



Issue Date	March 14, 1997
Audit Case Number	97-NY-250-1002

TO: Michael Merrill, Director, Community Planning and Development
Division, Buffalo Area Office

FROM: A. Paul Kane, District Inspector General for Audit,
New York/New Jersey

SUBJECT: Montgomery County
Community Development Program
Fonda, New York

We examined the operations of Montgomery County, New York (Grantee) pertaining to its Small Cities Community Development Block Grant (CDBG) Program. The purpose of our examination was to determine whether the Grantee carried out activities as shown in its applications in an economical, efficient, and effective manner; complied with requirements, laws and regulations of the U.S. Department of Housing and Urban Development (HUD); and charged costs to the program which were eligible and reasonable. During our examination, we were assisted by auditors from the New York State Comptroller's Office and the Montgomery County Sheriff's Department. The period reviewed was from January 1, 1993 through July 31, 1996, and where appropriate was extended to include other periods. The on-site work was performed between September 3, 1996 and January 31, 1997.

The report contains three findings that show that the Grantee and its subrecipient, the Montgomery County Economic Development Corporation, did not always comply with program requirements, laws and regulations. Specifically, we found that the Grantee did not properly monitor its subrecipient and that the Grantee and its subrecipient made imprudent loan decisions, obligated and disbursed funds to recipients without adequate support, failed to address potential conflicts of interest, and jeopardized the effectiveness of the Grantee's economic development program. Also, we found unallowable costs of \$415,000 and unsupported costs of \$1,353,270 (See Appendix A).

Within 60 days, please furnish this office, for each recommendation cited in the report, a status report on: (1) the corrective action taken, (2) the proposed corrective action and the date to be completed, or (3) why action is not considered necessary. Also, please furnish us copies of any correspondence or directives issued related to the audit.

Should your staff have any questions, please contact Alexander C. Malloy, Assistant District Inspector General for Audit, at 212-264-8000, Extension 3976.

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Executive Summary

We reviewed the operations of Montgomery County (Grantee) pertaining to the Small Cities Community Development Block Grant (CDBG) program. We were assisted by auditors from the New York State Comptroller's Office and the Montgomery County Sheriff's Department. The purpose of the examination was to determine whether the Grantee carried out activities as shown in its applications in an economical, efficient, and effective manner; complied with requirements, laws and regulations of HUD; and charged costs to the program which are eligible and reasonable.

Our review disclosed that the Grantee and its subrecipient did not always comply with program requirements, laws and regulations.

Deficiencies Found

Specifically, we found that:

The Grantee has not established the administrative practices necessary to ensure that costs paid from grant funds are allowable and reasonable. CDBG funds and program income have been routinely used to provide loans or assisted activities of persons or entities that may violate regulations pertaining to conflicts of interest. Consequently, most of the loans made to the related parties are in default and have not achieved the required program objectives.

The Grantee has not monitored its subrecipient. Consequently, CDBG funds have been used for questionable activities carried out by for-profit companies established by the subrecipient. The Grantee has little assurance that the program funds were used for eligible activities or that the activities meet the required program objectives. We believe that the monitoring was not performed because the Grantee's staff and elected officials have not placed the appropriate emphasis or importance on ensuring that its CDBG program operates in an efficient or effective manner.

The Grantee and its subrecipient made imprudent loan decisions, obligated and disbursed funds to recipients without adequate support, failed to address potential conflicts of interest, and jeopardized the effectiveness of the Grantee's economic development program.

We Recommend

We are recommending actions that will strengthen the Grantee's future administration of HUD programs. Also, we are recommending that you require the Grantee to repay the ineligible costs of \$415,000 and either repay or document the

unsupported costs of \$1,353,270. Finally, we are recommending that you advise the Grantee that unless the corrective actions are implemented in a timely manner, that the provisions of Title 24, Code of Federal Regulations (CFR), Sections 570.910, 911, and 913 will be instituted. These sections provide the remedial actions that HUD may take in response to deficiencies and noncompliances by grant recipients.

Exit Conference

The results of the audit were discussed with Grantee officials during the course of the audit and at an exit conference held on March 5, 1997, attended by:

Grantee

Gerald Keller, Chairman, County Board of Supervisors
Miles Frasier Jr., County Board of Supervisors
Les Hassan, County Board of Supervisors
William Grzyb, County of Board of Supervisors
Bill Wills, County Board of Supervisors
Ronald J. Mead, County of Board of Supervisors
Edward R. Paton, County Board of Supervisors
Jim Cuzzo, County Board of Supervisors
Robert McMahan,, County Board of Supervisors
Wayne Allen, County Administrator
Michael Amato, County UnderSheriff
Richard Polikowski, Senior Investigator,
County Sheriff's Office
Norma Palmer, County Treasurer
Kelli P. McCoski, County Attorney

HUD - Office of Inspector General

Alexander C. Malloy, Assistant District Inspector General
for Audit
Lawrence W. Magiera, Senior Auditor
John A. Cameron, Auditor

New York State Office of the State Comptroller

Richard H. Dinolfo, C.P.A., Chief Examiner of
Municipal Affairs
John P. Arpei, Associate Examiner of Municipal Affairs
Peter Mahar, Examiner of Municipal Affairs

The Grantee generally agrees with the findings contained in this report, and has elected not to provide written comments. The Grantee has agreed to work with the HUD Buffalo Area Office to resolve the issues raised in the findings.

In conjunction with the joint effort, the State of New York Office of State Comptroller has issued an audit memorandum dated March 5, 1997. The memorandum is included as Appendix B in this report.

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Abbreviations

CDBG	Community Development Block Grant
CFR	Code of Federal Regulations
ECMI	Environmental Construction Management, Inc.
EDB	Montgomery County Economic Development Board
HUD	U.S. Department of Housing and Urban Development
MCEDC	Montgomery County Economic Development Corporation
OMB	Office of Management and Budget

Introduction

Title I of the Housing and Community Development Act of 1974 as amended, established the CDBG program that provides grants to states and units of local governments to aid in the development of viable urban communities.

The CDBG program is administered by the Grantee through its subrecipient, the Montgomery County Economic Development Corporation (MCEDC). The Grantee is located at County Annex Building in Fonda, New York. Wayne D. Allen is the County Administrator and Norma Palmer is the County Treasurer. The books and records are located at the Grantee's office.

During the audit period, the Grantee administered the following Small Cities CDBG grants:

B-93-DH-36-0229	\$379,270
B-94-DH-36-0095	\$600,000
B-95-DH-36-0089	\$600,000

In addition to the above grants, the Grantee also administered a CDBG revolving loan fund created from CDBG grants and program income received from earlier program years. The balance in the revolving fund at July 31, 1996 was \$161,057.

Audit Objectives, Scope and Methodology

The audit objectives were to determine whether the Grantee: (1) carried out its activities as shown in its applications and agreements in an economical, efficient, and effective manner; (2) complied with HUD program requirements, laws and regulations; and (3) charged costs to the programs that were reasonable and eligible.

The audit covered the period from January 1, 1993 through July 31, 1996. However, we reviewed activity prior and subsequent to the audit period as necessary. Based upon our survey results the audit focused primarily on the Grantee's administrative controls and economic development activities. The audit site work was performed between September 3, 1996 through January 31, 1997.

In order to accomplish the audit objectives the following audit procedures were performed:

- Examined records and files of the Grantee and interviewed staff.
- Reviewed records and files of the subrecipient and interviewed staff.
- Reviewed the Grantee's policies and procedures for managing its operations.
- Tested selected transactions.

The audit was conducted in accordance with generally accepted government audit standards.

A copy of this report was provided to the Grantee.

Inadequate Administrative Practices Resulted in Uneconomical and Unsupported Use of CDBG Funds

Effective administrative practices necessary to ensure that costs paid from grant funds are allowable and reasonable have not been implemented. Moreover, CDBG funds and program income have been routinely used to provide loans or assisted activities of persons or entities that may have violated the CDBG regulations pertaining to conflicts of interest. Consequently, most of the loans made to the related parties are in default and have not achieved the required program objectives. The specific loans and activities are discussed in the other audit findings contained in this report. Unless Grantee staff and elected officials place more emphasis on creating an internal control environment that will protect the program's assets, it is unlikely that the Grantee will have the capacity to administer its program in the future.

Criteria

Office of Management and Budget (OMB) Circular A-87, Cost Principles for State and Local Governments provides that grantees are responsible for the efficient and effective administration of grant programs through sound management practices. In addition, 24 CFR 85.40 provides that grantees are responsible for managing the day-to-day operations of grant and subgrant supported activities to ensure compliance with applicable Federal requirements. Finally, Part 570.611 of the CDBG regulations contains the conflict of interest provisions that must be complied with by grantees.

Background

The Montgomery County Administrator is primarily responsible for the overseeing of the Grantee's CDBG program. The Administrator is also the Chairman of the Montgomery County Economic Development Board (EDB). The EDB's primary function is to review and recommend approval of loans made through the CDBG program. The County Treasurer is responsible for drawing down grant funds and making disbursements related to the program.

The Montgomery County Economic Development Corporation (MCEDC) acts as a subrecipient for the Grantee. Generally, the MCEDC was responsible for implementing and

administering the Grantee's CDBG program. In connection with its duties, the MCEDC assembles and reviews applications for the Grantee's CDBG loan program.

Finally, the Montgomery County Board of Supervisors is ultimately responsible for all the operations of the County including the CDBG program. Both the County Administrator and the Treasurer report to the Supervisors. Many of the transactions and decisions involving the use of grant funds require Board approval.

Scope of Review

We reviewed the system of controls implemented by the Grantee and its subrecipient to ensure that the CDBG program is administered in accordance with HUD regulations. More importantly, we evaluated the control environment created by the Grantee and its Board of Supervisors.

A control environment can be defined as an overall attitude, awareness, and actions taken by the management of an entity and others concerning the importance of internal controls. An effective control environment will enhance the implementation and enforcement of controls, policies, and procedures. Conversely, an ineffective environment will weaken controls by permitting the controls to be circumvented or by failing to assure that the controls are operating and effective.

Ineffective Control Environment

Our review showed that the administration of the CDBG program has been impeded by the lack of an effective control environment at both the Grantee and its subrecipient. The current environment has allowed established internal controls to be overridden, circumvented, or not enforced. Particular weaknesses are described below.

Administrative Costs Paid Without Written Contracts

Since 1993, the Grantee has paid at least \$291,000 to the MCEDC for administering its program without the benefit of written contracts. As a result, there is no clear program performance and accountability guidelines established between the Grantee and the MCEDC.

The Grantee was aware of the need for an effective contractual basis because a 1993 HUD monitoring report raised concerns about the maintenance of supporting

documentation for costs and activity performance related to MCEDC. In fact, HUD provided the Grantee with a sample subrecipient agreement.

In April 1996, as a result of an investigation by the County Sheriff the Grantee ceased reimbursing the MCEDC for administration of its program. In September 1996, the Grantee entered into a written contract with the MCEDC for the administration of its program. The contract was signed by the Board of Supervisors despite their knowledge that the contract did not fully conform to HUD regulations including Part 570.503 and CFR Part 85. In addition, the contract was approved even though the Grantee's attorney recommended against approval.

Our review of the contract showed that the MCEDC's attorney deleted several provisions that are necessary for the Grantee to effectively administer its program. Examples of the omitted provisions include:

- Requirement for an annual independent audit.
- Provision giving HUD, New York State, and the Grantee the right to examine, copy, and audit the books and records of the MCEDC.
- Requirement to maintain books and records in accordance with generally accepted accounting principles.

Conflicts of Interest and Related Party Transactions

Contrary to HUD regulations and conditions of the grant agreements, the Grantee has not implemented proper safeguards to ensure that employees, local officials do not use their positions for private gain. Our review disclosed several instances where an elected official and a member of the EDB may be involved in conflicts of interest. Also, we found that officials of the MCEDC may be in violation of the regulations regarding loans provided to their for-profit entities.

Section 570.611 of the CDBG regulations provides that its provisions apply to any person who is an employee, agent, consultant, officer, elected official or appointed official of the recipient, or any designated public agencies, or subrecipients

receiving funds. This Section further provides that no persons who exercise or have exercised any functions or responsibilities with respect to CDBG activities or who are in a position to participate in a decision making process or gain inside information with regard to such activities, may obtain a personal or financial interest or benefit from a CDBG assisted activity, or have an interest in any contract, subcontract or agreement with respect thereto, or the proceeds there-under, either for themselves or those with whom they have family or business ties, during their tenure or for one year thereafter.

The circumstances involved in the potential conflicts of interest are described on a case-by-case basis below.

Case One

We found that a member of the County Board of Supervisors who was also a member of the MCEDC received \$11,800 for work performed by his construction company on MCEDC projects. In addition, he received at least two loans from the MCEDC rural revolving loan fund funded by the U.S. Department of Agriculture. We requested information from the MCEDC pertaining to the loans but the information was never provided.

Subsequently, allegations of ethics violations were raised about this individual regarding his vote to approve the aforementioned administrative contract for the MCEDC. His vote was crucial to the contract being approved.

On January 2, 1997, the County's Ethics Board ruled on the ethics charges. In summary, the Ethics Board held that an appearance of a conflict of interest did exist. It recommended that the vote be cancelled and voided.

Case Two

While a member of the three member EDB, this individual was an officer, principal, or stockholder of five entities that received loans or other funds from the CDBG program from MCEDC. The EDB's primary function is to review and recommend approval of loans funded from the CDBG program.

Apart from the above, we were informed by Grantee personnel that this individual has active business relationships with the MCEDC's Executive Vice President.

Finding 3 of this report discusses the default status of two loans totaling \$415,000 and another troubled loan guaranteed by the CDBG program for \$120,000. Moreover, we have confirmed that an affiliated entity has received and defaulted on another \$135,000 in CDBG loans in Utica and Rome, New York.

Case Three

The President of a local bank was serving as a Board member of the MCEDC and several wholly owned entities of MCEDC as follows:

- MCEDC - Executive Committee Member
- DeGraff Street Development Corp. - Director
- M.C.1 Development Corp. - Director
- M.C.2 Development Corp. - Director
- M.C.3 Development Corp. - President, Treasurer
- M.C.4 Development Corp. - Director
- Community Development Foundation - Treasurer

Our review of the loans and other grant activities showed that the local bank provided permanent and interim financing for the DeGraff Street Development and M.C.1 loans discussed in Finding 2 and the American Composite Materials, Inc. and Weeb Entertainment, Inc. loans discussed in Finding 3 of this report.

Case Four

The Executive Vice President (Executive Director) of the MCEDC was instrumental in establishing and operating the following for-profit and non-profit entities as follows:

- DeGraff Street Development Corp. - President, Treasurer
- M.C.1 Development Corp. - President, Treasurer
- M.C.2 Development Corp. - President, Treasurer
- M.C.3 Development Corp. - Assistant Secretary, Treasurer
- M.C.4 Development Corp. - President, Treasurer

- Environmental Construction Management, Inc. (ECMI)
- Director
- Community Development Foundation - Executive
Vice President, Pro Tem
- Main Street Alliance - Treasurer

This individual was also the Administrative Director for the Montgomery County Industrial Development Agency.

We believe that this case could constitute a conflict of interest because the MCEDC under administration of this individual was instrumental in obtaining loans and received associated administrative funds for several of the entities identified above. Finding 2 of this report details the significant problems associated with the loans to some of these related entities.

Weaknesses in Controls of the EDB

Our review of the EDB showed several weaknesses in controls that diminish assurance that the EDB is protecting the integrity of the Grantee's program. Specific weaknesses include the following:

- a. The County Administrator advised that the meetings required to be held prior to approving loan applications were not always held.
- b. The County Administrator advised that minutes were not maintained to support meetings when they were held.
- c. Although authorized to staff the EDB with seven members, only three were ever appointed.
- d. One of the three members received or had interests in loans approved by the EDB (See Case Two).

Other Unsupported Payments for Administrative Costs

Apart from the \$291,000 paid to the MCEDC identified in the first section of this finding, our review noted at least another

\$86,000 in administrative expenditures that may not be reasonable. Therefore, we have also considered those costs unsupported pending an eligibility determination by HUD. Particulars are as follows:

- a. At five CDBG loan closings, the MCEDC received administrative funds totaling \$63,000 to apparently administer the loans. We believe that these payments duplicate the services that should have been provided and paid for with the \$291,000.

It is significant to note that \$24,500 of the amount was for administering loans to M.C.1 and DeGraff Street Development, both wholly owned subsidiaries of MCEDC, and both in default.

- b. Since 1993, the County's Board of Supervisors approved \$23,000 in apparent donations to the Mohawk Valley Economic Development District. The Grantee was unable to provide evidence that any measurable service was provided as a result of these payments.

Conclusion

In summary, the weaknesses and deficiencies discussed in this finding have impaired the administration of the Grantee's CDBG program and represent not only non-compliances with CDBG regulations and OMB Circular A-87, but also the Grantee's guidelines. The deficiencies also limit the Grantee's ability to establish a reliable system to evaluate the performance of the program and preclude any assurance that costs are reasonable and proper.

Recommendations

We recommend that you require the Grantee to:

- 1A. Submit a plan of action for your review that addresses the conditions leading to the ineffective control environment.

Since the control environment extends to the Grantee's Board of Supervisors, it is unlikely that significant improvements can be made unless they agree to promote and enforce the plan of action.

At a minimum, the plan must ensure that the expenditure of grant funds are supported by adequate documentation and where applicable written enforceable contracts. Adequate controls must be established that will identify all possible conflicts of interest and enable appropriate action to be taken.

- 1B. Take appropriate actions to resolve the potential conflicts of interests mentioned in this report.
- 1C. Submit documentation so that the appropriate eligibility determination can be made in regards to the unsupported use of CDBG funds for administrative costs. The eligibility determination should address the \$291,000 paid to MCEDC without the benefit of a written contract. Moreover, the remaining \$86,000 pertaining to the other unsupported use of funds are to be reviewed.
- 1D. Reimburse the program from non-Federal funds for the amount determined to be unallowable by the eligibility determination done in 1C., above.

In addition, we request that you:

- 1E. Advise the Grantee that unless the plan is effectively implemented in a timely manner, that corrective actions identified in Title 24 CFR Sections 570.910, 911, and 913 will be instituted. These sections provide the remedial actions that HUD may take in response to deficiencies and noncompliances by grant recipients.

Effective Monitoring of Subrecipient's Use of Wholly Owned For-Profit Corporations Has Not Been Performed

The Grantee has not monitored its subrecipient, the Montgomery County Economic Development Corporation (MCEDC). Consequently, the Grantee did not promptly detect that CDBG funds had been used for questionable activities carried out by for-profit companies established by the MCEDC. Also, the Grantee did not have adequate assurance that program funds were used for eligible activities or that the activities meet the required program objectives. Moreover, the MCEDC and its related entities may have unduly profited from transactions involving CDBG funds. We believe that the monitoring has not been performed because the Grantee's staff and elected officials have not placed the appropriate emphasis or importance on ensuring that its CDBG program operates in an efficient or effective manner.

Criteria

Title 24 CFR, Part 85 contains the requirements that grantees are to follow regarding program monitoring including the activities administered by subrecipients. In addition, Part 85 provides financial management standards that must be met by the grantee and subrecipients. Finally, 24 CFR Section 570.501 provides that the grantee is responsible for determining the adequacy of performance under subrecipient agreements and for taking appropriate action when performance problems arise.

Apart from the above, 24 CFR, Part 570.203 provides that assistance provided to private for-profit businesses for economic development activities must not unduly enrich the business or result in excessive funding.

Background

Since 1993, the MCEDC created numerous for-profit and non-profit entities to carry out economic development activities. The entities share common officers and/or board members. CDBG funds were used for activities and/or expenses at several of these entities.

Scope and Objectives

We examined the files pertaining to loans made to DeGraff Street Development Corporation and M.C.1 Development Corporation. In addition, we reviewed cash disbursements and receipts at MCEDC pertaining to MCEDC, DeGraff Street Development and M.C.1 Development. The objectives of the examination were to determine whether the MCEDC complied with CDBG regulations and whether the grant activities carried out by the MCEDC substantially conformed to the provisions in the approved grant applications for funding.

MCEDC has not complied with program regulations

We found that the MCEDC has not complied with program regulations or the approved grant applications related to loans made to DeGraff Street and M C.1 Development Corporations. Moreover, we reviewed several transactions involving both receipts and disbursements that do not appear to conform to the intent of the funding, were unsupported, or are not authorized. The deficiencies are discussed on a case by case basis below:

DeGraff Street Development Corporation

The 1993 Small Cities Grant included funds for a \$319,270 loan to the DeGraff Street Development Corporation (a for-profit corporation of the MCEDC). The loan proceeds were to be used in conjunction with another \$290,000 in other funds and equity to acquire and renovate a DeGraff Street building. The renovated building was to be leased to businesses to create job opportunities and increase the local tax base. The acquisition and renovation work was substantially completed by December 1995. The loan is currently in default.

Our review of the project and the funds attributable to the acquisition and renovation disclosed several matters that need to be addressed by a HUD eligibility determination.

- DeGraff Street applied for and received additional funding for the project from the New York State Urban Development Corporation in the amount of \$150,000. Additionally, a \$150,000 loan was received from the Mohawk Valley Rehabilitation Corporation. This funding combined with the original financing from other sources resulted in \$869,270 in funds available for the completion

Loan Proceeds Exceed the Project Costs

of the project. We could not document that HUD and the Grantee were informed of the additional sources of funds.

Despite receiving \$869,270 in funds to acquire and renovate the project, an audit performed by DeGraff's independent auditor shows that only \$694,811 in project costs including acquisition had been incurred. The remaining loan proceeds of \$174,459 appears to have been a windfall profit to DeGraff Street Development Corporation.

Proceeds Disbursed Without Support

- Renovation work was performed without the benefit of competition or bidding as required by program regulations.
- Renovation costs were not always supported by properly executed contracts. Invoices and inadequately detailed proposals were used as a basis for payments.
- Documentation supporting compliance with labor standards and the Davis Bacon Act was not available for review. Adherence to these standards was mandated in the CDBG application for funding.
- County property records show that a lien protecting the CDBG loan was never filed. Therefore, at least \$400,000 from the other sources have lien positions ahead of the program loan.
- Repayment of back taxes amounting to \$115,000 highlighted in the project impact statement filed with HUD was never accomplished.

M.C.1 Development Corporation

The Grantee made two loans to M.C.1 Development Corporation (a for-profit corporation of MCEDC) totaling \$387,000. The loans were to be used in conjunction with a \$300,000 loan from a local bank. The purpose of the loans was to acquire a property in default under prior CDBG, State loans, and bank debt. In addition, the proceeds from the loans were also to be used to purchase an adjoining parcel of land for approximately \$20,000 and to perform certain renovations to the property up to \$45,000. Although the property was

Windfall Profits From
Property Acquisitions

acquired from a unaffiliated party, DeGraff Street Development acted as an intermediary by purchasing the property and reselling it to M.C.1. The loans are currently in default.

Our review of the use of the loan proceeds disclosed several transactions that raise significant questions about the necessity and reasonableness of the funding. The specifics are discussed as follows:

- a. Documented costs related to the DeGraff's acquisition and subsequent resale to M.C.1 totaled \$311,276. Conversely, DeGraff sold the property to M.C.1 for \$475,000. The difference amounting to \$163,724 represents a windfall profit to DeGraff Street Development Corporation.
- b. M.C.1 used the \$45,000 approved for renovation work to reimburse DeGraff Street Development for questionable and unsupported expenses. Invoices maintained by M.C.1 did not contain adequate information to determine the scope of work or to identify the contractors paid. In addition, at least \$9,120 of the amount reimbursed to DeGraff Street was for rent. Rent is not an includable expense because the funding application provided the tenant with 24 months of free rent.
- c. Property liens for at least \$212,000 of CDBG loans have not been filed.

We believe that the deficiencies identified in the related entity loans underscore the need for improvements in the Grantee's monitoring of its CDBG program. More significantly, the MCEDC and its related entities used HUD program funds to generate windfall profits for its operations, while at the same time failing to keep its loans current or to file property liens to protect the Grantee's interests. The last section of this Finding deals with other expenses paid for with the windfall profits and/or program funds. We believe that these payments are not reasonable, necessary or eligible.

- Unauthorized loan to ECMI (a for-profit entity of MCEDC) for \$20,000. The use of the loan proceeds was undocumented and no repayments were ever made.
- Payments totaling \$32,400 for land options to private owners for properties unrelated to the DeGraff Street Development Corporation's mission or activities.
- Purchase of \$10,000 in common stock of a local bank. The President of the local bank was a director on most of the for-profit entities of the MCEDC.
- Leasehold improvements amounting to \$15,977 to a tenant of DeGraff Street Development. The use of the proceeds are not documented. The tenant is also in default on another CDBG program loan.
- Funds totaling at least \$7,500 were paid to a bank on behalf of investors involved in a project unrelated to DeGraff Street Development.
- M.C.1 paid \$12,000 to retain a consultant to prepare a HUD Small Cities grant application for the City of Amsterdam.

The matters discussed in this finding constitute violations of the CDBG regulations stated above. As a result, HUD and the Grantee have little assurance that program costs are proper, funds are being used in an economical and effective manner, or that program objectives are met.

Recommendations

We recommend that you require the Grantee to:

- 2A. Provide all documentation related to the DeGraff Street and M.C.1 loans including the funds received from other sources and equity to determine the amount that is ineligible for inclusion in program costs.
- 2B. Reimburse the program with non-Federal funds for the amount determined to be ineligible in recommendation 2A.

- 2C. Adopt and implement procedures that correct the weaknesses addressed in this finding. The corrective actions should compliment the actions taken with respect to the other findings in this report.

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Deficiencies Exist In the Administration of the Grantee's Economic Development Activities

The Montgomery County Economic Development Corporation (MCEDC) and the Grantee made imprudent loan decisions, obligated and disbursed funds to recipients without adequate support, failed to address potential conflicts of interest, and have jeopardized the effectiveness of the Grantee's economic development program. Accordingly, loans totaling \$415,000 are ineligible and another \$270,000 are considered unsupported pending a HUD eligibility determination. We attribute these deficiencies to the Grantee and its subrecipient not having effective administrative controls to ensure that CDBG regulations and the Grantee's program requirements were followed.

Background

The MCEDC is a private, not-for-profit corporation and administers the economic development program for the Grantee. The MCEDC's mission is to process and administer low interest economic development loans to local businesses and developers. In addition, MCEDC processed and administered two CDBG loans to identity of interest for-profit corporations as discussed in Finding 2 of this report.

The MCEDC has operated the Grantee's program and received administrative funds without the benefit of properly executed agreements identifying the scope of services to be provided.

Scope and Objectives

We examined case files pertaining to three of twelve non-identity of interest businesses that participated in the loan program during the audit period. Also, we reviewed the files for one other entity that obtained a bank loan using a loan guarantee backed by CDBG funds. All four of the cases reviewed are in default. The objectives of the examination were to determine whether the MCEDC complied with the Grantee's program guidelines, CDBG regulations, and whether actions to resolve the defaults were adequate.

We found that the MCEDC has not complied with CDBG program regulations or with the Grantee's guidelines. The deficiencies found are discussed on a case by case basis below:

Loan Provisions
Disregarded, \$415,000
Loan in Default

American Composite Materials, Inc. The MCEDC used 1994 Small Cities grant funds and program income to provide the recipient with two loans totaling \$415,000 to establish an incubator business and create employment for low and moderate income persons. The loan proceeds were to be used to purchase production equipment from an identity of interest company and for leasehold improvements.

Our review found that the proceeds totaling \$415,000 were disbursed to the recipient without any meaningful evidence that the funds were used in accordance with the loan agreement. The loan files did not support the reasonableness of the proposed costs, or that any of the required funds were actually paid to the affiliated entity. Moreover, there is little assurance that the required \$175,000 in owner equity was provided as stipulated in the loan agreement or support identifying the use of \$95,000 borrowed from a local bank for use in establishing the business.

Conflict of Interest
Unresolved

Additionally, we found that a principal of the loan recipient was also a member of the three person economic development board charged with the responsibility of reviewing and recommending approval of the loans to the Grantee's Board of Supervisors. This apparent conflict of interest was not adequately resolved or addressed for that matter. More importantly, a conscious decision was made by the EDB board and the Grantee to ignore negative credit information pertaining to loans received by affiliated companies in other localities.

Despite receiving all \$415,000 in CDBG loan proceeds and \$95,000 in bank financing, the recipient never apparently initiated production, people were not hired, and after only a few months and \$15,910 in loan repayments the loans went into default.

We consider the \$415,000 to be ineligible because the activity did not meet the required CDBG national objective of creating jobs for low to moderate income and because documentation that would justify the reasonableness of the costs could not be provided.

Proceeds Disbursed
Without Adequate
Documentation

U.S. Products, Corp. Despite being soundly rejected for loan assistance in 1993 for failing to provide critical financial

information, the MCEDC reversed its funding decision in 1994 and provided the recipient with \$75,000. The loan amount was to be matched by an equity infusion of \$75,000. The purpose of the loan was to purchase machinery and equipment. In less than one year from the disposition of the loan proceeds, the recipient filed for bankruptcy. It is unlikely that the Grantee will collect any of the outstanding loan amount because the Grantee did not perfect its lien on the equipment.

Our review of the loan files and associated processing disclosed the following:

- Missing financial information that resulted in the 1993 loan rejection was apparently never provided to MCEDC prior to the 1994 funding approval.
- Documentation supporting the costs did not include canceled checks or sufficient information that the goods/services were paid or received. Several invoices were hand prepared with no company name or address. At least one invoice for \$8,687.22 did not mathematically foot.
- Invoices totaling \$27,400 were from an unincorporated business operated by the loan recipient. The identity of interest was not disclosed in the loan files and the invoices were not sufficiently detailed to ascertain their propriety or reasonableness.

Questionable Donations

Apart from the above, our review of the MCEDC's accounting records disclosed the receipt of two cash donations from the loan recipient. The donations were made in January and February 1994, and totaled \$3,000. A legal determination will be necessary to determine whether MCEDC's acceptance of the donations violates conflict of interest provisions of the program regulations, or other State and local ethics policies.

Due to the lack of documentation supporting the eligibility and reasonableness of the costs, we consider the loan amount of \$75,000 to be unsupported.

Weeb Entertainment, Inc. The company received a \$75,000 loan from the CDBG revolving loan fund for the purchase of equipment and working capital. The loan funds were matched with a \$75,000 line of credit from a local bank.

In Default Prior to Last Loan Drawdown

Our review found that the loan files did not contain any documentation to support the use of the loan proceeds or for the matching funds. The loan went into default one month prior to the recipients last drawdown of loan proceeds.

Consequently, the loan amount of \$75,000 is considered as unsupported pending a HUD eligibility determination.

Continental Marketing Group, LLC CDBG funds amounting to \$120,000 may have been improperly pledged as loan collateral for a \$150,000 bank loan for working capital approved in August 1995. The recipient was established as a incubator venture to telemarket lawn products built by an affiliated company in Utica, New York. The loan proceeds were to be used for working capital and were augmented by \$50,000 in private equity.

Improper Pledging of CDBG Funds

The loan recipient has not complied with the repayment terms of the agreement, namely it failed to make the required \$150,000 balloon payment due on July 14, 1996. To date, the bank has informed the MCEDC that they intend to exercise the loan guarantee of \$120,000.

Based on our review, we have concluded that the pledging of CDBG funds was not appropriate because the use of the loan does not meet a national program objective. Of equal significance, we found indications that the loan proceeds may have been used to pay expenses attributed to the affiliated company in Utica. There is also no evidence that any of the required private equity was provided. Finally, we found that the same economic development board member cited as having a conflict of interest in the American Composite Material's section of this finding acted as an officer of the corporation affiliated with the loan recipient. Again, this conflict was never appropriately addressed by the MCEDC or the Grantee.

Subsequent to our initial review we confirmed that the affiliated entity has received CDBG funds of \$135,000 in the form of loans from two entitlement programs located in Rome and Utica, New York. Both of the loans are in default.

Criteria and Effect

The deficiencies noted above, adversely affect the Grantee's ability to ensure and demonstrate that its economic

development program is complying with the CDBG regulations. Specifically, Section 570.208 of the CDBG regulations regarding the requirement that activities meet at least one national objective, and OMB Circular A-87, which require costs to be necessary and reasonable. In addition, the Grantee's and MCEDC's unwillingness to implement and use an effective system of controls as prescribed in Part 85 of the CFR, has further diminished their ability to properly administer the program.

Recommendations

We recommend that you require the Grantee to:

- 3A. Reimburse the CDBG Program for the \$415,000 related to the loan default by American Composite Materials, Inc. The reimbursement should be from non-Federal funds.
- 3B. Advise the MCEDC to provide information and justification including canceled checks to support the \$150,000 in costs questioned pertaining to the U.S. Products and Weeb Entertainment loans. Additionally, the MCEDC must document that the loan recipients provided the private equity required by the loan agreements.

Any costs that cannot be adequately supported should be reimbursed to the program from non-Federal funds.
- 3C. Refrain from using HUD funds to support the loan guarantee related to the Continental Marketing Group. If the bank proceeds to act against the guarantee, non-Federal funds should be used to satisfy the claim.

In addition, we request that you:

- 3D. Ensure that the Grantee adopts and enforces the necessary controls to prevent further noncompliance with HUD regulations. The controls must address the matters included in this finding and complement the recommendations contained in the other findings of this report.

Internal Controls

In planning and performing our audit, we evaluated internal management controls with respect to selected auditing procedures. The evaluation was not intended to provide an opinion on the overall adequacy of the internal controls.

Internal controls are management's adopted plan, methods and procedures to assure resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data are obtained, maintained, and fairly disclosed in reports.

Relevant Internal Controls

We determined that the following internal control categories were relevant to our audit objectives:

- Controls over cash receipts and disbursements.
- Controls over monitoring HUD programs.
- Controls over supporting documentation for costs.
- Controls over the processing and servicing of loans.

A significant weakness exists if internal controls do not give reasonable assurance that: (a) resource use is consistent with laws, regulations, and policies; (b) resources are safeguarded against waste, loss and misuse; and (c) reliable data are obtained, maintained, and fairly disclosed in reports.

Our review found significant weaknesses in all internal controls tested. The control weaknesses are detailed in the three findings contained in this report.

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Follow Up On Prior Audits

An audit of the Grantee was performed by an Independent Auditor for the period ended December 31, 1995. The report had not been issued as of the date we completed our field work.

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Schedule of Ineligible and Unsupported Costs

Finding Number	Ineligible (1)	Unsupported (2)
1		\$377,000
2		706,270
3	\$415,000	270,000
Total	\$415,000	\$1,353,270

(1) Costs clearly not allowed by law, contract, HUD or local agency policies and regulations.

(2) Costs not clearly eligible or ineligible but warrant being contested (e.g. lack of satisfactory documentation to support the eligibility of the costs, etc.).

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New York State Comptroller's Audit Memorandum

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