



Office of the Commissioner for Municipal Affairs, San Juan, PR

Section 108 Loan Guarantee Program



To: María Ortiz, Director, Community Planning and Development, San Juan Field Office, 4ND

From: //signed//
Nikita N. Irons, Regional Inspector General for Audit, Atlanta Region, 4AGA

Subject: The Office of the Commissioner for Municipal Affairs Needs To Make Improvements in Administering Its Section 108 Loan Guarantee Program

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of the Office of the Commissioner for Municipal Affairs' Section 108 Loan Guarantee program.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at <http://www.hudoig.gov>.

If you have any questions or comments about this report, please do not hesitate to call me at 404-331-3369.



Audit Report Number: 2015-AT-1001

Date: December 5, 2014

The Office of the Commissioner for Municipal Affairs Needs To Make Improvements in Administering Its Section 108 Loan Guarantee Program

Highlights

What We Audited and Why

We audited the Office of the Commissioner for Municipal Affairs' Section 108 Loan Guarantee program as part of our strategic plan and based on the deficiencies noted during our recent review of Municipal Affairs' Section 108 Loan Guarantee program, concerning the slow progress of the Vieques Sports Complex project.¹ The objectives of the audit were to determine whether Section 108 loan program funds were effectively used to meet a Community Development Block Grant (CDBG) program national objective and provide the intended benefits and whether borrowers complied with loan contract and the U.S. Department of Housing and Urban Development (HUD) requirements.

What We Found

Municipal Affairs did not ensure that borrowers completed three Section 108 Loan Guarantee activities that showed signs of slow progress. As a result, HUD had no assurance that more than \$21 million awarded and disbursed for three Section 108-funded activities met a national objective of the CDBG program and fully provided the intended benefits.

Section 108 loan program borrowers used more than \$1 million for ineligible expenditures and did not support the eligibility of more than \$367,000 in program disbursements. In addition, loan proceeds were not disbursed within the established timeframe, borrowers did not provide HUD the required loan collateral, borrowers did not establish a financial management system in accordance with HUD requirements, and investments were not fully collateralized. As a result, HUD lacked assurance that funds were adequately accounted for, safeguarded, and used for authorized purposes and in accordance with HUD requirements.

What We Recommend

We recommend that HUD (1) determine the eligibility of more than \$20 million in unsupported Section 108 program costs and activities that showed signs of slow progress and (2) require the repayment of more than \$1 million in ineligible expenditures.

¹ Audit memorandum number 2014-AT-1801, issued March 20, 2014

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Background and Objectives

The Section 108 Loan Guarantee program is the loan guarantee provision of the Community Development Block Grant (CDBG) program. Section 108 loans provide grantees with a source of financing for economic development, housing rehabilitation, public facilities, and large-scale physical development projects. The principal security for the loan guarantee is a pledge by the grantee or the State of current and future CDBG funds. Section 108 obligations are financed through underwritten public offerings and may be for terms of up to 20 years. A nonentitlement public entity may apply for up to five times the latest approved CDBG amount received by its State.²

For purposes of determining project and activity eligibility, the CDBG rules and requirements apply. All projects and activities must meet one of the following three national objectives of the CDBG program: (1) principally benefit low- and moderate-income persons, (2) assist in eliminating or preventing slums and blight, or (3) assist with community development needs having a particular urgency.

The Office of the Commissioner for Municipal Affairs is the lead agency in Puerto Rico charged with the responsibility of overseeing the administration of the State allocation of CDBG program funds. Municipal Affairs was created August 30, 1991, through the Commonwealth of Puerto Rico Autonomous Municipalities Act of 1991. One of its responsibilities is to regulate, advise, and give technical and professional assistance to municipalities in the areas related to their organization, administration, and operations. In fiscal year 2014, The U.S. Department of Housing and Urban Development (HUD) awarded Puerto Rico nearly \$26.1 million in State CDBG funds, distributed among 51 nonentitlement recipients.

Between 2006 and 2013, HUD approved more than \$23 million in Section 108 loans to five Puerto Rico nonentitlement recipients. The table below provides details of the five Section 108 loans.

Municipality	Loan amount	Loan purpose
San Lorenzo	\$6,000,000	Acquisition of property and development of activity center
Dorado	5,500,000	Acquisition of property and development of hotel facilities
Rincon	4,850,000	Acquisition of property and development of multicultural activity center and aquatic park
Camuy	4,264,000	Development of hotel facilities
Maunabo	3,000,000	Development of sports and entertainment center
Total	\$23,614,000	

² A nonentitlement public entity represents a unit of general local government that does not receive CDBG funds directly from HUD as part of the CDBG entitlement program.

The objectives of the audit were to determine whether Section 108 loan program funds were effectively used to meet a CDBG program national objective and provided the intended benefits and whether borrowers complied with loan contract and HUD requirements.

Results of Audit

Finding 1: Section 108 Loan Guarantee-Funded Activities Did Not Meet Program Objectives

Municipal Affairs did not ensure that borrowers completed three Section 108 Loan Guarantee activities that showed signs of slow progress. This deficiency occurred because Municipal Affairs did not implement adequate monitoring procedures for its Section 108 activities. As a result, HUD had no assurance that more than \$21 million awarded and disbursed for three Section 108-funded activities met a national objective of the CDBG program and fully provided the intended benefits.

Slow Progress Activities

More than \$21 million was invested for three activities that reflected slow progress without assurance that the activities would provide the intended benefits.

San Lorenzo activity center - In July 2006, HUD approved a \$6 million Section 108 loan to the Municipality of San Lorenzo for property acquisition and the development of an activity center that included movie theaters, bowling alleys, and other facilities. According to the loan agreement, all loan proceeds had to be withdrawn and disbursed by December 31, 2008.

The Municipality's Federal programs director informed us that the Municipality did not have the funds to complete the project as originally planned and that it had not found a private investor that could provide the additional financing needed to construct the activity center. We performed a site inspection of the activity center project in March 2014 and confirmed that the project had not been completed. At the time of our inspection, the project site had been converted to a parking facility (see picture 1). The Municipality did not provide documentation showing that HUD approved the change in the scope of the project.



Picture 1 - San Lorenzo activity center site converted to a parking facility

More than 8 years had elapsed since HUD approved the Section 108 funds for the activity, and the intended benefits had not materialized. Based on this condition, HUD had no assurance that the San Lorenzo activity center project would fully meet CDBG program objectives and provide the intended benefits. Therefore, more than \$7.9 million in Section 108 and CDBG funds invested in the project was unsupported.³

Dorado hotel facilities - In November 2006, HUD approved a \$5.5 million Section 108 loan to the Municipality of Dorado for property acquisition and the development of a 48-room hotel facility. According to the loan agreement, all loan proceeds had to be withdrawn and disbursed by February 29, 2008.

The Municipality's Federal programs director informed us that the Municipality did not have the funds necessary to develop the project as originally planned because of its high estimated construction cost and was revising the scope of the project. We performed a site inspection of the hotel project in June 2014 and confirmed that the construction had not started (see picture 2).



Picture 2 - Dorado hotel project site

More than 7 years had elapsed since HUD approved the Section 108 funds for the activity, and the intended benefits had not materialized. Based on this condition, HUD had no assurance that the Dorado hotel project would fully meet CDBG program objectives and provide the intended benefits. Therefore, more than \$7.3 million in Section 108 and CDBG funds invested in the project was unsupported.⁴

Camuy hotel facilities - In March 2006, HUD approved a \$4.2 million Section 108 loan to the Municipality of Camuy for the development of an 80-room hotel facility. According to the loan agreement, all loan proceeds had to be withdrawn and disbursed by December 31, 2008.

³ The \$7.9 million invested in the activity consisted of \$6 million Section 108 loan proceeds plus \$1.9 million in CDBG funds used for loan repayments.

⁴ The \$7.3 million invested in the activity consisted of \$5.5 million Section 108 loan proceeds plus \$1.8 million in CDBG funds used for loan repayments.

The Municipality's Federal programs director informed us that the Municipality did not have the funds necessary to develop the project because of its high estimated construction cost and was reviewing alternate projects to use the Section 108 funds. We performed a site inspection of the hotel project in March 2014 and confirmed that the construction had not started (see picture 3).



Picture 3 - Camuy hotel project site

More than 8 years had elapsed since HUD approved the Section 108 funds for the activity, and the intended benefits had not materialized. Based on this condition, HUD had no assurance that the Camuy hotel facility project would fully meet CDBG program objectives and provide the intended benefits. Therefore, more than \$5.8 million in Section 108 and CDBG funds invested in the project was unsupported.⁵

Lack of Monitoring Efforts

Municipal Affairs did not implement monitoring procedures for its Section 108 loan program. The most recent monitoring review was performed in 2005. HUD regulations at 24 CFR (Code of Federal Regulations) 570.710 assign the principal responsibility to the State CDBG grantees to ensure compliance with all applicable requirements governing the use of the guaranteed loan funds. Further, 24 CFR 570.492 provides that the State must review units of general local government and in cases of noncompliance, take such actions as appropriate to prevent a continuance of the deficiency, mitigate any adverse effects, and prevent a recurrence. Municipal Affairs' lack of monitoring efforts compromised the effectiveness of the Section 108-funded activities in meeting a national objective of the CDBG program.

Conclusion

The deficiencies discussed above occurred because Municipal Affairs did not implement monitoring procedures and controls to ensure that its activities met Section 108 Loan Guarantee

⁵ The \$5.8 million invested in the activity consisted of \$4.26 million Section 108 loan proceeds plus \$1.6 million in CDBG funds used for loan repayments.

program objectives. As a result, HUD had no assurance that more than \$21 million invested in the Section 108-funded activities met a national objective of the CDBG program and fully provided the intended benefits.

Recommendations

We recommend that the Director of the San Juan Office of Community Planning and Development instruct Municipal Affairs to

- 1A. Submit a plan for how it will proceed with respect to the Municipality of San Lorenzo activity center project, including a schedule that HUD can track to ensure its completion. HUD must reevaluate the feasibility of the activity and determine the eligibility of the \$7,010,276 already invested.⁶ If HUD determines that the activity has been canceled or is not feasible, Municipal Affairs must mitigate activity losses by committing any unused loan proceeds for future loan repayments.
- 1B. Submit a plan for how it will proceed with respect to the Municipality of Dorado hotel project, including a schedule that HUD can track to ensure its completion. HUD must reevaluate the feasibility of the activity and determine the eligibility of the \$7,369,000 already invested. If HUD determines that the activity has been canceled or is not feasible, Municipal Affairs must mitigate activity losses by committing any unused loan proceeds for future loan repayments.
- 1C. Submit a plan for how it will proceed with respect to the Municipality of Camuy hotel project, including a schedule that HUD can track to ensure its completion. HUD must reevaluate the feasibility of the activity and determine the eligibility of the \$5,474,376 already invested.⁷ If HUD determines that the activity has been canceled or is not feasible, Municipal Affairs must mitigate activity losses by committing any unused loan proceeds for future loan repayments.
- 1D. Conduct monitoring of the Section 108 activities with signs of slow progress to ensure that program objectives are met and provide the intended benefits.

⁶ Total investments of \$7,999,275 were adjusted to account for \$988,154 questioned in recommendation 2A and \$845 in recommendation 2C.

⁷ Total investments of \$5,830,878 were adjusted to account for \$436 questioned in recommendation 2A and \$356,066 in recommendation 2C.

Finding 2: Loan Agreement Provisions and HUD Requirements Were Not Followed

Section 108 loan program borrowers used more than \$1 million for ineligible expenditures and did not support the eligibility of more than \$367,000 in program disbursements. In addition, loan proceeds were not disbursed within the loan agreement timeframes, borrowers did not provide HUD the required loan collateral, borrowers did not establish a financial management system in accordance with HUD requirements, and investments were not fully collateralized. These deficiencies occurred because Municipal Affairs did not perform monitoring reviews of Section 108 borrowers to ensure compliance with the loan agreement and regulations. As a result, HUD lacked assurance that funds were adequately accounted for, safeguarded, and used for authorized purposes and in accordance with HUD requirements.

Program Disbursements Not Related to Approved Projects

Contrary to the loan agreement, more than \$1 million in Section 108 loan proceeds was disbursed to pay for expenditures that were not related to the approved Section 108 projects or were used as a source of temporary financing to the unit of local government. Therefore, the Section 108 Loan Guarantee program was charged with unnecessary costs that provided no benefits and did not meet program objectives.

The Municipalities of San Lorenzo, Maunabo, and Camuy disbursed more than \$589,000 in Section 108 funds for costs that were not related to the approved projects and for ineligible bank overdraft fees. Paragraph 1(a) of the loan agreement provided that funds could be withdrawn from the guarantee loan funds account only for the payment of the costs of approved Section 108 activity, transfer to the loan repayment account, or the temporary investment of funds under the contract. Regulations at 2 CFR 225, Appendix B, Paragraph 16 provide that fines and penalties are unallowable program costs. Appendix C provides details of the ineligible disbursements.

In addition, the Municipality of San Lorenzo inappropriately transferred Section 108 loan proceeds to its general fund account. Contrary to paragraph 1(a) of the loan agreement, between December 2008 and February 2014, the Municipality made 30 transfers to the general fund totaling more than \$6.1 million. Its Federal program director informed us that the funds were transferred to cover cash shortfalls in the general account and the Municipality was not aware that such transactions were contrary to the loan agreement. The Municipality's records showed that it had returned most of the funds to its guarantee loan funds account but owed more than \$490,000.

Program Expenditure Eligibility Not Substantiated

Section 108 loan program borrowers did not support the reasonableness and allowability of more than \$367,000 in Section 108 program funds disbursed. Regulations at 2 CFR 225, Appendix A, Paragraph C.1.b. provide that to be allowable under Federal awards, costs must be necessary, reasonable, and adequately documented. Since proper supporting documentation was not provided, HUD lacked assurance that funds were used for authorized purposes and in accordance with HUD requirements. See table 1 for details of the unsupported disbursements.

Municipality	Date	Check number	Amount	Comment
San Lorenzo	Dec. 6, 2007	110	\$845	No support provided
Maunabo	Apr. 11, 2008	32	10,929	Inspection services, support was not adequate to exclude other charges not related to the approved project.
Camuy	Jan. 23, 2009	32	112,320	No support provided
	Sept. 18, 2009	34	131,500	No support provided
	Mar. 18, 2010	35	23,441	No support provided
	May 14, 2009	36	1,100	No support provided
	Aug. 11, 2010	37	74,580	No support provided
	Aug. 25, 2010	38	13,125	No support provided
Total			\$367,840	

Table 1

Unexpended Section 108 Loan Proceeds

Three Section 108 loan program borrowers did not expend loan proceeds before the loan agreement deadline. The agreement for the Section 108 Loan Guarantee assistance, paragraph 1(a), required that all of the loan funds be withdrawn and disbursed by the borrower for the approved activities by a specified date. Any funds remaining after the deadline were to be transferred to an established loan repayment account. Despite this requirement, the borrowers maintained unused Section 108 loan proceeds totaling more than \$8.8 million.

HUD informed us that the borrower should make the transfer unless the funds were still needed to carry out the approved activity. The borrower should either transfer the unexpended funds to the repayment account or submit a request for extension to HUD. The borrowers did not transfer the unused funds to the repayment account and did not provide evidence that it had requested an extension from HUD. Table 2 provides details of the unexpended loan proceeds.

Municipality	Loan amount	Disbursement deadline date	Bank balance as of review date		Comment
Dorado	\$5,500,000	Feb. 29, 2008	\$4,307,775	Apr. 30, 2014	The Municipality informed us that it was aware of the disbursement deadline.
San Lorenzo	6,000,000	Dec. 31, 2008	666,948	Feb. 28, 2014	The Municipality informed us that it was not aware of the disbursement deadline.
Camuy	4,264,000	Dec. 31, 2008	3,826,760	Feb. 28, 2014	The Municipality informed us that it was not aware of the disbursement deadline.
Total	\$15,764,000		\$8,801,483		

Table 2

Loan Collateral Not Provided in Accordance With Loan Agreement

The Section 108 loan program borrowers did not provide additional security to assure the repayment of the debt obligation as required in paragraph 15 of the loan agreement. As a condition for receiving Loan Guarantee assistance, the borrower was required to submit additional security in the form of a sole first priority lien of real property within an established

timeframe. For one loan, the lien was filed more than 3 years after the deadline. For the other three loans, the lien was overdue and was not filed by the borrower. As a result, HUD was at risk of not being able to exercise appropriate remedies in the event of a borrower's defaulting on the Section 108 loan. Table 3 provides details of the overdue and late liens.

Municipality	Lien deadline	Comment
San Lorenzo	Sept. 27, 2006	Lien not submitted to HUD
Dorado ⁸	Nov. 17, 2011	Lien not submitted to HUD
	June 18, 2012	Lien not submitted to HUD
	Apr. 22, 2014	Lien not submitted to HUD
	June 11, 2014	Lien not submitted to HUD
	June 30, 2014	Lien not submitted to HUD
Maunabo	Sept. 21, 2006	Lien not submitted to HUD
Camuy	Sept. 21, 2006	Lien filed in January 2010, more than 3 years after the deadline

Table 3

Inadequate Accounting Records

The accounting records of the four Section 108 loan program borrowers did not reflect complete and accurate financial information on program activities and did not permit the adequate tracing of program receipts and expenditures. Regulations at 24 CFR 85.20(b) require recipients of Federal awards to maintain financial records that are accurate, current, and complete and that adequately identify the source and application of funds provided for assisted activities. However, the borrowers did not maintain a financial management system that permitted the tracing of funds to a level that ensured that such funds had not been used in violation of the restrictions and prohibitions of applicable statutes. For example, the records maintained did not properly account for program income, accounts receivable, and capital assets. The accounting records also contained several instances of incorrect balances and transactions not recorded. The Municipalities of San Lorenzo and Camuy did not maintain a general ledger for the Section 108 program. The accounting record maintained was a check register that contained incomplete and inaccurate financial information. As a result, HUD lacked assurance that funds were adequately accounted for, safeguarded, and used for eligible purposes.

Investments Not Fully Collateralized With Government Obligations

Section 108 loan program borrowers invested the loan proceeds in certificates of deposit at local commercial banks without ensuring that they were fully collateralized with Government obligations. Paragraph 1(a) of the loan agreement provided that any amount of Section 108 loan proceeds deposited into a bank and in excess of the Federal deposit insurance limit must be fully invested in Government obligations.⁹ The Municipalities of Camuy and Dorado invested \$7

⁸ The Dorado activity involved the acquisition of five properties, and the liens were due within 5 business days of the acquisition.

⁹ The Federal insurance amount is currently limited to \$250,000. Government obligations are defined as a direct obligation of or any obligation for which the full and timely payment principal and interest is guaranteed by the

million in loan proceeds in certificates of deposit at commercial banks in Puerto Rico. HUD informed us that the investment in certificates of deposit in excess of Federal insurance is not permissible unless the excess is fully collateralized with Government obligations. However, the borrowers did not provide evidence showing that these investments were fully collateralized with Government obligations. As a result, HUD had no assurance that Federal funds were properly safeguarded. Table 4 provides details of the Section 108 funds invested in certificates of deposit.

Municipality	Total amount invested in certificates of deposit as of review date	
Dorado	\$3,500,000	April 30, 2014
Camuy	3,500,000	March 6, 2014
Total	\$7,000,000	

Table 4

Lack of Monitoring

Municipal Affairs did not monitor Section 108 borrowers to ensure compliance with all applicable requirements governing the use of Loan Guarantee funds. Its monitoring director informed us that the most recent monitoring review of the Section 108 program was performed in 2005. HUD's regulations at 24 CFR 570.492 provide that the State must review units of general local government and in cases of noncompliance, take such actions as appropriate to prevent a continuance of the deficiency, mitigate any adverse effects, and prevent a recurrence. Municipal Affairs' lack of monitoring efforts compromised the effectiveness of Section 108-funded activities, and HUD lacked assurance that funds were adequately accounted for, safeguarded, and used for authorized purposes.

Conclusion

The deficiencies discussed above occurred because Municipal Affairs did not perform monitoring reviews of its Section 108 loan program borrowers. As a result, HUD lacked assurance that funds were adequately accounted for, safeguarded, and used for authorized purposes and in accordance with HUD requirements.

Recommendations

We recommend that the Director of the San Juan Office of Community Planning and Development instruct Municipal Affairs to

- 2A. Recover from the borrowers and reimburse \$1,080,242 to the applicable loan guarantee account from non-Federal funds for ineligible disbursements that were

United States of America, including but not limited to United States Treasury certificates of indebtedness and notes and bonds –State and local government series, or certificates of ownership of the principal of or interest on direct obligations of or obligations unconditionally guaranteed by the United States of America, which are held in trust by a commercial bank that is a member of the Federal Reserve System and has capital and surplus in excess of \$100 million.

not related to the approved projects and used to finance local government operations.

- 2B. Ensure that borrowers did not use Section 108 funds to finance local government operations and verify the return of any ineligible disbursement.
- 2C. Obtain and submit supporting documentation showing the eligibility and propriety of \$367,840 in disbursements or reimburse the loan guarantee account from non-Federal funds.
- 2D. Ensure that the borrowers either transfer the unexpended Section 108 loan proceeds to the repayment account or submit a request for extension to HUD.
- 2E. Ensure that the borrowers provide HUD the additional security requirements according to the loan agreement.
- 2F. Ensure that borrowers develop and implement a financial management system in accordance with HUD requirements to ensure that program funds can be traced to a level that ensures that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.
- 2G. Ensure that all Section 108 loan proceeds deposited at commercial banks are properly collateralized with Government obligations.
- 2H. Conduct monitoring reviews of all Section 108 projects and ensure that borrowers comply with all loan agreement provisions and HUD regulations.

We also recommend that the Director of the San Juan Office of Community Planning and Development

- 2I. Increase monitoring of Municipal Affairs' performance in the administration of its Section 108 loan program. Consider imposing sanctions if Municipal Affairs does not demonstrate program progress.

Scope and Methodology

The objectives of this audit were to determine whether Section 108 loan program funds were effectively used to meet a national objective of the CDBG program and fully provided the intended benefits and whether borrowers complied with loan contract and HUD requirements.

To accomplish our objectives, we

- Reviewed applicable laws, regulations, and relevant HUD program requirements, including the Section 108 loan contracts;
- Reviewed HUD Section 108 loan-related files, including the application for the loan, status reports, and disbursement information reported on loan proceeds and CDBG funds;
- Reviewed Municipal Affairs' and borrowers' project files and records;
- Reviewed HUD's Integrated Disbursement and Information System reports;
- Conducted site inspections of the projects; and
- Interviewed HUD, Municipal Affairs, and municipality officials.

Between 2006 and 2013, HUD approved more than \$23 million in Section 108 loans to five nonentitlement recipients. We reviewed the five Section 108 loans to determine whether the loan proceeds were used in accordance with the application and loan agreement and whether activities provided the intended benefits.

The borrowers' records reflected that more than \$7.8 million in Section 108 loan proceeds were disbursed between May 2007 and April 2014. We reviewed all the disbursements related to the Section 108 projects of the Municipalities of Camuy, San Lorenzo, and Maunabo totaling more than \$6.4 million. We reviewed additional disbursements from the Municipality of Dorado with amounts greater than \$10,000. The sample resulted in 10 disbursements totaling more than \$1.4 million. We did not review the disbursements related to the Municipality of Rincon because at the time of our audit, Section 108 loan proceeds had not been transferred. More than \$7.8 million in Section 108 loan program expenditures was reviewed to determine whether funds were used for supported and eligible efforts.

To achieve our audit objectives, we relied in part on computer-processed data contained in HUD's information system. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data adequate for our purposes. We did not rely on computer-processed data contained in Municipal Affairs' and borrowers' databases, nor were the data used to materially support our audit findings,

conclusions, and recommendations. We did not select 100 percent of the items for testing, as the selections made provided sufficient evidence for the findings presented. The results of the audit apply only to items selected for review and cannot be projected to the universe or population.

The audit generally covered the period January 1, 2005, through December 31, 2013. We conducted our fieldwork from February through August 2014 at Municipal Affairs' offices in San Juan, PR, and the borrowers' offices in Camuy, Dorado, Maunabo, and San Lorenzo, PR.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Internal Controls

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Program operations – Policies and procedures that management has implemented to provide reasonable assurance that a program meets its objectives, while considering cost effectiveness and efficiency.
- Relevance and reliability of information – Policies and procedures that management has implemented to reasonably ensure that operational and financial information used for decision making and reporting externally is relevant, reliable, and fairly disclosed in reports.
- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that program implementation is consistent with laws and regulations.
- Safeguarding of assets – Policies and procedures that management has implemented to reasonably prevent and promptly detect unauthorized acquisition, use, or disposition of assets and resources.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- Municipal Affairs did not implement adequate procedures and controls to ensure that activities provided the intended benefits and met a national objective of the CDBG program (see finding 1).
- Municipal Affairs did not implement adequate monitoring efforts to ensure that Section 108 loan borrowers complied with loan agreement provisions and regulations (see finding 2).

Appendixes

Appendix A

Schedule of Questioned Costs

Recommendation number	Ineligible 1/	Unsupported 2/
1A		\$7,010,276
1B		7,369,000
1C		5,474,376
2A	\$1,080,242	
2C		367,840
Totals	\$1,080,242	\$20,221,492

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.
- 2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.




Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 1

 <p>COMMONWEALTH OF PUERTO RICO Office of the Commissioner of Municipal Affairs</p>	<p>Hon. Alejandro García Padilla Governor</p> <p>Lcdo. Carlos M. Santini Rodríguez Commissioner</p>
<p>October 20, 2014</p>	
<p>Ms. Nikita Irons Regional Inspector General for Audit U.S. Department of Housing And Urban Development Region 4 - Office of Inspector General Office of Audit, Box 42 Richard B. Russell Federal Building 75 Spring Street, SW, Room 350 Atlanta, GA, 30303-3388</p>	
<p>COMMENTS TO DRAFT AUDIT MEMORANDUM THE OFFICE OF THE COMMISSIONER OF MUNICIPAL AFFAIRS NEEDS TO MAKE IMPROVEMENTS IN ADMINISTERING ITS SECTION 108 LOAN GUARANTEE PROGRAM</p>	
<p>Dear Ms. Irons:</p> <p>We appreciate the opportunity to comment on the subject draft Memorandum your Office submitted to our attention on October 9, 2014. As requested by your Office, we completed the review of the document and have prepared the following comments.</p> <p>Our comments are based on the information included in the report, as well as additional information provided during the exit conference. We would like you to consider our comments, and include them in the final audit memorandum.</p>	
	<p>COMMENT #1- FINDING #1</p> <p>OCAM is aware of its responsibilities as the Grantee for the Community Development Block Grant and the Section 108 Loan program and we are working toward the establishment and adoption of a new procedure that will address the deficiencies identified by the OIG. The outline of the new procedure was presented to HUD headquarters on September 10, 2014 and it's summarized as follow:</p> <ul style="list-style-type: none">• Establishes underwriting standards for projects to determine financial feasibility and completion feasibility;• Expedite access to funds by creating a process to help applicants overcome some of the initial approval hurdles by applying in advance on behalf of communities for future projects.
<p>P.O. BOX 70167 San Juan, P.R. 00936 - 8167 Tel: (787) 754 - 1600 Fax: (787) 753-8254 www.ocam.gobierno.pr</p> 	

Ref to OIG
Evaluation

Auditee Comments

Comment 1

- Establish financial and recordkeeping standards in compliance with the regulations.
- Establish a cap for the use of CDBG funds for Section 108 Repayment

This new procedure will help to overcome the deficiencies of the existing process in which the Municipalities maintains control of the funds without the intervention of OCAM and HUD's Field Office. The following diagram shows the existing procedure and the one proposed:

EXISTING PROCESS	PROPOSED PROCESS
Municipalities apply directly	OCMA review projects (pool of project)
OCAM review application for compliance	OCMA applies on behalf of Municipalities
HUD review and approve application	HUD review and approve application
Municipality execute agreement	OCMA execute agreement
Funds are transferred to the Municipality	Funds are transferred to OCMA
No oversight of project funds or progress	Disbursement = project progress
Municipality repays OCMA, OCMA repays HUD	OCMA repays with CDBG funds (Municipality repays OCMA)

During that meeting we requested the collaboration of HUD Headquarters and the Field Office in order to achieve the goals of improving the Section 108 loan process and prevent the recurrence of the situations identified in the report.

COMMENT #2- RECOMMENDATION 1A, 1B AND 1C

We agree with the OIG recommendations and we will work together with the Field Office to prepare a plan to address aspects related to feasibility and compliance with the national objectives.

COMMENT #3- RECOMMENDATION 1D

OCAM will conduct on-site monitoring reviews of the section 108 loan activities of the Municipalities of San Lorenzo, Dorado, and Camuy, starting next November 2014. In addition, OCAM will perform desk reviews of Section 108 activities conducted by other Municipalities not included in the report.

COMMENT #4- RECOMMENDATION 2A

We need clarification regarding the \$1,080,287 included in this finding. Some of the activities identified in Appendix C (Schedule of Ineligible Disbursement) are actually

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 4

CDBG eligible costs but they were not authorized by the Section 108 agreement executed by the Municipality. According to the initial communication with the Municipalities they will request after-the-facts amendments to the Section 108 agreement in order to include the eligible activities performed.

We request that appendix C is renamed to (*Schedule of Unauthorized or Ineligible Disbursement*).

Regarding the repayment of the \$490,000 used for the operation of the general funds, we will coordinate its reimbursement to the Section 108 Loan repayment account.

COMMENT #5- RECOMMENDATION 2B

Comment 5

The new procedure to be established will monitor periodically the use of the proceeds of Section 108 loans. A quarterly financial report will be required in order to identify the use of funds for eligible and allowable uses. This report must be accompanied by the bank statements and a certification from the Finance Director.

Comment 6

COMMENT #6- RECOMMENDATION 2C

We will require the supporting documentation to the Municipalities and will provide a copy to HUD for the final determination.

Comment 2

COMMENT #7- RECOMMENDATION 2D

The action to be taken regarding this recommendation is related to recommendation 1A, 1B and 1C. Once the plan is prepared with the Municipalities, we will proceed to take the corresponding action.

Comment 7

COMMENT #8- RECOMMENDATION 2E

We are working toward compliance with this requirement. We will prepare a memorandum to the Municipalities explaining the requirements and providing them sample documents to be used and the procedure for its execution and registration.

Comment 8

COMMENT #9- RECOMMENDATION 2F

As explained during the exit conference, OCAM initiated the implementation of the new financial management system that must be adopted by non-entitlement municipalities. Priority will be given to municipalities included in the audit in order to demonstrate compliance with the Financial Management requirements.

Comment 3

COMMENT#10-RECOMMENDATION 2G

We requested HUD headquarters technical assistance on this matter.

COMMENT #11- RECOMMENDATION 2H

As established in comment #3, we will conduct monitoring reports of the non-entitlement municipalities with approved loans.

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Should you need additional information regarding this comments please contact Mrs. Tomasita Rosado Assistant Commissioner for Federal Programs, at 787-754-1600 at your convenience.

Cordially,



Carlos M. Santini Rodríguez

OIG Evaluation of Auditee Comments

Comment 1 Municipal Affairs stated that under the current program procedures borrowers maintain control of the Section 108 funds without its and HUD's involvement. It also stated that it is in the process of establishing and adopting new procedures to address the deficiencies identified in the audit report.

Contrary to the Municipal Affairs' statements, the current regulations and program guidelines of the Section 108 program do not limit the ability of the State to monitor and properly track the use of program funds on behalf of the borrowers. HUD's regulations at 24 CFR 570.492 provide that the State must review units of general local government and in cases of noncompliance, take such actions as appropriate to prevent a continuance of the deficiency, mitigate any adverse effects, and prevent a recurrence. Any new procedures the Municipal Affairs implements must comply with all HUD requirements.

Comment 2 We commend Municipal Affairs for recognizing the need of a work plan for the three activities with signs of slow progress to ensure program objectives are met.

Comment 3 We appreciate Municipal Affairs efforts to promptly initiate monitoring reviews of the Section 108 borrowers.

Comment 4 Municipal Affairs stated that some of the questioned costs were not authorized by the Section 108 loan agreement but are CDBG eligible expenditures. The loan agreements will be amended to include the questioned costs as part of eligible activities. Municipal Affairs requested that appendix C be renamed to unauthorized disbursements. In addition, it stated that it will coordinate the reimbursement of the Section 108 funds transferred to the general account.

The Municipalities of San Lorenzo, Maunabo, and Camuy disbursed Section 108 funds for costs that were not related to the approved projects. Paragraph 1(a) of the loan agreement provided that funds could be withdrawn from the guarantee loan funds account only for the payment of the costs of approved Section 108 activity, transfer to the loan repayment account, or the temporary investment of funds under the contract. Therefore, more than \$589,000 in Section 108 funds is ineligible. We did not modify the report and recommendations. Amendments to the loan agreement to make the questioned costs eligible after the facts must be evaluated by HUD. HUD must determine whether such amendment is permissible under the program and it must ensure that all HUD requirements, such as procurement, environmental, and citizen participation, were met.

Comment 5 We appreciate Municipal Affairs efforts to implement new monitoring procedures on the use and disposition of Section 108 funds.

- Comment 6 We appreciate Municipal Affairs efforts to require the borrowers to submit the documentation related to the unsupported disbursements and provide it to HUD for an eligibility determination. Any amounts determined ineligible by HUD should be reimbursed from non-Federal funds.
- Comment 7 We appreciate Municipal Affairs efforts to ensure that Section 108 borrowers provide the additional security to assure the repayment of the debt obligation as required in paragraph 15 of the loan agreement.
- Comment 8 We commend Municipal Affairs for recognizing the need for improving the financial management system of its non-entitlement borrowers.

Appendix C

Schedule of Ineligible Disbursements

Municipality	Date	Check number	Amount	Comment
San Lorenzo	Feb.7, 2012	132	\$133,965	Disbursement for local road repairs not related to the approved project
	Mar. 21, 2012	133	34,161	Disbursement for local road repairs not related to the approved project
	Mar. 29, 2012	134	70,734	Disbursement for local road repairs not related to the approved project
	May 25, 2012	135	3,795	Disbursement for local road repairs not related to the approved project
	May 29, 2012	136	21,728	Disbursement for local road repairs not related to the approved project
	June 21, 2012	137	133,453	Disbursement for local road repairs not related to the approved project
	July 3, 2012	138	41,220	Disbursement for local road repairs not related to the approved project
	July 3, 2012	139	58,653	Disbursement for local road repairs not related to the approved project
Maunabo	Feb. 15, 2008	0001	32,267	Disbursement for construction patents and taxes not related to the approved project
	Mar. 18, 2008	0002	857	Disbursement for partial release of 10 percent retention of the construction patents and taxes not related to the approved project
	Mar. 25, 2008	0005	2,728	Disbursement for release of 10 percent retention of patents and local taxes not related to the approved project
	Nov. 9, 2010	1003	53,593	Disbursement for construction of baseball park not related to the approved project
	Sept. 1, 2011	1007	1,802	Disbursement for release of 10 percent retention of construction of baseball park not related to the approved project
	N/A	N/A	405	Overdraft bank charges, ineligible under 2 CFR Part 225
Camuy	N/A	N/A	436	Overdraft bank charges, ineligible under 2 CFR Part 225
Total			\$589,797	