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| Audit Report Number 2012-PH-1009 |
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TO: Nadab O. Bynum, Director, Office of Community Planning and Development,
Philadelphia Regional Office, 3AD

//signed//

FROM: John P. Buck, Regional Inspector General for Audit, Philadelphia Region, 3AGA

SUBJECT: The City of Philadelphia, PA, Generally Administered Its Neighborhood
Stabilization Program 2 Grant in Accordance With Applicable Requirements

HIGHLIGHTS

What We Audited and Why

We audited the City of Philadelphia, PA's administration of its Neighborhood Stabilization Program 2 grant that it received under the American Recovery and Reinvestment Act of 2009 as part of our fiscal year 2012 audit plan. Our objective was to determine whether the grantee administered the grant in accordance with Recovery Act and U.S. Department of Housing and Urban Development (HUD) requirements.

What We Found

The grantee generally administered its grant in accordance with Recovery Act and HUD requirements. However, the grantee and its grant subrecipient, the Philadelphia Redevelopment Authority, did not have a HUD-approved cost allocation plan as required by Federal regulations.

What We Recommend

We recommend that HUD require the grantee and its subrecipient to develop a cost allocation plan which provides an equitable method for distributing administrative costs to the benefiting programs and obtain HUD approval for the plan.

For each recommendation in the body of the report without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-4. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided a draft audit report to the grantee and HUD officials on May 18, 2012. We discussed the audit results with the grantee, its subrecipient and HUD officials during the audit and at an exit conference on June 7, 2012. The grantee provided written comments to our draft report on June 12, 2012. It generally agreed with the audit report. The complete text of the grantee's response, along with our evaluation of that response, can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVE

The Neighborhood Stabilization Program 2 was established by Title XII of Division A of the American Recovery and Reinvestment Act of 2009 to stabilize neighborhoods, the viability of which has been and continues to be damaged by the economic effects of properties that have been foreclosed upon and abandoned. The Recovery Act provided grants to States, local governments, nonprofits, and a consortium of public or private nonprofit entities or both on a competitive basis. The U.S. Department of Housing and Urban Development (HUD) awarded a combined total of \$1.93 billion in Program grants to 56 grantees nationwide.

The Program is a component of the Community Development Block Grant (CDBG) program, and basic CDBG requirements govern it. HUD's notice of funding availability¹ outlines additional requirements, including requirements that grant recipients (1) expend 50 percent of their Program funds 2 years from the date of the grant agreement or by February 11, 2012, (2) expend 100 percent of their Program funds 3 years from the date of the agreement or by February 11, 2013, (3) submit quarterly reports using the Disaster Recovery Grant Reporting system to report quarterly achievements, (4) comply with 24 CFR (Code of Federal Regulations) Part 85 for State and local governments and 24 CFR Part 84 for nonprofit entities regarding procurement practices, and (5) comply with 24 CFR Part 58 for environmental reviews and requests for release of funds. In addition, the notice of funding availability for NSP2 under the Recovery Act required that not less than 25 percent of the funds be used to benefit individuals or families whose incomes did not exceed 50 percent of area median income.

The City of Philadelphia is a municipal corporation under the laws of the Commonwealth of Pennsylvania. It was awarded approximately \$43.9 million in Program funding on February 11, 2010. Its Office of Housing and Community Development administers its Program through grant subrecipients. The Philadelphia Redevelopment Authority is a subrecipient.² The Redevelopment Authority was originally established in 1945 under the Pennsylvania State Charter Urban Redevelopment Law. The law granted the Redevelopment Authority powers of condemnation and the ability to buy and sell property and undertake programs for voluntary repair, rehabilitation, and conservation.

The grantee, as part of its grant agreement, allocated its Program funding as shown below. The activities focused on (1) the purchase, renovation, and resale of properties; (2) gap financing for multifamily properties; (3) gap financing for the redevelopment of properties; (4) demolition; (5) loan loss reserves; and (6) administrative costs.

¹ Notice of funding availability for the Neighborhood Stabilization Program 2 under the Recovery Act, Docket No. FR-5321-N-01

² The grantee also assigned the administration of some of its Program funds to the City of Philadelphia Department of Licenses and Inspections for the demolition of blighted structures as allowed by the Recovery Act and approved by the Philadelphia City Council.

| Activity | Responsible entity | Program funds | Projected number of units |
|------------------------------|--|----------------------|----------------------------------|
| Purchase, renovate, resale | Grantee- Redevelopment Authority | \$ 8,875,000 | 105 |
| Gap financing, multifamily | Grantee- Redevelopment Authority | 14,673,279 | 73 |
| Gap financing, redevelopment | Grantee- Redevelopment Authority | 12,000,000 | 85 |
| Demolition | Grantee- Philadelphia Department of Licenses and Inspections | 4,000,000 | Not applicable |
| Administrative costs | Grantee- Redevelopment Authority | 4,394,253 | Not applicable |
| Totals | | \$43,942,532 | 263 |

Our objective was to determine whether the grantee administered its grant funds according to Recovery Act and HUD requirements. We focused our review on the purchase, renovation, and resale of properties because the grantee had drawn down a majority of the funds in these areas when we selected audit samples at the beginning of the review.

RESULTS OF AUDIT

Finding: The Grantee Generally Administered Neighborhood Stabilization Program 2 Funds in Accordance With Applicable Requirements

The grantee expended its grant funds in accordance with the terms of its grant agreement and made eligible and adequately supported drawdowns. Also, the grantee's subrecipient qualified developers in accordance with requirements; developer contracts complied with requirements; and the subrecipient completed property appraisals, marketing plans, and rehabilitation as required. However, the grantee and its subrecipient did not have a HUD-approved cost allocation plan for indirect costs as required by Federal regulations.

The Grantee Expended Grant Funds in Accordance With Its Grant Agreement

The grantee met several specific requirements in the grant agreement, including but not limited to expenditure timelines and allocations and provisions related to property rehabilitation and home buyer eligibility. According to the grant agreement, 50 percent of the grant funds were to be expended by February 11, 2012. As of February 11, 2012, the grantee had expended approximately \$24.7 million, which was 56 percent of the total funds it received. As of October 2011 when we began audit testing, the grantee, through its subrecipient, had expended approximately \$8 million for the purchase and redevelopment of abandoned or foreclosed-upon single-family homes and was on track to spend its grant funds in accordance with a grant provision which required that about \$11 million of the grant funds be used for the purchase and redevelopment of abandoned or foreclosed-upon homes or residential properties.

The grant agreement also required the grantee to return a minimum of 100 abandoned or foreclosed-upon homes to productive use or otherwise eliminate or mitigate the negative effects on the stability of the target area. We reviewed a nonstatistical sample of 8 of 40 foreclosed-upon single-family properties, which the subrecipient stated were in some stage of acquisition and rehabilitation, and verified that they had been foreclosed upon and were within the targeted census tracts. The notice of funding availability required that Program funds benefit persons whose income did not exceed 120 percent of the area median income. Four of the eight properties in our review sample had been sold. We reviewed the

buyer files and determined that each home was sold to a buyer whose estimated annual income did not exceed 120 percent of the area median income, thereby meeting income eligibility requirements.³

The Grantee's Drawdowns Were Eligible and Supported

As of October 2011, the grantee had made 23 drawdowns in support of expenditures totaling \$8 million for Program activities administered by the subrecipient. We reviewed a nonstatistical sample of three of the drawdowns valued at \$1.8 million to determine whether the drawdowns were supported. We also reviewed a nonstatistical sample of nine large and medium expenditures totaling \$1 million associated with the three drawdowns. We reviewed invoices associated with the nine expenditure amounts to determine whether the payments were accurate and allowable according to HUD and Recovery Act requirements. The \$1 million was supported and used to pay for eligible expenses including acquisition, construction or rehabilitation, marketing, and sales costs of homes that were sold in accordance with HUD eligibility requirements. Section VIII, B.1 of HUD's Sample NSP Single-Family Development and Sales Program manual requires a 10 percent retainage from each payment request and that invoices or other documentation from subcontractors be submitted for soft costs. Each payment request in our sample included a 10 percent retainage as well as supporting documentation for soft costs.

The Subrecipient Qualified Developers in Accordance With Requirements

The subrecipient met HUD procurement requirements and had adequate procedures in place for qualifying its developers as required by the grant agreement. Regulations at 24 CFR 85.36 require that requests for proposals be publicized, identify all evaluation criteria, and be solicited from an adequate number of qualified sources. The subrecipient's Request for Qualifications also states that bid packages submitted by developers must contain: a letter of authority, developer description, development team capacity, list of completed, planned and under construction projects, evidence of financial position, references, certificate of non-indebtedness, and a conflict of interest statement. The subrecipient's publicly solicited request for qualifications contained bid package requirements and identified all evaluation factors. The subrecipient

³ The subrecipient made a minor technical error, resulting in the overstatement of one home buyer's estimated annual income. The error did not materially affect the estimate as a percentage of area median income or the home buyer's eligibility. We presented this issue to the subrecipient, and it agreed with the minor finding.

issued two rounds of requests for qualifications and qualified 50 developers in total. As of March 2012, the subrecipient reported that 17 qualified developers were actively participating in the program. We reviewed eight developer files associated with the sample of nine expenditures discussed above. All of the files were submitted with the required documents and were reviewed and approved by the subrecipient.

Developer Contracts Complied With Requirements

According to the HUD Program manual, developers can designate contractors and approve their work proposals without competitive bids. Developers must provide cost estimates including builder overhead and profit, which will be reviewed by the grantee for cost reasonableness and then approved. Once approved, the cost proposal becomes the basis for approving cost reimbursement for work completed and the amount of draw requests. We reviewed nine developer contracts associated with our sample of nine expenditures to determine whether the terms of each contract met HUD requirements. The contracts contained adequate provisions and statements of work, which detailed the work to be performed and met the intent and requirements of the Recovery Act and HUD regulations. Each contract included an appropriate scope of work, cost estimates including builder overhead and profit, and evidence that the grantee had approved the cost estimates for reasonableness.

The Subrecipient Completed Property Appraisals, Rehabilitation, and Marketing Plans as Required

The subrecipient completed appraisals, rehabilitation or construction, and marketing plans for Program-funded properties or units in accordance with section 2301(d)4 of the Housing and Economic Recovery Act of 2008 and its policy and procedures manual. The Act states that any purchase of a foreclosed-upon home or residential property must be acquired at a discount from the current market appraised value and rehabilitated to the extent necessary to comply with applicable laws, codes, and habitability requirements and that the sale price must be in an amount equal to or less than the acquisition cost plus rehabilitation cost. The subrecipient's policy and procedures manual requires that an appraisal be performed for compliance with the Program discount requirement and developers complete rehabilitation in accordance with subrecipients' requirements and submit marketing plans. We reviewed 8 of 40 single-family properties and determined that each was a foreclosed-upon property in a census tract that was targeted in the grantee's grant application. The appraisals were conducted as

required, and acquisition prices were in accordance with Program requirements. We also reviewed marketing plans for the eight single-family properties and determined that they were prepared and executed as required and in accordance with the related developer agreements. In addition, we conducted onsite observations of 27 units that were rehabilitated or under construction and determined that they were at a stage of completion consistent with the subrecipient's reporting.

The Grantee Did Not Have a HUD-Approved Cost Allocation Plan

The grantee and its subrecipient did not have a HUD-approved cost allocation plan for indirect costs as required by regulations at 2 CFR 225, Appendix E, Section D. The regulations require a cost allocation plan when an accumulation of indirect costs will ultimately result in charges to a Federal award. The subrecipient stated that it allocated indirect costs based on the ratio of direct salary costs by program to total salary costs. However, this process did not address allocations for salaries of administrative staff, such as executive director, deputy director, receptionists, executive secretary, etc., and certain other administrative costs. The condition existed because the grantee and the subrecipient considered the allocation process sufficient. However, the process did not ensure that all activities which benefited from the governmental unit's indirect costs would receive an appropriate allocation of indirect costs as required. The subrecipient's finance director acknowledged that the subrecipient should use a more equitable method for distributing administrative costs to the benefiting programs. To comply with Federal requirements, the grantee and its subrecipient should develop a cost allocation plan which provides an equitable method for distributing administrative costs to the benefiting programs and obtain HUD approval for the plan.

Recommendation

We recommend that the Director of HUD's Philadelphia Office of Community Planning and Development require the grantee to

- 1A. Develop and submit to HUD for approval a cost allocation plan which provides an equitable method for distributing administrative costs to the benefiting programs.

SCOPE AND METHODOLOGY

We performed our onsite audit work between October 2011 and March 2012 at the offices of the grantee's Office of Housing and Community Development and the Philadelphia Redevelopment Authority, both of which are located at 1234 Market Street, Philadelphia, PA. Our review covered the period January 1, 2010, through September 30, 2011, but was expanded as necessary to achieve our audit objective.

During the audit, we assessed the reliability of relevant computer-processed data by comparing the data to hardcopy information during the performance of the various review steps. We found the computer-processed data sufficiently reliable to meet our audit objectives.

To accomplish our audit objectives, we reviewed the following:

- Applicable laws, regulations, the Program notice of funding availability, and related HUD documents.
- Applicable sections of the Code of Federal Regulations, HUD guidance, and other directives that govern the Program.
- The grantee's approved Program application, budgets, agreement between the grantee and the subrecipient, subrecipient agreements with developers, and developer agreements with general contractors.
- Policies and procedures related to the grantee's and the subrecipient's expenditures, disbursements, procurements, monitoring plan, and Line of Credit Control System draw requests; the subrecipient's disbursements register; the organizational charts for the grantee and subrecipient; and prior HUD Office of Inspector General (OIG) audits.
- Program appraisal and monitoring requirements.
- HUD's monitoring reports for the grantee.
- The grantee's fiscal years 2009 and 2010 audited financial statements, fiscal year 2010 schedule of expenditures of Federal awards, and internal monitoring report for the period July 1, 2010, through June 30, 2011.
- Information obtained from public records including Accurint data retrieval tools.

Additionally, we conducted interviews with the grantee's employees, its subrecipient's employees, and HUD officials.

We also performed the following:

We selected a nonstatistical sample of 3 grant drawdowns totaling approximately \$1.8 million from 23 drawdowns valued at about \$8 million as reported in HUD's Line of Credit Control System as of October 11, 2011. Our sample represented the range of dollar amounts expended during the audit period. We reviewed the drawdowns to determine whether they were supported. We further selected a nonstatistical sample of nine large and medium expenditures totaling approximately \$1 million from the three drawdowns. The sample represented the subrecipient's range of expenditure amounts that the developers used during the audit period. We reviewed invoices associated with the nine expenditure to determine whether the payments were accurate, allowable, or eligible.

We reviewed 8 of 40 foreclosed-upon single-family properties that the subrecipient stated were in some stage of acquisition and rehabilitation as of October 24, 2011. The eight properties were rehabilitated during the audit period and were associated with the sample of nine expenditures discussed above. Four of the eight properties were sold to income eligible homebuyers. We reviewed property appraisals for the eight properties to determine whether the appraisals were conducted as required and ensure that acquisition prices were in accordance with the notice of funding availability⁴ for the Program and the grant agreement. We also reviewed marketing plans for each of the properties to determine whether they were prepared and executed as required and in accordance with the related developer agreements.

The subrecipient provided an updated listing of 46 single-family units that were in some stage of acquisition or rehabilitation as of November 23, 2011. It identified 35 of the units as completed or under rehabilitation and stated that the remaining 11 units were at a zero percent completion level. The subrecipient also identified 101 units within 6 multi-unit developments that were in some stage of acquisition or rehabilitation. We nonstatistically selected a sample of 8 single-family units and 19 multifamily units for site visits. The 27 sample units were representative of units that were at a 50 percent or greater completion level. We visited the units and performed onsite observations to verify that they were at a stage of completion consistent with the subrecipient's reporting.

We reviewed eight developer files associated with the sample of nine expenditures discussed above to determine whether each developer submitted the documents required by the subrecipient's request for proposal and whether the documents were reviewed and approved by the subrecipient. We also reviewed nine developer contracts associated with the nine expenditures to determine whether the contracts between the developers and contractors contained required provisions and statements of work which adequately showed that the work to be performed met the intent of the Recovery Act and HUD requirements.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit

⁴ See footnote 1.

objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Policies and procedures that were implemented to reasonably ensure that the grantee's grant administration, appraisal reviews, monitoring, financial management, and procurement activities were conducted in accordance with Recovery Act and HUD requirements.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we identified a minor internal control deficiency in that the grantee and its subrecipient did not have a HUD-approved cost allocation plan. The grantee's and subrecipient's cost allocation process did not ensure that all

activities which benefited from the governmental unit's indirect costs would receive an appropriate allocation of indirect costs as required.

We evaluated internal controls related to the audit objective in accordance with generally accepted government auditing standards. Our evaluation of internal controls was not designed to provide assurance on the effectiveness of the internal control structure as a whole. Accordingly, we do not express an opinion on the effectiveness of the grantee's internal control.

Separate Communication of Minor Deficiencies

Minor internal control and compliance issues were reported to the auditee in a separate memorandum dated May 17, 2012.

APPENDIX

Appendix A

AUDITEE COMMENTS AND OIG'S EVALUATION

CITY OF PHILADELPHIA

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1234 MARKET STREET, 17TH FLOOR
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DEBORAH McCOLLOCH
DIRECTOR

June 11, 2012

John P. Buck
Regional Inspector General for Audit
Philadelphia Region, 3AGA
U.S. Department of Housing and Urban Development
The Wanamaker Building, Suite 10205
100 Penn Square East
Philadelphia, PA 19107-3380

RE: Audit of City of Philadelphia's Neighborhood Stabilization Program 2 Grant

Dear Mr. Buck:

I am writing in response to the draft audit report presented by your staff at the Exit Conference held last Thursday, June 7, 2012. The City of Philadelphia is pleased with the result of the audit which reported that the grantee, the City of Philadelphia's Office of Housing and Community Development (OHCD), generally administered the Neighborhood Stabilization Program 2 (NSP2) funds in accordance with applicable requirements. Specifically, the City expended grant funds in accordance with its grant agreement and the expenditures were eligible and supported. The City exceeded the requirement that 50 percent of the grant funds were to be expended by February 11, 2012. As of that date the City had expended \$24.6 million, which was 56 percent of the total funds received.

In addition, the audit report stated that the Philadelphia Redevelopment Authority (PRA), City's subrecipient, met HUD procurement requirements and had adequate procedures in place for qualifying its developers as required by the grant agreement. The PRA developer contracts complied with the intent and requirements of the Recovery Act and HUD regulations. The PRA also completed appraisals, rehabilitation or construction, and marketing plans for NSP2 program-funded properties in accordance with Section 230 (d) 4 of the Housing and Economic Recovery Act of 2008 and its policy and procedures manual.

The City's response to the one finding in the audit report follows:

John P. Buck
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Comment 1

Finding: The grantee and its subrecipient lacked HUD-approved cost allocation plan for indirect costs as required by OMB Circular A-87, Attachment E, Section D – Submission and Documentation of Proposals.

Recommendation: The Director of HUD’s Philadelphia Office of Community and Planning and Development (CPD) require the grantee to develop and submit to HUD for approval a cost allocation plan which provides an equitable method for distributing administrative costs to the benefiting programs.

Response: The City disagrees with this finding. First, OHCD allocates all its costs on a direct program basis and therefore is not required to complete an indirect cost allocation plan. Second, the NSP2 program activities and administrative costs are CDBG eligible and the City of Philadelphia’s *Consolidated Plan* governs the use of CDBG and NSP2 funds. However, unlike the CDBG program which caps administrative costs at twenty percent of the CDBG allocation, the NSP2 program requirements cap administrative costs at ten percent of the total NSP2 allocation. Given this differential in administrative cost caps, the PRA and OHCD made the decision to charge a portion of the administrative costs to the CDBG Program. This allocation of costs did not result in an inequitable distribution of administrative costs to the benefiting programs. Although OHCD does not agree with this finding, it will work with the PRA to develop an indirect cost allocation plan to submit to HUD’s Philadelphia CPD for review and approval.

Again, the City of Philadelphia is pleased that the draft audit reported that the City administered the NSP2 Program in accordance with applicable requirements. The NSP2 Program provides much-needed funding to transform foreclosed-upon and vacant properties into affordable housing opportunities. Should you have any questions or require additional information, please feel free to contact Melissa Long at 215-686-9789.

Sincerely,

Deborah McColloch
Director

cc: Nadab O. Bynum, HUD
Mary Anne Bellacima, HUD
Melissa Long

OIG Evaluation of Auditee Comments

Comment 1 Federal regulations at 2 CFR 225⁵, Appendix E, require a cost allocation proposal or plan in order for indirect costs to be reimbursed under a Federal award. Also, primary fund recipients are responsible for negotiating and/or monitoring subrecipients' plans. The audit disclosed that the grant subrecipient's process for allocating indirect Program costs did not properly account for administrative staff salaries and other administrative costs. As the grantee, the City was responsible for negotiating and monitoring an indirect cost allocation plan for its subrecipient. The City was also responsible for obtaining HUD approval of the plan according to the regulations. HUD Program officials confirmed that the City needs to submit an indirect cost allocation plan.

We are pleased that the City plans to work with its subrecipient to develop and submit a cost allocation plan to HUD for review and approval.

⁵ The City referred to OMB A-87 in its response; however, OMB A-87 was relocated to 2 CFR 225 in August 2005.