

TO: THE COMMON COUNCIL

DATE: February 11, 2010

FROM: THE DEPARTMENT OF
AUDIT & CONTROL

SUBJECT: Audit Report – The BERC Business
Loan Program and One Sunset
Item No. 89, C.C.P., 6/9/09

We have prepared an evaluation of the performance of the Buffalo Economic Renaissance Corporation (“BERC”) and its business loan program with a particular focus on the loans and other activities related to One Sunset. Beyond our own interest, we acted in response to requests from the Mayor and the Common Council.

When the initial reports about the One Sunset restaurant loans came to light in the summer of 2009, concern grew over BERC’s spending and management of community development block grant dollars. While one can conclude that the loans represented a waste of taxpayer dollars, the same should not be said for BERC itself. The One Sunset situation was symptomatic of an organization that, over a course of years, has experienced a lapse of controls. Particularly, high turnover, critical vacancies and certain staff decisions begat a breeding ground for a breakdown of controls.

Even before the One Sunset controversy, BERC recognized the need for reform and engaged in an effort to change how it did business. This is crucial as BERC’s failings are structural in nature and a new culture must emerge for meaningful change to take place. We recognize that this is not a quick process and cannot occur overnight. By their nature, audits tend to look back in time, so while it highlights past problems within BERC, it is important to distinguish the improvements and changes that reflect how the organization stands going forward. We do not support the idea of dissolving BERC, as the corporation’s not-for-profit structure is a necessary component to the local economic development matrix, and any attempt to replace it would not effectively address pre-existing liabilities and other outstanding legal issues.

Under new management, BERC has aggressively pursued a reform program that engages its Board of Directors in the decision-making process, better utilizes the talents of its professional staff, and examines its core mission. There is certainly much to be done, and BERC alone cannot shoulder the burden of jumpstarting economic development activity in the City of Buffalo on its own. This will require a coordinated effort involving all governmental entities (local, state and federal) that play a role within this region.

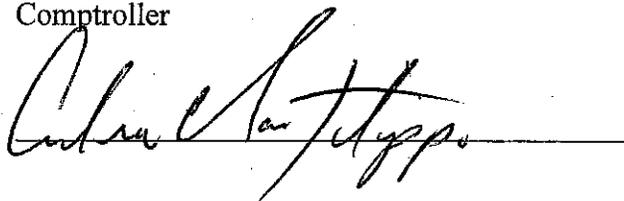
This office cannot dictate economic development policy. Our role provides fiscal oversight and protection of public assets, including precious block grant dollars. A non-voting role on the BERC Board could provide some safeguard and give some assurance to the public that an independent presence is involved.

If you have any further questions on this matter, please feel free to contact the Department of Audit and Control.

DEPARTMENT HEAD: Andrew A. SanFilippo

TITLE: Comptroller

SIGNATURE:



A handwritten signature in black ink, appearing to read "Andrew A. SanFilippo", is written over a horizontal line.

CITY OF BUFFALO
DEPARTMENT OF AUDIT & CONTROL

AUDIT REPORT ON THE
BUFFALO ECONOMIC RENAISSANCE CORPORATION
BUSINESS LOAN PROGRAM & ONE SUNSET

**ANDREW A. SANFILIPPO
COMPTROLLER**



DARRYL McPHERSON
CITY AUDITOR

FEBRUARY 2010

Background

“In 1978, the City of Buffalo established the **Buffalo Economic Renaissance Corporation** (BERC) as a public-private partnership organization eligible to receive federal economic development aid designed to more appropriately involve the private sector in City economic development initiatives. BERC is a Section 501(c)(4), not-for-profit local development corporation pursuant to the statutes of New York State. BERC also qualifies under HUD and EDA regulations to receive funding as a local development corporation. It is a membership corporation that meets SBA requirements. BERC's semi-independent operation is representative of most urban economic development corporations nationally.

BERC Mission Statement

The emphasis will be placed toward the development of small businesses and strengthening neighborhood commercial districts. Success will be measured ultimately by the amount of jobs created for residents in low-moderate income communities, our ability to leverage our diverse population and our ability to enhance trust through open and ongoing dialogue within BERC, amongst our strategic partners and the community.”¹

Background of One Sunset Restaurant

One Sunset restaurant opened its doors on December 14, 2007. The restaurant was incorporated under the name Candies Culinary and Hospitality Group Inc. Leonard Stokes, Jr., a native of Buffalo and talented basketball player with college and NBA notoriety, was the sole owner of this establishment. The restaurant was located in the former site of the Locker Room and Lotis Restaurant at 1389 Delaware Avenue. The restaurant theme was premised on an upscale food menu, entertainment on Sundays and a late night club type atmosphere. With the help of an experienced staff, the restaurant started off with excellent reviews of customer service and culinary imagination. However, within a short period after opening, the establishment began to experience cash flow problems. In February 2008, the restaurant was given an influx of new money in the form of a loan to keep operating but was falling further into debt to its vendors. By September of 2008, One Sunset received one final infusion of cash, but by December 2008, the restaurant was out of business.

One Sunset Audit

The Department of Audit and Control has completed a review of the Community Development Block Grant monies that were given to Candies Culinary and Hospitality Group Inc. doing business as One Sunset. The intent of this audit is to focus on BERC lending procedures and practices as they relate to One Sunset restaurant. We investigated the loan process for One Sunset from the beginning application dated March 3, 2007 through the opening of the business in December 2007 to its subsequent closing in December 2008.

¹ Source: BERC website, http://www.berc.org/about_history.php

\$160,000 in loans and grant were given to the business as summarized below.

| <u>Source of Funds:</u> | <u>Amount</u> | <u>Approved</u> | <u>Received</u> |
|---|---------------|-----------------|------------------------|
| BERC Small Business Matching Investment Fund Grant | \$30,000 | Sept. 2007 | Sept. 2007 |
| BERC Neighborhood Micro Loan (1 st Loan) | \$40,000 | June 2007 | Dec. 2007 |
| BERC Neighborhood Micro Loan (2 nd Loan) | \$40,000 | Feb. 2008 | Feb. 2008 |
| Erie County Industrial Development Agency Loan | \$50,000 | Aug. 2008 | Aug. 2008 ² |

Audit Scope

We made an evaluation of the circumstances and procedures behind the particular loans and grant that One Sunset received from BERC and the Erie County Industrial Development Agency ("ECIDA"). The audit will include the application process, disbursement of funds, payment history, performance monitoring, business failure, loans in default and collection procedures.

Findings

The complete findings of this audit will be presented in the sections below, starting with the One Sunset Loan Process followed by the Buffalo Economic Renaissance Corporation review.

The Business Plan

The business plan One Sunset submitted to BERC, as part of the first loan consideration, was overly aggressive. Food, beverage and catering sales for the first 3.5 months of operation were projected to be **\$309,000**. Actual sales of \$110,255 were \$198,745 lower than plan, a 64% shortfall. In the area of cost of goods sold and labor which are the primary costs of operating a restaurant, projections were again off the mark. Costs of goods sold were expected to be 32% of sales while labor costs were estimated to be 19% of sales. However, three and a half months after opening, One Sunset was running cost of goods sold at 63% of sales and labor costs at 59% of sales. The business' primary costs had ballooned to 122% of sales, which equates to a **loss of \$24,106 before any other expenses** are taken into consideration. (See chart below). These financial results reveal poor internal financial control from the very start of the operation. Sales and primary costs for One Sunset are summarized below. Percentages are based on a ratio of costs to total sales figures.

| Dec 07 – March 08 | Projection | % | Actual | % | Difference |
|--------------------|------------|-------|------------------|-------|-------------|
| Total Sales | \$309,000 | | \$110,255 | | (\$198,745) |
| Less | | | | | |
| Cost of Goods Sold | \$97,480 | 31.5% | \$69,701 | 63.2% | \$27,779 |
| Labor Cost | \$57,500 | 18.3% | \$64,660 | 58.6% | (\$7,160) |
| Profit (Loss) | \$154,020 | | -\$24,106 | | (\$178,126) |

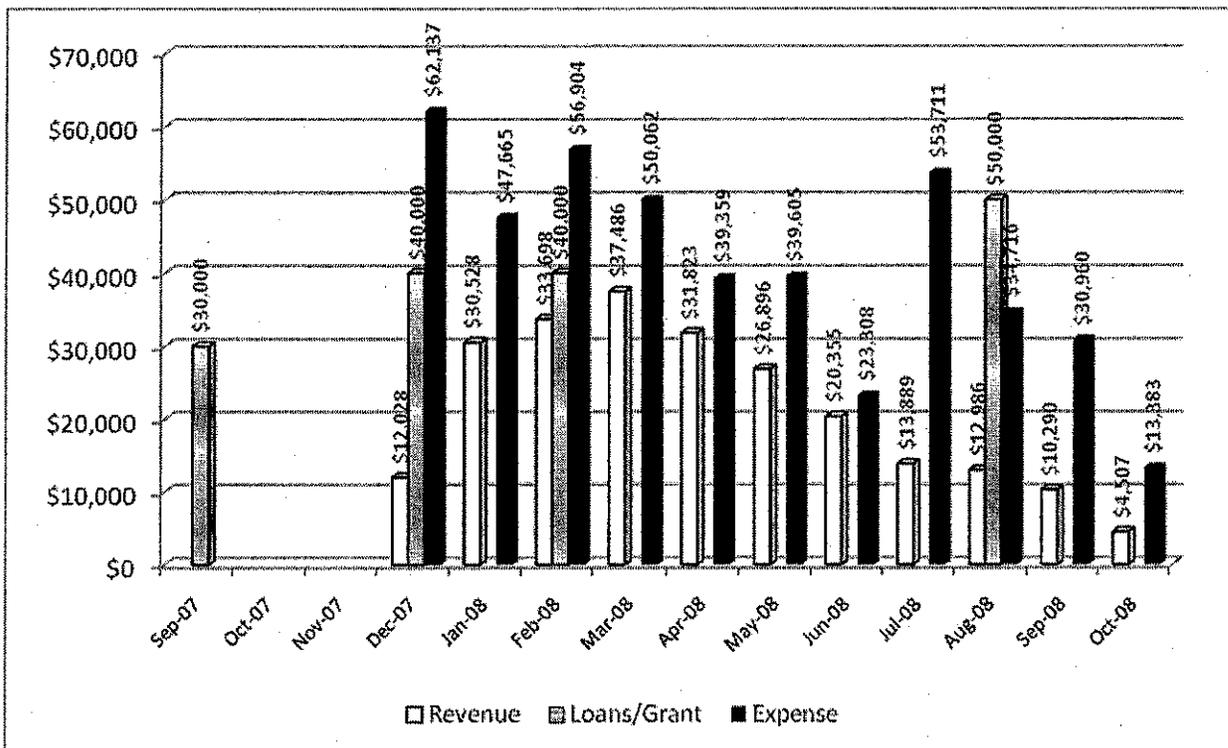
Data compiled using P&L statement through 3/31/08 along with a business plan submitted through Buffalo State.

² Source: http://www.buffalorising.com/2009/08/one-sunset-is-one-big-mess.html#SlideFrame_0

Actual Revenues Never Exceeded Expenses of One Sunset

The following finding is based on financial records received from the bookkeeper of One Sunset in August 2009. Since the inception of the restaurant there was never a period according to Profit and Loss Statements that the restaurant's sales exceeded expenses. The restaurant had its highest recorded sales in March of 2008, \$37,486 but had expenses of over \$50,000 during that same timeframe. After the restaurant's peak sales month in March 2008, the sales continued on a downward spiral never again coming close to their best selling month. One of the largest areas of concern to this audit was the overall payroll expense. Total labor spent from inception was over \$160,000 or 68.3 % of the restaurants total sales. This is a sure sign of mismanagement by the owner. It should be noted that this finding is based solely on actual net sales reported. It does not take into consideration that the establishment was not paying sales tax on items purchased. This audit did not see actual sales receipts from the Micros cash register system, so we cannot verify whether all sales were rang in. **See graph below for actual sales and expenses reported by accountant.**

One Sunset Revenue, Expense, Grant and Loans



Note: Revenues never exceeded expenses from inception to closure.

First Request Denied

The One Sunset business plan was modified several times and the financial projections were altered to fit the constraints of funding. Specifically, the BEREC files contain copies of two BEREC Business Credit Applications both dated March 3, 2007. Each pertains to Candies Culinary and Hospitality at 1389 Delaware Avenue. On one application total project costs were \$423,000, the loan request was \$192,500 and equity to be provided was \$50,000. On the other application total project costs were \$260,000, the loan request was \$120,000 and equity to be provided was \$120,000. The \$120,000 loan application was packaged by a BEREC Credit Analyst, who concluded his loan narrative with the statement the loan "is not recommended". On April 26, 2007, the BEREC Large Loan Committee, comprised of four non-BEREC employees and the BEREC President, turned down the loan due to the applicant's poor credit.

During May and early June 2007 the project was repackaged and presented at the **June 15, 2007** Small Loan Committee meeting as a \$139,000 project, with a \$35,000 loan request and a \$79,000 equity investment. The BEREC Credit Analyst prepared the Loan Committee Project Data Sheet and again recommended against the loan. Of note, there is no BEREC Business Credit Application on file corresponding to this loan request amount. A June 4, 2007 letter to Leonard Stokes from BEREC personnel "memorializes" Leonard's application for a \$35,000 loan.

The Small Loan Committee, consisting of then-existing employees, BEREC President, Chief Financial Officer, General Counsel, and Vice President of Neighborhood Economic Development, approved \$40,000 for the \$35,000 loan at the June 15 meeting, with the VP of Neighborhood Economic Development abstaining from the vote. This initial loan was made on an **exception basis** as it exceeded the \$25,000 maximum limit for a small loan.

\$30,000 Grant

On **August 23, 2007**, Leonard Stokes Jr., President of Candies Culinary and Hospitality Group Inc. submitted a Small Business Matching Investment Project Application Form to BEREC. This form requested \$30,000 in funds for the purpose purchasing furniture, fixtures and equipment (FFE) for One Sunset restaurant. Candies Culinary and Hospitality Group Inc. received approval from the Grant Committee which was comprised of the BEREC VP of Business Development, the BEREC Loan Analyst and two other BEREC staff members. **The grant requires matching funds, but the match was waived.** Grant guidelines specify a \$10,000 limit but indicate that exceptions can be made on a case by case basis. **An exception** was made to award \$30,000. The BEREC Neighborhood Commercial Specialist on the Committee recommended approval of the grant without review of the business plan submitted by One Sunset. The grant approval process was fast tracked and funds were disbursed within 23 days.

The terms of this grant called for the borrower to repay the full amount if the business closed within one year and a percentage of 66.7% if the business was closed within two years. In accordance with this clause, subsequent to the business closing, a lawsuit was filed to recoup 66.7 % of the \$30,000 grant, *i.e.*, \$ 20,000.

A breakdown of grant expenditures is shown below.

One Sunset Purchases Paid with Grant Funds

| Vendor | Dollar Amount | General Description of Purchases |
|-----------------------|----------------------|---|
| Micros Systems Inc.** | 7,393.92 | Computer equipment |
| Sherwin Williams | 5,651.38 | Floor mats |
| Details | 5,572.50 | Furniture |
| Apple | 4,284.92 | Mac door pro, 1 Mac |
| Ward Fire Protection | 2,318.00 | Kitchen equipment |
| Be Cool Refrigeration | 2,000.00 | Freezer on wheels |
| Nor-Den | 1,056.06 | Inspection, equipment |
| Office Depot | 919.93 | Phone, office equipment |
| Home Depot | 803.29 | Lamps |
| | \$ 30,000.00 | |

**One of the payments made with this grant was to a company called Micros, a computer software company. The Micros purchase of \$7,393.92 was paid with a two party check by BEREC. It is noted on the Balance sheet of One Sunset ending December 2007, that this same dollar amount was recorded as a long term liability, "Due to Shareholder LS". It is unknown why the exact amount paid by the Grant to Micros is shown on the business' balance sheet as money owed to Leonard Stokes Jr.

Credit Report

Mr. Stokes received the two BEREC loans despite failure to meet certain BEREC loan criteria. His credit scores did not meet minimum requirements. BEREC stipulates that a National Risk Score must be below 500 when applying for a BEREC Micro Business Loan. National Risk Scores range from 0 to 1000. Unlike a traditional credit score where a low score is bad, a low National Risk Score indicates credit worthiness of the borrower. Mr. Stokes credit report revealed his National Risk Score to be 664 at the time of his application. **He was approved on an exception basis by providing more of his own equity.** When applying for his second loan, his National Risk score of 666 failed to meet BEREC requirements. Yet again **an exception** was made and Mr. Stokes was given the second installment loan.

First \$40,000 BEREC Loan

The 1st loan was approved contingent on the borrower's commitment to inject \$79,000 into the business. The total equity injection is not definitively substantiated in BEREC documents. BEREC approved the first of two \$40,000 loans in June 2007. BEREC One Sunset files contain a preliminary Balance Sheet as of December 31, 2007 showing an Opening Equity Balance of

\$22,694.85. An independent BERC document to substantiate the \$79,000 equity injection only totaled to \$63,751.98 comprised of:

- \$16,475.11 Expenditures with invoice documentation traced to bank statements and general ledger paid by check or debit card.
- \$21,020.87 Cash expenditures with invoice documentation but without any supporting bank statement or general ledger entries.
- \$23,000.00 No invoice documentation, a cashier's check to an individual.
There is no proof that work was actually done to the business.
- 3,256.00 Expenditures without invoice documentation. \$1,056 submitted in support of an earlier grant and therefore not allowable.

It should be noted, in August 2009, the accountant for One Sunset provided a revised December 31, 2007 balance sheet reflecting opening balance equity of \$142,296.85. \$119,000 of the owner's equity was recorded by the accountant based upon a verbal communication with Mr. Stokes with no supporting documentation. This lack of documentation was readily acknowledged by the accountant to the City Auditor on a conference call on August 25, 2009.

By December of 2007 the business had received \$70,000 in government funds, *i.e.*, \$30,000 BERC grant and \$40,000 loan. The terms of this loan called for interest only payments of \$166.67 per month for the first year. The interest rate on this loan was 5% for the first four years and 6 % for the fifth year of the loan.

It should be noted that the last interest only payment on this loan was in September 2008. On January 2009 this first loan was put in default status which was triggered by a 90 day delinquency in payment.

This loan was then sent to collections with the law firm of Bulan, Chiari, Horwitz & Illecki LLP. No further money has been collected. A law suit has since been filed by BERC.

Second BERC \$40,000 Loan

The second loan, approved approximately within a month of the restaurant's opening, stipulated the business must engage a CPA to prepare monthly financials. **The requirement was never met.** An escrow account of \$5,000 was to be set up by the owner to help bridge the gap on cash flow problems and to provide working capital. **Again this loan requirement was never met.** It should be noted that the request for a second loan was withdrawn by the owner on January 24, 2008, but it was later deemed absolutely necessary for the business to continue.

On February 15, 2008 the second loan was disbursed to One Sunset. The deposit of this loan into the business can be verified by a bank statement on February 19, 2008. **It is duly noted that the Chief Financial Officer voted against the approval of this second loan.** Pursuant to records obtained from BERC, One Sunset had outstanding accounts payable to vendors amounting to over \$38,000 in January 2008. Several vendors were put on payment plans along with only accepting cash as payment for goods and services delivered. It was communicated to

auditors by BERC that with this second loan outstanding vendor invoices would be paid and the restaurant would become more cash solvent. **This did not happen.** A balance sheet and accounts payable aging report, obtained in August 2009 from the owner's accountant, reveals outstanding accounts payable of \$75,679.90 as of January 31, 2008, which is higher than BERC records suggested. Despite the receipt of loan funds, accounts payable increased yet further to \$76,031 in February 2008 and \$78,036 in March 2008.

The terms of this loan called for interest only payments of \$208.33 per month for the first year. The interest rate on this loan was 6.25% for the first year and escalated to 6.75% in the fifth and final year of the loan. It should be noted that the last interest only payment on this loan was in September 2008. On January 2009 this second loan was put in default status which was triggered by a 90 day delinquency in payment. This loan was then sent to collections with the law firm of Bulan, Chiari, Horwitz & Illecki LLP. No further money has been collected. A law suit has since been filed by BERC.

\$50,000 ECIDA Loan – Minority Entrepreneurs Grant/Loan Program

The ECIDA, despite evidence of the restaurant's sinking financials, somehow awarded a new loan of \$50,000 to One Sunset in August 2008. **Given the debt accumulated by the restaurant to that point and evidence of a lien against the business as well, the ECIDA compounded One Sunset's already questionable public loan history by approving a new loan of public funds for the clearly failing enterprise.** BERC executives attended the meeting at which the loan was approved and tacitly endorsed the project, despite the fact that indicators of the business' grave financial condition were available (internal financials showing nearly \$90,000 owed to vendors and one lien on file against it). Somehow, the ECIDA awarded the new loan despite the history of business failure documented in the financial records.

The Project Summary Sheet states the loan was to finance start-up capital, furniture, fixtures and equipment. Certainly, by the time the loan was awarded, the project was well beyond the start-up phase. The owner, Leonard Stokes Jr., agreed to invest \$50,000. On the pre-application for the loan, Mr. Stokes states that he "received extensive training from professionals in the food and hospitality industry". ECIDA did nothing to substantiate that assertion.

As previously outlined in this report, Leonard Stokes' business had already been the recipient of \$110,000 from BERC sources. In August 2009, the accountant revealed to the audit team that he was not asked by ECIDA to provide any balance sheet or profit and loss statements for One Sunset on this loan, but did provide an accounts payable report. **If the ECIDA had performed adequate due diligence, as they publicly stated in newspaper reports, they would have discovered the downward trends in revenue (see graph on page 4) and presumably would have never approved the new loan.**

The use of the \$50,000 ECIDA loan proceeds is not fully accounted for because monthly bank statements were not given to the audit team.

A deposit of \$20,000 was made into One Sunset's checking account at Bank of America around the same time that the loan proceeds were received. Balance Sheet activity on his business checking accounts cannot reveal a completely accurate picture of where these dollars went; at best we have an impression that suggests what may have happened to some of the funds. We feel that this loan cannot be fully examined in its entirety to render a qualified opinion on these monies.

There was **\$27,984.88** in unverified funds that remained on One Sunset's unaudited monthly financials from October 2008 through December 31, 2008. The accountant did produce one Key Bank checking account statement dated October 2008 for Candies Culinary which gave a zero ending balance and showed the bank account as closed. This discrepancy cannot be explained with the records available to us. **The whereabouts of all these funds still remain a mystery and are considered unaccounted for.**

An order and judgment was obtained on May 4, 2009, by the Buffalo and Erie County Regional Development Corporation against Candies Culinary and Hospitality Group Inc. and Leonard Stokes Jr. in the amount of \$50,000 plus interest of \$1,166.69 plus legal costs of \$730.00 totaling \$51,896.69.

Missing Inventory at One Sunset

On June 18, 2009 two auditors and a BEREC employee went to One Sunset restaurant to conduct an ending inventory count of the furniture, fixtures and equipment that was left after the restaurant closed. It was communicated to auditors after the inventory was counted that police reports show the restaurant had numerous break-ins of the establishment. When the inventory was first valued on Schedule "A" of the 1389 Delaware Lease, it had an approximate value of \$96,000.

It should be noted that this inventory value did not have any food or beverage assets. It also did not include other valuable items, such as bar stools, paintings, tables, chairs, glassware and other related miscellaneous restaurant items (ex. silverware). **After the final count of inventory by the auditors on June 18, 2009, it was noted that approximately \$38,000 was missing in actual inventory.** Items missing from the inventory included: television sets, speaker system and security cameras.

Site Visit Documentation

Documentation of site visits to One Sunset is nonexistent except for a July 18, 2008 visit conducted by the BEREC Senior Loan Officer. Numerous sources reveal that the Vice President of Neighborhood Economic Development was physically present at One Sunset, however no site visits were included in BEREC files to substantiate this and most would be considered social, non-business related contacts.

Site Visit Monitoring Guide

The site visit monitoring guide dated July 17, 2008 and filled in by the Senior Loan Officer states "no report submitted yet" in relation to the section II – national objective creation low to middle income jobs. At the time of the report, One Sunset had been open for business for over seven months; however this report had not yet been submitted. **This lack of reporting constitutes a failure to comply with the terms of the loan.** To note, another loan was still given in August 2008 by the ECIDA.

All Active Loans in the Collection Process

BERC provided the audit team with an Excel document showing 133 active loans in their system as of June 26, 2009. An analysis was performed on the number of loans in collections. Thirty-two loans from this spreadsheet were in collections. Twenty of these loans pertain to businesses that are now closed. Eighty-one percent (81 %) of the original loan amount in this category is uncollected. This equates to \$1,029,394. It would appear that very little of the outstanding amount will ever be collected. The average outstanding days on these loans is approximately 579 days or 1.6 years. (See summary below)

Nine of the collection loans pertain to businesses that are currently still operating. (It should be noted that two businesses were subtracted because they settled.) Of these, 65 % or \$520,202 is still outstanding. The average days out on these loans are 617 days or approximately 1.7 years. (See summary below)

The audit team received a spreadsheet which was represented as the BERC Loan Database. It was determined that information in this file was not up to date.

This file contains a loan status field which contains pertinent information, such as when a business goes into collections, last payments received, check number and days outstanding. It was discovered during this audit that some loans showed far more days outstanding than actually were.

BERC uses a software program to manage their loan portfolio that is called Portfolio Management. The assistant accountant acknowledged difficulty updating the Portfolio System for payments received from the BERC collection lawyer due to the sporadic nature of the payments. Since the Loan Data Report Spreadsheet and Portfolio system both contain information on each particular loan, emphasis should be made to keep both of these in sync. Without this information being current, analysis and decisions relating to loans in collections may be based on inaccurate information.

Active BEREC Loans in Collections: Closed Businesses

| Original BEREC Loan Amount | Average Loan Amount | Amount Still Owed | Average Days Outstanding |
|----------------------------|---------------------|-------------------|--------------------------|
| \$ 1,273,920.37 | \$ 63,696.02 | \$ 1,029,394.14 | 579 |

Active BEREC Loans in Collections: Open Businesses

| Original BEREC Loan Amount | Average Loan Amount | Amount Still Owed | Average Days Outstanding |
|----------------------------|---------------------|-------------------|--------------------------|
| \$795,000.00 | \$88,333.33 | \$ 520,202.44 | 617 |

Majority of BEREC Loans (Business, Micro, Minority/Women and Small Business Loans)

There were 133 active loans, 21 were granted through the following loan programs, HUD 108, 60/40, EDA, TTL IX, UDAG/BEREC, Non Federal, EAP and FEC. 112 were awarded through the Business, Micro, Minority/Women and Small Business Programs. It is these 112 loans which we present in the tables and graphs which follow. These loans represent the type of loans which were the focus of the audit. The loans are presented by:

1. Council District
2. Loan Justification or Eligibility Criteria
3. Type of Business

Data was extracted from a spreadsheet provided by BEREC. The data reveals a program which has a geographic breadth. All council districts participate. The loans are awarded primarily for job creation and a wide array of business sectors are represented.

A Breakdown of BERC Business, Micro, Minority/Woman and SBA Loans

Active BERC Loans* Presented by Council District

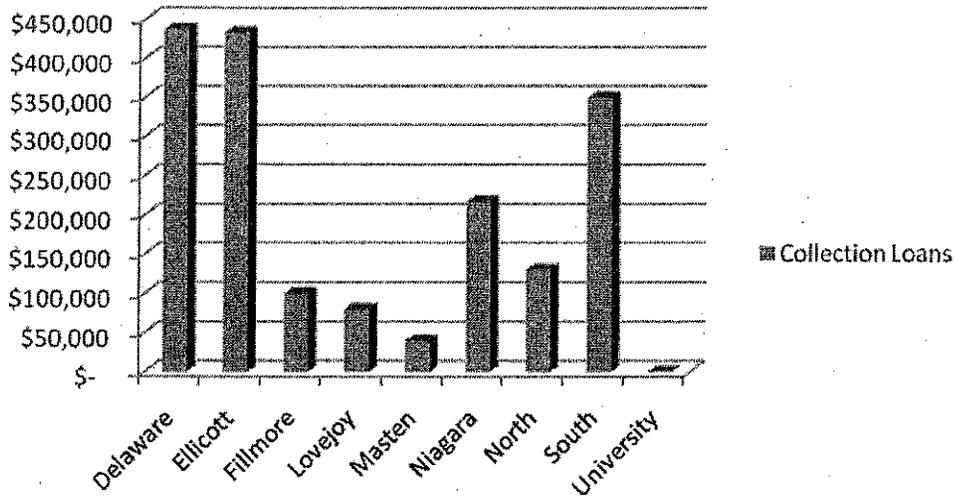
All Dollar Amounts based on Original Loan Amount

| Council Districts | Number of Loans | Total Original Loan Amount | Current Category | Collection Category | Past Due Category |
|-------------------|-----------------|----------------------------|------------------|---------------------|-------------------|
| Delaware | 20 | \$1,954,782 | \$1,472,782 | \$437,000 | \$45,000 |
| Ellicott | 28 | \$3,314,779 | \$2,784,500 | \$432,500 | \$97,779 |
| Fillmore | 5 | \$707,000 | \$607,000 | \$100,000 | - |
| Lovejoy | 9 | \$698,000 | \$618,000 | \$80,000 | - |
| Masten | 11 | \$1,030,000 | \$990,000 | \$40,000 | - |
| Niagara | 10 | \$874,083 | \$465,500 | \$216,811 | \$191,771 |
| North | 14 | \$1,007,365 | \$877,365 | \$130,000 | - |
| South | 11 | \$773,226 | \$423,726 | \$349,500 | - |
| University | 4 | \$767,000 | \$767,000 | - | - |
| | 112 | \$ 11,126,234 | \$ 9,005,873 | \$ 1,785,811 | \$ 334,550 |

* Loans of the following types: Business, Micro, Minority/Women, SBA

Total = Current + Collection + Past Due Loans

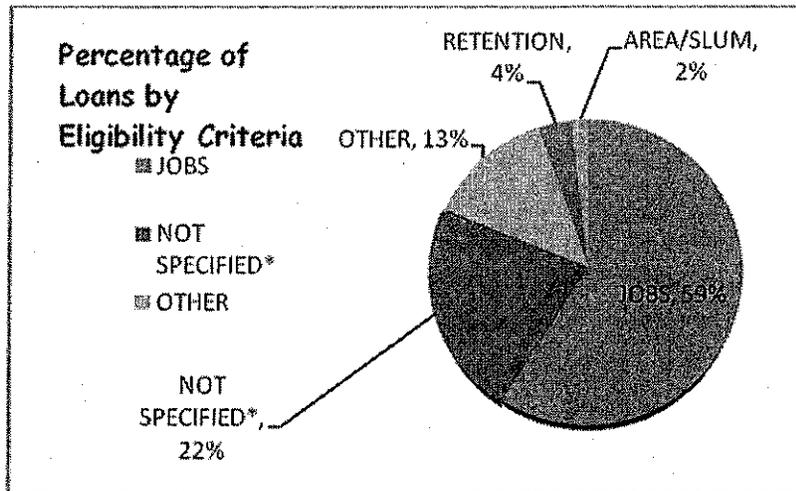
Dollar Amount of Loans in Collections by District



Job Creation

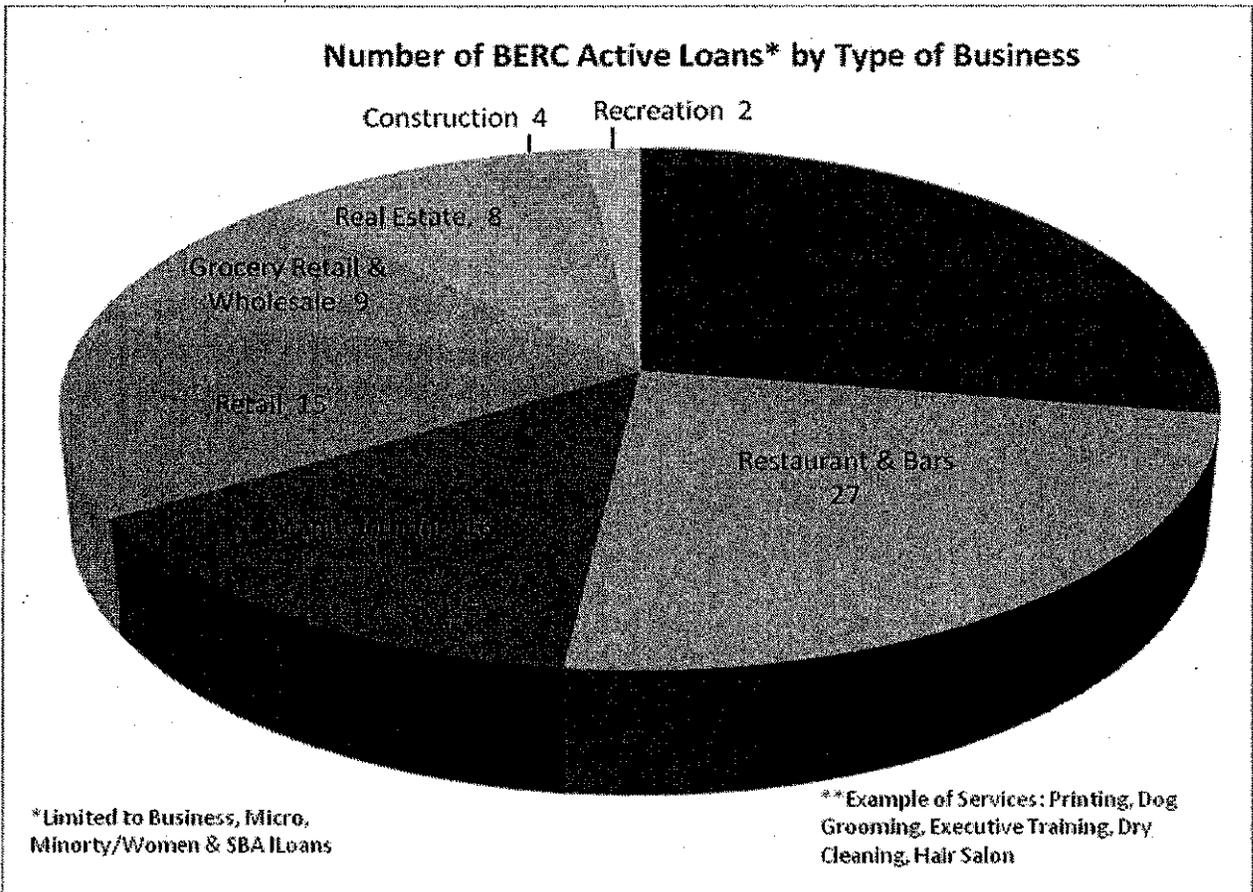
Fifty-nine percent (59 %) or 66 of the 112 Business, Micro, Minority-Woman, and Small Business Loans were awarded on the basis of job creation. (See graph below) These 66 loans were expected to produce 571 jobs. Fifty percent (50%) of the planned jobs were to be created by the following 5 businesses: *jobs planned are in parenthesis*; Niagara Ceramics (170), Neapolis Family Restaurant (35), Sonitrol Security Systems (31), Carmina Wood, Morris PC (26), and Empire Grill (25). **A total calculation of Low/Moderate Actual Jobs created is not possible because BERC did not input adequate information into the Loan Database.**

Loan Criteria Graph:



- Note: "Not Specified" means eligibility field in Loan Data Base was left "Blank"

Loan Categorization by Type of Business:



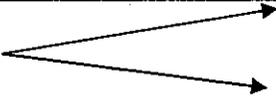
Loans Grouped by Type of Business

| Type of Business | # of Loans | # of Current Loans | # Past Due & Collections Loans | Original Loan Amount | Current Loans - Original Loan Amount | Past Due & Collections - Original Loan Amount | % Current | % Past Due & Collections |
|-------------------------|------------|--------------------|--------------------------------|----------------------|--------------------------------------|---|------------|--------------------------|
| Construction | 4 | 2 | 2 | 172,500 | 100,000 | 72,500 | 58% | 42% |
| Food Wholesale & Retail | 9 | 8 | 1 | 1,365,811 | 1,174,000 | 191,811 | 86% | 14% |
| Manufacturing | 16 | 14 | 2 | 1,482,865 | 1,245,865 | 237,000 | 84% | 16% |
| Real Estate | 8 | 6 | 2 | 1,130,000 | 1,070,000 | 60,000 | 95% | 5% |
| Recreation | 2 | 2 | 0 | 255,001 | 255,001 | - | 100% | 0% |
| Restaurants | 27 | 20 | 7 | 2,194,007 | 1,924,007 | 270,000 | 88% | 12% |
| Retail | 15 | 6 | 9 | 1,049,771 | 361,000 | 688,771 | 34% | 66% |
| Services | 31 | 22 | 9 | 3,476,279 | 2,876,000 | 600,279 | 83% | 17% |
| Total | 112 | 80 | 32 | 11,126,234 | 9,005,873 | 2,120,362 | 81% | 19% |

The Audit team used information from the BERC Loan Database, i.e. Nature of the Business column, to categorize the 112 Micro, Business, Minority, Women and SBA Loans into 8 broader categories, (See Chart Above). The loans which are current represent 81% of the original loan amount. The non current loans represent 19% of the original loan amount. The poorest performing category was **Retail**, dominated by the used appliance business and several women's clothing stores.

The Cost Increase when a Loan goes into Default (Sample of BEREC Loans)

As part of the Audit several other Business and Micro loans were reviewed. These included loans made to 6 businesses. The total amount of these loans was \$1,178,865. Four of the loans or 66% of the sample are in default or delinquent. The table below provides information on these loans.

| | Status: Loans Current | | Status: Loans Delinquent or in Default | | | | Sample Loans |
|---|--|--------------------|--|---------------------------------|-------------------------|-------------------------|--------------|
| | 31 Club | Niagara Lubricant | Delish | Chop Chop by Delish | Quality 1 Appliances | The Performance Group | |
| Status of Business | Open | Open | Open | Open | Closed | Closed | |
| Status of Loan | Current | Current | Delinquent | Delinquent | Default | Default | |
| Amount of Loan | \$300,000 | \$53,865 | \$35,000 | \$40,000 | \$400,000 | \$350,000 | \$1,178,865 |
| Loan Justification | Other | Blank | Blank | Other | Jobs | Jobs | |
| Loan Closed | Feb-09 | Nov - 06 | Mar-05 | Oct-07 | Feb 04, July 06 | Mar-05 | |
| Council District | Ellicott | North | North | Ellicott | Fillmore | Delaware | |
| Collateral | 3rd Mortgage 3rd M/E | 2nd M/E 3rd M/e | 2nd M/E | 2nd M/E | 2nd Mortgage 4th M/E | 2nd Mortgage 2nd M/E | |
| Last Payment Date | Current | Current | Aug-08 | Oct-08 | May 08 | Dec-07 | |
| Days Outstanding | - | - | 405 | 282 | 557 | 1378 | |
| Collection Attorney Remarks | | | Holding per Client Instructions | Holding per Client Instructions | Claim filed to estate | Chapter 7 Bankruptcy | |
| Planned Jobs | 20 | 2 | 3 | 3 | 9 | 17 | 54 |
| Loan Amount per Planned Job | \$15,000 | \$26,933 | \$11,667 | \$13,333 | \$44,444 | \$20,588 | \$21,831 |
| Loan Amount per Planned Job (exclude jobs from Closed Businesses) | <p style="text-align: center;">Cost of 1 Job increases when businesses fail.</p>  | | | | | | \$42,102 |

(In this example it cost an extra \$20,271 per job when a business failed to retain planned jobs.)

Highlights of Sample Loans

The Performance Group, an Executive Training business, was unsuccessful. The minutes of the Loan committee meeting held July 8, 2004 state "BERC is hereby authorized to issue a \$350,000 BEREC Business Loan (on an **exception basis**) for a 10 year term, fixed at 4%." The exception related to the size of the loan, it exceeded the \$300,000 lending limit. The loan closed in early 2005 and by 2006 a forbearance agreement was reached. The business closed and the borrower defaulted. BEREC had a second position lien on the property. Property which was valued in the business case in excess of \$800,000 is now estimated to sell for much less.

Delish Inc, a bakery and café located on Elmwood Avenue received a \$35,000 Micro Loan in March 2005. The owner was to inject \$10,000 into the business. The business was labeled high risk as a start up, however the owner had cash reserves and a good credit score. Site visits on file state that the business met their job goal. In October 2007 BEREC gave a second loan in the amount of \$40,000 to **Chop Chop by Delish** a spin off restaurant located on Cathedral Park in downtown Buffalo. Both loans at the time of this audit are in collections, yet are still open for business.

31 Club, an upscale restaurant and bar received a \$300,000 loan in February, 2009. Of note, the loan was approved and then rescinded by the committee based on concerns over collateral and terms of bank debt. The issue was resolved and the loan was approved. The collateral value was based on significant renovation expense which has inherent risk.

Niagara Lubricant, founded in 1923, this manufacturing company is known for its packaging of lubricating oils, greases, industrial oils and tire care products. BERC awarded two loans in September 2006 and November 2006 totaling \$53,865 for the purchase of new equipment, which resulted in the planned creation of two new positions.

Quality 1st Appliances opened for business in 1985. After the death of the proprietor, the business became known as Everything Appliance. On January 15, 2004 BERC forwarded a \$290,000 advance from a \$300,000 loan to Quality 1st of which \$100,000 was used to acquire property at 95 Dorothy Street in the City of Buffalo. This location would serve as the home of Everything Appliance and provide room for expansion of the business. This property would then be sold in May 2008 for \$394,000 to satisfy outstanding debt in accordance with the proper disposition process. In addition to the above referenced loan an additional loan was approved by BERC in March 2006 in the amount of \$100,000.

Payments on loans made by BERC to Quality 1st Appliances have not been made since May 2008. The loans are now in the collection process with a claim being made by the BERC collection lawyer against the estate of the original proprietor of Quality 1st.

A Comparison of Sample Loans

Based on our six sample loans from the 112 Micro, Business, Minority, Women, SBA Loans we conclude that seventy percent of these loans are either in the past due or collection stage in comparison to the 112 loans which had a default rate of only 19%.

Positions with High Turnover and Vacancies

During the time frame which the audit covers, BERC experienced significant management turnover. The President, Chief Financial Officer, General Counsel, Chief Lending Officer, Deputy for Business Assistance and the Portfolio Manager positions all had turnover. It should be noted, that Michele Barron, Vice President of Neighborhood Economic Development was terminated during the course of this audit on August 19, 2009. The President of BERC was also asked to resign in the course of this audit in July 2009. Certain key positions were left unfilled for months e.g. no Chief Lending Officer from June through December, 2007, leaving lower level staff to assume greater responsibility. The Chief Financial Officer's position was vacant from September 2008 through June 2009.

Recommendations

The following recommendations on BERC lending practices relate to the overall loan process, and go beyond the specifics of One Sunset. The recommendations will touch upon the business application, disbursement of funds, loan repayment and collections.

1. City of Buffalo Comptroller Presence on BERC Board of Directors

We recommend that the City Comptroller or his representative be appointed to the BERC Board of Directors as a non-voting, *ex-officio* member. This would provide independent oversight and would help the Board by identifying “red flags” before bad loans are approved. At the present time, the City Comptroller acts as a “watch dog” on City finances. The City Comptroller does not have direct oversight of semi-private agencies such as BERC. This should change.

2. Stricter adherence to BERC Lending Guidelines and Policy.

We recommend no loans be given to businesses whose principal owners’ credit does not meet minimum standards set by BERC. In the case of a Business Loan (\$50,001 to \$300,000), a National Risk Score of 350 or lower is required. In the case of a Micro Loan (\$50,000 or lower), a National Risk Score of 500 or lower is required. **Exceptions** to these requirements should not be granted, except under extremely exceptional circumstances with verifiable and valuable security measures or collateralization.

3. Equity investment should be certified.

We recommend that when an infusion of personal equity is made in support of a loan application, the equity injection should be independently verified and certified by the applicant, preferably through a sworn statement. The person responsible for this is currently the Loan Officer. We suggest that a checklist be developed that would identify various hallmarks of a completed application that would be verified by this position and signed off accordingly. The Vice President of Lending would then have the tools necessary to move the loan application forward with the written documentation.

4. Financial statements reviewed.

We recommend that BERC strictly require monthly financial statements for all businesses and continue requiring annual financial statements for all businesses.

The Vice President of Lending should ensure that financial statements are obtained. These statements and other supporting information should be reviewed and signed off by both the Vice President of Lending and the Chief Financial Officer before being presented to the loan committee for approval. Any non-compliance should be reported to the appropriate committee.

The financial statements must be submitted prior to any consideration of a second loan. The obligation to provide financial statements should become a term of all loans.

5. Loan Evaluation Process

We recommend the BERC Vice President of Lending ascertain the viability of the loan through an initial review of the applicant's business plan including proforma financial statements. This review is done after the initial credit review has proven the applicant meets minimum standards. If the Vice President of Lending views the project as viable he will assign the loan to a loan officer. The loan officer then does a full loan workup assuring all documentation is in order. The loan officer presents the completed loan package to the Vice President of Lending, who then recommends for or against the approval of the loan.

6. Job Creation

We recommend that the BERC take a more balanced approach to the awarding of the loans with more emphasis placed on businesses which will provide needed services to low to moderate income areas and the elimination of blight. The majority of the loans in the BERC loan portfolio are awarded to businesses based on their planned creation of new jobs, sometimes as few as one projected over a three year period. In addition, **we recommend** that BERC maintain complete and up to date records relative to the loan objectives, *i.e.*, how many low moderate/ jobs were created.

7. Staffing

We recommend BERC review their organizational structure, clearly defining all roles and job requirements. Job vacancies should be filled in an expeditious manner. During the time frame covered by this audit there was an increase in responsibility for certain staff due to employee turnover. Decisions were made without a full complement of personnel. Development of key performance indicators and annual performance assessments should be conducted to measure performance against goals. **We further recommend** the Neighborhood Business Specialist positions take a more active approach in some of the geographic areas of the city, e.g. North, South, East and West that have been neglected. The characteristics of this position should entail an individual that has high energy, salesmanship and thorough city knowledge. These positions should also serve as a liaison between the business community and BERC central office.

8. Loan Monitoring

We recommend that all payments be deposited and applied in a timely manner. The loan payments are applied by the Assistant Accountant into a loan database called Portfolio Management. The same individual issues invoices, receives payments and makes deposits. It was noted on one occasion that a payment from the cash receipts report was applied to the wrong loan number.

A different employee, most likely the Portfolio Manager, should take the responsibility of verifying receipts. Without this separation of duties, a serious lack of internal control exists.

9. Site Visits

We recommend that site visits be conducted semi-annually. We further recommend the site visit form be filled in and kept on file with BEREC. The Site Visit Monitoring Guide/form was modified in June 08. Section II of this form identifies the eligibility criteria upon which the BEREC loans are based. There are 3 possible criteria which the borrower must meet, *i.e.*; **1.** Creation of Low to Moderate Income jobs, **2.** Provide a service or product that will benefit a low/moderate income area a.k.a. Area Benefit, and **3.** Eliminate Slums/Blight. Site visits should be done by an individual, other than the loan officer in order to verify that the loan proceeds were used appropriately. **We recommend** the Neighborhood Business Specialist perform these duties.

10. Inventory

We recommend that in the event of a loan default any BEREC liens on the remaining assets or business inventory be exercised according to the terms of the loan. A procedure should be established that would aggressively pursue and protect the collateral to which BEREC has legal rights (to the extent BEREC can establish a priority position). This may include, but is not be limited to, confiscation of furniture, fixtures and equipment.

11. HUD Fundability and Eligibility Determination Form

We recommend that the Buffalo Urban Renewal Agency review and approve the Fundability and Eligibility Form submitted by BEREC. This form attests that the loan justification meets HUD Federal Regulations for appropriate use of funds. Signatures of both agencies should be required.

12. Loans in Collections

We recommend that the collection process be more aggressively pursued. Delinquent accounts must be addressed sooner. The Portfolio Management system should be updated regularly. Timely follow up on receipt of payments should occur. This would provide a more accurate number of days outstanding on the loan. It should be mentioned that those businesses that are no longer operating be a top priority for some kind of settlement in regard to liens on collateral, *e.g.*, One Sunset inventory.

Conclusion: One Sunset

This audit of the One Sunset loan process was initially started in June 2009 and completed in September 2009. Our audit findings were presented in a time line fashion, starting with the original initial application and ending with the restaurant being in collections.

The beginning grant and loans that Mr. Stokes received from BERC have been documented in this audit for compliance. We do agree that these funds, which totaled \$110,000, were instrumental in driving the business forward, but the use of these funds was mismanaged from the very start. It was communicated to auditors that the second loan totaling \$40,000 was to be used specifically to pay off One Sunset's accounts payable. It never was, and his accounts payable grew as the months passed. Follow up and verification of vendor payments by BERC was never performed. This would be Mr. Stokes' last loan from BERC.

Mounting debt and lower than anticipated sales would continue to be the theme until Stokes received his last loan, this one originating from the Erie County Industrial Development Agency in August 2008. The proceeds from this ECIDA loan totaled \$50,000, and this was seen as a last gasp effort to save the struggling restaurant. According to One Sunset's bookkeeper, no credit check was ever done to examine the financial footing of the establishment.

Unfortunately, ECIDA did not exercise due diligence in checking the financial condition of this business. If it had, One Sunset's overwhelming debt would surely have been discovered. Word of mouth of early success of One Sunset led to the loan approval instead. Our audit concluded that the vast majority of this ECIDA loan is still considered unaccounted for. One Sunset officially stopped serving customers in October of 2008, since then no payments on any of these outstanding loans have been made. Vendors and former employees remain unpaid. In December 2008, the BERC loans to Mr. Leonard Stokes Jr. President of Candies Culinary and Hospitality Group Inc. were put into collections. Inventory which was to be used as collateral is now missing. The missing inventory, valued at approximately \$38,000, may never be recovered.

Conclusion: BERC

BERC is a conduit for Federal funds to private businesses in the city of Buffalo. The 2008-2009 BERC Final Budget as portrayed on the BERC website shows grant revenues to BERC from Federal funds estimated at \$6.4 million. Of this, \$1.7 million was designated for new loans and grants. BERC expenses in 2009 were planned at \$5.2 million. Like any not-for-profit, the corporation must strive to maintain a high percentage of program dollars dedicated to the direct benefit of the target population; simply said, they should strive to lend as much money as possible with the least amount of overhead. The funds have several intended purposes, *i.e.*, job creation for low/moderate income individuals, provision of needed services to low/moderate income areas, elimination of slums and blight. The managers responsible for these funds must

not lose sight of the reason these funds were created. Buffalo cannot afford to lose investment dollars especially in the current harsh economic climate.

The lessons of One Sunset are many and can be applied to all future loans, most notable **Adherence to Policy**. The One Sunset audit brought to light some serious weaknesses in the BEREC organization, most noteworthy, high management turnover leading to absence of leadership and sub-optimal results. This program needs strong leadership of both fiscal and program policy.

Our audit began with a review of 133 BEREC active loans. Of these 133 loans, 22 were for businesses that closed and were in the collection stage and 11 were open businesses in the collection stage. The audit team keyed on 112 loans in the business, micro, minority-women and small business categories. We found that 59% of the loans awarded were based on job creation. Some loans were awarded with one (1) job created and that being the proprietor of the business. Our analysis of the BEREC database found that 35% of the 112 loans used the eligibility criteria of "other (13%) and "not specified" (22%). Actual jobs created versus planned jobs are not precisely measured by BEREC.

As part of the audit team's final leg of the investigation, we researched the City of Rochester's Economic Development Corporation (REDCO) and the City of Syracuse Economic Development Office. On July 1, 2009 the City of Rochester merged the Departments of Economic Development, Community Development and Neighborhood Service Centers into the Department of Neighborhood and Business Development. In the words of the Commissioner, "We have created a leaner, more efficient agency that is faster and more responsive because it eliminates layers of bureaucracy that existed between our customer and the decision makers." A board of directors was maintained which included the Mayor, Deputy Mayor, Council President, Commissioners, bankers and business and neighborhood leaders.

The City of Syracuse's Economic Development Office funnels loan applications through an "Economic Development Specialist." The Specialist tours the existing business or reviews a start up business' plan and makes recommendations to the loan committee based on the information submitted. Loans require final approval by the Syracuse Economic Development Corporation (SEDCO) or the Syracuse Industrial Development Agency (SIDA).

The underlying theme displayed here is that the loan application process is channeled through a Municipal department or office with final approval resting in the hands of an independent board.

Our Final Conclusion is Twofold:

1.) The possibility of merging BEREC with the Department of Economic Development, Permit and Inspection Services should be explored. Some notable benefits of this merger would streamline government, enhance transparency, create fiscal oversight by the City Comptroller and stabilize staff positions. Communication with REDCO and SEDCO may provide valuable insight as to the feasibility to the City of Buffalo of such a merger. A governing Board of

Directors would remain in place with the makeup of the Board designed to enhance efficiency and transparency with City of Buffalo operations.

2.) If BERC is to remain as a separate corporation, further policy changes must be submitted to the Board of Directors for approval and implemented to the fullest. Exceptions to the rules should not be allowed.

To their credit, the BERC Board of Directors has modified its loan and grant committees by merging them into a single Loan and Grant Committee. This Committee will review and approve all loans and grants and be comprised of at least three Board members. BERC management has proposed many policy changes still to be adopted by the full board:

- Enhanced monitoring of start-up businesses that includes using a panel of professional advisors. Monthly financials must be included for the review by the loan officer.
- A new policy is to be formalized regarding minimum lending qualifications, a definition of start-ups and setting the minimum loan criteria for start-up businesses.
- Employment data will be tracked as loan payments are presently done (30, 60, and 90 days) with default notices sent after 90 days.
- Site visits will be modified to include NYS sales tax filings, financial statements, tax returns, property insurance as well as job creation information.
- High risk loans will be monitored periodically and required to submit financial statements and marketing plans semiannually in order to prevent loan default.
- A corrective action plan is currently underway with the new CFO to enlist the technical assistance of HUD to reform and restructure the City of Buffalo Economic Development operation.

The current management of BERC should be recognized for taking significant steps to reverse years of structural decline that have crept into BERC's operations. An influx of new staff, leadership and aggressive Board involvement are setting the stage for new reforms and clarity of purpose for the organization.

Business creation or sustainability is crucial to the future of the City of Buffalo. Business equals jobs. According to BERC's mission statement, success will be measured ultimately by the amount of jobs created for residents in low/moderate communities. Let's work together to make it happen.