
AUDIT REPORT



PUBLIC HOUSING AGENCY
DEVELOPMENT ACTIVITIES

2004-AT-0001

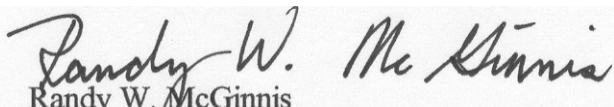
JANUARY 13, 2004

OFFICE OF AUDIT, REGION 4
ATLANTA, GEORGIA



Issue Date	January 13, 2004
Audit Case Number	2004-AT-0001

TO: William Russell, Deputy Assistant Secretary, Office of Public Housing and Voucher Program, PE

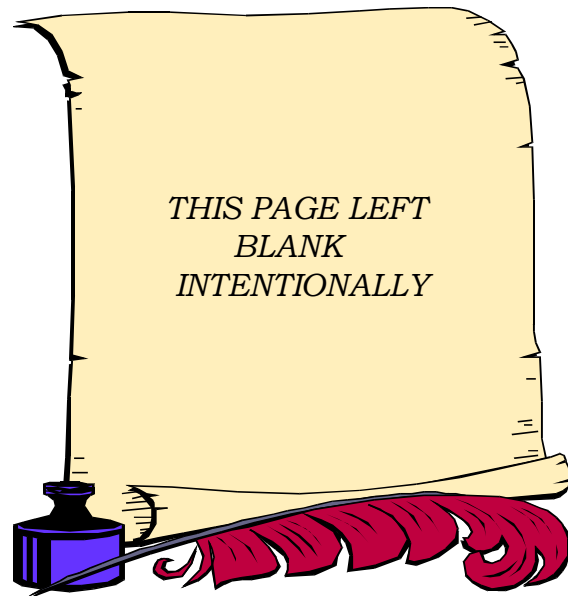
FROM: 
Randy W. McGinnis
Acting Regional Inspector General for Audit, 4AGA

SUBJECT: Public Housing Agency Development Activities

We completed an audit of the Department of Housing and Urban Development's (HUD) oversight of Public Housing Agency (PHA) development activities with related nonprofit entities. Our objectives were to determine whether HUD had adequate management controls to assess development activity and detect violations of HUD's regulations. This report includes one finding with recommendations for corrective action.

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

We appreciate your cooperation during the review. Should you or your staff have any questions, please contact me at (404) 331-3369, or Gerald Kirkland, Assistant Regional Inspector General for Audit, at (865) 545-4368.



Executive Summary

Recent audits of PHAs around the country have disclosed a trend of abuses in the PHAs' affiliation with related nonprofit organizations and private investors. These audits showed PHAs misused public funds for private investments, obtained unauthorized bank loans, pledged assets, entered into agreements that were not equitable and placed the PHAs at risk, created identity of interest (IOI) relationships with nonprofit organizations that resulted in conflicts-of-interest, and failed to allocate PHA staff and other costs devoted to nonprofit activities. Development efforts focused as much on enriching PHA officials and private investors as on serving the public good. Therefore, we conducted a review to determine whether HUD had adequate management controls to assess PHA development activities with related nonprofit entities and detect violations of HUD's regulations. We reviewed activities generally for the period October 1, 1999, to June 30, 2003.

Our inquiry revealed that HUD often was unaware of the extent to which activities with related nonprofit organizations impacted PHA operations and of the numerous Annual Contributions Contract (ACC) violations associated with them. HUD did not have mechanisms to readily identify or monitor such activities, nor have staff adequately trained to detect improper transactions. Further, even when field offices did become aware of improper activity, they did not aggressively pursue corrective actions to stop the activities or recover funds. PHAs did not fully disclose activities with related nonprofit organizations in their financial statements and Independent Public Accountants (IPAs) did not include findings when those activities violated ACCs or other requirements. PHAs also claimed to misunderstand HUD's rules. The impact of known and potential violations is high. Our analysis of key account balances from PHAs' audited financial statements identified 777 PHAs with indicators of possible unauthorized development activities. Eleven PHAs recently audited by OIG and four PHAs we reviewed for this audit, all of which had unauthorized development activities, were included in the 777 PHAs. The OIG audits questioned over \$16 million. For the 777 PHAs, the potential risk to the low-income public housing (LIH) program alone could be \$600 million or more.¹ The potential negative impact of the inequitable agreements is unknown, but also could be substantial. We believe HUD needs to take immediate steps to identify PHAs involved in nonprofit development activities, halt deals that violate the ACCs, and begin training its own staff and the public housing community on the legal avenues for developing low income housing through nonprofit affiliates.

We provided the draft audit report to you on October 10, 2003. You provided written comments to the draft findings on December 19, 2003, which are summarized within the finding and included in their entirety as Appendix B. We also discussed the draft audit report with you on October 30, 2003. You generally agreed with the report; however, you expressed some concerns and offered comments for our consideration in preparing the final report. We considered your comments in preparing our final report.

¹ We analyzed financial statement data maintained in HUD's Real Estate Assessment Center (REAC) database for all PHAs for fiscal years 1999 through 2002 in the database as of April 9, 2003. We highlighted PHAs with miscellaneous accounts receivable of at least \$50,000 or a net *due from* balance of at least \$100,000 for either its LIH or Section 8 Programs for any of those fiscal years. We used \$50,000 and \$100,000 as our minimum account balances because we considered lower balances to be a less significant indicator of risk. We determined that 777 PHAs nationwide met at least one of the criteria. For those PHAs the balances in the LIH accounts alone totaled over \$600 million.

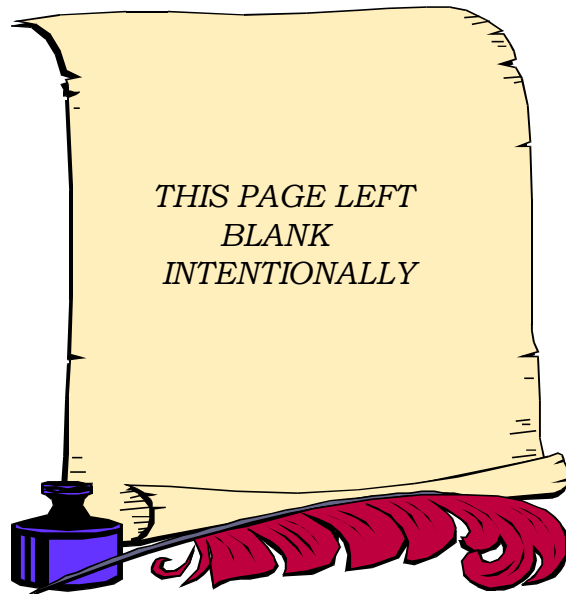


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Abbreviations

ACC	Annual Contributions Contract
CFR	Code of Federal Regulations
HDC	Housing Development Corporation
HUD	Department of Housing and Urban Development
IOI	Identity of Interest
IPA	Independent Public Accountant
LIH	Low-income Public Housing
OIG	Office of Inspector General

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PHA	Public Housing Agency
PHAS	Public Housing Assessment System
PIH	Office of Public and Indian Housing
REAC	Real Estate Assessment Center

Introduction


Background

HUD's Office of Public and Indian Housing (PIH) provides funds for rent subsidies to PHAs through its public housing operating subsidies and its tenant-based Section 8 Rental Assistance Programs. PHAs obtain funds from other programs, such as Section 23 funds from issuing bonds and Turnkey III funds from selling homes. PHAs are required to use these funds in accordance with their ACCs, regulations, and other program requirements. HUD is required by 42 U.S. C. 1437d(j), Cranston-Gonzalez National Affordable Housing Act of 1990, as amended, to assess the performance of PHAs so that the Secretary of Housing can evaluate them in all major areas of management operations.

Title 24 Code of Federal Regulations (CFR), Section 941, Subpart F, authorizes PHAs to develop public housing using a combination of private financing and public housing development funds. Many potential scenarios for ownership and transaction structures exist, ranging from the PHA or its partner(s) holding no ownership interest, a partial ownership interest, or 100 percent ownership of the public housing units. PHAs and/or their partner(s) may choose to enter into a partnership or other contractual arrangement with a third-party entity for the development and/or ownership of the units. The resulting developments may consist of 100 percent public housing units or a combination of public and non-public housing units.

While regulations provide multiple avenues for PHAs use in developing housing, HUD has encouraged PHAs to develop housing in accordance with 24 CFR 941. However, prior to developing such housing, PHAs must submit a proposal to HUD for approval. Following review of the proposal, HUD will notify the PHA if approved and indicate the approved total development cost of the public housing units in the development. HUD will also send the PHA an ACC amendment and/or a grant agreement for execution. HUD then monitors the implementation of the approved proposal in accordance with the amendment to the ACC or grant agreement.

PHAs often create related nonprofit Housing Development Corporations (HDC)s to perform housing development activities.



Audit Objective, Scope and Methodology

We conducted an audit of HUD's oversight of PHAs conducting development activities with related nonprofit entities. Our objectives were to determine whether HUD had adequate management controls to assess development activity and detect violations of HUD's regulations. We focused on PHAs that we believed pursued such activities outside HUD's regulations or without HUD's knowledge or consent. Such activity often included housing developed using a variety of funding sources, including tax credits, private funds, and HUD funds, similar to those HUD might

approve under 24 CFR 941. Generally, we excluded HOPE VI and other PHA development activities that were pre-approved by PIH under 24 CFR 941 or other existing regulations.

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

- Program Operations – Policies and procedures that management implemented to reasonably ensure that program objectives were met.
- Validity and Reliability of Data – Policies and procedures that management implemented to reasonably ensure that valid and reliable data was obtained, maintained, and fairly disclosed in reports.
- Safeguarding Resources – Policies and procedures that management implemented to reasonably ensure that resources were safeguarded against waste, loss and misuse.

To assess the relevant controls we:

- Reviewed applicable HUD regulations and other requirements including 24 CFR 941, Subpart F, and PIH Notice 91-39;
- Reviewed prior OIG audit reports;
- Reviewed monitoring files and interviewed HUD officials at the North Carolina and Mississippi State Offices, and the San Antonio, Texas Area Office, and in Washington, D.C. Headquarters.

To identify PHAs with indications of possible misuse of funds for development activity, we analyzed financial statement data maintained in REAC's database. We included financial statement data for all PHAs for fiscal years 1999 through 2002 in the database as of April 9, 2003. We highlighted PHAs with balances equal to or greater than \$50,000 in Miscellaneous Accounts Receivable (line item 125). We considered that a large balance in this account would be highly unusual and an indicator of risk. We also highlighted PHAs with a net *due from* balance of at least \$100,000 for either its LIH or Section 8 Programs. PHAs often used line item 144 (Interprogram Due From) and line item 347 (Interprogram

Due To) to record transactions between other program funds or other entities. The accounts are primarily intended to be used as clearing accounts when expenses for one program, such as LIH, are paid by another program, such as Section 8. When repayment is made, entries are made to reduce the payable or receivable as applicable. The account balances should periodically be cleared with all amounts repaid to the appropriate program. Large *due from* balances can be an indication of funds diverted to HDCs, other entities, or other programs. We used \$100,000 as our minimum account balance because we considered lower balances to be a less significant indicator of risk.

Based on the above criteria for selection, we determined that 777 PHAs nationwide, of which 186 were in Region 4, met at least one of the criteria. Because there can be legitimate reasons for large balances in the accounts, we then reviewed the notes to the financial statements for the 186 PHAs in Region 4 for further indications of improper development activities. Considering the information found in the notes and the miscellaneous accounts receivable and/or due from balances, we rated the PHAs potential risk of abuse as high, moderate, low or very low. We selected four high risk PHAs for on-site review to test reliability of our analysis:

Housing Authority of the City of Durham, North Carolina.
Housing Authority of the City of Asheville, North Carolina.
Housing Authority of the City of Cuthbert, Georgia.
Cookeville Housing Authority, Cookeville, Tennessee.

At these PHAs we:

- Interviewed PHA officials;
- Reviewed PHA general ledgers, bank statements, and other accounting and administrative records; and,
- Reviewed available nonprofit or related entity records, including general ledgers, bank statements, bank loan documents, tax credit records, and various guaranty and development agreements.

To assess the validity and reliability of the REAC data we performed direct tests of transactions at the four PHAs. We verified that the balances for line items 125 and 144 agreed between the REAC data and the PHAs' audited financial statements. We also verified that the PHAs' financial statement balances agreed with their general ledger accounts. We then traced relevant transactions from the general ledgers to the source documents. Notes to the financial statements for the PHAs also contained information regarding loans and other transactions that were critical to our audit objectives. Thus, we traced amounts reported in those notes to the source documents. We concluded the data was sufficiently reliable given the audit objectives and intended use of the data.

Our audit covered the period October 1, 1999, to June 30, 2003, and was performed from March through August 2003. We conducted our review in accordance with generally accepted government auditing standards.

PHAs Are Misusing Federal Funds In Their Attempts to Develop Housing Through Related Nonprofit Entities

Recent audits of PHAs around the country have disclosed a trend of abuses in the PHAs' affiliation with nonprofit organizations (or HDCs) and private investors. These audits showed PHAs misused public funds for private investments, obtained unauthorized bank loans, pledged assets, entered into agreements that were not equitable and placed the PHAs at risk, created IOI relationships with HDCs that resulted in conflicts-of-interest, and failed to allocate PHA staff and other costs devoted to nonprofit activities. Development efforts focused as much on enriching PHA officials and private investors as on serving the public good. Our inquiry as to why this was occurring revealed a failure of controls. HUD was unaware of the extent HDCs impacted PHA operations or of the numerous ACC violations associated with them. HUD lacked mechanisms to identify or monitor such activities. When field offices did become aware of improper activity, they did not effectively stop it or recover funds. In addition, PHAs did not fully disclose activities with HDCs in their financial statements and IPAs did not include findings when those activities violated ACCs or other requirements. PHAs also claimed to misunderstand HUD's rules. The impact of known and potential violations is high. Our analysis of key account balances from PHAs' audited financial statements identified 777 PHAs with indicators of possible unauthorized development activities. Eleven PHAs recently audited by OIG and four PHAs we reviewed for this audit, all of which had unauthorized development activities, were included in the 777 PHAs. The OIG audits questioned over \$16 million. For the 777 PHAs, the potential risk to the LIH program alone could be \$600 million or more. The potential negative impact of the inequitable agreements is unknown, but also could be substantial. We believe HUD needs to take immediate steps to identify PHAs involved in nonprofit development activities, halt deals that violate the ACCs, and begin training its own staff and the public housing community on the legal avenues for developing low income housing through nonprofit affiliates.

Criteria

The ACCs for low rent public housing allow PHAs to withdraw funds from the General Fund only for public housing development and operating costs, purchase of investment securities as approved by the Government, and other purposes specified in the contract or specifically approved by the Government. The ACCs prohibit obtaining unauthorized loans and pledging or encumbering assets, all of which constitute a substantial default of the agreement. The ACCs do not permit use of public funds for privately owned development expenses.

However, PHAs have been encouraged by HUD to partner with State and local governments and nonprofits to develop low-income housing using various sources of funds. Title 24 CFR 941, Subpart F, provides requirements for developing such housing. Prior to developing housing, PHAs must submit a proposal to HUD for approval, prepared in a form prescribed by HUD. Required documentation that must be included with the proposal may vary, but must be submitted as deemed necessary by HUD. Documentation that HUD may require includes, but is not limited to:

- Identification of the participating parties, description of the activities to be undertaken, and the legal and business relationships between the PHA and each of the participating parties.
- All documents relating to the financing including, but not limited to, any loan agreements, notes, mortgages or deeds of trust, and other agreements or documents pertaining to the financing.
- Preliminary construction cost estimate.
- Demonstration of the operating feasibility of the development.

PHAs must certify there are no conflicts-of-interest in the selection of the partner or the owner entity to develop or operate the proposed public housing units.

HUD Handbook 1840.1 REV-3, Departmental Management Control Program, dated February 1999, requires managers to evaluate their programs and establish appropriate controls to ensure that HUD programs and activities are efficiently and effectively managed; protect against fraud, waste, and abuse; and follow applicable laws and regulations. It prescribes maximizing HUD's available resources by incorporating risk management concepts and strategies in the conduct of all programs and activities.

Prior warnings of possible abuse

Over 13 years ago, on April 2, 1990, the OIG reported that HUD's controls over PHAs' establishment and operation of HDCs were virtually nonexistent. There was little HUD oversight and its field offices were unaware of the extent to which PHAs used HDCs or their impact on PHAs' operations. Some contractual relationships made PHAs' assets vulnerable to fraud, waste, and abuse:

- In project syndications, PHAs and HDCs entered into Indemnification Agreements to be jointly and severally liable to the limited partners for any loss of tax credits.
- Other agreements between PHAs and HDCs for management or development services were inequitable and possibly illegal.
- HDCs' general lack of independence from PHAs might result in misuse of PHAs' assets and unfair treatment of program participants. The HDCs' Board members were selected by the PHAs, and day-to-day operations were controlled by PHAs. Examples of abuses and conflicts-of-interest included steering tenants to HDC-owned projects and ineligible administrative expenses.
- PHAs did not account for HDCs' activities according to Generally Accepted Accounting Principles or their ACCs and often withheld from HUD fiscal information on HDCs' activities.
- PHAs used HUD funding and pledged assets, including project revenues, as collateral to secure the debts of HDCs.

The OIG report prompted HUD to issue Notice PIH 91-39, *Applicability of Public Housing Program requirements to transactions between Public Housing Agencies or Indian Housing Authorities and their related nonprofit entities*, to help PHAs avoid violations. Its intent was to:

- Provide monitoring guidance for HUD staff;
- Define an IOI nonprofit entity as one whose governing board had a majority of members who were PHA Commissioners, officers, or employees;
- Instruct that transactions between PHAs and IOI nonprofit entities were not exempt from conflict-of-interest prohibitions that applied to public housing in general;
- Provide that a person on both the PHA and nonprofit Boards could not participate in actions by the PHA Board on agreements with the nonprofit entity that

presented a financial conflict-of-interest – unless the PHA obtained a written waiver from HUD;

- Require the costs of shared staff, facilities, equipment, or other resources be allocated per the ACC and Office of Management and Budget Circular A-87; and,
- Warn PHAs against encumbrance of PHA property prohibited by the ACC, including:
 - Mortgages or other liens on project real estate;
 - Pledging or other encumbrance of project funds, including future revenues;
 - Use of project tangible assets as collateral;
 - Creation of contingent claims against project assets under a guaranty or indemnity agreement; and,
 - Granting of leasehold interest.

The Notice instructed HUD staff to review transactions with IOI nonprofit entities in routine monitoring at PHAs. Where a PHA had one or more related nonprofit entities, special attention was to be given to their interaction to identify and remedy violations and provide technical assistance. HUD staff was to use a prescribed checklist for IOI nonprofit entities to identify such entities or other affiliated entities, determine their involvement in contracting and procurement, determine encumbrances, and verify cost allocations.

The Notice required IPAs to include transactions between a PHA and any related nonprofit entity in their audit testing, and ensure the financial statements disclosed the related nonprofits and related party transactions.

Notice 91-39 expired on September 30, 1992, and was not renewed.

Recent OIG audits found abuses in nonprofit development

OIG audits during the last few years have found that conditions that led HUD to issue PIH Notice 91-39 continue to exist. Eleven OIG reports issued between December 1999 and January 2003, showed abuse by PHAs and related nonprofit HDCs and questioned \$9.7 million. The reports disclosed PHAs:

- pledged public assets to support HDC activities (4);
- misused LIH funds (10);

- misused Comprehensive Grant Program or Capital funds (3);
- misused Section 8 funds (5); and,
- misallocated resources, such as staff and equipment (7).

PHAs obtained unauthorized loans of at least \$7.6 million in support of HDC activities. The PHAs pledged assets as collateral for over \$4.6 million of the loans. The Northwestern Regional Housing Authority in Boone, North Carolina pledged assets, including tenant funds held in trust, as collateral for loans of about \$2.35 million. The Housing Authority of the County of Chester, West Chester, Pennsylvania pledged a \$400,000 Certificate of Deposit as collateral for a \$500,000 loan it obtained to finance its private developments. The PHA defaulted on the loan and the bank seized the Certificate of Deposit.

PHAs also continued to enter into agreements that were not equitable and placed the PHAs at risk. These agreements held the PHAs accountable for HDC performance and liable for any loss of tax credits and development cost overruns. The potential negative impact of such agreements is unknown, but could be substantial.

Seven PHAs created IOI relationships with the HDCs that resulted in conflicts-of-interest. In whole or part, the PHA and related entities shared governing boards and officers. In many cases, the PHAs' Executive Director, who was also an officer of the nonprofit, was responsible for the day-to-day operations of both entities. Since the PHAs frequently acted as the project developer and managed the properties upon completion, the Executive Directors had prohibited conflicts-of-interest. The relationships between the HDCs and PHAs can leave the PHAs vulnerable should the HDC sever ties with the PHA. In fact, the former Executive Director of the Housing Authority of the City of Uvalde, Texas did sever the relationship, apparently without Board knowledge. Acting as the Secretary/Treasurer of the HDC, he executed an amendment to the original partnership agreement which withdrew the PHA from the partnership and admitted a new limited partner.

In at least six cases, the PHAs' financial condition was severely impacted. For example, the former Executive Director's financial management of the Wilmington Housing Authority, Wilmington, Delaware, left the PHA in a difficult financial situation that was predicted to have long-term effects on its financial stability.

The violations occurred for various reasons. Audits, such as the one of South Carolina Regional Housing Authority, revealed that IOI relationships allowed officials to create opportunities through their HDC to financially benefit themselves. Often, complex financing arrangements were integral to the overall development plan; arrangements included combinations of Internal Revenue Service tax credits, other Federal and State grants or assistance, bank loans, and PHA contributions. Violations also occurred because PHAs did not understand the governing regulations, or have expertise to understand the complexities of the arrangements and properly record transactions in the books of record.

Two reports recommended HUD declare PHAs in substantial default of their ACC's and take control of PHA operations and assets. Other recommendations included:

- Taking administrative actions against PHA officers and Board members;
- Instructing PHAs to discontinue using funds for development activities;
- Seeking release of encumbered PHA assets and recovering amounts owed by related nonprofit entities;
- Repaying funds used for ineligible development expenses; and/or,
- Curing conflicts of interest.

Appendix A contains summaries of the 11 audits, all of which are also available in full text on the internet at www.hud.gov.

Abuses appear to be widespread and costly

Using REAC's database as of April 9, 2003, we assessed PHA audited financial data for fiscal years 1999 through 2002 to identify potential misuse of HUD funds for ineligible development activity with related nonprofit HDCs. Based on our criteria for likely abuse (described in Scope section of this report), we found that 11 of the 11 PHAs recently audited by OIG met the criteria.

In addition, we selected four high risk PHAs for on-site review in Durham and Asheville, North Carolina, Cuthbert, Georgia, and Cookeville, Tennessee. We reviewed each of the four PHAs. Each had created related nonprofit entities that were involved in various development activities. We found at least one ACC violation at each including misuse of over \$6 million, unauthorized loans, inappropriate guarantees, ineligible expenses, and conflicts-of-interest. The PHAs had provided LIH funds, Turnkey III funds, and Section 23 project escrows to the nonprofit entities without prior HUD approval. An attorney for the Cookeville Housing Authority expressed concerns about the PHA's agreement with a limited partnership. He wrote in part,

“...affiliate status means that Cookeville Housing Authority irrevocably and unconditionally guarantees any and all obligations of the General Partner under the Partnership agreement. This guaranty is made for the ‘benefit of’ Apollo, the Limited Partner. In addition, the guaranty grants Apollo the unfettered discretion to modify, accelerate, or to take and order the sale of security with regard to any indebtedness or obligations guaranteed by Cookeville Housing Authority. Also, the Guaranty provides that the Cookeville Housing Authority waives practically every defense imaginable...this agreement is extremely one sided...it places all potential liability on Cookeville Housing Authority while giving Cookeville Housing Authority seemingly no way to challenge it, even meritorious defenses.”

Despite his legal advice, the PHA's Executive Director signed the agreement.

We also found that although HUD became aware of improper activities and misuses of funds by the Durham and Asheville PHAs, it did not effectively stop the activities or recover funds. For example, in 1999, Greensboro PIH learned that Asheville had improperly used \$1.8 million and instructed it to repay the funds within 30 days. As of July 2003, the PHA had not repaid the funds. We are in the process of preparing external audit

Finding 1

reports addressing the concerns we identified at these four PHAs.

As shown in the following table, the prior OIG reports and our current review have identified over \$16 million of ineligible expenses at the PHAs.

PHA	LIH	SECTION 8	TURNKEY III	SECTION 23	OTHER
City of Bridgeport, CT	\$ 2,500,000				
City of Asheville, NC	1,850,833				
City of Tupelo, MS	1,398,471				\$ 37,572
City of San Antonio, TX	865,409				
Muskegon Housing Commission, MI	836,893	\$ 298,970			
City of Cuthbert, GA	800,000				
City of Durham, NC	733,499		\$ 2,653,064		
Omaha Housing Authority, NE	653,893				
Cookeville Housing Authority, TN	393,500				
Northwestern Regional Housing Authority, NC	274,248	310,610			598
South Carolina Regional Housing Authority No. 3	210,524				
Wilmington Housing Authority, DE	13,929	15,209			657,716
City of Uvalde, TX	7,108	181,176			
Pinellas County Housing Authority, FL				1,336,225	
County of Chester, PA		170,000			
TOTAL	\$10,613,346	\$ 975,965	\$ 2,653,064	\$ 1,336,225	\$ 695,886

While our analysis does not allow for statistical projection of the extent of PHA violations, it did prove to be 100 percent true in our small test. If true for the remainder of PHAs meeting our criteria, the abuse could extend to as many as 777 PHAs nationwide and \$600 million misused from the LIH Program alone. (See footnote 1)

PHAs may have been misled on procedures for developing housing

Conference agendas for the National Association of Housing and Redevelopment Officials and the Public Housing Authorities Directors Association have included presentations on PHA housing development. Speakers at the conferences included consultants who are current or former Executive Directors of PHAs who were found to have developed

housing and performed other activities in violation of ACC requirements. We are concerned that PHAs have received improper guidance on how to develop housing at these conferences.

HUD risk assessment and monitoring processes failed to detect violators

The abuses by PHAs often went undetected because HUD did not have adequate monitoring procedures, staff was not always adequately trained to identify such activities, and IPA's failed to disclose the relationships and violations.

Since expiration of Notice 91-39, HUD has used various techniques to monitor PHAs. Currently, HUD uses the Public Housing Assessment System (PHAS) which examines four essential areas of operations: (1) physical condition, (2) financial condition, (3) management operations, and (4) resident satisfaction. In addition, HUD established the PIH Information Center database to collect information about funding, compliance, and other problems. In 1998, HUD created REAC to capture, standardize, improve, and evaluate the PHAS data. The PIH Information Center generates a risk assessment for HUD field offices to use in planning their monitoring strategies and targeting their resources. Neither PHAS nor the PIH Information Center specifically target nonprofit activity. Likewise, neither does REAC nor field office monitoring. Handbook 7460.7 REV-2, Field Office Monitoring of Public Housing Agencies, does not directly address such issues. Also:

- Five Year/Annual PHA Plans did not specifically require full disclosure of these activities,
- PIH had limited resources for on-site monitoring,
- Self proclaimed High Performing PHAs received reduced oversight, and
- No central record existed of PHAs approved to develop under 24 CFR 941.

Generally Accepted Accounting Principles, which PHAs must follow, require full disclosure of any and all information that affects the full understanding of a company's financial statements. We found that at least eight PHAs did not fully disclose activities with HDCs.

Office of Management and Budget Circular No. A-133 (Revised June 24, 1997), *“Audits of States, Local Governments, and Nonprofit Organizations,”* requires a PHA, that expends Federal financial assistance of \$300,000 or more in a year, to have an audit of its financial statements. Government Auditing Standards require auditors to assess risk and perform procedures designed to detect illegal acts or violations of provisions of contracts or grant agreements. In at least eight instances, IPA auditors did not detect and report violations. HUD Handbook 7476.1 REV-2, Appendix 2 - Compliance Supplement for Single Audits of State and Local Governments provided compliance requirements and suggested audit procedures for the various HUD programs, including Public Housing and Section 8. However, there were no audit procedures to test a PHA's dealings with nonprofit and related entities.

Conclusion

There is no effective way to measure the potential negative impact on the PHAs, their residents, or the Federal government from the activities undertaken by these PHAs and their nonprofits. PHA assets are at substantial risk because they have guaranteed HDC performance with private investors, including indemnifying them for any loss of tax credits, and have pledged assets as collateral for loans. We believe the risk is widespread and needs immediate action by HUD.

HUD Comments

HUD believed the potential risk of \$600 million is overstated. HUD provided possible scenarios whereby amounts might be recorded as miscellaneous receivables or net due from account receivables. HUD stated that only an analysis of the transactions giving rise to the amounts would reveal actual amounts of abuse. It agreed that greater scrutiny of the accounts was needed.

HUD believed the report did not differentiate between a development containing only public housing units and a mixed-finance/mixed-income development composed of public housing, tax credit, and/or market rate units. HUD's concern was that the monitoring and approval processes, and lines of responsibility are different between the two types of development.

HUD was concerned about our reference to the ACCs' prohibition of use of public funds for privately owned development expenses. HUD also questioned our reference to PIH Notice 91-39 warning against encumbrance of PHA property by granting of leasehold interest. HUD's concerns were that such activities might now be permitted under mixed-financed regulations.

At the exit conference, HUD expressed concern about the language in Recommendation 1D. HUD explained that the actions listed in the recommendation would not violate the ACCs if PHAs obtained prior HUD approval for such actions.



OIG Response to
HUD Comments

As stated in the Finding, our analysis did not allow for statistical projection of the extent of abuse, but did prove to be 100 percent true for our small test. We recognize there may be legitimate reasons for balances in the accounts. However, the balances should be minimal and should periodically be cleared. We agree with HUD that the extent of actual abuse cannot be determined without additional analysis. As such, we are continuing to perform external audits to evaluate the extent of any abuse.

As stated in the report, our objective was to determine whether HUD had adequate management controls to assess development activity and detect violations of its regulations. Our primary concern was that HUD did not have adequate oversight of PHAs conducting development activities with related nonprofit entities. We focused on PHAs that we believed pursued development activities outside HUD's regulations or without HUD's knowledge or consent, often with related nonprofit entities. We cited 24 CFR 941 as a method for developing housing primarily because we found many of the unauthorized developments included tax credits, private funds, and HUD funds, similar to those HUD might approve under 24 CFR 941. Generally, we excluded HOPE VI and other PHA development activities that were pre-approved by PIH under 24 CFR 941 or other existing regulations. We intentionally did not use the term "mixed-finance housing" in the report because we felt that use of the term might be construed to mean that HUD had approved the developments. HUD's oversight weaknesses identified in

the report are not limited to one program. We revised the background and scope sections of the report to clarify that regulations provide multiple avenues for PHAs use in developing housing.

As stated in the Finding, the ACCs prohibit use of public funds for private development activities and encumbrances of assets. If a PHA obtains HUD approval to develop housing, the ACC should be amended to allow such activities. Otherwise, any such use of public funds for privately owned developments or encumbrances of assets likely constitute ACC violations.

We revised Recommendation 1D to clarify that the actions listed in the recommendation violate the ACCs unless prior HUD approval is obtained.

Recommendations

We recommend you:

- 1A. Issue guidance to field offices on monitoring PHAs' use of HDCs or other related nonprofit entities. The guidance should require field offices to review the following areas:
- The scope of HDC or related nonprofit service corporations.
 - The agreements between PHAs and the HDCs or other related nonprofit entities and whether they comply with HUD requirements. Special attention should be given to compliance with conflict-of-interest requirements.
 - The propriety of cost allocations.
 - Project syndications and propriety of the contractual relationships between PHAs, HDCs, and other entities, such as limited partnerships and limited liability corporations.
 - The propriety of transactions and associated accounting between PHAs and HDCs or other related nonprofit entities.
 - Disclosure of related nonprofit activities in the audited financial statements.
 - Any bank loans to ensure PHAs did not pledge assets or guarantee repayment by another entity.

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- 1B. Revise risk assessment techniques to target PHAs involved in development activities. Revise PHAS to query accounts that indicate related financial activity (line items 125, 144, and 347).
- 1C. Advise PHAs that conflicts-of-interest between PHAs and their affiliated nonprofits are prohibited according to their ACCs.
- 1D. Notify PHAs that, without prior HUD approval, the following actions violate their ACCs and should be remedied immediately:
- Guaranty agreements with other parties, including banks and private investors;
 - Use of program funds for development activity without prior HUD approval;
 - Use of PHA staff or other resources, including office space, vehicles, and equipment without allocation of costs in accordance with the ACCs and Office of Management and Budget Circular A-87; and,
 - Encumbering of assets, including:
 - o Mortgages or other liens on project real estate;
 - o Pledging or other encumbrance of project funds, including future revenues;
 - o Use of project tangible assets as collateral;
 - o Creation of contingent claims against project assets under a guaranty or indemnity agreement; and,
 - o Granting of leasehold interest.
- 1E. Train PHAs and HUD staff on the rules for developing housing in accordance with 24 CFR 941, Subpart F.
- 1F. Remind PHAs that they are required to disclose planned development activities in their 5-Year/Annual Plans.

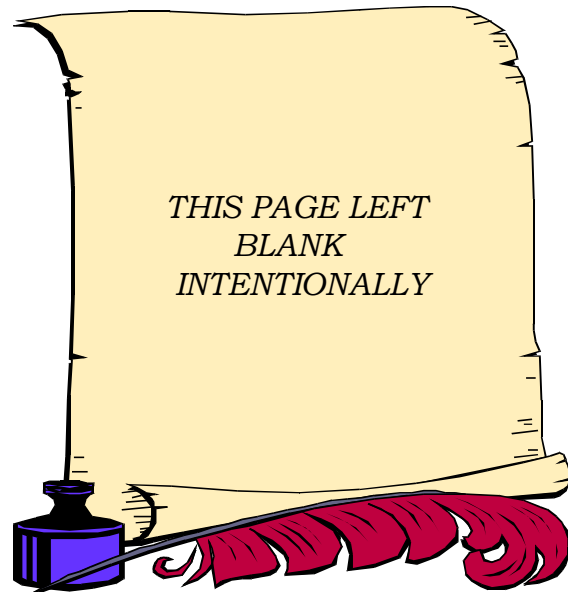
- 1G. Amend the compliance supplement to require IPAs to test PHA development activities, and disclose any inappropriate activities and all relationships with nonprofit entities.
- 1H. Require self-reporting by PHAs under PHAS of all development activities and transactions. Include certifications that PHAs have not violated their ACCs for any of the actions noted in recommendation 1D.
- 1I. Seek legal advice on how to protect the PHA and HUD from a nonprofit severing its ties leaving the PHA with debt and liability and/or taking public assets.

Follow Up On Prior Audits

On April 2, 1990, the OIG issued a Memorandum Report, Number 90-TS-108-0007, detailing results of its review of HDCs which were being established by PHAs to perform housing-related activities. The report disclosed that HUD's controls over PHAs establishment and operation of HDCs were virtually nonexistent. There was little HUD oversight and its field offices were unaware of the extent to which PHAs used HDCs or the impact of HDCs on PHAs' operations. The review found that PHA-HDC contractual relationships made PHAs' assets vulnerable to fraud, waste, and abuse.

HUD agreed with the report conclusions and recommendations. As a result, HUD issued Notice PIH 91-39, *Applicability of Public Housing Program requirements to transactions between Public Housing Agencies or Indian Housing Authorities and their related nonprofit entities*. The Notice intended to help PHAs avoid violations of existing requirements, and provided HUD monitoring guidance. It provided guidance and implemented specific requirements. The Notice expired in September 1992, and was never renewed.

As discussed in the Finding of this report, conditions cited in April 1990 continue to exist.



Summary of Recent OIG Audits (2000-2003)

PHA: Northwestern Regional Housing Authority, Boone, North Carolina
HDC: Northwestern Housing Enterprises, Inc.
Report: 2003-AT-1001, January 09, 2002

Management violated its ACC's with HUD when it inappropriately pledged PHA assets as collateral for unauthorized bank loans. The loans helped offset development cost overruns and pay operating costs for five privately owned rental properties, pay pre-development costs for another privately owned property, and construct a homeownership project. Management also misused \$584,858 of HUD Section 8 and public housing funds for development activities. As a result of payments and advances by the PHA, Northwestern Housing Enterprises, Inc. and the developments owed the PHA at least \$4,224,342. Management advanced another \$45,324 for development of a property owned by another nonprofit company. Management and the Board put the PHA at further risk by guaranteeing repayment of private development loans and exposing the PHA to potential liabilities. These actions not only violated the ACC's, but also reduced funds available for public housing operations. Management and the Board's disregard for HUD requirements left the PHA in a precarious financial condition and led to the selling of 18 public housing units.

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PHA: Housing Authority of the County of Chester, West Chester, Pennsylvania
HDC: Not Specified
Report: 2001-PH-1803, August 31, 2001

In brief, we found the PHA is in substantial default of its ACCs (Low Rent and Section 8). Specifically, contrary to Section 7 of the Low Rent ACC, the PHA pledged assets covered under its ACC as collateral for loans for its private developments. The PHA defaulted on a \$500,000 loan and a local bank seized a \$400,000 Certificate of Deposit. It appears other collateralized loans may be in jeopardy. Also, in violation of Section 11 of its Section 8 Annual Contribution Contract, the PHA used Section 8 funds to pay interest and principal on a \$4 million bond issue in June 2001. Furthermore, under its present structure, it appears the PHA no longer has the financial resources to meet its immediate and long-term debt obligations. Consequently, in accordance with Section 17 of the ACC (low rent) and Section 15 of the Section 8 ACC, we recommend HUD take immediate action in declaring the PHA in substantial default of its contracts, and take appropriate actions it deems necessary to cure the substantial default.

PHA: South Carolina Regional Housing Authority No. 3, Barnwell, South Carolina
HDC: Southeastern Housing Foundation
Report: 2003-AT-1801, October 09, 2002

The PHA's Executive Director and Director of Management took advantage of their positions, and inadequate oversight by the PHA and Foundation Boards, to financially benefit themselves, their families, and friends at the expense of both entities. The Executive Director and Director of Management violated the ACC with HUD by executing an illegal agreement between the PHA and the Foundation, including the use of PHA funds to finance the Foundations' operation. The Foundation owed the PHA \$210,524 for operating costs as of January 31, 2002. Furthermore, the Executive Director and Director of Management collected over \$958,738 in development and other fees on Foundation property purchases. As a result, the financial positions of the PHA and Foundation were materially weakened.

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PHA: Housing Authority of the City of Uvalde, Uvalde, Texas
HDC: Uvalde Housing Development Corporation
Report: 01-FW-203-1003, December 18, 2000

The former Executive Director ignored HUD's instructions and violated HUD requirements by using \$563,702 in HUD Program funds to pay for excessive and questionable expenses. The PHA incurred \$375,552 in excessive administrative costs in the Section 8 Program and \$188,150 in questionable costs in the Low Rent Program. The excessive or questionable costs are: (1) \$188,284 used to undertake various projects not related to the operation of these programs, including the construction of an affiliate's apartment complex; (2) \$85,012 paid in excessive salaries; (3) \$167,960 in Low Rent funds transferred to Section 8; (4) \$38,023 in unsupported costs; and (5) \$84,423 in additional administrative expenses in excess of the amount earned.

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PHA: Muskegon Housing Commission, Muskegon, Michigan
HDC: Family Investment Center Limited Housing Development Corporation
Report: 01-CH-202-1002, November 29, 2000

We found that the Housing Commission transferred \$836,893 between housing programs without HUD authorization. In addition, we estimated that \$298,970 of Section 8 subsidy funds were improperly used by the Housing Commission to pay operating expenses of the Low Rent Public Housing Program. The Housing Commission pledged 14 Low Rent Public Housing Program homes and proceeds from the sales of those homes as collateral for a loan in violation of HUD regulations. The Housing Commission did not cease these activities after being instructed by HUD to do so.

PHA: Housing Authority of the City of Bridgeport, Bridgeport, Connecticut
HDC: Fairfield 2000 Homes Corporation
Report: 00-BO-204-1004, July 5, 2000

Poor management of a duplex development project resulted in a \$2.5 million loss of Federal low-income Public Housing funds. The PHA used \$2.5 million of Low-income Public Housing operating funds to complete a nonprofit development which was not financially sound. Federal regulations prohibit the use of Low-income Public Housing operating funds for development purposes.

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PHA: Housing Authority of the City of Tupelo, Tupelo, Mississippi
HDC: Tupelo Affordable Properties System, Inc
Report: 2002-AT-1002, July 3, 2002

The Housing Authority of the City of Tupelo improperly advanced over \$1.4 million of public housing program funds for non-Federal development activities from 1998 to 2001. The funds were advanced to cover operating and rehabilitation deficits for a private development, until tax credits were approved. The former Executive Director instructed the staff to make the advances, which violated the ACC. The PHA received repayments of \$707,884 between January 1999 and October 2000. However, the PHA's General Fund account is still owed \$728,159. As a result, the advances reduced the public housing program funds available for operating expenses and placed the funds at risk of possible non-repayment. The Authority also pledged assets as collateral for loans totaling \$1.1 million.

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PHA: Wilmington Housing Authority, Wilmington, Delaware
HDC: East Side Charter School of Wilmington, Inc.
Report: 00-PH-204-1004, September 28, 2000

The PHA lacked fiscal responsibility over its operations during the period of review. This occurred because the former Executive Director ignored applicable Federal regulations and the PHA's operating guidelines. Specifically, the former Executive Director routinely allowed expenditures to be made, and/or approved expenditures that were contrary to the PHA's operating budget and Federal requirements. As a result, the PHA incurred \$1,331,315 of ineligible cost (\$687,349, \$629,716, and \$14,250 in Findings 1, 2, and 4, respectively) and \$373,105 of unsupported cost (\$309,273 and \$63,832 in Findings 1 and 4, respectively). In addition, we identified another \$174,609 in expenditures which, although they were considered eligible to the program they were charged, we believe should have been deferred due to the nature of the expenditures and deteriorating financial position of the PHA.

PHA: Housing Authority of the City of San Antonio, San Antonio, Texas
HDC: San Antonio Housing Assistance Corporation
Report: 00-FW-201-1004, August 09, 2000

Managers entered into a noncompetitive arrangement with their affiliate, the San Antonio Housing Assistance Corporation resulting in HUD programs paying questioned costs of about \$822,508 for 3 fiscal years ending June 30, 1999. HUD programs paid: excessive disposal service fees of about \$336,865; the affiliate's disposal service operating costs of about \$461,028; and about \$24,615 for debris removal at non-HUD properties. PHA managers also permitted the affiliate to use HUD equipment and facilities without paying rental or utility costs.

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PHA: Pinellas County Housing Authority, Clearwater, Florida
HDC: Crystal Lakes Housing Corporation
Palm Lake Village Housing Corporation
Report: 00-AT-202-1004, March 23, 2000

The PHA did not obtain HUD approval to use residual Section 23 Leased Housing Program funds for rebuilding Crystal Lake Manor Apartments. Further, the PHA did not ensure the apartments would remain affordable to low income families because the PHA: (1) donated the property without a required deed restriction, (2) did not plan to use a \$2 million escrow fund, and (3) did not have adequate control over \$3.2 million of donated Section 8 fees. As a result: (1) the PHA used \$1.3 million of residual Section 23 leased housing funds to pay construction costs rather than offset public housing operating subsidies; and (2) the PHA may not maximize assistance to low income families.

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PHA: Omaha Housing Authority, Omaha, Nebraska
HDC: Housing in Omaha, Inc.
Omaha Housing Foundation, Inc.
Gateways of Opportunity, Inc.
Report: 00-KC-201-1001, December 03, 1999

The PHA did not maintain an effective control environment, lacked adequate cash controls, used \$1,082,992 in federal funds to pay unallowable expenses or expenses it could not support, did not follow federal or its own procurement regulations, conducted an inadequate year-end inventory for 1998, did not exercise adequate control over implementation of its management information system, did not follow federal regulations regarding a Special Purpose Grant, did not properly administer its Section 8 program, and did not properly account for cable television revenues.

HUD Comments



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-5000

ASSISTANT SECRETARY FOR
PUBLIC AND INDIAN HOUSING

DEC 19 2003

MEMORANDUM FOR: Nancy H. Cooper, Regional Inspector General for Audit, 4AGA

William O. Russell, III
FROM: William O. Russell, III, Deputy Assistant Secretary, for Public Housing and Voucher Programs, PE

SUBJECT: Draft Report-Public Housing Agency Development Activities

The Office of Public Housing Investments (OPHI) appreciates having the opportunity to comment on the Office of the Inspector General's draft report on Public Housing Agency (PHA) Development Activities. While many of the items that you point out related to the use of federal public housing resources for the development and management of non-public housing are appropriate for Departmental action, the Department does not want to discourage entrepreneurial PHAs and their non-profit affiliates from using non-public housing resources to the benefit of the public housing program.

In resolving other audits prepared and released by the OIG, the Department has taken remedial steps to resolve individual audit recommendations and has made referrals to the Enforcement Center recommending administrative actions be taken against those that violated the Annual Contributions Contract. The Office of Public and Indian Housing fully intends to continue those efforts as we pursue the resolution of this audit.

However, the Department is concerned that without an analysis of the individual transactions that account for the \$600 million in miscellaneous accounts receivables or net due from account receivables, it is premature and inaccurate to characterize all of the \$600 million as being "at risk". The reason for this is that the ACC allows for PHAs to use the Low Rent Program as a general fund. A general fund under this definition allows PHAs to deposit money from various programs (like the Capital Fund Program) into a single account. Therefore it is a common practice to see amounts reported under the due to and due from accounts, as this reflects cash and investments balances of other programs being held under the low rent program. Also PHAs can use their reserve balances to fund public housing related projects. Therefore, PHAs will use their reserves as working capital to be later reimbursed by the Capital Fund (A PHA will complete CFP work while the paper work and draw-down of funds occur later). This type of transaction would also give rise to amounts being reported in the "indicator" accounts. The above two scenarios will be the typical norm. Only when a PHA becomes financially distressed do these indicators represent true risk. It is our position that the potential risk of \$600 million dollars is overstated. Only an analysis of the transactions that give rise to amounts will reveal actual amounts of abuse. At best, these accounts might be considered in need of greater scrutiny and transparency – actions that we will be aggressively pursuing.

While our response to this draft audit does not include a point-by-point response to recommendations 1.A-I, the Department agrees that more formal guidance for both PHAs and HUD Field Offices is appropriate to ensure that the use of non-profit affiliates serves the best interests of the public housing program and HUD.

The following comments are offered for your consideration:

1. Page 6, paragraph 3 – The draft report does not differentiate between a development containing only public housing units and a mixed-finance/mixed-income (MF) development composed of public housing, tax credit, and/or market rate units. The monitoring and approval processes, and lines of responsibility are quite different between these two basic types of development.

The one process in common for both types of development is the requirement that the PHA submit a Development Proposal to the HUD Field Office (FO) or to Headquarters to initiate the public housing project approval process. In either case, the FO must review and approve the environmental assessment, and site and neighborhood information. Once the proposal is approved, a public housing Project Development Number is issued by the FO, the ACC is amended and the development of the public housing project is authorized. The ACC Amendment and the Project Development Number are required for the PHA to receive operating subsidy when the development is completed.

The filing of the Development Proposal is the basis for knowing that a PHA is contemplating a development project. If the Development Proposal and budget indicates that there will be private sources of funding utilized for the development then HUD knows that a MF proposal is being proposed. The FO is responsible for notifying the Office of Public Housing Investments (OPHI) of any proposed MF development.

In addition, if a PHA is proposing to utilize public housing assets to secure financing for either a public housing or private development project the FO must notify OPHI in order for the proper procedures to be implemented by OPHI under Section 30.

In addition, many PHAs have interpreted the language of Section 30 language as being permissive, not as an activity requiring the Secretary's approval. The Department agrees that guidance would be helpful to clarify the procedures that the FO, OPHI, and the PHA are to follow for when public housing assets are security for the development of projects.

2. Page 9, 2nd paragraph – states, "The ACCs do not permit use of public funds for privately owned development expenses." This is an overly broad statement in the context of mixed-finance developments. It is permissible to use public funds in conjunction with private funds provided that the public funds are proportionate to the number of public housing units constructed, including common area improvements in

a mixed-finance developments.

3. **Page 11, 6th bullet** – states the “granting of leasehold interest” may not encumber the PHA property. Prior to the adoption of QHWRA and mixed-finance development this was essentially true, however, it is not true at this time. 24 CFR 941, subpart F allows for such encumbrances with HUD approval. The reference in the bullet is Notice 91-39, which expired in 1992. The bullet, therefore, is relevant only as background, not as precedent to current development activities.

