



Issue Date	October 18, 1996
Audit Case Number	97-PH-241-1001

TO: Joseph K. Aversano, Director, Community Planning
and Development Division, Virginia State
Office, 3FD

FROM: Edward F. Momorella, District Inspector General
for Audit, Mid-Atlantic, 3AGA

SUBJECT: City of Charlottesville
Community Development Block Grant Program
Charlottesville, Virginia

We audited selected activities of the City of Charlottesville (Grantee) Community Development Block Grant (CDBG) Program. The purpose of the audit was to determine whether the activities were administered in accordance with applicable HUD regulations and requirements and Grantee policies.

Based on our review, the Grantee needs to improve its management and oversight of the Economic Development Loan Program.

Within 60 days, please give us, for each recommendation made 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 considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

If you have any questions, please contact Irving I. Guss, Assistant District Inspector General for Audit, at (215) 656-3401.

Executive Summary

The purpose of the audit was to determine whether the City of Charlottesville administered selected CDBG Program activities according to HUD regulations and requirements and Grantee policies.

Grantee improperly funded three loans

The audit disclosed that the Grantee effectively administered the CDBG Program. However, a problem was identified requiring corrective action by the Grantee.

The Grantee did not administer the Economic Development Loan program properly as required by Federal regulations and program guidelines. The Grantee did not provide the necessary management oversight by ignoring its own written guidelines. The Grantee failed to document that the appropriate analysis was done, national objective met, financial commitment obtained and loan expenditures were supported. As a result, the Grantee provided ineligible loans totaling \$54,821 to three borrowers.

We recommend the Grantee: (1) repay the program from non-Federal funds the loan principal totaling \$54,821 and pay to HUD all interest earned on the loans, and (2) implement written procedures to ensure program regulations and requirements are followed.

We discussed the draft finding with Grantee representatives during the audit and at an exit conference held on October 10, 1996. The draft finding was provided to the Grantee and the response received was considered in our report. The Grantee response is included as Appendix C.

Table of Contents

Management Memorandum	i
Executive Summary	iii
Introduction	1
Finding	
The Grantee Needs to Improve the Management of the Economic Development Loan Program	3
Internal Controls	15
Follow Up On Prior Audits	17
Appendices	
A Finding Loan Analyses - Borrowers A, B and C	19
B Schedule of Ineligible Costs	25
C Auditee Comments	27
D Distribution	31

Abbreviations

CDBG	Community Development Block Grant
CFR	Code of Federal Regulations
HUD	Department of Housing and Urban Development
OIG	Office of Inspector General

Introduction

The City of Charlottesville has received a total of \$8,826,790 in CDBG entitlement funds since 1982. HUD provided CDBG entitlement funds to the Grantee for the following three recent program years:

<u>Program Years</u>	<u>Amount</u>
1993	\$697,000
1994	\$758,000
1995	\$735,000

The Grantee is governed by City Council and administers the CDBG program through the City Manager and the Department of Community Development. Mr. Satyendra Singh Huja is the Director of Planning and Community Development.

To administer the Economic Development Loan Program the Grantee established a Loan Committee. The Committee is responsible to review and recommend projects to be funded with an economic development loan. The Loan Committee consists of five members: a staff member of the Department of Community Development, a member of the Charlottesville business community, two loan officers of lending institutions located in Charlottesville and a resident of a CDBG target neighborhood.

CDBG Program records are maintained at City Hall in Charlottesville, Virginia.

Audit Objective

The primary objective of the audit was to determine whether the Grantee administered its CDBG Program in accordance with HUD regulations and requirements, and local policies. Based on survey results the audit focused on selected program activities covering public improvements, property rehabilitation and the Economic Development Loan Program.

Audit Scope

We reviewed HUD, Grantee, and subrecipient records and interviewed staff responsible for program activities. We reviewed four economic development loans and interviewed accessible borrowers. We inspected four rehabilitated properties and interviewed owners. We conducted windshield inspections of 20 properties painted under the Free Paint Program.

Audit Period

Our audit was performed between April 1996 and September 1996, and covered the activities from July 1994

through March 1996. The audit period was expanded when appropriate.

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

The Grantee Needs to Improve the Management of the Economic Development Loan Program

The Grantee did not administer the Economic Development Loan Program properly as required by Federal regulations and program guidelines. The Grantee did not provide the necessary oversight by ignoring its own written guidelines. The Grantee failed to document that the appropriate analysis was done, national objective met, financial commitment obtained and loan expenditures were supported. As a result, the Grantee provided CDBG assistance for ineligible loans to borrowers.

Eligibility and national objective determinations not done as required

HUD requires that a CDBG Grantee must make an eligibility determination and a national objective determination before providing CDBG financial assistance to a for-profit business. Both determinations must be completed and documented before the Grantee executes an agreement to provide assistance.

We reviewed the Grantee's entire portfolio consisting of 4 loans with outstanding balances. For three of the four loans, the Grantee failed to meet the eligibility and national objective determinations as follows:

<u>Borrower</u>	<u>Loan Amount Ineligible</u>	<u>Inadequate Appropriate Analysis</u>	<u>National Objective Not Met</u>	<u>Financial Commitment Not Supported</u>	<u>Unsupported Expenditures</u>
A	\$25,000	X	X	X	X
B	12,321	X	X		
C	<u>17,500</u>	X	X	X	X
Total	<u>\$54,821</u>				

Inadequate appropriate analysis

The Grantee did not maintain the required written analyses for the three loans. As a result, the Grantee could not show that the loans did not unduly enrich the borrowers and that the assistance is appropriate to carry out the project.

According to 24 CFR 570.203(b):

"...In order to ensure that any such assistance does not unduly enrich the for-profit business, the recipient shall conduct an analysis to determine that the amount of any financial assistance to be provided is not excessive, taking into account the actual needs of the business in making the project financially feasible and the extent of public benefit expected to be derived from the economic development project. The recipient shall document the analysis as well as any factors it considered in making its determination that the assistance is necessary or appropriate to carry out the project...."

The financial statements for borrower A indicated that there was \$135,000 in liquid assets which was more than sufficient to cover the borrower's investment of \$15,000 and the economic development loan of \$25,000. In addition, the borrower and her spouse had a net worth of \$672,866.

Grantee failed to justify borrowers needed program financing

For the loans to borrowers B and C, the Grantee did not document the appropriate analyses to determine that the assistance requested was (a) not excessive and met the actual needs of the borrower, (b) necessary to make the activity financially feasible, and (c) not substituted for funding available from other sources.

We were advised by the Grantee that the loans to borrowers A and C were made because they were minorities and the location of the businesses.

The Grantee did not justify that the borrowers maximized private financing prior to executing the agreements. Therefore the Grantee had no assurance the borrowers needed CDBG financing.

National objective not met

The Grantee did not support achievement of the national objective for the three loans reviewed. The Grantee accepted information which did not meet HUD regulations and did not perform an on-site review to verify the information. As a result, the Grantee could not ensure that

CDBG assisted activities met the low and moderate income benefit for the creation or retention of jobs.

According to 24 CFR 570.506:

"Each recipient shall establish and maintain sufficient records to enable the Secretary to determine whether the recipient has met the requirements of this part. At a minimum, the following records are needed: ...(b)(5) For each activity determined to benefit low and moderate income persons based on the creation of jobs the recipient shall provide the documentation described in either paragraph (b)(5)(i) or (ii) of this section...:

According to 24 CFR 570.506(b)(5)(ii):

"Where the recipient chooses to document that at least 51 percent of the jobs will be held by low and moderate income persons, documentation for each assisted business shall include: ...(B) A listing by job title of the permanent jobs filled and which jobs were initially held by low and moderate income persons; and (C) For each such low and moderate income person hired, the size and annual income of the person's family prior to the person being hired for the job."

Family income not determined for persons employed

For the loans awarded to borrowers A, B, and C, the Grantee did not maintain documentation that identified the size and annual income of each family for the person benefitting from the employment. In addition, the Grantee did not maintain information identifying the permanent jobs by job title for borrower C.

Borrower B was not informed of the need to document the size and annual income of the employee's family prior to employment.

The Director of Planning and Community Development stated that he was not aware that in order for an individual to be considered low income, the size and income of the entire family was to be considered.

Grantee failed to validate private funds provided

Financial commitment not supported

The Grantee did not ensure that private funds identified by the borrowers to leverage the CDBG funds were committed, provided and expended for the activity. The loan files identified private funding for the activity. The Grantee guidelines require that they ascertain the source of private funds is committed and the source has the capacity to deliver the funds. However, the Grantee's commitment letter did not require the borrower to support that the private funds had been provided before disbursing the loan to the borrower. As a result, the assisted project may have been financially weakened and the borrower unduly enriched.

Borrower A determined that \$110,000 was necessary to make leasehold improvements, purchase equipment and have initial working capital to open a delicatessen/convenience market. The financing was to come from the following sources:

Bank financing and letter of credit	\$ 70,000
Economic Development Loan	25,000
Borrower equity	<u>15,000</u>
	<u>\$110,000</u>

We accounted for \$80,357 of the funds provided. The balance of \$29,643 was not accounted for. There was no evidence that the borrower provided the \$15,000 for the business.

The Grantee did not obtain adequate documentation to support borrower C's fifty percent commitment for the loan. The borrower determined her commitment to be \$26,327. She provided a letter stating that she had invested over \$25,000 of her own funds but provided a listing showing only \$15,044 of equipment purchased and renovations, of which \$8,862 was supported by invoices. The borrower did not provide support for the remaining \$17,465.

Borrowers A and C have declared bankruptcy and have gone out of business. By not requiring borrowers to evidence that private funds were committed and provided before disbursing the loan, the Grantee did not assure the business had an opportunity to succeed.

Unsupported loan expenditures

For two loans, the Grantee did not maintain the required documentation needed to support the eligibility of payments made from loan proceeds. As a result, the Grantee is unable to verify that the loan proceeds were spent for eligible activity costs.

According to 24 CFR 85.20(b):

"The financial management systems of grantees and subgrantees must meet the following standards: (1) Financial reporting. Accurate, current, and complete disclosure of the financial results of financially assisted activities must be made in accordance with the financial reporting requirements of the grant or subgrant. (2) Accounting records. Grantees and subgrantees must maintain records which adequately identify the source and application of funds provided for financially assisted activities. These records must contain information pertaining to grant or subgrantee awards and authorizations, obligations, unobligated balances, assets, liabilities, outlays or expenditures, and income."

Borrowers use of loan funds for activities unsupported

For borrower A, the loan conditions required the borrower submit copies of all invoices to the Grantee before disbursement of loan proceeds. The loan approval letter stated that the borrower was to use the \$25,000 loan proceeds for leasehold improvements to the business. The Grantee improperly disbursed the \$25,000 without obtaining full documentation to support the improvements. Only \$15,027 of the loan proceeds was supported by the borrower.

Borrower C's loan documents did not require the borrower to maintain necessary records for loan expenditures. The borrower's loan application showed that \$13,510 was to be spent for leasehold improvements and \$3,990 for

equipment. The \$13,510 was documented by a contractor's proposal but there was no evidence provided that the leasehold improvements were done. No support was obtained for the equipment purchases.

The Director of Planning and Community Development stated that the economic loan program was a cost reimbursable program and thought the costs were supported.

Without complying with the financial management standards, the Grantee cannot assure the CDBG funds were used for eligible activities.

* * * *

The level of risk for a loan must be thoroughly evaluated to avoid assisting a business which has no likelihood of success regardless of the amount of assistance. In our opinion the Grantee underwrote loans which were not likely to succeed, as evidenced by borrowers A and C defaulting on their loans within seven months of execution.

Because the Grantee did not make and maintain the required written determinations and analyses, and support that the assisted economic development activities met the low and moderate income national objective, three loans reviewed, totaling \$54,821 were determined to be ineligible.

Auditee Comments

Borrower A:

Inadequate appropriate analysis

The Grantee states that the loan granted to borrower A was based solely upon the borrowers income and assets. Spousal income and assets were not considered. The Grantee states that the purpose of the program was encouraging minority entrepreneurship and the hiring of low and moderate income employees. The borrower was a minority and a woman. The borrower, in addition to Grantee financing, obtained financing from a bank and

invested personal funds. This diversification made her liability affordable.

National objective not met

The Grantee's former analyst stated that it was very difficult and possibly illegal to request verification of income from people applying for employment. She had discussed the issue with the Richmond HUD office and had received permission to give the income guidelines to the employers and let the employers ask the employees if they met the criteria in the guidelines. The employer would then report the employee's income to the city if it was low or moderate.

Financial commitment not supported

The Grantee submitted documentation to support \$52,978. Additional leasehold improvements totaling \$8,650 were made. The city's guidelines state that a borrower is eligible for up to \$25,000 or 50% of the total cost of rehabilitation, whichever is less.

Unsupported expenditures

The Grantee states that they have documentation showing that the borrower spent approximately \$61,628 on the business which included approximately \$16,868 spent on leasehold improvements. The Grantee felt that the borrower had paid more than half of the required investment.

Borrower B:

Inadequate appropriate analysis

The Grantee states that the borrower was not a minority but her business was located in a CDBG target neighborhood. The loan was needed to move her to a more visible location that was more accessible to her clientele which included minorities and allows her to provide employment to low and moderate income people.

The Grantee states that various estimates were received as a basis for comparison to assure the assistance requested

was not excessive and met the needs of the borrower. Representatives of the city visited the site and future site to verify the needs of the borrower.

National objective not met

The Grantee obtained information from the borrower concerning family size and other sources of income. The documentation accompanied their response.

Borrower C:

Inadequate appropriate analysis

The Grantee states that the applicant was very enthusiastic about fulfilling the public benefit requirement for the loan. The Grantee states that they were eager to begin the economic development loan program and to encourage women and minorities to pursue business ownership in CDBG target areas and on the Downtown Mall. The loan allowed the borrower to expand her business and create employment for low and moderate income people.

National objective not met

The Grantee repeated their response given to national objective not met for borrower A.

Financial commitment not supported

The Grantee states that their guidelines show that a borrower might be eligible for up to \$25,000 or 50% of the total cost of rehabilitation, whichever is less. The borrower reduced her loan request from \$25,000 to \$17,500. The Grantee states that the borrower met her obligations by spending \$15,044 on inventory and that they had records from Building and Life Safety showing that another \$3,050 was spent.

Unsupported expenditures

The Grantee states that it was their understanding from the Richmond HUD office that they only had to verify the expenditures that the Grantee paid for and that the

borrower's funds did not have to be verified. They also state that they have invoices and records in their files showing that the borrower spent \$14,178 for leasehold improvements and \$4,301 on equipment.

In response to recommendation 1A the Grantee states borrower B is currently repaying the loan with all principal and interest being deposited in a CDBG account. \$375 was repaid by borrower C. \$2,727 was repaid by borrower A and \$7,573 was recovered through enforcement of the City's security interest in her inventory. All funds recovered have been deposited in CDBG accounts, and should be deducted from any amount alleged to be due from the City.

OIG Evaluation of
Auditee Comments

Borrower A:

Inadequate appropriate analysis

The Grantee states that the loan was based solely upon the borrower's income and assets. However, the Grantee file documented only the joint or combined financial statements of the borrower and spouse.

Based upon Grantee files documentation, the borrower had access to liquid assets to fund the business rather than using CDBG funds.

National objective not met

The Grantee did not provide documentation supporting the achievement of the national objective by the borrower. Providing the employer the income guidelines and asking the employee if they met the guidelines does not comply with the regulations. The employer was required to obtain from the employee the family size and the annual income of the family prior to being hired. The Grantee did not provide the legal statute why obtaining this information was illegal.

Financial commitment not supported

The Grantee resubmitted receipts previously reviewed. The documentation supplied did not change the amount of financing found unsupported. The Grantee did not support that the borrower provided her contribution of \$15,000.

Unsupported expenditures

The Grantee did not support \$9,973 of leasehold improvement expenditures required by loan documents.

Borrower B:

Inadequate appropriate analysis

The Grantee did not provide documentation to verify the appropriate analyses was performed. In addition, the Grantee states that they had received various estimates and had visited the site. However, the Grantee did not provide documentation to support their statements. The borrower's file contained no documentation to support that alternative financing had been pursued.

National objective not met

Documentation provided by the Grantee did not document income of the employee's family prior to the person being hired for the job as required. The Grantee only required the borrower to determine if the income received by the employee was the only source of income. Family income was not required.

Borrower C:

Inadequate appropriate analysis

Documentation was not provided by the Grantee showing the appropriate analyses supporting their justification for executing the loan. The borrower's files contained no documentation to support that alternative financing had been pursued.

National objective not met

Our response under borrower A applies.

Financial commitment not supported

The reduction of the loan amount does not change the Grantee's failure to document and support the borrowers commitment of \$15,044 or the additional \$3,050 recorded on Building and Life Safety records.

Unsupported expenditures

The Grantee did not provide documentation to support borrower expenditures.

Recommendations

We recommend the Grantee:

- 1A. Repay the program loan proceeds repaid by the borrower plus from non-Federal funds, principal balances outstanding for the three loans cited in this finding totaling \$54,821. Pay to HUD all interest earned on the loans.
- 1B. Implement written procedures to ensure program guidelines are followed and Grantee files include documentation to support eligibility with Federal regulations. The procedures must make it clear that before CDBG financial assistance is provided, eligibility and national objective determinations shall be completed, documented, and included in the loan file of the applicant. No agreement shall be executed with a for-profit applicant unless these conditions are met.

Internal Controls

In planning and performing our audit, we considered the internal control systems of the management of the Grantee in order to determine our auditing procedures and not to provide assurance on internal control.

Internal control is the process by which an entity obtains reasonable assurance as to achievement of specified objectives. Internal control consists of interrelated components, including integrity, ethical values, competence, and the control environment which includes establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Internal controls assessed

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

- Administrative controls over the Economic Development Loan Program
- Administrative controls over rehabilitation and public improvement activities
- Procurement
- Program Income

Assessment Results

A significant weakness exists if internal control does not give reasonable assurance that the entity's goals and objectives are met; that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports. Based on our review, we believe the following item is a significant weaknesses:

- Administrative controls over the Economic Development Loan Program

This weakness is detailed in the finding in this report.

Follow Up On Prior Audits

This is the first audit of the Grantee's program by the OIG.

Finding Loan Analyses

Borrower A

LOAN AMOUNT: \$25,000

LOAN TERMS: Interest at 3% for 5 years. If promised employment not accomplished within the period of time specified, or ceases for a period of three consecutive months during the life of the loan, the interest rate will be increased to 3 points above the prevailing market rate of the bank.

CLOSING DATE: June 10, 1994

PROPOSED USE OF FUNDS: To open a delicatessen/convenience market that will serve downtown Charlottesville.

PROPOSED OBJECTIVE: To create and fill the equivalent of 8 full time jobs. The applicant agreed to hire low to moderate income individuals for at least 51% of the jobs (equal to at least 5 full time positions). At least two of the low and moderate income individuals shall be hired during the first six months of operations with the remaining positions filled within two years of the opening of the business.

SUMMARY OF ANALYSIS: We consider the loan ineligible for the following reasons:

- Inadequate appropriate analysis

The Grantee did not document analysis justifying the financial need of CDBG funds for the business. Financial statements indicated that the borrower had \$135,000 in liquid assets which were more than sufficient to cover the borrower's investment of \$15,000 and the economic development loan of \$25,000. In addition, the borrower and her spouse had a net worth of \$672,866. Therefore, CDBG funds were substituted for the available private funds of the borrower.

- National objective not met

The borrower submitted reports which indicated that the business hired low and moderate income individuals. No documentation exists identifying the size and annual income of the employee's family prior to the employee being hired. The borrower last submitted a report in September 1995 since then the business closed. The Grantee did not verify any of the information on the reports.

- Financial commitment not supported

The borrower promised to invest \$15,000 into the business. The borrower did not support financing of \$29,643 and related costs incurred for the business. Therefore, we have no assurance that the borrower provided the \$15,000 for the business.

- Unsupported expenditures

The loan conditions included that the borrower submit copies of all invoices to the Grantee before loan proceeds will be disbursed. The loan approval letter stated that the borrower used the \$25,000 loan proceeds for capital improvements to the business. However, the Grantee could support only \$15,027 of the \$25,000. The balance of \$9,973 was unsupported and is included in the \$29,643 listed above.

LOAN STATUS:

Since the loan went into default in December 1994, the borrower has made only three payments. The business is presently closed.

Borrower B

LOAN AMOUNT: \$12,321

LOAN TERMS: Interest at 3% for 3 years. If promised employment not accomplished within the period of time specified, or ceases for a period of three consecutive months during the life of the loan, the loan will be due, and payable in full at the time the Grantee determines that the required employment has not been accomplished.

CLOSING DATE: August 11, 1995

PROPOSED USE OF FUNDS: To renovate a new facility for use as a full-service beauty salon that will allow more visibility by being on the street level.

PROPOSED OBJECTIVE: The borrower agrees to hire one stylist who is low-and-moderate income individual within 90-days from the start of the loan. In addition, the borrower will retain at least 4 low-and-moderate income individuals during the life of the loan.

SUMMARY OF ANALYSIS: We consider the loan ineligible for the following reasons:

- Inadequate appropriate analysis

The Grantee did not document the appropriate analysis to determine that the requested assistance was needed. According to the Grantee, the borrower did not seek assistance from any other source.

- National objective not met

The borrower submitted a report created by the Grantee and copies of the pay stub indicating that low and moderate income individuals were employed but did not provide information of the size and annual income of the person's family prior to the person being hired for the job. The Grantee did not verify any of the information on the report.

LOAN STATUS:

The loan is current.

Borrower C

LOAN AMOUNT: \$17,500

LOAN TERMS: Interest at 3% for 7 years. If promised employment is not accomplished within the period of time specified, the Grantee shall increase the loan interest rate to three (3) points above that of the prevailing market rate as announced periodically by the bank.

CLOSING DATE: January 28, 1994

PROPOSED USE OF FUNDS: To enlarge an existing restaurant located in downtown Charlottesville.

PROPOSED OBJECTIVE: To hire two full-time low/moderate income individuals within the first six months of the loan, and two additional full-time low/moderate income individuals within three months thereafter.

SUMMARY OF ANALYSIS: We consider the loan ineligible for the following reasons:

- Inadequate appropriate analysis

The Grantee did not document analysis justifying the financial need of CDBG funds for the business. There was no evidence showing that the borrower had attempted to obtain financing from other sources.

- National objective not met

The borrower submitted a report indicating that low and moderate income individuals were hired. The report did not provide information identifying (1) the permanent jobs by job title and (2) the size and annual income of the person's family prior to the person being hired for the job. The borrower submitted the report on May 12, 1994, the month the business closed. The Grantee did not verify any of the information on the report.

- Financial commitment not supported

The borrower promised to commit half the cost of business improvements totaling \$26,327. The borrower supported \$8,862 of equipment owned. The borrower did not provide support for the remaining investment of \$17,465 to be committed.

- Unsupported expenditures

The Grantee's loan agreement did not require that the borrower maintain required documentation for loan expenditures. According to the economic development loan application, the borrower was to spend \$13,510 for leasehold improvements and \$3,990 for equipment. The borrower did not provide evidence, cost documentation, that the improvements were done and equipment purchased.

LOAN STATUS:

The loan is in default, and the borrower has filed for bankruptcy. The borrower made two payments before default. The business is presently closed.

Schedule of Ineligible Costs

	<u>Ineligible 1/</u>
Finding	\$54,821

1/ Ineligible costs are clearly not allowed by law, contract, or HUD policies or regulations.

Distribution

Director, Community Planning and Development Division,
Virginia State Office, 3FD
Secretary's Representative, Mid-Atlantic, 3AS
Internal Control & Audit Resolution Staff, 3AFI
Manager, Virginia State Office, 3FS
Assistant to the Deputy Secretary for Field Management, SDF (Room 7106)
Audit Liaison Officer, CPD (Room 7228)
Acquisitions Librarian, Library, AS (Room 8141)
Chief Financial Officer, F (Room 10164)
Deputy Chief Financial Officer for Operations, FO (Room 10164)
Assistant Director in Charge, US GAO, 820 1st St. NE Union Plaza,
Bldg 2, Suite 150, Washington, DC 20002

City Manager
P.O. Box 911
Charlottesville, VA 22902