

*State of New York*  
*Office of the State Comptroller*  
*Division of Management Audit*

**NEW YORK JOB DEVELOPMENT  
AUTHORITY**

**MANAGEMENT OF LOAN PORTFOLIO**

**REPORT 95-S-13**



*H. Carl McCall*  
*Comptroller*



# State of New York Office of the State Comptroller

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**Division of Management Audit**

**Report 95-S-13**

Mr. Charles A. Gargano  
Chairman  
New York State Job Development Authority  
1515 Broadway  
New York, New York 10036

Dear Mr Gargano:

The following is our audit report on the New York State Job Development Authority's management of its loan portfolio.

This audit was performed pursuant to the State Comptroller's authority as set forth in Article X, Section 5 of the State Constitution. Major contributors to this report are listed in Appendix A.

*Office of the State Comptroller  
Division of Management Audit*

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# Executive Summary

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## New York Job Development Authority Management of Loan Portfolio

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### Scope of Audit

The purpose of the New York Job Development Authority (Authority) is to promote, encourage and develop the economic welfare of State residents and to improve employment opportunities. The Authority provides loans and loan guarantees to companies seeking to expand facilities, build new plants, and acquire machinery and equipment. Many of these companies might not otherwise have been able to obtain such funding on their own. The Authority's Board of Directors (Board) is responsible for overseeing and operating the Authority. The Authority was intended to be a self-sustaining entity. The Authority generates the funds to provide loans by selling bonds and notes guaranteed by the State. Since its inception in 1961, the Authority has approved loans and loan guarantees totaling about \$800 million for over 2,000 projects. Bond and note principal and interest, as well as Authority operations, are funded by monthly loan repayments, interest earnings on Authority investments, and loan fees charged.

Our audit addressed the following question:

- ! Has the Board properly discharged its fiduciary and oversight responsibilities to help protect and preserve the Authority's loan portfolio?

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### Audit Observations and Conclusions

We found that the Authority's loan review, approval and monitoring systems are seriously deficient and ineffective. Despite being alerted to some of these problems in two prior audits by the State Comptroller, Board members, who have ultimate responsibility for approving loans, have not ensured that prospective borrowers are able to repay the loans as required by law. Since these were higher risk loans, more careful monitoring of the borrower's ability to pay was essential. Since at least 1990 the Authority's financial condition has deteriorated dramatically, resulting from extensive loan losses. From April 1, 1990 through March 31, 1995 Authority expenses exceeded revenues by \$66.4 million. In June 1995, the Authority's independent auditor reported that the Authority has incurred recurring losses from operations and has an overall accumulated deficit of over \$42.7 million. This deficit mainly results from major write-offs of losses on loans, guarantees and foreclosed property. The issues relating to the Authority's financial condition as well as its loan operations must be immediately addressed because the Authority may reach a point where it is unable to repay bond and note investors without the State's guaranteed assistance.

We found that Board members generally accepted recommendations for loan approvals without question. Such loan recommendations come from loan review staff, the Board's Loan Advisory Committee and the Authority's President. Board members generally did not inquire of these parties as to any details to substantiate the quality of the loan or the underlying assumptions and claims made by both the borrower and loan reviewer. Records we reviewed indicated that Board members rarely, if ever, denied a loan application proposed for approval, even though it seemed obvious that certain loan

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recommendations were not justified based on available loan records. Our report contains examples of some of the poor quality loans approved by the Board. (see pp. 5-9)

The lack of Board oversight at the Authority was especially detrimental because compensating controls did not exist. Authority management did not follow prudent loan review, approval and monitoring practices. We found that loan reviewers generally did not follow a standard loan review checklist to ensure that the loan file was complete and that all essential loan factors and criteria had been determined and evaluated. In addition, Authority staff did not independently verify the reliability of the financial and other related data submitted by applicants. In some cases loans were approved even though the related loan files were missing important financial information. (see pp. 11-13)

Loan review and evaluation reports, along with staff recommendations, are forwarded to the Loan Advisory Committee for consideration and action. However, we have no evidence that the Loan Advisory Committee provided the necessary independent analysis of loans before recommending the loans for Board approval. Consequently, the Board had little or no assurance that loan applicants were creditworthy and able to repay the loan. In addition, after the loans were approved by the Board, Authority staff did little to monitor the financial viability of the borrowers, and took action concerning adverse loan conditions only after the loans became delinquent. (see pp. 11-15)

As part of our audit of the Authority's loan operations, we examined the administration of the AI Tech Trust Fund. This fund is used to make loans for economic development in Albany and Chautauqua Counties. Our review of this fund found similar problems relating to the review, approval and monitoring of loans. In addition, some of the loans issued by the Authority in Chautauqua County appear to have been very risky, resulted in little or not repayment, and may be indicative of negligence, fraud, abuse or other irregularities in the loan process. (see pp. 17-20)

Based on the results of our review of regular Authority loans as well as loans made from the AI Tech Trust Fund, we are referring these matters to appropriate investigatory officials for their consideration of possible improprieties. (see pp. 5-9, 17-20)

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## **Comments of Authority Officials**

In responding to the report, Authority officials stated that it is expected that within the next three months a “workout” plan will be developed and recommended to the Governor’s office, so that JDA can resume its role as a viable economic development tool in New York State.

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<b>Appendix A</b>	Major Contributors to This Report
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<b>Appendix B</b>	Comments of Authority Officials
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The comments of Agency Officials are not available in an electronic format. Please contact our Office if you would like us to mail you a copy of the report that contains their comments.

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# Introduction

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## Background

The New York Job Development Authority (Authority) is a public benefit corporation of the State, created in 1961 by a Constitutional amendment and Title 8 of the Public Authorities Law. The Authority's purpose is to promote, encourage and develop the economic welfare of State residents and to improve employment opportunities. The Authority provides loans and loan guarantees to companies seeking to expand facilities, build new plants and acquire machinery and equipment. In addition, the Authority operates smaller, special programs for rural development, long-term economic development and construction bonding assistance. The Authority also administers specific funds which include the AI Tech Trust Fund, Greater Massena and Niagara Development Funds, the Fisherman's Assistance Fund and Secondary Materials Program.

The membership of the Authority Board of Directors (Board) consists of the State's Commissioner of Economic Development as chairperson, the Commissioner of Labor, the Superintendent of Banks, and the Commissioner of Agriculture and Markets, each serving ex-officio. In addition, seven members are appointed for four year terms by the Governor with the advice and consent of the State Senate. The Board is authorized to appoint officers, staff, consultants and advisory committees to assist the Board in overseeing and operating the Authority.

The Authority generates the funds to provide loans by selling bonds and notes guaranteed by the State. Since inception, the Authority has approved loans and loan guarantees totalling about \$800 million for over 2,000 projects. Bond and note principal and interest, as well as Authority operations, are funded by monthly loan repayments, interest earnings on Authority investments, and loan fees charged. As of March 31, 1995 \$322.2 million in bonds and notes were owed to investors. For the fiscal year ended March 31, 1995 total revenue was \$21.7 million and total expenses were \$40.1 million, resulting in a loss of \$18.4 million. As of March 31, 1995 the Authority had an overall accumulated deficit of \$42.7 million, which means that total liabilities exceed total assets by this amount.

On July 1, 1995, overall responsibility for the Authority was transferred to the newly formed Empire State Development Corporation along with the Urban Development Corporation, the Science and Technology Foundation, and the Department of Economic Development. The Authority operates as a separate entity, but is administratively part of this new corporation. The purpose of this consolidation was to eliminate duplication of services, streamline operations and reduce costs.

The Authority's Board is still responsible for Authority oversight. The Authority currently employs an Executive Vice-President, Chief Financial Officer, Treasurer, Controller and General Counsel.

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## **Audit Scope, Objective and Methodology**

We audited selected aspects of the Board's oversight of Authority loan operations, including the administration of the AI Tech Trust Fund, for the period April 1, 1992 through March 31, 1995. Certain loan transactions initiated prior to April 1, 1992 were also reviewed in detail.

The Board is authorized to appoint a loan advisory committee to make recommendations to assist the Board in deciding whether or not specific loans should be granted. The State Comptroller, prior to being elected State Comptroller, served on the loan advisory committee as a private citizen during the period of September 1989 to July 1991.

The objective of this audit was to determine whether the Authority's Board members properly discharged their fiduciary and oversight responsibilities to help protect and preserve the Authority's loan portfolio. In this regard, we focused on whether the Authority complied with the Public Authorities Law by approving loans only for borrowers who were able to repay them, and whether the Authority properly monitored the status of the loans. To accomplish this objective, we interviewed appropriate Authority officials and staff, reviewed available information and documentation for certain approved loans, and reviewed the procedures used to review, approve and monitor loans.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess those operations of the Authority which are included within the audit scope. Further, these standards require that we understand the internal control structure of the Authority and its compliance with those laws, rules and regulations that are relevant to the operations which are included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records, and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments, and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions, and recommendations.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on those operations that have been identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, finite audit resources are used to identify where and how improvements can be made. Thus, little audit effort is devoted to reviewing operations that may be relatively efficient or effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

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## **Response of Authority Officials**

Draft copies of this report were provided to Authority officials for their review and comment. Their comments have been considered in preparing this report and are included in Appendix B.

In their response to the draft report, Authority officials stated that in the foreseeable future, without corrective action, JDA will not be able to meet its bond obligations without accessing the State guarantee. Officials expect that within the next three months a “workout” plan will be developed and recommended to the Governor’s office, so that JDA can resume its role as a viable economic development tool in New York State.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Chairman of the New York Job Development Authority shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

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# Board of Directors Oversight

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The Authority's Board members are required by law to approve or deny completed loan applications. In addition, loans or guarantees are required to be made only to companies found by the Authority to be financially responsible and presumed to be capable of repaying the loan.

In 1986 and 1990, the State Comptroller issued audit reports (Report 85-S-84 and Report 89-S-38) criticizing the Authority's loan review, approval and monitoring practices. Authority staff were not obtaining company financial statements as required, were not monitoring the companies in default or the underlying causes of the default, and were not monitoring loan recipients to verify that funds are used as intended. Our current audit shows that, despite being alerted to shortcomings in the loan process, the Board members and Authority management did not take adequate steps to properly manage the Authority's loan portfolio in compliance with law.

Since at least 1990, the Authority's financial condition has deteriorated dramatically, resulting from extensive loan losses. From April 1, 1990 through March 31, 1995, Authority expenses exceeded revenues by \$66.4 million, mainly because of the write-off of \$61.5 million from losses on loans, guarantees and foreclosed property. In June 1995, the Authority's independent auditor reported that the Authority has incurred recurring losses from operations and has an accumulated deficit of over \$42.7 million, which Authority management will need to address. This accumulated deficit is comprised of a \$57.8 million deficit in the Authority's Special Purpose Fund (related to bonds issued and normal operations), and a \$15.1 million surplus in the Special Revenue Funds (related to other smaller Authority funds and programs).

We believe that such a poor financial condition must be immediately addressed because the Authority may reach a point where it is unable to repay bond and note investors. Although repayment of the Authority's bonds and notes is guaranteed by the State, the need for the State to step in would cause an additional burden to State government and taxpayers. As of July 1, 1995, the Board has not taken steps to address the Authority's weak and tenuous financial condition.

Board members, who have ultimate responsibility for approving loans, have not aggressively inquired or determined whether prospective borrowers are able to repay loans. Consequently, Board members have approved loans to companies which had very precarious financial conditions based on a review of available records. As detailed in later sections of this report, our review showed that the Authority's loan review, approval and monitoring systems have serious shortcomings. In addition, certain approved loans violated the Public

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Authorities Law which prohibits working capital loans and unsecured loans, and requires that lines of credit be in place before loan approval.

We also found Board members generally accepted recommendations for loan approvals without question. Such loan recommendations come from loan review staff, the Board's Loan Advisory Committee (LAC) and the Authority's President. Board members generally did not inquire of these parties as to any details to substantiate the quality of the loan or the underlying assumptions and claims made by both the borrower and loan reviewer. Records we reviewed indicated that Board members rarely, if ever, denied a loan application proposed for approval by the staff, the LAC and the President, even though it seemed obvious that certain loan recommendations were not justified based on available loan records. As a result, Board members approved loans which had a very high risk of delinquency or default.

The lack of the Board's oversight at the Authority was especially detrimental to its operations because compensating controls did not exist. Authority management did not establish or follow prudent loan review, approval and monitoring practices. In addition, the LAC did not operate in a manner that would help prevent extensive loan losses. Consequently, the Board had little or no assurance that loan applicants were creditworthy and able to repay the loans.

The following three cases of approved loans graphically illustrate the numerous and serious deficiencies in the Authority's loan review, approval and monitoring systems. These are examples of the some of the poor quality loans approved by the Board. There was no assurance that these loan applicants were creditworthy and that the loans could reasonably be expected to be repaid. Of primary importance is the fact that the Board inappropriately relied on the less than adequate loan review and evaluation work done by Authority staff, management and the LAC when these loans came before the Board for approval.

- ! Despite a relative loan risk rating of 9 (the Authority's highest risk rating on a 1 to 9 scale), a start-up food warehouse, located in Onondaga County, was awarded a loan guarantee of \$9 million in August 1991. The company never made a payment on the loan and defaulted on September 1, 1991. When negotiating with the principals after default, Authority staff released the principals from their personal guarantees on the loan in return for taking possession of the building. In late 1993, the Authority paid almost \$9.2 million to the lender bank and took possession of the warehouse in April 1994.

There was no documentation in the loan file indicating that the Authority had verified the company's optimistic net income projections. In fact, the Authority's financial analysis stated that "based on a detailed marketing

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feasibility plan submitted by management the financial projections appear viable." This indicated that Authority officials were relying on the borrower's own data.

Authority officials should have confirmed the company's optimistic revenue and income projections by contacting prospective customers, reviewing the need for this enterprise and the market demand for the company's products, as well as comparing industry trends. The company had projected revenues of \$5.9 million and profits of \$415,000 for fiscal 1992, as well as revenues of \$6.1 million and profits of \$496,000 for fiscal 1993. Actual figures in subsequent financial statements submitted to the Authority showed significant variations. For fiscal 1992, sales were \$1.2 million and losses were \$1.5 million; for fiscal 1993, sales were \$1 million, while losses were \$1.3 million. There was nothing in the Authority's loan file indicating why sales and income had fallen so far short of projections. Considering that this one loan constituted approximately 11 percent of the entire amount loaned by the Authority during this two year period -- \$82.6 million, Authority officials should have exercised more care to evaluate the soundness of this company's plan.

In addition, the original loan application stated that a 150,000 square foot building would be built on purchased land of 13.5 acres. However, the building was constructed on 6 acres of leased land and was only two-thirds of its planned size (103,508 sq. ft.). Authority officials did not properly monitor this loan to ensure that loan proceeds were used as intended. The loan application also stated that there was a need for this warehouse and that the company would generate 150 jobs over three years. However, Authority records indicate there are at least five other similar facilities for sale in this area. In addition, Authority officials who are currently operating the warehouse at 50 percent capacity with 4 employees, estimate that only 20 to 25 employees would be needed at full capacity. Currently, Authority officials have a contingent contract with a current Authority loan recipient to sell the building for \$5.3 million cash.

! In our review, we found that two very large loan guarantees were given to one company. The loans violated the governing law for Authority loans, in addition to being inappropriate loan decisions. This company was a manufacturer of submicron integrated circuit production equipment located in Rochester, New York. The Authority awarded the company two loan guarantees totaling over \$15.7 million in April 1988 and May 1991. Both loan guarantees received the highest risk ratings of 9. From 1986 through 1991 the company lost over \$62 million. However, loan files indicated that the company projected net incomes ranging from almost \$5.5 million in 1993 to \$182 million in 1996. Given the company's past performance, such projections should have been viewed with skepticism. In fact, all of the company's certified financial statements from 1986 through 1991 reported there

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was a substantial doubt as to the company's ability to continue as a going concern. This should have been a "red flag" to Authority management, before approving the loans, that this company may not be able to repay its debt.

The company went bankrupt in May 1993. The Authority was called upon to satisfy the guarantees and, as of May 1994, the Authority still owed over \$11 million on the loans. The Authority's potential loss after liquidation is estimated to exceed \$7.8 million. It should also be noted that the money was to be used for equipment manufactured for resale. Therefore, the loan guarantees were for working capital, in violation of the law. The company's audit report also states that an additional unsecured loan was made to the company by the Authority for \$764,000. This again, is in violation of the law, since the Authority cannot approve unsecured loans or loan guarantees.

! A distributor of song books and sheet music located in Suffolk County was awarded a \$500,000 loan in July 1991. The company defaulted on the first payment because it did not receive a \$1 million line of credit it had expected to receive. The loan report, prepared by Authority staff and later presented to the Board members for approval in July 1991, stated that the projections seem to be based on reasonable assumptions, and indicated that the company will be able to service the debt incurred. For the 1991 fiscal year, the company projected working capital of \$1.5 million. However, actual working capital for this period, based on unaudited statements, was a negative \$77,000. In addition, Authority staff had not ascertained that the line of credit was already in place before the loan was granted, nor did the Board ask if it was approved.

Based on the results of our review of these loans, we are referring these matters to appropriate investigatory officials for their consideration of possible improprieties.

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### **Recommendations**

1. The Board and State policymakers must take immediate steps to address the Authority's deteriorating financial condition and consider ways to strengthen the Authority's ability to meet both current and long-term obligations.
2. The Board must comply with the Public Authorities Law and uphold its fiduciary responsibilities by taking an aggressive role in reviewing and approving only loans which are deemed repayable based on verified data concerning financial operations, market demand and need, as well as other important factors. Board members should not accept staff or LAC loan recommendations without detailed verification of the facts presented at Board meetings.

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# Loan Operations

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We reviewed the Authority's loan review, approval and monitoring practices and found serious deficiencies. We believe that the major cause for the loan losses is that Authority Board members have not ensured that prudent loan review, approval and monitoring systems have been established or followed. In addition, the LAC has not provided the intended independent analysis of loan applications. As a result, the Authority has little or no assurance that borrowers are creditworthy and are able to repay loans provided.

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## Loan Review and Approval Practices

Applicants should present the Authority with complete information that will provide reasonable assurance that the loan will be repaid. Such information should include reliable cash flow projections, income statements, and indicators of overall financial condition. The Authority's loan review staff are required to analyze loan applications to assess project feasibility as well as compliance with the Authority's program goals and objectives. Loan approvals are to be based on many factors including business reputation, management's character and ability, financial condition, market demand and distribution methods for products, and other factors.

In this regard, it is a standard industry practice to verify certain basic items relating to the applicant, such as employment history, credit history, assets held, liabilities, as well as tax payment and litigation history. Certain financial ratios should also be computed and compared with industry norms before any lending decision is made. These ratios indicate the relationship of assets to liabilities and are useful in evaluating a company's ability to meet obligations. Failure to use such ratios can allow financially weak companies to obtain loans, resulting in late payments or default.

We found serious deficiencies in the Authority's loan review and approval process. We found that generally, loan reviewers did not follow a standard loan review checklist to ensure that the information was complete and that all essential loan factors and criteria had been determined and evaluated before recommending loan approval to the LAC. We also noted that generally no comprehensive analysis was made of market demand, the distribution method for products, or the need for such an enterprise in that geographical area. As a result, the LAC and Board members, who eventually approved such loans, did not have a sound basis for making their decisions.

In the absence of such a standard loan review process, we developed a comprehensive checklist of factors to be considered before granting a loan. These factors are either cited in the Public Authorities Law or have been developed by us in conjunction with the National Association of Bank Loan and Credit Officers. We discussed our checklist with Authority management, who agreed that the factors we included should be considered in evaluating applicant creditworthiness. We selected for review a judgmental sample of 25

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loans and guarantees, valued at \$32.2 million, which were approved by the Board from April 1, 1992 through March 31, 1994. Our purpose was to determine what factors and information were considered and evaluated by Authority loan reviewers before recommending loan approval, and whether the loan applications were complete.

Generally, Authority staff did not independently verify the reliability of the financial and other related data submitted by applicants. In 16 of the 25 loans, some of which exceeded \$1 million, loan reviewers relied on unaudited financial statements prepared by the borrowers, without independently verifying the reliability of this data. Furthermore, loan reviewers did not take alternative steps to determine applicant creditworthiness. This could include requesting tax returns, verifying the employment histories of company principals, obtaining credit reports, contacting known vendors and customers, and performing other independent checks of financial data submitted. Therefore, Authority officials had no assurance that the applicants' true financial condition was known. In fact, Authority staff recommended some loans to LAC for approval, with the explanation "based on reasonable assumptions", without verifying financial conditions, claims and projections. This practice is a major contributing factor in the granting of certain risky loans.

Authority officials stated that requiring audited financial statements from their applicants would be too expensive for small to medium-sized companies. However, in the absence of audited financial statements, it is essential that Authority staff verify the reliability of financial data through alternative means, as previously discussed.

In 22 of the 25 loans, financial ratios were computed but not compared to industry norms. Moreover, 2 of the 25 loans showed no indication that such ratios had even been computed. In response to our preliminary findings, Authority officials stated that they discontinued comparing ratios to industry norms because most loan applicants were small firms and the results of such comparisons were misleading. However, some industry ratios have been developed specifically for firms of various sizes, and Authority staff could compare such ratios.

In addition, we noted that four borrowers had submitted incomplete applications. Two borrowers were missing the balance sheet and projected income statements. One of these borrowers was an auto parts manufacturer who had been approved for a loan guarantee of \$13,800,000 in May 1992. Another borrower had not included cash flow projections and another was missing schedules for pending litigation, bankruptcy or receivership, charges and convictions, and violations and citations. Authority officials admitted that these applications were incomplete.

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Loan review and evaluation reports, along with staff recommendations, are forwarded to the LAC for consideration and action. On the basis of this information, the LAC is to conduct an independent analysis of the financial strength of the company and the project feasibility. The members of the LAC are appointed by the Board from leaders in the financial community and meet monthly. The LAC reports its results to the President, who forwards recommended loans to the Board for approval. The Board also receives a condensed version of the loan reports prepared by Authority loan reviewers.

We were told that formal minutes of LAC meetings are not kept, and notes that were maintained by Authority staff were sketchy and not very useful to assess meeting activities and results. We also found that the LAC rarely, if ever, denied a loan that was recommended by Authority staff. Consequently, we have no evidence that the LAC provided the necessary independent analysis of loans before recommending the loans for Board approval.

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## **Loan Monitoring Practices**

It is a sound business practice to continually review and assess the borrower's creditworthiness and loan history throughout the loan's term. Such an assessment would allow Authority management to take necessary steps to respond to problems with a loan. By law, the Authority is authorized to modify the terms of loans whenever necessary or desirable. The Authority could also help the borrower contact other entities which could provide assistance in resolving financial problems. In addition, periodic loan monitoring would help ensure that borrowers are using the funds as intended and in accordance with the loan agreement.

Authority procedures require that companies with outstanding loans submit annual financial statements. Authority staff are required to review these statements and compile a list of companies that reported a loss for the year. They must also follow up to obtain statements that were not received within 90 days of the end of the company's fiscal or calendar year. We found that Authority staff do not receive all required statements, nor review the companies' financial statements on an ongoing basis. The Authority takes action concerning adverse loan conditions only after the loans become delinquent.

We reviewed a judgmental sample of 15 loans—10 out of 88 delinquent loans as of September 30, 1994 and 5 out of 28 loans foreclosed from April 1, 1992 through October 31, 1994. We found that 10 of the 15 loans had become delinquent more than a year after they were approved. Therefore, it would have been reasonable to expect that the Authority would have requested and received an annual financial statement. However, 8 of those 10 borrowers had not submitted required annual financial statements. Authority management took no action after these companies failed to submit the required statements. Therefore, the loans were not being adequately protected by monitoring the financial viability of these companies.

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Even when financial statements were submitted, staff had not reviewed them to identify the need to take certain remedial actions. For example, a \$220,000 loan was made by the Authority in 1984 to a commercial lighting fixtures manufacturer. In financial statements submitted from 1987 through 1992, the company showed annual losses ranging from \$64,000 to \$631,000. No statements were available for this company for 1993. The company had defaulted on the loan in July 1993. We found no evidence that Authority management had reviewed previous statements, or that it had taken any action during those years to protect its loans.

The Authority's failure to monitor a borrower's financial position is a contributing factor to the number and extent of loans, which may have been precarious to start, and that later become delinquent or go into default. If the borrowers' financial statements had been monitored and reviewed in a timely manner, Authority management would have been alerted to the companies' precarious financial position and could have considered remedial action, if possible, to prevent losses.

### **Recommendations**

3. The Board should take steps necessary to ensure that a reliable and effective system for reviewing, approving and monitoring loans and guarantees is put in place. The Board should determine that each phase of the system is working properly and that the LAC is providing independent analysis of loan applications as intended.
4. Board members should ensure that Authority management and staff comply with loan industry standards in reviewing prospective loans to ensure that applicants are deemed able to repay loans.
5. Authority management should utilize a comprehensive loan review checklist of essential factors to be verified and analyzed for each loan application, and ensure that it is followed by loan officers. Loan recommendations submitted to the LAC for approval should be fully documented and based on completed loan applications with an independent verification of the applicant's financial condition.

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# Administration of the Al Tech Trust Fund

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In 1976, the U.S. Economic Development Administration (EDA) awarded a \$10 million grant from Title IX of the Public Works and Economic Development Act (Act) to the State Department of Commerce. The purpose of the grant was to make a loan to the Al Tech Specialty Steel Corporation to purchase two steel manufacturing plants in Albany and Chautauqua Counties. The State was then authorized to use the loan repayments to establish the Al Tech Trust Fund (Fund) to make loans for economic development in these two counties. Loans could be used for working capital, real estate, and plant and equipment. The State agreed to act as the Federal government's fiduciary agent and comply with all requirements of the Act, pertinent Federal regulations, and grant terms and conditions. In October 1978 administration of the Fund was transferred to the Authority to act as trustee.

Assuming that this Fund should have earned a conservatively low rate of return on assets, ranging from 5 to 7 percent compounded annually, we estimate that the potential fund balance should be \$25 to \$35 million as of March 31, 1995, barring any significant losses. However, the audited statements for the Fund show \$7.4 million in assets, \$1.4 million in liabilities and a fund balance of only \$6.0 million as of that date. We concluded that there are several major factors which resulted in the depletion of the Fund's assets. First, the Fund has experienced at least \$9.1 million in loan defaults and an additional \$2.6 million has been set aside as an allowance for future loan losses. Second, a recent Federal audit of this Fund disclosed that the Authority improperly and unnecessarily depleted the Fund by at least \$12 million.

As detailed throughout our report, Authority officials failed to properly review, approve and monitor loans to help ensure that borrowers were creditworthy and able to repay loans. Our review of the loan approval and monitoring system for this Fund showed the same problems. One Authority official stated that Authority Board members did not review, approve or monitor the Fund's loans from about 1982 through 1992. Authority officials told us that the Board believed it was only the administrator of the Fund and not directly responsible for overseeing loans issued through the Fund. We found that loans and loan guarantees were generally awarded on the basis of recommendations by the Albany and Chautauqua County Industrial Development Agencies along with the approval of the Authority's President. Even when the Board reviewed some loans after 1992, their oversight was weak, as was the case of the regular Authority loans discussed earlier.

From January 1, 1979 through August 31, 1994 (latest available data we reviewed), the Authority awarded 90 loans in Chautauqua County exceeding \$14.3 million, and 90 loans in Albany County totalling about \$7.6 million. Of these amounts loaned, 23 loans totalling about \$8.2 million are in default

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in Chautauqua County and 14 loans totalling about \$900,000 are in default in Albany County. The Fund's audited statements for March 31, 1995 show \$2.3 million in the allowance for loan losses against \$2.7 million in loans receivable in Chautauqua County (an estimated loan loss rate of 85 percent). In contrast, there is only about \$300,000 reserved for loan losses against \$3.8 million in loans receivable in Albany County (an estimated loan loss rate of 8.5 percent using the precise figures).

The loans issued by the Authority in Chautauqua County appear to have been very risky. The carrying of an 85 percent loss reserve on the financial statements raises "red flags" as to the propriety of most of these loan transactions. Such an expected loss rate is far beyond reasonableness and is most likely indicative of negligence, fraud, abuse or other irregularities in the loan process. In addition, as illustrated below, some borrowers paid little or nothing toward these loans. Therefore, we are referring these matters to appropriate investigatory officials. In any event, we concluded that no additional loans for companies in Chautauqua County should even be considered for approval until proper systems are put in place and followed to help ensure that prospective borrowers are creditworthy and are able to repay such obligations.

The following examples illustrate the problems that resulted because Fund loans were not properly reviewed, approved or monitored. These examples typify the poor quality of many loans made to companies in Chautauqua County.

! A furniture manufacturing company (Company B) was incorporated in 1978 to buy the assets of another manufacturer of metal furniture (Company A) in Jamestown, Chautauqua County. Company A had fallen into financial trouble and subsequently, was downsizing operations and laying-off employees. Company B received a loan of \$280,000 from the Fund in May 1979, and \$150,000 of the loan was to be used to repay Company A's loan from the Authority. Since May 1979, Company B went through two reorganizations, in December 1984 and June 1985. According to an Authority official, Company B also later went into Chapter 7 bankruptcy between 1988 and 1989.

During these reorganizations, the Authority continued to loan money to Company B through the Fund. A total of \$1,669,907 in loans and loan guarantees were provided. The outstanding balances (including accrued interest) of these loans/guarantees was \$1,986,905 as of March 31, 1994. The Authority never received any money from this company and officials stated they do not expect any either. Authority management has not exercised its right to foreclosure because they claim the building is worthless and there is only one piece of equipment with any value.

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! A wine producer applied for and received loans from the Fund in January 1981. These loans totaled \$110,000 (\$35,000 for real estate, \$15,000 for equipment, and \$60,000 for working capital). The company made one payment on the loans. Shortly thereafter, Authority management was advised by an escrow agent that the company was basically bankrupt and suggested arranging with the Federal Small Business Administration for an orderly liquidation of assets.

The company filed for Chapter 11 Reorganization in May 1986. In September 1986, the company received its second working capital loan for \$30,000 from the Fund for the “finishing” of its raw wine. This loan resulted in no net proceeds to repay this loan.

The company filed Chapter 7 bankruptcy in July 1989. The company’s assets were eventually liquidated with a net distribution of \$2,000 to the Authority. Records showed the Authority was not successful in enforcing the principals’ personal guarantees. Agency records indicate that the principals claimed poverty to creditors, although there was no documentation to support this. There was no other information in the loan file indicating whether Authority officials pursued collection of the debt. In addition, the last \$30,000 loan was extremely questionable considering that the company was already in arrears on prior loans.

In addition, the U.S. Department of Commerce's Office of the Inspector General conducted an audit of the Authority's administration of the Fund, from May 1992 through June 1993, to determine the Authority's compliance with pertinent laws, grant regulations, terms and conditions. The audit reported that the Authority "has failed in its fiduciary responsibilities and wasted or abused the AI Tech Fund capital." The auditors concluded that the Fund has unnecessarily been depleted by at least \$12 million. Among other things, the auditors pointed out that the Authority had inappropriately:

- ! Used funds for projects with little or no economic benefit,
- ! Loaned money to ineligible companies and to firms outside the designated geographic regions,
- ! Transferred money to other funds in violation of the grant agreement, and
- ! Charged the Fund for unsupported administrative and operating costs.

The audit recommended, among other things, that the Authority replace monies inappropriately taken from the Fund, discontinue using funds for projects that

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are ineligible for Title IX grants, start periodic reporting on Fund activities, and develop a new plan for future loans.

Authority officials agreed to most of the recommendations. In addition, as a result, according to the Authority's March 31, 1995 audited statements, a \$3.3 million liability for the hockey rink in Albany County has been written-off and replaced as revenue in the same amount. However, the Authority's Vice President told us that the Authority could not afford to pay back the entire \$12 million as recommended by the EDA report. The Authority's poor financial condition is evidenced by a \$42.7 million deficit as of March 31, 1995. Authority management is still negotiating with EDA officials. In June 1995, the Authority's independent auditor also reported that no agreement has yet been reached with respect to the Inspector General's report and the attendant actions, if any, to resolve these matters.

### **Recommendations**

6. The Authority's Board members should uphold their fiduciary responsibility and take an active role in reviewing, approving and monitoring Fund loans, as should be done for all other loan activity under Authority control.
7. Before additional loans are approved for companies in Chautauqua County, Authority management must adopt and apply sound financial criteria for the reviewing and awarding of Fund loans to creditworthy applicants, and for the periodic monitoring of the financial condition of the borrowers.

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## Major Contributors to This Report

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