OFFICE OF THE NEW YORK STATE COMPTROLLER

DIVISION OF LOCAL GOVERNMENT
& SCHOOL ACCOUNTABILITY

Village of Waverly

Revolving Loan Programs

Report of Examination

Period Covered:

June 1, 2009 — July 13, 2011

2011M-265

Thomas P. DiNapoli

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State of New York
Office of the State Comptroller

Division of Local Government
and School Accountability

March 2012

Dear Village Officials:

A top priority of the Office of the State Comptroller is to help local government officials manage government resources efficiently and effectively and, by so doing, provide accountability for tax dollars spent to support government operations. The Comptroller oversees the fiscal affairs of local governments statewide, as well as compliance with relevant statutes and observance of good business practices. This fiscal oversight is accomplished, in part, through our audits, which identify opportunities for improving operations and Village Board governance. Audits also can identify strategies to reduce costs and to strengthen controls intended to safeguard local government assets.

Following is a report of our audit of Village of Waverly, entitled Revolving Loan Programs. This audit was conducted pursuant to Article V, Section 1 of the State Constitution and the State Comptroller's authority as set forth in Article 3 of the General Municipal Law.

This audit's results and recommendations are resources for local government officials to use in effectively managing operations and in meeting the expectations of their constituents. If you have questions about this report, please feel free to contact the local regional office for your county, as listed at the end of this report.

Respectfully submitted,

Office of the State Comptroller
Division of Local Government
and School Accountability

Introduction

Background

The Village of Waverly (Village) is located in the Town of Barton in Tioga County. The Village's population was approximately 4,400 residents.[1] The Village is governed by a Board of Trustees (Board) which comprises six elected members and an elected Village Mayor (Mayor). The Board is responsible for the general management and control of the Village's financial affairs, which includes designing and implementing specific controls to safeguard Village assets.

Village officials used federal Community Development Block Grant (CDBG) funds to establish two revolving loan programs, one for residential housing rehabilitation and one for business development. The proceeds received from the repayment of these loans provided an opportunity for officials to maintain these programs through continued re-circulation of these funds to eligible businesses and individuals. The objectives of the loan programs are to provide funding for decent housing, suitable living environments and to extend economic opportunities to develop viable businesses within the Village. Through their programs, Village officials have provided loans to individuals and businesses located throughout the Village. There were 24 loans with outstanding principal balances totaling $334,711, as of June 30, 2011.

Objective

The objective of our audit was to examine the Village's revolving loan programs. Our audit addressed the following related question:

- Did Village officials establish adequate lending, collection and payment processes for their revolving rehabilitation and business loan programs?

Scope and Methodology

We examined the Village's revolving loan programs for the period June 1, 2009 through July 13, 2011. We expanded our scope period through July 31, 2011 to determine the amount of uncollected loan payments.

We conducted our audit in accordance with generally accepted government auditing standards (GAGAS). More information on such standards and the methodology used in performing this audit are included in Appendix B of this report.

[1] Per the 2010 U.S. census

Comments of Local Officials and Corrective Action

The results of our audit and recommendations have been discussed with Village officials and their comments, which appear in Appendix A, have been considered in preparing this report. Village officials responded to our audit, but did not indicate whether they intended to initiate corrective action.

The Board has the responsibility to initiate corrective action. A written corrective action plan (CAP) that addresses the findings and recommendations in this report should be prepared and forwarded to our office within 90 days, pursuant to Section 35 of the General Municipal Law. For more information on preparing and filing your CAP, please refer to our brochure, *Responding to an OSC Audit Report*, which you received with the draft audit report. We encourage the Board to make this plan available for public review in the Clerk's office.

Revolving Loan Programs

To best support the continuation of the two loan programs offered by the Village, the Board should establish policies that outline their goals and guidelines of the programs, including lending criteria, collateralization, collection, and enforcement expectations, and should assign responsibilities for the day-to-day administration of the programs. The Clerk-Treasurer is responsible for collecting loan applications and forwarding them to the Village's attorney and a bank.[2] The Board is responsible for approving all loans. The Clerk-Treasurer is also responsible for processing loan disbursement checks, collecting loan repayments, and following up on payment delinquencies. The disbursement and collection of the loan money is subject to the same policies and procedures for disbursing and receiving any other Village money.

Village officials' lending, monitoring, and collection procedures, as well as their internal controls over disbursing loan moneys, were inadequate. Further, pursuant to article 18 of the General Municipal Law (GML), there appears to be a conflict of interest with a former Board member whose business received a $40,000 loan. As of June 1, 2011, the business was 24 months delinquent in repaying this loan.

Lending Procedures — While officials did have some lending procedures in place, we believe their procedures were inadequate and not uniformly followed. The Board typically approved a borrower's application based on a review conducted by personnel from a local bank. The bank's personnel reviewed statements on the borrower's application (e.g., monthly income, bank balances) to the extent possible using the supporting documentation (e.g., tax return, pay stub) provided with the application. However, Village officials did not always ensure that applications were complete and that supporting documentation was included, so the application information was not always verified. In addition, the Village did not request that the bank do a credit check to assess the applicant's credit worthiness (the continuing ability to repay the loan). The Village also lacked procedures that required loan recipients to provide collateral verification[3] or that assured the Board that loan proceeds were used for their intended purpose.

[2] The Village's attorney is responsible for preparing the loan documents and following up on payment delinquencies. The bank is responsible for reviewing the loan applications and advising the Board on the applications.

[3] Documentation supporting the ownership of the specific property pledged to secure repayment of the loan

Moreover, uniform procedures were not in place to help avoid potential conflicts of interest prior to loan approval, such as including a conflict of interest disclosure section of the loan application. Article 18 of the GML limits the ability of municipal officers and employees to enter into contracts in which both their personal financial interests and their public powers and duties conflict.[4] We found that a former Board member was a general partner of a commercial real estate company that received a $40,000 business loan from the Village's revolving loan program to remodel a building. The loan was made pursuant to an agreement with the Village, and, therefore, a contract for purposes of article 18. The interest rate was consistent with that of loans for similar amounts that the Board granted to other businesses. However, as a general partner in the real estate company, the former Board member has an interest in the contract. Because the Board was responsible for approving the loan agreement, the former Board member had at least one of the powers and duties that could give rise to a prohibited interest in a contract. Therefore, because none of the statutory exceptions apply in this instance,[5] it appears that the former Board member had a prohibited interest in the contract.

<u>Collection and Monitoring Procedures</u> — Appropriate and adequate collection and monitoring activities are required to ensure that loans are repaid according to the loan agreements, and for enforcing the collection of any loan that becomes delinquent. It is important that the Board develop and adopt policies that outline these monitoring activities, which should include guidance on the collection timeframe, the appropriate tone for collection letters as loans move through the progressive stages of delinquency, and additional enforcement actions to be used as loans become increasingly delinquent. It is essential that such policies also require that the Board receive periodic reports about

[4] Unless a statutory exception applies, the GML prohibits municipal officers and employees from having an interest in contracts with the municipality for which they serve when they also have the power or duty – either individually or as a board member – to negotiate, prepare, authorize, or approve the contract; to authorize or approve payment under the contract; to audit bills or claims under the contract; or to appoint an officer or employee with any of those powers or duties. For this purpose, a "contract" includes any claim, account, demand against or agreement with a municipality, express or implied. Municipal officers and employees have an interest in a contract when they receive a direct or indirect pecuniary (monetary) or material benefit as a result of a contract. Municipal officers and employees are also deemed to have an interest in the contracts of: their spouse, minor children and dependents (except employment contracts with the municipality); a firm partnership or association of which they are a member or employee; and a corporation of which they are an officer, director or employee, or directly or indirectly own or control any stock.

[5] We were informed that the former Board member abstained from voting when the Village approved the loan; however, there is no statutory exception for abstaining from voting on a contract (see, Ops St Comp No. 2000-7).

all outstanding loans, including the number and status of delinquent loans.

However, the Village did not have any written monitoring and collection procedures to ensure that loans were repaid. We found that Village officials sent delinquency letters with the appropriate tone for collection communications, but they did not enforce any other collection activities as delinquencies persisted. Further, the Board did not receive periodic reports about the status of loans. Therefore, the Board had no assurance that loans were repaid in accordance with loan agreements. We found that 15 of 24 active loans with outstanding principal balances totaling approximately $212,000 were from two to 96 months delinquent as of June 30, 2011; $91,000 of anticipated loan repayments remained uncollected as of July 31, 2011.

In addition, while loan agreements between the Village and the respective borrowers stipulated penalties for late payment, the Board never assessed any late payment penalties, even though 63 percent of outstanding loans were delinquent as of June 30, 2011. The loan to the former Board member's business was included among these delinquencies; as of June 1, 2011, the last payment on this loan occurred on May 24, 2009.

<u>Disbursement of Loan Money</u> — It is the Board's responsibility to segregate critical duties so that one person does not have the ability to authorize, record, and have custody of receipts or payments or mitigate the risk of conflicting duties. We found that the Clerk-Treasurer could perform most aspects of disbursing loan proceeds to borrowers. The Board established a dual signature requirement for all loan disbursement checks to authorize payment. However, the Clerk-Treasurer had the ability to sign these checks and apply the Mayor's facsimile signature using a rubber stamp, which circumvented the mitigating control represented by the dual signature requirement. The Clerk-Treasurer also had the ability to transfer money within the loan bank accounts and was responsible for reconciling the loan bank accounts. When one person can perform all these functions, there is increased risk that funds could be misused without detection.

Recommendations

1. Village officials should develop and implement comprehensive lending procedures that, at a minimum:

   - help identify potential conflicts of interest

   - require a thorough credit history review, including an analysis of the applicant's ability to repay the money borrowed

   - require collateral verification.

2. Village officials should establish collection enforcement and monitoring procedures to help ensure that all money lent is repaid in accordance with the loan agreements.

3. Village officials should ensure that late payment penalties are enforced on all delinquent loan accounts.

4. The Mayor should cosign loan checks, in accordance with Board requirements, and control the use of his signature stamp.

APPENDIX A

RESPONSE FROM LOCAL OFFICIALS

The local officials' response to this audit can be found on the following page.

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MICHELE WOOD
Clerk/Treasurer

BETTY J. KEENE
Attorney

March 16, 2012

Office of the State Comptroller
44 Hawley Street, Room 1702
Binghamton, NY 13901

Dear OSC,

We have reviewed the State Comptroller's audit for the Village of Waverly regarding our business and housing rehab loan programs.

There are no comments regarding this audit.

Sincerely,

Michele Wood

Michele Wood
Clerk Treasurer

APPENDIX B

AUDIT METHODOLOGY AND STANDARDS

To accomplish our objective, we interviewed appropriate Village officials and employees, tested selected records and transactions, and examined pertinent documents for the period June 1, 2009 through July 13, 2011. We expanded our scope period through July 31, 2011 to determine the amount of uncollected loan payments. Our examination included the following:

- We interviewed Village officials to obtain an understanding of the internal controls over the revolving loan programs processes and to assess whether those controls were working properly.

- We reviewed the Board minutes for all the loans approved by the Board during our scope period. We compared all the approved loan amounts to the disbursements on the bank statements to determine if each approved loan matched a disbursement and to determine whether there were any loans disbursed to loan applicants not approved by the Board.

- We identified the names of current and former property owners, from a list of all outstanding loans. We compared these names to a list of Village official to determine whether any Village official benefited from the sale of the property or the issuance of the loan.

- We reviewed all bank transfers made by the Clerk-Treasurer to the loan accounts during the audit period to determine if there were any inappropriate transfers.

- We traced all 23 loan repayments made during the month of November 2010 totaling $3,261 to the individual mortgage schedule, deposit slip, cash receipt book and bank statement to determine if the loan balances were manipulated.

- We traced five loan payments totaling $1,677, made during the month of November 2011, to the cash receipt book, deposit slip and bank statement to determine whether the Clerk-Treasurer was depositing all loan payments collected.

- We calculated the interest and penalties the Village could have charged and collected on loans delinquent as of June 30, 2011.

- We calculated the total amount of loan payment and interest the Village collected and compared the amount collected to the amount that the Village should have collected if all loan payments were made on time.

- We mailed confirmation letters to 10 individuals to determine whether the balance per the individual mortgage schedule was reported correctly. We selected all delinquent rehabilitation loans, all business loans issued during the scope period and any other loan for which a payment was made during the scope period, to determine whether the Clerk-Treasurer inappropriately adjusted individual loan balances.

- We calculated the level of delinquency on each loan and compared the level of delinquency to the collateral used to secure the loan, and the Village's position on the collateral used to secure the loan.

- We reviewed Board minutes and inquired from Village officials whether the former Board member and/or the Board discussed and disclosed any information regarding a possible conflict of interest between a former board member and the Village.

- We interviewed a bank official to determine how a credit history review is conducted by the bank on each applicant, to determine whether the credit history review performed by the bank was comprehensive.

- We reviewed loan application files for all 24 revolving loans, to determine whether each applicant submitted all the required documentation as stipulated in the loan application.

- We reviewed all liens filed on the 24 active loans, to determine whether a lien existed and or whether the Village is in first or second in position on each lien.

We conducted this performance audit in accordance with generally accepted government auditing standards (GAGAS). 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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

APPENDIX C

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