PLDC) provides

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1 Construction and remodeling expenditures may also be funded by a 504 loan. Additionally, in specially designated rural areas, the loan amount may be as high as $2.5 million. Loan amounts are typically between $500,000 and $2 million.

2 AEDC generates revenue from the fees it is allowed to collect from origination and servicing of SBA 504 loans. However, it is State-funded loan officers who currently perform the loan origination and servicing functions.

504 loans for businesses within the city's boundaries. The Commerce program has exclusive jurisdiction in the portion of the State not served by the other CDCs.

The Certified Development Companies serve two primary functions for the SBA program. First, they get the funds to the designated businesses through their marketing and outreach efforts. Second, the CDCs underwrite the SBA portion of the loan, protecting the SBA funds by ensuring the applicant's creditworthiness.[1]

Commerce Produces Low Volume of Loans Leaving Arizona Businesses Underserved

The Commerce CDC has been extremely unproductive through the years, leaving Arizona businesses underserved by the SBA 504 program (although increasing the volume of loans in 1992). The SBA has put the CDC on probation, giving them two years to increase the volume of loans. Additionally, there are quality problems with the loan packages submitted.

Commerce produces extremely few loans - Historically, the volume of Commerce 504 loans approved by SBA has been low. Although there are approximately four staff positions dedicated to the program, with the exception of this past year (Federal Fiscal Year 1991-92) in which 11 loans were approved, Commerce has not had more than 7 loans approved by SBA annually.[2] During the three Federal Fiscal Years 1989-90 through 1991-92, Commerce had 3, 2, and 11 loans approved, respectively. In Federal Fiscal Years 1985-86 and 1987-88, only one loan per year was approved.

In July 1992, the SBA categorized the Commerce 504 program as 'marginally active' and gave it two years to increase the volume of loans.[3] The following analysis was included in the SBA decision:

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1 The SBA provides up to 40 percent of the funding. Fifty percent of the project funds are provided by a bank or financial institution that is protected by having the first lien position on the fixed assets required as loan collateral (generally land or buildings). No State monies fund the 504 loans; the remaining 10 percent is provided by the applicant.

2 This is based on Federal Fiscal Years 1984-85 through 1991-92. Data from earlier years were not provided by SBA.

3 The Phoenix Local Development Corporation was also given two years to increase its loan volume.

TABLE 4

Annual SBA 504 Loans Per Million in Population
Comparison of Three Arizona CDCs to Region and Nation

Federal Fiscal Year	Commerce (AEDC)	Phoenix (PLDC)	Tucson (BDFC)	Arizona	Region	US
1989	3.0	3.1	12.0	4.6	6.0	5.0
1990	1.5	3.1	22.5	5.7	8.0	6.6
1991	1.0	3.1	16.5	4.4	7.2	6.3

Source: U.S. Small Business Administration

Although Commerce increased its 504 approvals significantly in Federal Fiscal Year 1991-92, its productivity is still far less than some other CDCs.[1] The average number of loans per staff position at the other three CDCs is between 8 and 12.[2] Commerce, on the other hand, is generating less than three loans per staff position annually. Furthermore, in the two Fiscal Years prior to 1991-92, the average number of loans was less than one per staff position annually.

Commerce 504 program leaves Arizona businesses underserved - SBA officials expressed concern that Arizona was not getting its fair share of SBA 504 loans. According to an SBA official in Washington, most of Arizona's activity is attributable to the CDC in Tucson (BDFC). Commerce, however, is chartered as the statewide CDC; and prior to July of 1992, had exclusive jurisdiction in all areas of the State, except the City of Phoenix and Pima County. When the Commerce program was put on probation for low loan volume, the SBA expanded the territory of the Tucson-based CDC, which now shares territory with Commerce in much of southern Arizona and parts of Maricopa County.

There are still a number of counties in the State for which Commerce is the only source of SBA 504 loans; for example, Yuma, Coconino, and Yavapai. Commerce is also the only source of 504 loans for cities in the northern and western Phoenix

1 Commerce management attributes the improvement to increased marketing efforts and to increased management commitment to the 504 program.

2 Table 5, page 21, shows the number of loans generated by Commerce and three other CDCs for Federal Fiscal Year 1991-92 and the staff positions dedicated. Dividing the number of loans by the staff positions results in the following annual loan volume per staff position; Commerce - 2.7, Tucson-based BDFC - 8.0, Nevada statewide CDC - 9.6, and the Utah statewide CDC - 12.6.

Metropolitan area, such as Glendale, Scottsdale, Peoria, etc. According to SBA historical data, only three 504 loans have been made in Coconino County and only three in Yuma. In 1991, a California CDC requested SBA permission to serve Yuma and La Paz County, but although SBA acknowledged that the counties had not received the appropriate attention, it decided to give Commerce the opportunity to prove they can effectively cover the market. The California company was told that Commerce should be producing about six loans a year in this area of the State.

Quality of work is also an issue - The low volume of loans is not the only concern with the Commerce 504 program -- there appear to be significant quality concerns as well. We interviewed people in the district SBA office who were in a position to review Commerce's product as well as the product of the other Arizona CDCs. The Commerce work is viewed as substandard. One official said that the local SBA office spends four to five times the effort on a Commerce loan compared to that on a loan from the Tucson-based CDC, and that there are questions on 70 to 90 percent of the Commerce loans.

During the audit, we reviewed correspondence (obtained from the department) between SBA and Commerce pertaining to loans approved in State Fiscal Years 1990-91 and 1991-92. We found that the local SBA has regularly pointed out deficiencies in the quality of Commerce work. The following are examples from this correspondence. Each case pertains to a different loan application.

- One SBA letter to Commerce had four pages detailing loan application deficiencies, including such problems as an applicant being ineligible as the loan was structured, lack of clarity as to whether one of the parties was a start-up or a franchise, and the SBA was unable to determine what businesses were to occupy the building.

- A letter from SBA points out that although the CDC is responsible for an accurate credit and financial analysis that *"in this case, little if any financial or credit analysis was presented for review."* The letter points out that the financial statements were more than 90 days old, and one of the balance sheets was inaccurately completed.

- One memo from a Commerce loan officer to Commerce management detailed a telephone call from a local SBA representative after receipt of a 504 loan application wherein Commerce had listed pillows and linens on a balance sheet. The SBA official was reported to have said, *"Does anyone over there ever read the SOPs (Standard Operating Procedures)? Do you think these items will last ten years?"*

High Cost For Substandard Program

The State's cost to produce an SBA 504 loan through Commerce is two to three times greater than the cost at other CDCs. We calculated the cost per 504 loan at Commerce, at BDFC headquartered in Tucson, and at two productive statewide CDCs in Utah and Nevada.[1] As shown in Table 5, based on the number of loans approved by SBA in Fiscal Year 1991-92 and the salaries of the staff positions dedicated to the programs, the Commerce cost per loan is $12,813--far more than that of the other CDCs.

TABLE 5

Cost Per SBA 504 Loan
Department of Commerce and Three Other CDCs

Development Company	Number of Loans Approved by SBA Federal FY 1991-92	Number of Staff Positions Dedicated	Gross Annual Pay	Cost Per Loan
AEDC-Commerce	11	4.08	$140,938	$12,813
BDFC-Tucson	16	2.00	71,850	4,491
NSDC-Nevada (Statewide CDC)	38	3.95	210,750	5,546
Deseret-Utah (Statewide CDC)	93	7.40	376,000	4,043

Source: Auditor General staff analysis. Annual loan volume provided by SBA in Washington. Staffing and salary information provided by individual CDCs.

State Funding Should Be Eliminated And The Program Should Become Self-Supporting

State funding for the SBA 504 program should be phased out. The program is poorly serving Arizona small businesses and the function could be performed more effectively and at a lower cost by a private organization. According to one SBA

[1] BDFC and the Utah CDC (Deseret) are self-supporting, private nonprofit companies. The Nevada CDC (NSDC) is a private, for-profit organization, also self-supporting. The Nevada and Utah CDCs were selected because of their proximity to Arizona, and their similar rural/urban business loan needs and characteristics.

representative, the healthy evolution of a CDC involves gradually lessening its government support until it is self-supporting.[1] While an SBA official in Washington said the SBA is reluctant to compare the productivity of government-run CDCs to private CDCs, he said that of the top 20 producers in the country, he could think of only one with ties to government.

The State should eliminate funding for the 504 function within Commerce, which would force AEDC to become self-supporting. Both of the other Arizona CDCs began using government funding but are now independent of government support. Both the statewide CDCs in Nevada and Utah, which are far more productive, (see Table 5), are also independent of government support. Since AEDC is a nonprofit entity given CDC status by the SBA, the State cannot abolish AEDC. However, since AEDC is almost totally dependent on State funding, the elimination of State funding would essentially force AEDC to become self-supporting.[2] AEDC has at least two alternatives to serve statewide 504 needs independently of State funding:

- One is a voluntary merger between AEDC and BDFC. This option has the advantage of increasing the territory of an already successful organization that is interested in servicing statewide 504 needs. If this option were chosen, the State might want to consider providing subsidy to the consolidated CDC for a limited period of time to assist with travel costs associated with serving the rural areas.

- On the other hand, the AEDC Board might choose to begin an organization independent of government support, as was recently done by PLDC. In part, to address its problem of low loan volume, in February 1992 PLDC broke ties with city government. According to one of the PLDC board members, a loan officer will perform better if his salary is totally dependent on the production of loans, and that City employees often were called upon to do tasks other than loan work. In PLDC's case, as well as in the start-up of the Tucson and Utah CDCs, government monies helped with the transition to a fully self-supporting operation.

Regardless of whether the AEDC merges with the Tucson organization or eliminates its association with Commerce, State funding assistance can be eliminated entirely over a short period of time.

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[1] A CDC may charge a servicing fee of between .50 and 2.0 percent on its outstanding loan balance. Additionally, it may charge a fee of up to 1.5 percent of the SBA portion of the loan upon origination. Because Commerce has had so few loans, its fees cover a small percentage of its costs.

[2] AEDC remits $2,500 per month to Commerce from the monies it receives for loan-servicing fees. As of December 1993, AEDC had a checking account balance of $45,000 earned from SBA origination fees.

RECOMMENDATION

1. The State should develop a plan to privatize the AEDC SBA 504 program and begin its implementation.

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FINDING III

THE DEPARTMENT OF COMMERCE SHOULD IDENTIFY AND PURSUE CHANGES THAT POSITIVELY INFLUENCE BUSINESSES' DECISIONS TO LOCATE IN ARIZONA

The Department of Commerce should continue to identify and pursue changes that would convince businesses to move or expand to Arizona. In recent months, the Department has seen an increase in the number of businesses who have announced moves to Arizona. Because so many factors and players impact businesses' decisions to locate in Arizona, it is difficult to pinpoint the Department's impact on these decisions. However, by surveying clients, the Department would be better able to monitor changes needed to improve its service, as well as being able to identify changes needed to improve Arizona's overall business climate.

The Department of Commerce has established a National Marketing Unit whose mission is to promote the State and to serve as a point of contact for businesses interested in locating in Arizona. The Division employs six representatives who interview prospective businesses to identify their needs, provide requested information, arrange visits to potential sites, and maintain contact with company representatives to ensure they obtain necessary assistance. In providing this assistance, the Department representatives frequently work with other economic development agencies, utility companies, and local community leaders.

Commerce Has Seen An Increase In Businesses <u>Announcing Moves</u>

The number of Commerce-assisted businesses announcing moves into the State have increased. According to Department of Commerce records, in Fiscal Year 1990-91, 24 companies assisted by its business representatives publicly announced decisions to locate a new business facility in Arizona, and another 21 companies did so in Fiscal Year 1991-92. As indicated in Table 6 (see page 26), during the first six months of Fiscal Year 1992-93, the number of location announcements by client firms is more than the total announcements in either of the two previous Fiscal Years.

TABLE 6

DEPARTMENT OF COMMERCE
Business Recruitment Activity
From July 1, 1992 through December 31, 1992

Status of Project	Number of Projects	Number in Rural Area	Jobs Involved	Amount to be Invested
Move Has Been Publicly Announced	30	7	5,199	$ 117,450,000
Move Has Been Committed, Unannounced	18	5	3,570	249,500,000
Arizona Is A Finalist	41	16	11,990	1,988,000,000
Site Visit To Arizona Is Expected	39	N/A	5,300	194,950,000

Source: Arizona Department of Commerce, Monthly Prospect Report, December 1992 (unaudited)

Many Factors Affect Business Decisions

Although the number of Commerce-assisted businesses moving into the State appears to be increasing, Commerce's impact on those decisions is difficult to measure. Business location decisions are impacted by a variety of factors. Further, a number of different agencies may be involved in efforts to recruit firms. Thus, pinpointing responsibility for what factor or group was responsible for a location decision is a difficult task.

Number of factors affect location decisions - Professional writings and studies indicate that the factors affecting business location decisions are numerous. One report notes, for example, that while such traditional factors as access to markets and suppliers, availability of financing alternatives, transportation systems, qualified sites or existing facilities, and costs of labor and utilities are still taken into consideration, nontraditional factors are becoming increasingly important. These include labor productivity and reliability, quality of life, an area's educational systems, overall costs of doing business, quality of telecommunication systems, spousal employment opportunities, environmental factors, and local inducements.

The ability of business recruitment programs to affect business location decisions at any given time depends, therefore, not just upon the recruitment services provided but upon the particular mix of factors that determines the overall business climate as well.

Array of participants involved in recruitment efforts - Not only do a number of business climate factors impact decisions, but a number of participants may be involved in influencing business decisions. Efforts to attract new businesses to the State often involve local economic development agencies, utility companies, universities, community colleges, banks, other public agencies, and the private sector. Therefore, a number of entities may actually share the credit for businesses' decisions to move into the State.

Outcome Of Program Should Be Monitored To Improve Service And Address Barriers

The Department needs to monitor its program to determine the impact of its efforts as well as any problems with Arizona's overall business climate. Arizona, like most states, lacks the information necessary to evaluate the effectiveness of its recruitment programs. Because the Department has little data regarding the outcome of its programs, we conducted a client survey. Although the results are limited by the response rate, we did identify potential areas to be addressed.

States lack data regarding program effectiveness - According to an official with the National Association of State Development Agencies, states are searching for ways of determining the effectiveness of their business recruitment programs. In response to this need, the Urban Institute and the States of Maryland and Minnesota undertook the task of designing a performance-monitoring system to monitor both the quality and results of economic development programs; their recommendations were summarized in a manual entitled *"Monitoring the Outcomes of Economic Development Programs."* The manual recommends the use of periodic client surveys to provide on-going monitoring information at regular intervals, and to provide year-to-year comparisons of performance.

Survey results inconclusive, yet show potential areas - As with most states, the Department lacked detailed information regarding its performance. Therefore, using a modified version of the client survey instrument recommended by the Urban Institute, we sent surveys to approximately 1,100 businesses who had been assisted by the Department's National Marketing Unit in Fiscal Year 1991-92.[1] In addition, we also surveyed the 45 companies that had publicly announced a move to Arizona in Fiscal Years 1990-91 and 1991-92.

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[1] See Appendix II for a copy of survey instrument.

Our survey response rate was lower than we would have liked -- we received responses from 188 (or 17 percent) of those contacted. Although our survey results must be tempered by the response rate, they do point to some areas where the Department is performing well, as well as identifying potential areas for improvement. Over 71 percent of respondents rated the assistance received by the Department of Commerce as excellent or good. Further, nearly 90 percent of those responding felt that the Department was performing as well as or better than other states they had contacted. Positive comments cited staff professionalism, helpfulness and overall quality of service as positive factors.

In addition, comments were received regarding areas where the Department could improve its service. For example, the Department should better track and follow up on contacts to ensure that the businesses receive the type of information they need. Eleven respondents noted that the Department never provided the information they requested or that the information was slow in coming, while 21 respondents indicated that the information they received was either too general, insufficient, or outdated. Further, 16 respondents commented on a general lack of follow-through to requests for assistance. The following quotes from respondents illustrate these concerns.

- *"Weak information received on sites/buildings - very generalized and lacking detail necessary for sound business decisions."*

- *"I was (and am) interested in the Prescott and Tucson areas - availability and costs of housing, workers' taxes, climate, business demographics - All I got was less than I could have gotten in a travel agent's brochure."*

- *"In the course of this project I have dealt with numerous economic development authorities who were extremely helpful - yours seemed relatively uninterested and gave me the impression that Arizona is not economically competitive."*

- *"After 3 phone calls to the Department it took 2 1/2 months to get any information at all."*

The Department is currently in the process of implementing new tracking software which could help its ability to follow through on companies who have contacted the Department. The software tracks client contacts and automatically schedules follow-up. The Department expects full implementation of the software by March 1993.

The survey also notes areas where the State appears to be performing well, as well as noting potential areas for improvement in Arizona's overall business climate. The factors most frequently rated as positively impacting businesses' decisions to locate, or consider locating, in Arizona included: quality of life, cost of labor, suitability of site, labor supply, and physical environment. Conversely, the factors most frequently rated as negatively impacting businesses' consideration of Arizona as a business location included: State and local financial incentives, business tax and personal tax levels, availability of private financing, and training and/or recruitment incentives. The following quotes illustrate businesses concerns with locating in Arizona.

- *"You have few incentives to offer a corporate headquarter seeking to relocate."*
- *"In comparison, others offer far greater financial assistance."*
- *"Arizona's package needs to be more aggressive (competitive with Nevada)."*
- *"No job-training funds available. Few state incentives to offset company costs."*
- *"When industry looks at Arizona, water access, affordability, and long-term outlook is always in question. Any reassurance or guarantees/forecasts, etc., would be beneficial in your literature."*
- *"We are still considering the move, but -- sales tax on leasing a commercial building -- . . . not right, not fair, discriminatory against business - needs change. Leasing rates are better in Arizona, but add tax and there isn't much difference, if any."*
- *"Review other states' packages and get aggressive. Jobs will mean balanced growth for Arizona. Focus should be on more incentives and start-up assistance."*
- *"Property tax rates and business sales tax rates are very much a disincentive to operate in Arizona. Should be reevaluated."*

The Legislature is taking action to address some of the concerns noted by respondents. For example, legislation was recently enacted which adds a job-training program to the State. Further, a tax reduction package is being considered which would phase out the State's commercial-real-estate lease tax and reduce the personal property tax on commercial, industrial, and agricultural improvements. In addition, the Legislature is establishing a committee to review the State's regulatory environment to make it less complex and expensive.

RECOMMENDATIONS:

1. The Department of Commerce should develop a survey mechanism to monitor the quality of service it is providing to clients. Further, the Department should take action in those areas identified by the survey as being deficient.

2. The Department of Commerce should continue its efforts to track businesses who have contacted the Department to ensure they are obtaining the needed information and assistance.

FINDING IV

POLICIES ARE NEEDED TO GOVERN ENTERTAINMENT AND PROMOTIONAL EXPENDITURES

The Department of Commerce lacks adequate policies for handling unique expenditures. Although allowed to use State funds for entertainment and promotion, the Department has come under fire for such expenditures. Policies are needed to ensure the appropriate use of State funds.

The Department of Commerce is charged with promoting and enhancing the economic environment of Arizona. To accomplish this goal, the Department has traditionally been allowed to expend State funds in areas that are generally prohibited in other state agencies (such as entertainment and purchasing promotional items). For example, the Department may give a gift to a business executive who is considering Arizona as a site for business expansion or relocation, or Commerce employees may take the individual to dinner. Use of promotional items and entertainment are typical for economic development offices or departments of commerce across the country.

Although these types of purchases may be typical, they may appear to conflict with State gifting provisions. The State Constitution and Arizona Revised Statutes preclude gifting[1] which can be construed to mean the purchase of meals as well as items which are used as promotional gifts. However, courts have concluded that if the gift has a public benefit and this benefit is not greatly outweighed by the cost of the gift, certain expenditures may be allowable.

The Department does not have well-defined policies regarding promotion and entertainment expenditures, and as a consequence has come under scrutiny. In 1992, various expenditures were the subject of news articles and legislative hearings.[2] During this time, the Department issued guidelines addressing some aspects of promotion and entertainment expenditures and documentation. (See Appendix III.) However, these guidelines are general in nature and do not address some current Department practices. Developing policies to more clearly define when such expenditures are appropriate could help avoid controversy in the future.

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1 A.R.S. Const. Art. 9, §7, and A.R.S. §38-601.

2 Subsequent to an article which appeared in the *New Times* describing questionable expenditures, a legislator began inquiring into Commerce's expenditures. This process continued as a part of the Director's confirmation hearing. This review covered expenditures from July 1991 through April 1992. These expenditures included memberships in a private club, reimbursement to State employees for working lunches and dinners, undocumented travel claims, and promotional items.

practices. Developing policies to more clearly define when such expenditures are appropriate could help avoid controversy in the future.

Need For Policies To Define Appropriate Uses

The Department's practices and lack of policies regarding its unique expenditures contribute to continued questioning of these areas. Our review[1] indicates that a policy is particularly needed to govern the use of State funds for entertainment expenditures when no prospective business client[2] is in attendance. Other states have measures that control these expenditures. In addition to policies, proper documentation is essential to ensure the appropriate use of State funds.

No prospective business client - As stated previously, entertaining clients may be considered a normal part of doing business for economic development offices or commerce departments. However, there is no clear benefit to the State in instances where no prospective business client is present. The following are examples of the entertainment expenditures we question. While the individual amounts of the expenditures are not always large, the nature of the expenditures makes them subject to question.

- Commerce employees entertain guests who are not prospective clients. Commerce staff charged lunches (ranging from less than $10 to more than $75) to entertainment although no prospective client attended. Instead, the lunch guests included local economic development people, utility representatives, or a member of the Governor's staff.

  Comment: Commerce has stated that meals with persons who are not prospects may involve discussions of economic development topics and are work related. We question whether there is a public purpose that would justify the use of State funds for entertainment where no prospect is involved. As mentioned earlier, the State may lawfully give its funds to individuals where there is a public purpose. However, a State employee is employed for the purpose of benefiting the public. Therefore, it does not appear consistent to make gifts (meals) to a State employee for doing his or her job. Further,

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1 We conducted several reviews of expenditures. First, for Fiscal Year 1991-92, a random sample of several expense categories was selected. These categories include: Out-of-State Per Diem, Out-of-Country Per Diem, Conference Facilities/Miscellaneous, Entertainment, Promotional Items, and Other. Secondly, a judgmental sample was also selected from all non-payroll expenditures in 1991-92. Finally, for the current Fiscal Year 1992-93 all claims for the first quarter were reviewed. This review began on October 19, 1992, and any first-quarter claims not filed by that date were not reviewed.

2 We define "prospective business client" as an individual who represents a company that is considering locating in or expanding his/her business in Arizona.

providing funds for meals where no prospective client is present may be a violation of A.R.S. §38-601.

- Commerce employees entertain members of boards or commissions. Lunch and dinner expenditures between Commerce employees and members of Commerce boards or commissions ranged from approximately $30 to more than $135.

  Comment: Again, Commerce contends that these are work-related luncheon or dinner meetings. However, it is questionable whether State funds should be used to entertain State employees and Board members. Furthermore, in some instances the employee was not in travel status and therefore not eligible for reimbursement of meals. In other cases, the employee was in travel status and eligible for per diem amounts; however, these amounts are limited to $5 per person for lunch and $10 per person for dinner. In these instances the full amount of the meal exceeded the allowed per diem but the excess was paid and was covered by claiming it as an entertainment expense.[1]

- Commerce employees or other State employees are the majority in attendance. For example, expenditures ranging from approximately $20 to nearly $200 were claimed for a banquet meeting, a working lunch, and meeting refreshments even though the expenditures were primarily for State employees in non-travel status.

  Comment: We believe these entertainment expenditures are unjustified because the majority of the individuals in attendance were State employees who were not in travel status. Although Commerce maintains these were work-related functions, we question the appropriateness of using State funds to entertain State employees.

Other States - We surveyed seven other states' commerce departments which, like Arizona, have entertainment and promotional expenditures.[2] We found that

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1 Members of boards and commissions are also eligible for per diem expenses. However, in these examples the members did not submit claims for these expenses; instead, these meals were claimed by the Commerce employee as an entertainment expense.

2 The states surveyed include Colorado, Utah, Georgia, Maryland, North Carolina, Tennessee, and Texas. We also contacted Nevada and New Mexico but they are not used in this comparison because Nevada no longer has a budget for these expenses, and New Mexico has an anti-donation clause in its constitution which prohibits employees from entertainment and gift purchases.

the majority of these states have either legal restrictions or informal guidelines that control these types of expenditures:

- **THE STATE OF TEXAS** may not purchase gifts/promotional items. The state will pay for entertainment expenses only when they occur while entertaining an individual(s) who represents a company that is not currently located in the state. The only allowable entertainment expenses are meals.

- **NORTH CAROLINA, GEORGIA, AND MARYLAND** allow entertainment and promotional expenses for prospective clients only.

- **UTAH AND TENNESSEE** report prospect entertainment expenses as a separate line item in the budget to allow for a more careful accounting of these types of expenditures.

- **MARYLAND** uses a promotional stamp that flags all promotional expenditures. Only those expenditures that are approved as appropriate promotional expenditures receive the stamp.

Lack of documentation - Once policies are established, there is a need for sufficient documentation and internal review of these expenditures. To ensure compliance with gifting statutes and the agency's own policies once developed, adequate documentation is necessary. Expenditures should be documented by the agency in such a manner that a public purpose and cost/benefit analysis are clear.

In our review, several expenditures were questioned because of inadequate documentation. Although some claims were adequately documented, many were not. Several entertainment claims did not specify the purpose of the meeting or the entertainment expense. Some promotional items were not accounted for because of inadequate inventory controls. Claims for many of the previously cited examples had a list of attendees attached, but no agenda or purpose was given. In a few cases, receipts were missing. Unless proper documentation is provided, the economic benefit to the State cannot be determined.

Lax documentation requirements may result in expenditures that are clearly a violation of gifting statutes and are potentially fraudulent. In our review we noted a claim for airfare to San Francisco. The employee occasionally traveled to the San Francisco area as part of his work duties, so this was not an unusual claim. However, no travel authorization was attached to the claim. (We found several instances in which claims included only the travel invoice without authorizing documentation.) We requested the supporting documentation for the trip. In its effort to provide the documentation, Commerce learned that the trip was not work related but personal. Because Commerce did not require appropriate documentation, it was not reimbursed for the plane ticket until almost four months after the trip was taken.

In addition, internal Department policies and reviews are critical with the conversion to the State's new accounting system, AFIS II. With AFIS II, agencies and departments are responsible for inputting claims and maintaining supporting documentation. The General Accounting Office will no longer be reviewing claims to determine if expenditures comply with State statutes and policy. In most cases, the only review will be within the Department.

RECOMMENDATION

1. The Department of Commerce should establish well-defined policies regarding promotional and entertainment expenditures, such as allowing these expenses for prospective clients only, stating what type of documentation is required, and instituting a clear method for describing the public benefit of such uses of public monies.

OTHER PERTINENT INFORMATION

During the audit we obtained other pertinent information regarding the Energy Office.

Depletion Of Energy Office Funds Expected Soon

As a result of a Federal lawsuit, Arizona received oil overcharge monies. These monies were used to fund the Department of Commerce's Energy Office. Because this office receives no General Fund appropriations and the existing funds will be depleted by 1996, the Legislature needs to decide whether it wants to continue the Office.

Arizona received $37.8 million to fund Energy Office and related activities - Beginning in 1986, the State received $37.8 million from a settlement wherein the Federal government had alleged that oil companies had overcharged consumers. The monies were provided to Arizona with the stipulation that they be spent for energy-related work. These monies were deposited with the State Treasurer to be invested and disbursed. Over the years, the funds have earned approximately $13 million in interest. The court order establishing the overcharge monies requires that the monies be used by 1998, or the State loses the remaining funds. Although an estimated $24 million remains in the fund, the Energy Office Director indicated that these funds are designated for specific projects and for administrative costs, and that these monies will be depleted by 1996.

The Office has approximately 40 full-time employees. Approximately 75 percent of the positions are funded by oil overcharge monies and the remaining 25 percent are funded by Federal energy grant monies. In addition, 7 additional positions located elsewhere in the Department are funded with oil overcharge monies. These positions include employees that provide support services (such as accounting and computer services) to the Energy Office as well as other divisions. In Fiscal Year 1991-92, $1.35 million in oil overcharge monies and an additional $291,000 from Federal grant monies were expended for personnel- and employee-related services.

The Office has four units:

- COMMUNITY ENERGY - This unit has three principal responsibilities: it assists Arizona communities regarding energy questions and issues; it is involved in transportation issues such as mass transit and ride sharing; and it works to influence the building community to improve the energy efficiency of homes and other buildings.

- **ENERGY CONSERVATION AND EDUCATION** - This unit has three main program areas. First, the weatherization program makes monies available to low-income people to improve the energy or water efficiency of their homes. The Office contracts with private service providers to perform the work, and staff monitor and inspect the work. Second, the institution conservation program provides monies for energy conservation improvements for schools and hospitals through matching grants. Third, the unit offers educational seminars on energy conservation and encourages and coordinates programs to improve conservation efforts.

- **PLANNING AND POLICY** - This unit was established approximately three years ago in response to a legislative mandate that the Office develop a policy on the energy supply and its use. The unit has served as a resource and staff to the public committee that formulated the policy and a new committee charged with implementing it. This unit also is responsible for emergency preparedness as it relates to energy emergencies and fuels. They also collect data on gas usage, prices, etc., and prepare a quarterly report.

- **SOLAR AND ENERGY ENGINEERING** - This unit serves as technical support to the Office. It evaluates grants, participates in demonstration projects (such as solar recharging stations), and monitors the Solar Energy Commission projects. It also evaluates products and in some cases has gone to the Attorney General's office when products appear to be fraudulent.

Depletion of overcharge monies may mean considerable changes are needed for Energy Office in the future - With the depletion of the oil overcharge monies, the Office will likely see considerable changes in the number of personnel and functions. Several options will need to be considered as to the future purpose, size, and funding of the Office.

Because approximately 75 percent of the Energy Office's staff and programs are currently funded with oil overcharge money and these monies are scheduled to be depleted by 1996, the Legislature and Department will need to decide the future direction of the Office. The Energy Office Director suggests the Office be reduced to approximately 20 full-time employees at a cost of $1 million per year. According to him, there are at least four possible sources of revenue to finance the Office.

- **FEDERAL GRANTS** - Assuming that the Office continues to receive Federal grants at current funding levels, approximately $250,000 would be available for administering the grants. The grants would provide some funding for FTEs. However, the direction of the office would be largely dependent on the nature of the grants.

- **PARTNERSHIPS** - According to the Energy Office Director, the Office has begun to investigate and enter into partnerships with government or quasi-government agencies, utility companies, and national labs. The Office would contract with these organizations to perform tasks such as monitoring the agency's energy contracts, research and development of energy conservation technologies or devices, and educational efforts. As with the grants, the number and availability of FTEs and nature of the Office's activities would depend on the individual partnerships.

- **TAX** - Some states have placed a tax on energy bills to help fund their energy offices.

- **STATE APPROPRIATIONS** - Should the State wish to continue the Office, State appropriations may be necessary if alternative funding sources are insufficient.

SUNSET FACTORS

In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether the **ARIZONA DEPARTMENT OF COMMERCE** should be continued or terminated.

1. ***The objective and purpose in establishing the agency***

The Department of Commerce serves as the lead economic development agency for the state of Arizona. Formerly the Governor's Office of Economic Planning and Development, the Department was established in 1985

> *"to facilitate the beneficial economic growth and development of the state and to promote and encourage the prosperous development and protection of the legitimate interest and welfare of Arizona business, industry and commerce, within and outside this state."*

To further meet its objective, the Department staff, along with volunteers from both the public and private sector, completed Arizona's new long-range economic development plan. The Arizona Strategic Planning for Economic Development process, or ASPED, developed a plan to provide guidance regarding the State's economic growth into the 21st century. According to Department officials, this strategic planning document has become the cornerstone of its operations.

Additionally, the Department acts as the State's designated clearinghouse for review and coordination of Federal programs, facilitating the development of low- and moderate-income housing, promotion of Arizona's energy programs (including solar), and promoting international trade and tourism. These activities are statutorily mandated.

2. ***The effectiveness with which the agency has met its objective and purpose and the efficiency with which it has operated***

The Department's effectiveness in meeting its overall objective appears to be improved based on the recent adoption of ASPED. An Auditor General Performance Audit released in 1981 (Report 81-3) severely criticized the agency for not having a statewide economic development plan. ASPED appears to deliver an economic planning model and strategic plan that places a specific focus on the State's efforts. ASPED serves as the cornerstone for future economic growth and development efforts and focuses economic development in Arizona on nine industry clusters. The nine clusters identified in ASPED are aerospace, agriculture/forest and food processing, business services, health and biomedical, information, mining and minerals, optics, tourism, and transportation and distribution.

Consideration of ASPED's initiatives is being coordinated by the Governor's Strategic Partnership for Economic Development (GSPED). GSPED is directed by a board of individuals from the public and private sectors. The Director of Commerce is a member of the Board, but the precise role of the Department in the formulation and implementation of the initiatives has not been defined. In practice, the Department has largely been involved with communication and administrative support; whereas cluster group activities and the coordination of efforts are overseen by an executive director chosen from and supported by private sector participants.

Although the Department has accepted the ASPED strategic plan, its overall effectiveness appears hampered due to its poor performance in delivering financial services to Arizona's small businesses. (See Finding I, page 7 and Finding II, page 17.) In addition, the Department's lack of complete and accurate information regarding its national marketing and business recruiting activities eliminates the potential for measuring the overall effectiveness of its efforts. (See Finding III, page 25.)

3. ***The extent to which the agency has operated within the public interest***

Aside from the problems that have negatively impacted the Department's effectiveness in meeting its objective, the Department may not have acted in the public's interest in providing proper financial management over State monies. (See Finding IV, page 31.) Also, the Department has failed to comply with the Open Meeting Law regarding the Housing Development Advisory Committee (§41-1505[D]). The Committee meets about four times a year to award contracts to various housing entities around the State; however, the public is not informed of the meetings. Also, no formal agenda is followed and no minutes are kept. According to commission members and staff, everything is handled very informally.

We found no Open Meeting Law problems or violations with the Department's other nine boards or commissions.

4. ***The extent to which rules and regulations promulgated by the agency are consistent with the legislative mandate***

The Department has been given statutory authority under A.R.S. §41-1504 (B) to adopt rules *"deemed necessary or desirable to govern its procedures and business."* According to the Department and the agency's Attorney General

Representative, all rules that have been adopted by the Department of Commerce are consistent with its legislative mandate.

5. ***The extent to which the agency has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public***

According to the Deputy Director, no rule changes have taken place during his one and one-half-year tenure. Currently, the Department is preparing several new rules. According to the Department, in the past, when proposed rules or rule changes have been considered, the agency has advertised them and holds preliminary meetings with the general public and interested parties for input prior to submission to the Governor's Regulatory Review Council. The Department plans to continue this process.

In addition, the Department publishes an annual report that summarizes its major accomplishments and activities as required by statute. This document is submitted to the Governor, the Legislature, and the general public.

6. ***The extent to which the agency has been able to investigate and resolve complaints that are within its jurisdiction***

This factor is not applicable since the Department of Commerce does not have investigative or regulatory authority.

7. ***The extent to which the Attorney General or any other applicable agency of State government has the authority to prosecute actions under the enabling legislation***

This factor is not applicable because the Department of Commerce is not a regulatory agency with enforcement or oversight responsibilities.

8. ***The extent to which the agency has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandate***

To fulfill its legislative mandate, the Department is seeking the following legislation during the 1993 legislative session:

- **JOB-TRAINING PROGRAM** - The Work Force Recruitment and Job-Training Program will provide training and retraining for specific employment opportunities for new and expanding businesses, as well as companies undergoing economic conversion.

- **ENVIRONMENTAL TECHNOLOGIES MANUFACTURING INCENTIVES** - If approved, this program will be established in the Department of Commerce to promote business and economic development by recruiting and expanding companies that manufacture solar and other renewable energy products and recycle materials.

- **SMALL COMMUNITY AFFORDABLE HOUSING STUDY COMMITTEE** - Proposed legislation will establish a study committee to examine the housing needs of small communities and draft legislation on a State-sponsored program to stimulate the development and financing of affordable housing in small communities.

9. *The extent to which changes are necessary in the agency's laws to adequately comply with the factors listed in the Sunset law*

Although not specifically addressed in the body of this report, certain statutory provisions regarding committees which fall under the Department's responsibility should be eliminated because the activity is being conducted administratively within the Department.

The *Main Street Program Advisory Committee* as referenced in A.R.S. §41-1505.02C and the *Rural Economic Development Program Advisory Committee* as referenced in A.R.S. §41-1505.03C should be eliminated. The Main Street Program Advisory Committee was established to provide advice to the Director on the selection criteria to be used for selecting *"main street communities"* and to assist in the selection of a minimum of five communities per year. Similarly, the Rural Economic Development Program Advisory Committee was formed to provide advice to the Director regarding selection criteria for determining awards to rural communities, and to assist in selecting a minimum of three communities per year to receive these awards.

According to the Department, the committees are no longer necessary because the selection process for participation is now being made administratively. In the past, the committees operated as mandated by statute. However, the committee members recommended that the Department eliminate the competitive selection process because it was viewed as ineffective. Thus, committee meetings are not presently being held. According to the Department, the Appropriation Committee's chairpersons were informed about this change.

10. *The extent to which the termination of the agency would significantly harm the public health, safety, or welfare*

Because other private and public sector agencies are involved in promoting economic development statewide, we believe that terminating the agency would not significantly harm public health, safety, or welfare. However, the elimination of the Department could eliminate equity and balance for the rural areas in terms of attracting and relocating new businesses, since these areas are less likely to have the resources available for economic development or business recruitment/retention programs.

11. ***<u>The extent to which the level of regulation exercised by the agency is appropriate and whether less or more stringent levels of regulation would be appropriate</u>***

The Department of Commerce is not a regulatory agency, thus this factor does not apply.

12. ***<u>The extent to which the agency has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished</u>***

The agency extensively uses the services of outside contractors in the performance of its duties. Examples include: the execution of most of its marketing and advertising programs, consulting services for the lending programs for both housing development and business finance, the performance of its energy programs, managing its foreign trade offices, and other specialized studies.

According to the Department, to the extent possible, the agency seeks to contract out a significant part of its activity so that the need for direct employees is somewhat limited to the areas of management, oversight, client contact, and administration.

SUNSET FACTORS

In accordance with A.R.S. §41-2954 the Legislature should consider the following 12 factors in determining whether the **ECONOMIC PLANNING AND DEVELOPMENT ADVISORY BOARD (BOARD)** should be continued or terminated.

1. ***The objective and purpose in establishing the Board***

   The Economic Planning and Development Advisory Board was created in 1984 to advise the Governor and the Department of Commerce *"on policies which encourage orderly planning and stimulate economic activity"* in the State. The Board was charged with recommending programs to assist communities in planning for growth. It also had responsibility to *"review policies to ensure the proper utilization of this State's energy and other natural resources."* According to the Department of Commerce, the Board is actually a holdover from the Office of Economic Planning and Development Advisory Board that was originally established by executive order.

2. ***The effectiveness with which the Board has met its objective and purpose and the efficiency with which the Board has operated***

   According to staff at the Department of Commerce, the Board has not met in four years. As a result, we have determined that the Board has not met its objective and purpose.

3. ***The extent to which the Board has operated within the public interest***

   Because the Board has not met its objective and purpose, it has not operated within the public interest.

4. ***The extent to which rules and regulations promulgated by the Board are consistent with the legislative mandate***

   The Board does not have authority to promulgate rules and regulations.

5. ***The extent to which the Board has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public***

This factor is not applicable because the Board has no authority to promulgate rules and regulations and it has not met in four years.

6. ***The extent to which the Board has been able to investigate and resolve complaints that are within its jurisdiction***

The Board has no statutory authority to investigate or resolve complaints.

7. ***The extent to which the Attorney General or any other applicable agency of State government has the authority to prosecute actions under the enabling legislation***

This factor does not apply.

8. ***The extent to which the Board has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandate***

For at least the past four years the Board has not sought to make statutory changes regarding its mandate.

9. ***The extent to which changes are necessary in the laws of the Board to adequately comply with the factors listed in the Sunset Law***

Our review indicates no statutory changes are necessary for the Board to comply with its mandate. However, see Factor 10.

10. ***The extent to which the termination of the Board would significantly harm the public health, safety, or welfare***

Because the Board has not met for the past four years nor has the Governor appointed any members to the Board during that time, it appears there would be no harm to the public if the Board were terminated. In addition, according to the Department of Commerce, the Board has been superseded by the newly designated Governor's Strategic Partnership for Economic Development. The Partnership will work to implement the Arizona Strategic Plan for Economic Development. Therefore, there is no need for the Board to continue.

11. ***The extent to which the level of regulation exercised by the Board is appropriate and whether less or more stringent levels of regulation would be appropriate***

The Board has no regulatory power and has no need for such authority.

12. ***The extent to which the Board has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished***

Again, the Board has not functioned over the past four years and therefore this factor does not apply.

SUNSET FACTORS

In accordance with A.R.S. §41-2954, the Legislature should consider the following 12 factors in determining whether the **ARIZONA SOLAR ENERGY ADVISORY COUNCIL** should be continued or terminated.

1. ***The objective and purpose in establishing the Arizona Solar Energy Advisory Council***

   The Advisory Council was originally established in 1975 as the Arizona Solar Energy Research Commission. The Commission had its own staff and funding. In 1987 statutes were amended and the Commission was incorporated within the Department of Commerce. It was also renamed the Solar Energy Advisory Council.

   Statutes specify a 15-member council and 2 advisory members who are not eligible to vote. The statutes also outline the council's duties, which include advising the Department on disbursement of Federal and State funds for solar purposes, identifying solar energy technologies that are feasible in both short- and long-term applications, encouraging cooperation among academic, business, professional, and industrial sectors that have expertise of solar energy technology, and recommending to the Department standards, codes, certifications, etc. necessary for commercialization and growth of solar energy use in the State.

2. ***The effectiveness with which the Council has met its objective and purpose and the efficiency with which the Council has operated***

   According to the Council and the Department's Energy Office, the Council has successfully worked on many programs and projects, including the solar village, a solar hotline, the solar emergency generator, and the John F. Long solar project. In addition, the Council has been involved with and supported legislative initiatives and solar tax credits in an effort to encourage use of solar technology.

3. ***The extent to which the Council has operated within the public interest***

   See Factor 2.

4. ***The extent to which rules and regulations promulgated by the Council are consistent with the legislative mandate***

The Council has no statutory authority to promulgate rules and regulations.

5. ***The extent to which the Council has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public***

Although the Council has not promulgated rules and regulations, it does regularly hold meetings to discuss planning and implementation of solar-related policies, activities, and projects. According to the Department, these meetings are advertised and are open meetings. In addition, members of the Council have made presentations to other solar interest groups, homebuilder associations, schools, and other entities regarding Council activities and projects. According to the Council it also encouraged statewide public hearings during the development of the State energy policy.

6. ***The extent to which the Council has been able to investigate and resolve complaints that are within its jurisdiction***

This factor is not applicable because the Council has no statutory authority to investigate and resolve complaints.

7. ***The extent to which the Attorney General or any other applicable agency of State government has the authority to prosecute actions under the enabling legislation***

This factor does not apply.

8. ***The extent to which the Council has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandate***

According to the Council, *"[t]here are no significant defects in the enabling statutes which prevent the Council from fulfilling its statutory mandate."*

9. ***The extent to which changes are necessary in the laws of the Council to adequately comply with the factors listed in the Sunset Law***

Our review indicates no statutory changes are necessary for the Council to comply with its mandate. However, see Factor 10.

10. ***The extent to which termination of the Council would significantly harm the public health, safety, or welfare***

It appears there would be no harm to the public health, safety, and welfare if the Council were terminated. According to the Department, *"[t]ermination of the Council will have little public effect, since there no longer exists a corresponding funded staff to carry out their suggestions"* due to legislative elimination of the solar budget. However, the Council maintains termination could impact the State economically by removing *"the only organized body left in Arizona that is working to revitalize the solar industry in Arizona."* Also it contends that the Council is the only group *"which has the broad technical knowledge to understand, evaluate and recommend actions related to the myriad of solar-related technologies."*

11. ***The extent to which the level of regulation exercised by the Council is appropriate and whether less or more stringent levels of regulation should be appropriate***

The Council has no regulatory authority and has no need for such authority.

12. ***The extent to which the Council has used private contractors in the performance of its duties and how the effective use of private contractors could be accomplished***

The Council is not funded and does not contract for services.

APPENDIX I

CEDC LOAN PORTFOLIO CATEGORIES

BUSINESS LOCATION ASSISTANCE - Provides financial assistance for out-of-state firms wanting to locate in Arizona. The category is described as business attraction/recruitment, the traditional glamour area of economic development. The investments are not necessarily risky but can consume capital quickly, and it is not the greatest area of capital need. The guidelines caution the Commission that these projects be carefully considered and assistance be rationed or this category will quickly consume the money available for Small Business Expansion and Retention. Medium-sized businesses should be the target of the location assistance category.
Category Goal: 22%

BUSINESS EXPANSION AND RETENTION - Assistance to Arizona-based small- and medium-sized businesses. Per the guidelines, *"the expansion of small- and medium-sized companies will play a leading role in Arizona's economy in the next decade."* Over 80% of all new jobs come from firms employing less than 100. The cost of creating these jobs in Arizona is about 10% of the cost of creating a job in a large corporation.
Category Goal: 55%

PRODUCTION FINANCING - Another category to assist small- and medium-sized locally based businesses. Provides financing for companies needing to increase production capacity as a result of receiving large orders.
Category Goal: 9%

CO-VENTURE FUND - Provides venture capital to Arizona businesses through a partnership with specialists in the field. This is a category of high risk and the guidelines have only a small percentage of total funds dedicated to this area.
Category Goal: 6%

SPECIAL INCENTIVES - A small category for projects in disadvantaged areas of the State, and for projects where the State wants to take some defensive action to keep a company from moving out.
Category Goal: 8%

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Please Circle The Number Which Applies
and/or Mark The Appropriate Box/Blank

CONFIDENTIAL CLIENT QUESTIONNAIRE

ARIZONA DEPARTMENT OF COMMERCE
BUSINESS ASSISTANCE PROGRAM

1. What initially led your company to consider Arizona as a place to locate a facility? (PLEASE CIRCLE ALL THAT APPLY.)

Dept. of Commerce advertisement in a publication	1
Dept. of Commerce information obtained at a trade show	2
Personal Contacts with staff of the Dept. of Commerce	3
Company analysis that indicated Arizona should be considered	4
Other (please specify): ____________________	

2. Please rate each of the four following characteristics for each service you received from the Arizona Dept. of Commerce as: 1. Excellent, 2. Good, 3. Fair, 4. Poor, or N/A for Not Applicable. **(PLEASE CIRCLE A NUMBER FOR EACH CHARACTERISTIC, OR N/A, AS APPROPRIATE.)**

	Services Received	Timeliness of Assistance				Overall Helpfulness of Assistance				Not Applicable
		Ex.	Good	Fair	Poor	Ex	Good	Fair	Poor	
a.	Information on Arizona's economic and social conditions	1	2	3	4	1	2	3	4	N/A
b.	Information on sites and buildings in Arizona	1	2	3	4	1	2	3	4	N/A
c.	Personal assistance of Arizona Dept. of Commerce staff	1	2	3	4	1	2	3	4	N/A
d.	Financial assistance or incentives	1	2	3	4	1	2	3	4	N/A
e.	Job training/employment recruitment assistance	1	2	3	4	1	2	3	4	N/A
f.	Assistance in coordinating with local economic development authorities	1	2	3	4	1	2	3	4	N/A
g.	Other (Please Specify)	1	2	3	4	1	2	3	4	N/A

Please Circle The Number Which Applies and/or Mark The Appropriate Box/Blank

h. If you rated any of the above as Fair (3) or Poor (4), would you please explain why?

____

____

____

i. Overall, how would you rate the assistance you received from the Arizona Department of Commerce? **(PLEASE CIRCLE ONE.)**

1. Excellent	2. Good	3. Fair	4. Poor	5. Don't know

j. If you contacted economic development agencies of any other states, how would you compare the assistance provided by the Arizona Department of Commerce to that provided by the other states? **(PLEASE CIRCLE)**

Services provided by the Arizona Department of Commerce were:

1. Much Better	2. Somewhat Better	3. About the Same	4. Somewhat Poorer	5. Much Poorer

3. What is the status of the project for which you requested assistance? **(PLEASE CIRCLE and PROCEED TO THE QUESTION INDICATED.)**

Located in Arizona	1	(Go to Question 4)
Project still active but no decision yet	3	(Go to Question 4)
Located elsewhere	2	(Skip to Question 6)
Project is on "Hold"	4	(Skip to Question 7)
No longer planning to move or expand	5	(Skip to Question 7)
Don't know	6	(Skip to Question 7)

4. Would you please indicate the extent to which each of the following factors may have had a positive or negative impact on your decision to locate, or to consider locating, in Arizona.

Please Circle The Number Which Applies and/or Mark The Appropriate Box/Blank

	Factor	Very Positive	Somewhat Positive	No Effect	Somewhat Negative	Very Negative
a	Suitability of site	1	2	3	4	5
b	Labor supply	1	2	3	4	5
c	Cost of labor	1	2	3	4	5
d	Proximity of markets	1	2	3	4	5
e	Physical environment	1	2	3	4	5
f	Business tax level	1	2	3	4	5
g	Personal tax level	1	2	3	4	5
h	Provisions of needed information	1	2	3	4	5
i	Help of Arizona Dept. of Commerce staff	1	2	3	4	5
j	Help of local community staff	1	2	3	4	5
k	Help of Arizona Business people	1	2	3	4	5
l	State/local financial incentives	1	2	3	4	5
m	Training/recruitment incentives	1	2	3	4	5
n	Availability of private financing in Arizona	1	2	3	4	5
o	Quality of life in Arizona (education, housing, recreation, cost of living, etc.)	1	2	3	4	5
p	Other (please specify) ____________ ____________	1	2	3	4	5

Please Circle The Number Which Applies and/or Mark The Appropriate Box/Blank

5. If you have located your project in Arizona:

   a. In what city or county did you locate?____________________________

   b. Approximately how many full-time equivalent employees work at your facility in Arizona as of this date? (PLEASE CIRCLE)

0	1
1 to 10	2
11 to 20	3
21 to 50	4
51 to 100.	5
101 to 500	6
501 or more	7

   c. What do you estimate is the total capital investment your firm has made at this Arizona location to date?

$0	1
Less than $100,000	2
$100,000 to $499,000	3
$500,000 to $999,000	4
Over $1,000,000	5

Please Circle The Number Which Applies and/or Mark The Appropriate Box/Blank

6. If your project is located elsewhere:

   a. In which jurisdiction did you locate? ______________________________

   b. Please circle the three major reasons why you selected that jurisdiction. **(PLEASE CIRCLE *NO MORE THAN THE THREE* MOST IMPORTANT.)**

Could not find a suitable site in Arizona	1
Supply of labor not as adequate as other options	2
Cost of labor was more expensive than other options	3
Not close enough to markets	4
Physical environment not as attractive as other options	5
Taxes were higher than other options	6
Did not receive needed information on Arizona or on specific sites	7
The attitude or behavior of *business* people in Arizona with whom you dealt	8
The attitude or behavior of *government* personnel in Arizona with whom you dealt	9
Received more incentives elsewhere (such as *financial* or *training* assistance)	10
Could not obtain competitive private financing in Arizona	11
Quality of life (such as education, housing, cost of living, etc.) more attractive in other locations	12
Other (please specify): ______________________________ ______________________________ ______________________________	

7. Do you have any other comments or suggestions on the services you received from the Arizona Department of Commerce that might help improve the Department's assistance to companies considering a location in Arizona?

____

____

____

____

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
DEPUTY AUDITOR GENERAL

December 2, 1992

Dear Business Official:

Our Office is conducting a Performance Audit of the Arizona Department of Commerce. This is a routine review which State agencies periodically undergo to evaluate performance and note any areas needing improvement.

We are very interested in obtaining information and comments from business officials like yourself, who are considering locating, or have located a facility in Arizona. Your response to the enclosed survey will help us to determine: (1) what programs and services are needed in Arizona to help recruit and retain businesses, (2) the overall effectiveness of the Department's marketing programs, and (3) what changes may be needed in our State's approach toward economic development in order to foster a more healthy business climate.

Would you please take a few minutes of your time to fill out the enclosed survey? Responses from business leaders like yourself will allow us to more accurately assess the business communities' opinions and needs.

As with your interaction with the Department during the process, your company's identification and comments will be treated with *strict* confidentiality. Thus, the survey does not request the identification of an individual company, business, or location.

Please complete and return the questionnaire by ***December 15, 1992.*** Thank you very much for your help.

Sincerely,

Debbie Klein
Performance Audit Manager

2700 NORTH CENTRAL AVENUE • SUITE 700 • PHOENIX, ARIZONA 85004 • (602) 255-4385 • FAX (602) 255-1251

ARIZONA DEPARTMENT OF COMMERCE
3800 N. Central Avenue, Suite 1500
PHOENIX, ARIZONA 85012
(602) 280-1335

M E M O R A N D U M

TO: Dave Guthrie, Dorothy Bigg, Sara Goertzen, Jack Haenichen, Deborah Howard, Bill MacCallum, Paul Pugmire, Bruce Sankey, Pat Schroeder, Lois Yates

FROM: Jim Marsh

DATE: June 16, 1992

SUBJECT: **Promotional Items, Conferences and Entertainment**

Based upon the discussions we had at our staff meeting on June 11th, I am asking that the following guidelines be utilized on the above referenced expenses:

Promotional Items

1. The purchase of any new promotional items not currently being used should be authorized by me beforehand.

2. Each purchase request should be documented with a letter attached explaining the reason for purchasing the items and the affiliation of the intended recipients.

3. Keep inventory records of all items purchased and the names and affiliation of each recipient. If the items are given out to groups, each group should be identified.

Conferences

1. Other than events sponsored by your respective divisions, travel to conferences should be limited to yourself and at a maximum, one other employee.

2. When conferences are scheduled which cover several areas of Commerce activity, we should discuss these situations at a staff meeting so that the department's attendance is not excessive.

3. Try to spread out the scheduling of out-of-town conferences or business meetings so that in any given week the major portion of your time is spent in the office.

Entertainment

1. Document the reason, the persons hosted and their affiliations on all expenses.

2. Keep the expenses at a reasonable level.

We have been the subject of criticism for the above referenced activities. Hopefully, these guidelines will help minimize this problem in the future. But remember, our task is to market this great State! Let's continue to use these resources in a positive manner.

ARIZONA
Department of Commerce

Fife Symington
Governor of Arizona

James E. Marsh
Director

April 22, 1993

Mr. Douglas Norton, Auditor General
Office of the Auditor General
2700 North Central Avenue, Suite 700
Phoenix, Arizona 85004

Dear Mr. Norton:

In response to your audit, I have attached a detailed examination of a number of the findings of the audit that your agency conducted. However, before I outline these specifics, I would like to commend your staff for conducting themselves in a most professional manner. Each individual was very sensitive to and cognizant of the daily operation of the Agency. I appreciate you and your staff respecting the time and workload of all Commerce employees.

It is most heartening that your audit shows that nearly 90% of companies that the department assisted found that our agency is performing as well as or better than other state commerce departments. This finding clearly recognizes that under this administration's leadership, and with the positive marketing approach under which the Department of Commerce now operates, there is a significant increase in not only prospective companies considering moving into the state, but actual locates that have settled in Arizona. Your audit also suggests and recommends that the Department should track and follow up on contacts to ensure that the businesses receive the type of information requested. I wholeheartedly agree! A new tracking program is in place and will allow the Department a very defined process on follow up. Also, the Legislature has provided the Department with additional resources in next year's budget to allow for this most essential component of the marketing program.

Additionally, your audit suggests that the CEDC should improve the controls governing its decisions to award state economic development funds. Your report also suggests that the Commission develop administrative rules that clearly state the Commission's application and decision-making process and award criteria. I do concur with the latter recommendation of adopting administrative rules but do not agree with the audit's opinion that the CEDC has been inconsistent in applying its loan criteria nor with the subjective opinion that the process gives an appearance of unfairness. Please note that the attached response delineates a factually based rebuttal to the audit's findings. Having said that, I do accept your recommendation to improve this relatively new program.

Your audit also recommends that the state-run program, which administers the SBA 504 loans, be privatized. Although the program has increased its loan portfolio and production three fold over the last year, I too believe that this function should be privatized.

Again, the attached response will expand on a few of the shortcomings of the program, but let me just add that it is quite difficult to run any successful program when the destiny of it is controlled by an outside entity, namely, in this case, the local SBA office.

Your audit's recommendation that the Department of Commerce needs structured policies to govern entertainment and promotional expenses is well taken and well advised. However, I have developed such a policy and it was given to all Agency directors in June of 1992. I concur that the guidelines could be more specific concerning the appropriate individuals who can be entertained, although, as your audit correctly points out, the Department of Commerce is a bit of an anomaly from a typical state agency.

In closing, I would like to add that the leadership of the Arizona Department of Commerce underwent almost continual change for several years prior to my appointment in July 1991. This produced considerable instability in the Department with no sense of direction. Since becoming Director, it has been my primary goal to get the Department into a productive and results orientated mode and to resolve the issues that have produced criticism in the past.

Thank you for your detailed review of our activities and I look forward to implementing the positive improvements with which I have concurred in the above remarks.

Sincerely,

James E. Marsh
Director

JEM/DG:tt

Attachments

ARIZONA DEPARTMENT OF COMMERCE
SUMMARY RESPONSE TO FINDINGS

THE COMMERCE AND ECONOMIC DEVELOPMENT COMMISSION NEEDS TO IMPROVE THE CONTROLS GOVERNING ITS AWARD DECISIONS

The Department concurs that Administrative Rules should be developed for the CEDC Program.

The Department also agrees that 13 of the 26 CEDC projects are Arizona small business expansion projects. It is relevant to note that the Department has also done 15 Arizona small business expansion projects through its SBA 504 program during the past 18 months, totalling more than $3.8 million in loans.

The Department has been consistent in applying loan criteria to CEDC applicants. Flexibility is a key component of the CEDC. The CEDC Guidelines clearly state that the CEDC should "maintain a flexible, entrepreneurial response" to business investment in Arizona.

Attachment A is a detailed response to this finding.

STATE-RUN LOAN PROGRAM (SBA Program) SHOULD BE PRIVATIZED

The Department concurs that the SBA loan program should be privatized, even though, as the Audit Report recognizes, the volume of loans has increased dramatically. This increase in volume has occurred because the program has become well-marketed, pro-active and results-oriented, providing more loans for Arizona's small businesses. Loan volume went from three loans in FY91 to 11 loans in FY92. **It is estimated that this loan program will do 20 loans in FY93, resulting in Arizona Enterprise Development Corporation, being one of the top ten statewide CDC's in the nation in FY93.**

Attachment B is a detailed response to this finding.

THE DEPARTMENT OF COMMERCE SHOULD IDENTIFY AND PURSUE CHANGES THAT POSITIVELY INFLUENCE BUSINESSES' DECISIONS TO LOCATE IN ARIZONA

We agree and appreciate the findings of the Auditor General's survey that indicated that "...nearly 90% of those responding felt that the Department was performing as well as or better than other states they had contact with." Clearly this factual survey does suggest that the Department's impact on the site selection process is significant.

We also concur that the Department should better track and follow-up on contacts to insure that businesses receive the type of information they need. The new computer tracking system which has recently been installed in combination with additional resources in next year's budget will allow us to better perform this most essential component of the marketing process.

In addition to its marketing efforts, the Department has taken a proactive approach to establish a positive business climate in the State. The Auditor General's report does not take into consideration the significant impact that the Department of Commerce has made in public policy formation to attract businesses to Arizona through legislative efforts such as Defense Restructuring, Job Training, R & D Tax Credits, Double Weighted Sales Factor, Commercial Leasing Tax, Accelerated Depreciation, CWIP and the recently passed Environmental Technology Manufacturing initiative.

In the Auditor General's survey, some negative comments received were extracted and noted in its report. It would be helpful to have access to some of the positive comments received from the 90% of those favorably responding so that the Department could emphasize these activities in the service it provides.

POLICIES ARE NEEDED TO GOVERN ENTERTAINMENT AND PROMOTIONAL EXPENDITURES

On June 16, 1992, a memorandum was distributed to all Commerce division heads issuing guidelines for promotional items, conferences, and entertainment. These guidelines clearly establish the framework for handling these types of expenditures. The Department concurs that these guidelines could be more specific for expenditures when no prospective business client is present, and will address this issue. The Department also concurs that the expenditures should contain sufficient documentation to establish a public purpose.

To ensure that these types of expenditures are not excessive, the Department also contacted the commerce departments from the states contacted by the Auditor General's staff, and a few other states as well to ascertain the policies from these respective states. Although the policies differed somewhat from state to state, the Department's guidelines regarding entertainment and promotional expenditures were similar in nature to those in other states and not unusual.

OTHER PERTINENT INFORMATION

The Department concurs with your recommendations concerning the Department of Commerce Energy Office (pages 37 through 39). We have for some time recognized the need to downsize the staff and to look for alternative funding sources for the long term.

When the current management put in place by Director Jim Marsh assumed responsibility of the operation, the active head-count (people on board) was 46. In addition, there were ten approved new FTE's for the energy office. The department immediately recognized the need to downsize, and embarked upon an aggressive program to do so by attrition. At the time of the interviews with the Auditor General's staff, the Energy Office was down to 40 employees, as stated in their report. Since that time, the division is now at 34 FTE's. Additionally, one of the management sections has been eliminated.

Our goal is to reduce the Energy Office to approximately 20 full time employees. That size of operation can carry out the work necessary to provide an effective energy program.

The Department concurs with the recommendation that the Legislature in the future needs to consider permanent funding for the Energy Office.

ATTACHMENT A

RESPONSE TO FINDING I: THE COMMERCE AND ECONOMIC DEVELOPMENT COMMISSION NEEDS TO IMPROVE THE CONTROLS GOVERNING ITS AWARD DECISIONS

The Department concurs that Administrative Rules should be developed for the CEDC Program.

The Department also agrees that 13 of the 26 CEDC projects are Arizona small business expansion projects. It is relevant to note that the Department has also done 15 Arizona small business expansion projects through its SBA 504 program during the past 18 months, totalling more than $3.8 million in loans.

The Department has been consistent in applying loan criteria to CEDC applicants. Flexibility is a key component of the CEDC. The CEDC Guidelines clearly state that the CEDC should "maintain a flexible, entrepreneurial response" to business investment in Arizona.

I. **"Broad Guidelines May Result in Inconsistent Loan Award Decisions"**

To state that broad guidelines **"may"** have resulted in inconsistent loan award decisions is a purely subjective and speculative suggestion. The Audit Report ignores the fact that every CEDC project is different. Each CEDC request must be evaluated on its individual merits. The guidelines must be applied to each loan request with the goal of achieving the legislative intent of the program. Each guideline element by itself does not make or break a project. It is the overall package with all its elements that is examined for adherence to generally accepted credit underwriting standards and CEDC program goals and objectives.

To state that "Commission loan awards **appear** inconsistent" is again subjective and speculative. The Audit Report alludes to five criteria listed on page 8 which are commonly used as the basis to disqualify applicants and then states that other businesses were approved for loans did that did not meet the same criteria. We will demonstrate below that the five examples given in the Report are not black and white issues and that they should continue to be used only as "guidelines."

1. **"The Company must not be a start-up"**

One of the program guidelines is that the CEDC will not assist start-up businesses. The CEDC portfolio includes only one start up project. This project was approved prior to this administration and existing management. However, there were specific reasons why

it was funded. It was a Small Business Investment Corporation and it was chartered by it was funded. It was a Small Business Investment Corporation and it was chartered by the federal government. The CEDC was assisting it to help capitalize its small business revolving loan fund. This would allow the CEDC to leverage CEDC loan funds many times and assist many small businesses with one loan. The CEDC felt these were important and worthwhile reasons for approving the loan even though it was technically a start-up. All other applicants that have been denied CEDC assistance, because they were start-up businesses, were entrepreneurs who had only an idea for a business and no capital to start the business. The CEDC feels these investments are too risky and that they require a level of expertise not available at the Department.

2. **"CEDC funds must be leveraged by 50 percent private sector participation"**

Another of the program guidelines is that the CEDC will not provide more than 50% of a project's cost. There has been only one instance where the CEDC provided more than 50% of the total project cost. This was done for specific reasons. First of all, the loan amount was small. More importantly, the applicant/business owner had recently injected a large amount of equity into the business. When this amount is taken into consideration, the CEDC loan amount is much less than 50% of the total new funding injected into the business around the time of the CEDC loan. All loan applications that have been denied solely or in part because the request for CEDC assistance was more than 50% of the project have been done so because there was no recent or current substantial equity injection by the owner(s) and/or private sector financing for more than 50% of the project could not be found.

3. **"Funds are not for working capital but must be used for and collateralized with fixed assets"**

Another of the program guidelines is that the loan must be collateralized, usually by fixed assets. There have been 5 loans that have not been collateralized with fixed assets. These projects all are of a similar type and are sufficiently collateralized, although not with fixed assets. These projects are all loans from the CEDC to organizations that, in-turn, make small loans to small and very small businesses. The loans made by these organizations are assigned to the CEDC and serve as collateral for the CEDC loan. These organizations are all social service or financial service organizations and, as such, have little or nothing in the way of fixed assets to serve as collateral. It is very proper and normal to collateralize these loans in this way. All other CEDC loans are collateralized by fixed assets because they are loans to businesses that have land, buildings, and equipment to use as collateral. The purpose of this guideline is to insure proper security and collateralization of the loan, not that the collateral must always take the form of fixed assets. All loan applications that have been denied solely or in part for lack of collateral have been done so not solely on the basis of the availability of fixed assets to serve as collateral, but that there is insufficient collateral of any and all kinds to adequately secure the loan.

4. **"The company must show that it has adequate cash flow and profitable operations"**

Another of the program guidelines is that there should be adequate cash flow and profitable operations in order to make a loan. This reflects standard lending and credit criteria. However, it must be remembered that the CEDC is an economic development program and as such may make loans that are not strictly bankable by all normal standards. As a normal practice the CEDC looks for adequate historical and/or projected cash flow to support existing and new debt, sufficient collateral to secure the loan, and a history of profitability. As has been stated before, each project is evaluated individually. This does not mean inconsistent application of the guidelines. On the contrary, it means that all the criteria were applied to every loan.

Also, there are cases where the lack of operating profit is not as critical as in others. Many times Sub-S corporations and partnerships are operated in such a way that the profitability of the firm is not reflected on the net operating profit line. There may be more than sufficient cash flow generated by the operations to support the debt service. Profits and losses flow through to the owners who declare such income or losses on their personal income tax statements. In these cases there may technically be an operating loss but still sufficient cash flow to support the debt. We do not consider this kind of operating loss as a true loss in terms of indicating that the business is in trouble, is managed poorly, or is unable to repay a loan.

Every project in the CEDC portfolio has been carefully evaluated by experienced loan officers who have recommended to the CEDC approval of the project based on his or her comfort with the credit. All loan applications that have been denied solely or in part for lack of adequate cash flow and profitable operations are usually because credit evaluations of the projects indicate an inability to repay the loan and/or insufficient collateral.

5. **"Funds are to provide capital to businesses that cannot get funding from other sources"**

The guidelines state that one of the goals of the CEDC should be to help those companies that need assistance and not help the company if other resources are available to it. Of course, another CEDC goal is to do no more than 50% of the total project. Obviously, the company must be able to get half the requested funds from somewhere other than the CEDC. Usually this is a combination of bank or other private sector lender and some amount of new, additional owner's equity. The CEDC has never described itself as a "lender of last resort." On the contrary, the CEDC has stated that it will do only "credit worthy" projects. The niche that the CEDC tries to fill is one that assists credit worthy companies that may not be able to get the full amount of necessary funding from a private bank or lender. There have been a number of instances where a business has approached one or more banks that have refused to lend the full amount the business needs. When the CEDC enters the picture to provide half the funds and take a second position to the bank, the same bank that initially refused the full loan will do 40% or 50% of the project in cooperation with the CEDC. This is exactly the kind of service the CEDC was designed to provide. There have been instances where the CEDC made a loan to a company that possibly could have eventually found the full amount somewhere without CEDC participation. In most cases these were instances where the existing bank relationship could not from a regulatory or credit policy standpoint provide the full amount needed. The CEDC felt that the overriding job creation/retention aspects of these projects justified CEDC involvement on a timely basis.

Again, each project is evaluated on its own merits. Sometimes if a project has been turned down by several different banks it is because there is a credit problem or some aspect that makes the project one that the CEDC should not do. In other cases being turned down by several banks may not reflect badly on the credit worthiness of the project or there may be overriding economic development reasons for the CEDC to do the loan. Loans have been turned down both when other credit couldn't be found and when it could. Loans have been approved both when other credit couldn't be found and when it could. This should not be taken as a indication of inconsistency in the program. It is the normal variability resulting from a consistent application of the sum of all program guidelines to each project.

The first example on Page 9 of the Report describes a candidate who dropped the CEDC process because of the tax revenue calculation requirement. **This tax revenue calculation is required by the CEDC statute (ARS 41-1505.07C):**

> **"The total value of the assistance provided pursuant to this Section shall not exceed fifty per cent of the estimated increase in tax revenues received by this state and its political subdivisions as a direct or indirect result of the retention, expansion or location of such business..."**

The Report then states that **"it appeared Commerce calculated" revenue information for certain loan recipients. This statement is not true.** The Department is aware that this calculation can be very complicated so staff always offers assistance to those applicants who need it. We do not fill out the form for them - we only assist them in performing the calculation. No CEDC applicant or potential applicant has ever been denied access to the program because he or she could not complete this portion of the application. To clarify our willingness to assist potential applicants with the tax revenue calculation, the Department will state this in a revised CEDC application.

II. "CEDC Funds Are Not Getting to the Businesses That Most Benefit the State"

This comment is based on a study performed by the Department's consultant in 1989 suggesting the type of loans CEDC should make. Since that time, other small business loan programs have become more productive and new programs have been created to address the needs of existing Arizona small businesses. The Department will be doing another study in 1993 to determine the best use of CEDC funds in the state, taking into consideration new small business loan programs and historical business demands on the CEDC fund.

To date, 19 of the 26 CEDC projects have been assistance to small businesses (less than 100 employees) and, 41.62% of the CEDC funds have gone to small businesses. The CEDC has successfully focused its efforts to assist small businesses through the program. See page 11 for a detailed account of the current CEDC portfolio.

The Audit Report states that not enough CEDC funds are going to Arizona small business expansion projects. One reason that only 21% of the CEDC portfolio are for small business expansions is because Commerce staff always strives to direct these projects to the SBA program first which has unlimited federal funds rather than drain the limited CEDC funds. During federal fiscal year 1991-1992, the Department did 9 SBA small business expansion loans totalling $2.4 million and during the first 6 months of federal year 1992-1993 the Department did 6 SBA small business expansion loans totalling more than $1.4 million. These 15 loans could have been funded through the CEDC, however, the Department felt it was not financially responsible to do so.

The CEDC Guidelines make it very clear that the portfolio targets must be flexible. On page 3 of the Program Summary and Guidelines is the statement **"It must be remembered that these categories and percentages are guidelines only. The exact composition of the portfolio at any particular time will be determined by the level of funding available, type and viability of projects submitted to commission, estimated impact of each project..."** Program flexibility is stressed throughout the CEDC Guidelines.

The Department concurs with the Report that the CEDC has not met its original portfolio targets, however, most of the Arizona small business expansion projects have been funded through the Department's SBA program. These constituents have not been ignored. In the near future the Department will recommend to the CEDC that the portfolio target areas be adjusted to reflect historical business demands on CEDC funds. Additionally, the Department is currently working on an export finance program which will be an additional tool for existing Arizona small businesses.

III. "More Commission Involvement Needed in Decision-Making"

Under the direction of the CEDC, the Department has instituted the policy of screening applicants before they submit applications and/or before a full credit review and staff write-up is performed. There are several reasons for this process. However, the Department agrees it should provide the Commission with monthly reports on loan denials for Commission review.

In the first couple of years of the program, everyone who called inquiring about the CEDC was sent an application. Every application that was submitted to the Department had a complete analysis performed on it, and every request went to the Commission with a recommendation from staff to either approve or deny.

For several reasons this process was revised. First, many applicants did not meet even threshold criteria for the program. The staff and Commission felt that it was burdensome on these applicants to complete a full application when they had little chance of being funded. Also, having these applicants complete an application and have it go the Commission may have raised their expectations higher than was warranted by the strength of their project. In addition, much valuable staff time and Commission time was spent analyzing, preparing, and reviewing these applications. Therefore, the policy was made, and supported by the Commission members that the staff should screen CEDC applicants for minimum criteria, as established by the Commission, and reject the ineligible ones before applications were completed and before they went to the Commission level. These applicants all receive a letter notifying them of the status of their application. At the present time, all applicants who are notified of the rejection of their application, if they wish, can request that their application go to the Commission for review and disposition by the Commission.

This change was made with the knowledge and acquiescence of the CEDC Commission and the recommendation of the CEDC program consultant (NDC) and has therefore become standard operating policy for the staff.

The Department cannot comment on Example 1 on Page 13 because this occurred prior to this administration. The loan officer and manager involved are no longer with the Department.

Example 2 on page 13 has been misstated. First of all, this applicant did not have three years of operating losses, rather it had two years of losses and 11 current months of profitable operations. **To state that 3 different versions of a credit analysis were done on the same day is false.** What the Audit team didn't know is that at the time those drafts were prepared, it was staff's practice to put the date of the ultimate CEDC meeting on all drafts of write-ups that were performed. The several different drafts that the Audit team found were performed over a period of several weeks leading up to the date on the forms which was the date of the CEDC meeting. The differing conclusions expressed in the different versions reflect the changing information received by staff over a several week period. Staff frequently goes through several drafts of reports, each one an update based on new information. The fact that they all carried the same date was misleading to the auditors. Because of this unanticipated effect, especially to someone from the outside looking through the files, we have now instituted the practice of dating the write-ups the date we do each one or complete each one. Then the change over time can be tracked and understood for what it is -- the reflection of new information received by the staff over time and the changes created by it.

IV. **"The Commission Needs to Adopt Administrative Rules"**

The CEDC agrees with the Report that Administrative Rules should be instituted. The Department has been awaiting this Report in order to incorporate recommendations from this Report into the Commission's Rules.

Small Businesses Assisted:		NUMBER OF EMPLOYEES (Includes existing, new and/or retained jobs)	CEDC LOAN AMOUNT
1.	Ferrell Secakuku	20	$ 42,000
2.	First Commerce and Loan	*	150,000
3.	K-Tronics	16	70,000
4.	Project PPEP	*	157,500
5.	Smith and Bell	13	85,000
6.	Coronado Venture Fund	*	200,000
7.	Urban Coalition West	*	80,000
8.	Yavapai Block	45	300,000
9.	Eurofresh, Inc.	40	400,000
10.	Signature Industries	62	76,000
11.	Navi-Hopi Tours	40	25,530
12.	AACCO Foundry	78	140,000
13.	Arizona Economic Council	**	60,000
14.	Arizona Technology Incubator	*	300,000
15.	Riotech Inc.	56	100,000
16.	Barnjo, Inc.	8	50,000
17.	Jack of All Trades	33	25,000
18.	Lakeside Entertainment Group Inc.	38	150,000
19.	Crossroads Automart	9	105,000
	TOTAL		$ 2,516,030

Medium Sized Businesses Assisted:

1.	Muscular Dystrophy Association	105	$1,000,000
2.	Atlas Headware	165	100,000
3.	Monsey Products	300	250,000
	TOTAL		$1,350,000

Large Businesses Assisted:

1.	McDonnell Douglas Travel	615 (by '95)	$ 700,000
2.	Evergreen Air Center	700 (by '97)	230,000
3.	Capin Mercantile	1,490 (by '96)	250,000
4.	America West Airlines	7,000	1,000,000
	TOTAL		$ 2,180,000

* The loans made to these borrowers are put into small business loan, venture or seed funds which are in turn loaned to small businesses.

** Arizona Economic Council will use it's CEDC funds for the implementation of GSPED. GSPED affects mainly small businesses throughout the state.

ATTACHMENT B

RESPONSE TO FINDING II: STATE-RUN SBA LOAN PROGRAM SHOULD BE PRIVATIZED

The Department concurs with Finding II, that the SBA loan program should be privatized. The Department, in partnership with the Board of Directors of AEDC, will conduct a cost/benefit analysis to determine what privatization structure will best provide capital to small businesses across the State.

The State SBA loan volume has increased dramatically in the past two years. In FY91, AEDC had 3 SBA loan approvals, totaling $1.3 million. In FY92, AEDC obtained 11 SBA approvals for a total of $2.9 million.In the first 6 months of FY93, AEDC has obtained 8 SBA 504 approvals for a total of $2.1 million. This volume ranks AEDC as the fifth largest SBA lender in Arizona for the first half of SBA's fiscal year. AEDC placed ahead of both other Arizona CDC's, as displayed on page 14. Considering the number of applications being prepared for SBA approval, the volume for FY93 is projected to reach at least 20 approvals for approximately $5 million. This activity level will result in AEDC being one of the top 10 state-wide CDC's in the country in FY93. Currently, of the 33 statewide CDC's nationwide, AEDC ranks 15th in volume.

The Department, however, does take exception to many of the findings and conclusions stated in the Auditor General's report. In an attempt to bring greater understanding to the evolution of AEDC and the issues faced by CDC's, the Department offers the following comments.

1. It is true AEDC has had years when it was not operating at capacity. Several factors contributed and are important to recognize when a privatization plan is considered.

    - <u>Much of AEDC's service area is rural.</u> Historically it has been difficult to entice the rural lenders into financing economic development projects because of collateral concerns. It is misleading to compare AEDC's volume to PLDC's and BDFC's, both of which operate in exclusively urban, commercialized areas, where lender support has been outstanding.

    - Further, <u>it takes significantly more time to produce loans in rural areas</u> because of the time required for travel, the relative lack of sophistication of many borrowers and their support systems. Marketing to and educating lenders on rural areas is also more costly in terms of time and expense. Additionally, staff devotes much time to evaluation of many applications before finding a project acceptable to the lenders. As our volume increases, we are finding that the urban lenders refer projects to AEDC but it is still necessary to expend the extra time and expense to serve rural Arizona.

2. The quality of work performed by AEDC was found by the Auditor General to be "substandard." This conclusion was drawn after selecting comments from AEDC correspondence files. The underlying assumption made by the Auditor General was that all of SBA's stated concerns were, in fact, accurate or a problem caused by AEDC. This assumption is not true. Many of the selected comments reflected misunderstandings on the part of SBA, several were taken out of context and some reflected the usual human fallibility to which both AEDC and SBA staff are subject. Further, in some cases, the structuring and eligibility issues are part of the natural give and take between all CDC's and their SBA district offices and are usually not seen as "problems" but as a team approach to problem solving.

3. The report also indicates that the cost of the State's 504 program is "exorbitant." Recent efforts to increase volume indicate AEDC's awareness of the need for greater cost effectiveness. However, AEDC staff has responsibility for both AEDC and other department financial programs. As a result, their workload extends beyond what is typically required of CDC staff.

   Conservative FY93 projections of 20 loans for AEDC, puts the **projected AEDC cost per loan at $7,247.** As volume increases, staff expertise increases, which in turn, increases volume. AEDC expects the cost per loan to continue to decline given recent trends.

In conclusion, the Arizona Department of Commerce and the AEDC Board of Directors have recognized the program's shortcomings and have taken active steps to correct them. These steps have produced significant performance gains. Dialogue has been initiated among the AEDC Directors and staff, with SBA at district, regional and central levels to find ways to improve loan processing both at AEDC and at the SBA. AEDC's volume is increasing exponentially now that AEDC has addressed those areas needing improvement.

The above does not describe the features of a "substandard" program with "exorbitant" costs. Rather, this is a picture of a CDC that is reaching maturity, with an openness to suggestions and changes that enhance program delivery.

Arizona SBA Lender Performance*
Loan Volume for the six month period ending March 31, 1993

	Lender	Number of Loans	Dollar Amount
1.	The Money Store Investment Corp.	30	10,877,500
2.	Bank One (Valley National Bank)	15	2,783,200
3.	Bank of America Nevada	10	2,290,000
4.	M & I Thunderbird	9	3,219,000
5.	**AEDC**	**8**	**2,128,000**
6.	ITT Small Business Finance Corp.	8	1,915,000
7.	**BDFC**	**8**	**1,472,000**
8.	First Interstate Bank of Arizona	6	1,529,194
9.	Founders Bank of Arizona	6	824,300
10.	**PLDC**	**5**	**1,670,000**
11.	Republic National Bank of Arizona	4	2,357,000
12.	Zions Bank	4	1,156,000
13.	Rio Salado Bank	4	827,000
14.	Rocky Mountain Bank	3	785,000
15.	Western Security	3	445,700
16.	Bank of Arizona	2	316,450
17.	Bank of Scottsdale	2	82,000
18.	Harris Bank & Trust	1	600,000
19.	Southern Arizona Bank	1	283,500
20.	Biltmore Investors Bank	1	130,000
21.	Community Bank of Arizona	1	80,000
	Total	151	35,770,894

*Source: SBA News, SBA # 13:04:93; release date April 12, 1993. Contact Gary M. Petersen, Deputy District Director, (602) 640-2320.