AUDIT REPORT

HOUSING AUTHORITY OF THE

CITY OF LAKELAND

LAKELAND, FLORIDA

2004-AT-1013

AUGUST 19, 2004

OFFICE OF AUDIT, REGION 4
ATLANTA, GEORGIA

Table of Contents

audit report

Issue Date
August 19, 2004
Audit Case Number
2004-AT-1013

TO: Karen Cato-Turner
Director, Office of Public Housing, 4DPH

Milan M. Ozdinec, Deputy Assistant Secretary,
Office of Public Housing Investments, PI

Margarita Maisonet
Director, Departmental Enforcement Center, CV

James D. McKay

FROM: James D. McKay
Regional Inspector General for Audit, 4AGA

SUBJECT: Housing Authority of the City of Lakeland
Lakeland, Florida

We reviewed the Housing Authority of the City of Lakeland's (Authority) administration of housing development activities. We performed the review as a result of our audit of the Department of Housing and Urban Development's (HUD) oversight of Public Housing Agency (PHA) development activities with related nonprofit entities. The primary objective of our review was to determine whether the Authority diverted or pledged resources subject to an Annual Contributions Contract (ACC) to the benefit of other entities without specific HUD approval. This report includes one finding with recommendations for corrective action.

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

We provided a copy of this report to the Authority.

Table of Contents

Should you or your staff have any questions, please contact me at (404) 331-3369 or Bill Glover, Senior Auditor at (904) 232-1777, Extension 2160.

Executive Summary

We reviewed the Authority's administration of housing development activities. The primary objective of our review was to determine whether the Authority diverted or pledged resources subject to an ACC to the benefit of other entities without specific HUD approval.

The Authority violated HUD program requirements

We found the Authority paid at least $296,140 for ineligible expenses that were not authorized under its Housing Opportunities for People Everywhere (HOPE VI) Grant. This included $270,437 for legal fees and $25,703 for financial consultant fees. Also, the Authority failed to obtain timely repayment of $990,169 it advanced to the lead developer, The Communities Group (TCG). As of December 31, 2003, TCG still owed the Authority $704,542, which is at risk of nonpayment. On January 23, 2004, the Authority issued a Notice of Default to TCG for failure to adequately perform. The Authority assumed the role of lead developer for the remaining phases. However, the Authority has not demonstrated the capacity to serve as lead developer. Thus, we question whether the Authority has the capacity to complete its HOPE VI Revitalization Plan. Also, the Authority and TCG are currently involved in legal disputes that could affect completion of the remaining phases. We are also concerned as to whether sufficient funds remain to complete all the remaining phases and whether they can be completed timely. Accordingly, successful completion of the remaining phases of the Revitalization Plan and the remaining $7.6 million of Grant funds are at risk.

These actions occurred because the Authority did not have adequate controls to ensure Grant funds were spent only for eligible activities, the Authority did not timely enforce the terms of its Pre-Development Agreement with TCG, and because TCG failed to fulfill its responsibilities as specified in the Master Project Development Agreement, Pre-Development Agreement, and Lead Developer Agreement.

Table of Contents

Recommendations

Our recommendations include:

- Requiring the Authority to repay $296,140 to its HOPE VI Grant for ineligible legal and financial consultant fees. Repayment should be from non-Federal funds;

- Closely monitoring the Authority's attempts to recover the remaining $704,542 of the $990,169 due from TCG. Should the Authority fail to aggressively seek recovery, or should the Authority jeopardize its legal rights to recover the funds, require the Authority to repay the funds to its HOPE VI Grant from non-Federal funds;

- Performing a comprehensive review of the Authority's capacity and ensure the Authority takes appropriate measures to address any capacity issues to successfully complete activities in accordance with the Grant Agreement and Revitalization Plan. If your review determines the Authority has the capacity to function as the lead developer, issue formal written approval and take any other necessary steps to recognize the Authority as lead developer, in addition to its role as Grant Administrator.

- Performing reviews of all drawdowns of HOPE VI funds until HUD determines the Authority has the capacity to successfully complete activities in accordance with the Grant Agreement and Revitalization Plan. If HUD determines the Authority does not have the capacity to complete the activities, terminate the Grant and recapture the remaining $7.6 million, or current balance, of unused funds.

- Taking appropriate administrative actions against TCG, its principals, and any known related entities, including possible debarment actions.

Auditee comments

We discussed our review results with the Authority during our review and at an exit conference on July 15, 2004. We provided a copy of the draft report to the Authority on July 8, 2004, for their comments. The Authority provided written comments on July 26, 2004, and generally disagreed with the report. The complete text of the Authority's comments, along with our evaluation of the comments can be found in Appendix B of this report.

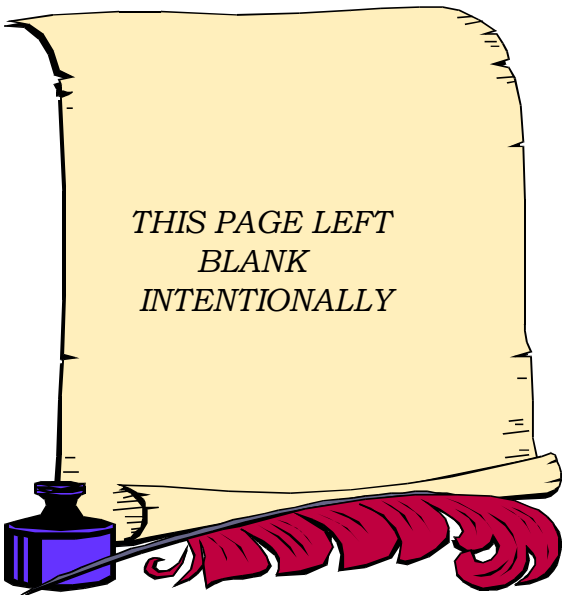
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Table of Contents

Abbreviations

ACC	Annual Contributions Contract
CFR	Code of Federal Regulations
HOPE VI	Housing Opportunities for People Everywhere
HUD	Department of Housing and Urban Development
LPHC	Lakeland-Polk Housing Corporation
LPHC2	Lakeland-Polk Housing Corporation 2

OIG	Office of Inspector General
OMB	Office of Management and Budget
PHA	Public Housing Agency
TCG	The Communities Group

Introduction

The Authority was organized by the City of Lakeland in 1939 under Florida Law. The Authority's primary purpose is to provide low rent housing for qualified individuals in accordance with the rules and regulations prescribed by HUD and other Federal Agencies.

A seven member Board of Commissioners governs the Authority. The Mayor of Lakeland appointed the Commissioners with the approval of the Lakeland City Commission. The Authority's Board of Commissioners appointed the Executive Director. During our review period, the Executive Director was Herbert Hernandez.

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

In August 1999, HUD awarded a $21,842,801 HOPE VI Revitalization Grant to the Authority. The Grant was for the redevelopment of two obsolete public housing developments, Washington Park Homes and Lake Ridge Homes consisting of a total of 380 units, and the surrounding Paul A. Diggs neighborhood. On February 28, 2000, HUD approved the Authority's procurement of TCG as its Developer Partner. On April 28, 2000, the Authority and TCG entered into a Lead Developer Agreement that provided various terms and conditions, including the responsibilities and the scope of work TCG would provide. The scope of work included, but was not limited to: implementation of the Revitalization Plan; detailed architectural and environmental work; construction financing, marketing; construction; and development of property management plan(s).

Under the HOPE VI Washington Ridge Revitalization Plan (Revitalization Plan), approved by HUD on May 29, 2001, all 380 public housing units would be demolished and replaced with 478 rental and home ownership units. The Revitalization Plan was to be accomplished in 11 phases. The original Revitalization Plan Budget included $21,842,801 of HOPE VI Grant funds and $48,271,791 of non-HUD funds to complete all 11 phases. The non-HUD funds included funds obtained from the syndication of Low Income Housing Tax Credits. HUD amended the Authority's ACCs to include the terms and conditions of the Mixed-Finance arrangements.

As of December 31, 2003, the Authority had expended about $14.2 million of the Grant Funds, leaving a balance of about $7.6 million. The Authority and TCG had completed construction of only the first three phases, Dakota Park, Magnolia Pointe (Lake View Gardens), and Renaissance at Washington Ridge. Occupancy of the rental units at Dakota Park and Renaissance at Washington Ridge and attempted sale of home ownership units at Magnolia Pointe was ongoing. Most of the remaining phases are in the early stages. In fact, no construction of units has started

at any of the other sites. The Dakota Park and Renaissance at Washington Ridge phases involved Mixed-Finance arrangements that included Low Income Housing Tax Credits.

As lead developer, TCG had primary responsibility, along with the Authority, for development of various phases in accordance with the Revitalization Plan. For several phases, the Authority was the Co-Lead Developer and was to receive a portion of the developer fees. Two of the phases, Dakota Park and Renaissance at Washington Ridge, involved owner entity partnerships. The individual who owns and controls TCG also exercises controlling interest, directly and indirectly, in both owner entity partnerships. These partnerships executed Regulatory and Operating Agreements with the Authority covering a period of 40 years. Thus, TCG and its affiliated partnerships not only played significant roles in ensuring the successful completion of the Revitalization Plan, but also have continuing interests in the subsequent operation of the developments. The Authority issued a Notice of Default and terminated its agreement with TCG on January 23, 2004, for failure to adequately perform. TCG's failure to adequately perform as the lead developer not only hampered completion of the Revitalization Plan, but its relationships and disputes with the Authority could affect future operations.

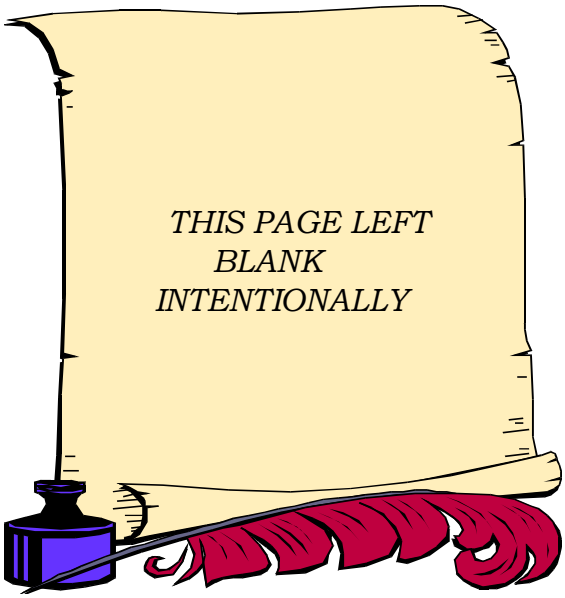
As Grant Administrator, the Authority was directly responsible for the overall management of the Grant. It was responsible for ensuring funds were used only for approved expenses and was responsible for protecting HUD's interest. HUD Headquarters and the Miami, Florida, Office of Public Housing were responsible for reviewing and approving various documents and for providing technical assistance, oversight, and monitoring of the grant. The Miami, Florida, Office of Public Housing performed annual monitoring reviews of the Authority's administration of the Grant.

Audit Objectives, Scope and Methodology

The primary objective of our review was to determine whether the Authority diverted or pledged resources subject to an ACC to the benefit of other entities without specific HUD approval. To accomplish our objective, we reviewed applicable HUD requirements and regulations, including the ACC, Title 24 CFR, Part 941, and the Authority's HOPE VI grant. We also reviewed Office of Management and Budget (OMB) Circular A-87, interviewed HUD and Authority staff, and reviewed various documents including financial statements, general ledgers, and minutes from Board of Commissioners meetings.

The review generally covered the period from August 1, 1999, to December 31, 2003. The review focused primarily on the Authority's housing development activities under its HOPE VI Revitalization Plan. We performed our fieldwork at the Authority's administrative offices located at 430 South Hartsell Avenue, Lakeland, Florida. We conducted

our review in accordance with generally accepted Government auditing standards. We performed the review from September 2003 to March 2004.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At Least $296,140 Paid For Ineligible Expenses And Over $8.3 Million Of Grant Funds At Risk

The Authority paid at least $296,140 for ineligible expenses that were not authorized under the Grant. This included $270,437 for legal fees and $25,703 for financial consultant fees. Also, the Authority failed to obtain timely repayment of $990,169 it advanced to TCG. As of December 31, 2003, TCG still owed the Authority $704,542, which is at risk of nonpayment. On January 23, 2004, the Authority issued a Notice of Default to TCG for failure to adequately perform. The Authority assumed the role of lead developer for the remaining phases. However, the Authority has not demonstrated the capacity to serve as lead developer. Thus, we question whether the Authority has the capacity to complete its HOPE VI Revitalization Plan. Also, the Authority and TCG are currently involved in legal disputes that could affect completion of the remaining phases. We are also concerned as to whether sufficient funds remain to complete all the remaining phases and whether they can be completed timely. Accordingly, successful completion of the remaining phases of the Revitalization Plan and the remaining $7.6 million of Grant funds are at risk. These actions occurred because the Authority did not have adequate controls to ensure Grant funds were spent only for eligible activities, the Authority did not timely enforce the terms of its Pre-Development Agreement with TCG, and because TCG failed to fulfill its responsibilities as specified in the Master Project Development Agreement, Pre-Development Agreement, and Lead Developer Agreement.

HUD requirements

OMB Circular A-87 establishes principles for determining the allowable costs incurred by State, local, and federally recognized Indian tribal governments (governmental units) under grants, cost reimbursement contracts, and other agreements with the Federal Government. To be allowable under Federal awards, costs must be necessary and reasonable for proper and efficient performance and administration of Federal awards. A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. The question of reasonableness is particularly important when governmental units or components are predominately federally funded. In determining reasonableness of a given cost, consideration shall be given to whether the cost is of a type generally recognized as ordinary and necessary for the operation of the governmental unit or the performance of the Federal award. Costs must be net of all applicable credits. Applicable credits refer to those receipts or reductions of expenditures that offset or reduce expense items allocable

to Federal award direct or indirect costs. To the extent that such credits accruing to or received by the governmental unit relate to allowable costs, they shall be credited to the Federal award either as a cost reduction or cash refund, as appropriate.

Both the Pre-Development Agreement and the Lead Developer Agreement between the Authority and TCG provided for advances of Grant funds to TCG for pre-development costs. The Authority was to advance TCG 75 percent of eligible pre-development costs that TCG incurred prior to the Mixed-Finance closing. TCG was responsible for paying the remaining 25 percent of pre-development costs. All amounts advanced to TCG were to be considered a loan. TCG was required to either repay the advances from proceeds received at the Mixed-Finance closing or the Authority was to receive a credit (offset) against its funding obligations for the project.

The Agreements between the Authority and TCG required TCG to, among other things: (1) establish and implement appropriate administrative and financial controls for the design and construction of each development including preparing financial reports and monthly progress reports; (2) maintain an accounting system that is in compliance with the requirements of the Grant; (3) repay advances for pre-development costs when financing closed for each project; (4) certify that all payments received to reimburse third-party costs were actually paid; (5) not make any expenditure or incur any obligation by or on behalf of the Owner entity or the Authority involving a sum in excess of $10,000 except as authorized pursuant to and specifically set forth in contracts approved by the Authority; (6) not assist in the preparation of tax credit applications in the State of Florida, for any other entity other than the Authority, and; (7) comply with all applicable laws, ordinances, orders, rules, regulations and requirements of all Federal, state, and municipal governments.

Title 24 CFR, Part 24, provides for Administrative Sanctions. Administrative Sanctions include limited denials of participation, suspensions, and debarments, which are discretionary actions that may be taken to protect the public interest.

The Authority had multiple roles

In addition to being the Grant Administrator, the Authority held other key roles pertaining to the development activities. The Authority was the co-lead developer for several phases, for which it was to be paid a portion of the developer fees from non-grant funds. The Authority was also a limited partner in the ownership entity for the Renaissance at Washington Ridge phase. An entity affiliated with TCG was the controlling General Partner of this ownership entity. Because of its dual roles, the Authority had multiple relationships with TCG - Grant Administrator, co-lead developer, and partner in an ownership entity. Further, the Authority helped establish and fund Lakeland-Polk Housing Corporation (LPHC), an affiliated non-profit entity. LPHC subsequently formed Lakeland-Polk Housing Corporation 2 (LPHC 2), a for profit corporation. LPHC 2 was a general partner in the Dakota Park ownership entity. The Authority's Executive Director was also the Executive Director of LPHC and the President of LPHC 2. LPHC and LPHC 2 relied almost exclusively on the Authority for funding, accounting, and management.

Ineligible legal and financial consultant fees

The Revitalization Plan and Grant Agreement included budgets that provided detailed line item expense amounts, as well as the sources of funds to be used to pay the various expenses. The budgets were updated throughout the execution of the Revitalization Plan and became the basis for controlling the Grant draws and disbursements. The Authority was not authorized to pay any expenses that were not specifically approved in the budgets. As Grant Administrator, the Authority was responsible for ensuring funds were used only for approved expenses and was responsible for protecting HUD's interest. The original budget approved by HUD projected total legal fees of $161,753 for all 11 phases that would be paid from Grant funds. The budgets included other legal fees that were to be paid using non-grant funds.

While the total HOPE VI Grant amount did not change, the Authority submitted budget revisions that increased the amounts for legal and consultant fees. The increases were reflected on its HOPE VI Revitalization Grant Quarterly Progress Reports. The Reports showed the current (latest revised) HOPE VI budget amounts by line item. Although HUD approved the budget revisions, which included increases for legal fees and financial consultant fees, HUD

Table of Contents

may not have realized these were for the benefit of related entities and not incurred by the Authority in its role as Grant Administrator.

As of December 31, 2003, legal fees totaled $643,409. Financial consultant fees totaled $137,960 as of September 30, 2003. We began reviewing the bills to determine eligibility. We reviewed legal expenses totaling $209,013, or 32 percent, and financial consultant fees totaling $39,995, or 28 percent. We then learned the Authority, along with its legal counsel, had already performed a review of the expenses. We verified the validity and reliability of their review results by (1) discussing the review with Authority personnel and Authority legal counsel to gain an understanding of the methodology and logic used for the review, (2) testing a sample of the results by comparing them with our results, and (3) reviewing the accounting records. We accepted the Authority's results as credible evidence directly related to our audit objective. Their review determined the Authority paid $270,437 for legal fees and $25,703 for financial consultant fees that should be reimbursed by the owner/borrower entity.

The expenses were not pre-development expenses that were to be paid by the Authority and later reimbursed. Rather, the expenses were incurred for the benefit of the owner entity partnerships. The expenses were to be paid from non-grant funds. However, because of the Authority's poor accounting controls, it paid the expenses from Grant funds. Further, the Authority had included the amounts in the Quarterly Progress reports, which became the basis for HUD's approval of the revised amounts. The documentation submitted to HUD, upon which it based its approval of budget revisions, did not clearly distinguish what the legal fees were for. However, they were not attributable to the Grant, thus they are not in compliance with OMB Circular A-87 requirements. The Authority should repay the funds from non-Federal funds.

Further, legal fees and financial consultant fees have continued to escalate during the past few months and will likely see substantial increases due to ongoing mitigation and potential litigation between the Authority and TCG. If the Authority continues to expend additional funds for legal and financial consultant fees, there will be less funds

available to pay other expenses necessary to complete all phases. As such, it is imperative that HUD closely review any such expenses to ensure not only that they are eligible to be paid from Grant funds, but also to assess the impact of the increased expenses on the overall budget.

TCG did not repay $704,542 it owed the Authority

The Mixed-Finance closing for the Renaissance at Washington Ridge phase occurred on December 23, 2002. At that time, the Authority had advanced $938,431 to TCG. At the closing, TCG received about $2.2 million. According to the Authority, TCG was to reimburse $636,447 of the advances from the closing proceeds.

Although TCG received substantial funding at the Mixed-Finance closing for the Renaissance at Washington Ridge on December 23, 2002, the Authority did not immediately require TCG to repay the advances. The Authority was reluctant to force the issue until the projects were completed because it was concerned that TCG would suspend construction work. Although the Authority made some attempts to get TCG to repay portions of the advances, its efforts were untimely and inadequate. It did not take actions to force repayment or initiate offsets until about May 2003. Subsequently**,** TCG repaid $285,627 to the Authority. However, TCG had not repaid the remaining $704,542 as of December 31, 2003. Further, TCG has disputed recent offsets of $652,804 made by the Authority, thus the outcome is uncertain. In the past, even when TCG agreed that it did owe a portion of the amounts advanced to it, it claimed that it did not have funds to make repayments. The ongoing disputes between the Authority and TCG and TCG's possible lack of funds, raise questions as to whether TCG will repay the $704,542.

Also, TCG failed to pay some vendors. According to the Lead Developer Agreement, TCG was to submit draw requests to the Authority to pay amounts owed to vendors for goods and services they provided. As TCG submitted each draw request, it was required to provide supporting documentation and certify that the Grant funds it received would be used to pay the vendors. Further, each time TCG submitted a draw request, it was required to certify that any amounts previously received pursuant to draw requests had been used to pay vendors.

TCG requested funds for some expenses which the Authority had already provided based on previous draw requests. Even though the Authority had already provided the funds, TCG did not pay some vendors. Subsequently, the vendors informed the Authority that they had not been paid. In order to prevent financial hardship to the vendors and prevent possible work stoppage, in May 2003, the Authority paid the vendors a total of $79,404 from its Grant funds. Recently, the Authority reclassified $27,666 (included in the total advances of $938,431 to TCG) as pre-development advances leaving a balance of $51,738.

Successful completion of the revitalization plan is jeopardized

Successful completion of the remaining phases of the Revitalization Plan is in jeopardy. HUD approval of the Revitalization Plan was based largely on TCG serving as the lead developer. Upon terminating TCG, the Authority assumed responsibility as lead developer. For the two current phases for which the Notice of Default relates, the Authority had assumed duties that should have been performed by TCG. However, we are not aware of any experience the Authority has as a lead developer. Past performance by the Authority as Grant Administrator and co-lead developer does not, in itself, demonstrate the capacity or ability of the Authority to successfully perform all the functions of a lead developer.

As previously discussed, legal and consulting fees have exceeded original budget amounts. Also, the Authority advanced funds to TCG and made payments for which TCG has not reimbursed the Authority. As such, Grant funds originally budgeted for other items have been reduced. The Authority has not demonstrated to HUD the source of funds that will be used to cover budget shortfalls that may occur as a result of the excess expenditures.

While the Authority notified HUD of many on-going problems and issues with TCG, we do not believe HUD is fully aware of all the potential issues facing the Authority and the future phases under the Revitalization Plan. For example, there are issues between the Authority and TCG that involve the non-grant funded portion of the Revitalization Plan that could have a significant negative impact on the Authority.

We are concerned the Authority may not be able to successfully perform as lead developer. Further, we believe the remaining $7.6 million of Grant funds are at considerable risk of being spent without adequate assurance of the successful completion of the remaining phases of the Revitalization Plan.

HUD needs to perform a comprehensive review

HUD needs to perform a comprehensive review to assess the Authority's capacity to perform as lead developer and whether sufficient funds remain to timely complete the Revitalization Plan. At a minimum, HUD should consider:

(1) The latest HOPE VI Quarterly Progress Report for the period October 1, 2003, to December 31, 2003, showed that there might be difficulties ahead in completing the remaining phases within budget or on time. The Authority has already expended large amounts for legal, financial consultant, and architect and engineering fees for the remaining phases. For some of the remaining phases, the Progress Reports reflect that the amounts expended are already at the budgeted levels. Most of the remaining phases are in the early stages. In fact, no construction has started at any of the sites. We question whether the amounts spent are reasonable given the status of completion. Further, the authority has indicated it plans to seek a 2-year extension to complete the HOPE VI Grant.

(2) Cost overruns for legal, financial consultant, and architect and engineering fees on the three completed phases may have been inappropriately charged to the remaining phases. By charging any cost overruns for the completed phases to remaining phases, the Authority would not have to request additional budget changes or increases for the completed phases, thus avoiding drawing HUD's attention to the costs overruns. However, if any cost overruns were charged to the remaining phases, there may not be sufficient HOPE VI funds to complete all phases. Further, the Authority continues to incur legal fees as a result of its mitigation with TCG. The Authority has included a comment on its Quarterly Progress Report for the period October 1, 2003, to December 31, 2003, that

Table of Contents

it needs more funds for legal fees. The Authority plans to either ask HUD for more funds for legal fees or for approval to reallocate within the existing budget expenses line items.

(3) Pending mitigation and potential litigation with TCG may impact the Authority's ability to focus on the remaining phases under the Revitalization Plan, and completing all remaining actions pertaining to the phases where construction is complete. For example, although construction was completed on the Magnolia Pointe home ownership phase in March 2003, the Authority has not sold any of the units.

(4) Since there is no longer a set-aside of tax credits for non-profit organizations, the Authority may have difficulty obtaining additional Low Income Housing Tax Credits needed to complete remaining phases that involve Mixed-Finance arrangements. To date, the Authority has not been successful in obtaining additional Tax Credits, and is now considering other funding arrangements to raise funds necessary to supplement the HOPE VI Grant funds. Also, without HUD's formal approval of the Authority as lead developer it is likely the Authority will experience increased difficulty in obtaining leveraged funding necessary for the completion of future phases.

(5) The proposed settlement agreement between TCG and the Authority does not provide any reimbursement to the Authority by TCG for professional fees or other costs the Authority incurred because of TCG's lack of performance. In fact, the agreement specifically provides that neither party will be responsible to the other for any professional fees with respect to the project or dispute resolution, including attorneys, accountants, or others. Further, the agreement seems to be primarily for the benefit of the two owner entity partnerships, not the Authority.

In performing its assessment, HUD should also consider any other factors that could negatively affect completion of the remaining phases.

Increasing risk to Grant funds already expended

The circumstances are further complicated by the on-going mitigation and possible litigation between the Authority and TCG. As previously discussed, TCG holds a controlling interest, directly or indirectly, in the owner entity partnerships. These partnerships executed Regulatory and Operating Agreements with the Authority covering a period of 40 years. As such, the Authority will continue to have a business relationship with TCG or its affiliates for 40 years. Due to the control that TCG and its affiliated entities continue to exercise over the owner entity partnerships, the unresolved issues and differences between the Authority and TCG may adversely impact the Grant funds that have already been invested. These conditions may also hamper completion of the remaining phases, as well as, lead to problems with the ownership entities throughout the life of the Agreements. For example, the Authority has already identified projected operating deficits for both the Dakota Park and Renaissance at Washington Ridge projects. Thus, the Authority intends to request a reduction in the number of public housing units under the Renaissance at Washington Ridge phase from 109 to 99 units, even though the HOPE VI funding was based on 109 units.

We believe HUD needs to closely review and monitor the ongoing situation to ensure HUD's interests and investments continue to be protected to the fullest extent possible. We recommend HUD review the various Agreements between the Authority, TCG, and its related entities for any provisions that would allow HUD to remove TCG and its affiliated entities from the owner entities.

TCG failed to fulfill its responsibilities as lead developer

The Authority's Notice of Default letters included citations of numerous breaches of the various agreements. For example, TCG obtained loans of $250,000 and $750,000 in the name of the Owner Entity Partnerships without the knowledge or approval of the Authority. Further, TCG inappropriately pledged interests in the Revitalization Plan projects as collateral for the loans during the time the loans were outstanding. Although TCG repaid the loans, it did not disclose them to HUD as part of the Evidentiary

Table of Contents

Documentation submitted to HUD for review in connection with the Mixed-Finance closings.

Further, obtaining the loans to fund development costs raises concerns about TCG's financial capacity to meet its financial obligations related to the developments. TCG's financial soundness and capacity were factors HUD considered when it approved the Revitalization Plan and approved TCG as the lead developer.

HUD should impose administrative sanctions against TCG

The problems with TCG have adversely impacted the execution of the Grant and have had a negative impact on the Authority. We believe TCG's failure to adequately perform and its violation of the various agreements warrants HUD imposing administrative sanctions. Such actions are increasingly important to protect the Secretary's interest since TCG, its affiliates, and/or principals are the lead developer for other developments with other PHAs.

Recommendations

We recommend the Director, Office of Public Housing:

1A. Require the Authority to repay the $296,140 to its HOPE VI Grant for ineligible legal fees and financial consultant fees. Repayment should be from non-Federal funds.

1B. Require the Authority to ensure that it properly allocates future legal and financial consultant fees and ensure the HOPE VI funds are used only for eligible expenses.

1C. Closely review and scrutinize future legal fees and financial consultant fees on a continuing basis.

1D. Closely monitor the Authority's attempts to recover the remaining $704,542 due from TCG. Should the Authority fail to aggressively seek recovery, or should the Authority jeopardize its legal rights to recover the funds, require the Authority to repay the funds to its HOPE VI Grant from non-Federal funds.

1E. Perform a comprehensive review of the Authority's capacity and ensure the Authority takes appropriate measures to address any capacity issues to successfully complete activities in accordance with the Grant Agreement and Revitalization Plan. If your review determines the Authority has the capacity to function as the lead developer, issue formal written approval and take any other necessary steps to recognize the Authority as lead developer, in addition to its role as Grant Administrator.

1F. Review the various Agreements between the Authority, TCG, and its related entities for any provisions that would allow HUD to remove TCG and its affiliated entities from the owner entities.

1G. Closely scrutinize the proposed settlement agreement between TCG and the Authority to ensure HUD's interests are protected.

1H. Monitor any actual settlement that occurs to ensure funds are returned to the HOPE VI Grant as appropriate.

1I. Closely monitor any other HOPE VI Grants in your jurisdiction that involve TCG or any of its affiliated entities.

We recommend the Deputy Assistant Secretary, Office of Public Housing Investments:

1J. Perform reviews of all drawdowns of HOPE VI funds until HUD determines the Authority has the capacity to successfully complete activities in accordance with the Grant Agreement and Revitalization Plan. If HUD determines the Authority does not have the capacity to complete the activities, terminate the Grant and recapture the remaining $7.6 million, or current balance, of unused funds.

Table of Contents

We recommend the Director, Departmental Enforcement Center:

1K. Take appropriate administrative actions under Title 24 CFR, Part 24 against TCG, its known affiliates, and their principals and take any other necessary steps to protect the interest of the Secretary.

Management Controls

Management controls include the plan of the organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include systems for measuring, reporting, and monitoring program performance.

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

- Compliance with Laws and Regulations – Policies and procedures that management has implemented to reasonably ensure that resources 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 by:

- Reviewing regulations and HUD policies and procedures governing HOPE VI Revitalization Grants;

- Reviewing the HOPE VI Grant, the HOPE VI Revitalization Plan, Evidentiary Documentation submitted to HUD as part of the Mixed-Finance closings, and other documentation as appropriate;

- Interviewing HUD and Authority officials and staff; and,

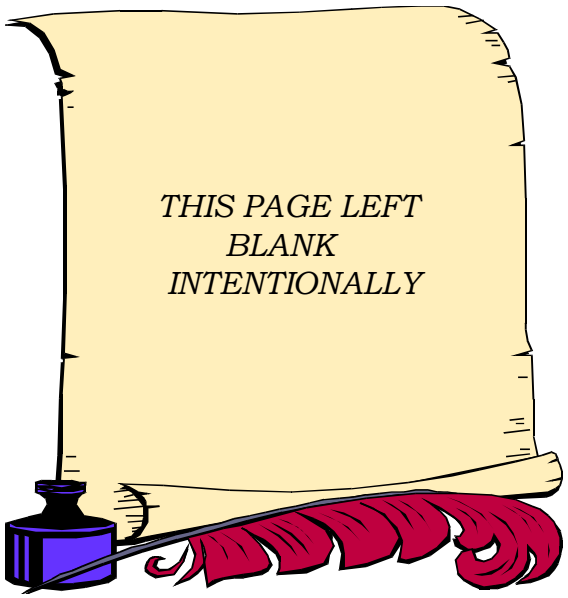
- Reviewing Authority financial and accounting records and reports.

A significant weakness exists if management controls do not provide reasonable assurance that resource use is consistent with laws, regulations and policies; that resources are safeguarded against waste, loss and misuse; and that reliable data are obtained, maintained and fairly disclosed.

Based on our audit, we identified the following significant weaknesses:

- Compliance with Laws and Regulations - The Authority paid at least $296,140 for ineligible expenses.

- Safeguarding Resources – Because the Authority did not timely enforce the terms of its Pre-Development Agreement with TCG, it placed $990,169 of its HOPE VI Grant funds at substantial risk.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Follow-Up On Prior Audits

This is the first Office of Inspector General Audit of the Authority's Housing Development Activities. The NCT Group CPA's, L.L.P. completed the most recent Independent Public Accountant audit of the Authority's financial statements for the 12-month period ended December 31, 2002, and provided an unqualified opinion. There were no findings or reportable conditions with relevance or impact to our audit objectives.

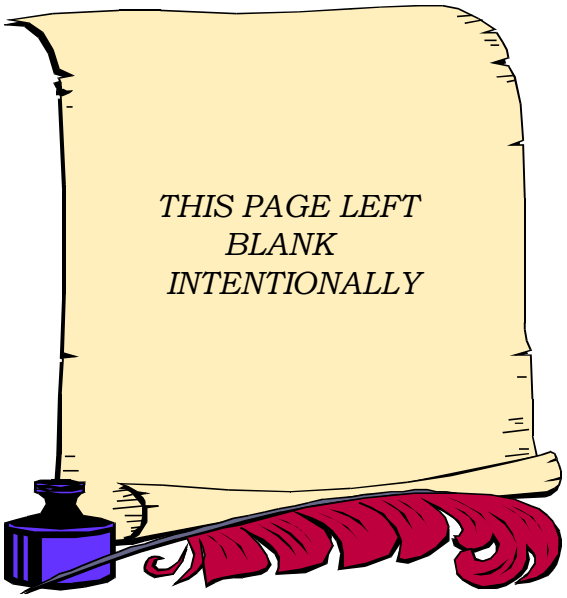


Table of Contents

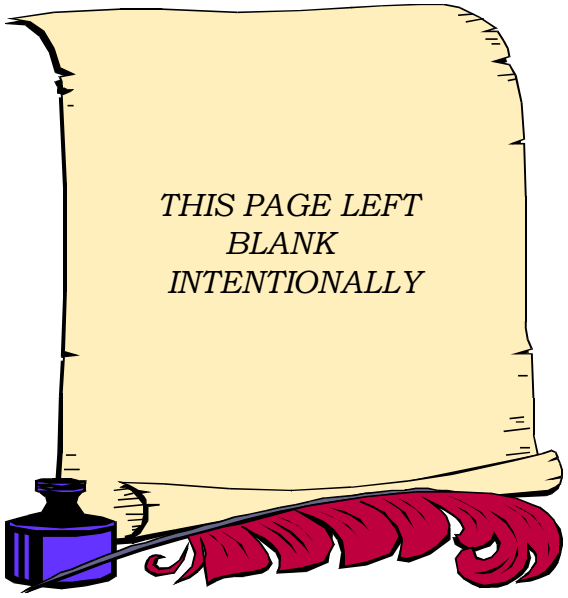
Schedule of Questioned Costs and Funds Put to Better Use

Recommendation Number	Ineligible 1/	Funds Put to Better Use 2/
1A	$ 296,140	
1D	$ $704,542	
1J		$ 7,600,000
Total	$ 1,000,682	$ 7,600,000

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 policies or regulations.

2/ Funds Put to Better Use are quantifiable savings that are anticipated to occur if an OiG recommendation is implemented resulting in reduced expenditures in subsequent period for the activities in question. Specifically, this includes costs not incurred, de-obligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

Table of Contents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Auditee Comments And OIG Evaluation

Ref to OIG Evaluation **Auditee Comments**

The Housing Authority of the City of Lakeland

July 26, 2004

Mr. James D. McKay
Regional Inspector General
U.S. Dept of Housing and Urban Development
Richard B. Russell Federal Building
75 Spring Street, SW, Room 330
Atlanta, GA 30303-3388

Dear Mr. McKay:

We have previously emailed to Bill Glover and Gerald R. Kirkland our response to the draft OIG audit report. A hard copy is also enclosed for your review.

Thank you for your consideration, and we look forward to clearing this finding immediately with the assistance of the Miami HUD Office.

Sincerely,

Herbert Hernandez
Executive Director

cc: Gerald Kirkland, Regional Inspector General, HUD, w/enclosure
William Glover, Office of Inspector General, HUD, w/enclosure
Karen Cato-Turner, Director, Office of Public Housing, HUD, w/enclosure
Jose Cintron, Development Coordinator, HUD, w/enclosure
Sam Crosby, LHA Chairman, w/enclosure
File

Table of Contents

AUTHORITY COMMENTS
TO DRAFT AUDIT REPORT

Following are the comments of the Authority to the draft audit report dated July 8, 2004 (the "Report"). The Authority requests that these comments be included in their entirety in the Report. Capitalized terms, not defined herein, shall have the same meanings ascribed to them in the Report. As a preliminary matter, the Authority would like to acknowledge that auditing HOPE VI grants can be difficult in that unlike other HUD Programs, HOPE VI is not driven by Handbooks, rules and clear guidance on all matters. A policy strength of the HOPE VI Program is that it permits creativity and new approaches that can vary by housing authority. We believe that the Authority administered its HOPE VI Grant in an appropriate manner and utilized creative approaches to ensure that the maximum amount of non-Federal resources were utilized. The Authority takes its reputation in our immediate community, with lenders, with funders and with HUD very seriously. The Authority also acknowledges that there were certain failures by the lead developer. The Authority maintains, however, that its actions to counteract those failures were appropriate and in furtherance of its and HUD's interests. There are some assertions in the Report that are not supported by facts and that are damaging to the Authority. The Authority is disappointed that some content of the Report was not agreed to be removed after the exit interview and seeks to clarify below the issues in question.

I. Finding

The Report focuses on one (1) finding which contains three (3) components, each of which will be commented upon by the Authority.

Comment 1

A. Professional Fees

The $296,140 that the Authority paid for legal and consulting fees that were characterized as "Part A" fees were eligible fees. All of the fees in question were:

- for the benefit of the Authority and not for the benefit of related entities (including owner entity partnerships), all of whom had independent counsel;
- incurred by the Authority in its role as Grant Administrator, lender, ground lessor, regulator and provider of operating subsidies;
- reasonable in relation to the services rendered in accordance with OMB Circular A-87; and
- expended in accordance with HUD-approved budget revisions.

Comment 2

Housing authorities routinely pay the professional fees which they incur in mixed finance closings out of HOPE VI Grant funds, and they typically appear as Part B expenses, as indicated on Exhibit F of the Mixed Finance ACC Amendment. These fees are often significant because the transactions are complex, housing authorities generally assume varied roles including Grant Administrator, lender, ground lessor and regulator, and these expenses are exacerbated where the developer is unable to effectively or efficiently carry out its responsibilities. What housing authorities do not regularly do, but what the Authority did here, was to seek reimbursement for its professional fees from the owner/borrowing entity. Since the Authority was a lender (and also provided substantial Grant funds outright), the Authority sought to have its expenses reimbursed just as the other lender, SunTrust Bank, had its fees reimbursed, and which is common commercial practice. The Authority had a specific right to seek reimbursement pursuant to Section 9.02 of its HUD-approved Loan Agreement in

Table of Contents

Renaissance. In order to determine what portion of the overall fees were reimbursable, the Authority in coordination with its outside professionals performed a detailed review of the expenses (the "Review"). This detailed accounting and ability to classify the fees as "Part A" expenses indicates that the Authority's accounting controls were quite sophisticated, and so there is no basis for the Report's determination that such accounting controls were poor.

Comment 3

The Professional Fees were Attributable to the Authority

The professional fees were all attributable to the Authority and in furtherance of its interests. Any challenge to the eligibility of the legal and consulting fees would necessarily require an in-depth examination of the bills themselves. There is no evidence in the Report that such an examination took place, and in the exit interview the auditor present acknowledged that the bills were not reviewed. Such a review would have indicated that the fees were in furtherance of the Authority's multiple roles (but all of these roles in its capacity as a housing authority) and were expended to carry out the Authority's fiduciary duty. In HOPE VI transactions, such fees are typically included in Part B expenses and therefore are paid out of public housing funds (and are not typically repaid). The fact that the Authority sought repayment from the developer for such fees should not change the determination that these are acceptable and eligible expenses. Rather, as a small housing authority with limited resources, the Authority was aggressive in seeking reimbursement of expended funds to ensure the ability to complete its development activities. The statement in the Report that the Review determined that $296,140 of the fees were "not attributable to the Authority" is wrong and without any basis. Rather, the Review determined that $296,140 of the fees were *reimbursable*. Simply because all of the reimbursement was not received during the audit period does not make the fees ineligible. (Approximately $100,000 of the fees were offset during the audit period for the Dakota Park project, and as part of its settlement with TCG as referenced below, the Authority will recover more than the balance from TCG).

Comment 4

The Professional Fees were Necessary and Reasonable

All professional fees incurred by the Authority were both necessary and reasonable. OIG provides no information, other than that the expenses were not for the benefit of the Authority (which, as discussed above, is incorrect), to make a finding that the expenses were not necessary and reasonable. As the Authority played an active role in the negotiation of the relevant closing documents, we believe the costs to be both necessary and reasonable and believe that a finding to the contrary should require some reasonable, articulated basis for such a finding and should further require that the Authority be provided an opportunity to respond to such a determination. As indicated in the Report, HUD reviewed and approved the legal fees. While the Report hypothesizes that HUD may not have had adequate information to make an appropriate determination of reasonability, HUD was informed of all budget modifications in the Authority's HOPE VI Quarterly Progress Reports and was informed that the expenses were re-assigned from Part B to Part A expenses. Furthermore, HUD routinely reviews such fees and so we believe that HUD is better situated than OIG to determine reasonableness. HUD made such a determination based on HUD's experience with the complexity of HOPE VI/mixed finance transactions and HUD's understanding of the multiple roles that housing authorities typically play in such transactions (one of the auditors, on the other hand, pointed out that this was his first HOPE VI review). Furthermore, HUD guidelines allow a line item variation in sub-accounts of a Budget Line Item so long as the Budget Line Item is not increased (the Authority received a letter from the Office of Urban Revitalization articulating this policy on July 3, 2003). The Authority complied with this policy. Again, the Authority has been provided no basis for a determination of unreasonableness and so a more in-depth justification by the Authority of reasonableness is impossible at this juncture.

Table of Contents

Comment 5

B. Predevelopment Costs

All Predevelopment Loans not Reimbursed by the Developer were Recaptured by the Authority

All predevelopment funds not repaid by the developer were recaptured through inclusion in the Authority's loan. Once again, there is a basic misunderstanding of the facts resulting in the Report criticizing the Authority for being more diligent than required. Under Section 10.1 of the Predevelopment Agreement between the Authority and TCG (which was approved by HUD), any predevelopment advance which TCG did not repay to the Authority at the mixed finance closing was to be treated as a loan between TCG and the Authority (this structure was acknowledged in the Report). Consequently, the entire $938,431 of predevelopment advances by the Authority to TCG could have been evidenced by a loan. Including the predevelopment loan in the construction loan is a common practice and approved by HUD on a regular basis in mixed-finance transactions. Nonetheless, the Authority chose to seek reimbursement for the entire amount.

Given that TCG had the responsibility as lead developer to handle the accounting/finance aspects of the projects, the Authority presumed that TCG would be able to provide the Authority with a reconciliation of funds from the mixed finance closings. The Authority did not initially realize that TCG's repeated delays to ongoing demands by the Authority for information related to project expenditures were due to TCG's lack of sufficient financial controls and accounting systems. Once the Authority established (through its own audit), the extent of the TCG problem, the Authority undertook to maximize recovery from TCG and to insure that the projects were completed on time. Both of which have been accomplished as a result of the Authority's accounting procedures and diligent oversight of the HOPE VI activities.

Comment 6

The $652,804 in Predevelopment Funds were Recaptured by the Authority through Inclusion in its Loan

The Report reflects the Authority's success in obtaining $285,627 in repayment of predevelopment advances to TCG during the audit period. The Authority also concurs with OIG that those remaining funds were to be recaptured by the Authority. However, the Report fails to acknowledge that what are described in the Report as "disputed recent offsets of $652,804" are in fact amounts that reduced the predevelopment advances as of December 31, 2003. The offsets of $652,804 were taken by reducing the Authority's disbursements under its Renaissance Loan Agreement, which is standard practice, as discussed above, and which was done in accordance with the above-referenced Predevelopment Loan Agreement so these funds were never at risk. In other words, as the predevelopment loans covered items that were included in the development budget, the Authority was able to record those amounts disbursed under the Predevelopment Loan Agreement as disbursements under the Renaissance Loan Agreement. In fact, the Renaissance Loan Agreement provided that any amount required to be disbursed under the Renaissance Loan Agreement that was not disbursed (after applicable notice periods) could "be deducted by the Lender from any undisbursed portion of the Loan Amount and treated as a disbursement under [the loan agreement]" (See Renaissance Loan Agreement, § 9.03). As the Authority had never disbursed the full amount of the loan, as the amounts disbursed under the Predevelopment Loan were included as expenses to be paid by the Renaissance Loan Agreement, and as the Authority retained the right to treat the $652,804 as a disbursement under the Renaissance Loan Agreement, such funds were never at risk. It should also be noted that the Authority exercised its right to

Table of Contents

treat the funds in question as a disbursement through a year-end closing of the Authority's books of account.

Comment 7

The $51,738 was Paid with non-Federal Funds

The $51,738 that the Authority paid to local vendors to avoid a work stoppage when TCG did not pay such vendors for their work were paid out of Section 8 administrative fees and so should not be classified as federal funds that are subject to repayment. As such, such payment should not be included in the Report. However, the Authority does agree with OIG that, as a factual matter, such payment by the Authority should be repaid by TCG. Since December 31, 2003, the Authority has entered into a settlement agreement term sheet with TCG, which will be more fully discussed below. As part of the settlement, all disputes with TCG are resolved, and in furtherance of the settlement, TCG has thus far, paid in excess of $500,000 to the benefit of the Authority and the projects. Therefore, in spite of the $51,738 having been paid out of non-Federal funds, the Authority has been able to recoup funds in excess of the $51,738 referenced above, further assuring that none of the funds cited in the Report are at risk.

C. The Authority as Lead Developer

Comment 8

The Authority has Exhibited the Capacity to Serve as Lead Developer

The Authority believes that it has more than sufficient capacity to serve as lead developer and believes that its ability to mitigate TCG's lack of experience is proof of such capacity. The Authority has provided HUD with detailed information as to why it has the demonstrated capacity to serve as lead developer. Rather than repeating all of that information here, the Authority highlights the following:

- without the Authority's leadership and management of the projects throughout all phases, the Dakota Park and Renaissance projects would not be quality projects which were completed on time;
- the projects were understaffed by TCG, so the Authority's staff had to fill the void;
- TCG assigned inexperienced staff to the projects, whereas, the Authority has a team of experienced professionals and staff;
- as a result of the Authority's intervention, in excess of $100,000 was saved on the Dakota Park project, and in excess of $400,000 was saved on the Renaissance project (through in-depth reviews of invoices, inspections of the work-sites and other activities in which the Authority played the de facto role of developer and construction manager);
- the Magnolia Pointe project was developed entirely by the Authority and is expected to meet its two (2) year timetable for all units to be sold, with the first closings scheduled for August, 2004; and
- Renaissance is already 70% occupied (even though the closing did not take place until December 2002) and Dakota Park is 95% occupied.

Table of Contents

Comment 9

The Authority's Development Capacity is Well Documented

The Authority's ability as lead developer has been further documented by the high marks it has received in other work it has done, during field inspections prepared by HUD's contractors from the U.S. Corps of Engineers. One of the many examples follows: "The HA [Authority] in essence acted as the general contractor and supervised the work. The Project Superintendent is a licensed architect and is very knowledgeable… The force account work is of exceptional quality… The files are well maintained. All the required information for each contract is available for review."

II. Impact on Future Phases

A. Costs for Completion

All Charges to Future Phases are Appropriate

Aside from the finding, the Report implies that cost overruns on the completed phases may have been inappropriately charged to the remaining phases. This is not the case. No overruns were charged to future phases, and again, no basis has been provided for a contrary assertion. In fact, to the extent that cost overruns occurred on the projects, they have been charged as receivables due from TCG or its affiliates to the partnerships in accordance with the various agreements amongst the parties. As part of the global settlement with TCG, these cost overruns will be paid.

Apportionment of costs to future phases only occurred to the extent that a future phase benefited from the work, and only after completing a detailed analysis of how to allocate the benefit. Thus, for example, demolition costs were spread over more than one phase because the demolition cleared the ground for all those phases. This structure is encouraged in the HOPE VI Program, as part of the budget setting process in which housing authorities create an overall budget and phase-specific budgets. Housing authorities are allowed to utilize any reasonable methodology to spread costs over multiple phases.

The Increased Professional Fees have not Jeopardized the Completion of the Revitalization Plan

A careful analysis of the fees in question indicate that such fees were utilized to help ensure that the activities in the HOPE VI Grant were carried out in an appropriate manner. The utilization of such fees has in no way jeopardized the successful completion of the Revitalization Plan. Again, OIG's failure to carefully analyze the bills results in erroneous and unjustified conclusions. As discussed above, one of the primary reasons that these fees have exceeded their initially budgeted amounts is that the Authority, from the inception, has played a far greater role in the redevelopment process than is typical for a housing authority to play – and in fact larger than the Authority originally anticipated, given that it had procured a private developer to manage many aspects of the project. Related to this increased role is also the legal and financial consultant guidance that became necessary as a result of the failures of the lead developer to meet certain of its contractual obligations, utilization leading to several default notices issued to the lead developer. The purpose of these default notices was not only to protect the Authority but also to protect the investment by HUD of HOPE VI funds. Compensation through the project budget (as discussed above) is one way that the Authority mitigated the effect of increased legal and consultant fees. And, through retention of experienced attorneys and consultants, the Authority has greatly strengthened its capacity to play the role of lead developer in future phases. It has also increased the amount of funds available to complete such phases; as developer, the Authority will be able to claim a development fee, which can be used to cover the increased administrative costs due to its more intensive role. With a private developer, those fees would be profits taken out of the project.

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Table of Contents

B. Expended Grant Funds at Risk

Expended Grant Funds are not at Risk

The Report states that already expended Grant funds are at risk and cites the fact that the Authority has considered reducing the number of units at Renaissance. The Report points to the fact that the Authority has requested lowering the number of public housing units in Renaissance from 109 to 99, even though the funding level was based on a greater number of units. According to the Report, this suggests that funds already utilized are at risk. Certainly, it is not desirable to come back to a closed phase and make such requests. However, the conclusion of jeopardy is inconsistent with the facts for the following reasons:

- Most importantly, no such request has actually been made, though the Authority has discussed it several times with HUD, both in DC and in Miami. Therefore, as such request was never formally made, it should not be contemplated in the Report;

- The primary reason such revisions were contemplated is operational -- the problem is caused primarily by the fact that HUD has severely under funded the Authority's operations.[1] Thus, TCG's original assumptions about the percentage of public housing units the project can support were unduly optimistic; and

- A lowered number of units (from 109 to 99 units) would continue to be within HUD's allowable Total Development Cost (TDC) and Housing Cost Cap (HCC) limits[2]. So, while the initial projections were unrealistic, the Authority could stay within regulatory requirements and not expend funds in excess of what is allowable even with the lower public housing unit projections.

The Authority will Complete a Sufficient Number of Units to Comply with Regulatory Requirements

Finally, on an ongoing basis, the Authority will have no problem completing the number of units that can be supported by TDC and HCC requirements. The problem has been the fact that the Authority and TCG proposed initially too many units for the given level of operational and construction funding. As HUD routinely allows housing authorities to amend their Revitalization Plan (and the Authority has, in fact, been given such permission verbally by HUD to reduce the total number of public housing units built and a written request is pending), the Authority is not placing federal funds at risk, but merely proposed too many public housing units for the level of funds awarded. In fact, if the Authority were to build the number of public housing units initially proposed, its leveraging of federal funds would be far in excess of what is typically seen[3]. The Authority's proposed modification to its Revitalization Plan will create two hundred more affordable units than initially proposed, albeit with a reduced number of public housing units (the Authority proposes to utilize Project-Based Section 8 to ensure continued affordability). As long as the Authority stays within regulatory requirements on per unit expenditures, we do not believe that federal funds can be deemed "at-risk".

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[1] In fact, the recently released Harvard Cost Study found that a reassessment of actual project expense levels would raise the Authority's operating subsidy by 55%. This represents one of the largest proposed increases in the nation.
[2] In fact, by "converting" up to ten (10) Public Housing Units, the Authority would remain under the following cost caps: (1) TDC; (2) HCC; and (3) Authority Percentage (in other words, Public Housing funds as a total percentage of Development funds), as calculated by either units or bedroom count.
[3] As measured by the fact that the TDC and HCC calculations would be well below regulatory maxima.

Comment 10

C. TCG Settlement

Following mediation in April, 2004, the Authority and TCG entered into a global settlement. The parties are in the process of implementing that settlement which they expect to be complete within sixty (60) to ninety (90) days.

When the settlement is completed, subject to HUD approval, the Authority will have accomplished the following in both the Dakota Park and Renaissance projects:

- all development costs will be paid in full;
- operating reserves will be fully funded;
- TCG will resign as general partner, to be replaced by the Authority; and
- TCG will have paid, net of any funds to be paid by the Authority, in excess of $550,000 over and above those amounts TCG has paid prior to December 31, 2003, and the total amount of funds that will either be (i) recaptured or (ii) repaid will be far in excess of those funds deemed "at-risk" in the Report (although we want to reiterate that the Authority has already complied with all federal requirements with regards to safeguarding federal funds).

Since the Authority has been able to fashion a settlement with TCG, there are no concerns about TCG impacting "the Authority's ability to focus on the remaining phases under the Revitalization Plan, and completing all remaining actions pertaining to the phases where construction is complete." To the contrary, being able to overcome tremendous obstacles demonstrates the Authority's determination and capacity to successfully complete activities in accordance with the Grant Agreement and Revitalization Plan.

Comment 11

Conclusion

The Authority agrees with OIG's findings that predevelopment funds not repaid by TCG should have been repaid. The Authority effectuated this repayment by operation of its HUD-approved loan documents and consistent with standard practice in HOPE VI transactions. As described above, at no time were federal funds at risk and therefore no finding is necessary or appropriate. Furthermore, the Authority believes that the professional fees in question were both necessary and reasonable. While the Authority acknowledges that the mechanism through which the Authority charged the professional fees to the partnership appears confusing to an outside observer, we want to reiterate that all of such fees were in furtherance of the Authority's interests and that the mechanism utilized was to the Authority's benefit. We also believe that as referenced in these comments, the Authority's ability to deal with a difficult development situation, its ability to safeguard federal funds, and its ability to ensure that the various referenced phases have been completed in a quality manner has illustrated a capacity to serve as lead developer. Finally, as articulated in these comments, the Authority has diligently protected its interests by entering into a settlement agreement with TCG that ensures that all funds due to the Authority are repaid.

We are concerned that OIG drew serious and reputation-damaging conclusions about the Authority which are not supported by specific facts as required by Government Auditing Standards. For example, OIG does not have any real reason to question the Authority's capacity as lead developer, but cites it nonetheless. In addition, OIG has concluded that legal and financial fees were not eligible without looking at what the work was. As indicated throughout these comments, the auditors have provided no

Table of Contents

showing of having obtained "[s]ufficient, competent and relevant evidence…to provide a reasonable basis for the auditor's findings and conclusions." (See Government Auditing Standards, §7.48 (June 2003 Revision). The auditors have not provided "credible evidence that relates to the audit objectives." (Id. at §8.13). Furthermore, the Authority has orally provided feedback to OIG's preliminary findings and has been told by OIG at the exit interview that OIG will likely not modify its Report based on the Authority's feedback. The Authority has been provided no basis for the auditors' unwillingness to modify such findings or to address the Authority's disagreement, as presented at the Authority's exit interview, over factual matters on which the findings are based (other than by inclusion of the Authority's comments in the Report). Note that auditors are instructed to "modify their reports as necessary if they find the comments valid". (Id. at §8.34). As the Authority believes that OIG has made findings related to the Authority that are inconsistent with factual matters, that the Authority has provided ample evidence to correct such factual inaccuracies, and that OIG has not provided any factual basis to support its findings as to the Authority, we believe that the Report should be modified to address the Authority's assertions and the factual inaccuracies inherent in the Report. Detailed information as to the factual matters asserted and summarized in these comments for the period ending December 31, 2003 have been provided to OIG (during the Audit review) and information for the audited period to the present is available upon request.

Table of Contents

OIG Evaluation of Auditee Comments

Comment 1

The Authority's comments acknowledge only some of the multiple roles it assumed. As discussed in our report, the Authority assumed other significant roles in addition to its role as Grant Administrator. These include co-lead developer and partner in one of the owner entity partnerships. Also, the Authority claimed that it relied on HUD's approval of revised budgets as authorization to charge increased professional fees to the Grant. The Authority continues to fail to recognize or acknowledge that expenses incurred for the benefit of related entities are not allowable under the grant. As stated in the report, we do not believe HUD realized these expenses were for the benefit of the related entities and not incurred by the Authority in its role as Grant Administrator.

The Authority's comment that each of the related entities had their own independent counsel is not totally accurate. For example, our review of LPHC and LPHC2 records showed that the Authority's legal counsel also provided legal services for the two related entities. This same firm, or members of the firm, are recorded as the Registered Agents for the related entities. Both of these related entities relied almost exclusively on the Authority for funding, accounting, and management.

Comment 2

Both during our audit and at the exit conference, the Authority's legal counsel (who is the recipient of a large portion of the legal fees we consider ineligible) attempted to emphasize the Authority's role as lender. The Authority's comments also discuss its role as a lender and seem to attempt to place the Authority on the same level as a bank. The Authority only loaned $2.2 million of Grant funds for the Renaissance project.

We agree the Authority has a legal right to seek reimbursement of professional fees from the owner/borrower entity. The expenses were for the benefit of the owner/borrower entity. As such, it supports our assessment that the fees were not eligible Grant expenses. We believe the Authority not only had a right to seek reimbursement, but also an obligation to do so since the funds were spent for ineligible purposes.

We do not agree that the complexity of mixed finance transactions justifies the level of professional fees incurred and paid by the Authority. We recognize these fees can be exacerbated where the developer is unable to effectively or efficiently carry out its responsibilities, and we recognize the Authority assumed additional responsibilities because of the lead developer's lack of performance. However, we believe some of the responsibilities the Authority assumed

represent an expansion of the co-lead developer role beyond that originally envisioned. We agree the Authority should collect the costs associated with these additional duties and responsibilities from the developer. However, because the costs were ineligible and the Authority should not have paid them, the Authority should repay the funds to its Grant whether or not it collects them from the developer.

Comment 3

The Authority is incorrect in its statement that an in-dept examination of the legal and consulting fees did not occur, and in its statement in the Conclusion section that OIG did not comply with Government Auditing Standards (GAS). GAS does not require that we examine 100 percent of the bills to reach our conclusion. We initially examined a sample of the bills and interviewed key Authority personnel to determine how the Authority allocated the bills and charged them to the various projects and entities. At the time of our review, legal fees totaled $643,409 of which we examined bills totaling $209,013 or 32 percent. Financial consultant fees totaled $137,960 of which we examined $39,995, or 28 percent. We then learned the Authority along with its legal counsel and financial consultant had already performed a review of the fees. We verified the validity and reliability of the results of this detailed review by (1) discussing the review with Authority personnel and Authority legal counsel to gain an understanding of the methodology and logic used for the review, (2) testing a sample of the results by comparing them with our initial sample results, and (3) reviewing the accounting records.

We accepted the Authority's results as credible evidence directly related to our audit objective, which is an accepted GAS auditing technique. While the Authority used the resulting dollar amount from its detailed review as the basis for seeking reimbursement, we used the results to reach our conclusion concerning the eligibility of these fees.

Comment 4

HUD's approval of budget revisions does not constitute a determination that the professional fees were eligible. HUD relies on the Grant Administrator to ensure expenses are eligible.

To be allowable in accordance with OMB Circular A-87, costs must be net of all applicable credits. Applicable credits refer to those receipts or reductions of expenditures that offset or reduce expense items allocable to Federal award direct or indirect costs. To the extent that such credits accruing to or received by the governmental unit relate to allowable costs, they shall be credited to the Federal award either as a cost reduction or cash refund, as appropriate. The Authority states that it has the legal authority to seek reimbursement for

Table of Contents

professional fees, and that it has taken action to seek reimbursement of $296,140, $270,437 for legal fees and $25,703 for financial consultant fees. Such a reimbursement constitutes the basis for an applicable credit discussed by OMB Circular A-87.

Based on the Authority's efforts to seek reimbursement, the Authority seems to agree that the expenses should not be borne by the Grant, but by the developer or the owner entity partnerships. We agree with the Authority on that issue. However, the Authority has not provided assurance that if it does receive reimbursement, it will return the funds to its Grant. Also, the Authority continues to fail to recognize that in its role as Grant Administrator it was responsible for ensuring funds were used only for authorized expenses.

Comment 5

The reimbursement the Authority is seeking is for expenditures it made as far back as December 2000. As stated in our report, the Authority did not have adequate controls, which resulted in the Authority paying the ineligible expenses. If the Authority had proper controls and accounting procedures in place, then the basis for the reimbursement would have been established much earlier.

The Authority's position that the entire $938,431 of predevelopment advances to TCG could have been treated as a construction loan between TCG and the Authority is moot. The Authority has not provided documentation to support that there was ever a construction loan between TCG and the Authority. The primary method for handling the advances, as provided in the Predevelopment Agreement was for the advances to be considered a loan (but not the construction loan discussed by the Authority) that would be repaid at the time of Mixed-Finance closing or credited to the Authority's obligation to fund the project. The Authority's suggestion that a construction loan could have been executed between TCG and the Authority to cover the outstanding advances has no bearing on what actually happened. The fact remains that the Authority did not take any of the possible actions provided in the Predevelopment Agreement in a timely manner. As such, the funds remain at risk.

Comment 6

We do not agree with the Authority's position that the $652,804 was never at risk, or that the recent offset has fully satisfied this outstanding advance. The $652,804 was disbursed (advanced) for the specific purpose of paying the corresponding pre-development expenses. Disbursement of the funds resulted in the funds being outstanding and thus at potential risk at that point in time. Since the advances were allowable under the Predevelopment Agreement, the risk would have been considered minimal and acceptable if the Authority had adequately enforced the terms of the Predevelopment Agreement.

The Authority claims it made accounting entries and adjustments on its books to treat the $652,804 as an offset. However, the proposed settlement agreement between TCG and the Authority, does not clearly address the $652,804, or whether TCG is in agreement with the offset. We have other concerns with the settlement agreement, which we discuss in our Comment 10.

Comment 7

The Authority now claims the $51,738 it paid local vendors was paid from Section 8 administrative fees and that it has recouped funds in excess of this amount. This position is contrary to the explanations the Authority provided us during the audit. Upon our questioning the source of funds, the Authority's Director of Operations and Finance told us, and confirmed in writing, that the Authority made the payments from HOPE VI funds. Further, according to its accounting records, the Authority charged the expenses to the HOPE VI grant. The Authority did not provide support for its claim that it has recouped funds in excess of the $51,738.

Comment 8

Our draft audit report recommended HUD perform a comprehensive review and make a determination as to the Authority's capacity to function as lead developer. Thus, it is appropriate that the Authority provide detailed information to HUD for their review so that HUD can begin its assessment.

We cannot attest to the Authority's assertion that it has saved over $500,000 on two mentioned projects by its intervention. If the Authority played the de facto role of developer and construction manager because of the developer's lack of performance, it should be compensated for its efforts with a developer's fee to be paid from non-Federal funds. TCG should pay the Authority for any duties it had to undertake because of TCG's failures.

The Magnolia Point project was completed in March 2003, but the Authority has not sold any of the units. The Authority cites development of the project as an example of its capacity to serve as lead developer. We do not believe this is a successful development since the units have sat vacant for over 16 months. Since the units have not been sold, the Authority has forgone the expected sales revenue that was to be used for other phases of the Revitalization Plan. This delay has also deprived low and moderate-income families of the opportunity to purchase these affordable housing units at a time of historically low mortgage interest rates.

Table of Contents

Comment 9 The Authority provided several comments concerning completion of future phases of the Revitalization Plan. It claimed that all charges to future phases are appropriate, increased professional fees have not jeopardized completion of the Revitalization Plan, grant funds are not at risk, and a sufficient number of units will be completed to comply with regulatory requirements. As future phases were not in the scope of our audit, we did not reach any definite conclusions in our report. We included examples of areas of concern in the report based on the information available to us at that time and expressed our concerns and opinions for the purpose of advising HUD that it needs to consider the issues in its review. For example, the Authority argues that our draft report stated that the Authority had requested to reduce the number of units in Renaissance from 109 to 99. For clarification, we did not say that such a request had been made, only that the Authority intended to make the request, which the Authority recognizes in its comments. We did not perform an assessment as to what, if any, effect this might have on the Revitalization Plan. However, given this issue and the other concerns raised in the report, the significant amount of remaining unused HOPE VI funds, and the importance of the Authority's Revitalization Plan for all interested parties, we believe it is imperative that HUD perform a comprehensive review to ensure the Authority can successfully complete the remaining phases. Hopefully, HUD's assessment will resolve our concerns and the goals of the Revitalization Plan will be met. If not, HUD must protect its interest by terminating the Grant.

Comment 10 The Authority and TCG continue to attempt to resolve their disputes. After completion of our fieldwork, the Authority provided us a copy of a proposed settlement agreement. The Authority claims that once the settlement is completed all development costs will be paid in full and TCG will have paid in excess of $550,000 over and above those amounts paid prior to December 31, 2003. The Authority also claims there will be no impact on its ability to focus on future phases. First, we must emphasize that HUD has not approved the agreement, and as far as we are aware, no resolution has actually occurred. Thus, neither the Authority nor the OIG knows what, if any, settlement will actually occur. Further, the Authority inevitably will continue to have to focus resources, including funds for legal fees, to resolve the disputes until a settlement is approved. We did not perform a comprehensive review of the proposed agreement. However, based on our limited review, we are concerned that the agreement does not provide any reimbursement to the Authority by TCG for professional fees or other costs the Authority incurred because of TCG's lack of performance. In fact, the agreement specifically provides that neither party will be responsible to the other for any professional fees with respect to the project or dispute resolution, including attorneys, accountants, or others. Further, the agreement seems to be primarily for the

Table of Contents

benefit of the two owner entity partnerships, not the Authority. HUD should closely scrutinize the proposed agreement to ensure its interest is protected before granting approval. Further, HUD should monitor the actual settlement to ensure funds are returned to the HOPE VI Grant as appropriate. We added recommendations to the Finding to address these issues.

Comment 11

Our report accurately presents the facts we found during our review, are adequately supported, and represent valid conclusions and concerns. At no time were we unwilling to modify the findings if appropriate based on the Authority's comments. The Authority did not provide any information at the exit conference that justified making changes to the report, which we communicated to them at that time. Conversely, had the Authority provided information warranting revisions at the exit conference, we would have communicated to them that we would make appropriate changes. We informed the Authority its complete written comments would be included as part of the final report as well as our responses to the comments. Inclusion of the Authority's complete written comments in the final report is assurance that the reader has full knowledge of the Authority's position.

We reviewed the Authority's written comments and made appropriate changes to the finding. For example, based on the Authority's comments that we drew serious and reputation-damaging conclusions that were not supported as required GAS, we added additional clarification on our methodology. While we do believe the issues in the Finding are serious, we did not intend to damage the Authority's reputation. We understand the Authority is in a difficult position because of TCG's lack of performance. However, the fact remains that the events discussed in our report did occur and at least to some extent, could have been prevented or minimized if the Authority had taken appropriate steps sooner. The Authority knew, or should have known TCG was not adequately staffed, it did not pay its predevelopment loan after the closing, and it did not pay some vendors. The Authority should have taken quick action that might have helped mitigate some of the resulting difficulties.

Table of Contents