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Audit Report Number	2011-DE-1005
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TO: LeRoy Brown, Director, Denver Office of Community Planning and Development, 8AD

FROM: //signed//  
Ronald J. Hosking, Regional Inspector General for Audit, 8AGA

SUBJECT: The State of Montana Generally Used Its CDBG-R Funds in Compliance With Requirements but Improperly Negotiated and Serviced Loans

## **HIGHLIGHTS**

### **What We Audited and Why**

We reviewed the State of Montana's Community Development Block Grant-Recovery (CDBG-R) program. We selected the State for review based on the U.S. Department of Housing and Urban Development's (HUD) concern with the State's directly loaning CDBG-R funds to entities and because of our focus on the administration of American Recovery and Reinvestment Act funds. Our objective was to determine whether the State used its CDBG-R funds in accordance with the Recovery Act rules and regulations. We reviewed whether the funds were used for eligible activities, met the specified national objective, were adequately supported, and were properly distributed.

### **What We Found**

The State generally used its CDBG-R funds in compliance with Recovery Act rules and regulations. However, it incorrectly negotiated and serviced loans with the final recipients of the funds. The State decided to directly handle these high-risk loans instead of placing the risk on the nonprofits with which the counties contracted for this function. Since the State serviced the loans, the nonprofits did not have direct access to the program income generated by the CDBG-R loans.

### **What We Recommend**

We recommend that the Director of HUD's Denver Office of Community Planning and Development require the State to transfer the loan servicing of the CDBG-R loans to the pertinent nonprofits.

For each recommendation in the body of the report without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

### **Auditee's Response**

We provided the draft report to the State on September 12, 2011. The State provided written comments on September 16, 2011 and decided an exit conference was not needed. State officials concurred with the recommendation. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix A of this report.

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## **BACKGROUND AND OBJECTIVE**

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The American Recovery and Reinvestment Act of 2009 became public law 111-5 on February 18, 2009. It provided for the creation and preservation of jobs, infrastructure investment, energy efficiency and science, assistance to the unemployed, State and local fiscal stabilization for the fiscal year ending September 30, 2009, and other purposes. Authorized under Title XII of the Recovery Act, the U.S. Department of Housing and Urban Development (HUD) allocated \$1 billion in Community Development Block Grant (CDBG) funds to state and local governments to carry out, on an expedited basis, eligible activities under the CDBG program. The CDBG program works to ensure decent affordable housing, provide services to the most vulnerable, and create jobs through the expansion and retention of businesses.

On August 14, 2009, the State of Montana and HUD signed a grant agreement for more than \$1.8 million in CDBG funds under the Recovery Act (CDBG-R). The funds were provided to the State with the understanding that CDBG-R program activities should meet the Recovery Act's goal of creating and preserving jobs. CDBG-R funds provide financing for infrastructure activities, housing activities, economic development activities, public service activities, real property acquisition, and administrative costs.

The State established the Department of Commerce to administer CDBG and other programs. The governor appointed the Department's director, who had oversight responsibility for the CDBG-R program. The Department's mission is to enhance and sustain a healthy economy so Montana businesses, communities, and people can prosper.

Our objective was to determine whether the State used its CDBG-R funds in accordance with the Recovery Act rules and regulations.

## RESULTS OF AUDIT

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### Finding: The State Generally Used Its CDBG-R Funds in Compliance With Requirements but Improperly Negotiated and Serviced Loans

The State generally used its CDBG-R funds in compliance with Recovery Act rules and regulations. However, it incorrectly negotiated and serviced loans with the final recipients of the funds. The State decided to directly handle these high-risk loans instead of placing the risk on the nonprofits with which the counties contracted for this function. Since the State was servicing the loans, the nonprofits did not have direct access to the program income generated by the CDBG-R loans.

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#### **The State Generally Used Its CDBG-R Funds According to Requirements**

The State generally used its CDBG-R funds in compliance with Recovery Act rules and regulations. We reviewed all six projects established with the \$1.8 million CDBG-R grant. The six projects consisted of one community development grant and five economic development loans to for-profit entities. The State granted funds to the counties for economic development loans, and the counties paid the loan amounts to for-profit entities but did not have the nonprofits negotiate or service the loans.

The CDBG-R funds were used for eligible activities, which met the specified national objective. The expenditures were adequately supported. Therefore, there were no questionable or ineligible costs. The State required the counties to submit quarterly reports showing the expenditure of the loan funds and draw requests for disbursement of the grant funds. It met HUD and Recovery Act reporting requirements.

#### **The State Improperly Negotiated and Serviced Loans**

The State improperly negotiated and serviced the loans with the for-profit entities. The purpose of the State CDBG program was for the State to grant funds to units of general local government (counties), which then would grant or loan funds to entities for eligible CDBG activities. The State used a different procedure for the CDBG-R loans than for the regular CDBG loans without obtaining HUD approval. HUD required the State to prepare a consolidated plan, which included a method of distribution for CDBG funds. For major changes, such as the CDBG-R grant, HUD required the State to submit a substantial amendment to the

consolidated plan. The State provided the substantial amendment but did not change the method of distribution to show its intent to negotiate and service the loans. Therefore, HUD did not approve this procedure.

Montana had mainly rural counties with limited administrative capabilities, so the State established Certified Regional Development Corporation regions with a nonprofit for each region to help the counties in each region. The counties contracted with the nonprofits to help them prepare applications and administer the CDBG revolving loan funds.

The State's regular CDBG economic development procedure was to have the county work with the nonprofit to prepare an application for the for-profit entity seeking a loan. The county submitted the application to State officials, who reviewed and approved the application. The State then granted the CDBG funds to the county to pass through to the nonprofit, which negotiated and serviced the loan with the for-profit entity. The nonprofit maintained a revolving loan fund in which the program income from the loan was deposited and later used for other loans. The State followed the same procedure for the CDBG-R grant with the exception of the loan negotiation and servicing. The State signed the loan documents and collected the loan payments, which were deposited into a State revolving loan fund.

**The State Wanted  
Responsibility for the Loans It  
Considered High Risk**

The State decided to negotiate and service these loans because the entities receiving the loans were distressed; therefore, the loans were high risk. The State did not want the nonprofits to be responsible if problems arose with any of the loans.

**The Nonprofits Did Not Have  
Direct Access to the Program  
Income**

The nonprofits did not have direct access to the program income generated by the CDBG-R loans. For the regular CDBG loans, the nonprofits received the program income directly, to be used for like purposes. Since the State received the program income for the CDBG-R loans, HUD required the State to distribute the income in compliance with CDBG requirements. Therefore, the nonprofits did not have the funds available for other loans without submitting an application request to the State.

## **Recommendation**

We recommend that the Director of HUD's Office of Community Planning and Development

- 1A. Require the State to transfer the loan servicing of the CDBG-R loans to the pertinent nonprofits.

## SCOPE AND METHODOLOGY

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Our review period was from August 1, 2009, through May 31, 2011. We performed our onsite review work during June 2011 at the State's Department of Commerce offices at 301 South Park Avenue, Helena, MT.

To accomplish our review objective, we reviewed the Recovery Act, applicable HUD regulations, HUD handbooks, HUD notices, and State policies. We did not rely on computer-processed data to complete the review work. To evaluate the controls over the State's administration of the CDBG-R funds, we interviewed pertinent HUD and State employees, reviewed the State's documentation for all six of the grants and loans established with CDBG-R funds, and reviewed the accounting records and related documents pertaining to the CDBG-R grant and related activities.

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 objective.



# INTERNAL CONTROLS

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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.

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## Relevant Internal Controls

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

- Controls over the use of CDBG-R funds in compliance with laws and regulations.

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.

We evaluated internal controls related to the audit objective in accordance with generally accepted government auditing standards. Our evaluation of internal controls was not designed to provide assurance on the effectiveness of the internal control structure as a whole. Accordingly, we do not express an opinion on the effectiveness of the State's internal controls.

# APPENDIX

## Appendix A

### AUDITEE COMMENTS AND OIG'S EVALUATION

#### Ref to OIG Evaluation

#### Auditee Comments



Dore Schwinden, Director

301 S. Park Ave. ★ P.O. Box 200501 ★ Helena, Montana 59620-0501  
Phone 406-841-2700 ★ Fax 406-841-2701 ★ TDD: 406-841-2702 ★ <http://commerce.mt.gov>

September 16, 2011

Ronald J. Hosking  
Regional Inspector General  
US Department of Housing and Urban Development  
Office of Inspector General  
UMB Plaza Building, 24<sup>th</sup> Floor  
1670 Broadway  
Denver, CO 80202-4801

Dear Mr. Hosking:

The State of Montana-Department of Commerce has reviewed the draft report and comments from the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General regarding the recent audit of the state's use of Community Development Block Grant – Recovery (CDBG-R) funds.

The state will comply with recommendations made by HUD related to the servicing of loans made with CDBG-R funds, and will work with HUD staff to ensure that the transfer of the loans is made with HUD's approval.

Sincerely,

A handwritten signature in black ink, appearing to read "Dore Schwinden", written in a cursive style.

Dore Schwinden, Director  
Department of Commerce

- c. Andy Poole, Deputy Director  
Karyl Tobel, Assistant Division Administrator

Comment 1

## **OIG Evaluation of Auditee Comments**

**Comment 1** State officials concurred with the recommendation and will work with HUD on the resolution.