AUDIT REPORT

URBAN EDUCATION DEVELOPMENT RESEARCH
AND RETREAT CENTER (UEDRARC)
PHILADELPHIA, PENNSYLVANIA

01-PH-241-1001

NOVEMBER 2, 2000

OFFICE OF AUDIT, MID-ATLANTIC
PHILADELPHIA, PENNSYLVANIA

Issue Date
November 2, 2000
Audit Case Number
01-PH-241-1001

TO: Joyce Gaskins, Director, Office of Community Planning and Development, 3AD

for J. Phillip Griffin

FROM: Daniel G. Temme, District Inspector General for Audit, Mid-Atlantic, 3AGA

SUBJECT: Audit of the Philadelphia Commercial Development Corporation's (PCDC) Funding of the Urban Education Development Research and Retreat Center (UEDRARC) Rehabilitation Project

We completed an audit of PCDC's loan assistance to UEDRARC, a non-profit entity which needed financial help for a rehabilitation project. The audit included loan activity by PCDC and the Philadelphia Industrial Development Corporation (PIDC). This report focuses on PCDC's loan to UEDRARC. The conditions we observed regarding the PIDC loan evaluation process, loan servicing, and loan monitoring practices, are addressed in a separate report. Since Community Development Block Grant (CDBG) funds were the source of the loan assistance, we wanted to ensure the funds were used to meet a CDBG national objective. We also wanted to ensure that PCDC used good business practices in making the loan, had effective controls for evaluating requests for financial assistance, employed good loan oversight procedures, and took timely and aggressive action to obtain loan recipient compliance with its loan requirements. Finally, we wanted to assess the condition of the UEDRARC loan and determine UEDRARC's present and future financial capacity to meet the loan's terms.

We determined that the CDBG funds loaned to UEDRARC for building rehabilitation met the CDBG national objective of preventing or eliminating a slum and blighted condition. However, despite meeting this national objective, we found that PCDC did not observe many of its procedures in evaluating, authorizing, and servicing the loan. By not following prudent business practices and its own loan evaluation and authorization procedures, PCDC unnecessarily jeopardized CDBG funds totaling $550,000. The outcome is that PCDC now holds a severely non-performing loan with little prospect the loan will become performing in the future.

Although we found PCDC had established controls for evaluating, authorizing, and monitoring its loans, it appears PCDC did not follow these controls fully for the UEDRARC loan. PCDC needs to document fully all waivers to its loan requests or procedures. Because PCDC violated its own procedures and did not observe sound business practices for the UEDRARC Project, it put the

CDBG funds used for the loan at excessive risk. Therefore, in the event of a default by UEDRARC which causes PCDC to write off the loan, we are recommending that the City of Philadelphia use non-Federal funds to repay its CDBG Program for the loan portion written off as uncollectable.

Within 60 days please provide us with a status report on each recommendation made in this report which covers: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact Thad Staniul, Assistant District Inspector General for Audit, at (215) 656-3401.

Executive Summary

We completed an audit of the Philadelphia Commercial Development Corporation's (PCDC) funding of the Urban Education Development Research and Retreat Center (UEDRARC) rehabilitation project. The objectives of the audit were to determine whether: Community Development Block Grant (CDBG) funds were used to accomplish a national objective; the UEDRARC Project met its objectives; and PCDC effectively administered the CDBG funds provided to UEDRARC.

We noted positive effects from the UEDRARC Project. UEDRARC met a CDBG national objective by eliminating a slum and blighted condition, and accomplished its mission to provide an institutional environment encompassing programs designed to promote education, research, employment training, and human development to serve the needs of Philadelphia's African American community. PCDC had designed good management systems and controls to provide project oversight and to account for all the loan funds disbursed to the project. Despite having these good controls, PCDC did not follow its own and HUD's requirements, and did not use prudent financial judgment in evaluating, approving, and administering its $550,000 loan to UEDRARC - a high risk borrower. PCDC did not observe existing loan approval policies and procedures; enforce its loan monitoring policy and procedures when administering the loan; and take full advantage of available recourses when UEDRARC defaulted on its loan. As a result of PCDC's loan decision, it is likely PCDC will need to write off the loan to UEDRARC, depriving other applicants of needed funds.

PCDC Did Not Follow its Loan Approval Procedures

PCDC's Board of Directors overruled their Vice President for Lending's recommendation to reject the loan and bypassed their Loan Committee in providing the loan to UEDRARC. Based on the Office of Housing and Community Development's (OHCD) assurances of UEDRARC's financial viability and a Pennsylvania State Senator's encouragement, PCDC's Board authorized the loan. The State Senator, who was a member of both PCDC's and UEDRARC's Boards of Directors, used his influence in PCDC's loan decision making process. Despite individual Board members' concerns, the Board authorized the loan, featuring unusually favorable terms including: a loan amount exceeding the $100,000 maximum amount, an interest rate of only 3½ percent, and a 96 month moratorium on principal payments. Finally, PCDC used a for-profit loan vehicle to provide the loan to UEDRARC, a non-profit organization.

PCDC Did Not Monitor The Project

PCDC did not enforce its loan monitoring policy and procedures, and removed its loan officer from the loan monitoring process. PCDC relied on the Philadelphia Industrial Development Corporation (PIDC) to monitor the loan because PCDC lacked the resources to monitor the project and the PCDC loan was subordinate to the PIDC loan. We evaluated PIDC's monitoring process and found it to be ineffective. Also, PCDC did not pursue UEDRARC for annual financial statements required by the loan agreement or a final audit of the project. UEDRARC defaulted on the loan within a month of receiving loan proceeds. As of March 13, 2000, UEDRARC had been delinquent 50 of the 53 months of the loan term and was $22,496.01 in arrears. PCDC never required UEDRARC to prove it lacked the capability to make its loan payments. PCDC did not take more forceful default action because of outside pressure and the desire to see the project succeed.

UEDRARC Project Was Not Financially Sound

The UEDRARC Project met a CDBG national objective by eliminating a slum and blighted condition and met its goal by creating an educational facility at its project location. However, its ability to sustain this success is questionable. UEDRARC currently lacks the resources to complete facility renovations needed to increase revenue. Furthermore, current operations do not generate sufficient revenue to cover long term debt and operating expenses. During the 17 months ending May 31, 2000, UEDRARC experienced an average monthly shortfall of $24,672.86 or a total of $419,438.62 over the period. Due to its current financial condition, it is unlikely that UEDRARC will be able to obtain the funding for the remaining renovations. Without this funding and the resulting increased revenue, it is doubtful that UEDRARC will be able to repay its debt and continue operations.

Recommendations

We recommended to HUD that PCDC comply with loan approval and administration policies and procedures and loan agreements; document the reasons for circumventing existing policies and procedures when approving and administering loans; and require UEDRARC to obtain an audit of the construction project.

We also recommended that, if PCDC writes off the loan, HUD direct the City of Philadelphia to repay, to the City's CDBG Program, with non-Federal funds, the loan portion written off as uncollectable.

Finding and Recommendations Discussed

We discussed the results of our review with PCDC during the audit and at an exit conference on September 22, 2000. By letter, dated October 4, 2000, the President/CEO of PCDC provided a detailed response to the conditions and recommendations discussed in the draft report. We have included PCDC's pertinent comments in the **Finding** Section of this report. PCDC's full response is included in **Appendix A**

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Abbreviations

CDBG	Community Development Block Grant
HUD	US Department of Housing and Urban Development
OHCD	Office of Housing and Community Development
PAID	Philadelphia Authority for Industrial Development
PCDC	Philadelphia Commercial Development Corporation
PIDC	Philadelphia Industrial Development Corporation
SBRLF	Small Business Revolving Loan Fund
UEDRARC	Urban Education Development Research and Retreat Center
UEF	Urban Education Foundation

Introduction

UEDRARC was founded as a non-profit organization to acquire the property at 4601 Market Street, rehabilitate the buildings, restructure the facility's governance and management, and attract appropriate new tenants. UEDRARC's mission is to provide an institutional environment in which programs designed to promote education, research, employment training, and human development can serve the needs of Philadelphia's African American community. UEDRARC is governed by a 12-member Board of Directors having community, educational, civic, corporate, and real estate development expertise.

In 1983, the Provident Mutual Life Insurance Company donated the property at 4601 Market Street to the Urban Education Foundation (UEF) to develop an educational and training center for West Philadelphia's disadvantaged residents. In 1991, UEF filed for bankruptcy, State and City officials were contacted to save the facility, and a reorganization plan was developed. The reorganization plan provided for UEDRARC to purchase and redevelop the property. UEDRARC, incorporated in 1991, was created to continue UEF's goal of sustaining an educational center at the 4601 Market Street location. On December 29, 1993, Meridian Bank provided a $1.6 million loan to UEDRARC. UEDRARC agreed to pass the funds to UEF to pay creditors and payroll, and to set up a loan interest reserve for UEDRARC. UEDRARC took control of the property at that time but did not actually purchase the property until March 29, 1995.

The property required substantial physical improvements, including utility systems; heating, ventilation, and air-conditioning systems; electrical systems; and asbestos removal. In April 1992, UEDRARC consultants estimated physical improvement costs at $4.55 million and estimated the cost of total development efforts at $7.21 million. As work progressed, these estimates increased due to additional renovation work and asbestos removal.

Funding for the UEDRARC Project came from several sources. From 1993 through 1997, the Commonwealth of Pennsylvania provided two grants of $3.675 million through its Redevelopment Authority Grant Program. PIDC provided six loans of $7.15 million, and PCDC provided one loan of $550,000. PIDC and PCDC are funded through the City's CDBG Program. Also, Meridian Bank provided UEDRARC a $1.6 million loan. Funding from all sources totaled $12.975 million ($6 million in HUD funds). UEDRARC used $4.1 million in subsequent loans and grants to pay off earlier loans, which resulted in a net $8.875 million ($5.2 million in HUD funds) in actual funding for the Project.

From 1995 through 1997, PIDC issued to UEDRARC three permanent loans totaling $4.65 million using CDBG and HUD Section 108 funds and three interim loans totaling $2.5 million using CDBG and PIDC (City) funds. PIDC qualified using CDBG funds for UEDRARC because the Project met the national objective of eliminating slum and blighted conditions. PIDC disbursed its loan funds to UEDRARC based upon contractor invoices it received from UEDRARC.

PCDC receives about $2.2 million a year in CDBG funding for operating expenses and loans. In 1993, the City of Philadelphia's OHCD approached PCDC to fill the funding gap for the UEDRARC Project. PCDC filled this gap by providing UEDRARC a $550,000 loan on March 29, 1995. The PCDC loan qualified for CDBG funding by meeting the elimination of slums and blight national objective. PCDC disbursed its loan funds by issuing checks in the name of UEDRARC and the contractor in response to contractor invoices received from UEDRARC.

In 1995, the Commonwealth of Pennsylvania provided two grants totaling $3.675 million to UEDRARC through an agreement with the Philadelphia Authority for Industrial Development (PAID), a division of PIDC. The Commonwealth provided its grants by reimbursing UEDRARC based on UEDRARC proof of payments submitted to PAID and the Commonwealth. During 1997, the Commonwealth did a limited scope audit that included only one of the nine grant disbursements it made to UEDRARC.

Even though UEDRARC had multiple funding sources, with funds delivered as loans and grants, as reimbursements and advances, there was no overall audit done to cover all the funds provided to the UEDRARC Project.

Audit Objectives

The primary objectives of the audit were to determine whether:

- UEDRARC:
  - accomplished a national objective;
  - was meeting its goals, could account for all funds and used the funds for appropriate purposes; and
- PCDC:
  - administered effectively its CDBG funds according to applicable laws, HUD regulations, loan documents, and other applicable directives;
  - evaluated objectively the feasibility of the UEDRARC Project, including:
    - determining if the UEDRARC Project was an effective use of CDBG funds; and
    - determining if UEDRARC had the financial wherewithal to sustain its operation long-term.

- had management systems and controls to provide effective oversight for the Project;
- monitored UEDRARC operation and rehabilitation procedures;
- accounted for all funds provided for the Project;
- validated UEDRARC's inability to make loan payments; and
- took appropriate action to make loan payments current.

Audit Period

We performed audit work from January 2000 to August 2000 and covered the period January 1992 through March 2000. We extended the review through June 2000 to analyze UEDRARC's more recent financial operating condition.

Audit Scope and Methodology

We reviewed UEDRARC's:

- compliance with the terms and conditions of the PCDC loan agreements;
- consultant's procedures and controls for tracking construction costs and compiling bills during the construction process to determine whether effective controls were in place; and
- construction and operations' accounting process to determine whether UEDRARC accounted for all funds received, used the funds for appropriate purposes, and to determine UEDRARC's current financial position.

We inspected the UEDRARC property and surrounding area to: determine whether the project met its goals of contributing to the community, becoming an anchor around which other positive activities could generate, and eliminating a slum and blight area in a section of West Philadelphia; and identify benefits realized by the community because of the UEDRARC activity.

We evaluated PCDC's procedures and controls over its loan approval, accounting, and loan monitoring processes to determine whether they are effective and to ensure they were used by responsible PCDC staff.

We reviewed the Commonwealth of Pennsylvania's audit of one of the nine grant disbursements made to UEDRARC to determine the audit objectives, scope, and results. We considered this information in formulating our audit scope.

We conducted our audit in accordance with generally accepted government auditing standards.

High Risk Borrower's Repayment of CDBG Funded Loan in Jeopardy

PCDC approved and administered a $550,000 loan to UEDRARC under its Small Business Revolving Loan Fund (SBRLF) without observing its own and HUD requirements and did not appear to use sound financial judgment in making the loan. Also, because PCDC did not have resources to effectively monitor a project and loan the size of UEDRARC, PCDC relied on PIDC to provide the necessary project oversight, which we later determined to be ineffective. Consequently, PCDC holds a UEDRARC loan that is in default and has been delinquent 50 of the 53 months the loan has been outstanding. Though the loan went into default, PCDC did not enforce loan default procedures because of external pressure and a desire to see the project succeed. Finally, UEDRARC's difficult financial situation makes it impossible to satisfy its current loan delinquencies and we are not optimistic regarding UEDRARC's potential for becoming current in the near future.

A. Loan Origination

SBRLF Funding and Program Description

The City of Philadelphia, through its Department of Commerce, provides about $2.2 million in CDBG funds annually to PCDC for operating expenses and loans. PCDC operates the SBRLF, among others. The purpose of the SBRLF is to foster economic growth within the City of Philadelphia by providing direct financial assistance to small businesses for expanding their operations. PCDC makes SBRLF loans to for-profit businesses to conduct economic development projects that will create or retain jobs and provide goods or services to benefit an area of mostly low and moderate income persons. PCDC used $550,000 in SBRLF funds to help finance UEDRARC.

PCDC Loan Guidelines

PCDC's general loan requirements prescribed that, "The applicant must possess the requisite experience to successfully manage the business/project to be financed." Further, according to the SBRLF section of the guidelines, the Department of Commerce and PCDC's Loan Committee are responsible for reviewing loan applications and approving the loans. The guidelines stipulate that SBRLF loans were for the benefit of "for-profit" businesses. Also, the guidelines limited the maximum amount for SBRLF loans to $50,000 originally, later increased to $100,000 by the time of the UEDRARC loan. The guidelines allowed for exceptions to the dollar limit "for special economic development projects with high job creation/retention prospects or strong community impact". The guidelines set 4½ percent as the SBRLF loan interest floor.

Loan Approval Procedures Were Not Followed

PCDC did not observe several of its loan evaluation and approval procedures in originating the UEDRARC loan. For example, though the UEDRARC Board of Directors includes professionals from various fields, there was no evidence that they had the requisite background and skills necessary to undertake a project such as UEDRARC. Further, there was no evidence that PCDC evaluated the UEDRARC Board members with the intent of establishing their capabilities to undertake a project of this type.

PCDC's loan application review process requires the Vice President for Lending to review and recommend the project for presentation to the Loan Committee. After evaluating the UEDRARC Project's request for funding, the PCDC Vice President for Lending rejected the request because he perceived cash flow problems. The PCDC Board of Directors overruled their Vice President for Lending's recommendation. Further, the Board bypassed the Loan Committee and any reluctance the committee may have had to approve the UEDRARC loan, by taking the authority upon themselves to make the loan. In fact, the Board granted UEDRARC unusually favorable terms. The more favorable loan terms included:

- an exception to the $100,000 maximum loan amount by awarding UEDRARC a $550,000 loan.
- a loan interest rate of 3½ percent as opposed to the normal 5½ percent rate.
- a 96 month moratorium on loan principal payments when other loan payments include interest and principal.

Finally, PCDC's SBRLF loans are intended for for-profit businesses, whereas UEDRARC is a non-profit entity.

Board Members Expressed Reservations Concerning Loan

Even though the PCDC Board of Directors awarded the loan, individual members had reservations. Members of the PCDC Board of Directors questioned UEDRARC's ability to meet operating expenses for the building, let alone the additional debt service burden for the project. In reviewing the application, the Board members noted that the prior owner of the Project, who had similar aspirations for the building, failed because the rent revenues generated were not sufficient to cover the building's high maintenance and operating expenses. They questioned what had changed so drastically to improve matters since the prior owner went into bankruptcy.

HUD Regulations at 24 CFR Part 85.12 recognized that special provisions should be made for high risk recipients of CDBG funds, and the UEDRARC Project clearly fell into this category. HUD defined "high-risk" grantees as having a history of unsatisfactory performance or being financially unstable. These provisions include: payment on a reimbursement basis; additional, more detailed financial reports; and additional project monitoring. The UEDRARC Project may have received heightened scrutiny because of the risk, but this caution was eventually overcome.

To assuage Board member concerns, representatives of the OHCD assured the PCDC Board that they had reviewed UEDRARC's financial information to support the loan request and found it reasonable. Also, a Pennsylvania State Senator, a member of PCDC's and the applicant's (UEDRARC) Board of Directors, appealed to PCDC to find a way to do the project rather than finding ways to turn it down. Despite the reservations noted earlier, PCDC's Board of Directors ultimately approved the UEDRARC loan, but not until OHCD agreed to increase PCDC's level of CDBG funding by the $550,000 loan amount.

Conflict of Interest

The Pennsylvania State Senator planned to maintain a Senate office and a support office in the UEDRARC building. PCDC asked the Philadelphia Divisional Deputy City Solicitor for a legal opinion on this situation. The Deputy City Solicitor stated that there was no conflict of interest, provided UEDRARC leased the space at fair market rents with comparable commercial terms, and the Senator did not involve himself in the loan approval process. Although the State Senator abstained from voting on the project, he actively participated in the discussion preceding PCDC's Board of Directors' vote. Though the Senator eventually rented office space in the UEDRARC building at rates comparable to other tenants, he clearly did not disengage himself from the loan approval process.

B. Loan Monitoring

HUD Loan Monitoring Requirements

HUD Regulations at 24 CFR Part 85.40 require that grantees monitor grant and subgrant supported activities to assure compliance with applicable Federal requirements and that performance goals are being achieved. HUD Regulations at 24 CFR Part 570.501 stipulate that the grant recipient is responsible for ensuring that CDBG funds are used in accordance with all program requirements. The use of designated public agencies, subrecipients, or contractors does not relieve the recipient of this responsibility. The recipient is also responsible for determining the adequacy of performance under subrecipient agreements and procurement contracts.

PCDC Loan Monitoring Guidelines

PCDC established effective guidelines for overseeing the progress of projects funded with PCDC loans and monitoring loan repayments. Specifically, PCDC Loan Policy and Guidelines stipulate that the loan officer is responsible for monitoring the repayment of loans and interacting with all interested parties and departments. The Technical Assistance Unit is to provide the Legal Department and Chief Loan Servicer with written briefings, monitor project progress, review financial statements, and recommend appropriate actions. The Fiscal Department is to disburse funds as requested by the loan officer and program manager, provide the loan officer and program manager with bi-weekly status reports of outstanding loans, receive payment from the borrower, and make recommendations regarding the loan portfolio. The Legal Department is to ensure borrower's compliance with regulations, initiate legal actions, assist in monitoring of judgments and liens against borrowers, and take other actions as appropriate.

Periodic financial statements from the loan recipient are another valuable monitoring tool that PCDC's procedures required. PCDC's Commitment Letter to UEDRARC, dated March 21, 1995, required unaudited financial statements within 30 days of the close of each calendar year. The statements were to include balance sheet and profit and loss statements.

PCDC Relied On PIDC To Monitor Loan

PCDC did not employ its loan monitoring policy and procedures when administering the $550,000 SBRLF loan to UEDRARC. Instead, PCDC relied on PIDC to monitor the loan because PCDC did not have the resources necessary to monitor a project of UEDRARC's size and because PCDC's loan was subordinate to much larger PIDC financing. Unfortunately, due to outside pressure and its desire to see the project succeed, PIDC did not effectively monitor the Project or take available default actions, which jeopardized PCDC's financial interest. Also, although PCDC guidelines required that the loan officer monitor the loan repayment, PCDC removed their loan officer from involvement in the process and turned the payment approval process over to their Vice President - Legal. PCDC did not enforce the terms of their loan agreement requiring annual financial statements and did not require a final audit of the Project's construction costs. The variable funding methods (advances and reimbursements) used to finance the UEDRARC Project, received from multiple sources (PCDC, PIDC, Commonwealth of Pennsylvania, and Meridian Bank) heightened the need for a final audit of construction costs.

UEDRARC Loan Payment History

UEDRARC defaulted on its loan immediately. PCDC's initial loan disbursement took place in October 1995, and UEDRARC's first loan payment to PCDC was due in December 1995. UEDRARC did not make its first payment on the PCDC loan until January 23, 1997. As of March 13, 2000, UEDRARC had been delinquent 50 of 53 months of the loan term, with arrears to March 13, 2000 totaling $22,496.01. Though UEDRARC was in default of their PCDC loan, and did not make their first loan payment until January 1997, PCDC continued to disburse additional loan funds to UEDRARC through September 1998. It appeared that PCDC continued to disburse the funds while UEDRARC was in loan default because it hoped UEDRARC would eventually improve financially, and PCDC did not want to jeopardize the Project by withholding loan funds. A PCDC official informed us that these were the reasons PCDC did not take more aggressive actions when UEDRARC went into loan default.

Default Procedure Guidelines

The Loan Policy and Guidelines listed a schedule of actions PCDC would take in the event of a loan default. These guidelines included providing technical assistance, deferring principal or interest payments, restructuring the loan, calling in the note, obtaining a pledge of additional collateral, and legal action as alternatives in the event of a loan default. Also, HUD Regulations at 24 CFR 570.501 specified that grant recipients take appropriate action when performance problems arise.

PCDC Response to UEDRARC Default

When UEDRARC defaulted on their loan, PCDC did not take full advantage of the recourses available to them in their Loan Policy and Guidelines and loan agreements with UEDRARC. They sent letters requesting payment and restructured the loan to recover delinquent interest payments, but these measures were ineffective. PCDC recently established a committee to help UEDRARC with its loan repayment problems. However, PCDC has yet to analyze UEDRARC's financial condition to determine its ability to make loan payments or prospects to become current at some future date. We believe PCDC did not act more forcefully when UEDRARC defaulted on the loan because of outside pressure and the desire to see the Project succeed.

C. Loan Maintenance

Future Prospects for UEDRARC

HUD provides CDBG funds for many purposes. Grantees use the funds to achieve any one of three national objectives. One of the CDBG national objectives is the prevention or elimination of slum and blight conditions. UEDRARC met a CDBG national objective by eliminating a slum and blight condition. However, though UEDRARC was successful in achieving this national objective, UEDRARC's ability to sustain this success in the long term as a viable project is questionable. Further, by failing to pay back its CDBG loans, UEDRARC continues to tie up funds that should be available for other projects.

If new funding becomes available, UEDRARC plans to continue renovating the remainder of its building to bring in new tenants and thereby increase revenue. The increased revenue is necessary if UEDRARC is to pay off its long-term debt. Our review indicated that UEDRARC currently lacks the resources to complete renovations to the building. Furthermore, UEDRARC's present operations do not generate sufficient rental income to cover its long-term debt and operating expenses. UEDRARC's financial operations over the last 17 months, from January 1999 through May 2000, are summarized below:

	Monthly Average	Total
Expenses w/out loan pmt 1/	$139,354.97	$2,369,034.49
Plus, Loan Payment 2/	36,890.09	627,131.53
Expenses with loan pmt 1/	176,245.06	2,996,166.02
Less, Revenue 1/	151,572.20	2,576,727.40
Arrears	$ 24,672.86	$ 419,438.62

1/ Revenue and expense amounts were obtained from UEDRARC's accounting system and are unaudited. Expenses included utilities, payroll, and maintenance costs.

2/ Amount includes payments to PCDC and PIDC.

UEDRARC's average monthly rent revenue covered its average monthly operating costs, but was not sufficient to also cover the required monthly loan payments to PCDC and PIDC. UEDRARC has experienced a $24,672.86 shortfall in average monthly revenue. Over the 17 month period the shortfall amounted to $419,438.62. Due to UEDRARC's loan history and its current financial condition, it appears unlikely that UEDRARC will be able to obtain the funding necessary for the remaining planned renovations. Without this funding and the resultant expected increase in revenue from new tenants, it does not appear likely that UEDRARC will be able to successfully pay off its long-term debt and continue operations.

Although PCDC's effort to eliminate a slum and blight condition is admirable, it appears PCDC made a questionable loan decision in UEDRARC's case. As a result of PCDC's loan decision, it appears PCDC will eventually have to write off the loan to UEDRARC, depriving other applicants of needed funds.

PCDC Comments

PCDC shared our concern that UEDRARC faces challenges to sustaining its success. However, they disagreed with our assessment of PCDC's participation in and their approval process for the UEDRARC Project, stating they served as a conduit for funding at the City of Philadelphia's request and direction. They stated that their September 23, 1993 Board meeting established requirements for UEDRARC to provide a sound fiscal and management plan for the Board's review, before the full Board would approve funding for the Project. They stated the report mischaracterized the Board's decision not to refer the Project to the Loan Committee as an effort to bypass the Loan Committee. They stated that the four members of the Loan Committee are members of the Board, and were present and voted in favor of funding the Project at the September 23, 1993 meeting. They also stated that the Chairman of the Board, who is also the Chairman of the Loan Committee, was present when the full Board unanimously approved the loan to UEDRARC at its August 3, 1994 meeting.

PCDC also disagreed with our conclusion that the UEDRARC loan terms were unusually favorable. They stated that although the terms of the loan were favorable, the senior lenders' (a group of local banks) loan structure dictated PCDC only charge UEDRARC interest for ten years at 3 ¼ percent per year for the PCDC loan. The stated terms were necessary for the Project's financial success.

Further, PCDC disagreed that the State Senator participated in the loan approval process. They stated that he abstained from voting on the UEDRARC Project at both meetings and did not actively participate in the Board's discussions of the loan.

OIG Evaluation of PCDC's Comments

PCDC's SBLRF guidelines stipulate that PCDC's Loan Committee is responsible for reviewing loan applications and approving the loans. In the case of UEDRARC, the PCDC Vice President for Lending recommended rejecting the application based on perceived cash flow problems. Subsequently, the application was presented directly to the Board of Directors without ever going to the Loan Committee, in effect bypassing the Loan Committee. We found no documentation in minutes to any of the Board's meetings or elsewhere explaining why PCDC presented this application to the full Board instead of to the Loan Committee. The minutes to the September 23, 1993 meeting state the final commitment of funding will be contingent upon the Board of Director's review and approval of a sound fiscal and managerial plan for the Project. All four members of the Loan Committee were present and voted to approve, in principal, the commitment of funds for the UEDRARC Project, pending review of a fiscal and managerial plan for the Project. However, at the August

3, 1994 meeting, when the Board approved the loan, the only Loan Committee members present were the Chairman of the Loan Committee and PCDC's President. The two remaining members of the Loan Committee were absent, and there was no indication that they had reviewed the fiscal and managerial plan. Because of the size of this Project and the impact it would have on PCDC, as stressed by PCDC's management during numerous discussions with OIG staff, it appeared unusual that PCDC would vote on a loan of this magnitude without the full Loan Committee's participation.

We do not dispute the fact that the terms of the UEDRARC loan were necessary to the Project's financial success. Our purpose was to state the fact that compared to other PCDC loans and PCDC's SBRLF guidelines, the UEDRARC loan was unusually favorable in terms of the loan amount, interest rate, and principal moratorium.

The minutes to both Board meetings state the State Senator abstained from voting on the UEDRARC Project. However, the minutes and the notes for the minutes to the August 3, 1994 Board meeting clearly state that the State Senator participated in the Board's discussion prior to the vote. As mentioned in the finding, the Philadelphia Divisional Deputy City Solicitor stated that there was no conflict of interest provided the Senator did not involve himself in the loan approval process. Clearly, by participating in the discussion leading to the Board's vote, the Senator placed himself in a conflict of interest position.

Recommendations

We recommend that HUD direct PCDC to:

1A. Explain and document, in the applicable loan file, all waivers to loan approval and administration policies and procedures regarding the UEDRARC loan.

1B. In the future, adequately explain and document, in the corresponding loan files, the reasons for waivers to the policies and procedures that govern its CDBG funded loan programs.

1C. Require UEDRARC to obtain an audit of the project construction costs which accounts for funds provided to the project from all funding sources including, PCDC loans, PIDC loans, State of Pennsylvania Grant Funds, and any other public and private funds loaned, donated, or granted to the project.

In the event that UEDRARC's default eventually causes PCDC to write off the loan as uncollectable, we recommend that HUD direct the City of Philadelphia to:

1D. Repay to the City's CDBG Program, with non-Federal funds, the loan portion written off as uncollectable.

Management Controls

Management controls consist of a plan of organization and methods and procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies. Management controls include the processes for planning, organizing, directing, and controlling program operations. They contain the control environment for risk assessment, information systems, control procedures, communication, and measuring and monitoring program performance.

Relevant Management Controls

In planning this audit, we evaluated the PCDC management controls related to our objectives to determine our audit scope and procedures. We determined the following management controls were relevant to our audit objectives:

- Loan approval policy and procedures to ensure PCDC evaluated the feasibility of the UEDRARC Project, including whether the UEDRARC Project: was an effective use of CDBG funds; affected a national objective; and had the financial wherewithal to sustain its operations;

- Loan administration and accounting policy and procedures to ensure PCDC had the systems and controls to oversee the project and used the controls to monitor the project and account for the funds provided; and

- Policies and procedures to ensure that PCDC administered HUD funds in accordance with applicable laws, HUD regulations, loan documents, and other directives.

Significant Weaknesses

A significant weakness exists if management controls do not give reasonable assurance that resource use is consistent with laws, regulations, policies, and resources are safeguarded against waste, loss, and misuse.

Our audit disclosed the following significant weaknesses:

- PCDC's Board of Directors overrode loan approval policy and procedures to provide a loan with unusually favorable terms to a financially risky project (see Finding 1).

- PCDC did not observe loan administration policies and procedures, including monitoring requirements and default procedures (see Finding 1).

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Follow Up On Prior Audits

This is the first audit of PCDC’s funding of the UEDRARC Project by HUD’s Office of Inspector General.

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Auditee Comments

P·C·D·C

Philadelphia Commercial Development Corporation

1315 Walnut St., Suite 600, Philadelphia, PA 19107-4706 Tel: (215) 790-2200 Fax: (215) 790-2222
www.PhiladelphiaCommercial.com e-mail: econpcdc@aol.com

October 4, 2000

Daniel G. Temme
District Inspector General for Audit
U.S. Department of Housing and Urban Development
Wanamaker Building, Suite 1005
100 Penn Square East
Philadelphia, PA 19107-3380

re: Urban Education Development Research and Retreat Center ("UEDRARC")

Dear Sir:

Following are PCDC's comments to your Draft Report on the above project.

We are gratified to note that you have concluded that the UEDRARC Project has met a Community Development Block Grant national object of eliminating a slum and blighted condition, and that UEDRARC is accomplishing its mission to provide an institutional environment encompassing programs designed to promote education, research, employment training, and human development to serve the needs of Philadelphia's African American community. The UEDRARC project has also spurred additional development in its adjacent West Philadelphia neighborhood including the construction of 200 safe, affordable new houses, and the opening of new businesses. But for the commitment of CDBG funding, the UEDRARC facility would have become a vacant blighting influence on the surrounding neighborhood, and the adjacent residential and commercial development might never have come to pass.

In addition to meeting this vital national objective of the CDBG Program, UEDRARC has also created in excess of 300 new employment opportunities for low and moderate income Philadelphians, surpassing by 27 percent the job creation goals mandated by UEDRARC's loan agreements with PCDC.

We also note your conclusion that PCDC has in place good management systems and controls to provide project oversight and to account for all loan funds disbursed to CDBG projects.

Rebuilding Neighborhoods By Building Small Businesses

Daniel G. Temme, Dist. .t Inspector General for Audit
U.S. Department of Housing and Urban Development
October 3, 2000
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PCDC shares your concern that UEDRARC faces challenges to sustaining its success. We have recently received UEDRARC's strategic plan outlining steps to improve the facility's operational and financial condition. UEDRARC has reported that it has already significantly increased the number of tenants. It also expects to complete by November 30, 2000 a study to identify needed cost savings and is also seeking to identify new income sources to fund additional capital improvements, including a major fund raising campaign.

We however disagree with your characterization of PCDC's participation in and approval process for the UEDRARC project. In effect, PCDC served as a conduit to provide funding for this project at the request and direction of the City of Philadelphia.

The UEDRARC project was initially presented to PCDC's Board of Directors at its meeting on September 23, 1993 by the City's Director of Housing and Community Development, who also served ex-officio as a PCDC Director. The Director of Housing and Community Development outlined the City's request that PCDC agree to re-program $549,683.00 of unused CDBG allocations from prior years to assist UEDRARC's development of a conference and service center at 4601 Market Street. The minutes of the September 23, 1993 Board meeting make clear that the Board withheld approval of the City's request until the Board could review a sound fiscal and managerial plan for the Project.

The minutes of the September 23, 1993 meeting further reflect that final action on funding for the UEDRARC Project would require authorization by the full Board of Directors. The Board's decision to retain jurisdiction over this Project rather than to refer it to a Board committee was not unusual given the size of the requested PCDC funding, and the visibility of this Project. The Board's decision not to refer consideration of the UEDRARC Project to its Loan Committee, a standing committee of the Board, is mischaracterized in your draft report as an effort by the Board to bypass its own Loan Committee, which your report alleges, may have been reluctant to approve the Project. We are at a loss to understand the basis for this conclusion. All members of the Board's Loan Committee were present and voting at the September 23, 1993 Board meeting and voted in favor of the Resolution requiring the full Board's, rather than the Loan Committee's, approval of funding for the UEDRARC Project. Moreover, your report ignores that the Chairman of PCDC's Board was also the Chairman of the Board's Loan Committee and was present at the August 3, 1994 Board meeting which unanimously approved a loan of Five Hundred Fifty Thousand Dollars ($550,000.00) to UEDRARC.

Daniel G. Temme, Dis\. .ct Inspector General for Audit
U.S. Department of Housing and Urban Development
October 3, 2000
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The Board's approval followed a full presentation by Mr. James Hartling, of Urban Partners, a consultant to OHCD, and by the City's Director of Housing and Community Development. Mr. Hartling's presentation included a ten year projection demonstrating sufficient rental income to service the Project's operating expenses and debt service (including the proposed PCDC and PIDC loans), provided that the PCDC and PIDC loans contained a ten year principal repayment moratorium and that their interest rates did not exceed three and one quarter percent per year.

Your report has questioned the terms of PCDC's loan to UEDRARC as "unusually favorable." We disagree with this conclusion as well. Although the terms of the PCDC loan were favorable, they were mandated by the cash flow projections as provided to PCDC. The interest rate on PCDC's loan was dictated by the senior lenders for the Project, a group of local banks which required a 1.3 debt service coverage with a market interest rate for tax-exempt bonds on the senior debt. The senior banks' loan structure dictated interest only payments for ten years at three and one quarter percent per year for the PCDC loan. The terms of the PCDC loan were therefore necessary to the financial success of the Project.

Moreover, UEDRARC is a not-for-profit Corporation carrying out a vital charitable mission of providing higher education, job training, social services, and business development opportunities to the residents of West Philadelphia. Any benefits conferred on UEDRARC by PCDC's favorable loan inured to the intended beneficiaries of UEDRARC's programs, not to the owners of the Project as would be the case were this a for-profit venture.

Your report further mischaracterizes the participation of one PCDC Director member who is also a State Senator in the loan approval process.

The Director in question abstained from voting on the UEDRARC Project at both meetings where it was discussed. Nor did he actively participate in the Board's discussion of the loan.

Very truly yours,

Curtis Jones Jr.
President/ CEO

Executive Summary

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Mr. Steve Redburn, Chief, Housing Branch, Office of Management & Budget, 725 17th Street, N.W., Room 9226, New Executive Office Building, Washington, DC 20503
President, Philadelphia Commercial Development Corporation, 1315 Walnut Street, Suite 600, Philadelphia, PA 19107
Principal Staff