AUDIT REPORT

LOS ANGELES COMMUNITY DEVELOPMENT BANK –
ECONOMIC DEVELOPMENT INITIATIVE GRANT/
SECTION 108 LOAN GUARANTEE PROGRAM
CITY OF LOS ANGELES
COUNTY OF LOS ANGELES

LOS ANGELES, CALIFORNIA

2002-SF-1003

SEPTEMBER 25, 2002

OFFICE OF AUDIT, REGION 9
SAN FRANCISCO, CALIFORNIA

Issue Date	September 25, 2002
Audit Case Number	2002-SF-1003

TO: Roy A. Bernardi
Assistant Secretary for Community Planning and Development, D

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FROM: Mimi Y. Lee
Regional Inspector General for Audit, 9AGA

SUBJECT: Los Angeles Community Development Bank - Economic Development Initiative Grant/Section 108 Loan Guarantee Program
City of Los Angeles, County of Los Angeles
Los Angeles, California

Pursuant to a Congressional request, we performed an audit of the Los Angeles Community Development Bank's (LACDB) Economic Development Initiative (EDI) Grant/Section 108 Loan Guarantee Program. Our audit was to determine whether allegations of mismanagement of LACDB's operations contained in a citizen's complaint prompting the Congressional request, as well as allegations of improper use of funds contained in another citizen's complaint, had merit. Specifically, we assessed LACDB's compliance with Department of Housing and Urban Development (HUD) and EDI Agreements' requirements and reviewed LACDB's policies, procedures, and practices for administering and using EDI Grant and Section 108 Loan Guarantee Program funds. The audit report contains three findings. We are providing a copy of this report to LACDB, the City, and the County of Los Angeles.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days, please furnish us, for each recommendation without management decisions, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why corrective action is considered unnecessary. Additional status reports are required at 90 days and 120 days after report issuance for each recommendation without a management decision. Also, please furnish us with copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact me at (415) 436-8101, or Ruben Velasco, Assistant Regional Inspector General for Audit, at (213) 894-8016.

Executive Summary

Pursuant to a Congressional request, we performed an audit of the Los Angeles Community Development Bank's (LACDB) Economic Development Initiative (EDI)/Section 108 Loan Guarantee Program. Our audit was to determine whether allegations of mismanagement of LACDB's operations contained in a citizen's complaint prompting the Congressional request, as well as allegations of improper use of funds contained in another citizen's complaint, had merit. Specifically, we assessed LACDB's compliance with Housing and Urban Development (HUD) regulations and EDI Agreements' requirements and reviewed LACDB's policies, procedures, and practices for administering and using EDI and Section 108 Loan Guarantee Program funds.

We found the allegations were partially correct. LACDB had not fully complied with HUD regulations and EDI Agreements' requirements. Specifically, LACDB:

- ✓ **Assisted 101 businesses that had not met the national objective standard of 51% of creating or retaining jobs for low- and moderate-income persons. Similarly, LACDB had not met the EDI Agreements' requirement of creating jobs predominantly for Empowerment Zone (EZ) target area residents;**

- ✓ **Provided City-funded loans or investments to businesses located outside the EZ target area in excess of the 25 percent funding limit; and**

- ✓ **Invested over $26 million of City-funded venture capital businesses that provided minimal benefit to EZ target area residents.**

LACDB also did not exercise prudent business practices and incurred unreasonable and unnecessary expenses in administering its program activities.

HUD And EDI Requirements Not Met

As of December 31, 2001, LACDB approved loans and investments that had not met HUD and EDI Agreements' requirements. Of the 150 businesses receiving $126,962,282 in assistance, LACDB approved $69,028,264 in loans and investments to 101 businesses that had not met the national objective standard of 51% of creating jobs for low- and moderate-income persons. Specifically, the 101 businesses assisted by LACDB only created 149 of 1,357 (11 percent) jobs for low- and moderate-income persons. In addition, LACDB spent over $21 million of City-funded loans and investments to businesses located outside the EZ target area in excess of the 25 percent funding limit.

These deficiencies occurred because LACDB had insufficient or did not follow established monitoring controls needed to ensure borrowers' compliance with job creation requirements. In addition, LACDB may have misunderstood the extent of its responsibility in assuring job creation requirements were being met. The lack of a control system to track the amount of loans and investments being approved caused LACDB to over spend outside the EZ target area. Consequently, funds earmarked principally for economic revitalization activities within the EZ target area were neither fully used in accordance with the terms and conditions under which the funds were approved nor met the national objective criterion of low- and moderate-income benefit.

Investments In The Venture Capital Program Did Not Benefit EZ Target Area Residents

LACDB invested $26.1 million of City-funded venture capital businesses and incurred related management fees of $2.6 million that provided minimal benefit to EZ target area residents. Contrary to HUD requirements and the security purchase agreements, 12 of 14 businesses did not relocate into the EZ target area and did not create jobs predominantly benefitting EZ target area residents. In fact, only 32 of 505 jobs created by these 12 businesses went to low- and moderate-income persons and only four of those were EZ target area residents. Based on our review, we concluded the financial viability of these investments was questionable to assure the required benefit would materialize because of the risky nature of early stage venture capital investments.

The deficiencies occurred because LACDB did not perform sufficient due diligence to include an evaluation of whether borrowers could reasonably hire EZ target area residents considering their job knowledge, skills, and expertise versus job eligibility requirements. As a result, LACDB's investments into the venture capital program did not provide the expected program benefits to the intended beneficiaries, thus, hampered its efforts to accomplish its mission of revitalizing the EZ target area. Therefore, in our view, the $28.7 million in venture capital investments and management fees could be considered a questionable use of HUD funds.

LACDB Spent Over $135,000 For Unreasonable And Unnecessary Expenditures

Cost principles applicable for non-profit organizations state in order for costs to be eligible, they must be reasonable, ordinary, and necessary for the operation of the organization or performance of the award. Contrary to these principles, LACDB paid: (1) $12,229 for meals and other items paid with LACDB credit cards or reimbursed to LACDB employees that were unnecessary LACDB expenses; (2) $32,421 in unnecessary staff bonuses and pay raises, contrary to LACDB's normal personnel practices; and (3) $90,500 in micro loan origination intermediary fees we considered to be unreasonably high. We attributed these deficiencies to LACDB's lack of familiarity with cost principles applicable to units of local government and non-profit entities. As a result, these expenditures prevented LACDB to further carry out other eligible activities.

LACDB May Not Have Sufficient Time Left To Accomplish Its Goals

Since its inception in 1996, LACDB had already spent or committed almost one-half of the $435 million in HUD funding. While the remaining $200 million in the City's Section 108 Loan Guarantees is still unused, this amount is not specifically earmarked for use within the EZ target area. Therefore, with just under three years remaining in its CDB agreement with the City and the County of Los Angeles, LACDB may not have enough time or grant funds to fully accomplish its primary mission to provide a positive investment environment and create/retain sustainable jobs for residents and others within the EZ.

Recommendations

We are recommending HUD to (1) require the City and the County of Los Angeles to ensure LACDB establish and implement, or follow monitoring controls and procedures to ensure businesses' compliance with job creation or retention requirements, (2) determine what action or adjustments to LACDB's existing policies, procedures, and practices should be taken to ensure the required level of employment of low- and moderate-income persons will be met, (3) instruct the City of Los Angeles to require LACDB to discontinue making venture capital program investments, and (4) take appropriate action pursuant to the provisions of 24 CFR, Section 570.910, to the extent assisted businesses are unable to meet the national objective standard of 51% for creating or retaining jobs for low- and moderate-income persons.

Audit Results Discussed With Auditee

We discussed the findings with LACDB, the City of Los Angeles, and the County of Los Angeles officials and staff during the audit and at an exit conference held on March 12, 2002. We also provided LACDB, the City, the County, and HUD with a copy of the draft audit report for comments on August 27, 2002. We received their written responses on September 13 and 16, 2002. Their responses and our evaluations are discussed in the findings and the full text of their responses is included as Appendix E.

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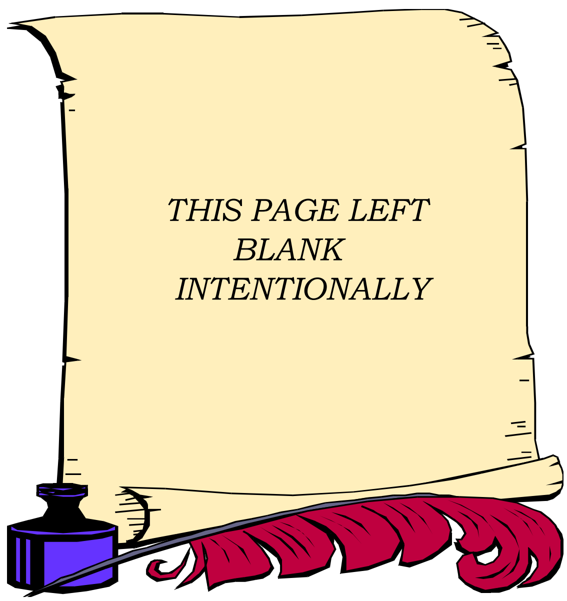
Appendices

Abbreviations

CDB	**Community Development Bank**
CDBG	**Community Development Block Grant**
CFR	**Code of Federal Regulations**
EDI	**Economic Development Initiative**
EZ	**Empowerment Zone**
HUD	**Department of Housing and Urban Development**
LACDB	**Los Angeles Community Development Bank**
NOFA	**Notice of Funds Availability**
RFP	**Request for Proposal**
OMB	**Office of Management and Budget**
OIG	**Office of Inspector General**
VP	**Vice President**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Introduction

Background

The President signed the Economic Development Initiative into law on April 11, 1994. It allows localities to carry out economic development activities where public and private dollars can be leveraged to create jobs and other benefits especially for low- and moderate-income persons. Originally, HUD did not designate Los Angeles as one of six Empowerment Zones in 1994. In January 1995, the City of Los Angeles and the County of Los Angeles were awarded a Supplemental Empowerment Zone. HUD upgraded Los Angeles to full empowerment zone status on January 30, 1998, but the designation did not become effective until January 1, 2000.

Geographically, the zone encompasses a 19-square mile area made up of 36 low-income census tracts in the City of Los Angeles that include sections of Central, South Central, and East Los Angeles, as well as Pacoima and five census tracts in the unincorporated county communities of Willowbrook and Florence/Firestone. The zone designation made the City and the County eligible for special economic development funding through HUD to create and capitalize a unique community development bank called LACDB.

EZ Program Funded By Section 108, Economic Development Initiative Grant, And CDBG Entitlement Program

HUD's funding for LACDB includes Section 108 Loan Guarantees, EDI Grants, and Community Development Block Grant (CDBG) entitlement funds. Under the Section 108 program, units of general local government pledge future years' CDBG allocations as security for loans guaranteed by HUD. The full faith and credit of the United States is pledged to the payment of all guarantees made under Section 108. In the event a Section 108 funded activity fails to generate sufficient funds to repay the Section 108 loan and there are insufficient EDI grant funds or other assets available to be used to make the payment, a community would be required to use its CDBG funds to make the loan payment. EDI grants minimize the potential loss of future CDBG allocations by either providing a loan loss reserve, lowering the cost of borrowing under Section 108, or providing other credit and economic enhancements that reduce the risk the pledged annual CDBG allocation would be required to fund repayment shortfalls.

HUD Initially Funded The Los Angeles "Supplemental Empowerment Zone" With $250 Million

Pursuant to the December 1994 Notice of Fund Availability (NOFA), HUD approved $250 million in EDI and Section 108 funds for the Los Angeles "Supplemental Empowerment Zone" target area, the same area originally nominated in the initial Los Angeles Empowerment Zone application:

Funding Type	Amount (in millions)
City EDI Grant	$100
City Section 108 Loan Guarantee	$100
County EDI Grant	$ 25
County Section 108 Loan Guarantee	$ 25
Total	$250

The City of Los Angeles and the County of Los Angeles were required to spend at least 75 percent of their EDI grant funds and an equal amount of matching Section 108 funds in the target area. The City received an additional $200 million in Section 108 Loan Guarantees to be used in any eligible area of the City, that were not linked as matching funds for the EDI grants. The City also appropriated $5 million of its CDBG entitlement for administrative costs. The County chose to withhold an additional $20 million, $10 million in EDI Grant funds, and $10 million in Section 108 Loan Guarantees, which the County can use in any eligible area within the County's five designated target area census tracts. In total, HUD funding amounted to $455 million, of which $435 million was used to fund LACDB. The other $20 million was not restricted to LACDB program activities.

LACDB Is A California Nonprofit Entity Formed In 1995

LACDB was incorporated on June 19, 1995, as a California nonprofit organization within the meaning of Section 501(c)(3) of the Internal Revenue Code. LACDB is organizationally independent from the City and the County of Los Angeles. A 15-member Board of Directors governs the LACDB. The Board is comprised of a diverse group of business and community leaders with experience in community development activities.

Mission Of The Bank

The mission of LACDB is to promote a positive investment environment and create/retain sustainable jobs for residents and others within the Empowerment Zone. The purpose of HUD's funding was to provide the resources to the City and the County of Los Angeles to revitalize the Empowerment Zone target area through LACDB.

The City And The County Are Responsible For LACDB's Program Compliance

According to the EDI Agreements between HUD and the City and the County of Los Angeles as "recipients" of the EDI Grants and matching Section 108 Loan Guarantees, the "recipients" agreed to carry out the "Approved Project", LACDB, on a timely basis and otherwise in compliance with their agreements including the Act, the NOFA, regulations, and approved application. The "recipients" also agreed to assure, and to accept responsibility for compliance by any other entities to which they make grant funds available for, or which they otherwise allow to participate in, LACDB. The Agreements further stated the "recipient" requested and HUD agreed the Community Development Bank be authorized to assume responsibility for ensuring the EDI Grant and Section 108 Loan Guarantee program requirements are met.

Volume Of Loans And Investments Closed

From June 1996 through December 2001, LACDB closed 248 loans and investments totaling $126,962,282. LACDB funded $27,705,603 from EDI and $99,256,679 of Section 108 funds as follows:

Year Closed	No. Of Loans	Total	EDI	Section 108
1996	5	$ 1,987,813	$ 10,619	$ 1,977,194
1997	49	17,117,271	1,993,059	15,124,212
1998	51	37,126,793	3,937,629	33,189,164
1999	83	52,902,157	14,528,589	38,373,568
2000	47	14,137,507	5,117,330	9,020,177
2001	13	3,690,741	2,118,377	1,572,364
Total	248	$126,962,282	$27,705,603	$99,256,679

Status Of Loans And Investments

The status of LACDB's loans and investments, as of December 31, 2001, are shown below:

Category	Amount	Percent of Total
Balance-Loan	$20,736,557	16
Balance-Investments	$23,688,591	19
Write-Offs	$41,715,957	33
Repayments	$40,821,177	32
Total	$126,962,282	100

Additional Losses May Be More Likely to Occur

Of the 150 businesses that received over $126.9 million in loans and investments, 51 of these businesses with loan balances of $41.7 million have been written off. LACDB has received $40.8 million in loan repayments. Of the remaining $44.4 million in its portfolio, $8.7 million was already 90 days delinquent as of December 2001. Additionally, 37 of the businesses had closed, including six of the 14 businesses under its venture capital program. The December 31, 2001 audited financial statements of its venture capital program showed the estimated fair market value of its stock investments was now only $18.2 million, $7.9 million less than its original investments of $26.1 million. Further, we also noted investments of $2.4 million for three of these venture capital businesses had been written off as uncollectible. On this basis, LACDB not only did not comply with HUD and EDI grant agreement requirements, but also, had already incurred significant losses from its loans and investments to businesses that had already closed. Judging from the amount of loans written off ($41.7 million), plus the amount of delinquent loans ($8.7 million), additional losses may be more likely to occur.

Audit Objective, Scope And Methodology

The objective of our audit was to determine whether allegations of mismanagement of LACDB's operations contained in a citizen's complaint that prompted the Congressional request, as well as allegations of improper use of funds in another citizen's complaint had merit. In addition, we also determined whether LACDB administered the program in accordance with HUD and EDI Agreements' requirements.

To accomplish our objectives, we performed the following:

- Reviewed pertinent HUD regulations, EDI Agreements, Comprehensive CDB Agreement, Zone Ventures Partnership Agreement, Office of Management and Budget Circulars, and other HUD requirements.

- Interviewed HUD, LACDB, City, and County of Los Angeles officials and staff, attended Oversight Committee meetings, and reviewed relevant files to obtain an understanding of procedures and practices for administering the EZ program. We also obtained clarification on EDI Agreements' requirements, and evaluated the extent of program monitoring and oversight.

- Discussed with HUD, Headquarters program officials, the applicability of HUD rules and regulations relating to the eligibility and use of EDI Grant and Section 108 loan guarantee funds.

- Evaluated the issues raised by the complainant that prompted the Congressional request to determine if they had merit. Specifically, we reviewed LACDB's use of EDI funds during 1998 and 1999 for administrative expenses to determine the reasonableness and necessity of expenditures.

- Analyzed and validated EDI/matching Section 108 funding expenditures to determine whether LACDB complied with EDI Agreements' requirements to spend at least 75 percent of the funds within the EZ target area.

- Analyzed and validated job creation/retention statistics to determine whether LACDB complied with EDI Agreements' requirements to create or retain at least one job for every $35,000 in loans and investments, and the jobs were held by or made available to EZ target area residents.

- Selected a non-representative sample of 13 businesses for site visits to determine reasons for non-compliance. We selected these businesses because they had significantly failed to hire EZ target area residents.

- Selected a non-representative sample of 30 borrowers and reviewed relevant underwriting and servicing files to determine whether underwriting decisions were made in accordance with its established policies and procedures, approval processing procedures assured EDI Agreements' requirements would be met, and LACDB approved fund disbursements in accordance with established procedures. We selected businesses that had the larger funding amounts or that had defaulted or closed.

- Interviewed Zone Ventures Management Company officials to obtain an understanding of their procedures and practices for administering the venture capital program, and reviewed relevant records to evaluate their bases for approving venture capital investments.

Our audit generally covered the period from June 1996 through December 2001. Where appropriate, we extended our review to cover other periods. We substantially performed our audit fieldwork from February 2001 through March 2002.

We conducted the audit in accordance with generally accepted government auditing standards.

LACDB Had Not Fully Met HUD And EDI Grant Agreements' Requirements

LACDB approved $69,028,264 in loans and investments, as of December 31, 2001, to 101 businesses that had not met the national objective standard of 51 percent of creating or retaining jobs for low- and moderate-income persons (See Appendix A). Although these businesses created 1,357 of 2,062 projected jobs, only 149 (11 percent) went to low- and moderate-income persons. More importantly, although the EDI grant agreements require LACDB to create or retain jobs predominantly for EZ residents, only 66 of the 1,357 (5 percent) jobs created went to EZ target area residents. LACDB also spent over $21 million of City-funded loans and investments to businesses located outside the EZ target area in excess of the 25 percent funding limit.

These deficiencies occurred because LACDB had insufficient or did not follow established controls needed to ensure borrowers' compliance with job creation requirements. In addition, LACDB may have misunderstood the extent of its responsibility for assuring job creation requirements were being met. The lack of a control system to track the amount of loans and investments being approved caused LACDB to over spend outside the EZ target area. Consequently, HUD funds earmarked principally for economic revitalization activities within the EZ target area were neither fully used in accordance with the terms and conditions under which the funds were approved nor met the national objective criterion of low- and moderate-income benefit.

Code Of Federal Regulations

Title 24, Section 570.208 (a)(4) of the Code of Federal Regulations (CFR), states in part: "… An activity designed to create or retain permanent jobs where at least 51 percent of the jobs, computed on a full time equivalent basis, involve the employment of low- and moderate-income persons. To qualify under this paragraph, the activity must meet the following criteria: (i) For an activity that creates jobs, the recipient must document that at least 51 percent of the jobs will be held by, or will be available to, low- and moderate-income persons."

EDI Grant Agreements' Requirements

HUD entered into EDI Grant Agreements with the City (E-95-EZ-06-0003) and the County (E-95-EZ-06-0002) of Los Angeles (Recipients). In turn, the Recipients entered into a Comprehensive CDB Agreement with LACDB mirroring the provisions contained in the EDI Grant Agreements. Specific provisions restricting the use of EDI grant funds and matching Section 108 loan guarantee proceeds are as follows:

a. Assisted activities <u>must</u> meet the national objective criterion of low- and moderate-income benefit. Consistent with the recipient's proposal, each EDI grant and matching Section 108 loan guarantee assisted activity will meet the low- and moderate-income national objective if (a) the assisted economic development activity is located in the urban empowerment zone target area and any jobs created/retained by an assisted economic development activity are located in the target area, or (b) the assisted economic development activity is located outside of the urban empowerment zone target area, but creates jobs 51 percent of which are held by or made available to residents of the urban empowerment zone target area.

b. For assisted economic development activities utilizing the EDI grant funds and/or the matching Section 108 Loan Guarantee proceeds that are located in the Empowerment Zone target area, such activities create jobs predominantly held by or made available to residents of the Empowerment Zone target area and any economic development activity that creates jobs, the amount of EDI and/or matching Section 108 Loan Guarantee proceeds does not exceed $35,000 of assistance per job created.

c. Activities must be located in or serve the EZ target area. Generally, at least 75 percent of both the EDI grant funds and no less than an equal amount of Section 108 proceeds <u>must</u> be spent for eligible economic development activities within the EZ target area and create jobs predominately for EZ target area residents. Up to 25 percent may be spent within one mile of the EZ target area provided 51 percent of the jobs created go to EZ target area residents.

LACDB Assisted 101 Businesses That Had Not Met The National Objective Standard

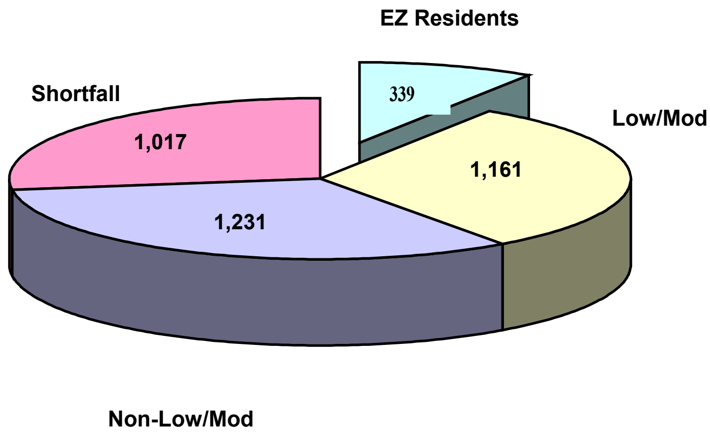
Over $69 Million In Loans And Investments Had Not Fully Met HUD Requirements

As of December 2001, LACDB approved $126,962,282 in loans and investments to 150 businesses, however, 101 of these businesses that received $69,028,264 in assistance (See Appendix A), had not met the national objective standard of 51 percent of creating or retaining jobs for low- and moderate-income persons. The 101 businesses created a total of 1,357 jobs but only 149 (11 percent) went to low- and moderate-income persons and only 66 (5 percent) went to EZ target area residents.

LACDB Created 73% Of The Total Number Of Jobs Projected

Overall, LACDB assisted 150 businesses that created 2,731 of 3,748 (73%) projected jobs, a shortfall of 1,017 jobs. Of the 2,731 jobs created, 339 went to EZ target area residents and 996 went to residents outside of the EZ target area but who were presumed to be qualified under the national objective criterion for low- and moderate-income benefit, plus an additional 165 jobs went to other qualified low- and moderate-income persons. The remaining 1,231 jobs went to other individuals that were neither residents of the EZ target area nor qualified as low- and moderate-income persons.

The following graph illustrates the job creation efforts by LACDB:



Only 339 Of The 2,731 Jobs Created Went To EZ Residents

LACDB's overall job creation effort of creating/retaining jobs predominantly for EZ target area residents had been minimal. Contrary to the EDI Agreements' requirement of creating jobs predominantly for EZ target area residents, only 339 of the 2,731 (12%) total jobs created as of December 2001 went to EZ target area residents. LACDB's assisted businesses, however, also created an additional 996 jobs under the presumptive benefit test.[1] In addition, these businesses created another 165 jobs for low- and moderate- income persons, for a total of 1,500 (339 + 996 + 165) jobs that met the national objective criterion for low- and moderate-income benefit. As of December 2001, 190 of the 1,500 jobs had been lost because the businesses that created those jobs had closed.

We Selected 13 Businesses For On-Site Visits

We selected a non-representative sample of 13 businesses for on-site visits to determine the reasons for these businesses' non-compliance with job creation requirements. We only interviewed officials of 10 of the businesses because two had ceased operations and we were unable to make contact with any official of the remaining business.

[1] Under the presumptive benefit test (24 CFR 570.208(a)(4)(iv)), if an employee resides in or the assisted activity through which he or she is employed is located in a census tract that meets the Federal empowerment zone eligibility criteria, the employee shall be presumed to be a person of low- and moderate-income.

Of these 10 businesses, six reported they had trouble with meeting the job creation requirements due to business problems. These problems included inability to begin manufacturing and lack of resources to hire employees. The president of one company stated it was impossible for a business to create one job for every $35,000 received, particularly in the technology field where people receive such high salaries due to the highly specialized skills needed to fulfill the job requirements. In addition, technology companies typically lose money for the first couple of years. Although some of these businesses had created jobs, they claimed they were unable to reach EZ target area residents because the specific qualifications required for the positions made it difficult to find qualified EZ target area residents. None of the businesses we visited, however, had any specific plan or procedure to reach EZ target area residents for any job openings available.

LACDB officials explained their primary responsibility was to provide access to capital for businesses that otherwise would be unable to obtain loans through conventional financing. Therefore, LACDB's emphasis was geared more towards loan production and servicing rather than compliance with job creation requirements.

Pilot Programs To Help Businesses Hire Target Area Residents Were Unsuccessful

Nonetheless, LACDB officials stated they were working on two pilot programs to help businesses hire EZ target area residents. First was a training program to give EZ target area residents the skills necessary to work for companies under the venture capital program, a program where LACDB purchased stock in starting technology companies solely for investment purposes. At the time of our review, this training program had not yet been implemented. The other program was to be an attempt to link EZ target area residents with the borrowers through a non-profit agency called One-Stop Program.

We found, however, that LACDB's efforts to use the services of One-Stop program also had not been successful. For example, LACDB claimed it sent 20,000 flyers out to two zip code areas in the EZ target area with a postage paid response card for the residents to indicate what kind of jobs they were interested in. The responses were then to be sent by LACDB to a One-Stop Program office. Only 168 responded from one zip code area and none from the other. None of the residents who responded were referred to LACDB's loan and investment recipients by One-Stop. One-Stop also participated in a job fair to try and get jobs for its clients, including those who responded to the LACDB flyers. However, none of the businesses that received funds from LACDB attended the job fair.

LACDB Approved Over $21 Million Of City-Funded Expenditures In Excess Of The 25% Funding Limit

HUD's Intent Was To Assist Mostly Businesses Within The EZ Target Area

LACDB exceeded the required 25 percent funding limit and approved over $21 million to businesses outside the EZ target area. The EDI Agreements require at the end of the program, at least 75 percent of the awarded EDI grant and matching Section 108 funds will be spent within the EZ target area and no more than 25 percent in the one-mile buffer zone, or non-target area. Since the total amount of EDI grant funds available to the City of Los Angeles was $100 million, only $25 million of this amount plus an equal amount of matching Section 108 funds could only be spent in the non- target area.

The County of Los Angeles's funded program activities did not exceed the 25 percent funding limit.

The following table shows the breakdown of the City of Los Angeles' funded expenditures:

(in millions)

Fund Type	Target Area	Non Target Area[2]	Total	Over
Section 108	$49.8	$43.1	$92.9[3]	$18.1
EDI	21.5	28.4	49.9[4]	3.4
Total	$71.3	$71.5	$142.8	$21.5
Percentage	50	50	100	

As shown above, LACDB spent $18.1 ($43.1 - $25 million) million of matching Section 108 and $3.4 million ($28.4 -

[2] Includes funds expended outside both the EZ target and non-target areas.
[3] Excludes $2 million of supplemental Section 108 (not restricted by the 75/25-ratio requirement).
[4] Includes $22,610,483 in administrative costs ($17,644,108 in the target area and $4,966,375 outside of target area).

$25 million) of EDI grants outside the EZ target area above the 25 percent spending limit.

The above table also shows that in total, $71.3 million, or 50 percent of total expenditures, was spent within the EZ target area. This included $17.6 million in administrative costs. For loans and investments alone, LACDB only spent $53.7 ($71.3 - $17.6 million) million or 45 percent within the EZ target area.

LACDB explained the reason for exceeding allowed expenditures for non target areas was partly due to the $24 million in loans given to one borrower located in the non-target area and another $21.3 million of investments in venture capital companies that chose not to relocate into the EZ target area once they received funding. While LACDB approved investments to venture capital companies based on written agreements with these companies to relocate into the EZ target area, we did not find any evidence (i.e., commitments to occupy or lease agreements) LACDB should have initially obtained from them to ensure they would actually relocate after receiving the investment proceeds. As a result, LACDB had very little or no leverage to enforce the terms of the agreement once the investments were made. At least two officials of the 10 businesses we visited informed us they were unaware of the requirement to be located within the EZ target area in order to be eligible for assistance.

Primary Cause Of The Deficiencies

LACDB had insufficient or did not follow established controls in its procedures to ensure borrowers' compliance with job creation requirements. LACDB's post-funding procedures required its staff to review businesses' job creation accomplishments and update job creation status reports and have the reports reviewed by a supervisor on a quarterly basis. If problems were identified, they were to provide the businesses access to resources to assist them in meeting job creation requirements. LACDB, however, did not always validate job creation information provided by the businesses nor conduct site visits to address deficiencies in meeting job creation requirements.

For example, we reviewed 27 compliance files (12 venture capital and 15 non-venture capital businesses) and found minimal or no evidence of on-site monitoring. The extent of monitoring appeared to be only limited to desk reviews by updating the quarterly status reports or reviewing the quarterly venture capital status reports. We did not find any evidence of follow-up or site visits to businesses experiencing difficulties meeting job creation requirements.

During LACDB's pre-funding processing LACDB performed financial underwriting to qualify applicants for funding[5], and verbally discussed the job creation requirements with the applicants; however, the businesses did not submit written job creation plans or projections until the funding was approved. In LACDB's underwriting credit summary and program compliance checklist, it stated the aggregate amount of funds will not exceed $35,000 per job created and the activity will create jobs predominantly for EZ target area residents. However, we did not find any documentation in the loan files evidencing specific analyses performed by LACDB to support these determinations prior to approving the loans. LACDB officials explained that no specific or written analyses were conducted to make these determinations. In our opinion, a specific review of the applicant's ability to create sustainable jobs, and particularly that the applicant will be able to create jobs predominantly for EZ target area residents, is important to help assure the job creation requirements are fully met.

As a contributing factor, LACDB officials may not have provided equal emphasis on both the financial and job creation aspects of its program. LACDB may have also misunderstood the extent of its responsibility for assuring job creation requirements were being fully met. LACDB officials stated they believed their primary purpose was to provide access to capital for businesses that otherwise would be unable to obtain loans through conventional financing.

LACDB exceeded funding restrictions because of the lack of a control system to track the amount of loans and investments being approved in EZ target and non-target areas. Since HUD requires LACDB to spend no less than 75 percent of the EDI Grant and an equal amount of matching Section 108 funds in the EZ target area, LACDB

[5] LACDB was unable to provide any underwriting documentation supporting its bases for approving the venture capital investments. This is discussed separately in more detail in Finding 2.

needed a control system to track the amount and location of loans or investments at the time the new loans and investments were being approved to ensure at least 75 percent of the funds were spent within the EZ target area.

Adverse Effect

Consequently, HUD funds earmarked principally for economic revitalization activities within the EZ target area were neither fully used in accordance with the terms and conditions under which the funds were approved nor met the national objective criterion of low- and moderate-income benefit.

Auditee Comments

Los Angeles Community Development Bank (LACDB):

LACDB disagreed with the draft finding with respect to (1) meeting the national objective of creating and retaining jobs for low- and moderate-income persons, (2) OIG's method of allocating administrative expenses between the EZ target and non-target areas, and (3) lack of control system to track loans and investments. Details of its disagreements are shown in sub-topics as follows:

(1) Meeting The National Objective of Creating Or Retaining Jobs for Low- And Moderate-Income Persons

Job Creation Accomplishments

LACDB stated that while the report was accurate in stating that, as of December 31, 2001, the businesses identified had not yet met the HUD and EDI Grant Agreements' requirements, LACDB contended its efforts at revitalizing the Los Angeles Empowerment Zone are not yet concluded. LACDB claimed businesses remain open and jobs continue to be created and as of March 31, 2002, total jobs created had increased from 2,731 to 3,445, of which 2,355 went to low and moderate-income persons.

Controls and Procedures

LACDB stated the federal regulations do not require that LACDB ensure that job creation/retention activities are fully met. The regulations require LACDB to document, not guarantee, that projected jobs "will be held by or made available to" eligible low-and-moderate income persons. Therefore, LACDB claimed it has met its obligations by documenting these requirements in all financing arrangements with borrowers and investees and by maintaining records.

LACDB disputed OIG's conclusion that LACDB's pre-funding compliance procedures were either insufficient or not followed. LACDB stated its procedures required each borrower to submit a preliminary job creation plan at the time of application, which was then finalized prior to loan approval and funding. Further, LACDB compliance staff analyzed job creation plans for reasonableness.

LACDB also disagreed with OIG's statement about lack of documentation in the loan files evidencing specific analyses performed by LACDB to support job creation determination prior to approving the loans. LACDB explained that it took a close look at the types of jobs that were projected, focused on the number and range of jobs, and discussed concerns with the business owner.

LACDB disputed OIG's conclusion that LACDB's post-funding compliance procedures were either insufficient or not followed. LACDB stated it had procedures in place to refer borrowers/investees to One-Stop Workforce Development Center to assist the borrowers with employment needs. In addition, LACDB stated it monitors the borrowers' progress through its quarterly reports.

Job Creation Monitoring Responsibility

LACDB agreed with OIG's statement that it previously misunderstood its level of responsibility for assuring its customers were meeting job creation requirements. LACDB erroneously believed that City, State, and Federally funded programs were equipped to address the needs of LACDB borrowers. LACDB acknowledged that it is responsible to monitor job creation by its customers and to assist those experiencing problems with hiring EZ or other low-and-moderate income persons. In that regard, LACDB stated it is committed to ensuring that its borrowers achieve their job creation requirements by expanding its efforts in this area. The expanded efforts will include: (1) conducting audits of borrowers' job creation potential; (2) hiring a job creation specialist; (3) implement a prepayment penalty for borrowers that prepay their loans prior to meeting the job creation requirements; (4) expanding its outreach efforts; and (5) working with HUD to help borrowers document that jobs were made available to low- and moderate- income persons.

(2) Method Of Allocating Administrative Expenses

LACDB disagreed with OIG's method of allocating the administrative expenses between the EZ target area (75 percent) and non-target area (25 percent). LACDB contended 100 percent of its administrative expenses should be allocated into the EZ target area since all such expenditures serve the EZ target area. LACDB's basis for its position included: (1) all administrative/ intermediary expenses should be counted as "serving" the EZ target area, which would consequently bring LACDB into compliance with the EDI Agreements' spending limits; and (2) loans/investments funded in the EZ non-target area should also be counted as "serving" the EZ target area.

(3) Lack of Control System To Track Loans And Investments

LACDB disagreed with OIG's conclusion that it exceeded funding restrictions because of a lack of a control system to track the amount of loans and investments to businesses located inside and outside the EZ target area. LACDB explained that it has a quarterly Closed Loan Report that provides detailed information, previously reviewed by LACDB's outside auditors, showing its compliance with funding limits.

City of Los Angeles (City):

The City disagreed with OIG's conclusion that LACDB had not met the national objective requirements. The City contended the federal regulations state that for an activity that creates jobs, the recipient must document that the jobs will be held by, or made available to low- and moderate-income persons; thus, the federal job creation requirement is met at the time job projections are documented. Additionally, the City stated the draft report misrepresents the benefits derived from LACDB activities because it focuses on individual loans rather than aggregate results.

County of Los Angeles (County):

The County agreed with the finding. The County stated that because of its due diligence and oversight of the loan activity in the County EZ target area, many of the issues identified for the LACDB program were not applicable to the County. In addition, the County stated it will request LACDB to consider HUD's final recommendations in the development of the next annual business plan and also to reconsider its possible role in future economic development activity in the EZ target area.

Office of Inspector General Evaluation of Auditee Comments

Los Angeles Community Development Bank (LACDB):

(1) Meeting The National Objective of Creating Or Retaining Jobs for Low- And Moderate-Income Persons

Job Creation Accomplishments

We believe that the draft audit report clearly stated our determination of LACDB's job creation and retention efforts was as of December 31, 2001, our audit cut-off date. We did not imply LACDB's job creation activities have been concluded. In fact, one of our recommendations is for HUD to determine whether, or when the businesses or activities have been or will be completed in order to determine whether these businesses have met the required level of employment of low- and moderate-income persons or not. Since we did not review LACDB's reported accomplishments as of March 31, 2002, we cannot comment as to their accuracy and validity.

Controls and Procedures

We disagree with LACDB's interpretation of Federal regulations claiming it has met its obligation of the National Objective of creating and retaining jobs for low- and moderate-income persons by documenting financing arrangements with borrowers and investees and maintaining records. While we agree there is no specific language in the Federal regulations requiring it to ensure job creation and retention should be fully met, compliance to the Federal requirement's National Objective of creating and retaining jobs for low- and moderate-income persons is not based on documentation but on actual jobs created or retained. Documentation is a procedure to show what and how many jobs were actually created or retained. Based on its record, LACDB was short in accomplishing its goal to create or retain permanent jobs where at least 51 percent of the jobs computed on a full time equivalent basis, involve the employment of low- and moderate income persons. To fulfill the Federal requirement, we believe it is incumbent upon LACDB to take proactive steps to ensure the national objective of creating and retaining jobs for low- and moderate-income persons is being met.

Our review did not support LACDB's statements relating to its pre-funding compliance procedures. Based on our review of 15 non-venture capital loan files and discussions with the Chief Credit Officer, we determined that LACDB performed financial underwriting to qualify applicants for funding and verbally discussed the job creation requirements with the applicants. However, these businesses did not submit written job creation plans or projections until funding was approved. We did not find any supporting documentation evidencing LACDB's claim that it conducted specific analyses of the jobs to be created by the businesses. In our review of 15 underwriting files, we did not find any documentation in the loan files evidencing specific analyses performed by LACDB to support their determinations that the applicant would be able to meet the public benefit and National Objective requirements.

We disagree with LACDB's claim that its post-funding compliance procedures are adequate. Even though LACDB gathered job creation information from the businesses and entered this information to update its quarterly reports, LACDB did not always validate the job creation information provided by the businesses or conduct site visits to address any short fall in meeting job creation requirements. In addition, LACDB's policies and procedures did not specifically require conducting site visits to the businesses. In our opinion, site visits to the businesses is important to validate the job creation information provided, as well as to identify and remedy problems encountered by businesses in meeting job creation requirements.

Job Creation Monitoring Responsibility

LACDB's previous misunderstanding of its responsibility to ensure job creation requirements were being fully met by the borrowers was a contributing factor to the businesses' inability to fully meet job creation requirements. Since LACDB has now acknowledged its responsibilities and has identified additional ways to expand its efforts to monitor borrowers' compliance, we have no further comment on this issue.

(2) Method Of Allocating Administrative Expenses

We disagree with LACDB's contention that 100 percent of its administrative expenses should be allocated to the EZ target area. Since the EDI Agreements required that at least 75 percent of EDI grant funds must be spent for eligible economic development activities within the EZ target area and up to 25 percent may be spent within the EZ non-target area, the related administrative expenses should also be allocated using the same formula. We noted that in past periods, LACDB was allocating its administrative expenses using the same 75/25 percent ratio. Another acceptable method would be to allocate expenses using actual expenditures, but this would increase the overspent amount even more. In our opinion, had LACDB complied with the spending restrictions for its loans and investments, this problem would not have occurred.

(3) Lack of Control System To Track Loans And Investments

We do not believe that the Closed Loan Report provided an effective means to track expenditures. LACDB's quarterly Closed Loan Report was used as a mechanism to summarize accomplishments; therefore, this report was being prepared after the fact.

City of Los Angeles (City):

The City's interpretation of the national objective requirements is incorrect. The national objective requirements are performance-based requirements that must be met on an activity-by-activity basis, subsequent to receiving the HUD funding, showing the number of actual jobs created or retained. The actual numbers of jobs created or retained for low- and moderate-income persons serve as the basis for determining whether the national objective requirements were being met. As it should be, the draft finding focused on individual activities that had not met the national objective requirements, however, the draft finding also discussed the overall job creation and retention efforts by LACDB.

County of Los Angeles (County):

Since the County agreed with the finding, we have no further comment.

Recommendations

We recommend you:

1A. Require the City and the County of Los Angeles to ensure LACDB establishes and implements, or follows monitoring control systems and procedures to ensure businesses' compliance with job creation and retention requirements are fully met.

1B. Determine whether, or when, the businesses or activities funded by EDI Grant and Section 108 Loan Guarantee funds listed in Appendix B have been or will be completed.

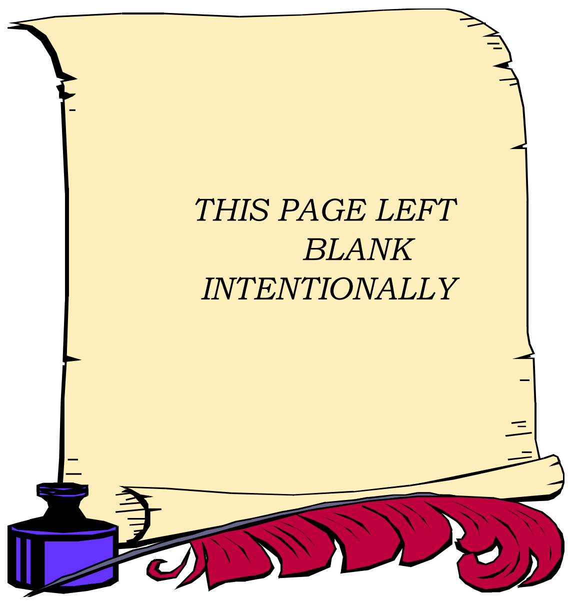
1C. Determine and evaluate the reasons why the completed and closed businesses identified in Recommendation 1B failed, and whether there were mitigating circumstances for not meeting the required level of employment of low- and moderate- income persons.

1D. Take appropriate action pursuant to the provisions of 24 CFR, Section 570.910, to the extent the completed businesses or activities identified in Recommendation 1B were unable to meet the national objective standard of 51% for creating/retaining jobs for low- and moderate-income persons.

1E. Determine what action or adjustments to LACDB's existing monitoring policies, procedures, and practices, should be taken to ensure the required level of employment of low- and moderate-income persons will be met for the uncompleted businesses or activities identified in Recommendation 1B. Also, at the completion of these businesses or activities, determine the extent these businesses met the national objective standard of 51% of creating/retaining jobs for low- and moderate-income persons.

1F. Instruct the City and the County of Los Angeles to require LACDB to revise and implement the policies and procedures in accordance with the results of your determination in Recommendation 1E. We also recommend you take appropriate action pursuant to the provisions contained in 24 CFR, Section 570.910, to the extent that these businesses or activities identified in Recommendation 1E did not meet the national objective standard of 51% of creating/retaining jobs for low- and moderate-income persons.

1G. Instruct the City of Los Angeles to require LACDB to restrict any future loans or investments involving the use of EDI grant funds only to businesses within or willing to relocate into the EZ target area.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LACDB's $28.7 Million City-Funded Venture Capital Program Provided Minimal Benefit To The Empowerment Zone

LACDB invested about $26.1 million to 14 City-funded venture capital businesses and paid about $2.6 million in related management fees to Zone Ventures Management Company (Zone Ventures), which provided minimal benefit to the EZ. More specifically, we found:

- ✓ **the financial viability of the investments was questionable to assure the required benefit would materialize because of the high probability of business failure amongst venture capital businesses;**
- ✓ **12 of the 14 venture capital businesses did not meet the national objective standard of 51 percent of jobs created or retained were held by or made available to low- and moderate-income persons; and,**
- ✓ **12 of the 14 venture capital businesses did not locate in or move into the EZ target area, in conflict with the basis upon which LACDB approved the investments.**

In addition, contrary to the terms of the Partnership Agreement between LACDB and Zone Ventures, Zone Ventures also did not locate into the EZ target area or create any jobs for EZ target area residents, as required. We concluded Zone Ventures did not fulfill its contractual obligation to ensure program requirements were fully met.

The deficiencies occurred because LACDB did not perform sufficient due diligence to assure only those investments which could reasonably meet HUD eligibility requirements were being approved for funding. LACDB also did not perform adequate monitoring of Zone Ventures and venture capital businesses to ensure program compliance. As a result, LACDB's investments into the venture capital program did not provide the expected program benefits to intended beneficiaries, thus, hampered its efforts to accomplish its mission of revitalizing the EZ target area. Therefore, in our view, the $28.7 million in venture capital investments and management fees could be considered a questionable use of HUD funds.

HUD Underwriting Requirements

The 24 CFR 570.209 provides guidelines for evaluating and selecting economic development activities eligible under 24 CFR 570.203. The regulations state the standards for evaluating public benefit are *mandatory*, but the guidelines for evaluating projects costs and financial requirements are not; however, grantees are expected to conduct basic financial underwriting prior to the provision of financial assistance. The guidelines serve as a framework for financial underwriting and selecting HUD-assisted economic development projects which are financially viable and will make the most effective use of the HUD funds. Further, the public benefit a grantee expects to derive from the assisted activity will not materialize if the project is not financially feasible.

The underwriting guidelines provide a project would be considered financially viable if all of the assumptions about the project's market share, sales levels, growth potential, projections of revenue, project expenses, and debt service (including repayment of the HUD assistance if appropriate) were determined to be realistic and met the project's break-even point. Generally, an economic development project that does not reach a break-even point over time is not financially feasible. In this regard, provisions should be made for a negative cash flow in the early years of the project while space is being leased up or sales volume built up. It is also expected a financially viable project will project sufficient revenues to provide a reasonable return on equity investment.

National Objective Requirements

Title 24, Section 570.208 (a)(4) of the CFR, states in part: "… An activity designed to create or retain permanent jobs where at least 51 percent of the jobs, computed on a full time equivalent basis, involve the employment of low- and moderate-income persons. To qualify under this paragraph, the activity must meet the following criteria: (i) For an activity that creates jobs, the recipient must document that at least 51 percent of the jobs will be held by, or will be available to, low- and moderate-income persons."

EDI Eligibility Requirements

HUD executed an EDI Agreement with the City of Los Angeles, which provided the requirements in connection with the economic development activities to be carried out. The Agreement provided assisted activities must:

- ✓ be located in or serve the qualifying urban EZ target area,
- ✓ create at least one job for every $35,000 of funding received, and

- ✓ create jobs of which at least 51 percent are held by or made available to EZ target area residents.

These eligibility requirements were subsequently passed through to the assisted venture capital businesses in the Program Compliance/HUD Addendum to the Securities Purchase Agreement between each of the assisted businesses and Zone Ventures.

Comprehensive Agreement Requirements

HUD's eligibility requirements were also incorporated into the Comprehensive Agreement between the LACDB, the City of Los Angeles, and the County of Los Angeles. The business plan attached to the Comprehensive Agreement also provides potential venture capital investments must create or retain jobs within the eligible areas of the City and should target companies owned or controlled by socially and/or economically disadvantaged individuals. The plan also states LACDB will seek transactions with high probability for success, which in many instances must be demonstrated by a minimum of two years of successful operations. The LACDB will primarily invest in companies in the development stage, expansion and growth stage, or acquisition stage, and will generally avoid pure "start-up" ventures or turn around and troubled situations.

Zone Ventures Partnership

LACDB contracted Zone Ventures to administer the venture capital program for a management fee of 2 ½ percent of LACDB's $35 million commitment to the venture capital program. The Zone Ventures Partnership Agreement between Zone Ventures Management Company (General Partner – 1%) and LACDB (Limited Partner – 99%) states the primary purpose of Zone Ventures is to make venture capital investments in companies located in the EZ, and its general purpose is to buy, sell, hold, sell short and otherwise invest in securities of every kind; enter into, make and perform all contracts and other undertakings; and to engage in all activities and transactions as may be necessary, advisable, or desirable to carry out the foregoing.

Further, Zone Ventures' General Partner covenants and agrees to cause Zone Ventures to comply with the provisions of each HUD Addendum executed on its behalf, and shall use its best efforts to ensure each assisted company complies with the terms and conditions of the HUD Addendum. The Agreement also provided Zone Ventures will locate in the EZ target area and will use all reasonable efforts to achieve the goal of hiring and retaining EZ target area residents for at least 51 percent of jobs it created and retained as a result of investments made.

Financial Viability Of The Investments Is Questionable

Between February 1998 and December 2001, Zone Ventures Partnership made stock investments totaling $26.1 million in 14 different venture capital businesses[6]. Based on our analysis of the businesses' performances, we question the financial viability of the investments and their ability to assure the required benefits would materialize because of the high probability of business failure stemming from the risky and volatile nature of the venture capital businesses.

Businesses Have High Probability Of Failure

Generally, venture capital businesses are early stage start up companies funded by investors to develop high technology products or services. In its response to the Request for Proposal (RFP) leading to the creation of Zone Ventures Partnership, Zone Ventures described early stage venture capital investments as the segment of the venture capital industry with the highest degree of investment risk. Zone Ventures further stated: typically, portfolio companies have no operating history, unproven technology, untested management, and unknown future capital requirements. As a result, there is no assurance there will be any success in producing any profits or any return on capital.

Zone Ventures officials acknowledged these businesses generally experience poor returns during the first three years because the businesses are expending their resources heavily on developing their envisioned products or services, to be marketed at some point in the future. Consequently, these businesses are highly dependent on the venture capital to fund their operations, until such time when they can create sufficient revenue to stabilize their operations. This,

[6] LACDB's initial venture capital investment was made prior to the contract with Zone Ventures.

however, contradicts the business plan attached to the Comprehensive Agreement, which stated LACDB would generally avoid pure "start up" ventures.

Venture Capital Businesses Have A 50% Failure Rate

Zone Ventures officials estimated the venture capital businesses have about a 50 percent failure rate, but explained their primary emphasis is on the potential financial success of the investment as opposed to whether the business will be able to create jobs for EZ target area residents. While there is a high failure rate, the officials stated it is offset by the potential financial returns of the businesses that do succeed. Nevertheless, the program intent is to create sustainable jobs, as opposed to making investments for the purpose of obtaining financial returns.

LACDB officials stated their primary responsibility was to provide businesses with access to capital and the justification for the venture capital program was the potential phenomenal financial returns on the investments. Further, the officials explained funds received would not only help sustain LACDB's operations, but could be re-invested in the EZ target area to offset any losses by other businesses that fail. We disagreed with this justification. HUD's goal is not to gain financial returns on HUD-assisted activities. But rather, each investment, on an individual basis, must meet HUD's eligibility requirements since it would be unreasonable, or unallowable, to hold future businesses accountable for meeting job creation requirements for businesses that failed in the past.

Despite Zone Ventures' and LACDB's claimed emphasis on the potential financial success of their investments, we noted since the first investment was approved in February 1998, LACDB has not yet received any returns on any of its investments. In fact, 6 of 14 venture capital businesses had closed or essentially ceased operations, at the time of our audit. These six businesses received funding totaling $7,066,526, of which $2,355,336 for three of these businesses had already been written off as uncollectible. Consequently, the EZ target area essentially did not receive any benefit from these funds, nor can LACDB re-invest the funds in the EZ target area.

Zone Ventures Did Not Support Bases For Approving Venture Capital Investments

Zone Ventures was unable to provide any documentation to support the underwriting it performed as bases for approving the venture capital investments, nor any documentation showing any analyses of whether the venture capital businesses could reasonably create the required jobs. Zone Ventures officials explained they generally do not generate any underwriting files, loan processing files, or similar types of documentation. They claimed the investment decision process consisted primarily of verbal discussions with the entrepreneurs, review of the proposed business plan, and research and knowledge of the industry. According to the officials, the primary focus was to make investments in new technologies Zone Ventures believed would succeed financially. However, as discussed above, the financial performance of these businesses, as of December 2001, did not seem to support Zone Ventures' claim. Without any documentation supporting the bases of underwriting decisions, HUD, the City of Los Angeles, and LACDB were less assured HUD's eligibility requirements would be met.

Venture Capital Businesses Had Not Met The National Objective

As of December 2001, 12 of 14 venture capital businesses had not met the national objective standard of 51 percent of creating or retaining jobs for low- and moderate-income persons.

None Of The Businesses Fully Met Job Creation Requirements

Based on LACDB's projections, stock investments totaling $26.1 million in 14 different venture capital businesses (see Appendix C) required these businesses to collectively create 768 jobs. Of these 768 jobs, LACDB projected at least 413 jobs would be held by, or made available to, EZ target area residents. As of December 2001, these businesses had not met the overall job creation requirements, and more importantly, had significantly failed to create jobs for EZ target area residents. For example, although these businesses created 582 of the 768 (76%) projected jobs, only 7 (1%) of the 582 jobs created went to EZ target area residents. An additional 102 jobs went to residents outside of the EZ target area but who were presumed-to-be qualified under the national objective criterion for low- and moderate-income benefit. In total, only 109 (19%) of the 582 jobs created went to low- and moderate-income persons.

Jobs Created Did Not Benefit EZ Target Area Residents As Required

We analyzed the jobs the venture capital businesses intended to create to determine the reasons for EZ target area residents not being hired. Our analysis of the jobs showed the jobs were predominantly (about three-fourths) categorized as management or skilled jobs, as opposed to unskilled jobs, therefore, these jobs may not be suitable to most EZ target area residents. The management or skilled jobs the venture capital businesses required and hired were jobs that generally required specific skills and training, beyond a high school education, such as chief technology officers, vice presidents, engineers, computer programmers, and marketing directors. Assuming the annual salary is indicative of the skill level needed to perform the job, we noted the annual salaries for the management and skilled jobs ranged from $24,000 to $250,000. Likewise, unskilled jobs were jobs, such as customer service assistants, office assistants, and administrative support personnel, with annual salaries ranging from $20,000 to $52,000.

To illustrate, below is a table showing the specific jobs that one venture capital business planned to create, in conjunction with receiving $1,980,000 in funding:

Management:			Skilled:			Unskilled:			
Position	**Salary**	**No.**	**Position**	**Salary**	**No.**	**Position**	**Salary**	**No.**	**TOTAL**
Chief Operating Officer	$100 - $150,000	1	Director, Technology	$75,000	24	Administrative Assistant	$40,000	7	
Chief Technology Officer	$100 - $150,000	1	Director, Strategy	$75,000	1				
VP – Human Resources	$100 - $150,000	1	Programmer	$60,000	20				
VP – Corporate Development	$100 - $150,000	1	Director, Marketing	$75,000	1				
VP - Strategy	$100 - $150,000	1							
TOTAL		**5**			**46**			**7**	**58**

As shown, the business planned to create 58 jobs, of which 51 jobs (88 percent) were management or skilled jobs, with salaries ranging from $60,000 to $150,000. Only 7 of 58 (12%) of the jobs were classified as unskilled. This business created only one job for a low- and moderate-income person.

In another example, the following table shows the jobs another venture capital business planned to create, as a condition to receiving $1,403,326 in funding:

Management:			Skilled:			Unskilled:			
Position	**Salary**	**No.**	**Position**	**Salary**	**No.**	**Position**	**Salary**	**No.**	**Total**
Chief Operating Officer	$75,000	1	Sr. Programmer	$48,000 - $75,000	12	Receptionist	$24,000 - $36,000	1	
Program Manager	$60,000 - $75,000	2	Jr. Programmer	$36,000 - $48,000	12	Administrative Assistant	$24,000 - $45,000	1	
Chief Financial Officer	$60,000 - $75,000	1	Software Quality Assurance	$24,000 - $36,000	7				
Director, Business Development	$48,000 - $90,000	1	Third Party Support/Sales	$48,000 - $60,000	1				
			Artist/Designer	$36,000 - $48,000	1				
			Game Developer	$50,000 - $80,000	1				
TOTAL		**5**			**34**			**2**	**41**

Again, this business planned to create 41 jobs, of which 39 jobs (95 percent) were management or skilled jobs, with annual salaries ranging from $24,000 to $90,000. Only 2 of 41 (5%) jobs were categorized as unskilled jobs. This business, however, is located within the EZ target area and, therefore, even though only two of the 32 jobs created went to EZ target area residents, the other 30 jobs were presumed- to-be held by low- and moderate-income persons.

EZ Target Area Residents Did Not Have The Qualifications For Available Venture Capital Jobs

We visited 4 of the 14 venture capital businesses to determine the reasons for not hiring EZ target area residents. Business officials were generally aware of the hiring EZ target area residents requirement, but explained EZ target area residents did not possess the qualifications and technical expertise to fill their vacancies. One official stated the qualifications were so specific he had to advertise the positions nationwide in order to get qualified applicants.

We discussed the comments made by the businesses with Zone Ventures officials who generally agreed EZ target area residents do not possess the skills necessary to qualify for the specialized, highly technical jobs being created by the businesses. Further, LACDB and Zone Ventures officials also stated the businesses could not provide training to EZ target area residents to enable them to qualify for the jobs because they do not yet have the resources or capability to implement a training program.

These businesses are early stage start-up companies and there is a "steep ramp-up"[7] in hiring of people with the needed skills to perform the jobs immediately and get the business off the ground. Therefore, without a training program these jobs may not be available to EZ target area residents that do not already possess the necessary skills and experience.

Zone Ventures Did Not Intend Jobs To Go To EZ Target Area

Zone Ventures' Managing Partner informed us Zone Ventures' primary focus was the financial performance of the venture capital businesses. Further, it was neither Zone Ventures' intent that the EZ target area residents be hired for the jobs listed on the loan agreements, nor did he believe EZ target area residents could qualify for the jobs. The Partner commented that with respect to meeting the job creation requirements for EZ target area residents, HUD needs to take a broader perspective, and any benefit to the EZ target area would be in the long term. The Partner further explained if the venture capital businesses became successful, it would create a general build up of the surrounding area, and the EZ target area residents would then be driven to get a better education to qualify for the better jobs. We disagreed with this logic. The funding was approved for the specific purpose of revitalizing the EZ target area through job creation for EZ target area residents, based on venture capital businesses' certification that they would create the specific jobs detailed in the job creation plans.

Venture Capital Businesses Failed To Locate In The EZ Target Area

Contrary to the terms of the HUD Addendum between each of the assisted businesses and Zone Ventures, we found 12 of the 14 venture capital businesses failed to locate in the EZ target area. Instead, these businesses located in the non-target area, except for one business that located outside both areas. Zone Ventures officials explained there was some confusion at the beginning of the program on the

[7] The term "steep ramp-up" means that once the business is funded, it immediately hires all the key employees with the necessary skills and expertise to develop the product or service to be marketed as quickly as possible. After this initial hiring, it plateaus until the operations have stabilized.

distinction between the target and non-target areas of the EZ. The officials also stated the venture capital businesses preferred locations outside the EZ target area because they offered better amenities, such as eating facilities and parking. Our discussions with officials at the four venture capital businesses we visited stated they were unaware of any distinction between the EZ target and non-target areas.

LACDB officials stated they were aware of the non-compliance with the location requirement, but did not require the businesses to re-locate because the confusion stemmed from the fact their EZ map did not clearly distinguish the target and non-target areas. LACDB's lack of enforcement, however, had adversely impacted their overall compliance with the 25 percent funding limit for the non-target area, as discussed in Finding 1.

Therefore, in our view, the venture capital businesses' failure to comply with program requirements, in conjunction with LACDB's failure to exercise sufficient due diligence supporting its bases for approving the investments, the $26.1 million in venture capital investments could be considered a questionable use of HUD funds (See Appendix C).

Zone Ventures Did Not Comply With The Partnership Agreement

Contrary to the Partnership Agreement, Zone Ventures did not locate into the EZ target area and did not hire any EZ target area residents for the eight jobs it created. Both LACDB and Zone Ventures officials claimed they were unaware these requirements also applied to Zone Ventures until we raised the issue during our audit. In addition, we found Zone Ventures did not comply with Partnership Agreement requirements to ensure venture capital companies were also complying with program requirements. Therefore, we concluded Zone Ventures did not fulfill its contractual obligation to ensure HUD requirements were fully met and the $2.6 million in management fees it received could also be considered a questionable use of HUD funds.

Venture Capital Program Investments Should Be Discontinued

Under the Zone Ventures Partnership Agreement, LACDB committed $35 million in funding for venture capital investments and related management fees. As of December 31, 2001, LACDB had expended $28,679,535 of the $35 million commitment, thus, leaving an unexpended balance of $6,320,465. Based on the results of our review and evaluation of LACDB's venture capital program, we believe LACDB should discontinue making venture capital program investments. (See Appendix D).

LACDB Did Not Establish Adequate Controls

In our opinion, the deficiencies occurred because LACDB did not implement investment approval processing controls to assure only those investments that could meet the HUD eligibility requirements were approved for funding. Our review disclosed LACDB did not provide Zone Ventures with any written investment approval processing guidelines or procedures to follow to determine whether investments should be approved or not. Specific procedures were needed that would require Zone Ventures to do analyses of the feasibility of the venture capital businesses to create the required total number of required jobs and of particular importance, to meet the EZ target area resident job creation requirements. Further, LACDB did not require additional controls, such as written lease commitments, to assure the venture capital businesses would locate or move into the EZ target area prior to receiving investments proceeds.

LACDB Did Not Provide Adequate Oversight

LACDB also did not provide adequate oversight over the venture capital program. LACDB officials stated they generally just relied on Zone Ventures to administer the venture capital program. While LACDB officials were aware of the venture capital businesses' lack of compliance with HUD eligibility requirements, they had not performed any on-site monitoring of Zone Ventures or the venture capital businesses, nor had they made any efforts to enforce compliance with the requirements.

LACDB's Venture Capital Program Did Not Accomplish Its Mission

As a result, LACDB's nearly $29 million in venture capital investments into the venture capital program did not provide the expected program benefits to intended beneficiaries, thus, hampered LACDB's efforts to accomplish its mission of revitalizing the EZ target area.

Auditee Comments

Los Angeles Community Development Bank (LACDB):

LACDB disagreed with the draft finding. LACDB stated there was nothing in HUD regulations precluding the use of EDI grant or Section 108 funds for equity investments or venture capital. Further, the suggestion in the draft report that LACDB entered into a risky venture is consistent with its mission. LACDB was created for the sole purpose of creating jobs by providing capital to businesses that could not otherwise obtain it. LACDB said the program has not run its course, and the companies that remain in the portfolio are the strongest, and still show potential to create jobs and generate a return. Therefore, LACDB believes it is premature to terminate the venture capital program. LACDB believes that if the venture capital program is terminated, this would ensure failure and could result in a significant or total loss of LACDB's investments.

LACDB also disagreed with the claim that it did not administer the program with diligence because it fails to take into account the oversight of each investments that was exercised by LACDB's Investment Committee when it approved the investments.

City of Los Angeles (City):

The City of Los Angeles claimed venture capital investments were part of the originally approved plan for LACDB in which HUD determined them to be an eligible federal expense. The City also stated it was confusing and misleading to use the word "questionable" with respect to venture capital investments and related management fees, if OIG did not determine these expenditures as questioned costs. Additionally, the City believes the $6.3 million in unexpended funds under the Zone Ventures partnership agreement should be deleted from the "Schedule of Questioned Costs", since these funds have not yet been expended. The City stated that in 1998 when LACDB invested in Zone Ventures, it anticipated that venture capital investments would result in companies growing and creating jobs, and fostering economic development.

However, as experienced by many investors, the stock market, and the technology sector in particular, such investments have suffered losses in ways not imagined several years ago. Therefore, the City is evaluating the potential of the venture capital program portfolio in order to determine the most prudent use of the funds in order to meet HUD requirements.

County of Los Angeles (County):

No comments.

Office of Inspector General Evaluation of Auditee Comments

Los Angeles Community Development Bank (LACDB):

The draft finding did not state the use of EDI grant or Section 108 funds for equity and venture capital investments was prohibited under HUD regulations. Based on our review of the venture capital program, we questioned the financial viability of the investments and their ability to assure the required benefits to Empowerment Zone residents would materialize because of the high probability of business failure stemming from the risky and volatile nature of the venture capital businesses. Therefore, in our view, the venture capital investments and related management fees could be considered a questionable use of HUD funds. Case in point, nearly half of the 14 venture capital businesses have failed resulting in significant investment losses. Consequently, we recommended LACDB to discontinue making venture capital program investments to prevent additional losses, thus, allowing LACDB to put the unexpended funds to better use.

Contrary to its claim, LACDB did not administer its venture capital program with sufficient due diligence. As stated in the draft finding, LACDB neither established adequate controls nor provided adequate oversight. LACDB also did not implement investment approval processing controls and did not provide Zone Ventures with any written investment approval processing guidelines. Specific procedures were needed to determine the feasibility of the businesses to create the required number of jobs, particularly with respect to HUD's requirements in creating and retaining jobs for EZ target area residents. We generally found that LACDB relied on Zone Ventures to administer the programs. Even though LACDB was aware of instances of non-compliances, it did not perform any on-site monitoring of Zone Ventures or the venture capital businesses to rectify issues of non-compliance.

City of Los Angeles (City):

The draft finding did not state venture capital investments were an ineligible use of program funds. Based on the results of our review of the venture capital businesses funded by LACDB, however, we determined the financial viability of those investments was questionable to assure the required criterion of low- and moderate-income benefit would materialize because of the high probability of business failure amongst the venture capital businesses. Our conclusion was further supported by the fact that the majority of the businesses funded under the venture capital program failed to create jobs for intended beneficiaries.

We included the $6.3 million in Appendix D, Schedule of Questioned Cost, to report quantifiable monetary savings that would be used more effectively if OIG recommendations were implemented. This amount was appropriately classified under the category “Funds Put To Better Use”.

Recommendations

We recommend you:

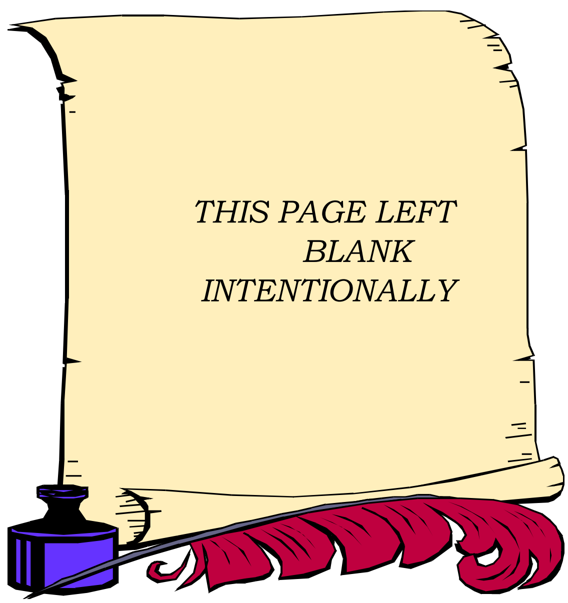
2A. Instruct the City of Los Angeles to require LACDB to discontinue making venture capital program investments.

2B. Instruct the City of Los Angeles to require LACDB to enforce the terms and conditions of the Partnership Agreement against Zone Ventures to the extent LACDB is unable to obtain full compliance.

2C. Require the City of Los Angeles and/or LACDB to seek recovery of the $2,628,446 in management fees from Zone Ventures, plus any additional amounts paid after December 31, 2001, if the City of Los Angeles and/or LACDB are unable to obtain full compliance with the Partnership Agreement in Recommendation 2B.

2D. Determine to what extent the venture capital businesses listed in Appendix C have met HUD's public benefit criteria and national objective standard of creating or retaining jobs for low- and moderate- income persons.

2E. Take appropriate action pursuant to the provisions of 24 CFR 570.910, based on your determination in Recommendation 2D.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EDI Funds Used For Unnecessary Or Unreasonable Expenses

Contrary to OMB Circular requirements, LACDB spent at least $135,150 in EDI funds for expenses that were either unreasonable or unnecessary. LACDB paid:

- ✓ **$12,229 for meals and other expense items not essential to LACDB's operation with LACDB credit cards or reimbursed to LACDB employees,**

- ✓ **$32,421 for unnecessary LACDB staff bonuses and pay raises given contrary to LACDB's normal personnel practices, and**

- ✓ **$90,500 for unreasonably high fees to intermediary businesses for originating microloans.**

We attribute these deficiencies to LACDB's lack of familiarity with cost principles applicable to units of local government and non-profit entities. As a result, these expenditures prevented LACDB from the ability to further carry out other eligible activities.

OMB Circular Requirements

Title 24 of the CFR 570.200(a)(5) states costs incurred with CDBG funds, whether charged on a direct or an indirect basis, must be in conformance with the applicable OMB Circular. Attachment A of OMB Circular A-122, "Cost Principles for Non-Profit Organizations", provides general principles for determining the allowability of costs, and states in part that costs must be reasonable for the performance of the award and be allocable thereto. The Attachment states: a cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs. In determining the reasonableness of a given cost, consideration shall be given to whether the:

- ✓ Cost is of a type generally recognized as ordinary and necessary for the operation of the organization or the performance of the award.

- ✓ Individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees, and clients, the public at large and the Federal Government.

We reviewed LACDB's expenditures for administrative expenses and found they used at least $135,150 of EDI funds for unreasonable or unnecessary expenses relating to meals, personnel, intermediary fees, and other expenses. Details of these expenses are discussed separately below:

Meals and Other Expenses ($12,229)

We reviewed the LACDB corporate credit card usage and LACDB's expense reimbursement to its employees for 1998 and 1999 and identified $12,229 in meals and other expense items we believe were unnecessary or imprudent uses of EDI grant funds.

Credit Card Expenses ($7,261)

During 1998 and 1999, four senior LACDB managers charged $31,055 to their corporate credit cards. We identified $7,261 for meals, flowers, hotel movies and a flight upgrade as unnecessary to LACDB's operations, and therefore, they should not have been paid with EDI funds. Our review identified the following:

Description	Amount
Meals for meetings	$7,088
Flowers	106
Hotel movies and flight upgrade	67
Total	$7,261

Employee Expense Reimbursement And Petty Cash Expenditures ($4,968)

We also reviewed employee expense reimbursements and petty cash expenditures during 1998. We found $4,968 spent for items such as meal expenses, birthday cakes and cards for LACDB staff. These types of expenses were not necessary to LACDB's day-to-day operations, thus, were also an unnecessary use of EDI funds.

Description	Amount
Meals for business/committee meetings, holiday parties, and office grand opening	$3,022
Meals, alcoholic beverages, and spa charges	1,238
Birthday cards and cakes for LACDB staff	327
Gift for staff member	46
Donations to local organizations	215
Staff AICPA membership dues	120
Total	$4,968

LACDB Staff Bonuses and Pay Raises ($32,421)

LACDB's normal practice is to give staff bonuses and pay raises at the beginning of each calendar year in connection with their annual performance evaluations. Consistent with this practice, all employees received a pay raise (ranging from 5 to 8 percent) on January 1, 1999. Additionally, in February and March 1999, the corporate officers and nearly all other staff received bonuses of differing amounts ranging from $500 to $5,000. We also found, however, in July 1999, LACDB's former CEO/President gave seven staff members additional bonuses and/or pay raises totaling $32,421. Contrary to LACDB's normal procedures, the former CEO/President gave seven staff members a total of $5,500 in bonuses in amounts of either $500 or $2,500, and three of these staff members also received additional pay raises totaling $26,921, which ranged from 13 to 21 percent. These employees also received the usual beginning of the year bonuses and pay raises in January 2000. In our opinion, the additional bonuses and pay raises were unnecessary since

LACDB has an established procedure for giving bonuses and pay raises on an annual basis.

Unreasonable Intermediary Fees ($90,500)

We reviewed LACDB's expenditures of EDI funds during 1998 for fees paid to intermediary businesses to originate microloans on behalf of LACDB. We found the fees paid were sometimes excessive or unreasonable in relation to the microloan amount. Specifically during 1998, LACDB made 20 microloans totaling $307,000, ranging from $3,300 to $25,000. In exchange, the intermediaries received a total of $90,500, and thus, the fee averaged about 30 percent per microloan. The microloans ranged from $3,300 to $25,000, and the related intermediary fees paid were flat amounts of either $3,500 or $5,000 per microloan. Therefore, the fees paid in relation to the microloan amounts ranged from about 18 to 152 percent. For example in one case, the intermediary received $5,000 (83 percent of the loan amount) to originate a $6,000 microloan for a photo shop. In another case, the intermediary received $5,000 (152 percent of the loan amount) to originate a $3,300 microloan to a toy store. LACDB subsequently changed their practice of paying a flat amount in February 2001, and changed the arrangement to paying the higher of $1,000 or 10 percent of the microloan amount. Therefore, since LACDB had already addressed this problem, we are not making any recommendation for corrective action.

We attributed the unnecessary or imprudent expenditures to LACDB management's lack of familiarity with OMB Circular cost principles applicable to units of local government and non-profit entities. As a result, these expenditures prevented LACDB from the ability to further carry out other eligible activities.

Auditee Comments

Los Angeles Community Development Bank (LACDB):

LACDB did not fully agree with the draft finding. Specific comments as follows:

Intermediary Fees

LACDB contended the $90,500 in fees paid to microloan intermediaries are necessary and reasonable. LACDB disagreed with OIG's conclusion that if the fee exceeded the microloan amount, the fee was unreasonable or excessive.

Staff Bonuses and Pay Raises

LACDB did not fully agree that the bonuses and pay raises were unreasonable and unnecessary. LACDB stated it believed special merit bonuses and pay raises to recognize exceptional staff performance is necessary and a generally accepted sound business practice and allowable, pursuant to OMB Circular A-122. LACDB also pointed out that OIG's calculation of the total amount of bonuses in question was understated and should have been $6,500, instead of $5,000 as reported. LACDB also stated OIG's calculation of the pay raises was also incorrect and should have been only $12,627.

Meals and Other Expenses

LACDB contended that pursuant to OMB Circular A-122, the expenses relating to the meals and other expenses items were related to the performance of the award, in accordance with LACDB's established customs for improving employer-employee relations, and therefore, reasonable.

City of Los Angeles (City):

No comments.

<u>County of Los Angeles (County):</u>

The County essentially agreed with the finding, and explained that in 1999 the County identified the questionable expenses paid with credit cards during its monitoring of LACDB and reported them to LACDB's management and accounting firm. Ultimately, both the use of the credit cards was discontinued, and LACDB's management and accounting firm were replaced. With regard to the salaries and bonuses, the County stated they were made within the authority granted to LACDB's Board of Directors under the articles of incorporation and by-laws. The County stated it will direct LACDB to comply with HUD's regulations.

Office of Inspector General Evaluation of Auditee Comments

<u>Los Angeles Community Development Bank (LACDB):</u>

<u>Intermediary Fees</u>

Even though LACDB disagreed with OIG's conclusion that the fees were unreasonable, it may actually have recognized that this payment structure was flawed since it changed the fee structure of paying a flat amount to the higher of $1,000 or 10 percent of the microloan amount.

<u>Staff Bonuses and Pay Raises</u>

As stated in the draft finding, LACDB already had an established practice of giving annual bonuses and pay raises at the beginning of each calendar; therefore, it was unnecessary to give <u>additional</u> bonuses and pay raises at mid-year. Concerning the differences between the amounts questioned in the draft finding versus the amounts pointed out by LACDB in its response, LACDB should provide HUD with documentation to support its position when responding to the corrective actions required under Recommendation 3B of this report.

<u>Meals and Other Expenses</u>

We disagree with LACDB's explanation. In our opinion, meals and other expense items were, unnecessary and imprudent use of EDI grant funds. More specifically, expenditures for snacks or meals at meetings, holiday parties, birthday cards and cakes, and gifts for staff members do not necessarily add to the efficient day-to-day operations of LACDB.

County of Los Angeles (County):

Since the County agreed with the finding, we have no further comment.

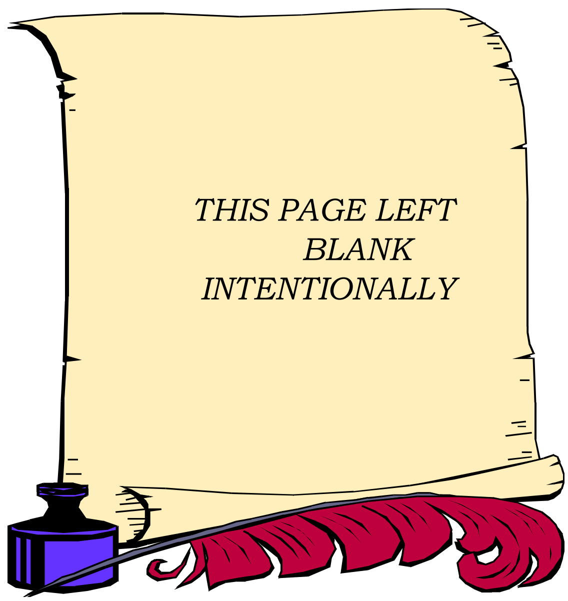
Recommendations

We recommend you require the City and the County of Los Angeles to:

3A. Instruct LACDB to adhere to pertinent provisions of OMB Circular A-122 concerning general principles for determining cost allowability.

3B. Require LACDB to provide justification supporting the eligibility of $44,650 in questioned costs.

3C. Reimburse the EDI Grant program from non-federal funds for any unsupported questioned costs stated in Recommendation 3B.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Management Controls

In planning and performing our audit, we obtained an understanding of LACDB's management controls applicable to its administration of the EZ program through its HUD-funded loans and investments activities that were relevant to the audit. Management is responsible for establishing effective management controls. Management controls, in the broadest sense, include the plan of organization, methods, and procedures adopted by management to ensure its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They also include the systems for measuring, reporting, and monitoring program performance.

Relevant Management Controls

We determined the following management control systems were relevant to our audit objectives:

- Program administration and oversight practices to assure program objectives are accomplished.
- Loan and investment processing and approval procedures.
- Processing and approving loans and investments in accordance with established underwriting procedures.
- Monitoring borrowers' compliance with program requirements.
- Approving of funds in accordance with Federal Government cost principles.

Significant Weaknesses

A significant weakness exists if management controls do not give reasonable assurance control objectives are met. Based on the results of our review, we conclude the following were significant weaknesses:

- Inadequate emphasis and oversight to assure timely corrective action was taken to correct non-compliances with HUD and EDI Grant Agreements' requirements. (Finding 1)
- Insufficient controls to assure loans and investments approved by LACDB met job creation/retention

requirements and EDI Agreements' spending limit restrictions. (Findings 1 and 2)

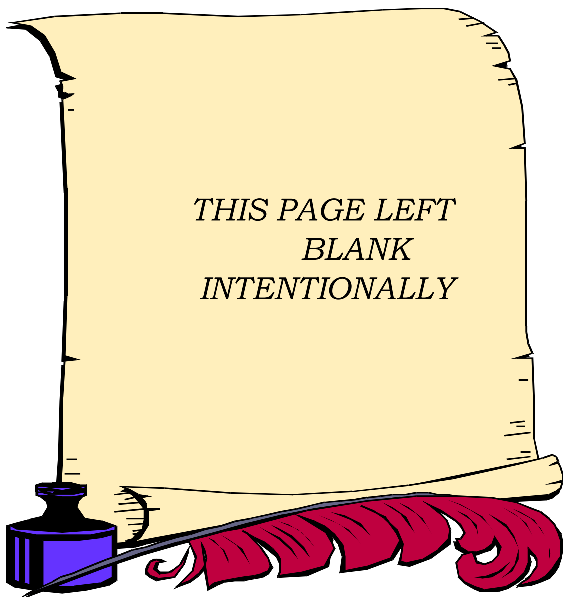
- Non-compliance with established financial underwriting policies and procedures. (Finding 2)

- Insufficient monitoring procedures and practices to assure timely corrective action was taken to correct borrowers' non-compliances with EDI Agreements' requirements. (Findings 1 and 2)

- Lack of familiarity with OMB Circular cost principles to assure administrative expenditures were reasonable and necessary. (Finding 3)

Follow Up on Prior Audits

This is the Office of Inspector General's (OIG) first audit of the Los Angeles Community Development Bank.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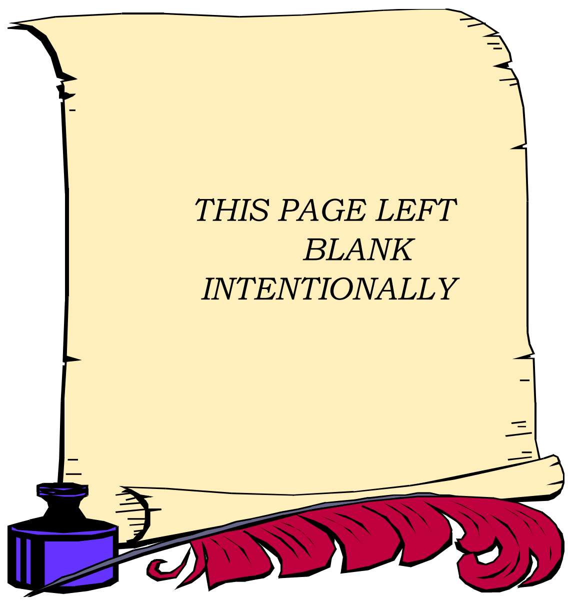
Schedule Of Businesses Not Meeting National Objective

Customer No.	Location	Funding			Jobs Projected	Jobs Created				
		Total	EDI	Section 108		Total	EZ Residents	%	Total Low/Mod[1]	%
Written Off, Activity Closed – No Further Job Creation Expected.										
038	NTA	$18,000	$18,000	$0	1	0	0	0%	0	0%
016	TA[2]	$25,000	$25,000	$0	1	0	0	0%	0	0%
017	NTA	$24,521,811	$7,807,691	$16,714,120	701	111	2	2%	13	12%
011	TA[2]	$199,549	$0	$199,549	7	4	0	0%	0	0%
032	NTA	$6,000	$6,000	$0	1	0	0	0%	0	0%
032	NTA	$1,264,762	$0	$1,264,762	37	128	18	14%	18	14%
006	NTA	$100,000	$0	$100,000	3	2	0	0%	1	50%
133	NTA	$495,000	$321,750	$173,250	15	11	0	0%	0	0%
010	NTA	$852,354	$0	$852,354	25	0	0	0%	0	0%
057	TA[2]	$19,900	$19,900	$0	1	0	0	0%	0	0%
081	NTA	$742,500	$482,625	$259,875	22	5	0	0%	0	0%
063	NTA	$500,000	$0	$500,000	15	9	0	0%	0	0%
062	NTA	$692,604	$0	$692,604	20	8	0	0%	1	13%
014	TA[2]	$75,000	$0	$75,000	3	0	0	0%	0	0%
018	NTA	$618,190	$0	$618,190	18	6	0	0%	0	0%
040	NTA	$3,300	$3,300	$0	1	0	0	0%	0	0%
041	NTA[4]	$15,000	$15,000	$0	1	0	0	0%	0	0%
009	TA[2]	$635,000	$0	$635,000	19	13	0	0%	0	0%
019	NTA	$590,697	$0	$590,697	17	9	0	0%	0	0%
008	OTHER[3]	$1,850,000	$0	$1,850,000	53	0	0	0%	0	0%
137	NTA	$25,000	$25,000	$0	1	0	0	0%	0	0%
148	OTHER[3]	$1,485,000	$965,250	$519,750	43	9	0	0%	0	0%
064	NTA	$15,000	$15,000	$0	1	0	0	0%	0	0%
050	NTA	$25,000	$25,000	$0	1	0	0	0%	0	0%
116	NTA	$25,000	$25,000	$0	1	0	0	0%	0	0%
003	NTA	$847,078	$0	$847,078	25	9	0	0%	0	0%
103	NTA	$1,733,198	$1,126,579	$606,619	52	24	1	4%	4	17%
066	TA[2]	$25,000	$25,000	$0	1	0	0	0%	0	0%
015	TA[2]	$552,555	$0	$552,555	17	0	0	0%	0	0%
112	NTA	$1,685,177	$1,095,365	$589,812	52	152	0	0%	6	4%
001	TA[2]	$925,000	$0	$925,000	27	147	17	12%	17	12%
075	NTA	$340,000	$0	$340,000	10	16	1	6%	7	44%
026	NTA	$16,000	$16,000	$0	1	0	0	0%	0	0%
044	NTA	$20,000	$20,000	$0	1	0	0	0%	0	0%
104	NTA	$925,650	$601,673	$323,977	28	8	0	0%	0	0%
Sub Total		**$41,869,325**	**$12,639,133**	**$29,230,192**	**1,222**	**671**	**39**	**6%**	**67**	**10%**
Inactive – Activity Not Yet closed or Written Off But No Further Job Creation Expected.										
096	NTA	$1,738,440	$1,129,986	$608,454	52	13	0	0%	0	0%
127	NTA	$15,000	$15,000	$0	1	0	0	0%	0	0%
090	NTA	$82,680	$0	$82,680	3	0	0	0%	0	0%

[1] Includes EZ residents, non-EZ residents but presumed to be qualified as low- and moderate-income persons, and other qualifying low- and moderate-income persons.
[2] Located in EZ target area (TA), but the business either did not create any jobs, or the jobs were prior to the January 1998 announcement of the full EZ designation.
[3] Located outside both the EZ target area and non-target areas (NTA).
[4] County of Los Angeles funded loan.

Customer No.	Location	Funding			Jobs Projected	Jobs Created				
		Total	EDI	Section 108		Total	EZ Residents	%	Total Low/Mod[1]	%
125	TA[2]	$15,000	$15,000	$0	1	0	0	0%	0	0%
093	NTA	$15,000	$15,000	$0	1	0	0	0%	0	0%
140	TA[2]	$25,000	$25,000	$0	1	0	0	0%	0	0%
061	TA[2]	$200,000	$200,000	$0	6	0	0	0%	0	0%
114	NTA	$25,000	$25,000	$0	1	0	0	0%	0	0%
134	NTA	$25,000	$25,000	$0	1	0	0	0%	0	0%
Sub Total		**$2,141,120**	**$1,449,986**	**$691,134**	**67**	**13**	**0**	**0%**	**0**	**0%**
Loan Paid Off– No Further Job Creation Expected										
074	TA[2]	$1,500,000	$0	$1,500,000	43	0	0	0%	0	0%
022	TA[2]	$882,549	$0	$882,549	26	8	4	50%	4	50%
035	TA[2]	$25,000	$25,000	$0	1	0	0	0%	0	0%
029	NTA	$25,000	$25,000	$0	1	34	0	0%	0	0%
092	TA[2]	$25,000	$25,000	$0	1	0	0	0%	0	0%
036	NTA	$9,500	$9,500	$0	1	0	0	0%	0	0%
021	NTA	$386,177	$0	$386,177	22	132	16	12%	24	18%
043	TA[2]	$10,000	$10,000	$0	1	0	0	0%	0	0%
028	NTA	$25,000	$25,000	$0	1	4	0	0%	1	25%
046	NTA	$15,000	$15,000	$0	1	0	0	0%	0	0%
004	TA[2]	$577,194	$0	$577,194	17	0	0	0%	0	0%
Sub Total		**$3,480,420**	**$134,500**	**$3,345,920**	**115**	**178**	**20**	**11%**	**29**	**16%**
Active – Further Job Creation Expected										
115	NTA	$572,177	$371,915	$200,262	17	22	0	0%	0	0%
154	OTHER[3]	$131,700	$0	$131,700	4	0	0	0%	0	0%
143	NTA	$13,000	$13,000	$0	1	0	0	0%	0	0%
055	NTA	$20,000	$20,000	$0	1	1	0	0%	0	0%
058	NTA	$25,000	$25,000	$0	1	0	0	0%	0	0%
132	TA[2]	$25,000	$25,000	$0	1	0	0	0%	0	0%
146	NTA	$49,898	$0	$49,898	2	10	0	0%	3	30%
095	NTA[4]	$125,000	$0	$125,000	4	4	2	50%	2	50%
039	NTA	$420,000	$0	$420,000	12	0	0	0%	0	0%
131	NTA	$7,500	$7,500	$0	1	0	0	0%	0	0%
067	NTA	$5,197,496	$3,378,373	$1,819,123	152	148	1	1%	5	3%
155	NTA	$0	$0	$0	58	0	0	0%	0	0%
033	NTA	$19,560	$19,560	$0	1	0	0	0%	0	0%
080	NTA	$3,959,999	$2,574,000	$1,385,999	115	98	2	2%	16	16%
099	TA[2]	$10,000	$10,000	$0	1	0	0	0%	0	0%
025	NTA	$265,000	$0	$265,000	8	4	1	25%	2	50%
068	NTA	$25,000	$25,000	$0	1	17	0	0%	0	0%
120	NTA	$100,000	$0	$100,000	3	3	0	0%	1	33%
113	NTA	$20,000	$20,000	$0	1	0	0	0%	0	0%
071	NTA	$4,000	$4,000	$0	1	0	0	0%	0	0%
030	TA[2]	$25,000	$25,000	$0	1	0	0	0%	0	0%
126	NTA	$10,000	$10,000	$0	1	0	0	0%	0	0%
145	NTA	$15,000	$15,000	$0	1	0	0	0%	0	0%
045	NTA	$4,800	$4,800	$0	1	1	0	0%	0	0%
142	TA[2]	$25,000	$25,000	$0	1	0	0	0%	0	0%
152	TA[2]	$25,000	$25,000	$0	1	0	0	0%	0	0%
088	TA[2]	$40,000	$0	$40,000	2	0	0	0%	0	0%
108	TA[2]	$25,000	$25,000	$0	1	0	0	0%	0	0%
122	NTA	$11,000	$11,000	$0	1	8	0	0%	3	38%
119	NTA	$1,299,446	$0	$1,299,446	38	2	0	0%	0	0%
070	NTA	$60,000	$0	$60,000	2	12	0	0%	0	0%
091	NTA[4]	$25,000	$25,000	$0	1	2	0	0%	0	0%
023	NTA	$800,000	$800,000	$0	23	5	0	0%	0	0%
027	NTA	$200,000	$0	$200,000	6	11	1	9%	1	9%
139	NTA	$7,000	$7,000	$0	1	0	0	0%	0	0%
124	NTA	$25,000	$25,000	$0	1	1	0	0%	0	0%

Customer No.	Location	Funding			Jobs Projected	Jobs Created				
		Total	EDI	Section 108		Total	EZ Residents	%	Total Low/Mod[1]	%
138	NTA	$5,000	$5,000	$0	1	0	0	0%	0	0%
111	NTA	$10,000	$10,000	$0	1	0	0	0%	0	0%
056	NTA	$5,000	$5,000	$0	1	0	0	0%	0	0%
082	NTA	$850,000	$0	$850,000	25	56	0	0%	1	2%
007	NTA	$100,000	$0	$100,000	3	15	0	0%	3	20%
094	NTA	$20,000	$20,000	$0	1	0	0	0%	0	0%
079	NTA	$4,769,823	$875,942	$3,893,881	86	81	4	5%	15	19%
156	TA[2]	$200,000	$0	$200,000	15	0	0	0%	0	0%
054	NTA	$10,000	$10,000	$0	1	0	0	0%	0	0%
147	NTA	$1,980,000	$1,287,000	$693,000	57	10	0	0%	1	10%
Sub Total		**$21,537,399**	**$9,704,090**	**$11,833,309**	**658**	**501**	**9**	**2%**	**53**	**10%**
TOTAL		**$69,028,264**	**$23,927,709**	**$45,100,555**	**2,062**	**1,357**	**66**	**5%**	**149**	**11%**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Schedule Showing Portion Of Funding Applicable To National Objective Shortfall

Customer No.	Total Funding	Jobs Projected		Jobs Created			Amount [2]	OIG Review (See Legend)
		No.	Cost	Total	Low/Mod[1]	%		
Written Off, Closed-No further job creation expected								
038	$18,000	1	$18,000	0	0	0%	$9,180	3
016	$25,000	1	$25,000	0	0	0%	$12,750	3
017	$24,521,811	701	$34,981	111	13	12%	$9,563,506	1,2
011	$199,549	7	$28,507	4	0	0%	$101,769	1,2
060	$6,000	1	$6,000	0	0	0%	$3,060	3
032	$1,264,762	37	$34,183	128	18	14%	$467,172	3
010	$852,354	25	$34,094	0	0	0%	$434,700	1,2
057	$19,900	1	$19,900	0	0	0%	$10,149	3
063	$500,000	15	$33,333	9	0	0%	$255,000	1,2
062	$692,604	20	$34,630	8	1	13%	$263,190	1,2
014	$75,000	3	$25,000	0	0	0%	$38,250	1.2
018	$618,190	18	$34,344	6	0	0%	$315,276	1,2
040	$3,300	1	$3,300	0	0	0%	$1,683	3
041[3]	$15,000	1	$15,000	0	0	0%	$7,650	3
009	$635,000	19	$33,421	13	0	0%	$323,850	1,2
019	$590,697	17	$34,747	9	0	0%	$301,255	1,2
008	$1,850,000	53	$34,906	0	0	0%	$943,500	3
137	$25,000	1	$25,000	0	0	0%	$12,750	3
067	$15,000	1	$15,000	0	0	0%	$7,650	3
050	$25,000	1	$25,000	0	0	0%	$12,750	3
116	$25,000	1	$25,000	0	0	0%	$12,750	3
003	$847,078	25	$33,883	9	0	0%	$432,009	1,2
066	$25,000	1	$25,000	0	0	0%	$12,750	3
015	$552,555	17	$32,503	0	0	0%	$281,802	1,2
001	$925,000	27	$34,259	147	17	12%	$360,750	3
075	$340,000	10	$34,000	16	7	44%	$23,800	3
026	$16,000	1	$16,000	0	0	0%	$8,160	3
044	$20,000	1	$20,000	0	0	0%	$10,200	3
Sub Total	**$34,702,800**	**1,007**		**460**	**56**	**12%**	**$14,227,311**	
Inactive – Businesses are not closed or written off, but no further job creation is expected								
127	$15,000	1	$15,000	0	0	0%	$7,650	3
090	$82,680	3	$27,560	0	0	0%	$42,166	1,2
125	$15,000	1	$15,000	0	0	0%	$7,650	3
093	$15,000	1	$15,000	0	0	0%	$7,650	3
140	$25,000	1	$25,000	0	0	0%	$12,750	3
061	$200,000	6	$33,333	0	0	0%	$102,000	1,2
114	$25,000	1	$25,000	0	0	0%	$12,750	3
134	$25,000	1	$25,000	0	0	0%	$12,750	3
Sub Total	**$402,680**	**15**		**0**	**0**	**0%**	**$205,366**	
Active – Further Job Creation Expected								
154	$131,700	4	$32,925	0	0	0%	$67,167	3
143	$13,000	1	$13,000	0	0	0%	$6,630	3
055	$20,000	1	$20,000	1	0	0%	$10,200	3

[1] Includes EZ residents, non-EZ residents but presumed to be qualified as low- and moderate-income persons, and other qualifying low- and moderate-income persons.
[2] Portion of the loan amount applicable to the percentage difference between jobs created for low- and moderate-income persons and the national objective standard of 51%.
[3] County of Los Angeles funded loan.

Customer No.	Total Funding	Jobs Projected No.	Jobs Projected Cost	Jobs Created Total	Jobs Created Low/Mod[1]	Jobs Created %	Amount [2]	OIG Review (See Legend)
058	$25,000	1	$25,000	0	0	0%	$12,750	3
132	$25,000	1	$25,000	0	0	0%	$12,750	3
146	$49,898	2	$24,949	10	3	30%	$10,479	3
039	$420,000	12	$35,000	0	0	0%	$214,200	1,2
131	$7,500	1	$7,500	0	0	0%	$3,825	3
155	$0	58	$0	0	0	0%	$0	3
033	$19,560	1	$19,560	0	0	0%	$9,975	3
099	$10,000	1	$10,000	0	0	0%	$5,100	3
068	$25,000	1	$25,000	17	0	0%	$12,750	3
120	$100,000	3	$33,333	3	1	33%	$18,000	3
113	$20,000	1	$20,000	0	0	0%	$10,200	3
071	$4,000	1	$4,000	0	0	0%	$2,040	3
030	$25,000	1	$25,000	0	0	0%	$12,750	3
126	$10,000	1	$10,000	0	0	0%	$5,100	3
145	$15,000	1	$15,000	0	0	0%	$7,650	3
045	$4,800	1	$48,000	1	0	0%	$2,448	3
142	$25,000	1	$25,000	0	0	0%	$12,750	3
152	$25,000	1	$25,000	0	0	0%	$12,750	3
088	$40,000	2	$20,000	0	0	0%	$20,400	3
108	$25,000	1	$25,000	0	0	0%	$12,750	3
122	$11,000	1	$11,000	8	3	38%	$1,430	3
119	$1,299,446	38	$34,196	2	0	0%	$662,717	3
070	$60,000	2	$30,000	12	0	0%	$30,600	3
091[3]	$25,000	1	$25,000	2	0	0%	$12,750	3
027	$200,000	6	$33,333	11	1	9%	$84,000	3
139	$7,000	1	$7,000	0	0	0%	$3,570	3
124	$25,000	1	$25,000	1	0	0%	$12,750	3
138	$5,000	1	$5,000	0	0	0%	$2,550	3
111	$10,000	1	$10,000	0	0	0%	$5,100	3
056	$5,000	1	$5,000	0	0	0%	$2,550	3
082	$850,000	25	$34,000	56	1	2%	$416,500	3
007	$100,000	3	$33,333	15	3	20%	$31,000	3
094	$20,000	1	$20,000	0	0	0%	$10,200	3
079	$4,769,823	86	$55,463	81	15	19%	$1,526,343	3
156	$200,000	15	$13,333	0	0	0%	$102,000	3
054	$10,000	1	$10,000	0	0	0%	$5,100	3
Sub Total	**$8,637,727**	**282**		**220**	**27**	**12%**	**$3,391,824**	
TOTAL	**$43,743,207**	**1,304**		**680**	**83**	**12%**	**$17,824,501**	

Legend:

1 – LACDB's underwriting credit summary and pre-funding checklist stated the activity will create jobs predominantly for EZ residents. We did not find any documentation in the loan files evidencing specific analyses performed by LACDB to support the determination that the activity will create jobs predominantly for EZ residents. The pre-funding checklist and credit summary also stated the aggregate amount of funds made available will not exceed $35,000 per job if LACDB funds the project.

2 – Minimal or no evidence of post-funding monitoring maintained in LACDB's compliance files. The extent of monitoring appeared to be primarily only desk reviews through completion of LACDB's quarterly national objective status report, and completion of public benefit determination report upon closure of the business. We found little or no evidence of on-site monitoring or specific efforts made with borrowers experiencing difficulties to ensure borrowers complied with job creation requirements.

3 – Business not included in OIG review sample.

[3]County of Los Angeles funded loan.

Schedule Of Venture Capital Investments

Customer No.	Funding			Jobs Projected		Jobs Created					OIG Review (See Legend)
	Total	EDI	Section 108	No	Cost	Total	EZ Residents	%	Total Low/Mod[1]	%	
Written Off, Activity Closed – No further Job Creation Expected											
133	$495,000	$321,750	$173,250	15	$33,000	11	0	0%	0	0%	1,2
081	$742,500	$482,625	$259,875	22	$33,750	5	0	0%	0	0%	1,2
148	$1,485,000	$965,250	$519,750	43	$34,535	9	0	0%	0	0%	1,2
103	$1,733,198	$1,126,579	$606,619	52	$33,331	24	1	4%	4	17%	1,2
112	$1,685,177	$1,095,365	$589,812	52	$32,407	152	0	0%	6	4%	1,2
104	$925,651	$601,673	$323,978	28	$33,059	8	0	0%	0	0%	1,2
Sub Total	**$7,066,525**	**$4,593,242**	**$2,473,284**	**212**		**209**	**1**	**1%**	**10**	**5%**	
Inactive – Activity Not Yet Closed or Written Off But No Further Job Creation Expected											
096	$1,738,440	$1,129,986	$608,454	52	$33,432	13	0	0%	0	0%	1,2
Sub Total	**$1,738,440**	**$1,129,986**	**$608,454**	**52**	**$33,432**	**13**	**0**	**0%**	**0**	**0%**	
Active – Further Job Creation Expected											
115	$572,177	$371,915	$200,262	17	$33,657	22	0	0%	0	0%	1,2
067	$5,197,494	$3,378,373	$1,819,121	152	$34,194	148	1	1%	5	3%	1,2
080	$3,960,000	$2,574,000	$1,386,000	115	$34,435	98	2	2%	16	16%	1,2
023	$800,000	$800,000	$0	23	$34,783	5	0	0%	0	0%	1,2
107	$2,855,452	$1,856,044	$999,408	84	$33,993	45	1	2%	45	100%	1,2,3
098	$1,881,000	$1,222,650	$658,350	56	$33,589	32	2	6%	32	100%	1,2,3
147	$1,980,000	$1,287,000	$693,000	57	$34,737	10	0	0%	1	10%	1,2
Sub Total	**$17,246,124**	**$11,489,982**	**$5,756,141**	**504**		**360**	**6**	**2%**	**99**	**28%**	
TOTAL	**$26,051,089**	**$17,213,210**	**$8,837,879**	**768**		**582**	**7**	**1%**	**109**	**19%**	

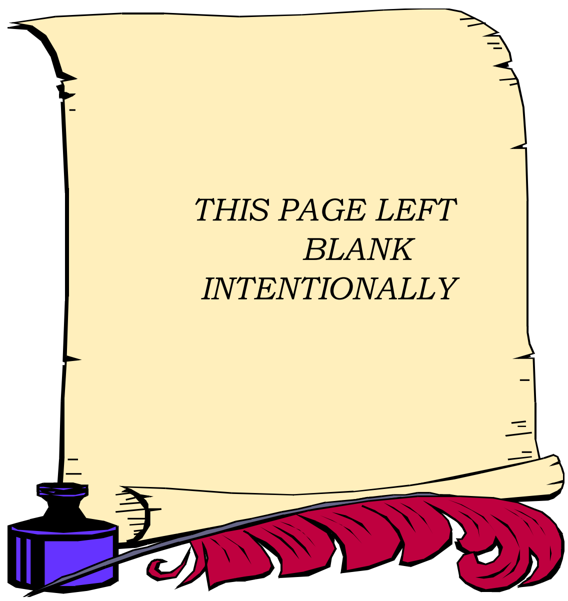
Legend:

1 – Zone Ventures/LACDB did not have written underwriting documentation to support their basis for approving the venture capital investment.

2 – Minimal or no evidence of post-funding monitoring maintained in LACDB's compliance files. The extent of monitoring appeared to be only limited desk reviews through (1) review of Zone Ventures' quarterly portfolio report on the financial status of the businesses; there was no evidence of any on-site monitoring or follow up on non-compliances by LACDB, and (2) completion of public benefit determination report upon closure of business.

3 – Business located in EZ target area; therefore, business met national objective based on the presumptive benefit test.

[1] Includes EZ residents hired, non-EZ residents but presumed to be qualified as low-and moderate-income persons, and other qualifying low- and moderate-income persons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Schedule of Questioned Costs

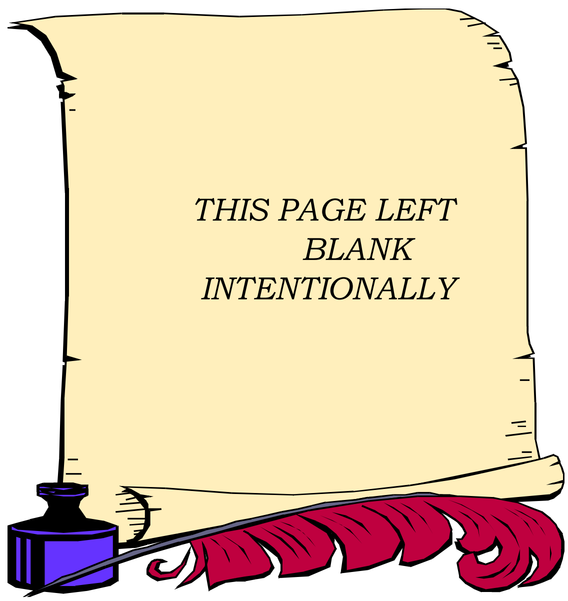
Recommendation Number	Unnecessary or Unreasonable	Unsupported	Funds Put To Better Use	Total
2A			$6,320,465[2]	**$6,320,465**
2C		$2,628,446[1]		**2,628,446**
3B	$44.650[3]			**44,650**
Total	$44,650	$2,628,446	$6,320,465	**$8,993,561**

Unnecessary costs are those that are not generally recognized as ordinary, prudent, relevant, and/or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by the ordinarily prudent person in the conduct of a competitive business.

Unsupported costs are costs charged to a HUD-financed or HUD-insured program or activity and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the costs. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

Funds put to better use relates to an action by management in response to the Inspector General's recommendations to prevent improper obligation or expenditure of funds to avoid further unnecessary expenditures.

[1] This amount represents the total management fee paid to Zone Ventures Management Company through December 31, 2001.
[2] This amount represents the unexpended balance ($35,000,000 - $28,679,535) remaining on the $35 million capital commitment under the Zone Ventures Partnership Agreement, as of December 31, 2001, for the venture capital program.
[3] This amount consists of expenditures of EDI funds paid for meals and other expenses ($12,229) not essential to LACDB's operations and unnecessary LACDB staff bonuses and pay raises ($32,421).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Auditee Comments

Los Angeles
Community Development Bank
(Not A Commercial Bank)

VIA EMAIL and US MAIL

September 13, 2002

Mimi Y. Lee
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General, Region 9
450 Golden Gate Avenue
San Francisco, CA 94102-3448

Re: **Draft Audit Report on the Los Angeles Community Development Bank (dated August 27, 2002)**

Dear Ms. Lee:

On behalf of the Board of Directors and staff of the Los Angeles Community Development Bank (LACDB), we appreciate your providing us with the August 27, 2002 draft report of the Office of Inspector General (OIG) audit of the EDI and Section 108 funded programs administered by the LACDB. As suggested in your letter transmitting the draft report, we have taken this opportunity to provide you with written responses to the OIG's findings and recommendations.

In the main, the LACDB disputes the findings in the OIG's draft report. As is more fully described in the enclosed materials, our principal disagreements are as follows:

- Meeting the National Objective – The OIG's analysis is a snapshot in time, and fails to adequately consider the substantial and continuing progress made by the LACDB and its customers towards meeting the Public Benefit and National Objective standards.
- Venture Capital Program - This program should be allowed to reach its contractual conclusion.
- Unnecessary and/or Unreasonable Expenditures – We strongly believe that the costs cited are necessary, reasonable and supportable as generally accepted sound business practices.

Headquarters: 1241 South Soto Street, Los Angeles, California 90023, Suite 118 • Tel. (323) 264-4290 • Fax (323) 789-2665
http://www.lacdb.org

In preparing our responses, we have taken due care to provide, where possible, a reference to the applicable federal or programmatic authority that underlies our position. In some cases, the LACDB's position is supported by additional factual information, such as additional low-and moderate-income jobs created since the audit period cutoff date of December 31, 2001.

We trust that you will give careful consideration to the LACDB's comments as you finalize your official public report. My staff and I are available to meet with you and your audit team if you should have any questions about the enclosed materials.

Sincerely,

William H. Chu
President and CEO

Enclosure

cc: LACDB Board of Directors
Lillian Kawasaki, City Authorized Representative
Carlos Jackson, County Authorized Representative

FINDING 1: LACDB Had Not Fully Met HUD And EDI Grant Agreement's Requirements

The LACDB does not agree with this finding.

While the report is accurate in stating that, as of December 31, 2001, the businesses identified had not yet met the HUD and EDI Grant Agreement requirements, the LACDB contends that its efforts at revitalizing the Los Angeles Empowerment Zone are not yet concluded. Businesses remain open and jobs continue to be created. The LACDB's renewed commitment to job creation monitoring has yielded impressive results. We offer, as partial support for this statement, the statistics presented in Figure 1.

Figure 1
Progress Toward Meeting Public Benefit and National Objective

Customer Jobs Documented Held By:	As of 12/31/01	As of 3/31/02	Percent Change
Empowerment Zone Residents	339	746	*120.1 %*
Presumed Low/Mod Persons	996	1,283	*28.8 %*
Other Low/Mod Persons	165	306	*85.5 %*
Totals Low/Mod Employees	1,500	2,335	*55.7 %*
Total Jobs Created	2,731	3,445	*26.1 %*
Low/Mod Benefit	54.9%	67.8%	

The OIG reports on page 11 that LACDB customers have created 2,731 jobs as of December 31, 2001. Of these, Empowerment Zone residents held 339 positions, employees presumed to be low/mod persons held 996, and other low/mod persons held 165 positions. In total, LACDB-financed activities have benefited 1,500 low/mod persons, nearly 55 percent of all jobs created. The benefits have continued. In the first quarter of this year, the LACDB has documented that low/mod residents of the City and County of Los Angeles held over two-thirds (2,335) of all jobs (3,445) created by its customers. Empowerment Zone resident hiring has more than doubled to 756 positions, representing 22 percent of all persons hired.

The LACDB recognizes that the EDI grant agreements call for special emphasis on hiring of Empowerment Zone residents. The LACDB has redoubled its efforts in this area, improving its monitoring of borrower's job creation and future prospects, enlisting the assistance of federally-funded workforce preparedness centers, and hiring job creation specialists.

In the following section, we provide specific responses to statements presented by the OIG in support of its findings.

LACDB had insufficient controls or did not follow established controls in its procedures to ensure borrower's compliance with job creation requirements.[8]

Response: The federal regulations do not require that the LACDB ensure that job creation/retention activities are fully met. The regulations require that the LACDB document, not guarantee, that projected jobs "will be held by or made available to" eligible low- and moderate-income residents.[9] The federal regulations further state that the LACDB must maintain records; if actual results show a pattern of substantial variation from anticipated results, the remedies include taking actions reasonably within its control to improve the accuracy of the projections.[10] The LACDB has met its obligations by documenting these requirements in all financing arrangements with borrowers and investees and maintaining records.

We address the OIG's comments on LACDB controls and procedures as follows.

Controls and Procedures

LACDB has well-established procedures and controls in place to ensure that job creation/retention requirements are met by borrowers/investees. These procedures were followed by LACDB staff in the origination and monitoring of loans and investments. The procedures are contained in two documents, both of which were available to the OIG audit team. The Pre-Funding Compliance manual was developed by outside counsel, in close consultation with the City, County and HUD.[11] A second companion manual of procedures was completed in April 1998, titled "Post-Funding Compliance Procedures", and deals with monitoring requirements. The second manual was developed in close consultation with the County's CDBG division and the City's CDD staff. The most pertinent procedures from both manuals, relating to job creation, are as follows.

Pre-Funding Compliance Procedures

There are two fundamental analyses conducted in the pre-funding stage. First, the account officer will require the applicant to complete and submit a "Job Creation Plan" in connection with its request for financial assistance. The Job Creation Plan has evolved over time. At the LACDB's inception, the Job Creation Plan was contained in the loan application form and required the applicant to identify the total number of jobs to be created and associated job titles. In 1998, the

[8] See page 16 of the OIG audit report dated 8/27/02.
[9] See 24 CFR 570.208(4)(i).
[10] See 24 CFR 570.209(d).
[11] The Pre-Funding Federal Program Compliance Checklist was drafted on December 13, 1996. The version currently in use was finalized on July 1, 1997, contains 74 pages and involves four steps. Step One ("Threshold Program Eligibility Requirements"), completed by the account officer and reviewed by compliance staff prior of initiation of underwriting, involves determinations relating to the Public Benefit and National Objectives Criteria. Steps Two through Four (relating to determinations on Federal Labor Standards, Environmental Assessment, Federal Record-Keeping Requirements, Relocation Assistance, and Special Loan Determination Policy), are completed prior to funding.

Job Creation Plan was revamped as a separate attachment to the loan application. Each borrower is required to submit a preliminary Job Creation Plan at time of application. The Plan is finalized prior to loan approval and funding. The Plan requires the applicant to provide a quarter-by-quarter description of employment build-up, by position and salary range. The Job Creation Plan is analyzed for reasonableness by LACDB compliance staff.

The second analysis is conducted by the account officer during credit underwriting. The account officer reviews the applicant's business plan, historical trends, and financial projections. In reviewing the applicant's loan package, the account officer is required to verify that the applicant has incorporated the projected jobs and labor expenses in the financial projections. The results of this analysis are presented in the Credit Authorization, a document that summarizes the requested financing, credit risks/mitigations, and staff recommendations.

Post-Funding Compliance Procedures

The post-funding procedures consist of monitoring, referral for assistance and corrective actions.

Following the funding of a loan/investment, the LACDB will refer the borrower/investee to the appropriate One-Stop Workforce Development Center (now called WorkSource Centers). While the number of City-certified centers has varied over time, there have been as many as 15 One-Stops located in or serving the Empowerment Zone. Thus, the LACDB would refer a Pacoima business to the One-Stop in Pacoima, a South Los Angeles business to a One-Stop in South Los Angeles. These referral procedures were developed following a collaborative process involving the Job Linkage Taskforce, a group organized by the City that included the LACDB, various One-Stops, the Empowerment Zone Oversight Committee, and the Employment Development Department. The role of the One-Stop is to identify employment needs, recruit, train and refer eligible empowerment zone residents and other candidates to the employer.

The LACDB monitored referrals of borrowers to the One Stops, to ensure that borrowers were utilizing these important publicly-funded resources and that the One Stops were assisting borrowers.

Each borrower/investee is required to submit to the LACDB periodic information on its employees.[12] The documents supplied by borrowers/investees are reviewed and summarized by LACDB compliance staff. The compiled information serves as the basis for the quarterly National Objective Status Report, and other reports to the City, County and HUD. The LACDB monitors the progress of job creation/retention activities of borrowers/investees through these quarterly reports. Based on the quarterly information, LACDB staff will evaluate the progress of borrower/investees in meeting the public benefit and national objective criteria. Key to making these determinations is the availability of the quarterly information. In cases where borrowers have not supplied current information; LACDB staff will contact the employer and request the

[12] This requirement is documented in the HUD Addendum, a standard exhibit to the Business Loan Agreement and the Securities Purchase Agreement with borrowers and investees, respectively. See CDB #006 (revised 4/14/98) for the procedure on monitoring job creation/retention activities.

documents.[13] If a borrower is responsive to assistance, the LACDB will make a referral to the appropriate One-Stop center. If a borrower is in non-compliance and unresponsive to LACDB efforts, the LACDB can and has implemented procedures that include charging an additional default interest margin of up to six percent over the contractual interest rate.[14]

We did not find any documentation in the loan files evidencing specific analyses performed by LACDB to support these (job creation) determinations prior to approving the loans.[15]

Response: The LACDB disputes the OIG's comments. In the course of underwriting a prospective loan, LACDB staff took a close look at the types of jobs that were projected to occur. The analysis focused on the number and range of jobs. The LACDB evaluated each job creation plan to see if the business owner had prepared a thoughtful Job Creation Plan which included a reasonable mix of white-collar to blue collar-positions; management/skilled and unskilled positions; and salary ranges that appeared competitive. LACDB staff discussed concerns with the business owner, resulting in revised Plan being prepared and submitted. The LACDB was mindful of the fact the employer/owner was responsible for managing its business affairs and avoided the potential liability arising from directing the employer/owner to revise its Plan in any particular way.

Second, in the course of reviewing and approving financing commitments, the LACDB's Board of Directors and Credit Committee often commented on the need to fund businesses that provided a "career ladder" of job opportunities. This meant that the LACDB should look for businesses that had a range of management, skilled and unskilled positions, such that empowerment zone residents qualifying for an entry-level position might have the promise of growth and upward mobility within the business enterprise. The Board advised the LACDB to avoid funding businesses that appeared to have a high number of low-wage, dead end jobs. By focusing on businesses with a range of skill levels, it was hoped that the Bank might help to break the cycle of poverty that has plagued the empowerment zone communities.

The LACDB contends that this approach has been implemented through its financing activities. A range of occupations has been created, from entry level positions at Gold Graphics, South Coast Metal Finishing and CNG Pleating; to moderate-skilled jobs created by Kids on the Move, Hayes Protective Services and Royal Heirlooms; to more highly-skilled and higher paying jobs like those created by the portfolio companies in the venture capital program.

It appears from the draft audit report that the OIG focused on the jobs being created by the Zone Ventures portfolio companies. The OIG argues that these jobs provide a poor match with skill levels possessed by empowerment zone residents. It is not uncommon for startup technology companies to first employ teams of highly-skilled persons to launch operations. This well-

[13] Pursuant to the agreements with each borrower/investee, the business is required to submit employment information within 45 days of each quarter-end. For example, the employment information for the period ending December 31, 2001 is due to the LACDB by February 15, 2002.
[14] See Page 4 of LACDB Post-Funding Compliance Procedure CDB #006.
[15] See page 16 of the OIG audit report dated 8/27/02.

established practice helps contribute to the long-term success of almost any business. The portfolio companies have high-skilled jobs, but also have and project to have many entry-level and skilled positions in data entry, customer service and order fulfillment. These positions were and will be available to EZ residents with real room for growth and real business and career opportunities.

A final but important point. The task of identifying eligible empowerment zone residents for hiring by LACDB borrowers remains a challenge. The LACDB continues to renew its commitment to conduct expanded outreach to the empowerment zone communities to identify additional employment candidates for its borrowers.

Government statistics bear out the challenge presented. As shown in Figure 2, in 1990, the City portion of the empowerment zone had a labor force of 67,119 persons. By 2000, the labor force had expanded modestly to 68,166, an increase of 1.6 percent. The number of persons unemployed actually declined from 12,236 persons in 1990 to 9,335 persons in 2000, a decline of almost 24 percent.

Figure 2
Incidence of Unemployment in the Empowerment Zone

Empowerment Zone	1990 Census		2000 Census	
	Labor Force	Unemployment	Labor Force	Unemployment
City EZ	67,119	12,236 (18.2%)	68,166	9,335 (13.7%)

Source: U.S. Bureau of the Census.

The LACDB draws two conclusions from these data. First, that its efforts have indeed contributed to the revitalization of the empowerment zone, as measured by the steep decline in unemployed EZ residents. Second, the diminishing pool of prospective hires to meet the national objective will require aggressive tactics to identify and recruit empowerment zone residents. The LACDB remains committed to its mission and will work with its borrowers to address the remaining unsatisfactory levels of unemployment in the empowerment zone.

LACDB may have misunderstood the extent of its responsibility in assuring that job creation requirements were fully met.[16]

Response: The LACDB did previously misunderstand its level of responsibility for job creation by its customers. The LACDB acknowledges that it is responsible to monitor job creation by its customers and intervene, where appropriate, to assist borrowers experiencing problems with hiring Empowerment Zone and other low/mod residents.

LACDB's previously approved business plans did not provide for any type of direct job development assistance, as it erroneously believed that City, State and Federally funded programs

[16] See page 17 of the OIG audit report dated 8/27/02.

were equipped to address the needs of LACDB borrowers. While we will continue to work with the available resources, LACDB management and staff will take a more direct hands on approach to managing the linkages of EZ residents to LACDB borrowers.

LACDB monitors each active borrower's progress relating to job creation on at least a quarterly basis. The account officer, as well as compliance staff, maintains communications with all active businesses and their owners or principals. When a business experiences a financial setback or other difficulty, LACDB's first objective is to help get the business back on strong financial footing, the expectation being that a strong or growing business has substantially greater prospects of fulfilling job creation requirements.

The deficiency in job creation is traceable to the nature of the businesses that are provided financing. Basically, assisted businesses fall into one of four categories. First, those businesses that are on target with their business plan and anticipated job growth. LACDB staff works closely with these business owners, referring them to the appropriate One-Stop Workforce Development Center ("WSC") for assistance with identifying and hiring empowerment zone residents. Many of these borrowers also participated in job fairs that were held in the empowerment zone or which served empowerment zone residents. The second category is those businesses that experienced a setback in executing their business plan, due to loss of key accounts or personnel, changes in the economy or other unforeseen factors. Several of these businesses are still projecting significant job growth and are being referred to CDD/WSC for assistance with hiring EZ residents. The third category is those businesses that were unable to achieve their business plans and have ceased operations. Businesses in this category have created the fewest jobs; there is no prospect for future job creation. The fourth category consists of the Venture Capital Program portfolio. While these businesses have created a significant number of jobs (561 jobs through March 31, 2002), very few are held by EZ residents. The portfolio companies experienced phenomenal job growth, outstripping the pool of experienced labor in the empowerment zone. The LACDB still plans to work closely with the portfolio companies and the resources available to identify and train empowerment zone residents that could fill positions created by turnover and attrition. Finally, while approximately one-half of the portfolio companies have closed, the remaining portfolio accounts for approximately 60 percent of the total jobs created. Many of these jobs are considered entry-level positions, they include data entry clerks, and customer services representatives and product fulfillment workers/warehouse employees.

Expanded Job Creation Efforts

The LACDB is committed to ensuring that its borrowers achieve their contractual requirements for job creation, for the ultimate benefit of empowerment zone and other low- and moderate-income persons. Beginning in 2001, the LACDB revamped its activities directed at improving overall job creation and hiring of Empowerment Zone and other low/mod residents by its customers.

1. Improving Job Creation by Borrowers/Investees

The LACDB is committed to significantly improve the job creation outcomes for its borrowers and the Zone Ventures' portfolio companies. To accomplish this, a detailed improvement process has been developed that has the following key components:

- Auditing Borrowers/Investees to Assess Job Potential
- Creating a Databank of Empowerment Zone residents
- Linking EZ Residents to Job Openings
- Leveraging relationships with existing borrowers
- Intervening early with new borrowers

Successful execution of the strategy will require the active cooperation of LACDB borrowers, Zone Ventures and its portfolio companies, assistance from the Empowerment Zone Oversight Committee in identifying empowerment zone residents, and close collaboration with the City's Workforce Development Division and its newly constituted WorkSource system.

2. Job Potential Audit

To better determine each active borrower's capacity to expand, create new jobs and ultimately meet the public benefit of job creation, LACDB is conducting audits of job potential. The audits focus on near-term job potential (i.e., over the next 90 days). LACDB will refer these high potential job creators to the CDD/Worksource system for assistance. LACDB intends to closely track each referral to monitor progress and coordinate assistance to its borrowers. The LACDB expects that this focused effort will lead to improved results.

3. Hiring of Job Creation Specialist

The LACDB retained a job creation specialist in 2002 to assist with the expanded job creation and monitoring activities. This contractor is dedicated to job creation monitoring, borrower referrals, coordinating assistance and contact with CDD/Worksource system, community outreach, and reporting.

4. Prepayment Penalty for Noncompliance

Beginning with new loans booked in the 2002 program year, borrowers who prepay their loans in advance of the maturity date, and have not complied with the public benefit criterion will be assessed a prepayment penalty equivalent to 20 percent of the original commitment amount.

5. Expanded Outreach

The LACDB is committed to an expanded collaboration with a wide range of government and nonprofit organizations to identify Empowerment Zone residents that may benefit from jobs being created. To accomplish this, the LACDB intends to expand its calling program to meet with the following organizations:

- City Council and County Supervisors offices
- Empowerment Zone Oversight Committee
- CDD/Worksource system
- Los Angeles Unified School District (principally adult programs)
- State and County agencies (including EDD, DPSS/GAIN, etc.)
- Community Development Corporations and other local nonprofits
- Governance bodies of the affected Enterprise Communities/Renewal Communities
- Faith-based organizations

Moreover, the LACDB will continue to actively participate in job fairs and other community-oriented activities that may attract empowerment zone residents.

6. Made Available To Criterion

Under existing HUD regulations, recipients can meet the national objective in certain cases where the borrower has not hired the required number of empowerment zone residents, but can document that jobs were made available to low- and moderate-income persons. The LACDB will analyze each new loan and seek approval from the City, County and HUD for loans it determines are suitable for this additional criterion. HUD has previously expressed its willingness to allow the LACDB to qualify loans, on a case-by-case basis, using the made available to criterion.

LACDB approved over $21 million of City-funded expenditures in excess of the 25% funding limit.[17]

Response: The OIG's audit findings state that, through December 31,2001, the LACDB has spent only 50% of the funds within the EZ target area, instead of the required 75 percent. In footnote 4 to the text table on Page 15, the OIG allocates only $17.7 million of the $22.6 million in administrative expenses to the EZ target area. The LACDB contends that 100% of its administrative expenses are within the EZ, since all such expenditures serve the EZ. The basis for this position is presented below.

- The EDI Grant Agreement states that the "assisted activities must be located in or serve the qualifying urban Empowerment Zone target area".[18] The agreement goes on to discuss how the requirement may be met, principally in terms of funding limits.

[17] See page 14 of the OIG audit report dated 8/27/02.
[18] See Paragraph 4 of the Special Contract Conditions, EDI Grant Agreement dated October 31, 1995.

- The LACDB funded loans/investments in the EZ target area in fulfillment of this objective. These eligible expenditures have been properly allocated by the OIG towards the 75% limit.

- The LACDB funded loans/investments in the EZ non-target area that also fulfilled the primary objective. We believe that HUD created the opportunity for the LACDB to fund activities in the non-target area specifically because the assisted businesses would serve the EZ target area. The service requirement was fulfilled inasmuch as each assisted business in the non-target area was contractually obligated to create jobs for the benefit of the EZ target area (i.e., 51% requirement). The OIG may argue that the public benefit and the national objective were not achieved; however, we contend that the regulations require prudent underwriting and documentation of the obligation, not a guaranty of outcomes.

- Therefore, all LACDB administrative/intermediary expenses should be counted as "serving" the EZ target area. This would bring $4,459,754 in EDI expenses back to the EZ side of the ledger, and eliminate the finding on exceeding the 25% funding limit.

- Further, the loans/investments funded in the EZ non-target area should also be counted as "serving" the EZ target area. This would bring $22.9 million of Section 108 expenditures back to the EZ side of the ledger.

LACDB exceeded funding restrictions because of the lack of a control system to track the amount of loans and investments approved in the EZ target and non-target areas. [19]

Response: LACDB has procedures and controls in place to track the source of funding for each loan and investment it makes. This is critical since the LACDB's programs encompass two political jurisdictions and are funded by at least five different public sources.[20] The funding controls have been audited on a quarterly basis by CPA firms since 1996, first by KMPG and more recently by Thomas Cobb Bazilio & Associates.

The principal source of information on this subject is the quarterly Closed Loan Report prepared by the LACDB beginning in January 1998.[21] The report provides detailed information that has been reviewed by the LACDB's outside auditors for compliance with the City and County EDI Grant Agreements funding limits.

In August 1999, LACDB's Chief Financial Officer informed the Bank's business development and intermediary programs that, with respect to the City EDI Grant Agreement, financing levels was approaching the 25% funding limit for activities in the EZ non-target area. The CFO directed that

[19] See page 17 of the OIG audit report dated 8/27/02.
[20] City EDI grants, City Section 108 loan guarantees, City CDBG, County EDI grants and County Section 108 loan guarantees.
[21] This report lists the borrower name, aggregate commitments, business address, location eligibility (i.e., City EZ, City SZ, County EZ, County SZ, etc.)

business development efforts (for both direct and indirect lending) be refocused on the EZ target area and other qualifying low- and moderate-income census tracts. These priorities were also reflected in the 2000 Annual Business Plan submitted in October 1999. By this time, the LACDB had already entered into the Zone Ventures limited partnership agreement and was contractually obligated to fund activities up to the capital commitment level.

Judging from the amount of loans written off ($41.7 million) plus the amount of delinquent loans ($8.7 million), additional losses may be more likely to occur.[22]

Response: The OIG's draft audit findings state that the LACDB has already incurred significant losses from loans and investments to business that have already closed. The OIG further states that judging from the amount of loans written-off ($41.7 million) and delinquent loans ($8.7 million), additional losses may occur.

Assisted businesses that have not created the required number of jobs are, in most cases, the same businesses that have failed or are failing. While the LACDB's primary mission is to create jobs for residents of the empowerment zone, it is restricted to assisting those businesses that are unable to obtain financing from other lenders.[23]

The expectation is that the LACDB would assist good businesses starved by the lack of capital in underserved communities to obtain needed financing that would enable the owners to grow their business and hire new employees from the adjacent communities.

Several additional points need to be made. First and foremost, the LACDB was created for the purpose of assisting the least-creditworthy businesses in the most distressed communities of Los Angeles. The probability that a high proportion of businesses would experience difficulties in executing their businesses and ultimately fail, was known at the inception of the program. This was acknowledged in the 1994 NOFA, which offered a 100% matching EDI grant funds to offset the expected high default risks of these assisted businesses, and in the original Business Plan approved in 1995 at the inception of the Bank.

Secondly, LACDB applies highly conservative procedures to determine when and what to charge-off. The procedure was developed by LACDB's manager of loan administration, a former national bank examiner, and has been reviewed and accepted by the Bank's former auditor, a Big-5 CPA firm.

Thirdly, the OIG gives no credit for recovery efforts by the LACDB that have led to the collection of $4 million of federal funds from failed or closed businesses. The LACDB is equally diligent at the back-end of a transaction, in order to effect maximum recovery of federally-funded assets. Each loan charge-off is reviewed to determine the probability of recovery based on a number of factors, including whether: (a) the business has ceased operations, (b) a scaled-down business can satisfy the debt through a full or partial repayment, (c) the business's pledged assets, guaranty and

[22] See page 5 of the OIG audit report dated 8/27/02.
[23] See 24 CFR 570.209(a)(3).

LACDB's collateral position are available to satisfy the debt, and (d) solvency of the business entity (i.e., evidence of bankruptcy of business and/or guarantors). These and other relevant factors are evaluated against the cost-effectiveness of available recovery options, which range from negotiating compromise/settlement agreements to litigation and foreclosure actions. The LACDB also employs other collection efforts that include reporting a borrower's default to the national credit agencies and to the GSA's Excluded Parties List System.

FINDING 2: LACDB's $28.7 Million City-Funded Venture Capital Program Provided Minimal Benefit To The Empowerment Zone

The Los Angeles Community Development Bank does not agree with Finding 2 and the related recommendations.

By way of background, there is nothing in HUD regulations or the 1994 NOFA that preclude the use of EDI grant or Section 108 funds for equity investments or venture capital. Accordingly, LACDB's Venture Capital Program was included in its original Business Plan and has been approved each year in subsequent business plans.

For purposes of this response, the conclusion reached in the OIG Report can be separated into several logical tiers, suggesting that (1) LACDB entered into a risky venture capital scheme pursuant to a contract that it did not enforce, (2) LACDB did not closely administer the contract, and (3) the result is a substantial financial investment in companies that have both failed and not met the requisite job creation requirement. The Report then goes on to recommend that HUD instruct the City of Los Angeles to require LACDB to (1) discontinue making venture capital program investments, (2) enforce the terms and conditions of the Partnership Agreement against Zone Ventures to obtain full compliance, and (3) seek recovery of the $2,628,446 in Zone Ventures management fees.

The suggestion that LACDB entered into a risky venture is consistent with our mission. As echoed in other parts of this response, LACDB was created for the sole purpose of job creation by getting capital to businesses that could not otherwise obtain it. Our market place is by definition the risky commercial venture. However, it is premature to conclude that the venture capital program has failed. The program has not run its course, and the companies that remain in the portfolio are the strongest, according to an independent third-party review, and they still show potential to create jobs and generate a return. A careful examination of the Partnership Agreement has also led us to conclude that the most prudent course of action is for the LACDB to continue the relationship with Zone Ventures.

Similarly, we believe that the claim that LACDB did not administer the contract with diligence is also flawed because it fails to take into account the oversight of each investment that was exercised by LACDB's Investment Committee. The OIG does not describe the information submitted by Zone Ventures to the LACDB Investment Committee for approval, nor the minutes of Investment Committee/Board of Directors meetings that addressed those discussions. LACDB carefully considered each investment that it ultimately approved. The fact that, in hindsight, some of the investments were not productive is not sufficient evidence of improper oversight. There was oversight to the extent permitted by a limited partnership agreement that is typical of venture capital arrangements.

While some of the companies have failed, and the program has not generated jobs in the aggregate that are consistent with HUD requirements, we believe, however, that it is too early in the program to conclude that it has failed entirely. Several of the companies show potential for growth and job creation. Accordingly, not until we have reached the end of the program will we know whether in the aggregate the program has performed in accordance with guidelines. We believe that we should allow the program to reach its contractual conclusion.

Therefore, we disagree with the recommendation that the LACDB's participation in the venture capital program be terminated. To do so may ensure failure and could result in a significant or total loss of LACDB's investment. The fact that all of the investments have not performed as hoped is no basis, in hindsight, for imposing a penalty on LACDB. In an effort to address these concerns, the LACDB Board and management implemented an extensive review of available options. Negotiations to improve the terms of the agreement were unsuccessful. After extensive deliberation, it is the consensus of the LACDB Board that the best course of action is to continue the contractual relationship with Zone Ventures.

FINDING 3: EDI Funds Used for Unnecessary or Unreasonable Expenses

The LACDB does not fully agree with the OIG analysis and subsequent findings.

Intermediary Fees [24]

The OIG's analysis compared the intermediary fees paid to the microloan commitment amount and concluded that if the fee exceeded the microloan, the fee was unreasonable or excessive. The OIG apparently did not consider either how the fee was determined or the scope of services covered by the intermediary agreements. We offer the following additional chronology and facts in support of our position.

In its July 6, 1995 approval of the various agreements and documents leading to the creation of the Los Angeles Community Development Bank, the Los Angeles City Council required that "all Request for Proposal ("RFP") documents regarding the selection of intermediaries be approved by the Council and the Mayor as part of an amended Business Plan."[25] This requirement was met.

On August 2, 1996, the LACDB issued a Request for Qualifications ("RFQ") to organizations interested in participating as financial intermediaries of the LACDB. The RFQ was developed to identify a pool of potential intermediaries for each of the LACDB's indirect lending programs (i.e., microloan, business loan and commercial real estate loan programs). Based on the qualifications received by September 30, 1996, the LACDB identified a pool of community-

[24] See page 38 of the OIG audit report dated 8/27/02.
[25] See Item 6 of Los Angeles City Council File No. 94-2167

based organizations with the requisite experience and skills to market and underwrite, microloans on behalf of the LACDB.

Given the public interest in serving the smallest and neediest of the borrower base, those small businesses having capital needs of $25,000 and below, the LACDB Board of Directors authorized staff to initiate an indirect lending program through the selection of microloan intermediaries.

Accordingly, on March 31, 1997, the LACDB issued a RFP for its microloan intermediary program to five organizations that satisfactorily responded to the aforementioned RFQ. The Microloan Intermediary Program RFP outlined the following scope of services to be performed by the organizations:

- Marketing and Outreach: The precise strategies being left to each organization, this task involved penetrating the very-small business community as well as home-based businesses to identify potential microloan applicants.
- Pre-screening for Threshold Eligibility: Conduct screening for location eligibility, and ability to achieve public benefit and national objective.
- Initial Credit Assessment: Conduct an early assessment of the credit to determine whether it merits further analysis.
- Technical Assistance: Provide assistance to the applicant in completing the loan application, including assistance with the business plan.
- Credit Analysis: Conduct due diligence on cash flow, financial projections, loan pricing, collateral, and credit history.
- Loan Presentation: Prepare a narrative summary, with supporting documents, for presentation to the LACDB microloan credit committee.
- Loan Closing: Review LACDB-generated loan documents with the applicant.
- Post-Closing Relationship Management: Assist the LACDB with the collection of periodic financial statements, job creation data, site visits, and technical assistance (as appropriate).

As should be evident, the level of effort required of microloan intermediaries was substantive and comprehensive. In a great many cases, the microloan intermediaries informed LACDB staff that they were spending upwards of 80 to 100 hours on a single applicant.

A key feature of the RFP was the LACDB's condition that financial intermediaries only be compensated on a closed loan basis. This was viewed as a means to focus the intermediary on the most probable microloan candidates.

By the April 30, 1997 deadline, four nonprofit, community-based organizations had submitted proposals to the LACDB. Each organization submitted an estimate of the anticipated microloan volume and fee estimates. Three of the respondents submitted fees of $5,000 per funded loan, the fourth proposed a fee of $7,500 per funded loan. The LACDB eventually entered into contracts with the three respondents at $5,000 per funded loan, being unable to reach agreement with the fourth respondent.

A final comment. In its draft audit report, the OIG comments that "in another case, the intermediary received $5,000 (151% of the loan amount) to originate a $3,300 microloan to a toy store."[26] The business that received the microloan was a home-based business operating out of a HUD-subsidized housing project in Pacoima. The business needed extensive technical assistance to prepare a business plan and loan application. With the funding, the small business was able to relocate to a storefront along Van Nuys Blvd., within the federal empowerment zone and purchase inventory. The LACDB believes this is exactly the type of enterprise that the microloan program was designed to assist.

In conclusion, and based on our understanding of the underlying costs principles, we contend that the $90,500 in fees paid to microloan intermediaries are necessary and reasonable.

Staff Bonuses and Pay Raises [27]

The LACDB does not fully agree with the finding that mid-year bonuses and pay raises to recognize outstanding performance were unnecessary and unreasonable. According to Attachment A of OMB Circular A-122, paragraph 3(b), "*a cost is reasonable when consideration is given to constraints or requirements imposed by such factors as generally accepted sound business practices*." We believe strongly that special merit bonuses and pay raises to recognize exceptional staff performances is necessary and is a generally accepted sound business practice.

We would like to also point out that certain errors on page 37 of the OIG Draft Report, as follows:

> *In July 1999, LACDB's former CEO/President gave seven (the actual number is nine) staff members additional bonuses and/or pay raises totaling $32,421 (the actual amount is $31,753). Contrary to LACDB's normal procedures, the former CEO/President gave seven (actual number is nine) staff members a total of $5,000 (actual amount is $6,500) in bonuses in amounts of either $500 or $2,500, and three of these staff members also received additional pay raises totaling $26,921 (actual amount is $25,253) which ranged from 13 to 21 percent.*

In addition, the calculation of the pay raise amount is incorrect. The amount stated in the OIG draft report was the total annual pay raises over a 12-month period. However, the three staff members received their salary adjustments 6 months earlier, in July 1999 instead of January 2000. Hence, the more appropriate amount should be $12,627, 6 months of the total annual pay raises.

[26] See page 38 of the draft OIG audit report dated 8/27/02.
[27] See page 37 of the OIG audit report dated 8/27/02.

Meals for Meetings ($7,088) [28]

These costs were primarily related to meetings with program advisors and loan applicants. Based on our understanding of the applicable cost principles, we contend that the costs incurred were reasonable for the performance of the award (Attachment A of OMB Circular A-122, paragraph A(2)(a)); necessary for the operation of the organization (Attachment A of OMB Circular A-122, paragraph A(3)(a)); and, were within generally accepted sound business practices (Attachment A of OMB Circular A-122, paragraph A(3)(b)).

Meals for business/committee meetings, holiday parties, and office grand opening ($3,022) [29]

Meals for business/committee meetings were costs primarily related to light snacks, coffee and non-alcoholic beverages for onsite meetings of the LACDB Board of Directors. The volunteer Directors were required to travel directly from their business locations to the LACDB's headquarters office in South Los Angeles for late afternoon meetings. The Board meetings typically began at 4:00 p.m., lasting between 2 to 4 hours. Based on our understanding of the applicable cost principles, we contend that the costs incurred were reasonable for the performance of the award (Attachment A of OMB Circular A-122, paragraph A(2)(a)); necessary for the operation of the organization (Attachment A of OMB Circular A-122, paragraph A(3)(a)); and, were within generally accepted sound business practices (Attachment A of OMB Circular A-122, paragraph A(3)(b)).

Holiday party costs are allowable pursuant to Attachment B of OMB Circular A-122, paragraph 13 because they were other expenses incurred in accordance with the LACDB's established custom for the improvement of employer-employee relations, employee morale, and employee performance.

Office grand opening costs are allowable pursuant to Attachment B of OMB Circular A-122, paragraph 29, because the event was held as part of the general administration of the organization.

Birthday cards and cakes for LACDB staff ($327) [30]

Based on our understanding of the applicable costs principles, we contend that the costs incurred were reasonable and are allowable pursuant to Attachment B of OMB Circular A-122, paragraph 13 as other expenses incurred in accordance with the LACDB's established custom for the improvement of employer-employee relations, employee morale, and employee performance.

Staff AICPA membership dues ($120) [31]

[28] See page 36 of the OIG audit report dated 8/27/02.
[29] See page 37 of the OIG audit report dated 8/27/02.
[30] See page 37 of the OIG audit report dated 8/27/02.
[31] See page 37 of the OIG audit report dated 8/27/02.

Based on our understanding of the applicable costs principles, we contend that these costs incurred were reasonable and are allowable pursuant to Attachment B of OMB Circular A-122, paragraph 30. It is also a generally accepted sound business practice for an organization to pay for professional memberships for its technical and professional staff (Attachment A of OMB Circular A-122, paragraph 3(b). This practice enables the LACDB to recruit and retain a licensed CPA in its accounting unit.

LILLIAN KAWASAKI
GENERAL MANAGER

CITY OF LOS ANGELES
CALIFORNIA

JAMES K. HAHN
MAYOR

COMMUNITY DEVELOPMENT
DEPARTMENT
215 W. 6TH STREET
LOS ANGELES, CA 90014

September 16, 2002

Ms. Mimi Y. Lee
District Inspector General for Audit
Office of Inspector General, Pacific/Hawaii District
U.S. Department of Housing and Urban Development
450 Golden Gate Avenue
San Francisco, California 94102

COMMENTS REGARDING DRAFT AUDIT REPORT OF AUGUST 27, 2002 CONCERNING THE LOS ANGELES COMMUNITY DEVELOPMENT BANK

Dear Ms. Lee:

The City of Los Angeles appreciates the opportunity to provide comments regarding the draft audit report of August 27, 2002 concerning the Los Angeles Community Development Bank. We appreciatate the cooperation of the staff of the Office of Inpector General (OIG). We do believe there is needed clarification and information not included in the draft audit that would provide a more complete perspective regarding the discussion and recommendations to be contained in the final report.

Background/Perspective

The Los Angeles Community Development Bank (LACDB) was created in partnership with HUD in 1996, as an innovative approach to address widespread and difficult conditions in some of the poorest communities in Los Angeles. This program had the following unique features:

- The Los Angeles Community Development Bank was established by the City, County and HUD as an independent entity to provide loans and investments to businesses in historically underserved areas within the Empowerment Zone, the one-mile buffer area, and other low and moderate income areas of Los Angeles.

- Although we recognize that the City is the recipient of federal funding (grantee), HUD advised the City to "assure the independence of the CDB". Therefore, the LACDB was granted unprecedented autonomy. The City did not participate in either day-to-day operations or in loan and venture capital investment decisions of the Bank. LACDB was to ensure compliance with the HUD requirements. The City did

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September 16, 2002

regularly review LACDB reports, independent audits and HUD monitoring and when issues regarding compliance were first reported, took appropriate action in its oversight of the Bank and approval of annual business plans.

- At its inception, it was mutually determined that LACDB would only lend money to businesses that had been turned down at least once by a commercial bank.
- Although federal funds were provided for LACDB operations, an important and critical element of the creation and development of the LACDB involved the commitment of private sector banks to co-lend with LACDB in order to minimize risk and maximize community resources. However, despite the intent for a public-private partnership, the private sector participation did not materialize.

From its inception, the LACDB was structured with full acknowledgement by all parties of the inherent risks, challenges and opportunities in providing critically needed capital for businesses that would create employment opportunities for residents of the target areas.

Findings/Recommendations

The City of Los Angeles objects to the following findings, recommendations, and conclusions set forth in the draft audit report.

Finding 1

The draft audit report states that as of December 31, 2001, LACDB had not met the national objective standard of 51% of the jobs being created or retained for low and moderate income persons.

We believe, however, that LACDB met the federal national objective requirements, and the audit report needs to be corrected accordingly. More specifically, as indicated in the audit report, the federal regulations state that "for an activity that creates jobs, the recipient must <u>document</u> that ...the jobs will be held by, or made available to low- and moderate-income persons." This federal job creation requirement is met at the time job projections are documented. We believe LACDB met this due diligence documentation requirement by requiring borrowers to submit Job Creation Plans, and having LACDB staff review the data for reasonableness, as part of the loan execution process. LACDB met federal national objective requirements and should be reflected in the OIG report.

Additionally, by focusing on individual loans and not aggregate results, the OIG draft audit misrepresents the benefits derived from LACDB activities. More specifically, as of December 2001, nearly 3,000 jobs were created by LACDB loans, with 55% of the jobs going to residents of the Empowerment Zone or persons presumed to be qualified under the national objective criterion for low- and moderate-income benefit.

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Moreover, it is important to note that since many LACDB loans and investments are still active and may provide additional jobs, it is premature to issue final conclusions. This point is made clear upon reviewing the data. Subsequent to the audit report cut-off date, for the first quarter of 2002, LACDB has reported nearly 400 additional jobs.

To assure continued compliance, the City has already initiated steps that are consistent with recommendations in the OIG draft audit. For example, a more rigorous review of LACDB's loans with respect to compliance with national objective, eligibility and public benefit requirements prior to the advancement of funding has been instituted.

Finding 2

Venture capital investments were part of the originally approved plan for LACDB. Moreover, HUD was aware of the venture capital investments, and determined them to be an eligible federal expense.

OIG staff has informed City staff that LACDB's venture capital expenditures are not questioned costs. Therefore, it is confusing and misleading to have the draft audit report use the word "questionable" with respect to the $28.7 million in capital investments and management fees.

Additionally, the $6.3 million amount (remaining under the Partnership Agreement between Zone Ventures and LACDB), should be deleted from Appendix D, Schedule of Questioned Costs, since these funds have not yet been expended.

As a matter of perspective, it is also worth noting that in 1998 when the LACDB invested in Zone Ventures, it anticipated that venture capital investments would result in companies growing and creating jobs, and fostering economic development. However, as experienced by many investors, the stock market, and the technology sector in particular, such investments have recently suffered losses in ways not imagined several years ago.

Therefore, the City, in cooperation with the LACDB and with the assistance of independent consultants, is further evaluating the potential of the venture capital portfolio in order to determine the most prudent use of funds to meet HUD requirements.

Finding 3

The draft audit has found $44,000 in LACDB expenditures unreasonable or unnecessary. The report recommends that LACDB provide justification supporting these costs. The LACDB will address this matter in their response.

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September 16, 2002

Conclusions

The City appreciates the analysis and input of the OIG. Many of the recommendations provided in the draft report are already underway. We have initiated discussions with HUD on issues regarding interpretation and application of the regulations regarding the OIG audit, and will work with HUD to address appropriate remedies as necessary.

It is essential, however, to recognize that, despite the accomplishments and any shortcomings of the LACDB, we must not lose focus on the continuing need to provide funding opportunities to individuals, businesses and programs in underserved communities.

Therefore, we have also begun discussions with HUD regarding reallocation of a portion of the City Section 108 loan authority that is currently allocated to the LACDB, as part of a transition plan for the LACDB.

We appreciate the consideration and opportunity that you have provided for our input. As indicated by our comments above, we believe that there are areas of the OIG draft audit that require revision prior to finalization. We would welcome the opportunity to meet on these remaining issues.

Sincerely,

Lillian Kawasaki
General Manager

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COMMUNITY DEVELOPMENT COMMISSION
of the County of Los Angeles
2 Coral Circle • Monterey Park, CA 91755
323.890.7001 • www.lacdc.org

Gloria Molina
Yvonne Brathwaite Burke
Zev Yaroslavsky
Don Knabe
Michael D. Antonovich
Commissioners

Carlos Jackson
Executive Director

September 12, 2002

Mimi Y. Lee, District Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General, Pacific/Hawaii District
450 Golden Gate Avenue
San Francisco, CA 94102-3448

Dear Ms. Lee:

AUGUST 6, 2002 DRAFT REPORT REGARDING
LOS ANGELES COMMUNITY DEVELOPMENT BANK (LACDB)

This letter transmits our comments to be included in the Audit Report of the Los Angeles Community Development Bank (LACDB). Your final report has been responsive to the majority of our points made to you in our March 12, 2002 and April 30, 2002 correspondence. Along with our correspondence, we provided documentation to evidence the County's due diligence in overseeing the LACDB Section 108 Loan Guarantee Program in the Unincorporated County Empowerment Zone area.

In the coming month, the City, the County and the LACDB will be focusing on the best way to proceed with the balance of the Economic Development Initiative Grant funds and related Section 108 Loan Guarantee Authority, to achieve the goals of the Empowerment Zone (EZ) target area. The needs of the EZ target area are significant and effective efforts to ameliorate the issues of the EZ target area will take several years and considerable determined effort on behalf of the public and private sectors.

If you have any questions regarding this matter, please contact Charles Taylor, of my staff, at (323) 890-7035.

Sincerely,

Carlos Jackson

CARLOS JACKSON
Executive Director

CJ:CT:lh

Attachment

Strengthening Neighborhoods • Supporting Local Economies • Empowering Families • Promoting Individual Achievement

NEW NEIGHBORHOODS for a NEW CENTURY

Auditee Comments

Audit Report
Los Angeles Community Development Bank
Economic Development Initiative Grant/Section 108 Guaranteed Loan Program
City of Los Angeles
County of Los Angeles

Los Angeles Community Development Bank (LACDB) Had Not Fully Met HUD and Economic Development Initiative Grant Agreements' Requirements

Auditee Comments:

Separate Unincorporated County Program

The LACDB Program in the Los Angeles County (County) Unincorporated Empowerment Zone (EZ) target area was operated under a separate grant agreement and was much more significantly controlled than the overall LACDB Program. Due to the County's oversight of loan activity in the County EZ target area, many of the issues identified for the LACDB Program were not applicable under the County's Program. In the County's EZ target area, there were only a total of six (6) businesses that received loans totaling $4,775,275. Of this amount, $4,332,275 went to one (1) business, the Cambridge Steel Corporation. The remaining five (5) businesses received a total of $443,000 in three (3) micro loans (below $25,000) and two (2) small business loans (below $250,000).

Adopted Procedures to Meet HUD/EDI Requirements

County oversight of the LACDB was thorough and all due diligence was taken to insure that the LACDB first developed and adopted pre-funding and post-funding procedures consistent with the U.S. Department of Housing and Urban Development (HUD) and Economic Development Initiative (EDI) requirements before any loans could be considered. In fact, the policies and procedures of the LACDB in this area were initially drafted by County staff as technical assistance to the LACDB. The LACDB was not permitted to issue loans in County areas until these policies and procedures were adopted. Under these procedures, the County staff visited the sites of each proposed borrower to verify location within the County's EZ target area or buffer zone, and to discuss job creation requirements with the assisted business.

Economic Factors Influence Job Creation

Following funding of the loans, County staff reviewed each quarterly report of the LACDB as to progress made by the County businesses on their job creation goals. The first County loan was funded in 1998, and the remaining loans were made in 1999. By the year 2000, the County was aware of problems among the businesses in meeting their job creation requirements. In all cases, these problems were directly related to poor economic performance by the businesses, which

cannot be controlled by the LACDB. County staff met with LACDB monitoring staff to review LACDB post-funding procedures, and in the case of the Cambridge Steel Corporation, with corporate management, to evaluate the diligence of the LACDB and the businesses in achieving the job creation goal.
It is essential that HUD recognize several factors that directly affected the ability of the assisted businesses to create the minimum required number of jobs:

- The majority of the assisted businesses were marginal companies, and the major cause of failure to meet job creation requirements was the economic failure of the businesses; and
- The volatile market conditions that not only affected large Fortune 500 companies, but also small businesses that are most sensitive to changes in the economy such as the Cambridge Steel Corporation.

Given the above factors that influence the businesses' ability to create jobs, it is not reasonable to expect the County to establish controls to offset economic factors. Short of managing the assisted businesses, the County could not further assist the businesses to generate sufficient earnings to create the minimum number of required jobs during the initial stages of loan assistance. The one resource that most of the assisted businesses needed was access to grant funds and other funding sources with fewer restrictions and longer terms. Unfortunately, the LACDB did not have these types of funds to provide to the businesses.

Conclusion:

The main reason for the failure of businesses to meet their job creation goals was the economic failure of the businesses themselves. These companies were not able to overcome the obstacles imposed by under capitalization, poor area economics and the lack of grant funds. Based upon our fiscal assessment of the companies at the time of assistance, if these businesses had succeeded, all projected jobs would have been created.

The LACDB will be requested to consider HUD's final recommendations in the development of the next annual business plan and to reconsider its possible role in future economic development activity in the EZ target area.

Finding No. 2: $28.7 Million City-Funded Venture Capital Program Provided Minimal Benefit To The Empowerment Zone

Auditee Comments:

None.

Finding No. 3: EDI Funds Used for Unnecessary Or Unreasonable Expenses

Disputed Accounting Procedures

The audit report states that "contrary to OMB Circular requirements" the LACDB paid $135,150 in EDI funds for expenses that were either unnecessary or unreasonable.

Credit Card Accounts Closed

In 1999, the County independently identified questionable expenses upon monitoring the LACDB and reported them to the LACDB's management and its accounting firm. When no further action was taken by the auditors or the LACDB management to resolve those expenditures, the auditors were replaced. Concurrently, LACDB management changed and at the direction of the succeeding management, credit card practices and questionable expenditures were discontinued and the accounts were closed at the direction of the LACDB Board. The County's share of questioned costs is **$1,599**.

LACDB Board Acted On Salaries and Bonuses

With respect to the $32,421 in disputed staff bonuses and pay raises, the County points out that the cited adjustments were made by the LACDB Board of Directors within the limits of the authority granted to the LACDB Board by their articles of incorporation and by-laws. Of the $32,421, the County's share of disputed costs is **$4,206**.

QUESTIONED COSTS

Questioned Cost	City Share	**County Share**
Credit Card Usage	$10,630	**$1,599**
Salaries/bonuses	$28,215	**$4,206**
Total	$38,845	**$5,805**

Conclusion:

The LACDB will be directed to comply with HUD's recommendations. The County's total share of questioned costs is approximately **$5,805**.

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Distribution Outside Of HUD

The Honorable Joseph Lieberman, Chairman, Committee on Governmental Affairs
706 Hart Senate Office Building, United States Senate, Washington, DC 20501
The Honorable Fred Thompson, Ranking Member, Committee on Government Affairs,
706 Hart Senate Office Building, United States Senate, Washington, DC 20510
Sharon Pinkerton, Senior Advisor, Subcommittee on Criminal Justice, Drug Policy & Human Resources, B 373 Rayburn House Office Building, Washington, DC 20515
Andy Cochran, House Committee on Financial Services, 2129 Rayburn H.O.B. Washington, D.C. 20515
Clinton C. Jones, Senior Counsel, Committee on Federal Services, U.S. House of Representatives, B303 Rayburn H.O.B., Washington, DC 20515
Kay Gibbs, Committee on Financial Services
Stanley Czerwinski, Director, Housing and Telecommunications Issues, United States General Accounting Office, 441 G Street, NW, Room 2T23, Washington, DC 20548
Steve Redburn, Chief Housing Branch, Office of Management and Budget
725 17th Street, NW, Room 9226, New Executive Office Building, Washington, DC 20503
Linda Halliday, Department of Veterans Affairs, Office of Inspector General, 810 Vermont Ave., NW, Washington, DC 20420
William Winthrow, Department of Veterans Affairs, Office of Inspector General, Audit Operations Division, 1100 Main, Room 1330, Kansas City, Missouri 64105-2112
George Reeb, Assistant Inspector General for Health Care Financing Audits
The Honorable Dan Burton, Chairman, Committee on Government Reform,
2185 Rayburn Building, House of Representatives, Washington, DC 20515
The Honorable Henry A. Waxman, Ranking Member, Committee on Government Reform
2204 Rayburn Building., House of Representatives, Washington, DC 20515
William H. Chu, President and Chief Executive Officer, Los Angeles Community Development Bank, 1241 South Soto Street, Suite 118, Los Angeles, California 90023
Lillian Y. Kawasaki, General Manager, Community Development Department,
City of Los Angeles, 215 West 6th Street, 3rd Floor, Los Angeles, California 90014
Carlos Jackson, Executive Director, Community Development Commission,
County of Los Angeles, 2 Coral Circle, Monterey Park, California 91755