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TO: Frank L. Davis, General Deputy Assistant Secretary for Housing, H

FROM:   
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3AGA

SUBJECT: Criteria Governing Local Government Participation in HUD's Single Family Property Disposition Discount Sales Program

## **HIGHLIGHTS**

### **What We Audited and Why**

This report addresses internal control concerns with the U.S. Department of Housing and Urban Development's (HUD) Single Family Property Disposition Discount Sales Program (Sales Program). Our audit (Report Number 2005-PH-1003) of the Town of Clifton (Town), a participant in the Sales Program, disclosed that requirements for local government entities may not fully protect HUD's interests. Our objective in this review was to assess HUD's criteria governing a local government entity's participation in the Sales Program and to determine whether current Sales Program criteria adequately protect HUD's interests.

### **What We Found**

HUD needs to strengthen its Sales Program criteria. HUD's requirements for local governments to participate in the Sales Program are less stringent than those for a nonprofit entity. As a consequence, local governments can use the Sales Program for purposes other than HUD intended.

HUD intended that the Sales Program be used to benefit low- to moderate-income individuals. However, in our previous audit of the Town of Clifton, we found the local government participated in the Sales Program primarily as a means to raise revenue for the Town. The Town did this by using its government status to purchase the homes and then contracted a for-profit entity to manage its program. Although the Town of Clifton did not violate HUD requirements by participating in this manner, HUD never intended the Sales Program to be used for this purpose. If HUD had required local governments to follow the same requirements as a nonprofit entity, the Town of Clifton would not have been allowed to use the Sales Program primarily as a source of revenue.

### **What We Recommend**

We recommend HUD strengthen the established criteria governing local government entities' participation under the Sales Program, by implementing criteria similar to which its nonprofits now operate under.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

### **Auditee's Response**

We provided our draft report to HUD on February 25, 2005. We discussed the findings and recommendations with HUD representatives from the Office of Single Family on March 15, 2005. At that meeting, the Office of Single Family agreed with the issues and recommendations presented in our report and agreed that formal written comments to the report were not necessary. In addition, we discussed and agreed to a tentative strategy as how the department would address the recommendation.

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## **BACKGROUND AND OBJECTIVES**

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The purpose of HUD's Single Family Property Disposition Discount Sales Program (Sales Program) is to dispose of properties in a manner that expands homeownership opportunities, strengthens neighborhoods and communities, and ensures a maximum return to the mortgage insurance funds. To provide increased affordable housing opportunities to low- and moderate-income homebuyers, HUD permits nonprofits and government entities to purchase HUD Real Estate Owned properties at a discount. These discounts range from 10 to 30 percent lower than the "as is" appraised value of the property. The entity must pass along the discounts received to increase homeownership opportunities for low- and moderate-income families and individuals.

Over a 2-year period, the Town of Clifton (Town) purchased 98 homes across the State of Virginia for a total purchase price of \$9,451,301. None of the homes purchased were within the Town of Clifton's geographic boundary, nor are they required to be under the competitive sales method for government entities. In purchasing these homes, the Town received \$1,417,695 in discounts from HUD. During our audit period, 89 of the 98 properties were resold for \$10,581,823. Using the Town's government status to purchase the properties, the for-profit contractor hired by the Town divided approximately \$721,164 in profits with the Town. The for-profit entity, Commercial Lending Corporation, received \$322,337 in management fees, and the Town received \$399,305 in net income. The Town of Clifton participated in the Sales Program under regulations noted in Mortgagee Letter 2001-30 and 24 Code of Federal Regulations, Part 291. These regulations also apply to nonprofit agencies; however, HUD places additional requirements on nonprofits.

Our overall objective in this review was to assess HUD's criteria governing a local government entity's participation in the Sales Program and to determine whether the criteria currently in place are adequately protecting HUD.

## RESULTS OF AUDIT

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### Finding 1: Sales Program Criteria Do Not Adequately Protect HUD's Interests

HUD's requirements for a nonprofit entity that participates in the Sales Program are more stringent than those for a government entity. Although both nonprofit and government entities must follow 24 Code of Federal Regulations, Part 291, and Mortgagee Letter 2001-30, HUD implemented additional criteria<sup>1</sup> for nonprofit entities. Some of the more significant differences relate to the need for the nonprofit to be approved to participate in the program, to demonstrate administrative and financial capacity, and to maintain support documentation. Local government entities do not have to follow these more stringent requirements.

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#### **Nonprofit Participation Requirements Are More Clearly Defined Than for Government Entities**

For a nonprofit entity to participate in the Sales Program, it must be approved by HUD. Listed below are some of the more significant requirements the nonprofit must meet to be approved for the program:

- 1) A nonprofit agency must assure HUD that no conflict of interest exists between it and its board of directors, principal staff, or any other entities that may participate in operating its affordable housing programs.
- 2) A nonprofit agency must have the administrative capacity to develop and carry out its homeownership programs.
- 3) A nonprofit agency must have the financial capacity to operate its homeownership programs.
- 4) An eligible nonprofit must have 2 years' tax-exempt status.
- 5) A nonprofit agency must have at least two consecutive years of housing development experience.
- 6) A nonprofit agency must have adequate facilities for employees and records. In addition, its office space must be located within a 200-mile radius of the geographical areas in which it plans to do business.

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<sup>1</sup> Such as Mortgagee Letter 2002-01

- 7) A nonprofit applying to continue as a Mortgagor must submit to HUD information relating to program performance (i.e., purchase prices and dates, resale price and dates, and evidence of rehabilitation completion).

None of the above requirements are included in the criteria for a government entity. According to HUD's Homeownership Center staff, a government entity only needs a name, address, and identification number to participate in the Sales Program. The Town of Clifton would not have qualified to participate in the Sales Program under the requirements for nonprofits. Several weaknesses in the criteria for a government entity are discussed below.

**A Government Entity Does Not Have To Demonstrate Administrative or Financial Capacity**

The Town of Clifton did not have the administrative or financial capacity to oversee the Sales Program. The Town of Clifton contracted with a for-profit entity (Commercial Lending Corporation) in November 2002 to administer its Sales Program. Mortgagee Letter 2001-30 does not prohibit the Town of Clifton from using a contractor. However, as a result of the lack of criteria governing contractors' services for local governments, Commercial Lending Corporation used the Town's government status to purchase the properties and divided approximately \$721,164 in profits with the Town. Commercial Lending Corporation received \$322,337 in management fees, and the Town received \$399,305 in net income.

According to Mortgagee Letter 2002-01,<sup>2</sup> if a nonprofit obtains consultant services to help implement its program, the nonprofit operations must be independent of the influence, control, or direction of the consultant or any other outside party, particularly those seeking to derive profit or gain from a proposed project. The nonprofit must disclose written and/or side agreements with parties that may derive financial gain through the homeownership program, and the consultant services shall not constitute more than half of the nonprofit's activities. In other words, the nonprofit must have the resources and capacity to run its own programs and only contract for services on a temporary and supplementary basis. Since these requirements do not include government entities, the Town of Clifton did not have to prove administrative and financial capacity and was able to use a for-profit contractor full time to administer the program.

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<sup>2</sup> The criteria that governs nonprofit entities

**A Government Entity Does Not Have the Same Documentation Requirements as a Nonprofit Entity**

Similar to Mortgage Letter 2001-30 governing government entities, Mortgage Letter 2002-01 requires nonprofits to maintain copies of payments to contractors. However, Mortgage Letter 2002-01 also requires that nonprofits maintain additional documents to support rehabilitation work performed on the properties. Some of the additional items include

- Change orders,
- Inspection of repairs by nonprofit,
- Invoices from contractors, and
- Work write-up/contractor estimate of repair costs.

Since these requirements do not apply to government entities, the Town of Clifton was not required to maintain more detailed support documentation that would have likely prevented it from making payments for repairs that were not made and ensuring repair costs were justified and reasonable.

We inspected 10 properties during the audit of the Town of Clifton. When we requested the support documentation for the repair work completed on each property, we found that the Town of Clifton's agent, Commercial Lending Corporation, maintained only limited documentation, consisting of an electronic home inspection/repair invoice prepared by Commercial Lending Corporation and copies of checks and wire transfers made to the repair contractors for the repair work performed on the property. Commercial Lending Corporation was not able to provide us with more detailed support, such as work orders or actual invoices from the repair contractors.

Representatives from the Town of Clifton and its agent stated that collecting the invoices was not necessary according to Mortgage Letter 2001-30. Mortgage Letter 2001-30 only requires that the government entity maintain canceled checks and corresponding receipts as proof of rehabilitation costs. In the Town's opinion, the home inspection/repair invoice and the canceled checks would be considered sufficient documentation under HUD criteria. Based on the current requirements for government entities, the Director of the Office of Single Family Asset Management and his staff agreed with the Town of Clifton's interpretation.

However, when we inspected the repairs made on the 10 homes sampled, we found the Town of Clifton, along with its agent, Commercial Lending Corporation, paid for repairs that were not performed on 7 of the homes. As a result, the Town of Clifton exceeded the 110-percent net development requirement in Mortgage Letter 2001-30.

## **Conclusion**

HUD's criteria governing local government participation in the Sales Program does not adequately protect HUD's interests. The criteria governing nonprofits' participation in the program are clearly defined. Thus, we believe similar requirements need to be established for government entities.

## **Recommendation**

We recommend that the Office of Housing:

- 1A. Strengthen Sales Program criteria to ensure HUD's interests are adequately protected in discounted sales to local governments. HUD should consider implementing criteria similar to controls over nonprofits.



## SCOPE AND METHODOLOGY

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To accomplish the audit objectives, we:

- Reviewed applicable HUD regulations relating to local governments' and nonprofits' participation in the Sales Program.
- Conducted interviews with officials and employees of the Town of Clifton, Commercial Lending Corporation, and HUD's Single Family Division.
- Reviewed established procedures formulated by the Town of Clifton and Commercial Lending Corporation in administering the Sales Program.
- Reviewed the Town of Clifton's documentation related to its Affordable Housing Program including its home inspection repair invoices.

We performed the majority of our fieldwork from June through September 2004 at the offices of Commercial Lending Corporation, located at 7603 Maple Branch Road, Clifton, VA. The audit generally covered the period November 1, 2002, through May 31, 2004, but was expanded when necessary.

We performed our review in accordance with generally accepted government auditing standards.

# INTERNAL CONTROLS

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Internal Control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

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## Relevant Internal Controls

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

- Monitoring of Local Government Performance - Policies and Procedures that management has in place to ensure that adequate supporting documentation substantiates the validity of the work performed.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

## Significant Weaknesses

Based on our review, we believe the following item is a significant weakness:

- Lack of policies and procedures for local government entities.