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Audit Report Number	2007-CH-1009
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TO: Robert E. Nelson, Director of Public Housing Hub, 5FPH

FROM:  Heath Wolfe, Regional Inspector General for Audit, 5AGA

SUBJECT: The Boyne City Housing Commission, Boyne City, Michigan, Failed to Follow HUD's Requirements for Its Nonprofit Development Activities

HIGHLIGHTS

What We Audited and Why

We audited the Boyne City Housing Commission's (Commission) nonprofit development activities. The review of public housing authorities' development activities is set forth in our fiscal year 2006 annual audit plan. We selected the Commission because it was identified as having high-risk indicators of nonprofit development activity. Our objective was to determine whether the Commission diverted or pledged resources subject to its annual contributions contract (contract), other agreement, or regulation for the benefit of non-U.S. Department of Housing and Urban Development (HUD) developments.

What We Found

The Commission, under the direction of its former executive director, defaulted substantially on its contract when it improperly pledged resources for the benefit of the Boyne City Nonprofit Housing Corporation (Corporation) and the Boyne City Housing Commission Limited Dividend Housing Association Limited Partnership (Limited Partnership), organizations created by the Commission, without HUD approval. The Commission obtained two bank loans to purchase 13.47 acres of land. The loans' promissory notes included a provision that allows the bank to setoff the amounts owed on the loans against any and all accounts the

Commission has with the bank. As of April 2007, the Commission owed more than \$137,000 on the two loans.

The Commission failed to file a declaration of trust on the land to protect HUD's interest and to prevent a conveyance or encumbrance without HUD approval. It also did not obtain HUD's approval to sell 4.82 acres of the land at more than \$51,000 below fair market value. Further, the Commission managed Deer Meadows, a 30-unit senior housing project receiving Section 8 housing assistance from the Commission that the Limited Partnership owns and the Commission performed unit inspections, thus creating a conflict of interest.

We informed the Commission's executive director and the director of HUD's Detroit Office of Public Housing of minor deficiencies through a memorandum, dated July 11, 2007.

What We Recommend

We recommend that the director of HUD's Detroit Office of Public Housing require the Commission to amend its promissory notes to eliminate the setoff provision to prevent the seizure of the Commission's funds in case of default on the notes; file a declaration of trust on the remaining land to protect HUD's interest; reimburse the applicable program for the sale of part of the land at below fair market value, and the improper Section 8 administrative fees received related to Deer Meadows; contract with an independent third party to perform housing quality standards inspections of Deer Meadows as required by HUD; and implement adequate procedures and controls to address the findings cited in this audit report. We also recommend that the director refer the Commission's substantial default of its contract to HUD headquarters and request appropriate action be taken against the Commission.

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 discussion draft audit report to the Commission's executive director, its board president, and HUD's staff during the audit. We held an exit conference with the executive director on June 19, 2007.

We asked the executive director to provide comments to our discussion draft report by July 2, 2007. The executive director provided written comments, dated July 2, 2007. The executive director generally agreed with our findings and

recommendations. The complete text of the written comments, except for eight attachments that were not necessary to understand the comments, along with our evaluation of that response, can be found in appendix B of this report. We provided the director of HUD's Detroit Office of Public Housing with a complete copy of the Commission's written response plus the eight attachments.

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BACKGROUND AND OBJECTIVE

The Boyne City Housing Commission (Commission) is a public housing agency established by the City of Boyne City, Michigan (City), on January 30, 1967, with the responsibility of serving the need for affordable housing. The Commission entered into contracts with the U.S. Department of Housing and Urban Development (HUD) and the State of Michigan. Under its annual contribution contract (contract) with HUD, the Commission operates 80 units of subsidized housing in the City for its Public Housing program. Under a separate contract with HUD, the Commission manages a Section 8 Housing Choice Voucher (Section 8) program with subsidies for 60 vouchers for qualifying low- and moderate-income households. The Commission also manages a transitional housing program with four units through the Michigan State Housing Development Authority (Authority). Funds from HUD's Supportive Housing Program fund the transitional housing program.

On April 8, 1997, the Commission obtained approval from the City to waive its payments in lieu of taxes for the specific purpose of financing the purchase of land adjacent to its existing Public Housing development. The City's approval included a provision that the payments would resume once the financing was paid in full. In 1997, the Commission sent letters to HUD's Grand Rapids and Milwaukee field offices explaining the Commission's proposal to purchase the land by obtaining a bank loan(s) and use the funds from the waived payment in lieu of taxes to repay the loan(s). The Commission also disclosed its intention to use the waived funds in its (1) annual public housing agency plans for 2000 to 2003; (2) five-year plan for 2000; (3) annual plan updates for the years 2001, 2002, and 2003; and (4) annual audit reports for 1997 to 2005.

In a letter, dated June 6, 1997, HUD approved the Commission's proposal to use the waived payments; however, it expected the land would be added to the Commission's contract with HUD. The City amended its ordinance for the Commission in June 1997 by eliminating the payments as long as the land continued to be tax exempt. In July 1997, the Commission purchased the land (13.47 acres) by obtaining two promissory notes. As of April 2007, the Commission was using the funds waived by the City to pay the principal and interest on the notes with Huntington National Bank (Bank) (see findings 1 and 2).

During March 2000, the Commission submitted an application for a low-income housing tax credit development for seniors to the Authority. The Authority approved the application and offered a commitment in October 2000. The Commission formed both the Boyne City Nonprofit Housing Corporation (Corporation) and the Boyne City Housing Commission Limited Dividend Housing Association Limited Partnership (Limited Partnership). The Corporation is the general partner of the Limited Partnership and is also a nonprofit entity. Both the Corporation and the Limited Partnership are affiliated entities of the Commission.

The Limited Partnership owns Dear Meadows, the 30-unit senior housing development that receives Section 8 housing assistance. Dear Meadows is located on 3.62 acres of land that the Commission purchased (part of the 13.47 acres) and later sold to the Limited Partnership in November 2000 (see finding 2). Dear Meadows' construction was completed in December 2001. From initial occupancy in 2001 through June 2004, Dear Meadows was managed by an

independent management agent. The Commission initially obtained the services of the agent to setup the rent roll and manage Deer Meadows. In July 2004 after the management agreement expired, the Commission took over on-site management and started charging Deer Meadows monthly management and maintenance fees (see finding 3). The financial statements of the Limited Partnership are accounted for separately and audited separately on a calendar year basis by a different independent certified public accountant than that of the Commission.

A five-member board of commissioners, appointed by the City's manager, governs the Commission. HUD placed the Commission on its list of troubled agencies in 2006 after its fiscal year 2005 financial statements were received late and received no financial score. However, HUD reclassified the Commission as a standard performer on January 18, 2007, after acceptance of its fiscal year 2006 unaudited financial statements. The Commission's books and records are located at 829 South Park Street, Boyne City, Michigan.

Our objective was to determine whether the Commission diverted or pledged resources subject to its contract, other agreement, or regulation for the benefit of non-HUD developments.

RESULTS OF AUDIT

Finding 1: The Commission Substantially Defaulted on Its Contract When It Obtained Loans That Included Setoff Provisions

The Commission substantially defaulted on its contract when it obtained loans that contained setoff provisions. The Commission signed two promissory notes with the Bank to purchase the 13.47 acres of land. The notes included a setoff provision that allows the Bank to seize the Commission's accounts with the Bank if it defaults on the loans. The improper pledging of the Commission's accounts occurred because the Commission lacked adequate procedures and controls to ensure that it complied with its contract. As a result, the Commission's assets would be subject to seizure in the event of default and more than \$137,000 was due on the notes as of April 2007.

The Promissory Notes Included a Setoff Provision

In July 1997, the Commission signed two promissory notes with the Bank to finance the purchase of land adjacent to its existing elderly Public Housing project. The appraised value of the land was \$225,000; however, the Commission obtained two loans totaling \$240,000 for the land. The Bank financed the loans for \$15,000 more than the appraised value because the proposed use of the property was for community reinvestment purposes. According to the vice president and a handwritten note by the loan officer for the Bank, the planned improvements during the next five years would enhance the land value and the intended use of the property would benefit the City's low-to-moderate income residents. The Commission used the \$15,000 to pay expenses related to the land purchase.

Both loans were for five years with irregular interest and principal payments. The final payments for the loans were due in 2002. In October 2002, the Commission refinanced the loans to include fixed monthly principal and interest payments. The terms and conditions of the initial and refinanced promissory notes contained a setoff provision that allows the Bank to collect the amounts owed from all of the Commission's accounts, including accounts held jointly and any future accounts with the bank, if the Commission defaults on the loans.

The Commission's Accounts Are Subject to Seizure

The inclusion of the setoff provision in the terms of the promissory notes puts the Commission's assets at risk. As of April 30, 2007, the Commission owed \$137,079 on the two loans and had eight accounts with the Bank. Of the eight accounts, five were held jointly. The combined funds in the five accounts totaled \$91,845. Further, the Commission anticipates receiving more than \$411,000 in HUD funds (Public Housing, Public Housing Capital Fund, and Section 8) for fiscal year 2007. Upon receipt, these funds will be deposited in the Commission's accounts with the Bank. If the Commission defaults on the two loans, more than \$137,000 in HUD funds is subject to seizure as of April 2007.

The Commission Lacked Adequate Procedures and Controls

The improper pledging of the Commission's accounts occurred because the Commission lacked adequate procedures and controls to ensure that it complied with its contract. The former executive director said that he did not consider that the land purchase to be subject to the terms and conditions of the contract with HUD. Therefore, he did not submit the promissory notes to HUD for prior review and approval. As a result, the Commission's assets of more than \$137,000 are at risk of seizure and it would have fewer funds available to operate its various HUD programs in case of default on the loans.

If the Commission implements adequate procedures and controls to ensure compliance with HUD's contract, we estimate that \$24,000 will be protected from improper pledging of the Commission's accounts. We determined this amount by dividing \$240,000 (land purchase price) by 10 years (land purchased in 1997) and limited our estimate to one year to remain conservative.

Recommendations

We recommend that the director of HUD's Detroit Office of Public Housing require the Commission to

- 1A. Amend its promissory notes to remove the setoff provision or obtain new promissory notes without the provision to protect the Commission's assets from seizure to payoff the \$137,079 owed on the two promissory notes as of April 2007.

- 1B. Submit the revised or new promissory notes to HUD for review and approval to ensure that they comply with its contract.
- 1C. Implement adequate procedures and controls to ensure that its loan provisions do not include setoff provisions that subject the Commission's assets from seizure. These procedures and controls should help to ensure that an estimated \$24,000 is used appropriately for future land acquisitions.

We also recommend that the director of HUD's Detroit Office of Public Housing

- 1D. Refer the Commission's substantial default of its contract to HUD headquarters and request that appropriate action be taken against the Commission based upon the information in this audit report (see findings 1 and 2).

Finding 2: The Commission Did Not File a Declaration of Trust and Inappropriately Disposed of Project Assets

The Commission failed to file a declaration of trust on the 13.47 acres of land purchased in July 1997. Further, it inappropriately sold 4.82 acres (3.62 to the Limited Partnership in 2000 and 1.2 for a senior citizens center in 2005) at more than \$51,000 below fair market value. This noncompliance occurred because the Commission lacked adequate procedures and controls to ensure that it complied with its contract and HUD's regulations. As a result, HUD's interest in the remaining land, valued at more than \$194,000, is not secured, and fewer funds are available to benefit the Commission's residents.

The Commission Did Not File a Declaration of Trust

In July 1997, the Commission purchased 13.47 acres of land adjacent to its elderly housing project. To finance the land purchase, the Commission obtained two promissory notes totaling \$240,000 (see finding 1). It used the funds normally reserved for its payments in lieu of taxes to the City to pay the principal and interest payments on the two loans. As of April 2007, the Commission had not filed a declaration of trust on the land as evidence that it would not convey or encumber the property as required by its contract with HUD.

The Commission Improperly Disposed of Project Assets

The Commission sold 3.62 of the 13.47 acres of land for \$54,000 to the Limited Partnership in November 2000 without obtaining an appraisal to determine the fair market value of the land. According to the Bank's vice president, the amount paid by the Limited Partnership was based on an August 2000 appraisal value of \$215,000 for 9.85 acres of land and the minimum loan pay down amount needed to satisfy the Bank's loan-to-value analysis on the existing loans. Therefore, the purchase price of the land was established as \$54,000.

However, using the same August 2000 appraised value of \$215,000, which established the value per acre to be \$21,827 (\$215,000 divided by 9.85), we determined that the sales price of the land should have been at least \$79,015 (\$21,827 times 3.62). Therefore, the Commission sold the 3.62 acres of land for \$25,015 less than the 2000 appraised value (\$79,015 minus \$54,000).

Further, the Commission sold another 1.2 acres of land for \$1 for a senior citizens center in July 2005. Using the \$21,827 per acre appraisal, we determined that the value of the land should have been \$26,193 (\$21,827 times 1.2) not considering any increased value of the land since 2000 due to improvements made. As a

result, the Commission sold the 1.2 acres of land for \$26,192 less than the 2000 appraised value (\$26,193 minus \$1).

The Commission's former executive director said that he believed that since the land was purchased using the payments in lieu of taxes normally paid to City, the land was not subject to the terms and conditions of the Commission's contract with HUD. The Commission did not obtain HUD's approval to sell the land.

As a result, the Commission disposed of 4.82 (3.62 plus 1.2) acres of land for more than \$51,000 below fair market value (\$25,015 plus \$26,193). Further, HUD lacks assurance that the proceeds from the disposition or future use of the remaining 8.65 (13.47 minus 4.82) valued at more than \$194,000 will benefit the Commission's residents.

Recommendations

We recommend that the director of HUD's Detroit Office of Public Housing require the Commission to

- 2A. File a declaration of trust on the 8.65 acres of land valued at \$194,600 to safeguard HUD's interests and prevent future conveyances or encumbrances without HUD's approval.
- 2B. Submit the declaration of trust to HUD for its review.
- 2C. Reimburse its Public Housing program \$51,208 from nonfederal funds for the sale of the 4.82 acres at below fair market value.
- 2D. Implement adequate procedures and controls to ensure that it follows its contract and/or HUD's regulations regarding the filing of declarations of trust and the disposition of property.

Finding 3: The Commission Violated HUD's Section 8 Requirements Regarding Its Nonprofit

The Commission violated HUD's Section 8 requirements when it performed housing quality unit inspections of Deer Meadows. Also, it did not always perform timely annual unit inspections or maintain documentation to support that Deer Meadows' contract rents were reasonable. The improper unit inspections and lack of supporting documentation for rent reasonableness determinations occurred because the Commission did not have adequate procedures and controls to ensure that its Section 8 program met HUD's requirements. As a result, the Commission improperly received Section 8 administrative fees related to its nonprofit.

The Commission Created a Conflict of Interest

In December 2001, the Commission obtained the services of an experienced management firm to manage Deer Meadows after construction was completed. After the management agreement expired in July 2004, the Commission took over Deer Meadows' on-site management. The Commission charged its Limited Partnership monthly maintenance and management fees for managing Deer Meadows.

In addition to managing Deer Meadows, the Commission inspected its Section 8 housing units and was required to perform contract rent reasonableness reviews and rent negotiations. HUD's regulations at 24 CFR [*Code of Federal Regulations*] 982.352 require a public housing agency with its own housing or substantially controlled housing to use the services of an independent party approved by HUD to perform unit inspections before assistance can be provided. HUD also requires that contract rent reasonableness and rent negotiations be handled by the independent party. By failing to comply with HUD's requirements regarding unit inspections, rent reasonableness, and rent negotiations, the Commission not only violated HUD's requirements, but also created a conflict-of-interest relationship.

The Commission Did Not Perform Timely Inspections

The Commission did not always perform timely annual inspections of Deer Meadows' Section 8 housing units. For the 24 annual unit inspections reviewed for the period June 2006 to January 2007 related to Deer Meadows, 14 (58 percent) were not performed within 12 months of the previous inspection (range of from one to nine months overdue). According to 24 CFR [*Code of Federal Regulations*] 982.405, the Commission must inspect the unit leased to a family at least annually during assisted occupancy.

The Commission Did Not Maintain Rent Reasonableness Documentation

The Commission did not maintain the results of its rent reasonableness reviews for its nonprofit development. According to the Commission's assistant director, the Commission did not maintain copies of the rent reasonableness reviews for Deer Meadows as of May 2007. However, she said that the Commission will start maintaining the required documentation. Further, since the Commission managed Deer Meadows, there was no independent party to assist the households with rent negotiations to comply with HUD's regulations. Deer Meadows' contract rents were within HUD's fair market rent requirements as of May 2007.

The Commission's Procedures and Controls Had Weaknesses

The Commission lacked adequate procedures and controls to ensure that federal requirements were appropriately followed. Further, the Commission's board did not ensure that when the executive director retired in January 2006, there was sufficient staff to manage the Commission's daily operations. The Commission's assistant director, who was only employed part-time, became the interim executive director. In addition to managing the daily operations of the Commission, she was responsible for performing Deer Meadows' annual unit inspections. However, as of May 2007, she had received no training regarding performing housing quality standards inspections.

As previously mentioned, the Commission violated HUD's Section 8 requirements when it performed housing quality unit inspections while managing Deer Meadows. Also, it did not always perform timely annual inspections or maintain documentation to support rent reasonableness determinations. As a result, HUD lacks assurance of the reliability of the housing quality unit inspections and that contracted rents paid were reasonable.

The Commission had provided Section 8 assistance at Deer Meadows without an independent third party performing unit inspections and rent reasonableness reviews since it took over on-site management in July 2004. From July 2004 to April 2007 (34 months), the Commission paid more than \$186,000 in housing assistance and received \$31,434 in administrative fees related to Deer Meadows.

HUD's regulations at 24 CFR [*Code of Federal Regulations*] 982.152(d) state that HUD may reduce or offset any administrative fee to a public housing authority, in the amount determined by HUD, if the authority fails to perform its administrative responsibilities correctly or adequately under the Section 8 program. Given the Commission's substantial noncompliance with HUD's requirements, it should not

receive the Section 8 administrative fees. Additionally, unless the Commission improves its operations for the Section 8 program, we estimate that it could improperly receive \$11,094 (\$31,434 divided by 34 months) in Section 8 administrative fees for Deer Meadows during the next 12 months.

Recommendations

We recommend that the director of HUD's Detroit Office of Public Housing require the Commission to

- 3A. Reimburse its program \$31,434 in Section 8 administrative fees received related to its management of Deer Meadows.
- 3B. Implement adequate procedures and controls to ensure compliance with HUD's regulations regarding housing quality standards, rent reasonableness, and rent negotiations related to Deer Meadows. By implementing adequate procedures and controls, the Commission should help to ensure that \$11,094 in Section 8 administrative fees is appropriately paid related to Deer Meadows.
- 3C. Discontinue performing the housing quality standards inspections for Deer Meadows and contract with an independent third party to perform housing quality standards inspections, rent reasonableness reviews, and rent negotiations for Deer Meadows' Section 8 households to ensure compliance with HUD's requirements.

SCOPE AND METHODOLOGY

To accomplish our objective, we reviewed

- Applicable laws; regulations; HUD's program requirements at 24 CFR [*Code of Federal Regulations*] Parts 85, 941, 970, and 982; Office of Management and Budget Circulars A-87 and A-133; and the Internal Revenue Service's requirements at 26 CFR [*Code of Federal Regulations*] Part 1.
- The Commission's accounting records, operating budgets, general ledgers, bank statements and canceled checks, and check vouchers and invoices for fiscal years 1999 through 2006; promissory notes for 1997 and 2002; warranty deeds and property appraisals for 1997 and 2000; annual audited financial statements for fiscal years 1996 through 2005; annual contributions contract with HUD; by-laws; board meeting minutes; policies and procedures; and applications for financial assistance to the State of Michigan and the Federal Home Loan Bank.
- HUD's files for the Commission.
- The City's ordinance A-29 and applicable amendments.
- The Corporation's articles of incorporation, by-laws, and board meeting minutes; and accounting records, general ledgers, financial statements, and bank statements for fiscal years 1999 through 2006.
- The Limited Partnership's agreements, warranty deed, and annual audited financial statements and compilation reports for calendar years 2001 through 2005.

We also interviewed the Commission's current employees, board president, and its former executive director; HUD staff; the vice president for the Bank; and the county assessor for Charlevoix County, Michigan.

We performed our on-site audit work between September 2006 and May 2007 at the Commission's offices located at 829 South Park Street, Boyne City, Michigan. The audit covered the period October 1, 2004, through September 30, 2006, and was expanded as determined necessary.

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

INTERNAL CONTROLS

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,
- Compliance with applicable laws and regulations, and
- Safeguarding resources.

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.

Relevant Internal Controls

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

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

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 Weakness

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

- The Commission lacked adequate procedures and controls to ensure that it complied with its contract and/or HUD's regulations regarding the pledging of the Commission's assets, protecting of HUD's interest in property through a declaration of trust, disposition of real property, and receipt of Section 8 administrative fees related to its affiliated entities (see findings 1, 2, and 3).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A		\$137,079
1C		24,000
2A		194,600
2C	\$51,208	
3A	31,434	
3B		<u>11,094</u>
Totals	<u>\$82,642</u>	<u>\$366,773</u>

- 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 policies or regulations.
- 2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. In these instances, if the Commission implements our recommendations, it will remove the pledging of the Commission's assets, protect HUD's interest in property through a declaration of trust, and ensure that Section 8 administrative fees related to Deer Meadows are earned appropriately. Once the Commission successfully improves its controls over its pledging of assets and Section 8 administrative fees, this will be a recurring benefit. Our estimates reflect only the initial year of these benefits.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Boyne City Housing Commission
829 South Park Street
Boyne City, Michigan 49712
213-582-6203

RESPONSE TO AUDIT FINDINGS

July 2, 2007

Kelly Anderson, Assistant Regional Inspector General for Audit
United States Department of Housing and Urban Development
Officer of Inspector General
77 West Jackson Boulevard, Suite 2646
Chicago, Illinois 60604-3507

Subject: Response to Audit Findings

Dear Ms. Anderson:

Thank you and the Detroit Office of HUD staff for meeting with me to discuss the findings and possible options for response to the recommendations.

It is truly unfortunate to be meeting under such a dark cloud. The community and citizens we serve deserve better. I pledge to work diligently and earnestly with you to get the Boyne City Housing Commission back into compliance with HUD as soon as possible.

My response to the Audit Findings is below:

Finding 1: The commission substantially defaulted on its contract when it obtained loans that included setoff provisions.

I can find no argument with this finding. While the signed loans include setoff provisions, it appears the director and officers of the Commission did not comprehend the risk to the Commission's assets found in the language of the loans. In addition, I have found nothing to conclude harm to the Commission was expected or intended. It also appears adequate internal controls did not exist to prevent incidents of this nature regardless of the intent.

In response to the recommendations, the following measures are being taken to prevent an incident of this nature in the future.

- 1A. The bank has prepared an amendment to the loans that removes the setoff provision.
- 1B. The amendments will be signed the week of July 2nd and submitted to HUD immediately after execution.
- 1C. In order to provide internal controls to prevent such action in the future, a Checklist of Approval to Enter Into a Loan or Promissory Note Agreement will be developed and

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adopted by the Board of Commissioners by Resolution. The checklist will include the following items:

- Request for Loan Approval
- Reason for the Loan
- Verification by Notarized Signature of the Director and two Officers that the Loan Documents have been reviewed and contain no language that would put the Commission or its assets at risk.
- Verification by Notarized Signature of the Director and two Officers that the original Annual Contributions Contract with HUD has been reviewed, and entering into the loan will not violate the Annual Contributions Contract with HUD.
- Verification, by attachment of a letter to HUD (and certified mail receipt) that the letter requesting approval to enter into the loan was sent.
- Verification by attachment of the letter of response from HUD acknowledging receipt of the request and noting that any and all concerns or requirements from HUD have been adequately met and approval to enter into the loan agreement is given.

Any items that HUD may suggest will be added to the checklist. The checklist is a legal document that must be completed before any loan is taken out.

Language on the checklist will state the following:

1. Any officer that signs a loan agreement without the Certified Checklist may be removed from the Board of Commissioners.
 2. Any director that signs a loan agreement without the Certified Checklist will be disciplined up to and including termination from employment.
- 1D. The Commission respectfully requests the intent of the action be considered during deliberation to determine the fate of the Commission. While the action taken violated the ACC, it appears the action was not taken with malice, ill intent or self interest. If anything, it appears the former director may have led the Commission down a path taken in ignorance. While ignorance is not an adequate reason or excuse, it may serve as an explanation.

Finding 2: The Commission did not file a declaration of trust and inappropriately disposed of project Assets.

I can find no argument with this section of the finding. While the Commission did purchase the land in questions and did not file a declaration of trust as required in the Annual Contributions Contract, it appears the officers of the Commission were not adequately informed about the requirements of the Annual Contributions Contract. Most certainly I have found nothing to conclude the Commission was willfully and knowingly keeping information from HUD.

The Commission did sell 3.62 acres for less than appraised value for the purposes of building a Low Income Tax Credit property, Deer Meadows, to be used to provide much

Ref to OIG Evaluation

Auditee Comments

needed housing for low income seniors in the community. The Commission did also sell 1.2 acres for less than appraised value for the purpose of building a community wide Senior Center.

It appears that in both cases the Commission was not adequately informed about the requirement to obtain permission from HUD. In addition, the Commission believed that both sales were made for the purpose of community benefit. Most importantly, in this matter, it also appears the Commission did not willfully and knowingly keep information from HUD.

It is my understanding that 24 CFR 970.9 allows sales or transfers of property or land for less than market value for "community, commission or government benefit". Clearly both developments meet the criteria set down in 24 CFR 970.9. Attachments to this response demonstrate the need and benefit both developments have made to the community and to the Commission's residents.

It appears adequate internal controls did not exist to prevent incidents of this nature regardless of the intent. In response to the recommendations, the following measures are being taken and requests made.

- 2A. A declaration of trust is being prepared and will be filed on the 8.65 acres of land valued at \$194,600 to safeguard HUD's interests and prevent future conveyances or encumbrances without HUD's approval.
- 2B. Upon execution, the Declaration of Trust will be submitted to HUD.
- 2C. The Commission respectfully requests HUD consider the reason the land was sold for less than appraised value and rule the sales were made in compliance with 24 CFR 970.9. Because the conveyance of the property was made for community and resident benefit, not personal gain, the Commission also respectfully requests HUD waive the repayment request of \$51,208.
- 2D. In order to provide internal controls to prevent such action in the future, a Checklist of Approval to Transfer or Sell Property will be developed and adopted by the Board of Commissioners by Resolution. The checklist will contain the following items:
 - Request for HUD Approval to Dispose of Property
 - Reason for Disposition
 - Verification by Notarized Signature of the Director and two Officers that the sales or transfer documents have been reviewed and contain justification for the same.
 - Verification by Notarized Signature of the Director and two Officers that the original Annual Contributions Contract with HUD has been reviewed and that selling or transferring the property will not violate the Annual Contributions Contract with HUD.
 - Verification, by attachment of a letter to HUD (and certified mail receipt) that a letter requesting approval to sell or transfer the property was sent.
 - Verification by attachment of a letter of response from HUD acknowledging receipt of the request and noting that any and all concerns or requirements from

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Auditee Comments

HUD have been adequately met and approval to sell or transfer the property is given.

- A new Declaration of Trust has been sent to HUD.
- A copy of the executed Declaration of Trust is attached to the checklist.

Any items that HUD may suggest will be added to the checklist. The checklist will be a legal document that must be completed before and after any property is purchased or disposed of. Language on the checklist will state the following:

1. Any officer that signs an agreement to purchase or dispose of land without the Certified Checklist may be removed from the Board of Commissioners.
2. Any director that signs an agreement to purchase or dispose of land without the Certified Checklist will be subject to disciplinary action up to and including termination of employment.

Finding 3, Item 1: The Commission violated HUD's Section 8 requirements regarding its nonprofit.

Response to Item 1:

I can find no argument with this section of the finding. Apparently, when the Commission took over management of Deer Meadows a conflict of interest situation was created when HUD Regulation 24 CFR 982.352 became applicable.

HUD Regulation 24 CFR 982.352 requires a public housing agency with its own housing or substantially controlled housing to use the services of an independent party approved by HUD to perform unit inspections before assistance can be provided. HUD also requires that contract rent reasonableness and rent negotiations be handled by an independent party. Since the Commission took over management of Deer Meadows in July 2004, it appears Commission staff unknowingly performed all of the above tasks.

No evidence exists to conclude the Commission was aware of the rules and regulations stated in 24 CFR 982.352. Had they been aware of the regulations, most assuredly the situation would have been handled differently and the conflict of interest would not have occurred. It is unclear whether or not the former director was aware of the rules and regulations in this case. While ignorance of the law is no reason or excuse, it may serve as an explanation.

Finding 3, Item 2: The Commission did not perform timely inspections:

Response to Item 2:

I have found no argument with this section of the finding. There is no adequate excuse, reason or explanation for the annual inspections not being completed in a timely manner.

Finding 3, Item 3: The Commission did not maintain rent reasonableness documentation

Response to Item 3:

I can find no argument with this item of the finding. The Commission did not maintain the results of its rent reasonableness reviews for its nonprofit development. Even though the Commission did not arrange for an independent third party to help determine the rents for Deer Meadows, as required by HUD regulations, the rents at Deer Meadows are within HUD's fair market rents. The assistant director and Section 8 staff person reported that Rent Reasonableness was determined by looking in local newspapers for the nearest comparable units and rents. Although it is common for smaller housing authorities, or commissions, to use an informal system such as described, it is also common for organizations using this method to provide copies of newspapers made during the time of the rent determination. It appears no formal or informal system exists. If it does, it was not documented.

Finding 3, Item 4: The Commission's procedures and controls had weaknesses

Response to Item 4:

I can not argue with the fact that the Commission procedures and controls had weaknesses. Employees did not have much needed training. Professional materials such as the Nan McKay Section 8 Manual were not kept up to date. The Commission has now adopted an aggressive training schedule for employees, and subscribed to annual updates to critical manuals.

When the assistant director insisted she be allowed to drop to part time with full benefits in June of 2006, she assured the Board she could carry out the responsibilities of the position. She also threatened to quit if she was not allowed to take another job and reduce her hours at the Commission. The Board felt they had not choice but to allow her request. They even consulted with HUD staff about the situation.

During this same time, another half time person was hired. The assistant director was to train and monitor her work. In addition, many day to day activities of the Commission were handed off to the Housing Specialist. She did many tasks required of the position, including preparing the Annual Plan and CFP Budget. By no means were all of the day to day activities left to the part time assistant director.

Response to Recommendations:

3A. Rents at Deer Meadows were not increased for two years before the increase in 2007. Although no independent firm was contracted to help with setting the rents, the Deer Meadows rents are still below Fair Market Rent. I request you consider the additional information that all of Deer Meadows utilities are paid by management. The only cost to the tenant is telephone and cable. Each unit has a washer and dryer and the coin operated washer and dryers are free. Because of this fact, the electricity and water bills for the property were running higher than could be absorbed. The rent increase was designed to defray the excess cost of utilities.

It appears the reimbursement requested is a factor of the housing quality control inspections not being conducted by an independent third party. The Commission respectfully requests you consider the building is only 5 years old and the percentage of time spent on the housing quality inspections when requesting reimbursement.

Comment 1

The Section 8 administration fee funds approximately .50 full-time equivalent. It appears that an inspection at Deer Meadows takes approximately one hour. If two hours of pre-inspection preparation and two hour of post-inspection response and follow-up are added, an inspection could be given a value of time of five hours (plus or minus).

There are 24 Section 8 funded units at Deer Meadows. If inspection of each unit is given a value of 5 hours, the total would be 120 hours. A .50 FTE employee works 1040 hours a year. 1040 hours divided by 120 hours equals 11.5% of time. The calculated amount of Section 8 administrative fees related to the management of Deer Meadows during the time in question is \$31,434. $\$31,434 \times 11.5\% = \$3,614.91$.

- 3B. A system of quality control will be developed. Program staff will be required to submit an inspection and recertification schedule to the executive director. At the end of each month, each program staff member will be required to submit a report detailing monthly activity including required annual and interim re-certifications and inspections and a certification of rent reasonableness. Non-compliance will be grounds for disciplinary action up to and including termination.
- 3C. Current staff completed training in developing and maintaining rent reasonableness system on June 29, 2007. A formal rent reasonableness system will be developed and maintained. An independent third party will be secured to perform housing quality inspections; rent reasonableness review; and rent negotiations for Deer Meadows. Securing these services is expected to add additional cost to the Section 8 program, but all Conflict of Interest concerns will be nullified. In addition Section 8 staff will be sent to housing quality standards inspection training as soon as possible.

In conclusion, as you well know, most Commissioners are only as informed as the director keeps them. This Commission is no different. Trust was given and it appears trust may have been misplaced. I sincerely hope you will consider the intent of the Commission, the need that has been met over the years, and the many more needs to meet.

Thank you for the consideration you have shown during this difficult process.

Sincerely,



Sheila R. Smith
Executive Director

SRS

enc. Supporting Documents

cc David Brazier

OIG's Evaluation of Auditee Comments

Comment 1 Our recommendation for the reimbursement of the Section 8 administrative fees is based on: (1) the existence of a conflict of interest due to the Commission's failure to obtain an independent third party to perform housing quality standards inspections of Deer Meadows' housing units, (2) the lack of documentation to support the Commission's rent reasonableness reviews, and (3) the Commission's untimely annual unit inspections of Deer Meadows' Section 8 housing units. Since HUD has not issued a schedule that identifies the distribution of the Section 8 administrative fees applicable to such tasks as unit inspections and rent reasonableness reviews, our recommendation cites the entire administrative fees received by the Commission related to Deer Meadows.

Appendix C

FEDERAL REQUIREMENTS

Finding 1

Section 401 of the contract with HUD prohibits the Commission from using funds in its general fund for non-HUD development activities without prior HUD approval. Section 422 of the contract prohibits any bank loans from any source not specifically provided for under the contract with HUD.

Section 313 of the contract with HUD states: “Unless and until all temporary notes, advance notes, permanent notes, and all other indebtedness of the local authority to the public housing authority have been fully paid (except repayment of annual contributions), and all bonds issued in connection with the project have been fully paid and retired or monies, sufficient for the payment and retirement thereof in accordance with the terms of such bonds, have been deposited in trust for such purpose with the fiscal agent, the local authority shall not transfer, convey, assign, lease, mortgage, pledge, or otherwise encumber, or permit or suffer any transfer, conveyance, assignment, leasing mortgage, pledge, or other encumbrance of such project, any appurtenances thereto, any rent, revenues, income, or receipts there from or in connection therewith, or any of the benefits or contributions granted to it by or pursuant to this contract, or any interest in any of the same.”

Section 506 of the contract with HUD defines substantial default. Events of substantial default include the default of any of the provisions of section 313.

Finding 2

Section 420 of the contract with HUD requires that the Commission promptly execute and deliver a declaration of trust or similar document upon acquisition of the site of any project to protect the interests of HUD and to prevent a conveyance or encumbrance without expressed HUD approval.

Section 308 of the contract with HUD states that excess real property must be sold at public sale for not less than fair market value unless other disposition or method of disposition is approved by HUD.

Section 312 of the contract with HUD states that the project should include all real property therein which is acquired and held in connection with such project and all personal property, tangible and intangible, and interest therein which is acquired and held in connection with such project. All property, immediately upon acquisition by the local authority, shall become a part of such project and shall be subject to the terms, covenants, and conditions of this contract.

HUD’s regulations at 24 CFR [*Code of Federal Regulations*] 970.9 state that HUD may authorize negotiated sales for less than fair market value for reasons found to be in the best interests of the Commission, the federal government, or the community where permitted by state law.

Finding 3

HUD's regulations at 24 CFR [*Code of Federal Regulations*] 982.352 require a public housing agency with its own housing or substantially controlled housing to use the services of an independent third party approved by HUD to perform unit inspections before assistance can be provided. HUD also requires that contract rent reasonableness and rent negotiations be handled by the independent third party.

HUD's regulations at 24 CFR [*Code of Federal Regulations*] 982.405 state that the Commission must inspect the unit leased to a family at least annually during assisted occupancy.

HUD's regulations at 24 CFR [*Code of Federal Regulations*] 982.507 state that the Commission may not approve a lease until it determines that the initial rent is reasonable. The Commission must redetermine the reasonableness of the rent before an increase in the rent if there is a 5 percent decrease in the published fair market rent in effect 60 days before the contract anniversary or if directed by HUD. At all times during the assisted tenancy, the rent may not exceed the reasonable rent as most recently determined or redetermined by the Commission. The Commission must determine whether the rent to the owner is reasonable in comparison to rent for other unassisted units.

HUD's Housing Choice Voucher Program Guidebook 7420.10, chapter 9, page 9-11, requires the Commission to provide staff with written guidance describing how the rent reasonableness database will be maintained and how rent reasonableness determinations will be made and documented. Clear performance standards should be set, and there should be monitoring and quality control performed throughout the year with training and feedback regarding both good and inadequate performance.