Issue Date February 12, 2009
Audit Report Number 2009-NY-1007

TO: Brian D. Montgomery, Assistant Secretary for Housing-Federal Housing Commissioner, H

Edgar Moore

FROM: Edgar Moore, Regional Inspector General for Audit, 2AGA

SUBJECT: The City of Rochester, New York's Management Controls Over the Asset Control Area Program Needs Improvement To Comply With All Requirements

HIGHLIGHTS

What We Audited and Why

We audited the City of Rochester's (City) asset control area (ACA) program as part of a nationwide audit of the U.S. Department of Housing and Urban Development's (HUD) monitoring of ACA participants. We selected the City because of the level of activity the participant had in HUD's ACA program. The objective of the audit was to determine whether the City administered its ACA program in compliance with program requirements to increase homeownership for low and moderate income borrowers and contribute to the revitalization of blighted communities.

What We Found

The City's ACA program generally met the program objectives for increasing homeownership for low and moderate income borrowers and contributed to the revitalization of blighted communities, but was not always administered in compliance with program requirements. Specifically, the City did not (1) obtain HUD approval before allowing a nonprofit organization, which lacked the administrative capacity, to participate in its ACA program; (2) administer its ACA program in a cost-effective manner, as excess development costs were incurred and properties were not resold within the timeframe imposed by HUD; (3) sell an ACA property within the price limit imposed by HUD; (4) obtain HUD's approval for conflict-of-interest issues; and (5) accurately calculate or report to HUD net development costs for each ACA property. Consequently, there was no assurance that the City's ACA program, which received an average annual discount of more than $1.6 million on ACA properties, was always administered in an effective and efficient manner.

What We Recommend

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner instruct the City to (1) develop procedures to ensure that any nonprofit hired to administer or participate in the ACA program is approved by HUD in accordance with ACA policies, (2) ensure that ACA properties purchased from HUD are resold within the timeframe imposed by HUD to avoid accumulating holding costs that increase the resale prices of the properties, (3) buy down the mortgage for the ACA property that was resold to the eligible purchaser for $4,700 more than the limit imposed by HUD, (4) cease participation with individuals or entities that have conflict-of-interest relationships with those who administer the ACA program unless HUD approval can be obtained, (5) develop procedures to ensure that net development costs for each ACA property are accurately calculated and reported to HUD, and (6) establish and implement internal control procedures to monitor the compliance of its ACA program participants with program requirements. In addition, the Assistant Secretary for Housing-Federal Housing Commissioner should review the noncompliance issues identified in the report and make a decision on whether to impose sanctions in accordance with section 8 of the ACA standard operating procedures.

Auditee's Response

We discussed the results of our review with the auditee during the audit and at an exit conference held on December 30, 2008. Auditee officials provided their written comments on December 29, 2008, in which they strongly disagreed with the finding. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

The City of Rochester (City) maintains its city hall at 30 Church Street, Rochester, New York. The City is administered by a mayor and a nine-member city council. The current mayor is Mr. Robert Duffy. On December 28, 2005, the City renewed its asset control area (ACA) agreement with the U.S. Department of Housing and Urban Development (HUD) for two years.

Section 204 of the National Housing Act (12 U.S.C. (*United States Code*) 1710) directs HUD to promote the revitalization of neighborhoods through the creation of ACAs in HUD-approved communities. HUD sells HUD-owned properties to authorized entities (local partners) located within the ACA at a discounted price. In turn, the local partners must ensure that the properties are rehabilitated and sold to eligible homebuyers.

The ACA agreement provided that the City would convey the properties to the Rochester Housing Development Fund Corporation (Corporation) and the Corporation would be bound with the respect to the properties as if it were the purchaser from HUD. The ACA agreement was executed by the Assistant Secretary for Housing, the City's mayor, and the president of the Corporation.

HUD sells properties to the City at a discount from the "as is" fair market value. The City then resells the properties to the Corporation. The Corporation is a nonprofit organization that was established to purchase vacant single-family homes for renovation and resale to first time low and moderate income families. It is located at 183 East Main Street, Suite 900, Rochester, New York, and shares office space with the Greater Rochester Housing Partnership (Partnership).

The Corporation's application to participate in HUD single-family programs was rejected by the Philadelphia Homeownership Center, Program Support Division, in 2004. The reasons for the rejection included the Corporation's lack of administrative capacity to manage the ACA program, allowing a member of the Corporation's board of commissioners to receive compensation through the Partnership that administers the City's ACA program, and sharing office space with the Partnership.

The Partnership was hired to administer the City's single-family programs including the ACA program. However, the Partnership has not sought or obtained approval to participate in HUD's single-family programs. The City has paid the Partnership $186,000 from Community Development Block Grant (CDBG) funds annually to administer the ACA program. HOME Investment Partnerships Program (HOME) and state grants were also used to pay various community housing development organizations and developers a total of $681,839 during 2006 and 2007 to monitor the rehabilitation of 155 ACA properties.

As of November 2008, HUD officials had not formally issued the ACA draft regulations. Therefore, in conducting the audit, we followed the ACA polices and guidance in the standard operating procedures, the ACA agreement, and instructions for potential ACA participants, as well as Mortgagee Letter 2002-01 and 24 CFR (*Code of Federal Regulations*) 84.4 and 42. Appendix C contains excerpts of these ACA policies.

The City has purchased 311 ACA properties from HUD since January 2004. During fiscal years 2006 and 2007, the City bought 70 and 62 ACA properties at discounts of more than $1.7 and $1.5 million, respectively.

The objective of the audit was to determine whether the City's ACA program was administered in compliance with program requirements of increasing homeownership for low and moderate income borrowers and contributing to the revitalization of blighted communities.

RESULTS OF AUDIT

Finding 1: The City of Rochester, New York's Management Controls Over the Asset Control Area Program Needs Improvement To Comply With All Requirements

The City's ACA program met the program objectives for increasing homeownership for low and moderate income borrowers and contributed to the revitalization of blighted communities, but was not always administered in compliance with program requirements. Specifically, the City did not (1) obtain HUD approval before allowing a nonprofit organization, which lacked the administrative capacity, to participate in its ACA program; (2) administer its ACA program in a cost-effective manner, as excess development costs were incurred and properties were not resold within the timeframe imposed by HUD; (3) sell an ACA property within the price limit imposed by HUD; (4) obtain HUD's approval for conflict-of-interest issues; and (5) accurately calculate or report to HUD net development costs for each ACA property. Consequently, there is no assurance that the City's ACA program, which received an average annual discount of more than $1.6 million on ACA properties, was always administered in an effective and efficient manner.

The City Did Not Obtain HUD's Approval for a Nonprofit Organization to Participate in Its ACA Program

The City did not obtain HUD's approval before allowing the Corporation, a nonprofit organization, to participate in its ACA program. The City purchases ACA properties from HUD and then resells the properties to the Corporation, which is legally responsible for accomplishing the ACA program objectives by repairing and reselling the properties to eligible purchasers. According to the ACA's standard operating procedures, section 4.5, an ACA participant may carry out its obligations through various departments and through arrangements with other approved participating entities that have been determined as eligible to participate in the ACA program. A participating entity must be a HUD-approved nonprofit organization. However the Corporation's application to participate in HUD's single-family program, which includes the ACA program, was rejected by HUD for several reasons, such as (1) a member of the Corporation's board of commissioners was an employee of the Partnership, a nonprofit organization that administered the ACA program, (2) the Corporation did not have sufficient staff to administer the ACA program, and (3) the Corporation was not located in a space that was separate and apart from any other entity as it was located in the same space as the Partnership.

Moreover, according to an internal HUD memorandum, dated August 12, 2005, HUD rejected the Corporation's application to become a HUD-approved nonprofit organization because it considered the Corporation to be a liability shell constructed to insulate the parent organization from any liability in the event of a serious financial problem. Therefore, reselling the ACA properties to the Corporation, which did not have staff to administer the ACA program, increased the risk that the program would not effectively achieve its objectives.

HUD officials from the Philadelphia Homeownership Center stated that although they did not provide the City with written approval to allow the Corporation to participate in the ACA program, they considered that approval was granted because the Corporation was mentioned in the City's ACA agreement approved by HUD headquarters officials. Nevertheless, the Corporation was not included in the HUD list of approved agencies authorized to participate in the single-family program.

Despite HUD's non-approval and contrary to regulations, during the years 2006 and 2007, the City bought 132 ACA properties from HUD at a $3.2 million discount and resold these properties to the unapproved nonprofit organization (the Corporation). Accordingly, the City received an average annual discount of more than $1.6 million from the ACA properties' appraised value during these two years.

The ACA Program Was Not Administered in a Cost-Effective Manner

The ACA program was not administered in a cost-effective or efficient manner because the Corporation did not have the administrative capacity to do so. As a result, the City annually used $186,000 in CDBG funds to pay another nonprofit, the Partnership, for administering the program. The Corporation also used HOME and state grants to pay various community housing development organizations and developers a total of $681,839 during 2006 and 2007 to monitor the rehabilitation of 155 ACA properties, thereby inefficiently increasing the development costs for these properties.

In addition, the City did not comply with the resale timeframes imposed by HUD for the ACA properties. During 2006 and 2007, the City resold 179 ACA properties to eligible homebuyers. Only 57 and 84 percent of 179 ACA properties were resold within 12 and 18 months, respectively. According to the ACA agreement, section 5.5, Resale Deadline, (1) 75 percent of the acquired properties must be resold within 12 months after the transfer effective date, and 100 percent of the properties must be resold within 18 months after the transfer effective date. The delay in quickly reselling the ACA properties increased the properties' holding costs (interest expense, property taxes, maintenance costs, etc.) that could have impacted the affordability of ACA properties for low to moderate income buyers (due to increased sales prices) and/or could have resulted in the need for additional grants from the CDBG or HOME programs to reduce the properties' resale prices to more affordable amounts.

We reviewed the financial records related to 21 ACA properties and determined that these properties had an "as is" appraised value of $802,000 and were sold by HUD with a $546,496 discount to the City for a total of $255,504. Under the ACA program, HUD offers discount prices for properties with the intent of contributing to the cost of rehabilitating and selling properties to homeowners at reduced prices. However, in this case, the City resold the properties to the Corporation, which did not have the capacity to properly administer the program. Consequently, as mentioned above, development costs increased because the Corporation had to hire a developer to monitor the rehabilitation for each property at a cost of more than $4,000 per property. Further, because the properties were not resold in a timely manner, unnecessary holding costs for property taxes, interest, security, and maintenance were also incurred. As a result, the development costs for these 21 properties amounted to more than $1.9 million. Although the appraised value for the rehabilitated properties was nearly $1.35 million, the properties were later resold for approximately $1.31 million. Thus, the difference between the total development costs and the resale proceeds for the properties, which amounted to $613,720, had to be absorbed by grants from HUD and state programs (this amount included $375,436 in community housing development organization/HOME program funds and loss reserves of the nonprofit corporation), which was not the intent of the program. Consequently, if the Corporation had the capacity to administer and monitor these properties itself, federal and state grants might not have been needed to inefficiently pay significant portions of the development costs incurred; thus, more federal and state grants would have been available for other eligible families.

One ACA Property Was Resold for $4,700 More Than the Maximum Allowable Price

One ACA property was resold for $58,700, although the appraised value at the time of resale was $54,000. According to the ACA agreement, section 5.3, Resale Price and Conditions, the purchaser shall not sell the acquired property for a resale price of more than the lesser of (1) fair market value of the property at the time of the resale or (2) 115 percent of the eligible expenses. As a result, the eligible buyer overpaid $4,700 for the property, and although not material, this excess could potentially increase the risk of default on the mortgage.

HUD's Approval to Resolve Conflicts of Interest Was Not Obtained

The City did not obtain HUD's approval before it allowed a vice president of a financial institution and the president of the Partnership to become commissioners of the nonprofit entity (the Corporation) that was legally responsible for accomplishing the ACA program objectives. In this instance, the financial institution obtained a fee from all banks that provided loans used for repair costs related to the ACA properties, and the Partnership received a fee from the City for administering the ACA program for the Corporation. Accordingly, due to the business relationships of the commissioners, it could appear that the financing of the program was conducted in a manner that benefited the financial institution by maximizing its fees, and it could also raise questions about the reasonableness of the fees paid to the Partnership to administer the program. The ACA agreement provided that the purchaser (the City) and its agents, board of directors, principal staff, and contractors were to avoid any and all conflicts of interest and self-dealings. However, as a result of not eliminating these conflict-of-interest matters, there was a potential that public and other interested parties might not believe that the program was administered in an efficient and independent manner.

Net Development Costs Were Not Accurately Calculated or Reported

Based on review of a status report of ACA properties and interviews with Partnership staff, we learned that the Partnership's procedures for calculating net development costs did not include removing grants or other sources of funding used to subsidize this cost. As such, the Partnership did not properly calculate or report to HUD the net development costs for the 132 ACA properties purchased from HUD during the audit period. The net development costs for each ACA property are used in the process of determining the maximum resale price for each ACA property. According to the ACA agreement, ineligible costs that cannot be a part of the net development costs or eligible expenses include housing developer fees, sales bonuses, resale incentives, and any development costs that are paid from local, state, or federal grant funds (including but not limited to HOME or CDBG funds).

For instance, total development costs related to an ACA property located at 420 Sawyer Street in Rochester were $86,951. Based on reports submitted to HUD by the Partnership, the ACA property net development costs were $81,951. Although the Partnership reduced the total development costs by $5,000, which represents the ineligible developer fees, the development costs were not reduced by the grants of $28,151 from federal and state sources used to subsidize the ACA property. Accordingly, based on the ACA agreement, net development costs for this ACA property should have been reported as $53,800 to reflect the reduction of the total grants received from different sources including federal and state sources. As a result of reporting inaccurate information to HUD related to the net development costs for ACA properties, HUD was not able to conduct effective monitoring of the ACA participant's compliance with the program requirements and determine whether the properties were sold for the lesser of the fair market value or 115 percent of the eligible development cost.

Conclusion

The City's ACA program was not always administered in compliance with program requirements. Specifically, ACA properties were resold by the City to a non-HUD-approved nonprofit organization that did not have staff to administer the ACA program. Also, the City did not administer the ACA program in the most effective manner as excess development costs were incurred and properties were not resold within the timeframe imposed by HUD, an ACA property was resold for $4,700 more than the limit imposed by HUD, HUD's approval was not obtained for conflict-of-interest issues, and net development costs for each ACA property were not accurately calculated or reported to HUD. This condition was caused by the City's lack of procedures to ensure that operations were conducted in accordance with program requirements. Consequently, there was no assurance that the City's ACA program, which received an average annual discount of more than $1.6 million on ACA properties purchased from HUD, was always administered in an effective and efficient manner.

Recommendations

We recommend that the Assistant Secretary for Housing Federal- Housing Commissioner instruct the City to

1A. Develop procedures to ensure that nonprofits hired to participate or administer the ACA program are approved by HUD in accordance with ACA policies and standard operating procedures.

1B. Ensure that ACA properties purchased from HUD are resold within the timeframe imposed by HUD to avoid accumulating holding costs that increase the resale prices of the properties, thereby impacting the affordability of the properties for low to moderate income buyers, and/or may require the use of other funds or grants such as HOME grants.

1C. Buy down the mortgage for the ACA property that was resold to the eligible purchaser for $4,700 more than the limit imposed by HUD.

1D. Cease participation with individuals or entities that have conflicts of interest with the administrators of the ACA program, unless HUD's approval can be obtained.

1E. Develop procedures to ensure that net development costs for each ACA property are accurately calculated and reported to HUD; procedures should ensure that ineligible expenses such as developer fees or grants received from different sources should be shown but not included in the computation.

1F. Establish and implement internal control procedures to monitor the compliance of its ACA program participants with program requirements.

In addition, the Assistant Secretary for Housing-Federal Housing Commissioner should

1G. Review the noncompliance issues identified in the report and make a decision on whether to impose sanctions in accordance with section 8 of the ACA standard operating procedures to ensure the integrity of the ACA program and enforce compliance

1H. Review and determine the eligibility of the $186,000 paid to the non-HUD-approved organization (the Partnership) to administer the program. If any amounts are determined not to be eligible, they should be repaid.

SCOPE AND METHODOLOGY

Our audit was conducted at the Corporation, located at 183 East Main Street, Suite 900, Rochester, New York. To accomplish our objectives, we performed the following:

- Obtained an understanding of the City's ACA program through a review of City policies and agreements related to the program.

- Analyzed information obtained from public records using data retrieval tools such as LexisNexis.

- Reviewed prior audits, reviews, and reports on the City's ACA program conducted by the Office of Inspector General (OIG), HUD, and independent public accountants.

- Analyzed information and reports submitted to HUD by the City and the Corporation.

- Conducted interviews with staff from HUD, the City, and the Corporation.

- Perfomed analytical procedures and selected items for testing based on evaluation of risks, including the relationship between appraised value and resale price, amount of holding costs per property, and questions about a specific category of cost. We selected the following samples:

  -Selected a nonstatistical sample of disbursements for expenses related to the ACA program and reviewed the supporting documents such as the check register, cancelled checks, and invoices.
  -Reviewed 21 ACA property files as well as associated homebuyer files.
  -Reviewed 73 ACA property appraisal reports.
  -Inspected 13 ACA properties.

We conducted our fieldwork from March through May 2008. The audit covered the period January 1, 2006, through December 31, 2007. However, the period was extended as necessary to achieve our objectives

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

INTERNAL CONTROLS

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

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They 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 objectives:

- Program operations - Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Compliance with laws and regulations - Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

- Safeguarding resources - Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

- Validity and reliability of data - Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

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 that the following items are significant weaknesses:

- The City's controls were not always adequate to ensure that program objectives were achieved. The City resold an ACA property for more than the limit imposed by HUD, and ACA properties were not resold within the timeframes imposed by HUD (see finding).

- The City's controls were not always adequate to ensure the reliability and validity of reports submitted to HUD. Reports submitted to HUD by the City did not include accurate information related to the net development costs for each ACA property (see finding).

- The City's controls did not always ensure compliance with the ACA agreement and program requirements. The City allowed a nonprofit organization (the Corporation), which did not have the administrative capacity, to administer the ACA program without obtaining HUD's approval. Also, the City did not obtain HUD's approval regarding conflict-of-interest issues.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Unsupported 2/
1C	$4,700	
1H		$186,000

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local polices or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	**Auditee Comments**

The City of Rochester and Rochester Housing Development Fund Corporation Response
To U.S. Department of Housing and Urban Development
Office of Inspector General
Draft Audit Report on:
Community Housing Division
City of Rochester, NY ACA Program Audit
December 2008

Comment 1

The Inspector General Auditor conducted a program Audit of the ACA program in May 2008 which resulted in the following finding: "The City's ACA Program was not always administered in compliance with HUD requirements."

The City of Rochester and the Rochester Housing Development Fund Corporation (RHDFC) strongly disagree with the Inspector General's opinion that the City and RHDFC did not comply with HUD requirements to increase homeownership for low- and moderate-income borrowers and contribute to the revitalization of blighted communities. The Rochester ACA has been a very successful program, acquiring, rehabilitating and selling more than 155 homes during the two years (2006 and 2007) that were subject to this audit review and substantially more over the life of the program. Each home was purchased by an income-qualified first-time home buyer who was required to participate in a minimum of eight hours of pre-purchase homeownership training. The development of these properties leveraged over $9.8M in private mortgage investment into HUD designated revitalization areas in the city of Rochester. Both the City and the RHDFC further disagree that the results of this audit review warrant an audit finding.

The Rochester ACA program has undergone a program compliance review by a third party accountant, contracted by HUD, on several occasions since signing the first agreement in 2004. The Rochester ACA program is currently operating under its third two-year contract. The reviewers of each compliance review have made minor program recommendations but have not directed HUD or the City of Rochester to make any significant changes to its ACA program operation. The IG report lists five specific items that support your finding. The City of Rochester and RHDFC response to each is listed below.

1. "The City did not obtain HUD's approval for a nonprofit organization to participate in its ACA program." The report further explains that "according to an internal HUD memorandum, dated August 12, 2005, HUD rejected the Corporation's application to become a HUD-approved nonprofit organization because it considered the Corporation to be a liability shell constructed to insulate the parent organization from any liability in the event of a serious financial problem." The IG report goes on to state that HUD considered that approval was granted because the RHDFC was "mentioned" in the City's ACA agreement which was approved by HUD.

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Response:

Comment 2

The organizational structure of the RHDFC has been the topic of many discussions between the City of Rochester, the HUD Philadelphia HOC, HUD Washington and the RHDFC. The Rochester ACA agreement is signed by three entities including the City of Rochester, the U.S .Department of Housing and Urban Development and the RHDFC. The RHDFC was not just "mentioned" in the ACA agreement but was required to sign the agreement. Without participation from all three entities the ACA program in Rochester would not be possible.

The articles of incorporation for the RHDFC, list of board members and a description of the organization's role in the ACA program were included in the original and two subsequent ACA applications to HUD. The corporate design of the RHDFC specifically meets the requirements set forth by New York State laws that govern Housing Development Fund Corporations which allow not-for-profit developers to create financing mechanisms to develop affordable housing.

The Rochester ACA utilizes a funding facility created through the RHDFC which has leveraged over $57,000,000 in privately funded construction financing including the current loan of $16,000,000 to acquire and rehabilitate vacant foreclosed properties. As stated in the IG report, "the liability shell insulates the parent organization from any liability in the event of a serious financial problem." The liability insulation isolates the functions of the RHDFC from the financial condition of the City of Rochester and the Greater Rochester Housing Partnership which administers the RHDFC. This liability protection is a requirement of the lenders that provide the $16M funding facility investment for the program to the RHDFC. HUD recognized the value of this private lending facility and also understood why the RHDFC would not be considered a HUD-approved nonprofit organization. The inclusion of the RHDFC as a signing party to the ACA agreement was to give the RHDFC the status of "direct ACA participant".

2. The IG report stated that "the ACA program was not administered in a cost-effective or efficient manner because the Corporation did not have the administrative capacity to do so. As a result the City annually used $186,139 in CDBG funds to pay another nonprofit for administering the program." The report goes on to state that HOME and State grant funds were also used to pay community housing development partners a total of $681,839 for the rehabilitation of 155 ACA properties during 2006 and 2007 "thereby inefficiently increasing the development cost for these properties."

Response:

Comment 3

The City of Rochester and the RHDFC strongly disagree with the statement that the ACA program was not administered in a cost-effective or efficient manner. The annual payment of CDBG funds was paid to the RHDFC to purchase services from the Greater Rochester Housing Partnership, Inc. to support the Rochester ACA program. A scattered site acquisition rehabilitation program of this

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volume requires staff to carry out specific functions which include at minimum, construction management, accounting, financial oversight, marketing and program management. The cost of these functions and each service must be factored into the operating budget of the program regardless of how the staff support is delivered. The accounting, financial oversight, program management and a portion of the marketing function is paid through the annual CDBG grant of $186,000 which accounts for less than 3% of the total program costs of over $13,175,000 for the development of the 155 properties.

The construction management and a portion of the marketing function are subcontracted to non-profit agencies that provide professional construction services. The IG report listed the expense paid for these functions to be $681,839 which is equivalent to 5% of the total budget for the development of these 155 homes.

We agree that proper staff capacity is an important component to the success of the ACA program and believe this can be achieved through out-sourcing specific functions which can help mitigate costs by allowing capacity to fluctuate with project inventories. Furthermore, the cost of these services and the manner in which they are delivered did not affect the affordability of the homes or impact the price to the final buyer.

Comment 4

2. **Continued:** The IG report also states that the City did not comply with the resale timeframes imposed by HUD for the ACA properties. During 2006 and 2007, the City resold 179 ACA properties to eligible homebuyers. Only 57 and 84 percent of 179 ACA properties were sold within 12 and 18 months, respectively. Holding costs that could have impacted the affordability of ACA properties could have resulted in requiring additional grants.

Response:

The City acknowledges that the deadlines were not met for 16% of the properties in this sample. It is important to note that although a small percentage of the properties were not sold within the sales deadlines the final price to the low and mod-income buyers was not impacted. Including these few homes that were not sold within the deadlines, the average holding time for all homes in the selected sample was less than 320 days or less than 10 months. It is important to acknowledge that most homes were sold well within the time frames imposed by the ACA agreement. The IG's opinion that holding cost for these properties could have impacted the affordability and efficiency of the ACA program, does not acknowledge that these costs are offset on average by the reduced holding costs for properties that sold well within the sales deadlines.

Sales deadlines are a necessary requirement for the successful operation of any acquisition rehabilitation program but it is important to note that once a property is fully rehabilitated the completion of sale is dependent on factors that are not controlled by program participants. It took an average of 112 days per property to complete the rehabilitation of properties in the IG sample yet the average number of days from completion to sales closing was 182 days. The ACA agreement also requires the City and the RHDFC to acquire every single-family property in the selected areas including

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those that have features that make them less appealing to buyers. Some properties have obsolete floor plans, no driveway or other issues that effect marketability. There are also factors outside of our control including: real estate market trends, seasonal market activity and financing availability which impact our ability to meet these deadlines. We anticipate the recent changes in the mortgage market will undoubtedly impact our ability to sell properties within the specified deadlines.

2. **Continued:** The first full paragraph on page 8 of the IG report states that "if the [RHDFC] had the capacity to administer and monitor these properties itself, federal and state grants might not have been needed to inefficiently pay significant portions of the development costs incurred." This paragraph goes on to specifically state the cost of construction management services and that "properties were not sold in a timely manner unnecessary holding costs were incurred."

Response:

Comment 5

This paragraph in the IG report seems to infer that the HUD discount was designed to be the total subsidy invested in each project and that the inefficiency of the Rochester program was the cause for the need of additional subsidy sources. The City of Rochester and the RHDFC strongly disagree with this statement and questions the auditors understanding of the Rochester real estate market or the markets of other north eastern "rust belt" cities.

Rochester is a northeastern city in which there is a disproportionately high number of HUD foreclosed properties combined with low family incomes and a weak real estate market. A trend of population loss has been recognized since the 1970's and the rate of homeownership has dropped in recent decades. Add to that an older housing the vast majority of which was built before 1950. In this community the discount value is rarely enough to cover the cost of rehabilitation. As part of the ACA requirements, the City must rehabilitate every property using lead safe work practices before selling it to an income qualified owner-occupant purchaser. In communities like Rochester with an older housing stock and depressed property values, the cost of rehabilitating a property frequently exceeds fair market value.

The ACA program allows the City of Rochester to purchase properties at a generous discount yet it is common for the cost of rehabilitation alone to exceed $70,000. In most cases the after rehabilitation market value will not exceed $55,000, this results in a shortfall as demonstrated below:

Average Purchase Price with discount	$10,000
Redevelopment and Rehab Costs	$70,000
Market Value/buyers mortgage	($55,000)
Shortfall	**$25,000**

Ref to OIG Evaluation **Auditee Comments**

The IG's opinion that subsidy is required because the Rochester ACA did not meet sales deadlines does not square with the fact that subsidy was required for every property, even those that were sold well within the HUD sales deadlines. This is easily demonstrated because each house is considered a separate project and as such has a separate budget.

The cost of construction management services is necessary for any acquisition rehabilitation program and providing staff capacity for program operations can be achieved without increasing fulltime salaried staff. Out-sourcing the construction management service allows payment on a fee per property basis so these costs are only incurred when a property is developed. Consequently, when inventory is low, the cost of construction management services is decreased proportionately. The Rochester participants consider this approach to be, in fact, more efficient than committing to pay annual staff salaries and fringe benefits regardless of the flow of property inventory.

For the program years 2006 and 2007 which were the subject of this audit review, the Rochester ACA program was able to leverage almost $10M in non-predatory mortgages, provide homeownership opportunities for 155 low and moderate-income families and helped to stabilize neighborhoods in the City. This is in complete compliance with the ACA program requirements "to increase homeownership for low- and moderate-income borrowers and contribute to the revitalization of blighted communities."

3. One ACA property was resold for $4,700 more than the maximum allowable price.

Response:

Comment 6

Using the bank appraisal as the sole means to determine Fair Market Value is not feasible. A sales price needs to be established prior to marketing the property to eligible homebuyers. The bank appraisal is ordered after the property is offered for sale, a purchase offer is in place and a mortgage application is made by the buyer. To determine the sales price of a property for listing purposes, an "in house" comparative analysis is prepared. The property referred to in the IG Audit is 76 Monica Street. The sales price for this property of $58,700 was established using an analysis of comparable sales. Once the purchase offer was in place, the homebuyer applied for a mortgage and the bank ordered an appraisal. The bank appraisal for 76 Monica Street was for $72,000.00. This appraisal was $13,300.00 over the sales price of the house. Per our ACA agreement, we have the ability to challenge an appraisal which we think may be too high or too low, by ordering a second appraisal from an independent appraisal company. The second appraisal came back with a value of $54,000.00. The range between these two appraisals was $18,000.00. Establishing a sales price between these two appraisal ranges was well within the definition of Fair Market Value.

The agreement requires that the property be sold at the lesser of Fair Market Value, which was determined to be $58,700 using a comparative market analysis or 115% of eligible expenses. The eligible expenses totaled $89,727 and 115% of that amount would be $103,220. The lesser of these values is the Fair Market Value of $58,700 as determine by the RHDFC comparative market analysis.

Ref to OIG Evaluation **Auditee Comments**

4. "The City did not obtain HUD's approval before it allowed a vice president of a financial institution and the president of the Partnership to become commissioners of the nonprofit entity (the Corporation) that was legally responsible for accomplishing the ACA program objectives. In this instance, the financial institution obtained a fee from all banks that provided loans used for repair costs related to the ACA properties, and the Partnership received a fee from the City for administering the ACA program for the Corporation. Accordingly, due to the business relationships of the commissioners, it could appear that the financing of the program was conducted in a manner that benefited the financial institution by maximizing its fees, and it could also raise questions about the reasonableness of the fees paid to the Partnership to administer the program. "

Response:

Comment 7

The by-laws of RHDFC specifically detail the make-up of the directors. Most of the directors are to be selected from among the agencies and organizations that are involved in the financing of the Rochester ACA program. The by-laws of the RHDFC have been submitted to HUD and were accepted with one comment. The Greater Rochester Housing Partnership (Partnership) has the opportunity to appoint one member of the RHDFC board. The president of the Partnership had been a member of the RHDFC Board. At the suggestion of HUD representatives, the president of the Partnership withdrew from the RHDFC board. The Partnership representative to the board may not be an employee of the Partnership. This change to the RHDFC by-laws was reported to HUD in July of 2005.

The fee paid to the lead lender is .25% of the interest changed by the bank lenders in the RHDFC financing and is used to cover the expense of reporting on a monthly basis and for processing the monthly draws, repayments, interest draws and interest repayments. Since each property is accounted for as a separate project, there is substantial reporting required by this loan.

5. "Based on review of a status report of ACA properties and interviews with Partnership staff, we learned that the Partnership's procedures for calculating net development costs did not include removing grants or other sources of funding used to subsidize this cost. As such, the Partnership did not properly calculate or report to HUD the net development costs for the 132 ACA properties purchased from HUD during the audit period"

Response:

Comment 8

The method used by the RHDFC for reporting total development costs was developed in close consultation with HUD representatives. It was designed to reflect the requirements of the ACA Agreement and the structure of the HUD data base used for reporting on the program. The method has been used consistently and has been reviewed by HUD auditors as well as the third party auditors contracted by HUD. The method used in the Rochester ACA program reflects the need to use a source of non-ACA subsidy to make each property both affordable and for sale at the fair market value. Without documenting those expenses and the funds used to pay for the expenses, the files would present an inaccurate and misleading picture of the development costs for each property.

Ref to OIG Evaluation **Auditee Comments**

Participant Response to Recommendations:

1A. Develop procedures to ensure that nonprofits hired to participate or administer the ACA program are approved by HUD in accordance with ACA policies and standard operating procedures.

Comment 9

Response: The City and RHDFC request a clarification of the distinction between "direct ACA participant" and "participating entity" and modify the ACA Standard Operating Procedures to allow, with separate HUD approval, participation of different types of non-profit organizations with specific corporate structures that either assist the operation or increase the capacity of the ACA program.

1B. Ensure that ACA properties purchased from HUD are resold within the timeframe imposed by HUD...

Comment 10

Response: The City and the RHDFC recommend that HUD review the ACA sales guidelines and consider extending them from 12 and 18 months to 18 and 24 months, respectively. The ACA standard operating procedures should also provide flexibility when addressing homes with undesirable features or economic events and market conditions that may impact program operations and the participant's ability to meet sales deadlines.

1C. Buy down the mortgage for the ACA property that was resold to the eligible purchaser for $4,700 more than the limit imposed by HUD.

Comment 11

Response: The City and the RHDFC disagree with the IG's opinion that the buyer "overpaid by $4,700 and that this excess could potentially increase the risk of default on the mortgage." The existence of a bank ordered third party appraisal showing a value of $72,000 and the sales price of $58,700 is a clear indication this buyer purchased this home at or below fair market price. The mortgage obtained for this property was $55,750 at an interest rate of 6.62% for 30 years. This buyer's income exceeded $50,000 and at this price, the buyer was paying 13% of his total income for housing. It is unlikely that the sales price this buyer paid would increase his risk of foreclosure and we contend that the sales price of $58,700 does indeed represent Fair Market Value.

1D. Cease participation with individuals or entities that have conflict of interest with the administrators of the ACA program unless HUD's approval can be obtained

Comment 12

Response: The City and the RHDFC will request written approval for the individual RHDFC board member who also works for JP Morgan Chase, the lender that packages and provides financial services as part of the funding facility.

1E. Develop procedures to ensure that t he net development costs for each ACA property are accurately calculated and reported to HUD; procedures should ensure that ineligible expenses such as developer fees or grants received from different sources are included in the computation.

Ref to OIG Evaluation	Auditee Comments

Comment 13

Response: The City and the RHDFC will request a meeting with HUD to determine the proper calculation and reporting method and request that the final determination is included in the HUD standard operating procedures for the ACA.

1F. Establish and implement internal control procedures to monitor the compliance of it ACA program participants with program requirements.

Comment 12

Response: The City of Rochester and the RHDFC will develop and implement a reporting procedure that includes information pertaining to the items listed in this IG report.

Authorized Signature: ____________ Date: 1/12/09

City of Rochester

Bret Garwood, Director of Development Services

Authorized Signature ____________ Date: 1·12·09

Rochester Housing Development Fund Corporation

Jean Lowe, President

OIG Evaluation of Auditee Comments

Comment 1 We have revised the report by changing the finding title and reflecting that the City and the Corporation met the general program objective in acquiring, rehabilitating and reselling ACA properties. However, we determined that the Rochester ACA program was not always administered in compliance with HUD requirements. For instance, the City did not 1) obtain HUD's approval before allowing a nonprofit organization that lacked administrative capacity, to participate in its ACA program; 2) sell ACA properties within the timeframe imposed by HUD; 3) sell an ACA property within the price limit imposed by HUD; 4) obtain HUD's approval for conflict of interest issues; and 5) accurately calculate or report net development costs for each ACA property to HUD.

Comment 2 It is true that the Corporation signed the City's ACA agreement as an ACA participating entity along with a HUD official. However, according to Mortgagee letter 2002-01 and the ACA Standard Operating Procedures, an ACA participating entity must be a HUD approved nonprofit entity. In addition, a nonprofit organization must have the administrative capacity to develop and carry out their FHA approved homeownership plans in a timely and successful manner to participate in FHA's Single Family activities, including purchasing discounted HUD homes. Consequently, although a HUD official signed the ACA agreements, this does not over ride the fact that the Corporation should not have been allowed to participate in the ACA program, since it was not considered an approved entity for participating in HUD's Single Family Programs. As such, the Corporation should now seek approval from HUD to participate in its Single Family Programs to ensure compliance with program regulations.

Comment 3 The City's ACA program could have been administered more efficiently and effectively. According to the ACA's Standard Operating Procedures, entitled Administrative Capacity-an applicant (ACA participant) should apprise HUD of its capacity to administer the ACA program and must demonstrate its ability to carry out a proposed business plan in a reasonable time frame and in a successful manner. The Corporation did not have administrative capacity to administer the ACA program, therefore other entities had to be hired and additional costs were incurred. Thus, the fees paid to the non-profit agencies were added to the costs of each ACA property, and home buyers had to pay the additional costs when they purchased the ACA properties. Furthermore, since the sales proceeds were not adequate to pay for the costs of administration, acquisition, rehabilitation and marketing, additional funds from state and federal programs had to be provided to cover the shortfall. As a result, these additional funds were not available to address other community needs, which was not the intent of the ACA program.

Comment 4 The auditee acknowledged that the sale deadlines were not met. According to the ACA agreement the City of Rochester was required to resell seventy five percent and hundred percent of the ACA properties within 12 and 18 months respectively of each property's transfer effective date. As a result of the noncompliance with the resale timeframe imposed by HUD, additional holding costs were incurred for some ACA properties. Contrary to City official's comments, the additional holding costs are not offset by properties that were sold within the program time limits. Marketability of properties can be impacted by the property's features or external factors, such as economic conditions, however, the 12 and 18 month time limit imposed by HUD is a reasonable amount of time to complete the rehabilitation and marketing of the properties. Thus, City officials need to develop procedures to ensure that the ACA properties are sold within time frames imposed by HUD, or seek approval to extend the timeframes due to market conditions.

Comment 5 We agree that the Rochester ACA met its general program objective in acquiring, rehabilitating and reselling ACA properties and that the ACA home buyers we reviewed, were qualified to receive HOME and CDBG grants. The costs incurred for program administration and monitoring included $186,000 paid annually to the Partnership and an average of $4,000 paid to developers for each property. For the two program years in our sample the administrative and monitoring costs were approximately $992,000 or on average $6,400 per property. However, these costs may have been lower if all the administration and monitoring would have been conducted by one qualified organization, thereby eliminating some expenses paid for developers' profits. Furthermore, hiring different organizations to administer the City's ACA program along with the noncompliance with HUD resale deadlines resulted in the use of HOME and CDGB funds to pay these costs and reduced the City's HOME and CDBG funds available for other community needs.

Comment 6 According to the ACA agreement, section 5.3 entitled Resale Price and Conditions, the Fair Market Value of the property at the time of resale shall be determined by the appraisal obtained by the resale buyer's lender, or if there is no resale buyer's lender, by the FHA Roster appraiser hired by the purchaser. The purchaser, at its own expense, may order a second independent appraisal and the lesser of the two appraisals shall be the Fair Market Value of the property at the time of resale. Therefore, the correct fair market value of the above ACA property was supposed to be $54,000 and the correct resale price of the property was supposed to be $54,000 because the fair market value of the property was less than the net development cost. Accordingly, as stated in the finding the property was sold for more than the maximum allowable price; thus, the City should pay down the mortgage by $4,700.

Comment 7 We contacted the president of the Partnership subsequent to the exit conference and she informed us that she had stopped being a member of the board of directors of the Corporation prior to the start of our audit, but she was not able to provide the exact date. We also received correspondence from another Partnership employee that indicated that the president of the Partnership was on the board of directors for the Corporation. As such, documentation explaining the composition of the Corporation's Board of Directors should be provided to HUD as part of the audit resolution process. Furthermore, the City is still required to obtain HUD's approval regarding the vice president of the financial institution being on the board of the Corporation. According to 24 CFR parts 84.42 & 84.4, HUD may apply less restrictive requirements when awarding small awards and when approved by OMB, except for those requirements, which are statutory. Exceptions on a case-by-case basis may also be made by HUD.

Comment 8 We agree that not documenting all the expenses would present an inaccurate and misleading picture of the total development costs for each property. However, the ACA agreement- (Exhibit 8) states that any development costs that are paid from local, state, or federal grant funds (including, but not limited to, HOME or CDGB funds) are ineligible expenses. Therefore, net development costs/total eligible expenses calculated and reported to HUD, should not include costs paid from local, state or federal funds. Total costs can be reported to HUD, but ineligible cost or other funding sources (grants, etc.) should be shown as being deducted from the total to arrive at net development costs. This will aide HUD in determining whether the properties were sold within the program limits of the lesser of fair market value or 115 percent of eligible/net development costs.

Comment 9 According to the ACA Instructions for Potential ACA Participants, prior to beginning negotiations for asset control area (ACA) contracts, the potential ACA participant must submit an application, known as the "ACA Business Plan", to the appropriate Homeownership Center (HOC). A potential ACA participant may apply as a "Preferred Purchaser" or a "Non-preferred Purchaser". The term "Preferred Purchaser" refers to Units of Local Government (ULG) or Nonprofit Organizations created pursuant to Section 501(c) of the Internal Revenue Code of 1986. The term "Non-preferred Purchaser" refers to organizations that are not Units of Local Government, or Nonprofit Organizations created pursuant to Section 501(c) of the Internal Revenue Code of 1986 (e.g. For-profit Organizations). <u>An ACA participant</u> is a local government agency or nonprofit organizations, which has obtained prior HUD approval to participate in HUD's single family program. The ACA participant may carry out its obligations through arrangement with other approved <u>participating entities.</u> The participating entities must be a HUD approved nonprofit organizations. Thus, the participating entity is an ACA partner that has been approved by HUD to purchase ACA properties at discount prices. However, nonpreferred entities are not eligible to purchase ACA properties at discount prices. In this case the Corporation did not have prior approval from HUD to qualify as being eligible to participate in HUD's single family programs, and therefore was not eligible to participate in the ACA program.

Comment 10 City officials' comments are not responsive to the finding; however, until HUD decides to change the time limits for selling the properties the City needs to develop procedures to ensure that properties are sold within the HUD established time frames to minimize holding costs and improve the affordability of the houses. As mentioned in our response to comment 4, the City can also formally request a waiver from HUD to extend the time period to sale the properties due to market conditions.

Comment 11 As mentioned in our response to Comment 6 the correct fair market value of the above ACA property was supposed to be $54,000, therefore, the correct resale price of the property was supposed to be $54,000 because the fair market value of the property was less than 115 percent of eligible expenses. As such the City should buy down the mortgage by $4,700 for the excessive price paid by the purchaser.

Comment 12 The auditee's comments are responsive to the recommendation.

Comment 13 The auditee's comments are responsive to the recommendation; however, the standard operating procedures and the ACA agreement already provide the method for reporting net development costs.

Appendix C

CRITERIA

ACA Agreement between HUD and the City

- Section 2.3, Conflict of Interest, Prohibited Transfers, Nondiscrimination, A. Purchasers and their agents, board of directors, principal staff and contractors shall avoid any and all conflicts of interest and self-dealing.

- Section 5.3, Resale Price and Conditions, A. Purchaser shall not sell an acquired property for a resale price of more than the lesser of 1) fair market value of the property at the time of resale, or 2) 115 percent of the eligible expenses as defined in Exhibit 8, attached to the ACA agreement.

- Exhibit 8, Eligible Expenses, section 5. Costs not listed above are ineligible and cannot be included in the Net Development Costs calculation. Ineligible costs include, but are not limited to:
  - b. Housing developer fees and/or real estate consultant fees.
  - c. Sales bonuses and sales incentives for selling or listing real estate brokers/agents.
  - h. Any development costs that are paid from local, state, or Federal grant funds (including, but not limited to, HOME or CDBG funds).

- Section 5.4, Resale Deadline. For each closing between Seller and Purchaser, Purchaser must 1) convey by deed or lease to eligible buyers, officers, or teachers; or, 2) pursuant to section 4.1B, reuse for community purposes, 75 percent (rounded down to the nearest whole number) of the properties acquired from seller at that closing within twelve months after the Transfer Effective Date, and 100 percent of the properties within eighteen months after the Transfer Effective Date.

Asset Control Area Standard Operating Procedures

- The ACA agreement, section 4.5. An ACA program participant may carry out its obligations through its various departments and through arrangements with other approved participating entities (PEs), which have been determined as eligible to participate in the ACA program pursuant to HUD's published guidelines. A participating agreement, specifically governed by the ACA agreement, must spell out a PE's rights and obligations as well as the duties HUD requires of its ACA program participants. Participating entities (PEs) must be HUD-approved nonprofit organization.

Instruction for Potential ACA Participants

- Section B9; identify participating entities that will administer a portion of the ACA program.

  It is a conflict of interest for a nonprofit to employ staff who also work for and receive financial benefits from a for-profit entity that is providing the nonprofit with services related to the nonprofit's affordable housing plan.

- Section G. The participant entity must describe its administrative capacity to develop and carry out its part in a reasonable and a successful manner.

- Section L. Nonprofits are required to have adequate office space, equipment and clerical assistance in each office, for employees to perform their duties in a responsible manner.

Mortgagee Letter 2002-01

This letter clarifies the requirements that new nonprofit applicants must meet to participate in FHA's [Federal Housing Administration] Single Family activities, including purchasing discounted HUD homes.

Conflict of interest issues. The department has a responsibility to ensure that no conflict of interest exists between nonprofit agencies, their board of directors, their principal staff or any other entities that may participate in operating their affordable housing programs.

Nonprofit agencies must have the administrative capacity to develop and carry out their FHA approved homeownership plans in a timely and successful manner.

The nonprofit's facilities must be located in a space that is separate and apart from any other entity.

24 CFR 84.42, Code of Conduct

The recipient shall maintain written standards of conduct governing the performance of its employees engaged in the award and administration of contracts. No employee, officer or agent shall participate in the selection, award, or administration of a contract supported by Federal funds if real or apparent conflict of interest would be involved. Such a conflict would arise when the employee, officer or agent, any member of his or her immediate family, his or her partner, or an organization which employs or is about to employ any of the parties indicated herein, has a financial or other interest in the firm selected for an award.

24 CFR 84.4, Deviation

The office of Management and Budget (OMB) may grant exception for classes of grants or recipients subject to the requirements of this rule when exceptions are not prohibited by statute. However, in the interest of maximum uniformity, exceptions for the requirements of this rule shall be permitted only in unusual circumstances. HUD may apply more restrictive requirements to a class of recipients when approved by OMB. HUD may apply less restrictive requirements when awarding small awards and when approved by OMB, except for those requirements which are statutory. Exceptions on a case-by-case basis may also be made by HUD.