To: Ken Wade, Jeff Bryson, Eileen Fitzgerald and Michael Forster

From: Frederick Udochi

cc: Nelson Merced, Ron Johnston, Mia Bowman

Date: October 7, 2009

Subject: Audit Review of Management’s Oversight of NeighborWorks® Capital

Enclosed is a copy of the recently concluded review of Management Oversight of NeighborWorks® Capital. Please review and let me know if you have any comments or questions. Thanks.
Executive Summary

Audit Review of Funding to Management Oversight of NeighborWorks® Capital

<table>
<thead>
<tr>
<th>Business Function and Responsibility</th>
<th>Report Date</th>
<th>Period Covered:</th>
</tr>
</thead>
</table>

Assessment of Internal Control Structure

<table>
<thead>
<tr>
<th>Effectiveness and efficiency of operations</th>
<th>Generally effective.¹ Recommendations in specific areas are noted below.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reliability of Reporting</td>
<td>Generally effective. Recommendations in specific areas are noted below.</td>
</tr>
</tbody>
</table>

This report was conducted in accordance with the International Standards for the Professional Practice of Internal Auditing.

¹ Legend for Assessment of Internal control Structure: 1. Generally Effective: The level and quality of the process is satisfactory. Some areas still need improvement. 2. Inadequate: Level and quality of the process is insufficient for the processes or functions examined, and require improvement in several areas. 3. Significant Weakness: Level and quality of internal controls for the processes and functions reviewed are very low. Significant internal control improvements need to be made.
Summary of Observations and Recommendations:

<table>
<thead>
<tr>
<th>Summarized Observation; Risk Rating</th>
<th>Management Agreement with Observation (Yes/ No)</th>
<th>Internal Audit Recommendation</th>
<th>Accept IA Recommendation (Yes/ No)</th>
<th>Management’s Response to IA Recommendation (Received 11/6/09)</th>
<th>Estimated Date of Implementation</th>
<th>Internal Audit Comments on Management Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. It was observed that NC has extended loans to entities that have or have had representation on its Board of Directors and/or Loan Committee.</td>
<td>Yes</td>
<td>It is recommended that NeighborWorks® Capital enforce the Conflicting Interest Transactions section of their by-laws and the Conflicts of Interest Policy at all times.</td>
<td>Yes</td>
<td>Management will continue to monitor NC conflict of interest policies, especially its Conflicting Interest Transactions section, to assure proper policy implementation.</td>
<td>On going.</td>
<td>IA accepts Management’s response.</td>
</tr>
<tr>
<td>Risk rating:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. It was observed that NeighborWorks® Capital is not scheduled for an OAD review until the “transition period” is over (subsequent to December 2009).</td>
<td>Yes</td>
<td>It is recommended that due to some of the transition in the executive leadership, and the loans made to entities on the Board of Directors, that OAD consider expediting their review date of NeighborWorks® Capital so that it occurs during the first half of FY 2010.</td>
<td>Yes</td>
<td>We expect that the review will occur within the second quarter of FY2010.</td>
<td>March-April 2010 time frame.</td>
<td>IA accepts Management’s response.</td>
</tr>
</tbody>
</table>

2 The observations and recommendations in this section are summarized at a high level for informational purposes. To obtain a full, detailed explanation of each, please refer to the “Observations and Recommendations” section. Management’s response is directly related to the detailed observations and recommendations noted in the “Observations and Recommendations” section.
**Risk Rating Legend:**

Risk Rating: **HIGH**

A serious weakness which significantly impacts the Corporation from achieving its corporate objectives, financial results, statutory obligations or that may otherwise impair the Corporation’s reputation.

Risk Rating: **Moderate**

A control weakness which could potentially undermine the effectiveness of the existing system of internal controls and/or operational efficiency, integrity of reporting and should therefore be addressed.

Risk Rating: **Low**

A weakness identified which does not seriously detract from the system of internal control and or operational effectiveness/efficiency, integrity of reporting but which should nonetheless be addressed by management.

<table>
<thead>
<tr>
<th># Of Responses</th>
<th>Response</th>
<th>Recommendation #</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Agreement with the recommendation(s)</td>
<td>#’s 1, 2</td>
</tr>
<tr>
<td>0</td>
<td>Disagreement with the recommendation(s)</td>
<td>N/A</td>
</tr>
</tbody>
</table>
Audit Review of Management Oversight of NeighborWorks® Capital

Objective

To ensure that NeighborWorks® America’s management has established an oversight activity based on clearly identified program objectives, measurable outcomes and risk evaluation function for the external business related corporation.

Scope

The scope of this review is from the effective date of the merger between Neighborhood Capital Corporation and RNA Community Builders, which formed NeighborWorks® Capital, on December 28, 2007, through April 30, 2009.

Background

NeighborWorks® Capital (NC) is a non-profit community development financial institution (CDFI) based in Silver Spring, MD. NC was formed in December 2007 as a result of a merger between two established CDFIs that served the NeighborWorks America network: Neighborhood Capital Corporation and RNA Community Builders. These two organizations combined their resources to better serve non-profit community development corporations in the NeighborWorks® network.

NC provides critical early stage project financing to more than 235+ NeighborWorks® member organizations engaged in the development of various real estate projects across the country including affordable residential housing and commercial projects. Vested with a community development commitment and market knowledge. NC works with NeighborWorks® America (NWA) and its network members to take advantage of local opportunities and overcome financing challenges.

NeighborWorks® Capital is governed by their Business Plan, which was adopted by their Board in December 2007. This Plan provides more details regarding their business strategy, target market, legal structure and governance, Management processes, and financial plans, which includes a plan for growth. In addition, the Business Plan also addresses NC’s special relationship with NeighborWorks® America. NWA provides financial support, technical assistance and training to NC. NC's strategic relationship with NWA provides an important platform for the identification of issues and the corresponding formulation of solutions. NC's Board of Directors consists of nine members. One of the Board positions is for the CEO of NWA, who is also appointed to The Finance and Audit Committee. Currently, the CEO has delegated the COO to attend the Board meetings on his behalf. In addition, the Director of National Initiatives and Applied Research attends the meetings as well. At each quarterly Board meeting, an overview of annual work plan results is provided with detailed information on its progress towards meeting targeted goals, as related to its key metrics. It is essentially a performance scorecard used by the organization, which identifies if their operational performance will meet predetermined targets.
OBSERVATIONS and RECOMMENDATIONS:

The following observations were noted and brought to the attention of management:

1. **Loans Extended to Organizations Represented by the Board or Loan Committee**

   It was observed that Statement 8 on NeighborWorks® Capital's Form 990 (2007) indicates that "the organization has extended loans to entities that have or have had representation on the Board of Directors and/or its Loan Committee."

   The following loans were made to the organizations of Board/Loan Committee members:

<table>
<thead>
<tr>
<th>Name of Organization</th>
<th>NC Board or Loan Committee</th>
<th>Date of Loan Commitment</th>
<th>Date of Loan Funding</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nuestra Comunidad Development Corp.</td>
<td></td>
<td>10/28/2007</td>
<td>2/19/2008</td>
<td></td>
</tr>
<tr>
<td>Cabrillo Economic Development Corp.</td>
<td></td>
<td>11/24/2008</td>
<td>12/19/2008</td>
<td></td>
</tr>
</tbody>
</table>

   * * served on the BOD during 2007 (time of loan approval and commitment, but not on the board during period of loan closing & funding.

   Boards have a duty to avoid apparent and actual conflicts of interest. The approval of a loan for an entity which has leadership on NC’s Board could be viewed as an actual conflict of interest, or as having an “apparent conflict of interest”. Internal Audit recognizes that it is not unusual for conflict of interest to arise on a non-profit Board since its members are usually affiliated with a number of community-based organizations, however, according to Board Source¹, a conflict of interest policy should be developed to address the following three essential elements²:

   • **FULL DISCLOSURE.** Board members and staff members in decision-making roles should make known their connections with groups doing business with the organization. This information should be provided annually.

   • **BOARD MEMBER ABSTENTION FROM DISCUSSION AND VOTING.** Board members who have an actual or potential conflict of interest should not

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¹ Board Source strives to support and promote excellence in board service, is a premier source of cutting-edge thinking and resources related to non-profit boards, and engages and develops future non-profit board leaders.
participate in discussions or vote on matters affecting transactions between the organization and the other group.

- **STAFF MEMBER ABSTENTION FROM DECISION-MAKING.** Staff members who have an actual or potential conflict should not be substantively involved in decision-making affecting such transactions.

It was noted that NC adopted a Conflict of Interest Policy since the merger went into effect (December 2007) which does address the three elements aforementioned. It is further noted that in May 2009, we determined that NeighborWorks® Capital revised their by-laws to include a “Conflicting Interest Transactions” section. It addresses loans to Board members, quorums and conflicts; however this was subsequent to the loan distributions identified above.

**Recommendation:**

It is recommended that management ensures that NeighborWorks® Capital enforces the Conflicting Interest Transactions section of the by-laws and their Conflicts of Interest Policy at all times. Any cases of exceptions made from the policy should be justified and noted in the Board minutes. In addition, if there are any issues which require the abstention of a Board member, due to an actual or potential conflict of interest, such abstentions or non-participation in discussions should also be duly noted in the Board meeting minutes.

2. **NeighborWorks Capital Program Review - Scheduled Date**

   It was observed that NeighborWorks® Capital is not scheduled for an OAD review until the “transition period\(^3\)” is over (approximately December 2009).

**Recommendation:**

Due to some of the transition in the executive leadership, and the loans made to entities on the Board of Directors, it is recommended that OAD consider expediting their review date of NeighborWorks® Capital.

NC has had turnover in the CFO and Loan Director positions in the last year. We recommend that, if possible, OAD's review occur within the first 6 months of FY 2010 and that during their assessment, they review the loan activities awarded to Board members' affiliated entities and note any exceptions which were given. Upon completion of their review, OAD should provide Internal Audit with a copy of their final report.

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\(^3\) The Transition Period is a two year moratorium beginning from the date of the merger. It was established in order to allow NeighborWorks® Capital transitional time to adjust to the new business operations, acknowledging that performance could vary dramatically during the period. NC is required to make reasonable efforts to meet certain target goals during the Transition Period, which ends in December 2009.
**General Observation**

NC's sources of funds are grant equity, low interest loans from supportive institutions and bank debt. Capital contributions from NWA were initially $13 million and were expected to increase to $20 million by 2012. NWA has committed to continue to provide equity, as stated in the Master Investment Agreement. NC projected self-sufficiency which was estimated to increase from 70% in 2008 to 84% in 2012; however the current economic climate continues to provide challenges, which may not allow for the original goal to be reached. Many financial institutions are scaling back investments in CDFI’s due to revised investment strategies and their own decrease in performance. NC is making a conservative estimate for 2010’s approach to raising debt capital and projects modest lending growth to NWOs for 2010. Based on their FY 2010 grant request, NC plans on leveraging their $2.2 million in NeighborWorks® capital with $9 million in bank and philanthropic capital, which will be a 4:1 debt/equity ratio. The overall goal for 2012’s debt/equity ratio, as expressed in the business plan, is 1.16:1. NC has requested that NWA’s operating support allow NC to focus on lending and raising loan capital, as opposed to fund raising.

**Conclusion**

Based on our review, it appears that NeighborWorks® America’s management has established an oversight activity based on clearly identified program objectives, measurable outcomes and risk evaluation function for NeighborWorks® Capital. We would like to thank the National Initiatives and Applied Research division for their assistance during this review.
Appendix A

NEIGHBORWORKS® CAPITAL CORPORATION
Conflicts of Interest Policy

The purpose of the conflicts of interest policy is to protect the Corporation's interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Corporation. This policy is intended to supplement but not replace any applicable Federal, state or local laws governing conflicts of interest applicable to nonprofit and charitable corporations.

Interested Person. Any director, principal, officer, or member of a committee with board delegated powers, who has a direct or indirect financial interest, as defined below, is an Interested Person.

Financial Interest. A person has a Financial Interest if the person has, directly or indirectly, through business, investment or family - (a) an ownership or investment interest in any entity with which the Corporation has a transaction or arrangement, (b) a compensation arrangement with the Corporation or with any entity or individual with which the Corporation has a transaction or arrangement, or (c) a potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Corporation is negotiating a transaction or arrangement. Compensation includes direct and indirect remuneration as well as gifts or favors that are substantial in nature.

A Financial Interest is not necessarily a conflict of interest. A person who has a Financial Interest may have a conflict of interest only if the appropriate board or committee decides that a conflict of interest exists.

Duty to Disclose. In connection with any actual or possible conflict of interest, an Interested Person must disclose the existence and nature of his/her Financial Interest and must be given the opportunity to disclose all material facts to the directors (or members of the appropriate committee with board-delegated powers) considering the proposed transaction or undertaking.

Determining Whether a Conflict of Interest Exists. After disclosure of the Financial Interest and all material facts, and after any discussion with the Interested Person, he/she shall leave the board or committee meeting while the determination of a conflict of interest is discussed and voted upon. After exercising due diligence, the board or committee, if appropriate, shall determine whether the Corporation can obtain a more advantageous transaction or arrangement with reasonable efforts from a person or entity that would not give rise to a conflict of interest. If a more advantageous transaction or arrangement is not reasonably attainable under circumstances that would not give rise to a conflict of interest, the board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the Corporation's best interest and for its own benefit and whether the transaction is fair and reasonable to the Corporation, and shall make its decision as to whether to enter into the transaction or arrangement in conformity with such determination. The minutes of the board and all committees with board-delegated powers

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shall record the names of all persons participating in the meeting, a summary of the discussion, including any proposed alternative arrangements, and a record of any votes taken in connection with the final determination.

To be considered fair and reasonable and to avail itself of the rebuttable presumption of reasonableness under the IRS's excess benefit transaction regime, 26 U.s.c. § 4958, fair and reasonable requires that the Corporation use comparability data, meaning that the Corporation has looked at similar transactions by at least three similar entities if the Corporation has annual gross receipts (including contributions) of less than $1 million (or more than three similar transactions for larger Corporations). A fair and reasonable transaction is generally an arms-length transaction.

**Annual Statements.** Each director, principal officer and member of a committee with board-delegated powers, shall annually sign a statement which affirms that such person (a) has received a copy of the conflicts of interest policy, (b) has read and understands the policy, (c) has agreed to comply with the policy, and (d) understands that the Corporation is a charitable organization and that in order to maintain its federal tax-exemption, it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

**Periodic Reviews.** To ensure that the Corporation operates in a manner consistent with its charitable purposes and that it does not engage in activities that could jeopardize its status as an organization exempt from federal income tax, periodic reviews of the conflicts of interest policy and requirements shall be conducted.

The above is NWA's Model Conflicts of Interest Policy as adapted from the IRS's model policy as provided in attachment A to Grant Agreement dated 5/4/04. This policy was adopted by the NC Board of Directors by Resolution #1 dated 1/10/08
Appendix B

ARTICLE IX - Conflicting Interest Transactions.

Section 9.1 Definitions. As used in this Article 9, “Conflicting Interest Transaction” means: a contract, transaction, or other financial relationship between the Corporation and a Director of the Corporation, or between the Corporation and a party related to a Director, or between the Corporation and an entity in which a Director of the Corporation is a director or officer or has a financial interest. For purposes of this Article 9, a “Related Party” shall mean a spouse, a descendent, an ancestor, a sibling, the spouse or descendent of a sibling, an estate or trust in which the Director or a party related to a Director has a beneficial interest, or an entity in which a party related to a Director is a director, officer, or has a financial interest.

Section 9.2 Loans. No loans shall be made by the Corporation to its Directors or elected officers. Any Director or officer who assents to or participates in the making of any such loan shall be liable to the Corporation for the amount of such loan until the repayment thereof.

Section 9.3 Void. No Conflicting Interest Transaction shall be void or voidable or be enjoined, set aside, or give rise to an award of damages or other sanctions in a proceeding by or in the right of the Corporation, solely because the Conflicting Interest Transaction involves a Director of the Corporation or a Related Party or an entity in which a Director of the Corporation is a director or officer or has a financial interest or solely because the Director is present at or participates in the meeting of the Corporation’s Board of Directors or of the committee of the Board of Directors that authorizes, approves, or ratifies the Conflicting Interest Transaction or solely because the Director’s vote is counted for such purpose if:

(a) The material facts as to the Director’s relationship or interest as to the Conflicting Interest Transaction are disclosed or are known to the Board of Directors or the committee, and the Board of Directors or committee in good faith authorizes, approves, or ratifies the Conflicting Interest Transaction by the affirmative vote of a majority of the disinterested Directors, even though the disinterested Directors are less than a quorum; or

(b) The Conflicting Interest Transaction is fair as to the Corporation as of the time it is authorized, approved or ratified by the Board of Directors or a committee thereof.

Section 9.4 Quorum. Common or interested Directors may be counted in determining the presence of a quorum at a meeting of the Board of Directors or of a committee which authorizes, approves, or ratifies the Conflicting Interest Transaction.

Section 9.5 Conflicts Policy. The Board of Directors shall establish and maintain a policy concerning identifying, disclosing and administering conflicts of interest of Directors, which policy may be amended and revised by the Board of Directors from time to time.