AGENDA ITEM #10
January 15, 2019
Discussion

MEMORANDUM

January 10, 2019

TO: County Council

FROM: Gene Smith, Legislative Analyst
Marlene Michaelson, Executive Director *mm*

SUBJECT: **Discussion** – OIG Report #19-002, A Review of Management Control Deficiencies Contributing to the Misappropriation of Montgomery County Economic Development Funds

PUPROSE: Receive briefing; discuss report and implementation of corrective actions

Those expected for this discussion:
Ed Blansitt, Inspector General
Michael Morgan, Investigative Analyst, Office of the Inspector General
Andrew Kleine, Chief Administrative Officer
Alex Espinosa, Director, Department of Finance
Rich Madaleno, Director, Office of Management and Budget
Marc Hansen, County Attorney
Bill Broglie, Internal Audit

The Inspector General (IG) will brief the Council on its investigation, and following the IG, Executive staff will brief the Council on actions taken to prevent a similar occurrence from happening again.

Background

The Office of the Inspector General (OIG) released a report identifying management control deficiencies that contributed to the misappropriation of funds in the County's Department of Economic Development (DED).[1] See the Summary of Findings from the OIG Report on ©1-27, and the actions taken by the County to strengthen the controls and processes to address these findings on ©27-31.

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[1] The full OIG report is available at
https://www.montgomerycountymd.gov/OIG/Resources/Files/PDF/IGActivity/FY2019/mcded_mismanagement_final_report_19_nov_2018.pdf.
Also included are two technical reports prepared by Baker Tilly Virchow Krause, LLP that helped identify fraudulent, questionable, and other transactions in DED. Those reports are available at
https://www.montgomerycountymd.gov/OIG/Resources/Files/PDF/IGActivity/FY2019/bt_scope_1_ded_forensic_report_16_nov_18.pdf and
https://www.montgomerycountymd.gov/OIG/Resources/Files/PDF/IGActivity/FY2019/bt_scope_2_bin_forensic_report_16_nov_18.pdf.

The OIG summarized its findings as follows:

Former DED Directors used a 2006 agreement with a public entity to escape oversight by County government and create a standing reserve fund for use by the DED Director. The fund's availability increased the risk of improper financial transactions. Essential segregation of duties was absent within DED, and top-level DED management oversight was extremely weak.

Over an eleven year period, the DED COO took advantage of control weaknesses to divert at least $7.2 million from the County's Incubator Program without apparent detection or impact on program operations.

In implementing the BioScience initiative, DED management used public entities to fund the development and operations of a BioHealth intermediary without executing a formal Memorandum of Understanding (MOU) or Contract.

Prior to the release of the OIG's report, the County implemented actions to address the weaknesses identified in the report. Below is a summary of key actions (not exhaustive) taken to date.

- The Department of Finance (Finance) published two policies governing accounts payable operations. Specifically, these policies strengthened the segregation of financial duties within each department, required sufficient documentation to support payments, and eliminated direct payment of invoices except on a limited basis. In addition, a review by management found that no other departments had an issue with segregation of duties like DED.
- Finance is establishing a new Compliance Unit to review and approve department requests for exempt transactions.
- The County implemented a new administrative procedure to tighten controls for non-procurement agreements.

Potential questions for the Council

Based on the OIG report, Council staff shared the following questions with Executive staff in preparation for today's discussion.

- How many County contracts/agreements remain in effect that operate with a revenue stream and/or a reserve fund outside of the County's budget process?
- How do the corrective actions affect, if at all, the County contracts/agreements or public-private partnerships?
- Has the County implemented corrective actions that address the OIG's recommendations sufficiently? If not, what additional actions should be considered?
- Generally, how many transactions and how many dollars are exempt from procurement each year? Will the County consider additional monitoring of the using departments that have a larger share of procurement-exempt transaction beyond the corrective actions already taken?

- What are the processes in place to assist new directors in their duties of oversight of the department's financial records? Does each department have a transition plan or a check list for new directors to understand the County's processes?
- What type of training is required for all directors and managers about the County's financial controls and about reporting potential fraud, waste, or abuse? Has any of this training changed, either in content or in frequency, since the findings of the OIG report?
- How can the County effectively rotate career staff that minimizes disruption of services but meets the OIG's recommendation to prevent career staff from becoming "entrenched" and "immune to oversight?"
- Can the County provide public access to the non-procurement agreements (similar to procurement contracts) so the public can see and review the deliverables or performance expectations for the County's funding?

Council's Next Steps

Council staff discussed with the Council President how the Council should continue to explore its oversight role of the items addressed in the OIG report. As a result, Council and Office of Legislative Oversight staff will coordinate this review and provide an update and recommendations during the March Audit Committee worksession.

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A Review of Management Control Deficiencies Contributing to the Misappropriation of Montgomery County Economic Development Funds *(including Management's Proposed Corrective Actions)*

Background

The Office of the Inspector General (OIG) had conducted inquiries into several previous complaints about problems within the department. In addition to complaints related to DED management misconduct related to personnel issues, which we referred to the CAO for internal review and action, we received complaints regarding circumvention of contracting and procurement rules. However, we did not identify violations related to the specific matters presented by those complainants. Further, none of the complaints implicated the DED COO.

We did not review all the functions of the former DED. Activities formerly provided by the DED, including the County's Incubator Program and bioscience intermediary activities, were reviewed in this report. Other former DED activities - agricultural preservation and enhancement functions, workforce development, the Economic Development Fund, and economic grants – are not included within the scope of this review.

In early April 2017, the Montgomery County Office of the County Attorney received a summons from the Internal Revenue Service requesting all records in possession of Montgomery County, Maryland, related to the former Chief Operating Officer of the Montgomery County Department of Economic Development, and the;

- Chungbuk Incubator Fund LLC, which received payments from the DED, and;
- Chungcheongbuk-do Province, a province of the Republic of Korea with which Montgomery County had had a relationship for mutually beneficial economic development, and a member of Chungcheongbuk-do's Exchange Staff.

Upon receipt of the summons, the County began its own review of transactions related to these parties.

In early May 2017, a member of the Office of the State's Attorney for Montgomery County met with the County Inspector General to discuss its ongoing criminal investigation involving the DED COO. At that time, the Inspector General agreed to not initiate, and further to suspend any ongoing audit activities that might involve or be related to the DED COO in order to avoid inadvertently interfering with the criminal investigation. Subsequently, the County Attorney asked the Inspector General to participate in his staff's briefing of the County Chief

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Administrative Officer (CAO), at which time they provided specific evidence of several improper transactions and other related facts.

The County CAO subsequently advised the Inspector General of the CAO's intent to immediately engage CAO staff, along with any necessary contract expertise, to perform a review of existing accounting controls, and fully investigate and identify all potentially fraudulent or inappropriate transactions, including those related to the former DED and related parties. We agreed that the IG would participate in this effort.

- The County Office of Internal Audits engaged the accounting firm of SC&H Group to evaluate the internal controls related to the County's oversight of specific aspects of Procure to Pay operations as they existed at the time of their review. An additional objective of their review was to focus on the identification of process and control deficiencies related to agreements for programs that are exempt from, or not subject to, procurement regulations.
- The Office of the County Attorney retained the accounting firm of Baker Tilly Virchow Krause to conduct a forensic investigation.
- The role of the IG, to complement the efforts of the County and avoid duplication of effort, was to understand the findings and recommendations in these reports and, along with our independent work, identify systemic financial and management control deficiencies over the multi-year period, and recommend effective remedies.

For the purposes of our review, we used the GAO's *Government Auditing Standards* definition of internal controls which includes planning, organizing, directing, and controlling program operations, and management's system for measuring, reporting, and monitoring program performance.

Throughout the time period covered by this report, the individual to whom we will refer as the DED COO served in more than one capacity in the Department of Economic Development (DED) from 1997 until its dissolution, and later served in a position within the County government conducting activities related to the Business Innovation Network (Incubator Program) until June 2017, when evidence of the misappropriations was discovered and provided to County management. The individual's County employment was subsequently terminated. Related criminal charges have become a matter of public record but are not the focus of this report.[1] However, the facts that were stipulated and agreed to had that case proceeded to trial in the US District Court for Maryland are contained in Appendix E of this report.

During our review, which covered the period of Fiscal Year 2005 into the beginning of Fiscal Year 2018 (the Period of the OIG's Report), we identified more than $7.2 million that had been diverted from intended use by the DED COO.

[1] The use and disposition of funds have been the subject of the investigation by the United States Department of Justice and the Office of the State's Attorney for Montgomery County Maryland.

Summary of Findings

Four individuals served in the position of Director of the Department of Economic Development between 1995 and 2016:

- DED Director 1 served from 1995 until 2006 during the creation of the Incubator Program[2], and subsequently served as Maryland Secretary of Business & Economic Development, as a Senior and Executive Vice President with different banks, and currently with Scheer Partners Management, Inc. (Scheer), a commercial office real estate firm and a sub-contractor to DED with whom he has served as a Senior Vice President since 2011. Former DED Director 1 was replaced as department director during the government transition that followed the election of County Executive Isiah Leggett.
- DED Director 2 succeeded DED Director 1, and served until 2009,
- The Former DED Director served between 2009 and 2015, and
- A person we will refer to as the Former Acting DED Director, who had served previously as the Director of the Rockville Economic Development Inc. (REDI) and as the former Deputy Director of DED, served as Acting DED Director from January 2015 until the DED was dissolved and replaced in 2016 by a non-profit, public-private partnership, the Montgomery County Economic Development Corporation (MCEDC) created with the recommendation of the County Executive and vote of the Council.

Finding 1 Former DED Directors used a 2006 agreement with a public entity to escape oversight by County government and create a standing reserve fund for use by the DED Director. The fund's availability increased the risk of improper financial transactions.

A 2006 Management Agreement (2006 Agreement) between Montgomery County and the Maryland Economic Development Corporation (MEDCO), a public entity[3], contains a Special Reserve Account funded from any royalties and annual operating surpluses, which provided the

[2] The Business Innovation Network traces its origins to the 1993 Montgomery County Technology Center in Rockville.

[3] County Code 11B-1 defines *Public entity* as: (1) the federal government; (2) a state government and any of its agencies; (3) any political subdivision of a state government and any of its agencies; (4) any board, commission, or committee established by federal, state, or local law; (5) any organization or association of the federal government, state governments, or political subdivisions of state governments; and (6) any other entity that is: (A) qualified as a non-taxable corporation under the United States Internal Revenue Code, as amended; and (B) incorporated by an entity under paragraphs (1) through (5) for the exclusive purpose of supporting or benefiting an entity under paragraphs (1) through (5)

DED with complete control of unused public funds available for the procurement of unspecified economic development projects approved at the sole discretion of the DED Director.

This arrangement circumvented management controls established by the County government, avoided transparency and oversight by elected County officials, and created a standing reserve fund for use by the DED Director. The County is required to follow County procurement law,[4] which does not require a public solicitation or justification for a public entity, non-competitive procurement. Contracting controls did, however, require that the Director of the Office of Procurement determine that the engagement was in the best interest of the County, and that the contract otherwise meets the legal and risk management review requirements set out under County procurement regulations.[5] DED circumvented all of these requirements, and was able to misuse the public entity contract with MEDCO to avoid existing management and financial controls.

The Special Reserve Account appears to trace its origin to the County's June 1998 Grant Agreement[6] with MEDCO to manage the Incubator Program housed in a facility that would result from MEDCO's issuance of Lease Revenue Bonds for the Maryland Technology Development Center.[7]

The 1998 Grant Agreement and 1998 Trust Indenture coordinated language to establish a Special Account at MEDCO to accumulate funds[8], the existence and amounts of which would not be readily apparent to management, the Council, or County residents (a relationship hereafter referred to as "Off-Book"). This Off-Book account appears to have been carried forward into the subsequent grant agreements for additional Incubator Program facilities and their renewals.[9]

After it entered into the management agreement with the County, MEDCO employed Scheer[10], the firm referenced above, as a subcontractor to provide facility management, accounting, and related services for the Incubator Program at that facility.

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[4] County Code, §11B, generally.

[5] County Code, §11B-41. COMCOR §§11B.00.01.01.3 and 11B.00.01.09.2.

[6] §1.1, Grant Agreement dated June 1, 1998 between The Maryland Economic Development Corporation and Montgomery County, Maryland. This agreement was recommended by then DED Director 1, and signed by then County Executive Doug Duncan.

[7] Trust Indenture for the $4,490,000 Maryland Economic Development Corporation Taxable Lease Revenue Bonds (Maryland Technology Development Center Project), Series 1998, Dated as of June 1, 1998, between Maryland Economic Development Corporation, As Issuer, and Crestar Bank, As Trustee.

[8] The agreements define the calculation of an "Operating Surplus" which may be deposited into a "Special Account" "only if the MIDFA Insurance Agreement is not in effect, MEDCO shall deposit the Operating Surplus into a separate interest bearing account (the "Special Account"), Monies deposited into the Special Account may only be used for economic development projects in Montgomery County, Maryland, as approved by the Director of the Montgomery County Department of Economic Development (the "Director")." 1998 Grant Agreement §1.1. 1998 Trust Indenture §4.08.

[9] The Special Reserve Accounts (alternately, Special Account) remained as a feature in the 2006 revision of the DED Management Agreement (2006 Agreement) with MEDCO and subsequent 2007 and 2016 grant agreements.

[10] This arrangement between MEDCO and Scheer occurred during DED Director 1's term. DED Director 1 currently serves as a Senior Vice President of Scheer.

Finding 1(a)Essential segregation of duties were absent within DED.

"Segregation of Duties"

> Management divides or segregates key duties and responsibilities among different people to reduce the risk of error, misuse, or fraud. This includes separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets so that no one individual controls all key aspects of a transaction or event.
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> *Source: GAO-14-704G Federal Internal Control Standards*[11]

The 2006 Agreement specified that the DED Director could make decisions or authorize actions without additional consent or approval from the County, and could designate such authority to other individuals. The agreement, as created through MEDCO and Scheer by then DED Director 1, and implemented by later DED Directors, either through intentional design or unintended consequence, ultimately ensured that all financial transactions and information related to the Incubator Program, although available to other entities within the County, would pass through the DED COO.

Budget formulation, budget execution, vendor engagement and management, and invoice processing and approval are responsibilities normally expected to be implemented and managed with appropriate segregation of duties within individual departments and offices within County Government. Decentralized management relies on the design and execution of effective controls at departmental levels, and the existence of centralized oversight and monitoring functions. Prior to August 2017, segregation of duties under the County's decentralized management concept was expected but not required, nor was there an external system of enforcement.

Accordingly, there were no systems in place designed to detect deviations on the parts of the departments that could indicate the misappropriation of County funds. Further, the lack of a formal, documented procurement-exempt agreement policy resulted in a gap in oversight that failed to identify ineffective department controls and allowed for the misappropriation of County assets.

This put the DED COO in a position to act with the full authority of DED management, but outside its oversight and outside the purview of internal controls in place for transactions within the County's systems. DED management did not implement effective internal controls designed to exercise its oversight responsibility, monitor the department's control systems related to payment approval authorities, safeguard against unsegregated key duties, nor evaluate results.

[11] Comptroller General of the United States, Government Accountability Office, *Standards for Internal Control in the Federal Government*, page 47. Government Printing Office, September 2014.

This situation represented a lack of segregation of duties that should have been recognized and corrected by DED management.

The agreements containing the Special Reserve Account arrangements were made openly, and seemingly with appropriate County approvals.[12] These circumstances, when combined with financial management control weaknesses (discussed later in this document) that existed within the County Department of Finance (DoF), left the County government vulnerable to losses from improper or inappropriate payments, and had future consequences.

Subsequent DED Directors either did not recognize or were unconcerned about the inherent operating vulnerabilities created by the 1998 and 2006 agreements. We found no indication that either the County Department of Finance or the County Office of Management and Budget were aware of or ever expressed concerns about these vulnerabilities.

Finding 1(b)Top-level DED management oversight was extremely weak.

In a voluntary interview during August 2018, the Former DED Director described his management of DED as "Hands Off". Other evidence we located indicates that the Former DED Director was not engaged in daily DED operations. In a June 2009 e-mail, the DED managers were advised to go through the Former DED Director's calendar and send him "a BRIEF e-mail updating him on any issue(s) that may be discussed during his meetings for that week." The purpose of the "bulleted" e-mails was to be sure that the Former DED Director was aware of what the staff reported they were doing in a concise fashion. This change followed an earlier message in which the DED COO had been directed to reduce the Director's weekly meeting with the department managers from one hour to one half-hour.

Politically appointed Directors are often short-tenured, focused on executing the policy objectives of an administration, and may not be either willing or qualified to manage career staff in a governmental organization. Career senior managers must be relied upon to carry out the agenda of the elected officials and their political appointees. However, those managers, especially those with financial responsibilities, should not be allowed to become entrenched in their program areas and immune to oversight and administrative or accounting controls.

[12] In June 1998, then DED Director 1 recommended a bond indenture agreement and Management Agreement, reviewed by an OCA Staff Attorney and signed by then County Executive Doug Duncan that established a Special Account at MEDCO to be funded by operating surpluses

"Tone at the Top"

> The oversight body and management lead by an example that demonstrates the organization's values, philosophy, and operating style. The oversight body and management set the tone at the top and throughout the organization by their example, which is fundamental to an effective internal control system. In larger entities, the various layers of management in the organizational structure may also set "tone in the middle."[13]
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> *Source: GAO-14-704G Federal Internal Control Standards*

The Former DED Director acknowledged that he had provided his password to the DED COO and possibly to other staff members, although he could not specifically remember with which other staff members he might have shared his password. Access to the shared password would have given the DED COO the ability to log on to the County information technology system as the Former DED Director and conduct transactions, such as sending e-mails, under the Former DED Director's name.

It might have been possible under those circumstances for the DED COO to have hidden e-mails from the Former DED Director. However, attempting to cover the traces of e-mails so that the Former DED Director would not have been aware of them would have required numerous steps. It is probable that then Former DED Director would have detected any proxy e-mails, unless he seldom checked his own e-mail. Nonetheless, during the August 2018 interview, the Former DED Director was presented with hard copies of many e-mails that appeared to have originated from his e-mail address and been sent by him. Some of the e-mails he claimed not to remember. Some of the e-mails, he further claimed, did not appear to be his work products.

Montgomery County's Administrative Procedure 6-7 and Computer Security Guidelines direct that employees must not share identification passwords with others.[14] Connection and access to computing resources is controlled through unique user identification (user-ids) and authentication (passwords). The Administrative Procedure states *"Each individual granted this privilege is responsible and accountable for work done under their unique identifier"* (IG emphasis added).[15] Administrative Procedures caution that "A County employee who violates this administrative procedure may be subject to disciplinary action, in accordance with [applicable laws and regulations[16]]" and that "[v]iolation of this procedure is prohibited and may lead to disciplinary action, including dismissal, and other legal remedies available to the County."[17]

Further examples of inadequate management oversight are presented in the discussion of Finding 2.

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[13] Comptroller General of the United States, Government Accountability Office, *Standards for Internal Control in the Federal Government*, §1.03, page 22. Government Printing Office, September 2014.

[14] Administrative Procedure 6-7 6-7 §4.4(B), and Computer Security Guidelines §5.2.

[15] Computer Security Guidelines §2.

[16] Montgomery County laws and executive regulations, including Personnel laws and regulations, and Ethics Laws, currently codified at Chapter 33, COMCOR Chapter 33, and Chapter 19A of the County Code, respectively, and applicable collective bargaining agreements, as amended.

[17] Administrative Procedure 6-7 §3.6

Recommendation 1: We recommend that County management provide and ensure implementation of specific and adequate guidance relating to public entity procurement regulations and guidelines for departments and agencies, to ensure they observe the intent of County public entity purchasing laws and appropriate use. It should be emphasized that serious consequences arise when an entity acts in any manner to circumvent contracting, financial, and procurement controls because the entity's management deems them to be an impediment to their operations.

Recommendation 1(a): County management should ensure that it divides or segregates key duties and responsibilities among different people to reduce the risk of error, misuse, or fraud. This includes separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets so that no one individual controls all key aspects of a transaction or event.

Recommendation 1(b): Periodic rotation of staff with financial responsibilities is a fraud prevention and detection technique. Periodic rotation of managers is an accepted executive development and succession planning technique. We recommend the periodic rotation of career managers among departments to help prevent them from becoming entrenched in their program areas and immune to oversight and administrative or accounting controls.

Flawed Execution of Two Department of Economic Development BioScience Initiatives

BioSciences emerged as a strategic economic initiative for the County during the fall of 2008.[18] At that time, press releases and internal memoranda indicate that the County Executive, County Council, and County management were focused on stimulating economic growth from new and previously untapped opportunities that existed within the County.

In December 2008, then DED Director 2 distributed an economic development strategy entitled "A Vision for Economic Development in Montgomery County' (DED Strategic Plan). That plan presented reasonably well articulated and measurable goals, action items, and related accomplishments for economic development in Montgomery County. Bioscience initiatives were addressed in the document.

Execution of the Chungcheongbuk-do Initiative

The County, led by County Executive Isiah Leggett and accompanied by local business leaders and a DED contingent, undertook a trade mission in October 2008 to visit the Republic of Korea (Korea) and its Osong biotechnology cluster. The mission promoted Montgomery County to South Korean companies seeking North America strategic opportunities, and encouraged investment in County's life sciences and advanced technology sectors. During this visit, the Governor of Chungcheongbuk-do Province Korea (Chungcheongbuk-do) pledged $2 million to be used for the construction of the East County Center for Science and Technology.

In a November 6, 2008 memorandum regarding the *Montgomery County Business Development Mission to Korea and China* to then DED Director 2 and the DED COO, DED Business Development Staff observed that "[t]he core strategy deployed by the County thus far has been to highlight the strong presence of federal regulatory agencies and research institutes. A missing piece of the puzzle here is how international companies could leverage these assets to achieve success in the U.S." With respect to the $2 million pledge, they recommended that the County should "[f]inalize the proposed joint incubator development agreement with Chungbuk" to enable Chungcheongbuk-do to incorporate the pledge in its 2010 budget request. The

[18] In early 2009, County Executive Isiah Leggett also commissioned a 29-member Green Economy Task Force for the purpose of charting "a bold new course for Montgomery County focused on creating opportunities for new and existing 'green' businesses, spurring innovation, increasing employment, and developing next generation technologies."

Chungcheongbuk-do Provincial legislature subsequently adopted a budget in 2010 that included funds for the contribution.

It is not certain whether the DED had articulated any strategic expectation or explored the specific outcomes for international companies to leverage the presence of federal regulatory agencies and research institutes to stimulate biotechnology economic development in Montgomery County. It was apparent, however, that as initial cooperative efforts for the development of the East County Center began to falter, the DED COO led efforts within the County to repurpose use of the pledged funds. Correspondence among the DED COO, the executive directors of DED and MEDCO, and a Chungcheongbuk-do official began to explore use of the Chungcheongbuk-do investment for rent-free office and lab space at the County's Shady Grove Incubator.

The initial intent of the relationship was to establish and promote cooperative strategies and processes related to the development, implementation and operation of joint programs and projects to accelerate biotechnology and other high-tech economic development in both regions. By February 2010, however, officials from Montgomery County and Chungcheongbuk-do Province developed a Memorandum of Understanding (MOU) to repurpose the Chungcheongbuk-do pledge for use as additional funding for the County's Small Business Revolving Loan program in exchange for Chungcheongbuk-do future access and use rights in the East County Incubator.

The repurposing of Chungcheongbuk-do pledged funds was not subject to clearly established objectives, nor monitored for performance. Additionally, the Office of the County Attorney (OCA) Staff Attorney raised questions regarding the MOU as it appeared to be unusually one-sided in the County's favor. DED Management's push to fulfill a biotechnology-focused economic development vison absent strategic expectation or anticipated outcomes may have provided an opportunity for mismanagement of the Chungcheongbuk-do relationship for the benefit of the DED COO.

The Chungcheongbuk-do bioscience initiative, largely negotiated and managed by the DED COO, does not appear to have achieved any meaningful result, and Chungcheongbuk-do's entire monetary contribution was ultimately returned after four years, with interest and fees[19], and with much wasted effort on behalf of, but no apparent beneficial impact for, the County. In a subsequent e-mail exchange with a consultant, the DED COO reminisced "it took me nine years and three governors to finalize a partnership with Chungbuk province but I terminated it after 3 years due to their non actions and ridiculous demands. Similar with China. We have two MOUS but all BS."

[19] The interest returned to Chungcheongbuk-do did not observe the interest calculation set forth in the MOU, paying a portion of the interest (70% of ~4%) and 100% of the fees (1% of the principal amount of any loan) for the two loans made by the Small Business Revolving Loan Program. The MOU provided for the County to retain interest earned on the $2 million before its use as part of the SBRLP.

Finding 2 Over an eleven year period, the DED COO took advantage of control weaknesses to divert at least $7.2 million from the County's Incubator Program without apparent detection or impact on program operations.

Between 2007 and 2016, the DED COO directed payments from resources belonging to the Montgomery County government and incubator-licensee funded Incubator Program to a relative of his spouse, to a business owned by that relative and his spouse, and to a commercial checking account for a shell company established in 2009 - the Chungbuk Incubator Fund LLC (CBIF) and to business associates related to that shell company. Records show that the DED COO established the CBIF commercial checking account and was a member of the CBIF. The majority of the payments went to this fictitious business that he controlled. To date we have identified 30 payments totaling more than $7.2 million made that originated either from the County government or the Incubator Program.

Payments made to CBIF related entities by:	# of Payments	$ of Payments
Montgomery County Government	12	5,529,464.63
Scheer	8	1,163,987.63
MEDCO	10	549,200.00
Total	30	$7,242,652.26

In our August 2018 interviews with former DED Directors from the 2009-2016 time period, neither the Former DED Director nor the Former Acting DED Director acknowledged ever having approved of the establishment of, or even having heard of, the CBIF. We found no legitimate business purpose served by the establishment of the CBIF shell company and no legitimate reason that any of the funds should have been transferred to the commercial account of the CBIF shell company. The Office of the Inspector General (OIG) was advised by law enforcement investigators that the DED COO withdrew funds from the account of the CBIF shell company exclusively for his personal use and that none of the funds deposited to that account were used to support the objectives of the DED Incubator Program.[20]

DED staff voiced concerns at some point prior to 2014 about the actions of the DED COO to the MEDCO Director, who was alleged to have replied "this is [the DED COO's] money - the County's money to spend. We're not going to argue with them. It's not [my] role to monitor how Montgomery County spends their funds." Between 2007 and 2016, the DED COO directed MEDCO to make 10 payments totaling $549,200 to a relative of the DED COO's spouse, a

[20] The use and disposition of funds deposited in the CBIF checking account have been the subject of the investigation and legal proceedings by the United States Department of Justice and the Office of the State's Attorney for Montgomery County Maryland. We were advised that these agencies had identified payments benefitting the DED COO.

business owned by the relative and spouse, to the shell company, and to business associates related to that shell company.

In an interview with MEDCO, the OIG was told that the MEDCO Director had contacted then Former DED Director to confirm whether or not MEDCO was to accept instructions it received from the DED COO. In a separate interview, the Scheer COO reported that he, too, sought similar assurances. We were advised that the Former DED Director defended the authority of the DED COO, provided oral authorization, and purportedly provided the following July 22, 2010 e-mail as evidence of the DED COO's authorities:

> "This e-mail is to require that effective immediately, all budget, fiscal, procurement (commodity/service purchase, contract and MOU), and administrative and human resource (except for the division unique time sheet and comp time approval, and performance review and work program setting) issues must be reported to [the DED COO]. As the department's Chief Operating Officer, his concurrence/approval must be obtained before a decision is made.
>
> Most of you already work under this protocol. However, with the implementation of new Enterprise Resource Planning System and the new Procurement Regulation, together with the County government's renewed emphasis on accountability and operational efficiency, I want to ensure that there is a central and traceable process in all expenditures, commitments, and administrative decisions that DED makes.
>
> If [the DED COO] is not available for urgent issues, [a named, alternate individual], Senior Financial Specialist must be consulted for the next course of action.
>
> I appreciate your adherence to this requirement."

MEDCO asserted that the above e-mail ceded complete authority for the DED COO to act on behalf of DED. However, the language of the e-mail only provides for the DED COO's concurrence on operational matters.

Although both MEDCO and Scheer claimed to have questioned the Former DED Director about the DED COO's authority to instruct that payments be made to CBIF, neither MEDCO nor Scheer received contracts or other appropriate documentation between CBIF and the County prior to making those payments directed by the DED COO.

We obtained copies of financial reports and records related to the incubators that Scheer provided to the County. Despite our concerns about the reliability of the accounting data presented in those financial reports, they contained significant useful information including such things as payments made from the Incubator Program accounts.[21] They also indicate payments to the shell company. A manager reviewing those financial reports could have found sufficient concerns about the Incubator Program and the activities of the DED COO to at least raise questions. During his tenure, the Former DED Director was in a position to detect the existence of the shell company. The Former Acting

[21] Upon our recommendation, the Office of the County Attorney modified the scope of its forensic investigation engagement with the accounting firm Baker Tilley to include an investigation and reconstruction of the Incubator Program accounting records maintained by MEDCO and Scheer.

DED Director was also in a position to detect the existence of the shell company during her tenure. Yet we found no evidence to demonstrate that either the Former DED Director or the Former Acting DED Director personally reviewed any financial reports or took any action to seriously examine the actions of the DED COO.

It is somewhat surprising that the Former DED Director never reviewed financial statements of the incubator programs since, as he told us, he had to become personally involved in managing issues related to licensees whose past due rent payments were putting a financial strain on the program. Former Deputy Director and the Former Acting DED Director confirmed the Former DED Director's account of the need for his involvement attributable to the past due payments. However, during their August 2018 interviews, both stated that they had not reviewed the financial statements provided by Scheer.

Their management of the staffing and finances of the Department demonstrated a lack of attention and oversight. We noted that the non-merit Position Description for the DED Director, occupied as a political appointee, did not specify any supervisory, oversight or managerial duties or responsibilities related to the department. However, in interviews, both the Former DED Director and the Former Acting DED Director told us that as Department Directors, they approved the performance ratings of top managers, including the DED COO. Therefore, despite the position description, they evidently understood themselves to have had responsibilities for supervision and oversight of the senior Department staff.

The individuals responsible for ensuring that the licensees made timely payments and that the Incubator Program was financially sound were initially direct subordinates of the DED COO, who should have been held accountable for the financial mismanagement due to delinquent rents collection that was observed. It is therefore notable that despite Incubator Program management problems that had developed to such an extent that the Former DED Director's direct intervention was required to effect correction, the DED COO evidently suffered no adverse consequences as the result of his mismanagement. Instead, both the Former DED Director and the Former Acting DED Director acknowledged providing the DED COO with the "highest possible" performance evaluations during their respective tenures resulting from what each characterized as the DED COO's high level of competence, strong abilities, and responsiveness.

The DED COO was highly placed within the organization, had financial management responsibilities, and had significant authority as well as knowledge of existing internal controls and management. He was unusually well positioned to understand the opportunities presented by gaps in the system of controls in place at various points in time. Several examples follow, and are described in further detail in the *Evaluation of Findings* section

1. Between April 2007 and September 2009, DED COO instructed MEDCO to make $163,000 in payments to a relative (Relative) of the DED COO's wife (Spouse). These payments, purportedly for the Relative's work on a Feasibility Study related to the Life Sciences Center, were drawn upon County funds on deposit in the Special Reserve Account with MEDCO. We found no evidence to support that the Relative had been authorized to undertake a Feasibility Study, nor was there evidence that such a study had been delivered by the Relative.

2. In June 2008, the DED COO instructed MEDCO to draw upon County funds on deposit with MEDCO to make a $145,000 loan to a restaurant owned 20% by the Spouse, and 80% by the Relative (Spouse/Relative Business). It is notable that with full knowledge of the potential conflict of interest and public attention that was drawn to the 2007 $25,000 Economic Development Program Loan made openly to a company whose Chief Marketing Officer was the son of the then DED Director 2, the DED COO chose to use the public entity, MEDCO, to disburse the loan funding in a manner that hid the existence of the loan.
3. Between 2010 and 2016, knowledge of funds available in, and the operations of the Special Reserve Account at MEDCO allowed the DED COO, pursuant to his delegated discretion and authorities, to redirect the County's grant funding for the Incubator Program to the shell company CBIF while using Special Reserve Account funds to cover any cash shortfalls within the operations of the Incubator Program.
4. Between 2010 and 2016, the DED COO caused invoices to be generated by his shell company, CBIF, purportedly for grant funding and leasehold financial obligations of the Incubator Program. As the financial manager for DED, he would have known that invoices that had been designated with the "Rent/Lease" exempt commodity payments code would have likely, at that time, been processed by DoF Accounts Payable Section without question or challenge for the underlying vendor agreement that supported the payment request submission (even though that agreement did not exist).
5. From at least May 2013 through February 2016 the DED COO directed that rental payments from a sub-lessor of DED office space totaling $125,276.32 be sent to accounts held for the benefit of the Incubator Program. It is not clear whether this action occurred with the knowledge and approval of the Former DED Director. However, this resulted in a clear augmentation of the Department's appropriation outside the view of the County Budget staff and without the knowledge and approval of the County's Executive and Council.

The structure of the Incubator Program provided for budgets to be developed by DED to justify requests for funding during annual budget deliberations. However, prior to FY 2017, once appropriations were approved, the Incubator Program appropriations were not separately identified in the published Council approved budgets. Large "blanket" disbursements from the County were provided to MEDCO, which had the responsibility to further disburse the funds, as necessary to pay for debt repayment, facility leases, facility management fees, and other related expenses.

Once County resources were placed under the control of MEDCO and its subcontractor, Scheer, County accounting and budget staff were forced to rely upon the financial accounting records maintained by those entities or the financial information the DED COO provided regarding the Incubator Program.

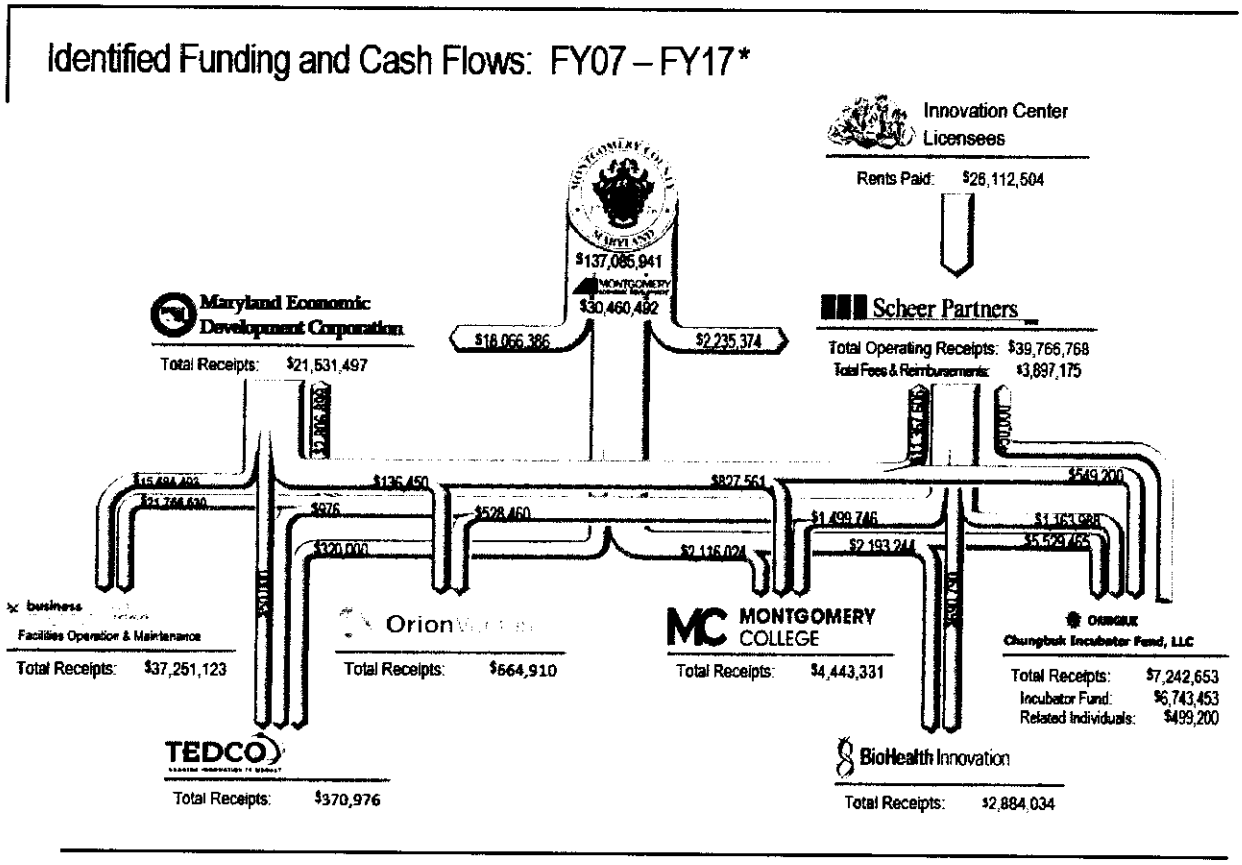
We found no evidence that anyone within the County ever made an effort to determine the adequacy of the accounting systems of either MEDCO or its subcontractor, Scheer. Although periodic financial audits of the Shady Grove and Rockville incubator locations were conducted by MEDCO auditors for the preparation of that agency's annual financial reports, none were conducted at the Germantown location at which the County resources were primarily being manipulated by the DED COO. Three transactions the DED COO charged against the Shady Grove and Rockville accounts were not selected for testing during review by MEDCO's auditors.

The County also had the authority to audit the financial records of MEDCO and its subcontractors relative to the Incubator Program, but did not do so. Had they audited the Incubator Program, it is possible that these control issues would have surfaced. Instead, it relied on the assurances provided from the DED COO's review of the financial records.

The DED COO was able, over time, to accumulate reserves from annual operating surpluses at the Incubator Program, derived from County funding and licensee fees. The composite net operating surpluses from the Incubator Program were retained within the MEDCO housed Special Reserves Account, and commingled with operating surpluses and funding activities from periods prior to the period between August 2006 and August 2017.

Based on data made available for our forensic review, net annual operating surpluses between FY2007 and FY2010 added $1.86 million to the Incubator Program funds, allowing the DED COO to cover and obscure any cash shortfalls created by the diversion of the County's annual funding payments for the Incubator Program to CBIF that he commenced in July 2011.

We found no documentary evidence that the Office of Management and Budget (OMB) identified or challenged the significant growth in funding requests (from FY11 to the peak incubator funding request, Germantown rose from $442,000 to $970,500 in FY15, and Shady Grove increased from $200,000 to $1,147,000 in FY16) when the payments were redirected to the CBIF. Neither did we find documentary evidence that OMB was aware of or considered funds available from annual operating surpluses that remained at year's end as a possible offset to new budgetary requests. During the period between August 2006 and August 2017, Montgomery County provided funding in excess of $30 million to its Incubator Program. The chart on the following page depicts the flow of those funds to MEDCO, Scheer, and other entities engaged in the operations of the Incubator Program:



* *August 22, 2006 - August 23, 2017*
Source: OIG Graphic from data provided by Montgomery County, MEDCO, & Scheer Partners

Excess reserves enabled the DED COO to submit invoices for legitimate DED departmental expenditures to be paid from the Incubator Program funding. The money that had been budgeted for these items at the DED departmental level was then available to enlarge the amount that the DED COO could direct as payment to CBIF.

Funding for the Incubator Programs was received as part of DED's annual County Council-approved appropriation. Incubator Program funding was not distributed to MEDCO until the DED received an invoice requesting the annual operating funding for each incubator. Evidence indicates that the DED COO routinely instructed MEDCO as to the Incubator Program funding amount that should be specified on the invoice. The funding amount was not routinely made available for public review, nor did it resemble the pro-forma budget requests prepared by Scheer and DED Staff. CBIF began to submit invoices to the County and receive the annual operating funding payments for the Germantown and Shady Grove Incubator Programs in FY2012.

The internal controls that should have detected or prevented the DED COO's activities were either missing or ineffective as implemented.[22] Although the internal controls present in the

[22] See the discussion of internal controls in the report *"Internal Control Review Procure to Pay – Specific Functions"*, prepared by SC&H Group under an engagement with the County's Internal Audit program, and the *Report of Forensic Audit to Montgomery County, Maryland* prepared by the firm of Baker Tilly Virchow Krause under an engagement with the Office of the County Attorney.

accounting system evolved over the period of approximately 10-years, primary responsibility for the failure to prevent the misappropriation of funds lies with the absence of oversight and management failure of DED Directors, the flawed structure of the Incubator Program, and its management agreements. Specific problems included the lack of segregation of duties, and the DED's deliberate construction of processes to circumvent contracting and procurement requirements, and management controls. It is likely that the budgetary and management system relied on inaccurate and unreliable information and could not effectively control Incubator Program resources or detect suspicious activities.

While DED's management actions and inactions may not at the time have presented an element of risk, over time, the cumulative effect of these decisions created the conditions that enabled the DED COO to opportunistically misappropriate at least $7.2 million of County economic development funding for his own personal benefit, including:

1. The availability of the public entity where funds could be parked, off books, and out of the direct control and scrutiny of the County procurement, legal, financial, and management and budget processes and systems;
2. the agreements with MEDCO and Scheer which institutionalized the creation of accounts within which budget surpluses could be hidden from the County, the ability of the DED Director to charge expenditures associated with programs unrelated to the incubators, and the ability of the DED Director to delegate operation of the incubator program;
3. the acquiescence of MEDCO and Scheer to the purported delegation of total authority for incubator program operations to the DED COO without authorizations from any other County officials;
4. the absence of management oversight and engagement in most DED operational activities which allowed the DED COO to act with impunity;
5. the DED COO's knowledge of accounts payable controls that allowed him to submit and approve payments to the shell company with little to no questioning about the legitimacy of the organization or use of the funds;
6. the absence of segregation of duties that placed the DED COO in a position that not only allowed him to be the central point of focus through which operational, financial, and strategic information flowed into and out of DED, but also allowed him to use accumulated and institutional knowledge that he possessed to navigate the system to his advantage;
7. ineffective Incubator Program performance metrics that apparently failed to detect any impact on program operations during the four-year period when the DED COO diverted the County's Incubator Program funding to the CBIF; and
8. agreements between the County and other parties that lacked a unique identifier, such as a contract or document number, to differentiate the documents by some method other than execution date and signatures of the authorized parties. The absence of a unique identifier made it difficult to match invoices to an appropriate contract, and allowed the DED COO to simply assert that a fictitious payment was authorized under an unrelated agreement.

Management revised accounts payable policies in April 2018, to match procurement payments authorizations to evidence of completion, and in August 2017, to strengthen segregation of duties and public entity payment controls.

Additional recommendations for improvement related to weaknesses identified in financial controls over payment approvals for pre-approved transaction types and contracts are detailed in the Office of Internal Audit's report on *Internal Control Review: Procure to Pay – Specific Functions*.

Recommendation 2

(a): The County should not disburse payment against any grant or contract prior to execution of a document that sets forth, at minimum:

- the terms and specific enumeration of quantifiable and measurable outputs,
- outcomes to be delivered, as well as when, how, and to whom they will be delivered, and
- Office of the County Attorney, Risk Management, and Office of Procurement contract requirements.

Management should require the awardee to submit verifiable evidence of having achieved the stated outputs and outcomes when submitting subsequent invoices for payment against the award.

(b): If the County is using the award to fund the delivery of an out-sourced program or operation, the County should additionally require the awardee to account for the use of the County's funds and require that any surplus funds at the end of the award period be identified and returned to the County, or reappropriated.

(c): *Audit and review of Third-party Providers*: Prior to awarding the responsibility for accounting for County funds, the County should require independent certification of the accounting systems that the public entity, public-private partnership, or subcontractor will use. Annual financial audits and reviews should be performed when expenditures reach significant (to be determined) dollar thresholds.

(d): *Ongoing Budget Execution Reviews* - County Management should ensure that:

- its analysts have the full and accurate information and the tools necessary to independently and continually monitor and compare actual expenditures to appropriated amounts to ensure that progress in programs is proceeding as intended,
- program surpluses or shortages are timely identified, and not allowed to accumulate unless approved by management and publicly reported,
- accounting controls are in place to ensure that any significant program expenditure variances can be apparent to budget analysts in both the Executive and Legislative branches, and
- Department Directors are required to document and report on significant program expenditure variances, as well as their effect on their programs, which are subject to judicious analysis.

(e): Because the elements of control listed below were missing or not evident at the time the questionable payments were processed, management should ensure that each element is addressed in a corrective action plan.[23]

- Enforce Evidence of Receipt: The payment system should ensure that evidence of receipt of goods or services is provided prior to approving any payment. Evidence should be provided that the purchase was authorized (e.g., via purchase requisition and matching purchase authorization) and received (e.g., receiving report).
- Unique identifier: Management should ensure that all contracts, MOUs, loans and mortgages, or other known recurring payments that cover multiple months and/or accounting periods (such as fiscal years) are recorded with a unique identifier in the accounting system. No payment should be allowed without reference to that unique identifier.
- Amounts established in the budget at the outset of each fiscal year for each unique identifier should be assigned a "funds control" such as an encumbrance and authorized payments per cycle (e.g., one payment per month). This is done both to ensure that the budgets are not over expended, and to ensure that the amount set aside for each expenditure is properly expended on the item for which the funding has been appropriated or otherwise intended. This process also guards against duplication of payments for any item since an inadvertent approval of a payment that exceeds funding available for the instrument should cause the payment item to be reviewed and confirmed prior to check issuance

[23] Many of these recommendations were shared and discussed with the County staff prior to the issuance of the first draft of this report. We also considered the recommendations contained in the Office of Internal Audit's report Internal Control Review: Procure to Pay – Specific Functions, as well as those contained in the Baker Tilly Virchow Krause Report of Forensic Audit to Montgomery County, Maryland referenced above. We believe that the County must develop corrective action plans to implement these recommendations.

Implementation of the BioHealth Innovation Initiative

In a second bioscience initiative that began in the fall of 2008, County Executive Isiah Leggett established a Biosciences Task Force (Task Force) "to help develop a strategy that will enable Montgomery County to more effectively leverage its rich asset base and become a global hub for life science research, development and technology commercialization." The forty-two person task force, whose membership included then Councilmember Mike Knapp and the Former DED Director, issued a December 2009 report, *Montgomery County's strategy for developing a world-renowned life science industry*, providing several recommendations. (See Appendix B: BioScience Task Force 2009 Report.) This OIG report does not evaluate the merit of the Task Force's report or its recommendations.

The Task Force report recommended the creation of a public-private partnership to augment the County's Business Innovation Network with an 'accelerator' that brings together capital resources with promising life science start-ups, and established five bioscience economic development objectives:

1. Enhance the environment for entrepreneurship and the creation of new life science companies.
2. Catalyze greater technology transfer and commercialization and leverage Montgomery County's federal and academic assets more effectively.
3. Foster a more enabling financial, regulatory, and business environment.
4. Enhance bioscience educational opportunities in Montgomery County and expand the higher education presence in Montgomery County to build a robust biosciences workforce and foster commercialization.
5. Market Montgomery County's biosciences sector nationally and internationally.

Finding 3 In implementing the BioScience initiative, DED management used public entities to fund the development and operations of a BioHealth intermediary without executing a formal MOU or Contract.

We sought to understand from County officials familiar with the process how the consultant ultimately selected was found and recruited. It is expected that the County would have solicited a highly qualified external expert to carry out the accepted task force recommendations. For such arrangements, the County Office of Procurement Guide indicates the issuance of a Request for Proposal (RFP). In this case, requirements would have been appropriate to identify and contract with an individual whose background demonstrates the appropriate technical or scientific expertise requisite to lead the process to develop and start up the public-private partnership and assist in engaging that entity's leadership. When we initially spoke with the Current Assistant Chief Administrative Officer Representative (ACAO Representative), we were told that the consultant was referred to the County by someone from Johns Hopkins University, which may be strictly accurate, but was misleading.

Instead of the above process, the Current ACAO Representative indicated that a consultant, the Founder, President, and CEO of the Philadelphia-based Innovation America (Consultant), was originally recommended to the County by an individual at Johns Hopkins University (JHU). Evidence we reviewed indicated the individual making the referral to be an associate of the DED COO with whom he had interacted since at least 2007. That individual was responsible for JHU real estate facilities and Great Seneca Life Sciences Center development initiatives.

We observed that during this same period, the Johns Hopkins University operated a technology transfer organization, then called Johns Hopkins Technology Transfer (JHTT) and currently called Johns Hopkins Technology Ventures (JHTV), was evidently already in existence and providing support similar to that intended by the BioScience Task Force. The County did not engage JHTT, an entity already engaged in biosciences and with a presence in Montgomery County, to lead the County's BioScience intermediary initiative. Instead, the DED turned to the JHU manager apparently responsible for the real estate development and management of the JHU Montgomery County Campus in the Great Seneca Science Corridor for input and recommendations.

We do not know why the DED relied on the individual from JHU's real estate facilities for a recommendation since neither his academic credentials nor his position at JHU are related to economic development, technology ventures, BioSciences, or any other area of science that could appear relevant to the Task Force recommendations. During interviews, we asked Former DED Directors and the Current ACAO Representative about JHTV and they claimed not to have knowledge of the entity.

During a telephone interview, the Current ACAO Representative did not profess to having personal knowledge about the Consultant's qualifications, but was able to provide documents provided by the Consultant. It appears from those documents that the Consultant was introduced to two County Council members via e-mail from the JHU real estate facilities contact as "...someone whom I believe is the best qualified person in the U.S. to advise Montgomery County on how TO PLAN AND EXECUTE our jobs and economic development strategy." According to the Consultant, the JHU real estate facilities individual approached him at a National Academy of Sciences event where the Consultant had been a speaker. They discussed a Montgomery County initiative and the Consultant was subsequently introduced to the Former DED Director. It appears that he was also introduced to other Council members, the County Executive, other County political appointees, and task force members based primarily on the Consultant's own marketing materials, website, and representations of his experience.

In examining the copy of the Consultant's resume provided by the Current ACAO Representative, we found both an absence of academic credentials as well as an absence of verified experience related to relevant BioScience endeavors. The resume lists numerous one-time presentations, membership on numerous boards and committees, and asserts a number of economic development activities since 2001, primarily within activities of which he was apparently the founder and CEO.

The Former DED Director confirmed that he personally "vetted" the Consultant. It is unclear when the vetting occurred. Further, the vetting process described to us appeared to have consisted of reviewing the websites of former entities at which the Consultant claimed to have

numerous successes. It does not appear that anyone affiliated with the County independently verified anything listed on the Consultant's resume.

DED solicited external funding to pay for the Consultant's performance of services related to the BioScience initiative on the County's behalf. In late 2010, DED arranged for a series of two contracts to be entered between Rockville Economic Development Inc. (REDI), a public entity, and the Consultant to prepare a Task Force-recommended assessment and implementation plan.

In its relationship with the Consultant and the resultant Consultant-led bioscience intermediary BioHealth Innovation, Inc. (BHI), DED Management allowed REDI to appear to represent the County in deals and funding arrangements to which the County government was not a legal party. The funding of the operations of BHI via a contractor-identified Council grant nullified a requirement for a competitive process. BHI's activities were not subject to any written agreement, nor were the relationship's intent or anticipated outcomes that should accrue to the benefit of the County clearly articulated.

We found no evidence of an agreement or MOU between DED and REDI that provided for REDI to act on the County's behalf in contracting with the Consultant. We did locate a copy of an unsigned letter from the DED COO acknowledging REDI's participation and agreeing to make reimbursement for any administrative costs incurred. This engagement was entered into without any competitive process. Further, an e-mail from the DED COO to the executive director of REDI evidences an intent to circumvent the County's contracting process.

The DED COO wrote to the then executive director of REDI stating *"Due to the make-up of the Committee structure, [the Former DED Director] needs to be the contract administrator. However, given the nature of how the funding is arranged, the County can neither receive the funds nor place a contract with the Consultant. We believe that REDI, as a non-profit organization could receive the private donation and hold the contract. We are making this request not just to circumvent the system and make REDI an accounting conduit. Rather, we make this request because REDI is one of the key stakeholder and the beneficiary in the overall Opportunity Assessment and Implementation Plan development."*

When asked why he deliberately did not use the County procurement process, the Former DED Director said that it would have taken months. It is our observation that an engagement directly between the County and a consultant would have required following the County procurement process, including documentation of a competitive search process and DED's preparation of a statement of work that specified its requirements and for the initial consultant engagement, none of which was done in this case.

"Tone at the Top" - *continued*

> Management enforces accountability of individuals performing their internal control responsibilities. Accountability is driven by the tone at the top and supported by the commitment to integrity and ethical values, organizational structure, and expectations of competence, which influence the control culture of the entity. Accountability for performance of internal control responsibility supports day-to-day decision making, attitudes, and behaviors. Management holds personnel accountable through mechanisms such as performance appraisals and disciplinary actions.[24]
>
> *Source: GAO-14-704G Federal Internal Control Standards*

It is apparent, however, that the Former DED Director acted to "fast track" the development of the BioScience implementation plan and make the BioScience intermediary operational. To accomplish this, the Former DED Director turned to the DED COO, who was well positioned to understand the system of controls in place. Evidence shows that the DED COO was provided wide discretion in his actions under the Former DED Director, who acknowledged that the DED COO was rewarded with the highest performance ratings and related salary adjustments.

It is unlikely that the Former DED Director could have effectively exercised any oversight responsibilities knowing that a.) he had violated Information Technology policy by providing his password to the DED COO, and b.) he had knowingly allowed, if not directed, the DED COO to avoid County contracting mechanisms.

The DED drafted, $100,000 consultant contract was to be funded by donations from universities and private sector companies. REDI made payments for the consulting work directly to the Consultant to the extent funds had been collected. However, to cover donation shortfalls, the County made an interest free, $20,000 advance to REDI. Another interest-free advance of $12,500 was paid to the Consultant by Scheer with funds drawn upon the Incubator Program, even though the Former DED Director, in an earlier presentation to the Council Planning, Housing, and Economic Development Committee (PHED), had made assurances that no County dollars would be used for this initiative.

Although the County is not a named party to the contract, correspondence between the Consultant, DED, and REDI clearly articulated that the Consultant considered the County to be his client. DED did not dispute that contention.

The first contract between REDI and the Consultant covered the period of November 8, 2010 to January 31, 2011, and it appears to have addressed most of then Councilmember Knapp's recommendations for building upon existing County assets and implementing economic development initiatives. (See Appendix C: *Councilmember Knapp October 2009 Blog*.) The contract's scope of work required that the Consultant identify and affirm initial research opportunities and resources available to support biosciences commercialization efforts within Montgomery County and provide initial recommendations for a biosciences innovation intermediary.

[24] Comptroller General of the United States, Government Accountability Office, *Standards for Internal Control in the Federal Government*, §5.02. Government Printing Office, September 2014.

Summary of Findings

In March 2011, the Consultant published a *Montgomery County, Maryland Biosciences Cluster Competitive Literature Review* consistent with the scope of his contract with REDI.

The second contract between REDI and the Consultant, covering the period from July 1, 2011 to August 31, 2012 created and implemented an organizational development plan for a new nonprofit entity, the America's BioHealth Intermediary (ABHI) [OIG Note: The intermediary was subsequently renamed BioHealth Innovation.]

The Former DED Director and the Former Acting DED Director stated that the Consultant lobbied for the position of BHI CEO, and he was subsequently named to that position (from this point forward, we will refer to the "Consultant" as the "Consultant/BHI CEO"). In an interview, the Consultant/BHI CEO told us he was asked to take the position. He said he neither needed nor wanted the job but only agreed to take it until the County could find another suitable candidate. The Current ACAO Representative was appointed to represent the County and currently serves as a member of the BHI Board of Directors.

On August 22, 2011, the Consultant/BHI CEO delivered an *Implementation Plan for BioHealth Initiatives for Central Maryland Region* (Implementation Plan) consistent with the scope of his contracts with REDI. (See Appendix D: *Consultant's Implementation Plan*.) The document laid out a one-year implementation plan and a multi-year program for continuing activities targeting the biotechnology, medical devices, healthcare services, e-Health/ mobile health, electronic medical records/ health informatics/ and cyber security industries. The implementation plan set forth key objectives to:

1. Significantly increase the flow of private and public early stage capital to businesses/ entrepreneurs and scientists in the region by leveraging federal/ private/ university, foundation, and international funding resources to support and grow BioHealth companies.
2. Develop an active talent network of entrepreneurs, investors, and experienced managers and an integrated network of all technical and financial innovation and commercialization resources in the region by connecting the federal labs, university, and industry research and technology transfer offices.
3. Actively facilitate tech transfer and commercialization by identifying candidate BioHealth technologies from public, academic, and private sources of research and technologies/ underwriting candidate firms to determine market feasibility, managing and growing funded early stage companies, and facilitating marketing and distribution of products and services of early-stage companies to both domestic and global markets.
4. Create global public awareness of the region's world class BioHealth and technology assets through effective branding, marketing/ market research and public relations.
5. Ensure an adequate supply of knowledge workers to support regional growth of the BioHealth industry by working with educators and workforce development organizations.

After completion and delivery of the Implementation Plan, the County Council appropriated $250,000 for current year funding against a three-year, $1.5 million program commitment. The appropriated funds were paid by the County to REDI, who, in turn, paid BHI.

However, we found no evidence of any contract, memorandum of understanding, or other program management agreement[25] that created, or ever existed among any of the parties - the Consultant/BHI CEO, BHI, MEDCO, REDI, or DED - between July 2012 through July 2016 that set forth the terms, conditions, and deliverables expected of BHI's bioscience intermediary activities in exchange for $2.8 million in County funding awarded under a "non-competitive contract awarded to a contractor identified in a Council-approved appropriation".[26] On multiple occasions, the DED COO and BHI openly stated that no contract or MOU existed, and there was no evident intent that one should be established.

Instead of aligning BHI's performance goals with the Task Force's commercialization and innovation objectives, DED allowed BHI, and consequently the Consultant/BHI CEO, to focus on the attraction of financing for regional activity, much of which was provided from indirect County contributions to the public-private venture capital activities within BHI's wholly owned subsidiary, BHI Management, Inc. (BHIM).

Since April 2012, the Consultant/BHI CEO has provided BHI annual reports to the County Council PHED Committee that consistently reported regional results that did not highlight BHI's direct impact within Montgomery County. Further, the self-reported results bear little relation to the Task Force Report's objectives.

The available data we reviewed did not demonstrate whether BHI provides economic value to the County at a level that exceeded BHI's cost. No meaningful criteria or metrics were created by DED or subsequent County leadership that would create clear expectations for BHI linked to economic development of Montgomery County or a return on the investment by the County government and other contributors. Further, those measures that were created and reported were inconsistent from year to year, and were not independently verified or validated. Absent transparent expectations for any program's contribution to the County, management cannot evaluate the value of its investment of resources in the program and cannot determine whether the funds expended were either put to good use or wasted.

Absent clearly defined expectations and outcomes, specified in a formal contract or MOU, and consistent with the Task Force's recommendations, it is difficult for the Executive and the Council to determine if the results of the initiative are a.) providing sufficient economic impact to justify the expenditure, or b.) are meeting or exceeding expectations and worthy for consideration of additional investment.

BHI's success, and collaterally the Consultant/BHI CEO's personal success, are based on the amount of funding that BHI raises for support of its business operations and investment in its intermediary Portfolio of companies (which as noted below, many of which are not located in Montgomery County).

The publicly available, IRS Form 990 - Return of Organization Exempt From Income Tax returns we reviewed indicate that BHI had collected in excess of $15.2 million in revenue and

[25] There was evidence of an August 2011 draft *Implementation Plan for BioHealth Initiatives for Central Maryland Region*, although that document set forth non-binding 90-day and one year goals.

[26] Montgomery County Code § 11B-14(a)(4) Non-competitive contract award.

contributions, and reported expenses in excess of $11.7 million. Of the expenditures, wages and benefits for employees and independent contractors made up 68% ($8.0 million) of total expenses, and the Consultant/BHI CEO's personal compensation comprised 28% ($2.2 million) of all wages and benefits for employees and independent contractors. The Consultant/BHI CEO provided the County's CAO with information about his level of compensation relative to nine other organizations that he identified as comparable. We reviewed the IRS Form 990 returns for the organizations the Consultant/BHI CEO-identified as comparable and observed that at a reported 2016 revenue of $2.79 million, BHI recorded the second lowest revenues of the organizations, yet BHI's CEO and total staff salaries as a percent of revenues were greater than those of any other organization.

The Consultant/BHI CEO's annual reportable compensation (in excess of $500,000 for each year from 2014 through 2016) was roughly equivalent to the County's annual appropriation for BHI operating costs.

BHI's publicly available Form 990 returns for 2015 and 2016 indicated that grants and loans in excess of $2.4 million were extended from BHI to BHIM, a wholly owned, for-profit subsidiary established in 2014. BHIM, an organization with no reported employees or operating expenses, benefited from BHI-shared personnel valued at $2.2 million via which BHIM provided services to a portfolio of organizations in exchange for fees to or equity ownership by BHIM. Of the portfolio of companies presented on its website[27] and its April 2018 listing of clients[28], BHI identified 33 companies in which BHIM held equity positions. BHIM's stated equity ownership provides the appearance of a portfolio that consisted of 9 (27 %) business entities with a presence in Montgomery County, 17 (52%) businesses located within the Baltimore area, and 7 (21%) entities that were distributed among 5 states and 1 foreign country.[29] We also observed that on its website, BHI asserts credit for helping to launch eight companies that JHTV also lists among the companies it helped launch.

The Current ACAO Representative was appointed to represent the County on the Board of BHI. In a communication to her/him, the County Attorney articulated that the Current ACAO Representative was on the BHI Board to look after the County's interest. However, during the Current ACAO Representative's interview s/he stated that s/he did not feel compelled to report back to the County. Accordingly, it appears that the County did not receive significant financial information or insight about the activities of BHI other than in information provided by the Consultant/BHI CEO. Further, it appears that the information provided by the Consultant/BHI CEO was not verified or validated by the Current ACAO Representative or by the County.

Management has recently introduced Administrative Procedure No. 2-4 to address agreements between Montgomery County Government and other organizations by assigning

[27] http://www.biohealthinnovation.org/portfolio last accessed 27 August 2018,

[28] FY 19 Operating Budget: Incubator Programs - Economic Development Partnership Non-Departmental Account (NDA), County Council Work session, May 10, 2018, analyst packet page ⑥.

[29] Two of the entities reported by BHI could not be located through internet search, and we were thus unable to confirm either existence or location.

responsibilities and establishing general policies and procedures for the preparation, review, clearance, approval, and monitoring of agreements.

Management has taken some steps to address internal controls. However, funds that leave the County as grants to an external entity will remain difficult to control unless management has tied such payments to contracted expectations, deliverables, and outcomes.

Recommendation 3

(a): The County government should ensure that management safeguards and controls are not circumvented, and that effective remedial actions are taken and appropriate sanctions are applied when violations are identified.

(b): For all County-funded economic development programs, the County should clearly identify quantifiable and measurable outputs and outcomes, the successful completion of which should demonstrate specific economic benefit.

(c): For the programs addressed in this review, County Management should conduct an analysis of the programs that determine the relative economic benefit to the County compared to the cost of each program.

Actions Taken by the County to Strengthen Controls and Processes

County management provided us with a summary of the corrective actions it has taken or planned as of October 2018 to strengthen controls and processes in response to the issues that came to light surrounding actions of the former Department of Economic Development (DED) Chief Operating Officer. We have worked with the contractors engaged by management, and agree that conceptually most of the steps they presented are consistent with the recommendations we have made and would endorse. We have not independently conducted field work to confirm the implementation of management's actions to date, and have not yet assessed or tested the effectiveness of the new controls and processes. Our future work programs to check and evaluate management's representations will represent a significant undertaking for the OIG to be incorporated in the work plan for the immediate future.

The summary of the actions provided by County management is displayed below:

Internal Control Review. The County's Office of Internal Audit conducted an internal process and control review (review) of the County's Procure to Pay function focused on specifically-identified aspects of the County's economic development incubator program. This program had been exempted from normal County procurement requirements by virtue of an exemption in place at the time for economic development activities. Under this exemption, the County executed a memorandum of agreement ("Agreement") with the Maryland Economic Development Corporation (MEDCO); an instrumentality of the State of Maryland created by the General Assembly in 1984 to serve as a statewide economic development authority, to encourage, attract and retain business activity and commerce and promote economic

development.

The review identified several control deficiencies related to the oversight of County funds disbursed through County programs managed by third party organizations, such as MEDCO; specifically:

- Lack of visibility into the ultimate disposition of funds by vendors responsible for operating a County program where funds are received in advance from the County ("externally-managed" program),
- Insufficient County oversight of department activity related to externally-managed programs, and
- Lack of effective management and control over the population of commodity/payment codes that are used as the basis to identify purchases deemed to be exempt, or otherwise not subject to, the County's procurement regulations.

The review also identified an ineffective segregation of duties that had existed within DED, in which one individual, the DED Chief Operating Officer, had responsibilities for budget formulation, budget execution, vendor engagement and management, and invoice processing and approval. The lack of appropriate segregation of duties – normally expected within individual departments and offices within County Government, increased the potential for one individual to avoid normal checks and balances in County financial processes.

Strengthening Existing Controls and Processes. As a follow-on to the internal control review, the County implemented changes in its existing processes to address and call attention to the control deficiencies identified above. Specifically:

Financial Controls. Finance published two policies (the first a revision to an existing policy) governing accounts payable operations. These policies, summarized below, are designed to build on existing procedures and processes, and enhance enforcement of the existing requirements:

- August 2, 2017 Accounts Payable Policies: Financial Governing Principles and Standards
  - Strengthened segregation of duties within each department by requiring that separate persons authorize the transaction, receive the services, and process the invoice. This critical internal control requirement supports three-way matching between authorizer, receiver, and invoice processor.
  - Required sufficient documentation supporting payments for exempt transactions, and sufficient information supporting basis for procurement exemption.
  - Centralized and improved controls over the Held Check process to require department director level authorization and workflow to identify specific individuals designated to pick up checks.
  - Vendor self-registration – Accounts Payable curtailed practice of accepting vendor information directly from departments. Implemented additional controls and authorizations to register vendors on a limited exception basis.
- April 1, 2018, Accounts Payable Section Policies: Authorized Payment (issued October 2017)
  - Direct payment of invoices (that is, invoices processed without a three-way match and receiving in the system as evidenced by a Purchase Order or Direct Purchase Order) no

longer authorized unless pre-determined on a limited basis to be exempt from this requirement.
  - Authorized payments via the County Purchasing Card (P-Card), Direct Purchase Order, or Purchase Order.
  - The policy ensures purchases are made by authorized individuals, supports segregation of duties, and increases transparency because purchases are reported earlier and/or with more detailed information in the County's financial system.
- Implemented an expanded checklist used by AP supervisor and staff to review payment request packages to increase oversight over payment processing and easily facilitate management review.
- We would note that even prior to the facts of the DED situation being known, in January 2017 Finance implemented automated forensic review of disbursements prior to payments being issued as a means to detect questionable payments.

New Compliance Unit to be Established. Finance is establishing a Compliance Unit by January 1, 2019, responsible for:

- Reviewing and approving department requests to enter into procurement exempt transactions. The purpose will be to validate the exemption or determine whether the request is subject to procurement prior to the acquisition of the goods or services and whether it otherwise complies with County rules and regulations.
- Ensuring direct purchase orders have appropriate support including a legally binding agreement if warranted.
- Performing post-payment audits to ensure payments were properly supported and authorized.
- Analyzing a series of tests run by forensic software that are designed to detect irregular payment transactions such as invoices with questionable amounts, purchases occurring at unexpected times, transactions that may have been designed to avoid procurement thresholds, and other identified fraud risks.

Public Entity Procurements and Procurement Exemptions. A joint effort by Finance, County Attorney, and Procurement resulted in strengthened controls in the following areas:

- Public Entity Checklist – by including all elements required to enter into a procurement transaction with a public entity and ensuring adequate support for the Director of Procurement to authorize a purchase order for the transaction. On April 6, 2018, the County provided guidance and direction to departments concerning use of procurement contracts with public-entities. That guidance emphasized that entering into a non-competitive contract with a public entity cannot be used as a means of circumventing the ordinary contracting requirements and procedures set forth in County Code and in the County Procurement Regulations. Such contracts are, with a few exceptions, subject to the entirety of the County's Procurement laws and regulations; and must be approved as to form and legality by the Office of the County Attorney, have approval by Risk Management as to applicable insurance requirements, and be executed by the Office of Procurement on behalf of the County.
- Revised exempt commodity/payment code list to clarify the legal basis for an exemption, eliminate codes that no longer have a legal basis, and to link the list to relevant Finance and Procurement policies that cross-reference to the list.

New Procedures Governing Agreements. On September 11, 2018, the County issued procedures (Interim Administrative Procedure (AP) 2-4, Agreements between Montgomery County Government and Other Organizations) tightening controls in several areas, including:

- Establishment of a standard review and clearance process for all non-procurement contractual agreements requiring the signature of the Chief Administrative Officer (or designee). Major requirements of this standard clearance process include:
  - Assignment of a unique County identification number (like the requirement already in place for procurement contracts) to facilitate review of payment invoices with the associated agreement.
  - Mandatory review by the Department of Finance (Finance), particularly with respect to agreements involving "advance payment" of funds prior to services being rendered. For agreement involving an advance payment, the AP also requires Finance to determine any specific audit requirements (with resourcing of such audits by the responsible department) that must be in place to protect County interests and ensure appropriate use of funds.
- Establishment of a standard set of required terms and conditions that include
  - Requirement for description of the work to be conducted; and, where applicable, performance measures, deliverables, and a schedule of milestones.
  - Right to audit clause.

Additional Internal Control Reviews. The County also undertook two additional reviews to ensure that situations similar to those found within DED's management of the incubator program were not present in other County departments/programs:

- A review of other purchases under procurement-exempt commodity codes – which found no instances in which a lack of segregation of duties and/or oversight by County personnel resulted in inappropriate payments of County funds to vendors. Changes to require improved documentation were already being implemented as part of the County's actions in response to the DED situation.
- A review of the alignment of financial and program management responsibilities/duties across all County departments and offices – which determined that appropriate segregation of duties was present in all major County departments and programs.

Forensic Audit. At the request of the Chief Administrative Officer, the County Attorney hired and audit firm to conduct a forensic audit of the County's economic development activities, including the incubator program, since 2007. The audit is comprised of two phases. In the first phase of the audit, the auditors determined the amount of County's funds the former DED COO misappropriated from DED. In the second phase of the audit, the auditors determined the amount of County's funds the former DED COO misappropriated through MEDCO and Scheer. In reviewing the incubator program, the auditors analyzed the County's transactions with MEDCO, Scheer, Rockville Economic Development, Inc., and Biohealth Innovation, Inc. (BHI). The forensic audit confirms the amount of misappropriated funds the County had identified during its own internal investigation and reinforces/supports the findings of the County's internal control review conducted earlier this year. The forensic audit also acknowledges the County's efforts to strengthen existing financial management policies and procedures to address gaps or weaknesses in processes and internal controls. The auditors are preparing two reports and that they expect to finalize shortly.

County Manager Training. The County conducted training on October 15, 2018, for all managers concerning their responsibilities to ensure effective internal controls and management oversight of financial transactions, including the importance of appropriate segregation of duties, identification of potential "red flags" of employee fraud and misappropriation of funds, and what to do if such allegations or issues are identified or brought forward as allegations by other employees.

Management of Incubator Program. Finally, the County is in the process of strengthening its oversight and management of the business incubator program by unwinding its relationship with MEDCO. This includes the following:

- Refinanced and assumed MEDCO debt on two County incubators.
- Terminated MEDCO as incubator manager effective December 31, 2018 for the following incubators: Rockville Innovation Center, Germantown Innovation Center, and Silver Spring Innovation Center.
- Contracted with Launch Workplaces, LLC to perform property and portfolio management of the Silver Spring Innovation Center as of September 1, 2018.
- Terminating, effective November 30, 2018, Scheer Partners, MEDCO's subcontracted incubator property manager. Scheer has already discontinued its operations at the Silver Spring Innovation Center. The County will have a property management contract in place by December 1, 2018 for the Rockville and Germantown Innovation Centers.
- Effective November 1, 2018, the County will invoice, collect, and deposit rent/fees from tenants of the Rockville and Germantown Innovation Centers directly into County accounts. After December 1, 2018, the County will directly oversee and account for the financial operations of the Rockville and Germantown Innovation Centers.
- Upon termination of MEDCO and Scheer, accounts held by those third parties will be closed and residual funds remitted to the County.
- The County will contract directly with entities providing economic development services, including BHI.

We would note that immediately following discovery of the misappropriation of County funds, the Department of Finance suspended grant payments to MEDCO and initiated a careful review of projected incubator and related program spending and funds held by MEDCO on behalf of the County, resulting in the following:

- Deferred most of MEDCO's FY18 appropriated grant funding (only disbursed $1.64 million of $3.4 million appropriation).
- Indefinitely suspended all of MEDCO's FY19 appropriated grant funding ($3.6 million).
- Advance repayment to the Maryland Technology Development Corporation (TEDCO) for a four-year liability that otherwise would have been paid by the County through MEDCO.