CITY of SPRINGFIELD

Internal Audit Report

Small Business Development Loan Program - Approval Process

February 2012

2012-08 - Special

Small Business Development Loan Program – Approval Process
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CITY of SPRINGFIELD

February 2, 2012

Honorable Mayor and Members of the City Council:

I am pleased to present the attached internal audit report which reviews loan approval procedures used by the Loan Committee for the Small Business Development Loan Program. The purpose of the audit was to ensure loan approval procedures were followed in connection with the loan issued to Mr. Travis Dibben and to evaluate the effectiveness of the loan approval procedures for the Small Business Development Loan Program.

A draft for discussion was provided to the Loan Committee and the City Manager's Office prior to the release. The Loan Committee was very responsive to the recommendations.

The accompanying Background and Statistical section of the audit report is presented for informational purposes. This information was obtained from the Loan Committee and was not subjected to the procedures applied in the audit of the loan approval process.

I would like to thank the Loan Committee for their full cooperation and assistance provided during this audit.

Respectfully submitted,

K Bork

Kristy Bork, CPA
Internal Auditor
City of Springfield

Attachment

cc: Greg Burris, City Manager
Fred Marty, Deputy City Manager
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Authorization

The Internal Audit Department has conducted an audit of the loan approval procedures used to approve loans under the Small Business Development Loan Program. The audit was conducted under the authority of Chapter 2, Section 15 of the Springfield City Charter and in accordance with a special directive from the Finance and Administration Committee of City Council.

Audit Objectives Scope and Rating

This audit was performed in accordance with *Generally Accepted Government Auditing Standards,* which included tests of the controls and records, and other audit procedures that the Auditor considered necessary under the circumstances. The following discussions and conclusions are based on the existing internal controls as of the date of this report. Opinions and conclusions could change as a result of changes to existing internal controls or changes in the applicable laws and regulations. This audit covered the year ending October 31, 2011, although the Auditor examined certain events and transactions occurring before and after that period.

The specific audit objectives and ratings of each objective are noted in the following table. The overall results of the audit indicate that the control environment of the Small Business Development Loan program is yellow. The rating definitions are included in *Appendix A* of this report.

	Objective Ratings		
Audit Objectives			
OBJECTIVE #1 - Ensure loan approval procedures were followed in connection with the loan issued to Travis Dibben Enterprises, LLC.		X	
OBJECTIVE #2 - Evaluate the effectiveness of the loan approval procedures on the small business development loans, to ensure that the risk of loan loss is properly mitigated.	X	X	

Overall Conclusion

As a result of audit inquiries, examinations, and tests, and testing of the City's loan losses, the Auditor concluded that the Loan Committee, based on loan loss rates, has a history of prudent lending. Additionally, all small business loan applications tested followed all policies and procedures that were in place as of October 31, 2011.

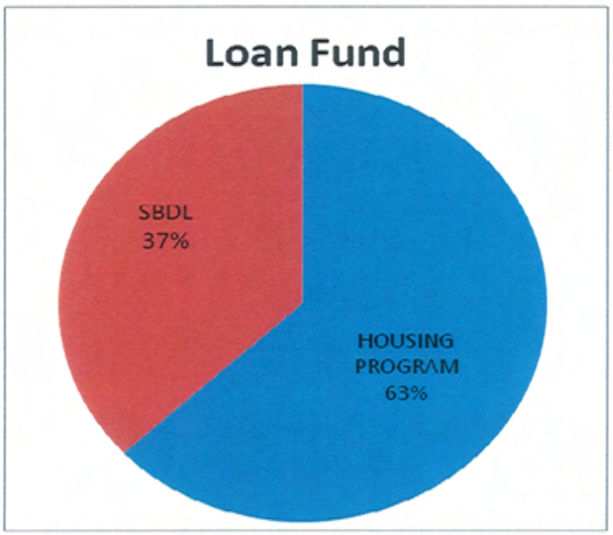
However, additional information regarding Mr. Dibben's loan should have been obtained prior to the Loan Committee reviewing and voting on his loan application. Going forward, the Loan Committee should evaluate the make-up and voting rights of the Loan Committee, and review the loan documents and security agreements.

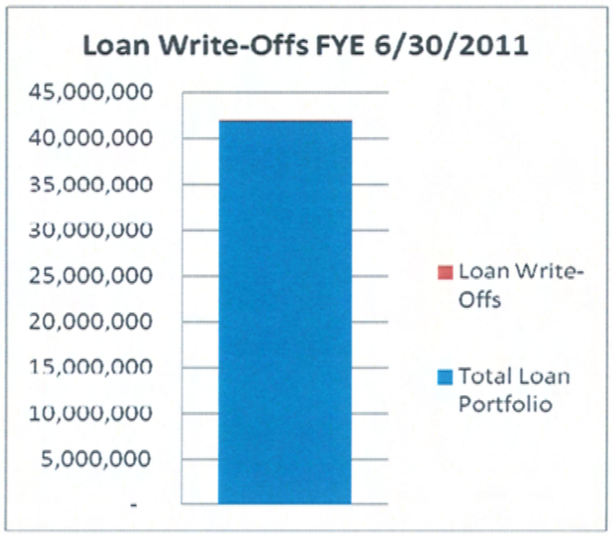
Background

The City of Springfield's Small Business Development Loan (SBDL) Program is designed to provide financial assistance for small businesses and nonprofit organizations to expand employment opportunities, stimulate private investment, and eliminate slum and blight conditions in selected areas of the community. City Council established the Small Business Development Loan Program in 1984. The Program is funded through the federal Community Development Block Grant (CDBG) program and through loan repayments.

Most communities use their CDBG allocation as pass-through grants and zero out their funds annually. However, the City of Springfield decided to hold businesses and homeowners responsible for the federal HUD programs and has built a large loan portfolio. The loan portfolio generates approximately $2 million in annual program income (roughly $1 million in Small Business Development Loan Program and $1 million in Comprehensive Housing Assistance Program), and the use of CDBG funds for a revolving loan fund has been approved by the U.S. Department of Housing and Urban Development.

Over the past 27 years, the City has made 200 loans of approximately $25,800,000 from the Small Business Development Loan Program. As of June 30, 2011, the total loan portfolio for all HUD programs was approximately $41,900,000. Of that amount, approximately $28,000 was considered bad debt for 2010-2011. There were no write-offs in the Small Business Development Loan Program in 2010-2011.

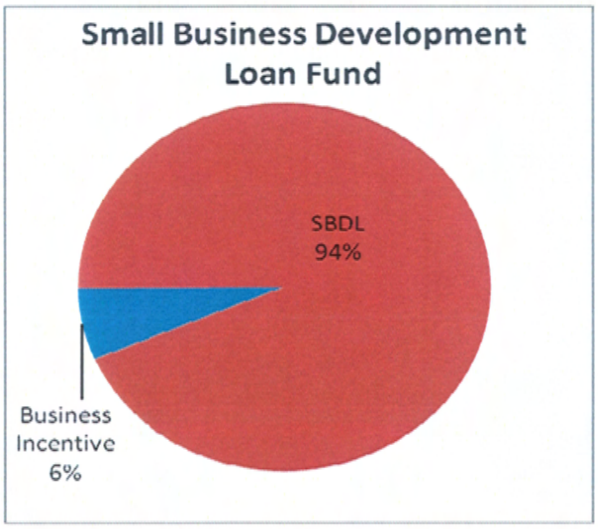


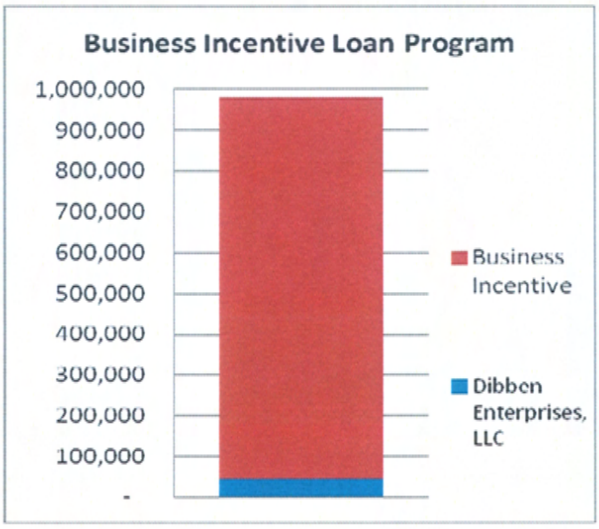


The City's Microenterprise/Business Incentive Loan Program was approved as a pilot program by City Council in 2008 and became a permanent program in 2009. Eligible applicants include new or expanding businesses within the loan boundaries, and have five or fewer employees at the time of application. The maximum loan amount is normally $25,000 to eligible businesses creating one job. However, the Loan Committee may consider providing additional financing if the business has plans to create at least one job per $10,000 in additional financing.

Eligible activities include working capital, inventory, equipment, furniture and fixtures, and other start-up costs. Each loan must be secured by appropriate collateral as determined by the Loan Committee,

including personal guarantees. Bank participation is recommended for leveraging, but it is not required. Applicants are required to submit a business plan with their application and attend business education classes sponsored by the City and the Urban Districts Alliance. Since the inception of the program in 2008, thirty-two (32) Business Incentive Loans have been approved by the Loan Committee for a total of $979,230.





In July 2011, Mr. Travis Dibben, sole owner of Travis Dibben Enterprises, LLC, applied for a Microenterprise/Business Incentive Loan. The Loan Committee awarded Mr. Dibben $95,000 to open and operate the Nine of Clubs, a comedy club. The Loan Officer processing Mr. Dibben's application had reviewed Mr. Dibben's previous criminal background on Missouri Case.net, which showed Mr. Dibben had previous legal issues and was on probation at the time of the loan application. Mr. Dibben's criminal history was discussed within the Loan Committee, and the loan was approved in August 2011.

Concurrently, while applying for the above loan, Mr. Dibben also applied for a liquor license. The City's Licensing Division provides a letter the applicant must send to the State Department of Liquor Control, as the State issues the liquor license. Licensing provides this letter to the applicant after Licensing reviews the applicant's business location to ensure the business location is properly zoned. The City's Licensing Division issued a letter on August 8, 2011, titled "Letter of Approval" which approved the business premises/zoning. Mr. Dibben did not immediately apply for a liquor license, and the letter from licensing was void after 30 days. Two identical letters were issued, one on September 7, 2011, and one on October 12, 2011.

The State Department of Liquor Control runs and reviews a background check on each applicant. The Department of Liquor Control has the authority to deny a liquor license based on an applicant's background. The Department of Liquor Control will not approve an applicant if they are first denied at the local level.

In late October, Licensing was notified by a police officer that pending charges would soon be filed against Mr. Dibben. The Director of Finance, after reviewing his previous criminal history, decided to

deny him a liquor license based on his moral character. This prohibited Mr. Dibben from applying to the State to obtain a liquor license.

Audit Objective Analysis and Opportunity for Improvement

Objective 1: Ensure loan approval procedures were followed in connection with the loan issued to Travis Dibben Enterprises LLC.

To test the above-stated objective, the Auditor performed the following tests: interviewing management and staff, observing Loan Committee procedures, reviewing loan approval procedures, and reviewing the loan documentation specific to the loan approved for Travis Dibben Enterprises, LLC. Based on these tests, the Auditor has concluded that all documented loan procedures were followed. However, additional procedures and documentation should have been obtained in this instance due to the nature of the applicant's background.

The Auditor identified the following opportunities for improvement of the above-stated objectives that would be considered deficiencies in internal controls specific to the approval of the Travis Dibben Enterprises, LLC, loan.

Opportunities for Improvement (OFI)

a. The loan application process, at the time Mr. Dibben applied for a business incentive loan, only required the Loan Officer to check Missouri Case.net for criminal background if there were "red flags" on the applicant's credit report. The Loan Committee should develop policies and procedures to strengthen background checks on applicants, including but not limited to, adding questions on the loan application about applicants' previous criminal background and formalizing how, when, and to what extent background checks are completed.

b. Based on records reviewed in Mr. Dibben's loan file, the Loan Officer reviewing his loan ran Missouri Case.net and noted numerous cases, charges, and a guilty plea for which Mr. Dibben was granted a suspended imposition of sentence and was on probation at the time of the application. The Loan Committee approved the loan without reviewing Mr. Dibben's terms of probation to ensure he could operate his business in accordance with his business plan. When the applicant is known to be on probation, the Loan Officer and Committee should review the applicant's terms of probation prior to approving the loan.

c. Mr. Dibben disclosed on his loan application certain financial information regarding owner capital and liabilities, and the Loan Officer requested additional documentation to verify Mr. Dibben's financial information. However, certain items were not properly followed up to ensure the owner capital going into the project was legitimate and properly valued.

   Additionally, the Loan Officer was aware that Mr. Dibben was paying restitution based on review of his credit report and Missouri Case.net, but the restitution outstanding was not listed as an outstanding liability on Mr. Dibben's personal financial statement. Loan Officers should properly verify and follow-up on personal financial information, especially when the Loan Officer is aware of missing information.

d. The Loan Officer and Loan Committee relied on the letter from Licensing, addressed to the State Department of Liquor Control, in which licensing approved the premise for the sale of alcohol. The heading of the letter is noted as "Letter of Approval" which misled the Loan Committee into thinking the liquor license was approved. However, in the body of the letter, it clearly notes the letter is approving the premise, not the applicant, see exert below:

> "The application has been approved for the premises described above and a license will be issued to the applicant upon receipt of any communication of approval from the officer of the State Supervisor of Liquor Control."

In the future, when loan applicants are being screened, and the business is reliant upon a liquor license, the Loan Officer and Licensing should clearly communicate all background information and decisions to one another.

Objective 2: Evaluate the effectiveness of the loan approval procedures on the small business development loans to ensure that the risk of loan loss is properly mitigated.

To test the above-stated objective, the Auditor performed the following tests: interviewing management and staff, observing loan committee procedures, reviewing loan approval procedures, and testing a sample of Small Business Development Loan applications to ensure all procedures documented by management were performed.

Based on these tests, the Auditor has concluded that all documented loan procedures were followed; however, additional procedures and documentation should be obtained going forward. The Auditor identified the following opportunities for improvement of the above-stated objective that would be considered deficiencies in internal controls over the approval of small business development loans.

Opportunities for Improvement (OFI)

a. The Loan Officers work directly with loan applicants and are also voting members of the Loan Committee. Loan Officers become very involved in the loan application process. Allowing them to vote on approval could give the appearance that the Loan Officers are not as objective when approving loans. City Management and the Loan Committee should review the make-up of the Loan Committee and determine if changes to the Loan Committee make-up would provide additional controls over the risk of lending funds.

b. As part of the audit testing, the Internal Auditor and Loan Committee sat down with a panel of five loan officers from banks within the City and discussed our procedures. The panel seemed complimentary of our procedures and provided insight on their processes. Based on the panel discussion, the Loan Committee should consider implementing a formal process of reviewing loan file documentation. Although this would not prevent issuing a loan that would be considered inappropriate, it would provide a safe guard that the loan application processes are being completed as documented.

c. Over the years, the Loan Committee, with assistance from legal counsel, has made minor changes to the loan documents and security agreements. The Loan Committee should formally

adopt rules on how often the formalized loan applications and documents are reviewed by legal counsel.

Management's Response to Findings

The following responses were provided by the Loan Committee:

Objective 1:

a. "Character" is one of the five "C's" of lending and the Loan Committee has recommitted a broad analysis of applicant character. The Loan Committee has developed a Criminal Background Disclosure Form that all applicants must complete. We also met with the Springfield Police Department to ascertain what level of information they can provide regarding criminal activity of loan applicants. Obviously, the Police Department cannot disclose undercover operations or any information that might jeopardize ongoing investigations or officer safety. We will continue to access Missouri Case.net for criminal history and are considering purchasing access rights to Accurint, a national database that includes information on assets, judgments, liens, criminal background and activity.

b. We concur and have adopted a new policy that indicates any applicant currently on probation must provide a copy of the conditions of his probation. This must be attached to the new Criminal Background Disclosure form at the time the application is submitted.

c. Mr. Dibben indicated that part of his owner capital was sound and lighting equipment purchased from a former nightclub, Club Intensity, and indicated the value set by the seller. One alternative to accepting the seller's value would have been to have the equipment independently appraised. The Loan Committee did not recommend this given the fact the Business Incentive Loan Program does not require matching funds and, in fact, the originating funder, U.S. Department of Housing and Urban Development (HUD), indicates that the program could be structured as an outright grant. In addition to the collateral already noted, staff did require that Mr. Dibben obtain a co-signor for the loan. We typically do not require this for Business Incentive Loans. In addition to the equipment provided as collateral, Mr. Dibben also indicated that he had funds in a bank account. Staff recognizes that we should have requested a copy of his bank statement to verify this. Staff also would like to point out that the City's investment in the Dibben project leveraged a significant amount of private investment.

Property owner Scott Tillman was privately funding approximately $350,000 in infill for the project and a national franchise, Steak-Out, had signed a lease to occupy a portion of the space and to provide food service for the club.

Staff acknowledges that we should have requested a copy of the conditions of probation. Had we done so, we would have known that there was court-ordered restitution and would have required any outstanding balance on the restitution be listed as a liability on the personal financial statements.

d. The Licensing letter can be parsed a number of ways. The Loan Committee relied on two phrases – "the application has been approved for the premises" AND "a license will be issued to the applicant" as indicating that the City had approved the premises and the applicant.

Obviously, the letter could be better written. It is our understanding that it is currently being rewritten to be clearer about the City's approval. Staff will make direct contact with Licensing regarding liquor licenses for pending Small Business applications, however, many times the applicant will not apply for liquor or business licenses until he is almost ready to open his business.

Objective 2:

a. There are four voting members on the Loan Committee - the two Loan Officers, the Neighborhood Conservation Manager and the Economic Development Director. In addition, there are several staff members who attend as advisors and make significant contributions in analyzing applications– a City Attorney, Development Economist, Loan Document Technician, and Financial Analyst. The Loan Officers consistently present the positive and negative aspects of the projects and applicants for the Loan Committee's review. A majority of the Loan Committee must vote to proceed with a loan, so the individual Loan Officer has limited influence on the outcome of the vote.

The meeting with local bankers provided interesting insight into the private banking industry. Some of the bankers indicated that their loan officers can vote on their own loans, while others noted that the loan officers abstain on their loans. Most private bank loan officers have some of their business goals and/or compensation tied to loan production, which certainly gives rise to conflict of interest. The City's Loan Officers, however, are not compensated based on loans closed. They are not commissioned sales staff, so the inherent conflict of interest is not present in them voting on their proposals. As noted above, they are one of four votes on the Loan Committee. Also, several of the private bankers indicated that their loan officers have the authority to make loans without loan committee approval – some of them have as high as $250,000 lending authority (note that they considered this a "small" loan). The City's Loan Officers do not have individual lending authority. All loans must be approved by the Loan Committee.

b. The private bankers indicated that most banks have separate departments or personnel who review loan documentation prior to closing and another "set of eyes" that review loan documentation post-closing. This type of oversight is certainly a good idea, but one that would require additional staff in order to provide independent review of 100% of all loan files. Currently, staff uses a checklist to make sure all appropriate documentation is included in the file. The file and checklist are then routed to the Loan Technician so that she can prepare closing documents. Random samples of loan files are reviewed on a periodic basis by HUD and, when selected for review, through the City's annual external audit. Very few problems have been identified during these random sample reviews. Should a decision be made to allocate staff to reviewing loan documentation, the position could be funded out of CDBG as project delivery, but it would reduce the amount of funds available for actual projects to benefit the community. Federal funding for CDBG and HOME continues to decrease and this would further limit our ability to address priority projects.

c. At their December 8, 2011 meeting, the Loan Committee discussed adopting a policy that a comprehensive review of all documents be completed by July 1, 2012 and that recurring comprehensive document reviews will occur every three years. The Loan Committee voted January 5, 2012 to schedule comprehensive document reviews every five years based on the volume of documents needing review.

APPENDIX A – AUDIT RATING SYSTEM

Red – An overall unsatisfactory or unacceptable state of control. The Red level of control denotes significant business risk or exposure to the City that requires immediate attention and remediation efforts. The overall control environment does not provide reasonable assurance regarding the safeguarding of assets, reliability of financial records, and compliance with City policies and/or government laws and regulations.

Yellow – A state in which the controls in place need improvement. If these controls are not improved, this could lead to an overall unsatisfactory or unacceptable state of control.

Green – An overall satisfactory or acceptable state of control, where risk is minimized and managed. The overall environment provides a high degree of assurance regarding the safeguarding of assets, reliability of financial records, and compliance with City policies and government laws and regulations. Control weaknesses noted, if any, are relatively minor.