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TO: Kathleen Naymola, Director, Community Planning and Development, 2FD

Edgar Moore

FROM: Edgar Moore, Regional Inspector General for Audit, New York/New Jersey, 2AGA

SUBJECT: The City of Paterson, New Jersey, Did Not Always Administer Its Community Development Block Grant Program in Accordance with HUD Requirements

# HIGHLIGHTS

## What We Audited and Why

We audited the Community Development Block Grant (CDBG) program administered by the City of Paterson (City). We selected the City for review due to its high risk score based on the U.S. Department of Housing and Urban Development's (HUD) 2007 annual risk assessment. Our audit objectives were to determine whether the City (1) disbursed CDBG funds efficiently and effectively in accordance with its submission to HUD and applicable rules and regulations and (2) had a financial management system in place to adequately safeguard the funds.

## What We Found

The City did not always disburse CDBG funds efficiently and effectively in accordance with its submission to HUD and with applicable rules and regulations**.** Specifically, (1) procurement requirements were not followed regarding demolition, housing rehabilitation, and public facility activities; and (2) funds were disbursed for unsupported fire truck leases, and an ineligible public service activity and planning and administration expenses. As a result, the City expended more than $3.9 million for activities that had not been procured in compliance with HUD's requirements and/or were either unsupported or ineligible. Further, budgeted funds of more than $1.2 million for these activities would be used more efficiently and in compliance with applicable requirements if increased management controls are implemented by the City.

In addition, the City's financial management system did not have adequate controls to properly safeguard funds. Specifically, the City did not (1) record and remit program income from property sales and demolition liens, (2) properly disburse funds to two demolition activities, (3) accurately record demolition activities in HUD's Integrated Disbursement and Information System (IDIS), (4) adequately maintain drawdown documentation, and (5) remit interest income to the U.S. Treasury. As a result, (1) $720,347 in program income was not recorded in IDIS, (2) $370,334 was disbursed for two unsupported demolition activities, (3) $6,262 in interest income was not remitted to the U.S. Treasury, and (4) $5,000 in demolition liens was not recorded in the City's accounting records. In addition, an unexpended budgetary balance of $91,871, related to completed demolition activities, remained available to be drawn down in IDIS.

## What We Recommend

We recommend that the Director of HUD's New Jersey Office of Community Planning and Development instruct the City to (1) provide documentation to support more than $3.7 million of costs related to the procurement of demolition, housing rehabilitation, public facility, and planning and administrative activities; (2) repay more than $641,000 of ineligible disbursements and (3) develop adequate procurement, management, and financial controls and procedures to ensure that planned demolition, housing rehabilitation, and public facility activities comply with regulations and that program income, demolition liens, and interest income are properly recorded to ensure that more than $2 million in budgeted funds is put to better use.

For each recommendation 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 a draft report to City officials on November 23, 2009, and requested their responses by December 15, 2009. Based on discussions with the HUD field office we made minor revisions and provided a revised copy to the auditee on December 8, 2009. We discussed the results of our review during the audit and at an exit conference held on December 09, 2009. City officials were unable to provide written comments and had requested a 90 day extension; as such, they will provide their comments as part of the audit resolution process. City officials agreed with several issues, but generally disagreed with the draft report findings.

# TABLE OF CONTENTS

# BACKGROUND AND OBJECTIVES

The Community Development Block Grant (CDBG) program was established by Title I of the Housing and Community Development Act of 1974 (Public Law 93-383). The program provides grants to state and local governments to aid in the development of viable urban communities. Governments are to use grant funds to provide decent housing and suitable living environments and to expand economic opportunities, principally for persons of low and moderate income. To be eligible for funding, every CDBG-funded activity, except for program administration and planning, must

- Benefit low-and moderate-income persons,
- Aid in preventing or eliminating slums or blight, or
- Address a need with a particular urgency because existing conditions pose a serious and immediate threat to the health or welfare of the community

The City of Paterson (City) is a CDBG entitlement recipient that has administered $11.8 million in CDBG funds from program years 2004 through 2007. These funds are available to support a variety of activities directed at improving the physical condition of neighborhoods by providing housing or public improvements and facilities, creating employment, or improving services for low- and/or moderate-income households.

The City is governed by an elected mayor and council, which consists of nine members. Files and records related to the City's CDBG program are primarily maintained at the Department of Community Development at 125 Ellison Street in Paterson, New Jersey. Financial records, as well as files regarding demolition activities, are located at 155 Market Street (City Hall) and 111 Broadway (Department of Community Improvement), respectively.

We audited the City's CDBG program due to its high risk score on the U.S. Department of Housing and Urban Development's (HUD) 2007 annual risk assessment. Our audit objectives were to determine whether the City (1) disbursed CDBG funds efficiently and effectively in accordance with its submission to HUD and applicable rules and regulations and (2) had a financial management system in place to adequately safeguard the funds.

# RESULTS OF AUDIT

## Finding 1: The City Did Not Always Disburse CDBG Funds Efficiently and Effectively in Compliance with Applicable Rules and Regulations

The City did not always disburse CDBG funds efficiently and effectively in accordance with its submission to HUD and applicable rules and regulations**.** Specifically, (1) procurement requirements were not followed regarding demolition, housing rehabilitation, and public facility activities; and (2) funds were disbursed for unsupported fire truck leases, and an ineligible public service activity, and planning and administration expenses. This condition was caused by the City not having adequate controls to ensure compliance with federal and local procurement requirements and that activities were eligible and complied with its HUD-approved action plan. As a result, the City disbursed more than $3.9 million for activities that had not been procured in compliance with HUD's requirements and/or were either unsupported or ineligible. Further, budgeted funds of more than $1.2 million for these activities would be used more efficiently and in compliance with applicable requirements if increased management controls are implemented by the City.

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**Nonadvertised Pool Used for Demolition Services**

The City did not have adequate controls over procurement for its subgrantees and contractors. Accordingly, it did not ensure that regulations at 24 CFR (*Code of Federal Regulations*) 85.36 and local procurement regulations established by the City were followed. Specifically, the City did not ensure that contracts were awarded in a manner providing full and open competition. Review of the procurement of 22 demolition contracts revealed that five were publically advertised but the remaining 17 were selected using a nonadvertised list of contractors.

According to City officials, contractors were added to the list upon visiting the City's building department and later taken off the list if they did not complete a demolition for an extended period as determined by the City. The selection of a contractor to complete the demolition was accomplished by placing telephone calls to a number of contractors on the list to solicit bids and then selecting the lowest bidder. The number of contractors providing bids varied from one to five contractors. City officials stated that contractors on the list were contacted on a rotational basis to ensure that each had a chance to be selected to perform a demolition service.

City officials stated that New Jersey State regulations were used to justify the cited bidding practices with no corresponding advertisement to the public. However, regulations at 24 CFR 85.36(d)(4)(i) and local City requirements specify that noncompetitive bidding is allowable when the small purchase, sealed bids, and competitive proposals methods of procurement are deemed infeasible and that either (1) the procurement is available only from a single source; (2) a public exigency or emergency for the requirement will not permit a delay resulting from competitive solicitation; (3) the awarding agency authorizes noncompetitive proposals; or (4) after solicitation of a number of sources, competition is deemed inadequate. However, City officials did not show that the use of a publicly advertised pool of contractors was not feasible for use by the City when procuring demolition services. Therefore, the City improperly used a non–publicly advertised list of contractors to award the contracts.

In addition, 24 CFR 85.36(c)(4) mandates that grantees and subgrantees ensure that all prequalified lists of persons, firms, or products that are used in acquiring goods and services are current and include enough qualified sources to ensure maximum open and free competition. However, the City did not ensure that sufficient competition was obtained when it used a list of contractors that had not been obtained through public advertising.

As a result of not following federal and local procurement requirements, the City precluded free and open competition and may have expended more in CDBG funds for demolition services than would have been necessary with the competitive bidding process. Accordingly, the City cannot ensure HUD that it used CDBG funds in the most efficient and economical manner for demolition services. Consequently, we view the $403,200 disbursed for the 17 demolition activities conducted as unsupported costs. We also consider $140,000 in CDBG funds planned to be expended during program year 2009 for demolition services as a cost savings if the City ceases this method of procurement and implements additional management controls when procuring for demolition services, as it will ensure that demolition services are efficiently procured at competitive prices and prevent the improper obligation or expenditures of agency funds.

## Inadequate Advertising for Housing Rehabilitation Services

The City also used a list of contractors compiled by the City to perform housing rehabilitation services as part of the Paterson Pride Program. Homeowners who were approved to participate in the housing rehabilitation program were provided a subset of six contractors from the list and instructed to obtain three bids. According to documentation provided by the City, homeowners are also given the opportunity to select their own contractors. If three bids were not obtained, community development employees were supposed to contact more contractors on the contractors list to obtain additional bids. City officials indicated that contractors were contacted on a rotational basis to ensure that each contractor on the list had a chance to be selected to perform housing rehabilitation services.

Unlike the lack of public advertisement for demolition services, the City attempted to publicly advertise for housing rehabilitation services; however, the advertisement used by the City did not meet the requirement of free and open competition as required by federal and local regulations. The advertisement conducted by the City consisted of placing a text message on the City's local public access television station for a period of six months. The text messages aired on the City's local television channel during calendar years 2000, 2005, and 2007 for six months each year.

Federal regulations at 24 CFR 85.36(c)(1) and local City regulations state that a procurement system has to ensure that all transactions are conducted in a manner that provides for maximum open and free competition consistent with reasonable and prudent practices. The City did not meet these requirements since the advertisement was limited to contractors based in Paterson and was aired on local public access television just three times in nine years. As a result, more than $1.9 million in CDBG funds expended for housing rehabilitation services is considered unsupported. We also consider $340,000 in CDBG funds to be expended during program year 2009 for housing rehabilitation services as a cost savings if the City ceases this method of procurement and implements additional management controls when procuring housing rehabilitation services, as it will ensure free and open competition at competitive prices and prevent the improper obligation or expenditures of agency funds..

**Noncompliance with Procurement Requirement for Public Facility and Demolition/Cleanup Activities**

Other instances of noncompliance with federal and local procurement regulations regarding public facility and demolition/cleanup activities involved similar deficiencies with regard to maintaining supporting documentation to justify the procurement.

A public facility activity (HUD's Integrated Disbursement and Information System (IDIS) activity #1630) received $150,000 in funding for a third floor renovation. This public facility was dedicated to providing social services for women and children and offering educational opportunities to help women compete in today's marketplace. The City selected a contractor for the renovation service after soliciting public bids in a local newspaper with only one bid being received from a contractor that was already on site providing other contracting services. Federal regulations at 24 CFR 85.36 and City policies provide that procurement transactions are to be conducted in a manner that provides full and open competition and that for sealed bidding to be feasible, two or more responsible bidders have to be willing and able to compete effectively for the business.  In addition, the invitation for bid must be publicly advertised and shall be solicited from an adequate number of known suppliers, providing them sufficient time before the date set for opening the bids.  The file, however, contained no evidence that two bids were received and that known contractors were solicited to provide free and open competition as required by federal and local regulations.  Therefore, the $150,000 public facility cost for the third floor renovation services is considered unsupported.

A second public facility activity (IDIS activity #1504) received funding of $250,000 for a renovation addition for a family life center.  Programs conducted in the addition of the facility included adult medical day care, early preschool care, family preservation services, and other counseling and training services. However, documentation for preparing the bids, taking and analyzing the bids, and preparation of the construction contracts was not adequately supported.  In a September 2006 monitoring review conducted by the City along with correspondence  issued in August 2007, the City attempted to obtain supporting documentation for the renovation project.  However, a review of the activity's file and related inquiries with City staff revealed that the required supporting documentation regarding the activity's procurement was never received from the subgrantee.  Accordingly, as a result of obtaining no supporting documentation to justify the activity's procurement, according to 24 CFR 85.36(b)(9) and local procurement regulations, and due to the City's failure to adequately follow up on its attempt to obtain the required supporting documentation from the subgrantee, the $250,000 public facility cost of the renovation addition is considered unsupported.

Another public facility activity (IDIS activities #1410 and #1485) involving the renovation of a pedestrian bridge was provided $345,840 in CDBG funds. However, as of the date of our pre exit conference, documentation had not been provided to support the activity's procurement compliance with 24 CFR 85.36(b)(9).  As a result, the $345,840 public facility cost to compete the renovation of a pedestrian bridge is an unsupported cost.

Further, another activity (IDIS activities #1486 and #1496) involved the demolition and cleanup of an abandoned factory owned by the City.  The cost for cleanup and demolition services drawn from CDBG funding amounted to $312,659 and was awarded to a firm without competitive bidding.  The City's awarding resolution attempted to justify not to competitively bid this procurement by mentioning that the services rendered were "extraordinary and unspecifiable" in keeping with state regulations.  However, the documents in the file did not contain justification that competition was deemed inadequate and that the small purchase, sealed bids, or competitive proposal methods of conducting procurements were not feasible as required by federal and local regulations. Therefore, the method of procuring this activity is also questioned (see also finding 2 for this activity).

Compliance with federal and local procurement regulations is a necessity in that the City may have expended more CDBG funds for public facility services than needed since competitive bidding was not performed. In addition, federal regulations at 24 CFR 85.36 (b)(9) require that grantees and subgrantees maintain records sufficient to detail the significant history of a procurement. These records will include but are not necessarily limited to the following: rationale for the method of procurement, selection of contract type, contractor selection or rejection, and the basis for the contract price. By applying these required procedures, the City will ensure that $790,000 in budgeted public facility funds for next year will be used more efficiently, as it will prevent their improper obligation and/or expenditure.

## CDBG Funds Disbursed for Three Ineligible Fire Truck Leases

Contrary to HUD requirements, the City charged $263,141, representing the first annual payment for the lease of three ladder fire trucks to the CDBG program. Federal regulations at 24 CFR 570.207(b)(1) state that the purchase of equipment with CDBG funds is generally ineligible. An exception is for the purchase of fire equipment, which can be an integral part of a public facility. However regulations do not allow for a lease of fire equipment unless requirements of 24CFR Part 85(b)(4) are achieved and documented. These requirements state that an analysis must be made concerning lease versus purchase alternatives to determine the most economical approach. In January 2006, the City prepared a lease versus purchase analysis in order to determine whether leasing the trucks were more economical. This analysis, however, based its conclusions on a five year lease instead of the actual lease term of nine years as applied by the City. In addition, the analysis stated that maintenance costs were included as part of the monthly lease payments. The leases, however, stated that the City is responsible for maintenance costs. As a result, City officials could not adequately demonstrate that leasing the fire trucks were more economical that purchasing them. Therefore, we view $263,141 representing the first annual payment for the lease of three aerial ladder fire trucks as an unsupported cost.

A review of the City's program year 2005 action plan for public facility and improvements disclosed that the City funded $100,000 for one new fire safety equipment purchase (IDIS activity #1443). The program year 2005 consolidated annual performance evaluation report stated that funding for this purchase was amended to $325,000.

During the months of March and June 2006, the City drew down a cumulative amount of $263,141 from its CDBG line of credit to pay for the first-year costs of three fire truck leases. See details below for the leases of the three fire trucks.

| A | B | C |
|---|---|---|
| **Truck make model type** | **9-year lease cost** | **Annual lease payment** |
| E-One HP100 Aerial | **$623,907** | **$69,323** |
| E-One Mid Mount Aerial | **$878,640** | **$97,626** |
| E-One HP 100 Tiller | **$865,729** | **$96,192** |
| **Total** | **$2, 368, 276** | **$263,141** |

Further review of the City's consolidated annual performance evaluation report for program year 2006 revealed that the funding for the fire station equipment amounting to $261,000 was removed and shifted to contingencies, as a result of discussions with representatives from HUD's Newark Office of Community Planning and Development. Nevertheless, the City charged the cost of the first year of the three leases to the CDBG program from the amount funded in the City's HUD-approved 2005 action plan.

## Inadequate Monitoring for a Public Service Activity

The City disbursed CDBG funds totaling $286,600 from program years 2004 through 2007 to pay for employees' salaries and other operating expenses associated with the Great Falls Historic District Cultural Center (IDIS activities #1323, #1391, #1423, #1525, #1584, and #1612). This activity's national objective was designated to provide a benefit to low- and moderate-income persons. Further, the activity's service to low- and moderate-income persons was determined to be based upon an area benefit in program year 2004. For program years 2005 through 2007, the City stated that the activity's benefit to low- and moderate-income persons was determined to be based upon a limited clientele; i.e., Paterson school children.

According to 24 CFR 570.208(a), activities will be considered to benefit low- and moderate-income persons unless there is substantial evidence to the contrary. In addition, 24 CFR 570.208(a)(2)(i)(D) and 24 CFR 570.506(b)(3)(ii) state that an activity needs to demonstrate that its clientele will primarily be benefiting low- and moderate-income persons. Lastly, 24 CFR 570.208(a)(2)(i) states that an activity may not qualify as a limited clientele activity if the benefits are available to all residents of an area. Documents in the activity's file and inquiries of City and visitor center staff revealed that a majority of visitors were not Paterson school children or residents of Paterson. Specifically, a majority of visitors were either from other cities in New Jersey or from other states and foreign countries. See the following table for details.

| (A) | (B) | (C) | (D) | (E) |
|---|---|---|---|---|
| **Program year** | **Paterson visitors** | **Non-Paterson visitors** | **Total number of visitors (A+B)** | **Percentage of non-Paterson visitors (C/D)** |
| 2004 | 1373 | 6205 | 7578 | 82% |
| 2005 | 1526 | 2604 | 4130 | 63% |
| 2006 | 4587 | 3162 | 4587 | 69% |
| 2007 | 1702 | 6036 | 7738 | 78% |

These deficiencies were due to inadequate monitoring by the community development staff.

As a result, since the center's visitors were predominately from outside Paterson, the $249,282 disbursed from CDBG funds to pay for the visitor center's salaries, as well as $37,318 for other operating expenses erroneously charged to general administration and planning, are considered to be ineligible costs. Therefore, a total of $286,600 should be repaid to the CDBG program's line of credit from nonfederal funds.

## Ineligible Planning and Administration Expenses Charged

During program years 2004 through 2007, salaries of three employees who neither performed tasks nor assumed responsibilities related to the CDBG program were charged as CDBG administration and planning costs. The total payroll costs charged to administration and planning amounted to $281,444 for the three employees. The three employees were community development specialists and were responsible for organizing various events for the City. These events included an Easter egg hunt; the Paterson-Great Falls Festival and Holiday Parade; a Black History Month flag-raising ceremony; Bangladesh Mother's Language Day; and various events for cancer, Fourth of July, and Patriot's Day.

The City also disbursed $12,052 in CDBG funds to pay for operating expenses associated with these special event activities. City officials stated that they were not aware that these administrative costs were an ineligible use of CDBG administration funds until the City's CDBG consultant instructed them.

Federal regulations at 24 CFR 570.207(a)(2) state that except as otherwise specifically authorized in subpart 570.207 or under Office of Management and Budget (OMB) Circular A–87, expenses required to carry out regular responsibilities of a unit of general local government are not eligible for assistance. Thus, salary and operating expenses for special events are an ineligible cost because they are general local government expenses. Therefore, the total cost of $293,496 was ineligible and should be reimbursed from nonfederal funds to the City's CDBG program line of credit.

In addition, during program years 2004 and 2006, CDBG funds were used to pay $60,710 for administrative salaries pertaining to other programs such as the Section 8 and economic development programs. The administrative salaries were related to four employees who assumed responsibilities and performed duties related to the CDBG program and other programs in program years 2004 and 2006. Regulations at 24 CFR 570.200(a)(5) state that costs incurred must be in conformance with OMB Circular A-87. OMB Circular A-87 states that cost principles provide that federal awards bear their fair share of costs and that a cost allocation plan is required when there is an accumulation of indirect costs that will ultimately result in charges to a federal award.

These deficiencies resulted from the City's not using a cost allocation plan. As a result, the City should reimburse $60,710 to the CDBG program from nonfederal funds for payroll costs that should not have been paid from the CDBG program.

During the conclusion of our fieldwork, we discovered a fifth employee who was functioning as a brownfields coordinator while performing duties as a CDBG program monitor. Additionally, this employee's salary was allocated entirely to the CDBG program. Consequently, we recommend that the City conduct an annual cost allocation analysis for all applicable years for the brownfields coordinator who performed duties for other programs in addition the CDBG program. The costs determined to be chargeable to other programs should be reimbursed to the CDBG program's line of credit from nonfederal funds.

## Conclusion

The City did not follow federal and local procurement regulations to ensure that CDBG funds expended are not more than needed according to the competitive bidding process. In addition, the City did not have adequate management controls to ensure that costs associated with its public facility, public service, and administration and planning activities were supported and/or eligible. This problem was caused by the City's not establishing adequate controls to ensure compliance with federal and local procurement requirements and that activities were eligible and in compliance with its HUD-approved action plan. As a result, the City disbursed more than $3.9 million for activities that had not been procured in compliance with HUD's requirements and/or were either unsupported or ineligible. Lastly, budgeted funds of more than $1.2 million for these activities would be used more efficiently and in compliance with applicable requirements if increased management controls are implemented by the City to ensure competitive procurements.

## Recommendations

We recommend that the Director of HUD's New Jersey Office of Community Planning and Development instruct the City to

1A. Provide supporting documentation regarding the procurements of $403,200 of demolition services so that HUD can determine whether the procurements were in compliance with HUD's requirements. Any procurements that did not comply with the procurement standards at 24 CFR 85.36 should be repaid to the CDBG program line of credit from non-federal funds.

1B. Provide supporting documentation regarding the procurements of $1,924,627 of housing rehabilitation services so that HUD can determine whether the procurements were in compliance with HUD's requirements. Any procurements that did not comply with the procurement standards at 24 CFR 85.36 should be repaid to the CDBG program line of credit from non-federal funds.

1C. Obtain adequate supporting documentation for three public facility procurement activities totaling $745,840 to jusify the rationale for the method of procurement, selection of contract type, contractor selection or rejection, and basis for the contract price or repay the amount determined to be ineligible from nonfederal funds.

1D. Develop and implement increased management control procedures to comply with federal and local procurement regulations for demolition services, housing rehabilitation services and public facility activities. These procedures would ensure that $1,270,000 in CDBG funds to be expended during program year 2009 for demolition services, housing rehabilitation services and public facility activities would be used more efficiently and in compliance with federal and local requirements.

1E. Obtain adequate supporting documentation for the procurement of the demolition and clean-up of an abandoned factory, owned by the City (IDIS activities #1486 and #1496) to jusify the rationale for the method of procurement, selection of contract type, contractor selection or rejection, and basis for the contract price.

1F. Develop and implement management control procedures to ensure compliance with the City's HUD-approved action plans when conducting monitoring reviews and disbursing CDBG funds.

1G. Obtain adequate supporting documentation for the first year lease payment for three fire trucks totaling $263,141 to jusify the rationale for leasing the trucks rather than purchasing them. Any amount determined to be ineligible should be repaid to the CDBG program line of credit from nonfederal funds.

1H. Reimburse $286,600 to the CDBG program's line of credit from nonfederal funds for the ineligible costs related to salaries and operating expenses of the Great Falls Historic District Cultural Center.

1I. Reimburse $293,496 from nonfederal funds to the CDBG program's line of credit for ineligible planning and administration costs charged to the CDBG program.

1J. Develop and implement a cost allocation plan to ensure that costs are correctly allocated and that the CDBG program does not pay more than its fair share of salary costs.

1K. Reimburse $60,710 from nonfederal funds to the CDBG program's line of credit for ineligible salary costs allocated to the CDBG program.

1L. Conduct an annual cost allocation analysis for program years 2004 through 2009 related to the brownfields coordinator who performed duties in addition to those for the CDBG program. Specifically, the City should determine the cost allocation percentage and apply the percentage to the program monitor's annual salary and reimburse the CDBG program's line of credit from nonfederal funds for any amounts determined to be ineligible, or not chargable to the CDBG program.

## Finding 2: The City Did Not Properly Safeguard Program Funds When It Improperly Recorded Program Income and Disbursements

The City's financial management system did not have adequate controls to properly safeguard funds. As a result, the City did not (1) record and remit program income from property sales and demolition liens, (2) provide documentation to support disbursements for two demolition activities, (3) accurately record demolition activities in IDIS, (4) adequately maintain drawdown documentation, and (5) remit interest income to the U.S. Treasury. We attribute these conditions to the City's inadequate internal and financial controls. As a result, (1) $720,347 in program income was not recorded in IDIS, (2) $5,000 in demolition liens was not recorded in the accounting records, (3) $370,334 was disbursed for two unsupported demolition activities, and (4) $6,262 in interest income was not remitted to the U.S. Treasury. Further, an unexpended budgetary balance of $91,871 in IDIS, related to completed demolition activities, remained available to be drawn down.

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**Program Income Not Recorded and Remitted from the Sale of Properties Owned by the City**

The City did not record and remit the proper amount of program income to the CDBG program for two properties that were owned and controlled by the City when demolition services were accomplished. These demolitions included the removal of abandoned factories for which some of the costs were paid with CDBG funds. After the demolitions were completed, both properties were sold, and no additional CDBG activities were created in IDIS to ensure that any future development of the properties would be eligible and meet a national objective under CDBG regulations. In addition, no documentation was provided to support that (1) the sale of the two properties was mentioned in the City's action plans and consolidated annual performance and evaluation reports as of the City's program year 2007, and that (2) affected citizens were provided reasonable notice and opportunity by the City to comment on the City's plan to sell the properties. As a result, the City should remit the applicable portion of the sales proceeds to the CDBG program because the properties had been improved with CDBG funds and had been sold without meeting program requirements.

The first demolition activity reviewed (IDIS activities #1486 and #1496) occurred at a 15-35 East 26th Street and 177-203 3rd Avenue site and required more than $1.1 million in total funds to complete the demolition, of which $312,659 (28.1 percent) was drawn from CDBG funds. During June 2007, the property, along with two other properties, was sold to a limited liability corporation for $2.3 million. Based upon the percentage of the site's assessed value when compared to the other two properties sold, the sales proceeds were adjusted to around $1.65 million. Therefore, program income in the amount of $463,825 (28.1% x $1,650,622) was generated from the sale but was not recorded and remitted to the CDBG program as required by federal regulations.

The second demolition activity reviewed (IDIS activities #1262, #1429, and #1433) occurred at 95-113 Cliff Street and required $562,669 in total funds to complete the demolition, of which $57,675 (10.25 percent) was drawn from CDBG funds. During 2007, the property was sold to the Housing Authority of the City of Paterson for $2.1 million. Therefore, program income in the amount of $215,250 (10.25% x $2.1 million) was generated but was not remitted to the CDBG program as required by federal regulations.

For real property within the recipient's control that was improved in whole or in part using CDBG funds in excess of $25,000, federal regulations at 24 CFR 570.505 apply. In addition, 24 CFR 570.505(a) states that a recipient may not change the use or planned use of any such property from that for which the improvement was made unless the recipient provides affected citizens with reasonable notice of and opportunity to comment on any proposed change. Further, the new use of such property must meet one of the national objectives. Since there was no documentation supporting that the disposition of the two properties was made available for public comment after they were improved with CDBG funds and since the future use of the properties was uncertain as far as meeting a national objective according to CDBG regulations, program income amounting to $679,075 should be remitted to the CDBG program. These funds, when properly remitted to the CDBG program, would permit other eligible CDBG activities to be accomplished and funded without drawing additional funds from the City's CDBG line of credit.

### CDBG Funds Not Properly Disbursed for Two Demolition Activities

The City did not provide supporting documentation in the activity's file that suggested that (1) the disposition of the two properties above was approved according to the City's action plans and consolidated annual performance and evaluation reports, and that (2) the affected citizens were provided reasonable notice and opportunity by the City to comment on the property's dispositions. Regulations at 24 CFR Part 85.20(b)(3), provides that effective control and accountability must be maintained for all real property and other assets. Further, grantees and subgrantees must adequately safeguard all such property and must ensure that it is used solely for authorized purposes. As a result, since adequate documentation was not provided to support the use of CDBG funds in the demolition of these properties, the $370,334 expended is considered unsupported.

## Program Income from Demolition Liens Not Recorded and Remitted to the CDBG Program

Twenty-one demolitions were completed and paid for with CDBG funds during program years 2004 through 2007 for properties that were not owned or controlled by the City when the demolitions were completed. New Jersey Statutes Annotated 40:48-2.5 provides that a municipal lien for the cost of the demolition shall be filed against the real property for which the costs were incurred. As such, these liens would represent program income to the City. However, of the 21 properties, 10 properties were later sold, and the correct amount of program income was not computed and remitted to the CDBG program. Specifically, for 1 of the 10 property liens amounting to $28,280, the City cancelled the lien as a result of a lawsuit by the owner of the property against the City, with no corresponding program income and interest being remitted to the CDBG program. Although the lien was canceled, CDBG funds were used for the demolition on this property, as such, these funds should be reimbursed to the CDBG programs line of credit. Of the remaining nine demolition liens, five liens were sold with $12,992 in computed interest not being remitted to the CDBG program, and four liens were sold with no interest being computed and remitted to the CDBG program. Therefore, $41,272 ($28,280 + $12,992) in program income should be recorded in IDIS for the cancellation of one lien and the sale of five liens. In addition, interest should be computed for the four remaining sold liens, and the interest should be remitted to CDBG program's line of credit.

Of the remaining 11 of 21 liens reviewed that were not sold, three liens were understated by a cumulative amount of $5,000 when compared to actual demolition costs of the corresponding activities. Federal regulations at 24 CFR 85.20(b) (3) provide 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. As such, if the City records the correct amount of these liens in its accounting records, the $5,000 should be considered as a cost savings measure since this will ensure that the City collects the proper amount of program income and will prevent unnecessary drawdowns in the future. In addition, the recording of these liens will ensure that funds owed to the City are properly accounted for.

Thirty-two additional liens for CDBG-funded demolitions were paid off during program years 2004 through 2007. These liens had corresponding demolition activities that were completed before program year 2004. The amount of these additional liens paid off totaled $286,890, and this amount was credited to the CDBG line of credit. However, interest was not remitted to the CDBG program between the time of the liens' recordings and the sale of the properties. As a result, program income resulting from the interest on the liens was not remitted to the City's CDBG line of credit. Therefore, the City needs to compute the amount of interest on the liens for CDBG-funded activities that have been sold and remit the amount of computed interest as program income to the CDBG program's line of credit.

Federal regulations at 24 CFR 570.501 state that the recipient is responsible for ensuring that CDBG funds are used in accordance with all program requirements. Also section 570.500(a) adds that program income is defined as gross income received by the recipient or a subrecipient directly generated from the use of CDBG funds. Lastly section 570.504(a) states that the receipt and expenditure of program income shall be recorded as part of the financial transactions of the grant program. By not correctly recording the liens for the demolitions that had been paid with CDBG funds and remitting the amount due to the CDBG program's line of credit, the City did not properly safeguard funds due the program. Properly recording the correct amount of income from demolition liens and remitting the program income to the CDBG program upon their sale ensures that other eligible CDBG activities can be funded without drawing additional funds from the CDBG program's line of credit.

**Demolition Information in IDIS Not Accurate**

Review of information recorded in IDIS for demolition activities revealed that the information was not always accurate. In a number of instances, financial information entered into IDIS did not match actual disbursement records for demolition activities. The following are examples of the types of deficiencies noted:

- Two demolition activities that were paid with CDBG funds were not recorded in IDIS (99 North Main Street, 108 North 2nd Street).

- IDIS activity #1481 stated that the status of two properties was "underway" (207 and 211/213 Governor Street). IDIS showed that the activity received $95,500 in funding, of which $70,220 had been disbursed and a budgetary balance of $25,280 remained. However, the disbursement amount for these demolition activities was $32,400, with both demolition activities having been completed.

- IDIS activity #1629 listed $14,900 as disbursed for 65-67 Market Street when actual disbursement records listed a total demolition cost of $88,580.

- The demolition costs recorded in IDIS was $62,095 for the property at 95-113 Cliff Street (IDIS activities #1262, #1429, and #143). However, this amount was overstated by $4,420. The actual disbursement cost charged to the CDBG program for this demolition was $57,675.

- Actual disbursement costs of $40,760 for the property at 415 Main Street were entered into IDIS as $66,893 disbursed, $133,484 funded, and a budgetary balance of $66,591 under IDIS activity #1617. However, the demolition activity for 415 Main Street had been completed.

These deficiencies occurred because to the City did not have adequate financial controls in place to ensure the accuracy of recording budgetary and disbursement information regarding demolition activities in IDIS. As a result, $91,871 in unexpended budgetary balances in IDIS remained available to be drawn down for demolition activities that have already been completed. According to regulations at 24 CFR 85.20(b)(1), accurate, current, and complete disclosure of the financial results of financially assisted activities must be in accordance with the financial reporting requirements of the grant. In addition, grantees must maintain records that adequately identify the source and application of funds provided for assisted activities. Therefore, if the City reconciles and reviews all demolition activity from program year 2004 to the present to ensure that demolition activity entered in IDIS accurately matches actual disbursement information, the $91,871 in unused funds would represent funds that could be put to better use. This measure will ensure that $91,871 in unexpended funds budgeted for demolition activities already completed is available to be applied to other eligible activities.

### Inadequate Supporting Documentation for Monthly Drawdowns

Review of the City's monthly drawdown and receipt folders maintained by the Community Development Department disclosed instances in which supporting documentation was not present in the file. Monthly drawdown and receipt folders included a monthly transaction report of all disbursement and receipt transactions initiated by the City for the current month concerning the CDBG program. Upon receipt of the monthly transaction report, the Community Development Department entered transactions into IDIS, which initiated monthly drawdowns with offsetting receipts to the City's CDBG program line of credit. The City was then reimbursed from the Community Development Department's CDBG bank account for costs paid in advance for CDBG-related activities.

Supporting documentation for program income receipts and disbursements recorded in IDIS related to demolition activities was not present in the monthly drawdown and receipt folders. In addition, the monthly drawdown folders did not contain monthly itemized listings of program income receipts recorded by the City. Therefore, City officials in the Community Development Department recorded receipts of program income in IDIS without disclosing the source of the receipts by activity. When four cumulative program receipts, totaling $244,304, could not be verified, City officials used staff from the Division of Accounts and Controls, as well as the Community Development Department, to obtain the supporting documentation that was not located in the monthly drawdown and receipt folders. City officials agreed that monthly drawdown and receipt folders needed to contain supporting documentation for all receipts and disbursements before financial information was entered into IDIS by Community Development Department staff.

Federal regulations at 24 CFR 85.20(b)(3) state that effective control and accountability must be obtained for all cash, real and personal property, and other assets. Grantees must adequately safeguard all such property and must ensure that it is used solely for authorized purposes. In addition, accounting records must be supported by source documentation. Implementing adequate management controls ensures accountability for the grantee and places the grantee in a more favorable position to properly evaluate the efficiency and effectiveness of its CDBG program. Accordingly, the Community Development Department needs to maintain supporting documents as per 24 CFR 85.20(b)(6) for all receipts and disbursements for the CDBG program when entering data into IDIS.

**Bank Interest Not Remitted to the Treasury**

In addition to the above, City officials did not remit bank interest earned from the City's interest-bearing account for the CDBG program during program years 2004 through 2007. The total amount of interest attributed to the CDBG program amounted to $6,262. This deficiency was due to the City's inadequate management controls. Regulations at 24 CFR 570.500(a) (2) prescribes that the interest earned on grant advances must be remitted to HUD for transmittal to the U.S. Treasury.

**Conclusion**

The City's financial management system did not have adequate controls to properly safeguard funds. These conditions are attributable to the City's inadequate internal and financial controls. As a result, (1) $720,347 in program income was not recorded in IDIS, (2) $5,000 in demolition liens was not recorded in the City's accounting records, (3) $370,334 was disbursed for two unsupported demolition activities, and (4) $6,262 in interest income was not remitted to the U.S. Treasury. Further, an unexpended budgetary balance in IDIS of $91,871, related to completed demolition activities, remained available to be drawn down.

## Recommendations

We recommend that the Director of HUD's New Jersey Office of Community Planning and Development instruct the City to

2A. Develop and impelement management control procedures that will ensure the proper recording of program income earned from the sale of properties and demolition activities in the City's CDBG account.

2B. Record program income of $679,075 in the CDBG program's line of credit for the sale of two City-owned properties ($463,825 for IDIS activities #1486 and #1496 and $215,250 for IDIS activities #1262, #1429, and #1433), which received demolition services that had been paid with CDBG funds. This measure will result in additional funds being available to pay for eligible CDBG activities.

2C. Provide supporting documentation for the use of $370,334 in CDBG funds for the demoliton of two properties so that HUD can determine whether (1) the sale of the two properties was mentioned in the City's action plans and consolidated annual performance and evaluation reports, and that 2) affected citizens were provided reasonable notice and opportunity by the City to comment on the property's dispositions or any other proposed change. Any disbursements that did not comply with regulations at 24 CFR 85.20(b)(3) should be repaid to the CDBG program line of credit from non-federal funds.

2D. Record program income of $41,272 in the CDBG program's line of credit related to the cancellation of one lien and from interest not being computed and recorded from the sale of five demolition liens. In addition, the City should compute the amount of lien interest for the sale of four additional demolition liens and record the amount in the CDBG program's line of credit.

2E. Record $5,000 for three demolition liens that were understated. This measure would ensure that the proper amount will be collected from the sale of these demolition liens in the future and would result in additional program income.

2F. Record the amount of lien interest on the 32 properties that were demolished before program year 2004 and remit the computed amount of interest to the CDBG program's line of credit.

2G. Develop and implement financial controls to ensure that disbursement information related to demolition activities is accurately recorded in IDIS. In addition, procedures should ensure that receipts of program income are recorded in IDIS by activity number to disclose the source and application of the receipts.

2H. Conduct a review of all demolition activity from program year 2004 to the present to ensure that demolition activity entered in IDIS accurately matches actual disbursement information. This measure will ensure that $91,871 in unexpended funds budgeted for demolition activities are available to be applied to other eligible activities.

2I. Maintain supporting documentation for all receipts and disbursements of program income by activity in the monthly drawdown and receipt folders.

2J. Remit $6,262 in bank interest generated in program years 2004 through 2007 to the U.S. Treasury as required. Also, calculate and remit any bank interest generated from programs year's 2008 to the present.

# SCOPE AND METHODOLOGY

The audit focused on determining whether the City complied with HUD regulations while administering its CDBG program. To accomplish our objectives, we

- Reviewed applicable federal, state, and local regulations.
- Conducted inquiries with HUD staff located at HUD's Newark Office of Community Planning and Development and reviewed monitoring reports, actions plans, consolidated annual performance and evaluation reports, and general correspondence files.
- Conducted inquiries with City staff located within its Community Development Department, Community Improvement Department, and the Division of Accounts and Controls to obtain an understanding of the City's administration of the CDBG program.
- Reviewed the City's independent audit reports, Community Development Department monitoring reports, and subrecipient agreements.
- Reviewed and tested CDBG activities for eligibilty and whether activity files contained adequate supporting documentation as required by HUD regulations.

Disbursement records reflected that more than $11.8 million in CDBG funds was disbursed between July 1, 2004, and June 30, 2008. Activities selected for review included those for public service, public facilities, and demolition and cleanup. We also reviewed funds disbursed for general administration and planning expenses. We reviewed 100 percent of the demolition and cleanup activities paid for with CDBG funds during the audit period, which consisted of 23 activities. We also selected one of seven public service activities that received funding in program year 2007 and four of five public facility activities with disbursed funds in excess of $50,000.

The review covered the period July 1, 2004, through June 30, 2008, and was extended as necessary. We performed audit work from December 2008 through July 2009 at the City's Community Development Department's offices in Paterson, New Jersey.

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 objectives. 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 an integral component of an organization's management that provides reasonable assurance that the following controls are achieved:

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They 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 reasonably ensure that a program meets its objectives.

- Validity and reliability of data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

- Safeguarding of resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

## Significant Weaknesses

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

- The City did not ensure compliance with laws and regulations regarding procurement for demolition, housing rehabilitation, and public facility activities. Also, the City did not always have adequate controls over program operations to ensure that funds were only disbursed for eligible activities (see finding 1).

- The City did not always adequately safeguard resources. Specifically, it did not accurately record program income receipts and disbursement information in IDIS related to demolition services (see finding 2).

# APPENDIXES

## Appendix A

### SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

| Recommendation number | Ineligible 1/ | Unsupported 2/ | Funds to be put to better use 3/ |
|---|---|---|---|
| 1A | | $403,200 | |
| 1B | | 1,924,627 | |
| 1C | | 745,840 | |
| 1D | | | $1,270,000 |
| 1G | | 263,141 | |
| 1H | $286,600 | | |
| 1I | 293,496 | | |
| 1K | 60,710 | | |
| 2B | | | 679,075 |
| 2C | | 370,334 | |
| 2D | | | 41,272 |
| 2E | | | 5,000 |
| 2H | | | 91,871 |
| 2J | | | 6,262 |
| Total | $640,806 | $3,707,142 | $2,093,480 |

1/ Ineligible 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 insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. If the City implements our recommendations and develops adequate procurement, management, and financial controls and procedures to ensure that planned demolition, housing rehabilitation, and public facility activities are in compliance with regulations and that program income, demolition liens, and interest income are properly recorded, it will ensure that more than $2 million in budgeted funds is put to better use.