U.S. Department of Housing and Urban Development
Wanamaker Building, Suite 1005
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Philadelphia, PA 19107-3380

District Inspector General for Audit

August 8, 1996

Audit Related Memorandum
No. 96-PH-250-1820

MEMORANDUM FOR: Joyce Gaskins, Director, Office of Community Planning and Development, Pennsylvania State Office, 3AD

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

SUBJECT: Community Development Block Grant Program
Economic Development Activities
City of Reading, Pennsylvania

INTRODUCTION

We performed a limited review of the City of Reading's (Grantee's) Economic Development Activities funded through the Community Development Block Grant Program. The purpose of the review was to determine whether the Grantee's internal controls were sufficient to achieve program objectives and safeguard program assets. Specific objectives were to determine whether the Grantee adhered to HUD guidelines for performing financial feasibility analyses; documented eligibility and national objectives determinations; and, performed follow-up monitoring to assure the program achieves the intended public benefit in terms of jobs creation and retention.

We performed our review during March and June 1996, and covered the period March 1, 1994 to February 28, 1996. The review was extended to other periods when appropriate. We reviewed documentation and interviewed staff in the HUD Philadelphia Office and at the Grantee's Bureau of Development and Inspections. Specifically, we reviewed the Grantee's loan underwriting and collections guidelines, interviewed Grantee staff responsible for administering the program, and reviewed seven of the 23 loans closed since November 1990 for compliance with HUD and Grantee requirements. The selected loans totaled $505,000, or eight percent of the total dollar amount of loans closed during the audit period.

SUMMARY

Based on our testing we determined that the Grantee adhered to HUD guidelines for performing financial feasibility analyses, documented eligibility and national objectives determinations and performed follow-up monitoring to assure that the loans achieved the intended public benefits in terms of jobs created or retained. The Grantee's controls were also adequate to achieve program objectives for economic development activities and safeguard related assets, except for two specific weaknesses involving loan underwriting and servicing.

The internal control weaknesses involve the underwriting of loans to borrowers who are or were delinquent on previous loans and the handling of loan payments mailed to the Grantee's office, for which we recommended that the Grantee revise its procedures in order to strengthen controls in these areas (Attachment 1).

We discussed the draft finding with the Director of the Grantee's Bureau of Development and Inspections at an exit conference on June 21, 1996. The Grantee provided a written response to the draft finding on June 24, 1996 (Attachment 2). The Director did not disagree with the draft finding but expressed concern that it did not fully describe the Grantee's loan underwriting and approval process, especially the role that City Council plays in approving each loan. The Director was also concerned that the finding addressed only the loans to two specific borrowers but did not relate the overall results of our review of the Grantee's economic development loan program.

Because the conditions cited in this memorandum require corrective action, the finding will be controlled in accordance with HUD Handbook 2000.6 REV-2, Audits Management System.

Within 60 days please give us, for each recommendation made in the memorandum, a status report on: (1) the corrective action taken; or (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 review.

BACKGROUND

The Grantee's CDBG-funded economic development activities are administered by the Bureau of Development and Inspections through a program called the Fund for Revitalization and Development (FRED). The objective of the program is to provide low interest rate financing to businesses which create and retain employment opportunities for low-to moderate-income residents and help enhance the City of Reading's tax base. Loans made available through this program have funded new construction, property acquisition, building renovation and rehabilitation, machinery and equipment and interim financing. Loan repayments are deposited into a revolving fund in order to make new loans to other borrowers. Each new loan must be presented to and approved by City Council.

Since December 1982 the Grantee has made 57 FRED loans totaling approximately $13.2 million. As of April 1996, 39 of the 57 loans were active, nine were paid off by the borrowers and nine were written off after the borrowers went out of business.

The City of Reading is governed by a Mayor and a seven member City Council. The Mayor is Paul J. Angstat. The Director of the Bureau of Development and Inspections is Ronald E. Miller. FRED program records are located at City Hall, 815 Washington Street, Reading, Pennsylvania.

Should you have any questions, please contact Richard J. DeCarlo, Assistant District Inspector General for Audit, at (215) 656-3401.

Attachments

1. Finding
2. Grantee Comments
3. Distribution

Finding 1 - The Grantee Should Improve Internal Controls over Loan Underwriting and Servicing.

The Grantee's internal controls should be improved in order to correct weaknesses in two specific areas involving loan underwriting and servicing. Strengthening these controls will help prevent loan defaults and improve accountability over loan payments.

24 CFR 85.20(b)(3) requires that effective control and accountability must be maintained for all grant and subgrant cash, real and personal property, and other assets. Grantees and subgrantees must adequately safeguard all such property and must assure that it is used solely for authorized purposes.

The internal control weaknesses that we observed were as follows:

Staff Analysis of Loan Applications from Previous Borrowers Should Be Improved.

The Grantee's staff did not give sufficient weight to evidence of financial problems experienced by two businesses which obtained second or third loans through the Grantee's Fund for Revitalization and Economic Development (FRED). Although the Grantee's staff had evidence that loan payments due from these borrowers either had been or were currently delinquent, written staff analyses did not adequately describe the problems causing these delinquencies or provide reasonable explanations showing how these problems could be overcome. A staff memorandum that concerned one of the loan applications for additional assistance actually noted that "there is no thought-out business plan, nor good solid explanation on how the funds are to be used, why revenue missed projections by 45%".

Because these two businesses were not in sound financial condition before applying for additional financing, one went into bankruptcy after it received a third loan from the Grantee and the other was unable to increase sales and hire additional employees, as promised. In August 1995, this latter borrower agreed to an amendment which reduced payments for a six month period on both loans to interest plus $25 for principal on each loan, which represented less than 10 percent of the total payments due on these loans each month.

We realize that economic development activities are inherently risky, since some borrowers will not be successful and loan defaults will result. When such borrowers either go out of business or are unable to expand as planned, the Grantee will not achieve the anticipated public benefits, such as the creation or retention of a specific number of jobs. However, evidence of delinquency on previous loans is a strong indication that the borrower's business is probably failing. Unless a thorough staff analysis can show that other factors or unique circumstances caused a borrower to miss scheduled loan payments on previous loans, or that the granting of more assistance will reverse an unfavorable long term trend, additional loans to already delinquent borrowers are questionable at best.

Controls Over Loan Payments Should Be Improved.

The Grantee's fiscal officer opens mail containing loan payment checks, while also maintaining accounting records for loans receivable. Information from the checks is used to update individual loan records and prepare a five-part voucher. The unendorsed checks and three voucher copies are then sent to the City Treasurer's office, which endorses the checks and prepares the bank deposits. Because loan payments are handled in this manner, there is a potential that check lapping or some other defalcation could occur.

A good system of internal control requires that the responsibility for maintaining accounts or loans receivable records be separated from the responsibility for opening mail and handling loan payments. In this case, controls could be improved by requiring that mail containing loan payments be sent directly to the City Treasurer's office, where a summary listing of checks and money orders could then be prepared and sent to the Bureau of Inspections and Development. If this is not possible, then an employee in the Bureau of Inspections and Development other than the fiscal officer should open all mail and simply list the checks and money orders before they are given to the fiscal officer.

Grantee Response

The Grantee generally agreed with the finding and recommendations, but expressed concern that the finding did not describe the procedures which require that staff analyze and evaluate loan applications before they are presented, at public hearings, to City council which must give final approval. The Grantee also noted that the finding described problems associated with specific loans to two borrowers but did not disclose the overall results of our review of the Grantee's economic development loan portfolio.

Recommendations

We recommend that you direct the Grantee to:

A. Implement procedures to assure that written staff analyses identify the causes for borrower delinquencies on previous loans, and that additional loans are not given to borrowers whose businesses are failing, unless they have creditable plans to reverse long-term unfavorable trends.

B. Monitor the borrower cited in the finding who continues to operate, and periodically increase his loan payments based on increases in net income.

C. Revise procedures for opening mail and updating loan records, to assure that these functions are performed by different individuals.

Distribution

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Attn: Mr. Cliff Fowler
Mr. Ronald E. Miller, Director, Bureau of Development and Inspections, City Hall, 815 Washington Street, Reading, Pennsylvania, 19601-3690

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3AGA:DECARLO:AMP:08/05/96

Correspondence Code	3AGA			
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Date				

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