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TO: William Rotert, Director, Office of Community Planning and Development, 7D
Wayne Cauthen, City Manager, City of Kansas City, Missouri

/signed/
FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

/signed/
Mark Funkhouser, City Auditor, City of Kansas City, Missouri

SUBJECT: The City's Housing Program and the Role of the Housing and Economic Development Financial Corporation, City of Kansas City, Missouri

HIGHLIGHTS

What We Audited & Why

The HUD Office of Inspector General and the City Auditor have issued two previous joint reports on Kansas City's housing programs. The first, *Special Report: Kansas City Needs a Housing Policy* (April 2000), assessed the City's overall approach to providing affordable housing. The second, *Review of Subrecipient Selection, Monitoring and Reporting* (July 2001), evaluated the City's methods for administering HUD funds in accordance with applicable rules. The reports recommended the City develop a housing policy, including strategies and goals, develop mechanisms for gathering information on housing conditions, and strengthen processes for selecting and monitoring subrecipients.

Our prior work raised concerns about the Housing and Economic Development Financial Corporation (HEDFC), the City's largest subrecipient of federal housing funds. Consequently, our original objective for this audit was to determine whether HEDFC is using grant funds efficiently and effectively. However, while planning the audit we concluded that the City continued to face problems we found in our previous audits. Therefore, we expanded our audit scope to review the City's overall system for implementing housing policy and HEDFC's role

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within the system. Accordingly, our sub-objectives were to answer these questions:

- What is the City's system for implementing housing policy?
- What is HEDFC's role in the system?
- How well has HEDFC carried out its role in the system?
- Could changes in the system improve the City's performance and ability to meet its housing goals?

What We Found

The federal government, City government and non-governmental agencies each play a role in the City's housing system, but no one party controls spending decisions or is held accountable for housing production or meeting other goals. The City spends a lot of money on housing – in fiscal year 2003 the Department of Housing and Community Development paid vendors and contractors over $34 million – but the outcomes of the City's investment are not readily apparent. The City's failure to set measurable objectives and its fragmented system for administering housing funds contribute to higher than necessary administrative costs; lack of information; poor communication; delays; and lack of accountability for poor performance.

In addition, the City has failed to adequately define HEDFC's role in providing affordable housing. The scopes of work in the City's contracts with HEDFC are broad and the performance standards are vague. Consequently, the City's Housing and Community Development Department – which is responsible for overseeing the contracts – and HEDFC have disagreed about whether expenditures or activities are appropriate. By entering into vague contracts the City cedes decisions about use of public funds to HEDFC and cannot fulfill its responsibilities as a recipient of federal grant funds.

There are significant deficiencies in HEDFC's operations: HEDFC lacks processes for tracking and reporting operational and financial information; its computer systems aren't integrated; duplicate data are entered into several systems, which staff does not reconcile; HEDFC's policies and procedures don't address tracking and reporting information about the different types of loans or projects; supporting documents for construction loans were not readily accessible, files contained multiple copies of some documents, while some files and documentation were missing altogether. We also found errors in the single family production report presented to the Board and in a loans closed report prepared for us. These deficiencies contribute to poor system performance and a lack of assurance that the City is getting the best results for its money. Since HEDFC is an integral component of the City's housing program, financial and operational problems result in not just underperformance for HEDFC, but for the system as a whole.

The City needs to change its system to improve its ability to address housing needs. A number of studies in recent years – including our previous joint audits – have made recommendations to improve the City's processes for administering housing funds and HEDFC's internal processes. However, serious problems remain. We believe that the problems are systemic and cannot be solved without addressing the system as a whole. The City should redesign its structure to simplify administration, reduce administrative costs, and improve performance and accountability.

What We Recommended

We recommend that the City Manager reevaluate and revise the city's processes for developing housing policy and administering housing funds. The City Manager should consider bringing some of the functions in-house and competitively award the remaining services. At a minimum, the City's process should:

- Identify and address housing needs using the housing condition study performed by the University of Missouri – Kansas City, or a similar effort.
- Establish measurable goals and objectives.
- Base funding decisions on specific, pre-identified needs.
- Track and report annual progress in meeting the housing goals.
- Incorporate specific scopes of work, goals and measurements in all contracts.
- Develop monitoring procedures that ensure all entities receiving funding are held accountable for meeting specific objectives.
- Identify and "in-source" all functions that City staff can efficiently perform.
- Competitively award all services not performed in-house.

The City Manager should also require HEDFC to repay the $900,000 in Beacon Hill program income it used without authorization and to repay the $600,000 balance of the Westside Business Park Section 108 loan.

We recommend that the Director of HUD's Office of Community Planning and Development ensure the City develops and implements the procedures necessary to ensure an effective and efficient housing program, and recovers from HEDFC the $900,000 in Beacon Hill program income it used without authorization and the $600,000 balance of the Westside Business Park Section 108 loan.

Findings and Recommendations Discussed

We provided discussion drafts of our audit report to the City Manager, the president of HEDFC, and the regional director of HUD's Office of Community Planning and Development; and held exit conferences with HEDFC and the City Manager on July 6, 2004 and July 27, 2004 respectively. HEDFC and the City Manager provided written comments to our findings on July 12, 2004 and July 14, 2004 respectively. We revised the report where appropriate based on their comments. The complete text of the comments and our evaluations of those comments are contained in Appendices C and D.

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BACKGROUND

The City receives funds for housing and community development from the U.S. Department of Housing and Urban Development (HUD). The City uses the funds to assist eligible individuals to obtain housing; to construct or rehabilitate affordable housing; to redevelop blighted neighborhoods; and to create business and employment opportunities. The City's Department of Housing and Community Development administers housing funds on behalf of the City, primarily by contracting with not-for-profit agencies. The Housing and Economic Development Financial Corporation (HEDFC) is the City's largest subrecipient of housing funds.

HEDFC is a not-for-profit organization incorporated in Missouri to receive and administer funds primarily to combat community deterioration and to secure adequate housing. HEDFC was formed in 1997 through a merger of the Housing Development Corporation and Information Center (HDCIC) and the Rehabilitation Loan Corporation (RLC). HEDFC's articles of incorporation provide for designing, constructing, repairing, remodeling and removing structures; conducting housing related research; providing technical assistance to not-for-profit corporations; making loans or grants; acquiring, maintaining, managing, selling or transferring real or personal property; entering into contracts; borrowing or raising money; and investing its funds. A nine-member Board of Directors governs HEDFC. Board members serve 3-year terms. Successors are nominated and elected by the Board. By-Laws require a majority of Board members to be residents in investment areas, or members of targeted populations eligible to receive benefits of the corporation's programs, but who are not direct or indirect recipients of program benefits.

HEDFC, or its predecessor organization HDCIC, has been the City's designated subrecipient of federal housing and community development funds for 29 years. The City contracts with HEDFC annually to provide loans and grants to eligible homebuyers; loans and grants for construction and rehabilitation of affordable housing; and economic development services. The City provided HEDFC with $52.2 million in fiscal years 2001 through 2003.[1]

Exhibit 1. City Payments to HEDFC June 1, 2000, through May 31, 2003

Fund	2001	2002	2003
Economic Development Initiative	1,775,329	2,972,912	4,507,672
Section 108 Loan Guarantee	3,449,837	6,502,437	14,896,689
CDBG	1,683,406	4,652,907	2,262,580
HOME	2,618,528	4,135,242	2,752,399
Total	9,527,100	18,263,498	24,419,339

Source: City's financial system.

Exhibit 2. City Payments to HEDFC by Fund 2001-2003

[1] HEDFC's fiscal year runs from June 1 through May 31.

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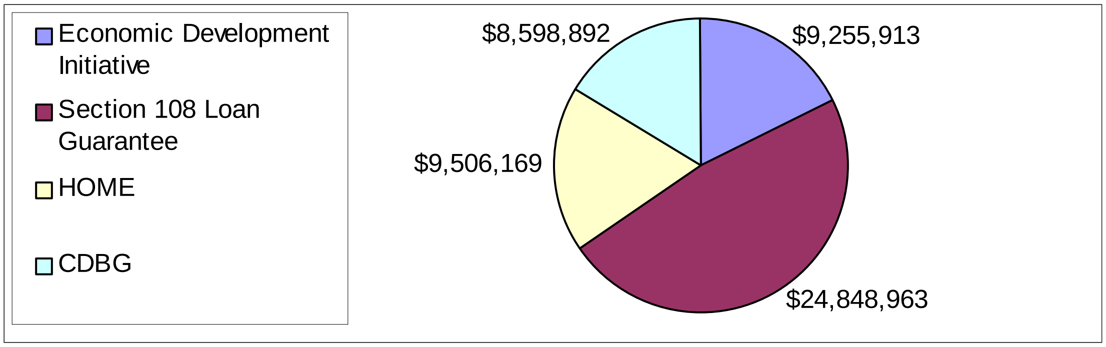

Source: City's financial system.

In addition, the City authorizes HEDFC to use program income, which includes payments of principal and interest on loans, proceeds from the sales of loans, proceeds from the sale or long-term lease of equipment or real property, and interest earned on program income. Use of program income is restricted to the purposes of the original grant. HEDFC collected $12 million in program income in fiscal years 2002 and 2003. City staff were unable to provide program income records for fiscal year 2001.

Exhibit 3. Program Income Collected by HEDFC June 1, 2000, through May 31, 2003

Fund	**2001**	**2002**	**2003**
CDBG Program Income	Unavailable	4,548,475	5,185,914
HOME Program Income	Unavailable	1,051,131	1,223,560
Total	Unavailable	5,599,606	6,409,474

Source: Summary of Federal Cash Transactions reports provided by Housing and Community Development.

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RESULTS OF AUDIT

Finding 1: The City's System For Administering Housing Funds Is Fragmented And Too Complex

The City still lacks an integrated strategy for implementing housing policy. We recommended in April 2000 that the City develop a clear, comprehensive housing policy including strategies and desired outcomes. The City took some steps toward assessing housing needs but has not yet developed a clear strategy for defining, identifying, and addressing housing needs. The current system for administering housing funds involves the federal government, City government and non-governmental agencies, but no one party controls spending decisions or is held accountable for housing production or meeting other goals. Under this fragmented system, the City awards federal grant funds to entities without a way to assess whether the system is fulfilling overall policy goals. Even if funds are used for eligible activities, the City hasn't established a process to ensure that funds are used effectively.

This fragmented system, combined with a lack of measurable goals and objectives, contributes to higher than necessary administrative costs; lack of information; poor communication; delays; and lack of accountability for poor performance. In short, the City's system provides little assurance that the money it pays to vendors and contractors, which was $34 million in fiscal year 2003, will meet its housing needs.

The City still needs a strategy to address housing needs and measurable goals to determine whether the strategy is working

We recommended in our April 2000 report that the City develop a clear, comprehensive housing policy including strategies and desired outcomes. The City took some steps toward assessing housing needs – the Mayor convened a task force to develop policy recommendations, which the City Council adopted, and the City contracted with the University of Missouri – Kansas City to conduct the 2001 Housing Assessment Survey. However, the City has not yet developed a strategy for defining, identifying and addressing housing needs. The City's 2003 Consolidated Plan is not significantly different than the 1999 Consolidated Plan. The plan does not specify measurable goals or objectives. It states how much money is expected by source but contains no specific actions that are to be undertaken to achieve the City's housing goals. City staff told us they did not use the housing assessment data to compile the plan.

The City Council adopted a housing policy. Following our 2000 audit, the Mayor convened a committee of 33 people associated with various aspects of housing development and asked them to discuss and make recommendations for a new housing policy for Kansas City. The committee met from September to November 2001 and wrote a proposed policy that defined some broad goals,

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policies, and outcomes. These provide broad criteria for evaluating housing programs, but don't identify specific, quantifiable benchmarks, nor do they target efforts to the City's most pressing needs. The City Council adopted the policy in Resolution No. 011428.

Housing condition survey collected detailed information. The City collected detailed information about housing conditions in 2001. The City contracted with the Center for Economic Information at the University of Missouri-Kansas City to conduct the 2001 Housing Conditions Survey. The survey rated residential housing conditions by parcel, including the roof, foundation and walls, windows and doors, exterior paint, sidewalks and drives, lawns and shrubs, and litter. In total, this effort detailed the condition of about 85,000 parcels of property.

The City paid $316,000 for the study, but did not use it in developing or administering the housing plan. See Appendix D for the map of the Kansas City, Missouri, Neighborhood Housing Conditions Survey.

Housing plan did not significantly change. Despite these efforts, the City's 2003 Consolidated Plan is not significantly different from the 1999 Consolidated Plan.[2] The City's 2003 Consolidated Plan still does not specify measurable goals or objectives. The plan states how much money is expected by source but contains no specific actions that are to be undertaken to achieve the City's housing goals. The 2003 Consolidated Plan is consistent with the broad goals described in Resolution No. 011428, but emphasizes community development activities more than the Resolution, which emphasizes housing activities. Housing Department staff told us that they did not use the 2001 survey condition data in compiling the 2002 and 2003 consolidated plans. The acting director said that they did try to use the data to target CDCs in certain census tracts in the 2004 plan.

The City's system for implementing housing policy is fragmented and complex

The City's system for implementing housing policy is fragmented and too complex. The federal government, City government and non-governmental agencies each play a role in the City's housing system, but no one party controls spending decisions and entities are not held accountable for housing production or meeting other goals. The flowchart on the following pages illustrates in detail how this process works.

[2] *Kansas City Missouri's 1999 Consolidated Housing and Community Plan*; Approved by HUD May 1999, and *Kansas City Missouri's 2003 Consolidated Housing and Community Plan*; Approved by HUD on May 2003.

Exhibit 4. Kansas City's Process for Implementing Housing Policy

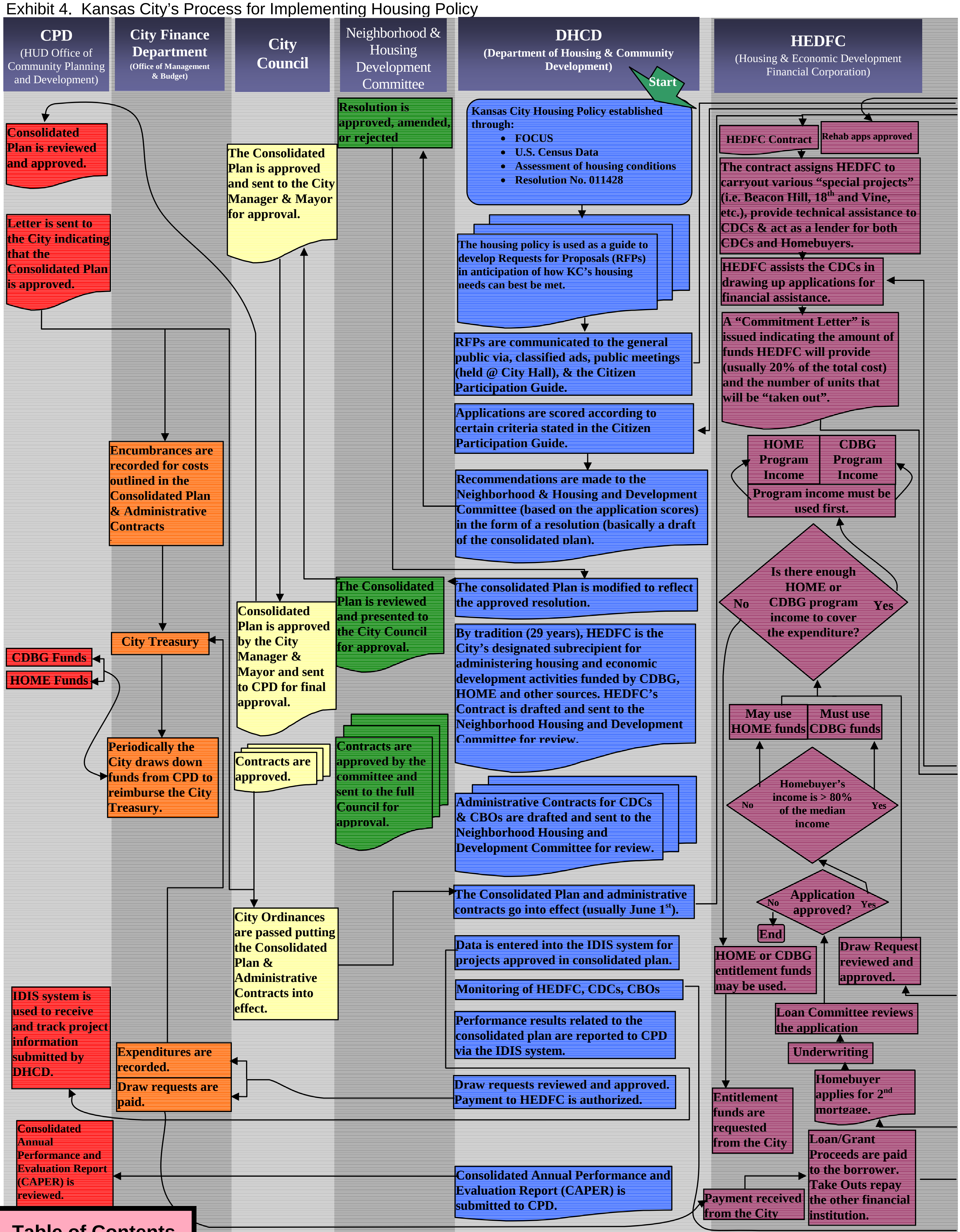

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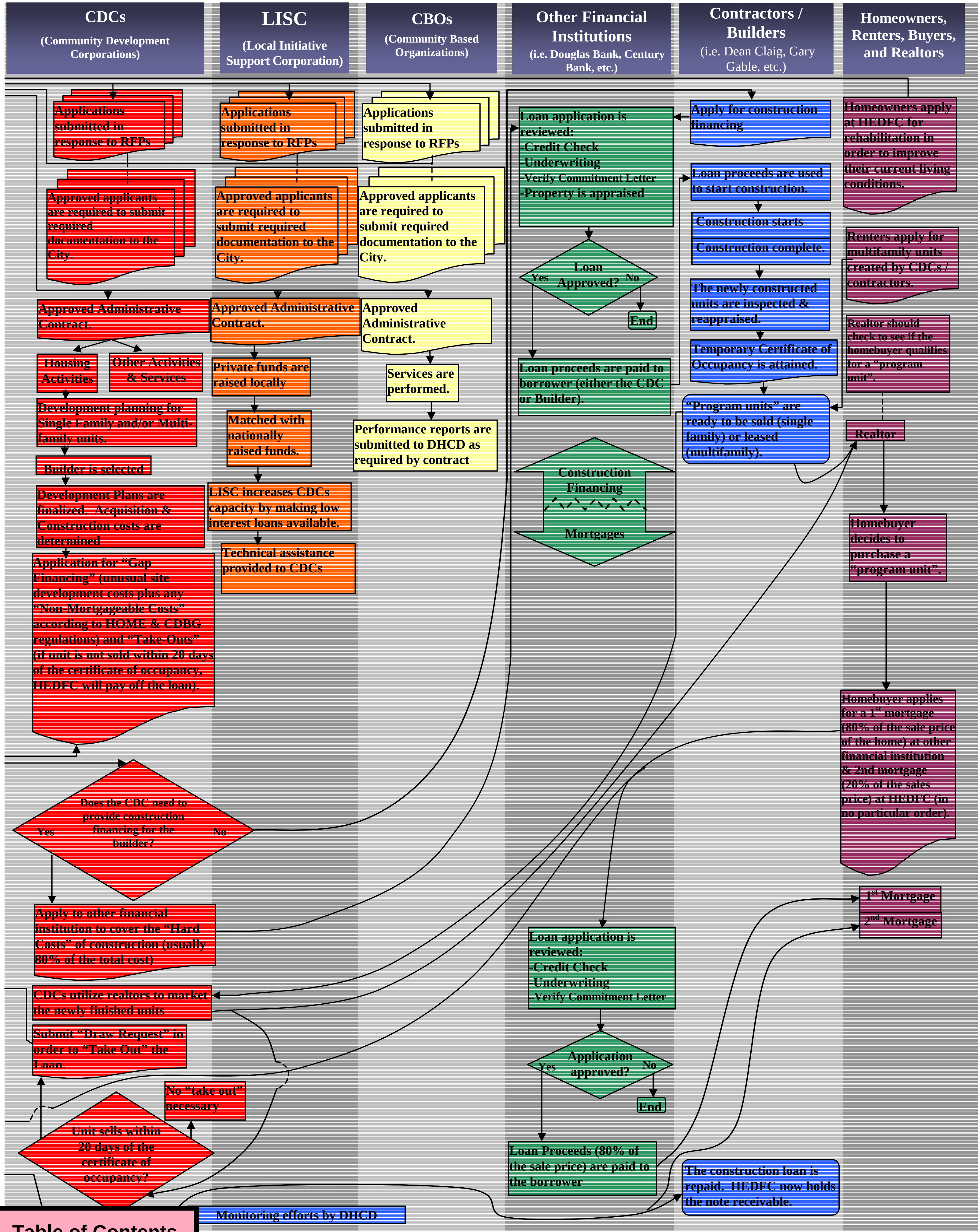
Exhibit 4 Continued.



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Many parties are involved in the system. The federal government, City Council, City departments, HEDFC, Community Development Corporations, and private financial institutions and builders each play a role in implementing the City's strategy for addressing housing needs.

The federal government, City Council and City departments primarily provide money, set policy and monitor policy implementation:

Exhibit 5. Government Roles in Administering Housing Funds

Agency	Roles
HUD Office of Community Planning and Development (CPD)	Responsible for approving the City's Consolidated Plan, tracking project information in the IDIS system, making CBDG and HOME funds available to the City, and reviewing the Consolidated Annual Performance Evaluation Report (CAPER).
City Council	Responsible for adopting the City's Consolidated Plan and approving City contracts for more than $250,000.
Neighborhood & Housing Development Committee (a standing committee of the City Council)	Hears testimony on the staff's proposed Consolidated Plan and contracts and may amend the Plan or contracts before passing them out of Committee for the full Council to consider.
City Housing and Community Development Department	Responsible for developing the Consolidated Plan, drawing up contracts, monitoring subrecipients and contractors, and submitting the CAPER to HUD. The department also disburses funds to CDCs, LISC, CBOs for administrative costs, and to HEDFC for administrative and program costs in accordance with the Consolidated Plan and individual contracts.
City Finance Department	Responsible for encumbering funds for costs outlined in the Consolidated Plan.

Source: Interviews with City Council members, HUD staff; reviewing related documents.

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Non-government agencies receive government funds to implement policies and monitor implementation:

Exhibit 6. Private and Non-Profit Organizations' Roles in Administering Housing Funds

Agency	Roles
Housing and Economic Development Financial Corporation (HEDFC)	Acts as a lending institution for both CDCs and homebuyers. Also responsible for providing technical assistance to CDCs, promoting economic development, and carrying out "special projects": large scale developments for which CDCs can't perform.
Community Development Corporations (CDCs)	Neighborhood-based not-for-profit organizations that work to revitalize their communities through new and rehabilitated housing, commercial development, neighborhood organizing, and a variety of residential services.
Local Initiative Support Corporation (LISC)	National not-for-profit corporation that provides grants, loans and equity investments to CDCs for neighborhood development. LISC is based in New York and operates in thirty-seven major cities across the U.S., including Kansas City. National LISC matches locally raised funds. The CDCs then designate the funds to a variety of projects in their respective neighborhoods.
Community Based Organizations (CBOs)	Perform a variety of services for the community such as child development and senior citizen center activities. CBOs generally do not perform housing-related services, but may receive funding through the Consolidated Plan.
Other Financial Institutions	Provide construction loans to CDCs and contractors in addition to home loans to homebuyers.
Contractors/Builders	Build and rehabilitate houses under contract with HEDFC or CDCs.

Source: Interviews with City Council members, HUD, Housing Department, HEDFC, LISC and CDC staff; reviewing related documents.

Each year, the City develops an approved consolidated plan for implementing housing policy. The process involves the City seeking proposals, identifying the proposals that will be funded, submitting its plan to HUD for review, and then funding the projects. Exhibit 7 summarizes how the City develops and implements its annual plan.

Exhibit 7. Developing and Implementing Kansas City's Annual Consolidated Plan

Agency	Activity	Output
Housing Department	The Housing Department develops a request for proposals, based on Forging Our Comprehensive Urban Strategy, census data, the 2001 housing condition assessment, and housing policy goals adopted by council resolution.	Request for Proposals
CDCs, CBOs, general contractors and LISC	Respond to the RFP with proposals.	Proposals
Housing Department	Reviews proposals, scoring them based on criteria from the Citizen's Participation Plan.	Draft resolution for City Council consideration
City Council	Considers and may amend the draft resolution.	Draft consolidated plan as an adopted resolution
Mayor and City Manager	Review and approve the adopted consolidated plan.	Draft approved consolidated plan
HUD	Reviews the City's consolidated plan.	Letter accepting the consolidated plan
City Council	Considers the consolidated plan.	Consolidated plan adopted by ordinance
Housing Department	Drafts contracts to fund administrative costs of organizations that submit proposals.	Draft contracts
Housing Department	Drafts a contract with HEDFC, which, by tradition, doesn't submit a proposal.	Draft contract
City Council	Considers and approves draft contracts by ordinance if the contract amount exceeds $250,000.	Contracts approved by ordinance.

Source: Interviews with City Council members, HUD, Housing Department, HEDFC, LISC and CDC staff; reviewing related documents.

The City doesn't systematically identify needs. Instead of the City targeting housing needs to address, the contractors and subrecipients drive this process because the contractors and subrecipients determine which projects will be performed by submitting their proposals. An effective process would have the City identify its needs, then identify projects to address those needs, and then contract with parties that can complete the projects.

The City hasn't established clear lines of authority and responsibilities. The fragmented system creates duplicate efforts, increasing costs and confusion. For example, CDCs have to apply separately for administrative and program costs. CDCs apply to the City for administrative costs then apply to HEDFC for program funding. This duplicate effort can lead to confusion about who a CDC is accountable to. City staff told us they have few options for addressing poor performance. HEDFC management told us they've been forced to pay off CDC construction loans that should never have been made. Exhibit 8 summarizes the construction and rehabilitation process for single family homes.

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Exhibit 8. Constructing and Rehabilitating Single Family Housing

Agency	Activity	Output
Housing Department	Makes payments to CDCs and HEDFC based on contracts.	Payments
CDCs	Apply to HEDFC for financing projects included in consolidated plan	Development plans; agreements with builders.
HEDFC	Reviews feasibility, provides technical assistance if needed, determines grant financing necessary to cover “unusual” costs of construction in the urban core.	Commitment letter
CDCs	Use commitment letter to obtain financing from a bank; begins project, submit invoices or requests for reimbursement to HEDFC as work progresses.	Draw request to HEDFC; Periodic progress reports to the Housing Department
HEDFC	Reviews and approves draw requests. HEDFC is required to use CDBG and HOME program income first, before requesting additional grant funds.	Payments to vendors and reimbursements to CDCs
HEDFC	HEDFC requests funds from the City if program income is insufficient to cover expenditures.	Request entitlement funds from City Housing Department
Housing Department	Reviews HEDFC’s monthly financial reports and bank statements. Reviews CDC progress reports.	Payments to HEDFC
CDCs	Once construction is completed, apply to HEDFC for “take-out” of loan.	Draw request to HEDFC
HEDFC	Approves payment.	Pays construction loan; holds mortgage on property.
CDC	Markets and sells house. Provides the sales price to HEDFC prior to closing.	Sales price
HEDFC	Calculates difference between outstanding loan and sales price; writes off difference if house sells for less than amount due.	Amount due on loan
Buyer	Pays HEDFC at closing	Payment

Source: Interviews with City Council members, HUD, Housing Department, HEDFC, LISC and CDC staff; reviewing related documents.

Federal grant funds are awarded to entities in the system without a way to determine whether the system is fulfilling the City’s goals. Even if funds are used for eligible activities, the City hasn’t established a process to ensure that funds are being used effectively.

Fragmented, complex system increases costs, weakens accountability

The fragmented system along with a lack of clear performance goals contributes to high administrative costs; lack of information and poor communication; delays; lack of accountability; and creates an environment in which there is friction and “finger-pointing” among the major players. Without clear performance criteria for

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making funding decisions and holding entities accountable, the City's system is driven by the agencies that receive the money. Private agencies make decisions about the use of public funds rather than the City.

Administrative costs are increased. According to HEDFC's audited financial statement and the City's financial management system, the Housing Department and HEDFC spent over $4.9 million on administrative costs in fiscal year 2003, not counting the CDCs' administrative costs paid through city grants. Administrative costs amounted to more than 40 percent of CDBG and HOME funds for the year. Clearly defined lines of authority and areas of responsibility would help ensure that administrative costs are held to a minimum, resulting in more funds being available to address the City's housing needs.

Decision makers lack adequate information. The City Council still lacks timely and accurate information to make decisions. Council members told us that the Housing Department provides information to the City Council's Neighborhood Development and Housing committee but the information has been inaccurate and untimely and reports don't reconcile. In addition, Council members are concerned that the Housing Department and/or HEDFC have, in some cases, approved funding for much larger amounts than originally approved by the Council. We also reported in our July 2001 report that City housing officials did not provide the City Council with adequate information to support decisions in awarding HUD funds.

The Comprehensive Annual Performance Evaluation Report (CAPER) – required by HUD to monitor the use of funds – provides inadequate information to assess system performance. For example, the annual report doesn't show the number of units produced or the cost per unit, information that is readily available in annual reports we reviewed from other cities.[3] HEDFC management told us they have this information, but the annual report is not their responsibility. HEDFC management provided us with this information separately, but we couldn't verify its source.[4]

The lack of accurate information also contributed to the City's $4.8 million shortfall in CDBG and HOME programs in early 2004. The Housing Department overestimated program revenue, and then the City appropriated funds based on overstated revenues. Weaknesses in the Housing Department's budgeting and reporting processes exacerbated the problem, as the Housing Department hadn't

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[3] We reviewed information from Boston, MA; Minneapolis, MN; Cleveland, OH; Indianapolis, IN, Springfield, MO; and St. Joseph, MO. We selected these cities because regional HUD directors identified them as having well performing systems for administering housing funds and their housing stocks are similar in age to Kansas City. We intended to compare Kansas City's production and performance to these cities, but could not due to lack of information about Kansas City's performance.

[4] HEDFC staff provided unit and cost information in emails dated April 26, 2004, and May 3, 2004. Staff said that the data were from the 2001-2002 CAPER. We could not find similar information in the most recent (2002-2003) CAPER. The cost figures staff provided were not consistent with the total amount of payments HEDFC received from the City or with expenses reported in HEDFC's audited financial statements.

been held accountable to the City's normal budgetary controls. For example, the former City manager did not include Housing Department funds in formal quarterly financial analyses. The City's Office of Management and Budget considered housing funds to be "continuing funds" and did not require an annual reappropriation of unexpended funds. Therefore, the shortfall wasn't found and corrected. About $18 million that the City paid to HEDFC in contract year 2002-03 was actually encumbered between January 1996 and December 2001. See Appendix E for a schedule of funds paid by contract year and the year they were encumbered. KPMG conducted a performance audit, released April 2004, to determine the amount of the shortfall. KPMG made a number of recommendations to the City to improve internal and external reporting, grants monitoring and contracting and reimbursement processes.

Stakeholders complained of slow payments. CDCs, banks and HEDFC all complained to us about slow payments:

- CDCs and vendors complained to us about slow payments from HEDFC. We saw files with invoices submitted more than once and loans paid off more than 60 days after approval. Delaying loan pay offs increases interest costs needlessly.
- Representatives from three of four banks we talked to said they don't work with HEDFC because of slow turnaround time.
- HEDFC complained to us about slow payments from the City.

Untimely draw downs. The City's single audits in the past three years have cited untimely draw downs of federal funds as a concern. The City's untimely draw downs result in borrowing from other City funds or incurring unnecessary interest costs and other fees. For example, the City's decision to draw down funds from a line of credit for the Beacon Hill development rather than using federal funds resulted in up to $82,500 in unnecessary stand-by fees. While the interest incurred is similar to the amount that would have been incurred using federal funds, the stand-by fees are specific only to the line of credit financing.[5]

The system weakens accountability. The fragmented system weakens overall accountability because control of spending and accountability for housing production is not clearly defined. For example, the Housing Department doesn't hold CDCs accountable for poor housing production. Program managers haven't consistently completed quarterly monitoring reports. Staff had not done 2003 quarterly reports for 3 of the 6 CDCs we reviewed. Housing Department management told us they have few options for addressing poor performance and that the City Council will fund agencies regardless of performance.

[5] The $10 million line of credit incurs a "stand-by" fee of 15 basis points due quarterly on the undrawn portion of the line of credit. Therefore, HEDFC is currently holding the $10 million dollar line of credit open at a cost of $7,500 per quarter. From the time the loan was established (10/26/2001) through the current quarter (06/30/2004), that is a maximum expense of $7,500 per quarter for 11 quarters, or $82,500.

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HEDFC's practice of "taking out" loans is another example of weakened accountability. Upon approving a project, HEDFC provides the CDC with a commitment letter to pay the bank. The CDC uses the commitment letter to get private financing. HEDFC then pays off ("takes-out") the loan three weeks after the certificate of occupancy is issued if the house hasn't sold. The "take-out" practice rewards CDCs even if they've built housing that is less desirable. CDCs lack the financial incentive to market the homes once the loan is taken out because they no longer owe the bank. HEDFC management told us that they perform take-outs to improve CDCs' credit to allow them to obtain more financing. HEDFC management also told us that the practice of take-outs has resulted in paying for loans that should never have been made. As a result, homes are built or rehabilitated but sell slowly. In December 2003, HEDFC had an inventory of 30 unsold homes (see also Finding 3).

Environment of mistrust. We observed "finger-pointing" and friction between City and HEDFC staff. In interviews, staff from the City and HEDFC blamed each other for problems. Back-and-forth correspondence between City and HEDFC staff indicated a lack of responsiveness and delayed responses to requests for information. In some cases the City and HEDFC had disagreements about documentation and ownership of property. Staff also dispute responsibilities, with HEDFC staff taking on responsibilities the City staff believe are their own and vice versa.

The City is required to have an adequate system

The City is responsible for using federal housing funds to achieve City goals and national objectives. Federal regulations allow cities flexibility in deciding how to spend HUD grant funds within established guidelines. However, federal requirements also dictate that "Governmental units are responsible for the efficient and effective administration of Federal awards through the application of sound management practices… Each governmental unit… will have the primary responsibility for employing whatever form of organization and management techniques may be necessary to assure proper and efficient administration of Federal awards."

These requirements also stipulate that "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."

The City must improve its system

A number of studies in recent years have raised concerns about the City's processes or HEDFC's processes and made recommendations for improvement. In the past, the City justified not changing the structure because an attorney in the City's Law Department had provided an oral opinion that the City was prohibited from directly administering a loan program. The Law Department issued a written opinion in October 2003 that the City is not prohibited from making loans as long as there is a public purpose before public funds are loaned; the funding source permits such a loan; and a recipient such as a CDC has empowered itself to receive or use the loan funds for the purposes for which the loan is made.

We conclude that the City's problems are systemic and cannot be solved without addressing the system as a whole. The City should redesign its program to simplify administration and/or reduce layers, as well as reduce costs.

Recommendations

1A. We recommend that the City Manager reevaluate and revise the city's processes for developing housing policy and administering housing funds. The City Manager should consider bringing some of the functions in-house and competitively award the remaining services. At a minimum, the City's processes should:

- Identify and address housing needs using the UMKC housing condition study or a similar effort.
- Establish measurable goals and objectives.
- Base funding decisions on specific, pre-identified needs.
- Track and report annual progress in meeting the housing goals.
- Incorporate specific scopes of work, goals and measurements in all contracts.
- Develop monitoring procedures that ensure all entities receiving funding are held accountable for meeting specific objectives.
- Identify and "in-source" all functions that City staff can efficiently perform.
- Competitively award all services that City staff does not perform.

1B. We recommend that the HUD Director, Office of Community Planning and Development ensure the City develops and implements the procedures necessary for an effective and efficient housing program. These changes should ensure that the City's processes:

- Identify and address housing needs using the UMKC housing condition study or a similar effort.

- Establish measurable goals and objectives.
- Base funding decisions on specific, pre-identified needs.
- Track and report annual progress in meeting the housing goals.
- Incorporate specific scopes of work, goals and measurements in all contracts.
- Develop monitoring procedures that ensure all entities receiving funding are held accountable for meeting specific objectives.
- Identify and "in-source" all functions that City staff can efficiently perform.
- Competitively award all services that City staff does not perform.

Finding 2: The City Has Not Clearly Defined HEDFC's Role In Implementing Housing Policy

The City has failed to adequately define HEDFC's role in providing affordable housing. The scopes of work in the City's contracts with HEDFC are broad and the performance standards are vague. Consequently, the Housing Department – which is responsible for overseeing the contracts – and HEDFC have disagreed about whether expenditures or activities are appropriate and about the disposition of program income.

By entering into vague contracts, the City cedes decisions about use of public funds to HEDFC and cannot fulfill its responsibilities as a recipient of federal grant funds.

Contracts don't adequately define HEDFC's role

The City contracts annually with HEDFC to service the $90 million portfolio of loans made with CDBG and HOME funds, make loans to CDCs to carry out construction and rehabilitation projects consistent with the Consolidated Plan, provide technical assistance to CDCs, and make loans to eligible home buyers. The scope of work described in the current contract is broad. Under its annual contract with the City[6], HEDFC is to provide:

(1) Housing Loan and Development Programs: administering CDBG and HOME funded housing development activities in designated areas; administering and processing loans for specific multi-family projects (Chambers and Hanover buildings and others as approved by the Housing director); financing, monitoring and providing technical assistance for specific development projects (Columbus Park In-Fill); assisting in redeveloping certain sites (Troostwood); acting as project manager for certain sites (Holy Temple Homes, Guinotte Manor); and providing predevelopment activities and lending services for Beacon Hill.

(2) Economic Development Services: provide the necessary services as a lender and administrator of federally funded loans and grants to carry out economic, commercial and industrial projects including 18th and Vine Redevelopment and Heritage Business Park Renovation.

(3) Public Facilities Services: provide funding as authorized to specific agencies for renovation projects.

(4) Home Ownership Counseling Services: enter into a cooperative agreement with the Family Resource Center to provide home ownership counseling services to potential HEDFC clients.

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[6] Consolidated Community, Housing, and Economic Development Programs and Administration, June 1, 2003 through May 31, 2004.

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(5) Administrative and Regulatory Services: administer the housing programs, prior contract activities, and all active loans from prior periods in accordance with policies and procedures and federal regulations. HEDFC is authorized to approve or reject loan applications based on determination of eligibility. HEDFC is authorized to determine the final disposition of defaulted loans, including foreclosure on properties and managing or renting acquired real estate.

These services are broadly defined and do not include specific, measurable goals. For the most part, it is not possible to trace in the contract the resources devoted to a specific program activity and the expected outcomes for the year.

Eligible activities are broadly defined. The contract describes eligible HOME program activities as including construction of new affordable homes, purchase and rehabilitation of existing homes, and the development of affordable housing by Community Housing Development Organizations (CHDO). The contract describes eligible CDBG program activities as including maintenance of vacant land and structures prior to disposition, home ownership counseling services, housing rehabilitation, new housing construction, multi-family housing development, economic development, public facilities services, and planning and administration activities.

The City hasn't established clear performance standards for HEDFC. The contract outlines performance goals from the Consolidated Plan – noting that in order to achieve the goals, HEDFC will need to receive adequate applications from borrowers and CDCs in sufficient numbers – and requires monthly progress reports to be submitted to the City. However, the performance goals are vague. The contract sets goals for numbers of loans and units but because housing production spans contract years, it's not clear whether a unit is counted more than once – when the loan is approved, while the unit is under construction, and again when the unit is complete. Neither City Housing nor HEDFC staff could clarify what the goal means without doing "further research." HEDFC's president told us that the contract authorizes a certain amount of spending and it isn't possible to produce the number of units called for with the funding provided.

Exhibit 9. 2003 Activities and Goals

Program/Activity	Goal
Rehabilitation Loan Program	35 Loans
Home Ownership Assistance Programs	120 Loans
Targeted Rehabilitation of Vacant Homes & New Construction	180 Units
Downtown Multi-Family Housing	75 Units
Total Housing Units	410 Loans
End Loan Closings	155 Loans
Loan Processing	165 Applications

Source: Non-Municipal Agency Funding and Services Contract Housing and Community Development Department and Housing and Economic Development Financial Corporation Consolidated Community, Housing and Economic Development Programs and Administration, contract no. 2003-002.

The City has also contracted with HEDFC for additional services. For example, the City entered into a cooperative agreement with HEDFC in February 2000 to implement the Beacon Hill Housing Development Project. Under the agreement, which is referred to in the annual contract, HEDFC is to coordinate with the Beacon Hill task force to monitor its selection of a master developer, assess the feasibility of the project plan, and perform predevelopment activities including acquiring property and demolishing structures consistent with the plan. The agreement requires HEDFC to submit reports to the City, but doesn't specify any performance standards.

Roles aren't clear to other stakeholders. While most stakeholders perceive that HEDFC's primary role is to provide low or no interest loans and grants to eligible home buyers and to CDCs to rehabilitate or construct homes in targeted areas, the City also contracts with HEDFC to acquire and develop properties. Almost 80 percent of the funding the City paid to HEDFC in the 2002-03 contract year was for direct development activities – $14.8 million in Section 108 funds and $4.5 million Economic Development Initiative grants out of a total of $24.4 million. However, HEDFC doesn't have policies and procedures in place for conducting development activities. Other stakeholders believe that HEDFC's role as a developer is inconsistent with their role as a lending institution.

City Housing and HEDFC disagree about the appropriate use of funds and other program issues.

Because the contracts aren't clear, City Housing staff and HEDFC have disagreed about the appropriate use of program income and whether expenditures or activities were appropriate. HEDFC believes it is authorized to make certain decisions, but City Housing staff believes it is not. For example, Housing staff questions the amount of money spent on the Beacon Hill project and the costs of rehabilitating two houses within the project. HEDFC has responded that the costs were authorized and the activities within the scope of their contracts.

HEDFC spent more than authorized by contract on Beacon Hill. The City's contract with HEDFC authorized spending $10 million in Section 108 loan guarantee funds and $1.25 million in Brownfields Economic Development Initiative funds to:

- acquire vacant and blighted structures;
- abate known environmental contaminants;
- demolish dangerous or obsolete structures;
- relocate displaced residents;
- construct new housing; and
- rehabilitate existing housing.

HEDFC spent about $12.2 million on the Beacon Hill development between May 4, 2000, and December 31, 2003. City records show that only about $300,000 has been drawn down from the Brownfields fund. Housing staff questions where the additional $1.8 million spent came from. HEDFC's monthly financial reports show that HEDFC spent about $900,000 in Beacon Hill program income on the project. However, neither the current annual contract nor the Beacon Hill cooperative agreement authorizes HEDFC to spend Beacon Hill program income. HEDFC management told us that they could not control the costs on the project because the City's Law and City Planning and Development departments were responsible for condemnation proceedings and negotiating the costs of properties.

HEDFC spent about $600,000 to rehabilitate two houses within the Beacon Hill project. HEDFC selected two single family homes on Tracy Avenue to renovate as model homes. HEDFC's president told us that the rehabilitation projects, while more expensive than intended, are part of an overall plan that the City's Housing Department doesn't yet see. He said that investors are interested in the properties – which are not yet for sale – but in the meantime they serve as educational laboratories for developers and investors to see how older homes can be restored and learn what not to do in order to keep costs down.

Exhibit 10. These photos show the front and back of 2523 Tracy. HEDFC spent $327,999 restoring the home.
(5/7/04)

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Exhibit 11. These photos show the front and back of 2518 Tracy. HEDFC spent $263,835 restoring the home. (5/7/04)

Contracts authorized use of public funds to rehabilitate housing. HEDFC's general counsel and director of lending wrote an opinion that the rehabilitation activities were eligible under federal regulations and authorized by the City under the 2001 and 2002 Consolidated Plans, HEDFC's annual contracts with the City for 2001 and 2002, the cooperative agreement for the Beacon Hill redevelopment, as well as CBDG eligibility and State Historic Preservation guidelines. The City's Law Department reviewed the opinion and concurred that the agreements provide HEDFC authority to acquire and restore properties without restriction on costs.

HEDFC failed to fully repay the Section 108 loan for the Westside Business Park. HEDFC was required to fully secure the $7.1 million Section 108 Westside Business District loan from HUD. The loan was supposed to be secured through property obtained and improvements made to that property. The property was sold to a developer and the sales proceeds should have gone toward repaying the Section 108 loan. After much delay, HEDFC repaid the City most of the loan amount but has yet to pay the outstanding balance of $597,388.

Monitoring focuses on compliance not effectiveness. In the absence of clear performance standards, City Housing staff focuses monitoring efforts on technical financial compliance of detailed transactions by reviewing bank statements and supporting documents for individual payments. This is time-consuming for City staff and frustrating for HEDFC. HEDFC management told us that City Housing staff is narrowly interpreting HUD regulations in requiring HEDFC to use program income before drawing down federal funds and cite this requirement as one of the primary causes of their cash flow problem. However, Housing staff perceives that they have little control over how HEDFC spends funds.

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By entering into vague contracts the City cedes decisions about use of public funds to HEDFC and cannot fulfill its responsibilities as grantee. As the grantee, the City is responsible under federal regulations for ensuring that use of the grant funds will meet national objectives and that subrecipients comply with applicable federal requirements and that performance goals are being achieved.

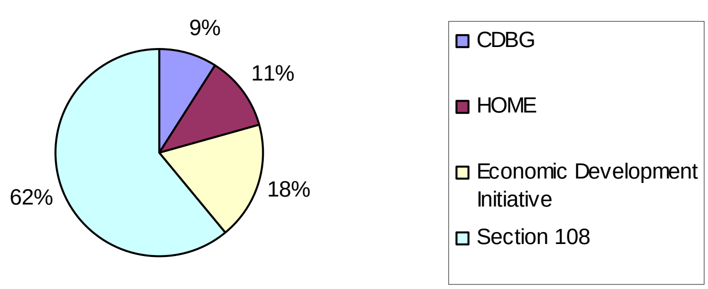
Unclear role prevents adequate assessment of HEDFC's effectiveness

HEDFC's unfocused mission and poorly defined performance goals prevent meaningful assessment of whether the agency is performing effectively. Other system stakeholders believe that HEDFC should solely act as a lender rather than developer.

HEDFC's primary role is lending. Most stakeholders perceive that HEDFC's primary role is to act as a lender. The president of HEDFC described its primary mission as providing assistance to low-income families in Kansas City's urban core through a variety of programs including loans for rehabilitation, and construction of new housing and economic development. He said that HEDFC occasionally acts as a developer for the City for large-scale projects because other agencies lack the skills and capacity to fulfill this role.

Most funding has been for development activities. Almost 80 percent of the funding HEDFC received from the City in the 2002-03 contract year was for direct development activities – $14.9 million in Section 108 funds and $4.5 million Economic Development Initiative grants. However, HEDFC doesn't have policies and procedures in place for conducting development activities.

Exhibit 12. City Payments to HEDFC by Fund, June 1, 2002, through May 31, 2003



Source: City's financial system.

Stakeholders we talked to perceive that HEDFC's primary role should be to act as a lender. Representatives of area CDCs that we talked to said that HEDFC has multiple roles, primarily lending and developing. Representatives of 4 of the 5 CDCs we talked to told us that HEDFC should act solely as a lender and that it is a

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conflict of interest for HEDFC to act as a developer because they, in effect, make loans or grants to themselves.

The City needs to ensure that each entity in the system has clear roles and responsibilities. The City should establish mechanisms for holding each entity – including HEDFC – accountable. Each contract should specify the scope of work agreed to and how the City will know that the agreed upon work was completed.

Recommendations

We recommend that the City Manager:

2A Require HEDFC to repay the $900,000 in Beacon Hill program income it used without authorization.

2B Require HEDFC to repay the $600,000 balance of the Westside Business Park Section 108 loan.

2C Ensure that the scopes of work and performance standards in all housing contracts are sufficiently clear so that the City can effectively manage, monitor and report on the contractor's performance. Contracts should clarify how much discretion the contractor may exercise in carrying out activities on behalf of the City.

We recommend that the HUD Director, Office of Community Planning and Development:

2D Ensure the City recovers from HEDFC the $900,000 in Beacon Hill program income it used without authorization and reprograms the money to be used for eligible activities.

2E Ensure the City recovers from HEDFC the $600,000 balance of the Westside Business Park Section 108 loan and reprograms the money to be used for eligible activities.

2F Ensure the City structures its future contracts with clear scopes of work and performance standards so that the City can effectively manage and monitor contractor performance.

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Finding 3: HEDFC's Operational Deficiencies Contribute To Poor System Performance

HEDFC lacks processes for tracking and reporting operational and financial information; its computer systems aren't integrated; duplicate data are entered into different systems, which staff does not reconcile; policies and procedures don't address tracking and reporting information about the different types of loans or projects; supporting documents for construction loans were disorganized and not readily accessible, some files and documents were missing, and we found errors in reports. Although several previous studies have recommended HEDFC improve its procedures for tracking and reporting operations, problems remain.

HEDFC's financial position is weak. Liquidity ratios and cash flow coverage ratios decreased while debt ratio increased between 2000 and 2002. HEDFC's cash position improved in 2003 with increased funding, but cash flow coverage was negative in three of the five years we reviewed. HEDFC experienced high interest expense relative to net income in some years and income and expenses fluctuated. These ratios reflect HEDFC's financial dependence on the City.

Since HEDFC is an integral component of the City's housing program, these problems result in not just underperformance for HEDFC, but for the system as a whole. The system failed to meet housing production goals for the year ending May 31, 2003. The city's annual contract with HEDFC called for 190 "loans or units" of targeted rehabilitation of vacant homes or new construction, but only 54 houses were sold or completed. The houses also took a long time to sell once completed.

HEDFC operational controls and processes are deficient

There are significant deficiencies in HEDFC's operations:

- HEDFC's financial audit wasn't timely. HEDFC's financial audit for the year ending May 31, 2003, was issued July 1, 2004. The auditor issued a qualified opinion because the scope of audit work was limited by missing documentation. Federal regulations and City code require agencies receiving funds to complete financial audits.
- The financial audit identified six reportable conditions, four of which were material weaknesses.[7] Material weaknesses included payments to vendors of about $329,000 that the auditors could not trace to executed contracts or purchase orders, adjustments to accounting records during the audit amounting to about $26.4 million, and adjustments to accounting records to reduce receivables based on the auditor's verification of information from third parties. The auditors also questioned whether the spending to restore the

[7] Housing and Economic Development Financial Corporation Financial Statements Together With Independent Auditor's Report for the Year Ended May 31, 2002. A reportable condition is a deficiency in the design or operation of an entity's internal control structure that could adversely affect the entity's ability to record and report financial data. A material weakness is a significant deficiency in which the design or operation of specific internal controls does not ensure that errors or irregularities material to the financial statements will be detected promptly by employees in the normal course of their work.

houses on Tracy was eligible under federal regulations due to conflicting documentation.

- The corporation's computer systems aren't integrated; duplicate data are entered into different systems, which staff does not reconcile.
- The corporation's policies and procedures don't address tracking and reporting information about the different types of loans or projects.
- Supporting documents for construction loans are not readily accessible. Files contain multiple copies of some documents, while some files and documentation are missing altogether.
- Some reports are inaccurate. We found errors in the single family production report presented to the Board and in a loans closed report prepared for us.
- Board reports vary in format and content – it is difficult to gather consistent information, especially about multi-family or special projects.
- HEDFC does not use detailed program budgets, or compare actual program expenditures to budgeted expenditures.
- Grant funds were commingled. HEDFC deposited four HOME entitlement payments totaling $230,157 into the CDBG income account in fiscal year 2003. Federal regulations require separate HOME and CDBG accounts.
- HEDFC did not consistently document periodic on-site inspections of work performed.
- HEDFC did not consistently complete monitoring reports required under City contracts.
- HEDFC does not maintain perpetual, real-time inventory of assets.
- HEDFC does not compare its performance to benchmarks or standards.
- HEDFC does not market its programs to targeted users.

Previous studies have noted similar operational problems

Two recent consultant reports and our July 2001 performance audit raised concerns about HEDFC's internal processes. However, we continue to see problems, including inaccurate reports, missing information, disorganized files, lack of common accounting practices, and little tracking of production progress.

At the City's request, the National Congress for Community Economic Development (NCCED) studied HEDFC as part of a review and analysis of the City's affordable housing programs. NCCED reported in August 2001 that HEDFC's internal processes and procedures lacked administrative discipline and compromised the organization's participation in financial transactions. The report also concluded that HEDFC's management information systems and procedures for tracking and reporting operations required significant improvements. The report recommended simplifying and standardizing internal procedures, rewriting the policies and procedures manual, eliminating duplicative processes, and automating paper processes to the extent possible.

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In April 2002, BKD, LLP performed an operations review of HEDFC's internal procedures and information technology, and assessed communication, procedures and reporting between HEDFC and the City. The review made several observations and recommendations to HEDFC management about the organization's problems with tracking and reporting information. BKD noted significant problems with loan documents being lost. Each department (within HEDFC) tended to maintain a separate file related to their piece of a given project or loan, resulting in multiple copies of some documents and other documents getting lost.

The study reported a lack of standardized written procedures for day-to-day processing. Each department (within HEDFC) developed its own procedures, tracking mechanisms, and software without considering the organization as a whole. HEDFC maintained an unnecessary and time-consuming cash availability report on a daily basis. HEDFC entered loan disbursement and payment records twice into their accounting system. Financial reports to HEDFC Board of Directors did not include enough explanatory language. HEDFC failed to accomplish proper and timely reporting as required by the City, contractual obligations, and regulatory agencies. The report recommended HEDFC:

- establish a process to identify and ensure that documents are properly filed;
- adopt detailed, written standardized procedures;
- reconcile the loan ledger to the general ledger at least monthly until an integrated system is implemented;
- clarify contract terminology and standardize reporting requirements; and
- look for ways to eliminate or automate manual processes

While BKD provided management a discussion draft in April 2002, the report was never finalized or released publicly. HEDFC management disagreed with most of the observations and recommendations.

Previous management letters accompanying HEDFC's financial audits in fiscal years 1999 through 2002 noted issues related to management controls including individual loan balances not reconciled to the general ledger, inadequate documentation in loan files, out-dated policies and procedures manuals, and inadequate separation of duties.

Our July 2001 performance audit also raised concerns about HEDFC's lack of an integrated management information system. We noted that HEDFC created reports from the accounting system, at least two stand-alone databases, and several stand-alone spreadsheets. Maintaining these systems required duplicate data entry, increasing the risk of data errors. We didn't make specific recommendations to HEDFC, but recommended that the Housing Department develop procedures for overseeing subrecipients, including guidance on validating reported progress through on-site reviews.

HEDFC's financial condition has declined

HEDFC's financial position is weak. Liquidity and cash flow coverage ratios decreased while the corporation's debt ratio increased between 2000 and 2002. HEDFC's cash position improved in 2003 with increased city funding, but cash flow coverage was negative in three of the five years we reviewed – operations consumed more cash than they generated. HEDFC experienced high interest expense relative to net income in some years, and net income fluctuated. HEDFC's general and administrative expenses have been high and consistently exceeded budgets. These ratios reflect that HEDFC is financially dependent upon the City and may be unable to survive funding delays.

Ability to cover short-term needs declined since 2000. The quick ratio has declined since 2000. Days cash on hand declined in 2002 but increased in 2003. Liquidity ratios focus on whether an organization has enough cash and/or other liquid resources to meet its obligations in the near term.

Exhibit 13. Liquidity Ratios Fiscal Years 1999-2003

	1999	2000	2001	2002	2003
Quick	6.3	9.4	4.1	1.8	1.3
Days cash on hand	244	328	243	123	286

Source: Audited financial statements.

Ability to cover long-term obligations has declined since 2000. HEDFC's debt ratio increased, primarily due to a $10 million line of credit with Fannie Mae to finance development activities at Beacon Hill. HEDFC paid off the line of credit in 2003 with Section 108 loan guarantee funds. HEDFC's cash flow coverage has decreased since 2000 and was negative in three of the five years we reviewed, indicating that operations consumed more cash than they generated. HEDFC's times-interest-earned ratio shows large fluctuations, reflecting large fluctuations in net income. The times-interest-earned ratio in 1999 was below 1.0, indicating that not enough income was available to pay interest expenses. Leverage and coverage ratios focus on whether an organization can meet its long-term obligations – the debt ratio compares debt to total assets; cash flow coverage and times-interest-earned ratios focus on the ability to make payments on debt. Jointly, these ratios provide a picture of an organization's solvency. Decreasing coverage ratios and increasing debt indicate that HEDFC is financially weak and dependent upon the City for funds.

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Exhibit 14. Leverage and Coverage Ratios Fiscal Years 1999-2003

	1999	2000	2001	2002	2003
Debt	.01	.01	.05	.10	.10
Times-interest-earned	0.91	13.65	11.25	1.23	1.5
Cash flow coverage	-3.8	3.3	-8.8	-12.8	1.7

Source: Audited financial statements.

HEDFC's general and administrative expense ratio has been high but has decreased as expenses have increased.

Exhibit 15. Administrative Expense Ratio Fiscal Years 1999-2003

	1999	2000	2001	2002	2003
General and administrative expenses	0.56	0.70	0.31	0.17	0.15

Source: Audited financial statements .

HEDFC has exceeded its administrative budget by increasing amounts since fiscal year 1999. HEDFC's chief financial officer told us that they cover costs through non-federal sources including fees, other grants, or lines of credit. The City has held HEDFC's funding for administration relatively constant in recent years.

Exhibit 16. Comparison of Budgeted to Actual Administrative Expenses

	1999	2000	2001	2002	2003
Budgeted Administrative expense	1,685,000	1,635,000	1,750,000	1,600,000	1,649,950
Actual Administrative expense	1,705,790	2,072,218	2,053,543	2,209,654	2,429,193
Administrative expense in excess of budget	20,790	437,218	303,543	609,654	779,243

Source: Audited financial statements.

The City failed to meet affordable housing production goals

The City, HEDFC, and local community development corporations failed to meet housing production goals for the year ending May 31, 2003. The system achieved less than a third of its housing production goal and multi-family housing was not completed. Single family houses took a long time to sell, once they were complete.

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The City's housing system achieved less than a third of its housing production goals. The City's contract with HEDFC for the fiscal year ending May 31, 2003, established a goal of 190 "loans or units" of targeted rehabilitation of vacant homes or new construction. According to HEDFC's Single Family Housing Production Report, the agency working with local CDCs completed 54 houses. The report lists an additional 37 addresses where construction is underway; 20 addresses with a status of application/underwriting; 12 addresses with a status of planning and development; 1 site acquisition; and 1 contractor selected.

As we reported in July 2001, the housing production report combines information from prior years as well as the current year, preventing analysis of whether subrecipients met the yearly contracted performance standards. All of the units listed as sold or completed in 2003 were started in a prior period. However, even counting all of the projects listed regardless of when they were started, the system produced well below the goal of 190 units.

Exhibit 17. Number of Single Family Homes
Sold or Completed During 2002-03 Contract Year

Project Status	Units
Sold/Closed	32
Sold	6
Sold-Under Foreclosure	5
Sold-Under Contract	1
Construction Completed	14
Total	58
Unduplicated	54

Source: Single Family Housing Production Report June 1, 2002 through June 1, 2003 attached to Board minutes 6/19/03.

The number of days until sale is long. The houses are taking a long time to sell. We selected a representative sample of 9 of the 54 houses reported as completed in the year ending May 31, 2003. One of the houses has not yet sold, although a certificate of occupancy was issued in November 2001. The median number of days between when HEDFC approved the CDC's application for financing and the sale of the home was 466 days.[8] The median number of days between when the City issued a certificate of occupancy or final inspection and the sale of the home was 293 days.

[8] This figure excludes two of the nine addresses for which HEDFC could not provide an application for funding.

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Exhibit 18. Time to Produce and Sell a Sample of Homes

Address	Type of Project	Days Between Application Approved And Sale	Days Between Application Approved And Certificate Of Occupancy	Days Between Certificate Of Occupancy And Sale
2012 Olive	New Construction	--[9]	--[9]	-3
4141 Tracy	Rehabilitation	441	148	293
4409 Paseo	New Construction	273	218	55
4415 Paseo	New Construction	466	465	1
5325 Swope	New Construction	528	--[10]	--[10]
6200 Tracy	Rehabilitation	492	113	379
7205 Askew	New Construction	--[9]	--[9]	308
3901 Forest	Rehabilitation	221	--[10]	--[10]
4016 E 16th Terrace	New Construction	1443[11]	541[11]	902[11]

Sources: HEDFC project files; Jackson County Tax and Real Estate records, City Codes Administration Department records.

Exhibit 19. These photos show two front views of 4016 E. 16th Terrace. This house has not yet sold although a certificate of occupancy was issued in November 2001 (4/23/04).

Public funding per unit varied. The amount of public funding and appraised values of the houses we sampled varied. One of the houses received no public

[9] HEDFC was unable to provide an application for funding for our review.
[10] City records did not show a certificate of occupancy or final inspection date.
[11] This house has not sold, the figures are time elapsed through May 12, 2004.

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funding; the maximum was $81,462. The median public funding per unit was $18,736. The ratio of direct public funding to appraised value varies significantly.

Exhibit 20. Ratio of Direct Public Funding to Appraised Value for a Sample of Homes

Address	Public Funding	Appraised Value	Ratio of Funding to Appraised Value
2012 Olive	6,557	118,000	$1.00:$18.00
4141 Tracy	81,462	43,329	$1.00:$0.53
4409 Paseo	19,893	102,000	$1.00:$5.13
4415 Paseo	20,453	103,000	$1.00:$5.04
5325 Swope	18,736	108,104	$1.00:$5.77
6200 Tracy	52,303	59,390	$1.00:$1.14
7205 Askew	17,673	92,000	$1.00:$5.21
3901 Forest	0	11,904	Not applicable
4016 E 16th Terrace	4,483	145,000	$1.00:$32.35

Source: HEDFC project, disbursement, and cash receipt files; Jackson County Tax and Real Estate records.

Multi-family housing not completed. The City's contract with HEDFC for the fiscal year ending May 31, 2003, also called for 99 units (2 loans) of downtown multi-family housing. We didn't see any reports in the Board minutes that multi-family housing was completed during the 2002-2003 contract year. HEDFC's president told us that they made the loans, but they can't make the developer do the work.

HEDFC met the target for number of home ownership assistance loans, but not for rehabilitation loans

The City's contract with HEDFC for the fiscal year ending May 31, 2003, set performance goals of 120 home ownership assistance loans and 40 rehabilitation loans. HEDFC made more home ownership assistance loans and fewer rehabilitation loans than called for in the contract. HEDFC made 15 rehabilitation loans and 134 home ownership assistance loans (118 HOME and 16 CBDG). The CBDG loans were made to families/individuals with higher than 80 percent of the median income. HEDFC increased the number of consumer loans closed in 2002-03 over prior years.

Exhibit 21. Number of Loans Closed by Type and Contract Year, June1, 2000 – May 31, 2003

Contract Period	CDBG	HOME	HOPE	Rehab	UDAG	Total
2000-01	29	68	1	10	5	113
2001-02	35	86	1	21		143
2002-03	16	118		15		149
Total	80	272	2	46	5	405

Source: Loans Closed June 1, 2000 through May 31, 2003 report provided by HEDFC.

Contract doesn't define loan servicing performance goals. The City contracts with HEDFC to service the portfolio of loans made with CDBG and HOME funds.

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HEDFC staff provides a monthly report to the Board on delinquent loan payments. HEDFC's overall default rate - measured as the percent of outstanding loans delinquent for 90 days or more – was 7.4 percent in fiscal year 2003, which is higher than the national average of about 2 percent for FHA mortgages. We excluded HOME loans from the calculation because these loans are converted to grants once the homeowner has remained in the home for an established period of affordability. HOME loan recipients are only required to repay the loan if they move or sell the home before the period of affordability is up. HEDFC's default rate on second mortgages was much higher than the overall rate. The average monthly percent of second mortgage loans delinquent for 90 days or more was 18.6 percent in fiscal year 2003. The bulk of the delinquent second mortgage accounts were 180 days or more delinquent.

Exhibit 22. Average Percent of Loans Delinquent June 2002 – May 2003

Type of Loan	Number of Days Delinquent						
	30	60	90	120	150	180 & over	Total 90+
Rehabilitation	5.15%	2.37%	0.92%	0.60%	0.72%	2.27%	4.51%
Second Mortgage	10.63%	3.25%	1.50%	0.69%	0.57%	15.83%	18.58%
Overall	6.28%	2.55%	1.04%	0.62%	0.69%	5.07%	7.42%

Source: Monthly Delinquency Reports June 2002 through May 2003.

Recommendations

We recommend that the City Manager:

3A Clearly define the packages of housing services the City plans to contract for and develop a competitive process to award all housing contracts.

As we recommended in findings 1 and 2, the City Manager should develop clear scopes of work, clear performance standards, and methods for monitoring contractors' performance. Once these processes are in place, the City should not enter into contracts with HEDFC unless HEDFC demonstrates an ability to perform the work and is selected through a competitive process.

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Objectives, Scope and Methodology

Our overall audit objective was to determine whether the Housing and Economic Development Financial Corporation (HEDFC) is using grant funds efficiently and effectively. Our sub-objectives were to determine the City's system for implementing housing policy; to determine HEDFC's role in the City's system for implementing housing policy; to determine how well HEDFC has carried out its role in the City's system for implementing housing policy; and to determine if changes in the City's system for implementing housing policy could improve the City's performance and ability to meet its housing goals.

To meet our audit objectives, we interviewed City and HEDFC staff and officials, representatives from Community Development Corporations, and other contractors. We reviewed selected City and HEDFC files, financial records and correspondence. We reviewed the City’s Consolidated Housing and Community Development plans for the past five years, and reviewed contracts, monitoring reports, accounting records, and payments. We also compiled performance data to compare with other cities.

We performed audit work from September 2003 through April 2004. The audit covered the period for HEDFC’s fiscal year 2003, or from June 1, 2002 through May 31, 2003. We conducted the 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; and
- Compliance with applicable laws and regulations.

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

Relevant Internal Controls

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

- The City's controls over spending of federal housing funds.
- HEDFC's controls over personnel recruiting and training.
- HEDFC's controls over loan marketing, origination, approval, and servicing.
- HEDFC's controls over performance management and reporting.
- HEDFC's controls over financial recording, management, and reporting.
- HEDFC's controls over asset management and safeguarding.
- HEDFC's controls over loan / grant approval.

We assessed the relevant controls identified above.

It is a significant weakness if internal controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet an organization's objectives.

Significant Weaknesses

As noted in Finding 1, the City's system for administering housing funds is fragmented and overly complex.

As noted in Finding 2, the City has not clearly defined HEDFC's role in implementing housing policy.

As detailed in Finding 3, the Housing and Economic Development Financial Corporation (HEDFC) does not have adequate internal controls.

Separate Communication of Minor Deficiencies

No minor deficiencies were provided to the auditee.

FOLLOW-UP ON PRIOR AUDITS

The HUD Office of Inspector General and the City Auditor have issued two previous joint reports on Kansas City's housing programs . The first, *Special Report: Kansas City Needs a Housing Policy* (April 2000), assessed the City's overall approach to providing affordable housing. The second, *Review of Subrecipient Selection, Monitoring and Reporting* (July 2001), evaluated the City's methods for administering HUD funds in accordance with applicable rules. The reports recommended the City develop a housing policy – including strategies and goals, develop mechanisms for gathering information on housing conditions, and strengthen processes for selecting and monitoring subrecipients. As explained in the body of this report, the conditions reported in those reports still exist.

We reviewed the BKD audit report dated April 12, 2002 and noted that HEDFC's organizational structure lacks a cooperative team focus, and management has failed to achieve a successful merger. Also, the report noted that after the merger it appeared that many of the employees of RLC were made subordinate to employees of HDCIC. Employees in the organization appeared to have lost sight of why they are there and what the mission of the organization is.

We reviewed the NCCED report and noted that HEDFC's organizational structure did not encourage communication between and among organizational units or vertical integration of processes. The report described how each unit in the organization appears to operate autonomously with little knowledge of what the other units do or how the operation of one unit affects the operation of the other with respect to processing applications or administering loans. Also, HEDFC's mission is a combination of the missions RLC and HDCIC had before the merger. These two missions were not the same. As a result, HEDFC's programs and procedures tend to be relatively complicated.

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Practices in Other Cities

We reviewed procedures in several cities that HUD regional directors characterized as “models” to identify practices that could improve the City's performance and ability to meet its housing goals. Following are some examples of practices implemented by other cities that could be beneficial to Kansas City.

Widespread input into needs assessment

The City of San Francisco has several committees that meet to discuss what areas of the City have the greatest need for CDBG and HOME funds. The City then uses a committee to determine what amount of money will be available for each area.

The City of Indianapolis determines housing needs by requesting Citizen Participation through surveys and town meetings. The City prioritizes these needs and reviews the five-year plan.

Request for proposals from all subrecipients

The City of San Francisco requests proposals from various Community Development Corporations (CDCs) and holds public hearings before granting the CDCs any spending authority.

The City of Indianapolis puts together selection criteria and advertises requests for proposals. The staff reviews the proposals in teams of three and makes recommendations to the Director who then sends them to the Mayor and City Council for final approval. After a public comment period, they submit the approved requests to HUD.

The City of Boston issues a request for proposal that meets the requirements for both City applications as well as state applications for funding. The applicant submits the one-stop application to the City, which in turn submits it to the state. This process takes place twice per year; once for homeownership and once for rental assistance. The City reviews the applications in house and scores each based on pre-released scoring criteria. The application is then submitted to the state along with the City's tentative housing commitments. They receive applications from both for-profit and not-for-profit businesses, though most approvals go to CDCs.

Required performance monitoring for all subrecipients

In San Francisco, after receiving their funding, the CDCs are required to provide annual budgets to the City for the length of their agreement (usually 50-75 years).

In Indianapolis, the City writes contracts yearly and requires project sponsor training prior to disbursing funds. The contracts are performance based and not

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reimbursed until certain benchmarks are reached. The benchmarks are based on a timeline to prevent the CDCs from lagging in drawing down funds and to keep production on schedule. Indianapolis developed their own standards that must be met. They require a minimum of two bids for all work performed in excess of $2,000 before it will be reimbursed. If work comes in more than 10% higher or lower than the budgeted estimate, the staff will inspect the work before payment is made. Additionally, The City monitors each project at least once per year. The monitoring process begins with a written notice sent two weeks in advance. They then complete an entrance with the Director, do some file reviews, and then complete an exit conference. They then follow-up with a letter for documentation purposes.

Outsourcing by competitive bid

San Francisco outsources the management of its loan portfolio to an independent company. They pay a nominal flat fee per loan per month. The independent company handles the City's closings as well.

The City of Cleveland, puts their HOME funds up for bid yearly. Almost all of the funds go to one agency every year. This agency has member groups that receive the funds for long-term lease agreements. They fund long term lease periods for 15 years, when the tax credits expire. At this point, the renters take ownership. The only compensation the independent agency gets is a small development fee that is included in the City's administrative budget.

The City of Minneapolis outsources their residential finance program to an independent company for administrative costs equal to approximately 10% of their total budget. Additionally, Minneapolis has a sub-recipient agreement with another agency to handle all of the mortgage foreclosures counseling and prevention program for administrative costs equal to approximately 25% of their total budget. This agreement calls for servicing a loan portfolio of 900 loans (as well as other services) for an administration fee reimbursing actual expenses not to exceed a certain dollar amount. This is the equivalent of a very nominal monthly fee per loan. The contract contained very specific goals as well as detailed consequences if the stated goals are not met.

Maintaining good relationships with related entities

The City of Boston has developed a relationship with various banks where if the bank does the initial intake and the City helps with assistance of closing costs or down payments, the buyer gets a 1% discount on their rate.

Providing easy access to services for potential users

Additionally, the City of Boston has "Home Centers" in several spots all over the City, targeting the needy areas that market the programs available to the lower income eligibles. They do outreach such as attending community meetings, providing information to libraries and other resource centers, etc. Before any person receives assistance, they are required to go through an education program where they receive a certificate of completion prior to applying for assistance.

Schedule of Questioned Costs and Funds Put to Better Use

Recommendation Number	Ineligible 1/	Type of Questioned Cost: Unsupported 2/	Unnecessary/Unreasonable3/	Funds Put to Better Use 4/
2A	$900,000			
2B	$600,000			
Totals	$1,500,000			

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/ Unsupported costs are costs charged to a HUD-financed or insured program or activity and eligibility cannot be determined at the time of the audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the cost. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

3/ Unnecessary/unreasonable costs are those, which are not generally recognized as ordinary, prudent, relevant, and/or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.

4/ Funds To Be Put To Better Use are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented, resulting in a reduced expenditure in subsequent periods for the activity in question.

City Manager's Comments and Auditor's Evaluation

Office of the City Manager

Date: July 14, 2004

To: Mark Funkhouser

From: Wayne A. Cauthen, City Manager W.A.C

Subject: Consolidated Housing Plan Audit

The City Manager recognizes the City Auditor believes improvements can be made in the Consolidated Housing Plan by establishing appropriate housing policies and developing an adequate housing plan. The City Manager's Office is in substantial agreement with most of the audit recommendations with the exception of one area that will be explained in the body of the response. It is important to note the Consolidated Housing Plan is a dynamic document, which was approved by the City Council and HUD, and must be approved by both in the future. The City Manager's Office is making significant changes in the approach the City will take in the future regarding housing policy in Kansas City. Much of this work is either already completed or is in the planning stages, although a few of the items will take some time to complete because of a lack of specialized skills within the City's structure. Our responses to the specific recommendations are as follows:

- **Identify and address housing needs using the housing conditions study performed by the University of Missouri – Kansas City, or a similar effort.**

  Agree:

  The City Manager's Office has formed a Citizen's Task Force to develop a specific housing plan for Kansas City, Missouri. The draft plan will be submitted to the City Manager in September of this year.

- **Establish measurable goals and objectives.**

  Agree:

  This will be done in context of the specific plan submitted and approved by the Manager and City Council for next year.

- **Base funding decisions on specific, pre-identified needs.**

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Agree:

As part of the previously mention Task Force, this is a planned outcome.

- **Incorporate specific scopes of work, goals and measurements in all contracts.**

  Agree:

  Future contracts with sub-recipients will include measurable outcomes. This is being done in conjunction with efforts of Councilwoman Deb Hermann and the Neighborhood Development and Housing Committee.

- **Develop monitoring procedures that ensure all entities receiving funding are held accountable for meeting specific objectives.**

  Agree:

  These are being developed by OMB at this time.

- **Identify and "in-source" all functions that City staff can efficiently perform.**

  Agree:

  It is our desire to move as much of the entire process as possible into City Hall. Some tasks that require specialized skill sets (such as single family underwriting) will take time to acquire.

- **Competitively award all services not performed in-house.**

  Substantially agree:

  OMB is currently reviewing these possibilities also.

- **The City Manager should require HEDFC to repay the $900,000 in Beacon Hill program income it used without authorization and to repay the $600,000 balance of the Westside Business Park Section 108 loan.**

  Substantially agree with the following reservation:

  OMB has already requested the balance of the 108-loan repayment. City staff, including the legal department is reviewing the Beacon Hill issue and a decision will be forthcoming after further review.

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Auditor's Evaluation of Auditee

The City Manager generally agreed with all audit recommendations. The City Manager's Office has formed a Citizen's Task Force to develop a more specific housing policy and is making significant changes to the City's process for implementing that policy.

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HEDFC's Comments and Auditor's Evaluation

HEDFC
Housing & Economic Development Financial Corporation

RECEIVED
JUL 12 2004
CITY AUDITOR'S OFFICE

July 12, 2004

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Re: Draft Audit of City's Housing Program

Gentlemen:

We have received a draft report of the joint audit of the housing program of the City of Kansas City, Missouri prepared by the City Auditor and the HUD Office of Inspector General. After review of the draft report we strongly encourage you to disregard the conclusions and many of the recommendations contained therein because they are based on erroneous assumptions, unsupported by the actual facts concerning the delivery of housing services and a lack of understanding of the current City housing program.

We agree there is a need to periodically review the City's housing program to assure that the program is meeting the goals and objectives established by the City Council. However it is imperative that the review be predicated on understanding the requirements of the federal laws and regulations with respect to the use of the federal money that funds the program, and the purpose of the five year and one year consolidated housing and community development plan ("Comprehensive Plan") required by federal law in order to receive such funds. The City Council approves the Comprehensive Plan annually and submits it to HUD for approval. It has been approved each year. The Comprehensive Plan sets forth a consolidated plan specifically describing the City's housing policy, goals, activities and plan of action. Contrary to the assertions contained

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in the draft report, the Comprehensive Plan does contain specific measurable goals and objectives and the actions to achieve the goals. In addition it assesses detailed needs by individual areas within the City and identifies the various programs and resources to accomplish the goals. The City enters into annual contracts with the various service providers to implement the policies and goals of the Comprehensive Plan. The City's annual contracts with HEDFC provide specific direction as to the programs it is to administer and goals for the programs. As a service provider under the contract with the City we do not agree with the conclusion of the auditors that "the City has not clearly defined HEDFC's role in implementing housing policy".

The City's housing policy is not fragmented. It is comprehensive as required by federal law and established by the Comprehensive Plan. Whether the Comprehensive Plan is too complex is a determination to be made by the City Council.

The draft report has alleged that HEDFC has under performed and has operational deficiencies. HEDFC has consistently performed its obligations under its contracts with the City and has played a vital part in the delivery of the City's housing services. The draft report has completely ignored the substantial achievements of the City's housing program and the important accomplishments of HEDFC in assisting the City in carrying out its housing objectives. HEDFC has acknowledged planned operational upgrades and the integration and update of our software packages which the auditors were advised of at the commencement of their audit. However those system issues are few in number and in no way prevent HEDFC from performing its services.

The following are our specific responses to some of the conclusions, incorrect statements, and recommendations to the draft report for your consideration.

Finding 1: The City's System for Administering Housing Funds is Fragmented and Too Complex – page 8

The statement that the City's; …"fragmented system for administering housing funds contribute to higher than necessary administrative costs; lack of information; delays: and lack of accountability for poor performance" must be challenged. Let us evaluate the statement in parts to define the whole;

The City's housing delivery system structured by Federal legislation is not "fragmented" **it is comprehensive.** Since 1932 the Federal Government has been the primary source of funds for affordable housing programs to assist poor and low income households residing in distressed urban neighborhoods. Kansas City Missouri, not unlike its sister cities nationwide, had no answers for thousands of human beings living in dangerous unsafe buildings, poor people with no income, poor people with no jobs and NO HOPE. The Demonstration Cities and Metropolitan Development Act of 1966 initiated the Model Cities Program of 1967 (hereinafter "Model Cities"). No hope "spawned" the civil disorder of 1968 when distressed neighborhoods in many urban cities were "ON FIRE".

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Kansas City Missouri, not unlike its sister cities, looked to the Federal Government and its "Riot Legislation", such as Model Cities and the Housing and Community Development Act of 1974, to light a candle of Hope for low and moderate income households residing in substandard housing and severely distressed environments. Model Cities in Kansas City in conformance with Federal law and regulations established a housing system comprised of three (3) primary components:

- City Housing Department
- The creation of the Model Cities Housing Development Corporation and Information Center (HDCIC) to provide Housing Assistance Services
- Neighborhood Improvement Committees to establish and define programs and projects to serve low and moderate income households.

Since 1967 Federal law and regulations have required changes in the housing system. One thing has not changed since 1964, the Federal Government continues to be the diminishing resource that keeps the candle lit. If Kansas City's administrative cost to provide housing assistance to low and moderate income households is "higher than necessary", it is increased by the requirements of Federal law and regulation.

A specific example of increased administrative costs created by Federal law and legislation was the Kansas City Missouri Single Family New Construction Affordable Housing Program" (hereinafter "AHP"), financially assisted by Community Development Block Grant (CDBG) funds. The City Council, in 1990 was provided the 1989 city land use survey which listed 10,282 vacant residential parcels citywide. These properties were owned by Land Trust and generating little of no income to the general fund, were targeted by the new AHP. Having no general funds to assist new housing construction, the City Council looked to its federal housing program resources. The City's Department of Housing and Community Development in reviewing Block Grant legislation and regulations determined New Single Family Construction was an eligible activity if: "the assistance was to be carried out by eligible sub-recipients, specifically a neighborhood based nonprofit organization" (Source: U.S. Department of Housing and Community Development regulation as set forth in 570.204 (a) Certain Activities by Certain Sub-recipients). This exception was important because in the same regulations at 570-270 sub part (b) the regulations state "CDBG funds may not be used for the construction of new permanent residential structures for any program to subsidize or assist such new construction except:...(iii) when carried out by a sub-recipient pursuant to 570.204 (a)."

In 1990 the federal regulations became more comprehensive with the inclusion of neighborhood based nonprofit associations to construct new single family infill housing on the ever-increasing vacant lots in the City. In addition, federal regulations controlling residential environmental hazards such as lead-based paint, asbestos-containing materials, and underground heating oil storage tanks have led to increased administrative and technical costs. In the year of this performance audit seven (7) neighborhood-based nonprofit associations were building new homes in the Urban Core. A list of the nonprofit developers is provided below:

- Move – Up
- Community Development Corporation of Kansas City
- Urban Housing Development and Management Council
- Old Northeast
- Westside Housing Organization
- 12th Street Heritage Community Development Corporation
- Swope Community Builders of Kansas City

HEDFC would interpret the introduction of nonprofit organizations as a housing development partner as mandatory by Federal law and regulations, specifically the 1990 NAHA which states in the regulations in Title II – INVESTMENT IN AFFORDABLE HOUSING Sec. 203 Purposes…(c) "to promote the development of partnerships among the federal government, states and units of general local government, private industry, and nonprofit organizations able to utilize effectively all available resources to provide more of such housing": (6) "to expand the capacity of nonprofit community housing development organizations to develop and manage decent, safe, sanitary and affordable housing."

The federal regulating language above referenced stating the purposes of the 1990 AHA clearly establish and mandate primary roles for non profit sub-recipients like HEDFC and the Community Housing Development Corporations ("CHDC") herein referenced to assist the housing delivery system for low and moderate income households in our community. There are clearly costs associated with nonprofit neighborhood based organizations achieving housing development capacity. The cost, we would not classify as administrative , are summarized below:

- Capacity Building (train or upgrade staff to achieve housing development experience) or contract with professional firms with housing development qualifications.
- Technical assistance expenses such as architectural, engineering, environmental, construction management, cost estimating, and surveying;
- Property "holding" expenses (costs incurred during marketing period) i.e. non insured losses for vandalism, theft, illegal occupancy, illegal dumping, maintenance, insurance, and taxes.

It should also clearly be understood that private for profit developers still consider the urban core housing developments extremely "High Risk and Dangerous". This negative perception lingers long after the civil disorders of the late sixties and early seventies when there was a mass exodus from Kansas City Missouri's central city.

For over three (3) decades the only system willing and able to develop and maintain shelter for low and moderate income households was the nonprofit system comprised of HEDFC and the CHDC's now being labeled "fragmented, ineffective and costly." What should it cost to provide descent, safe, and sanitary housing for poor people living in severally distressed central city neighborhoods is difficult to define. The fact remains

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that the nonprofit housing delivery system does work and it has improved housing conditions for over thirty (30) years.

In addition, and in a spirit consistent with congressional intent, various committees of the City Council hold hearings annually—as part of the Consolidated Plan process—to determine whether funds are in fact used effectively. Through the comparison of outcomes with goals contained in both the 5-year plan and the annual action plans, as well as hearing directly from the residents/constituents most impacted through these funds, the Council ultimately decides if funds are used effectively when it approves funding for the Plan. Additionally, HUD concurs with the Council's determination of effective utilization of funds when it approves the Consolidated Plan.

I. The City still needs a strategy to address housing needs and measurable goals to determine whether the strategy is working – page 8

A. The City Council adopted a housing policy – page 8

B. Housing condition survey collected detailed information – page 9

The UMKC housing condition survey is but one small tool in the community development toolbox. By federal law, Cranston - Gonzalez, National Affordable Housing Act of 1990 designates local political jurisdictions (hereinafter "cities") as the party accountable to the U.S Department of Housing and Urban Development ("HUD") for expenditures of federal funds and housing produced. A central provision of the Cranston – Gonzalez National Affordable Housing Act of 1990 ("NAHA") requires cities to develop and submit a document to HUD titled "Consolidated Plan" on an annual basis which provide the following:

- Assessment of Housing Needs
- Design of Affordable, Special Housing Strategies
- Formulation of Specific Action Programs to Meet assessed housing needs
- Establishment of Service and Housing Program goals
- Formulation of Budget to Achieve Housing Program Goals.

C. Housing plan did not significantly change – page 9

The Consolidated Plan discussed in the audit relates to the 5-year plan for the period 1999-2003. As such, the background information and data used in 1999 remains the same throughout the plan. Necessarily, the 2003 Action Plan remains consistent with Action Plans from the previous four years since it is the fifth and final year of implementing the 5-year Consolidated Plan. In addition, the 2000 Census data was not available for the 2003 planning period.

It is critical to understand the context in which the Consolidated Plan is developed, however broad it may be perceived, and that housing activities are a "part" of the larger objectives Congress intended.

A central provision of the Cranston-Gonzalez National Affordable Housing Act of 1990 requires cities to **develop and submit a document which assesses various housing needs in their community, and which designs affordable, special-needs housing strategies, and action programs to meet those needs**. This document, the Consolidated Plan, is a 5-Year Housing and Community Development Strategy which is submitted to the U. S. Department of Housing and Urban Development ("HUD") as a condition for receiving funding from most existing federal housing assistance programs, and most future programs as well. In 1995, HUD's Final Rules for the Consolidated Plan allowed cities to submit a One Year Action Plan on an annual basis, along with any amendments to the 5-Year Strategy and appropriate certifications. Community Development Block Grants (CDBG) and HOME programs are but two (2) of the nineteen (19) programs affected by this requirement.

All entities applying for federal housing assistance under one of these programs must include in their application a certification of consistency with a Consolidated Plan approved by the U.S. Department of Housing and Urban Development.

HUD has outlined the following purposes for developing the Consolidated Plan:

- To incorporate *all housing-related elements into a single planning document* making it a more useful tool in addressing housing needs;

- To encourage cities to develop housing strategies based upon a holistic examination of overall housing needs, to establish goals, and plan for carrying out various activities;

- **To serve as an action-oriented management tool for cities and as a monitoring tool for HUD to determine how effectively the city is satisfying its needs with the available resources;**

- To assess the housing needs of the city's very-low, low, moderate-income families, including the needs of homeless individuals and families, and to evaluate the availability of housing resources, both unassisted housing and assisted housing;

- To develop a strategy for meeting the City's housing assistance needs over a five-year period; and

- To develop a one-year action plan that consolidates the submission requirements of the Community Development Block Grant Program (CDBG), the HOME Program, the Emergency Shelter Grant Program (ESG), and the Housing Opportunities For Persons With AIDS Program (HOPWA).

Contained within the Consolidated Plan is information about citizen participation, Consolidated Strategy Areas, and a Timetable of Planning Activities. Outlined is the City's vision for the future from the fourteen Strategic Initiatives and corresponding Policy Directives as stated in FOCUS Kansas City's Strategic Plan

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and Neighborhood Assessments. These policy statements and assessments provide guidance for the 5-Year Housing Goals, Objectives, and Strategic Priorities for Investment.

Upon approval by City Council and HUD, the Action Plan is available with the previously approved 5-Year Consolidated Plan to provide the user with a comprehensive overview of the City's housing needs, strategies, and resource allocations.

As previously stated, the City Council has determined that funds are spent effectively based on its decision to continue the annual implementation of the 5-year Plan.

II. The City's system for implementing housing policy is fragmented and complex – page 9

As previously stated, the City's housing delivery system, as structured by Federal legislation, is not "fragmented" **it is comprehensive**. Furthermore, the statement that "…agencies each play a role in the City's housing system, but no one party controls spending decisions" is inaccurate. Pursuant to Federal law <u>there is</u> one party that controls spending decisions locally, and that is the City Council.

A. Many parties are involved in the system – page 12

B. The City doesn't systematically identify needs – page14

The City does in fact systematically identify needs through the 5-Year Consolidated Plan and Annual Action Plans. Section I – 2003 Consolidated Planning Introduction, Process and Methodology (pages 3-16) sets forth the requirement that all proposals submitted in response to the annual request for proposals must comply with both the 5-year consolidated plan and the 1-year action plans.

C. The City hasn't established clear lines of authority and responsibilities – page 14

This statement is inaccurate. By legislation, federal regulation, and ordinance, all activities relate to the Consolidated Plan. In addition, through direct contracts with service providers, these legally binding documents set forth party roles, responsibilities and outcomes. No grey areas or confusion exists.

III. Fragmented, complex system increases costs, weakens accountability – page 15

Audit Response continued

The system is not fragmented, there are performance goals in the contract, and we provide monthly reports and information that the City may use for IDIS.

A. ***Administrative costs are increased – page 16***

Administrative costs are reasonable in light of federal regulations and City Council determination that production activities and associated costs were necessary. For the contract year ending May 31, 2003, the City, HEDFC and CDCs total-combined public budget was in excess of $31 million. The "$5 million in administrative costs" represented approximately 15% of the total publicly-funded budget.. When compared against all funds and sources invested in housing and related activities by these entities, the total administrative costs are less than 5%.

B. ***Decision-makers lack adequate information – page 16***

HEDFC in conformance with its contract scope of services provides a series of housing production reports to DHCD monthly. The single family housing report created by DHCD in conformance with HUD, IDIS reporting requirement, tracks all single family housing production from application to sale. This report is prepared monthly by all CDCs who receive financial assistance from HEDFC. These reports are reviewed by HEDFC staff and construction status corroborated by quality control inspections. HEDFC provides a monthly status report to DHCD for multi-family and economic development loans. HEDFC provides a monthly financial and loan servicing report to the HEDFC Board of Directors and DHCD, including delinquencies and foreclosure actions in process. HEDFC provides special housing production reports upon request by the City. In contract year 2000, HEDFC compiled and provided to DHCD a ten (10) year production report summarizing production and expenditures for the time period 1990 – 2000 (summary page of the ten (10) year report attached). (Exhibit 1)

In December 2003 Third District City Council persons Sandra McFadden-Weaver and Troy Nash requested a three (3) year housing production report for the time period June 1, 2000 – May 31, 2003. The special report was compiled by HEDFC (updated July 2004) and transmitted to the Council persons and City Manger's office (summary of report attached). (Exhibit 2)

The City, as a direct recipient of HUD funds, is required to submit various types of information and reports, specifically CAPER and IDIS, to HUD. A portion of the data necessary for these reports is supplied to the City by subrecipients pursuant to their funding contracts. At no time are these subrecipients allowed, directed, expected or required to report to or communicate with HUD directly. Furthermore, HUD has expressly directed that ALL communication flow through the City. To imply that HEDFC is somehow thwarting the City's annual reporting to HUD indicates a failure to understand the roles and responsibilities of the City versus its subrecipients.

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At the time of this draft audit, the CAPER report was under development by DHCD. However, the monthly reports used for CAPER have been and are available from DHCD for auditor review.

C. Stakeholders complained of slow payments – page 17

Endemic in a consolidated plan approved by HUD are a myriad of federal regulations and local guidelines which set out very specific methods for expending federal funds. As such, there will be occasional slow payments.

It should also be noted that although "three or four" banks don't work with HEDFC, currently there are **FORTY-SIX (46)** lending institutions participating in the loan programs administered by HEDFC.

D. Untimely draw downs – page 17

E. System weakens accountability – page 17

CDBG legislation mandates the use of CDCs/community-based nonprofit organizations to develop new housing in urban core communities. The City has determined that CDCs will be supported in redeveloping the urban core of Kansas City. HEDFC instituted the practice of "take-outs" to attract more private developers, and the participation of private lenders, in the development of the urban core.

F. Environment of mistrust – page 18

The characterization of an "Environment of mistrust," to our knowledge, is untrue and misleading as to the relationship between the staffs of the City and HEDFC. While there are times when the staffs may disagree on certain matters we believe that overall the staffs have very good working relationships with each other. We understand that some responses may sometimes be delayed from both sides but we know that both staffs have there regular daily work as well as addressing other priority demands on their time. We believe that overall the response times are very good and timely. We do not understand your comment about disagreements about documentation and ownership of property. From time to time there are requests for duplication of previously delivered documents, but that is the exception not the norm. We are not aware of any disagreement over ownership of property. Maybe you can be more specific. Any issues or questions about staff responsibilities are worked out and never affect the performance of the parties. We believe a fair characterization of the working environment of the staffs would be one that actually reflects the facts that the staffs have a very good working relationship that tries very hard to address the needs of each staff to carry out their respective responsibilities.

IV. The City is required to have an adequate system – page 18

V. The City must improve its system – page 19

The statement "the City must improve its system" is incomplete. The City's problems are indeed systemic, derived from a pattern and practice of geographic segregation resulting in social and economic depravation. Today, Troost Avenue remains this community's Mason-Dixon Line. Addressing this system—as a whole—is necessary.

The cost to remediate the housing problems in Kansas City's urban core is $2.5 billion. The resources available to address this problem are approximately $15 million annually. So how do you eat an elephant? One small bite at a time!!

<u>Recommendations</u> – page 19

All of the recommendations noted are already a part of the current Consolidated Plan process and the contractual obligations which flow as a result. In actuality, the Consolidated Plan process is more comprehensive that the recommendations outlined.

The Focus Neighborhood Assessments, and policies and strategies developed by the 2001 Housing Task Force are living documents that reflect enormous hours of work by residents, stakeholders and elected officials. The ideas set forth in these documents are still valid, and should be revisited for the purpose of <u>updating</u> strategies in light of the 2000 census and current market conditions.

The regulatory process to create the Consolidated Plan mandates a competitive process for the award of all dollars for services the City staff does not perform. The City should maintain the flexibility to pursue and fund projects outside of the Consolidated Plan, much like it has with the Law Building , 817 Cherry, and 1600-04 Grand projects.

Again, the cost to remediate the housing problems in Kansas City's urban core is $2.5 billion. The resources available to address this problem are approximately $15 million annually.

<u>Finding 2: The City Has Not Clearly Defined HEDFC's Role in Implementing Housing Policy</u> – page 21

The City ultimately makes all the decisions concerning the implementation of housing policy. The City Council defines HEDFC's role in the Consolidated Plan, and it is further defined by contract between the parties.

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Audit Response continued

VI. Contracts don't adequately define HEDFC's role – page 21

We disagree that the contracts between the City and HEDFC do not adequately define HEDFC's role. A review of the contracts for Beacon Hill, Weld Wheel, PIAC, Westside Industrial Park, 18th and Vine, and the annual Consolidated Plan will clearly show a definition of our roles and responsibilities.

While to the uninitiated the scope of work described in HEDFC's contracts with the City may seem "broad," the contracts actually facilitate the goals set by Congress to afford every American a decent home in a suitable environment.

HEDFC's mission is to "provide financial and technical services to enhance the quality of life of low and moderate income residents, with a primary focus on urban core neighborhoods."

HEDFC—formerly Housing Development Corporation and Information Center/Rehabilitation Loan Corporation) was created January 1970 to, among other things, "…assist in the development of projects…in cooperation and in coordination with local governmental and civic bodies for the elimination of slums, blight and blighting influences, and to aid, assist and foster the planning, replanning, development and improvement of the City of Kansas City, Jackson County, Missouri, all for the primary purpose of combating community deterioration and securing adequate housing, community facilities and other related facilities, services and conditions, economic and otherwise, conducive to the progress and general welfare of the community;…"

For more than thirty (30) years the organization has been an integral part of the City's housing, community and economic development programs, and delivering services consistent with the public purposes for which funding from HUD is derived. HEDFC's creation was in direct response to the devastation of Kansas City's neighborhoods due to the all too familiar effects of white flight—disinvestment, abandonment, deterioration and crumbling public infrastructure, and the civil unrest that ensued. The vision was that HEDFC would be a partner with the City to facilitate its rebuilding, working with CDCs and other community-based organizations to deliver programs and services in housing development, mortgage lending, economic development, public facilities development, and technical assistance. Operations began in 1970 through funding under the provision of the Demonstration Cities Metropolitan Development Act of 1966 (commonly known as the "Model Cities Program"). This program provided financial and technical assistance to enable cities to plan and implement demonstration programs to improve the quality of urban life. Housing demonstration activities started under the Model Cities Program are now part of the ongoing programs for both the City and HEDFC.

All of the activities undertaken by HEDFC are in compliance with the City's Consolidated Plan ordinance, Federal law, Federal regulatory requirements, consistent with its mission, and are permissible under the laws of the State of Missouri. Furthermore, these activities have been tailored specifically in furtherance of the City's goals and objectives, since every investment of public dollar is tied to a specific project in

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the Consolidated Plan or identified by the 29th floor of City Hall such as the Jewell Redevelopment Project, Solo Lofts, Wayne Estates, and Midtown Marketplace. For "stakeholders" to pigeon-hole HEDFC as just a lending institution indicates their ignorance of both the genesis of this organization and its lawful authority to operate in a "broad" manner to carry out its mission and contractual obligations.

We disagree that the City cedes decisions about the use of public funds, by virtue of the fact that the City contracts with various entities to provide services which are funded with these public dollars.

A. Eligible activities are broadly defined – page 22

The eligible activities are defined by Federal regulations and are comprehensive in scope.

B. The City hasn't established performance standards for HEDFC – page 22

The goals are established pursuant to contract. See page 15 of the 2003-2004 Consolidated Plan Annual Contract, Contract No. 2003-002 (Ordinance No. 030602), and other such contracts in force.

C. Roles aren't clear to other stakeholders – page 23

The City has acknowledged our in-house capabilities to do development projects within Kansas City's urban core. HEDFC develops when others default on their contractual obligations, such as the Renaissance Place, Brooklyn Infill and East Meyer Redevelopment projects, and because of our experience in urban core/distressed neighborhood development.

VII. City Housing and HEDFC disagree about the appropriate use of funds and other program issues – page 23

HEDFC is not aware of any disagreements with City Housing Staff regarding the appropriate use of program income. The contracts clearly state how HEDFC is to both use funds and implement projects. Please refer to the following:

Contract No. 1999-036 (Ordinance No. 990532)
Contract No. 2000-048 (Ordinance No. 000728)—Section D.22
Contract No. 2001-088 (Ordinance No. 010776)—Section D.22
Contract No. 2002-128 (Ordinance No. 020601)—Section D(1)(f) and (k)
Contract No. 2003-002 (Ordinance No. 030602)—Section D(1)(f) and (k)

These contracts specifically identify that HEDFC shall provide technical or financial assistance for other projects as may be set forth and agreed upon through separate contracts during the term of the Contract and for Prior Contract Activities. In connection with the Beacon Hill example, the former director of the City's housing department supported the expenditure of funds for all project activities.

A. HEDFC spent more than authorized by contract on Beacon Hill – page 23

The statement that "HEDFC spent more than authorized by contract on Beacon Hill" is again inaccurate.

HEDFC's authority to spend $10 million in Section 108 loan guarantee funds and $1.25 million in BEDI funds was never intended to, and was incapable of, funding the entire Beacon Hill project. As indicated in the Beacon Hill Redevelopment Corporation Chapter 353 Plan application, the overall cost of site development and preparation to allow new lots to be sold was estimated at $20,000,000—that's before anything is renovated or built. The overall value of new houses to be built and sold, and existing houses to be renovated was estimated to exceed $70,000,000. The Section 108 and BEDI funds, along with PIAC funding, are but a portion of what is needed and expected to be utilized for this project. It is disingenuous at best to state that $900,000 was somehow inappropriately spent to advance a project HEDFC is under contract to implement and three City Councils have blessed. All activities in Beacon Hill have been and continue to be undertaken at the direction or with the consent of the City. For example, largely because of developer capacity issues, HEDFC is managing the Tracy Infill public improvements construction, facilitating housing renovations, and building two (2) new houses, all in an effort to jumpstart the project.

The former director of DHCD, when notified by HEDFC that over $920,000 of BEDI-related expenses had been incurred for property maintenance and demolition charges, directed HEDFC to submit a request for reimbursement of these costs. In November 2003, the then acting director of the department choose to reimburse only $419,000 of the amount submitted, thus creating a deficit of $501,000 in program income.

Furthermore, expenditures on behalf of the project did not exceed the initial funds available until after commissioners, pursuant to a condemnation suit, awarded fifteen (15) claimants over $1.5 million. Budgeting for condemnation awards can only be based on guesstimates (and the same is true for environmental remediation), but one thing is certain: *Section 523.045 of the Missouri Revised Statutes* states that if the amount of the commissioners' award is not paid within 30 days after the filing of the condemnation commissioners' report, then interest on the award (or subsequent verdict) is payable at the rate of 6% per annum from the date of filing the report. Based on the amount of the award, and the likely interest costs that would have ensued (notwithstanding the delays in the project if control of the properties was not obtained at that time), sound business practices dictated paying the condemnation award.

Lastly, in April 2003—prior to the condemnation award and in light of the remaining funds available—HEDFC instructed the City's department of Property and Relocation Services to cease making offers to purchase properties in the project area, and to remove additional properties from the second condemnation

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suit being prepared for filing. In other words, all reasonable steps were undertaken to limit expenditures to the funding sources in place.

B. HEDFC spent about $600,000 to rehabilitate two houses within the Beacon Hill project – page 24

The City's 2001 Consolidated Plan budget included $3,450,500 for the rehabilitation of homes in various neighborhoods, including Beacon Hill. These funds were allocated outside of the Section 108, but apparently have been overlooked by the auditors. The dollars used for this part of the Beacon Hill project came from this budget source. See Exhibit 3.

HEDFC has spent about $600,000.00 on an eleven (11) unit residential rehabilitation project within Beacon Hill. Construction has primarily been concentrated on 2518, 2523 and 2519 Tracy.

Tracy Avenue features two single family homes at 2518 and 2523 under "restoration" in a manner consistent with the preservation of historic properties as set out by the National Park Service/National Register of Historic Places. The Beacon Hill neighborhood contains a number of properties eligible for the National Register, and some are now in various stages of the nomination process. Prior to these recent nomination activities, HEDFC undertook the restoration of 2518 and 2523 Tracy in order to fully understand the magnitude of restoring homes to National Register standards, to ascertain whether this type of work could be financially feasible on a larger scale, and to demonstrate the Beacon Hill design standards for existing homeowners.

Both homes currently under construction will serve as educational laboratories—for developers, investors the historic preservation community, and potential homebuyers. Existing residents in Beacon Hill toured the properties on numerous occasions to gain ideas for the renovation of their homes and to make decisions on which techniques to employ based on cost. Two existing Beacon Hill residents on Tracy Avenue (one in the 2500 block and one in the 2600 block) did in fact renovate their homes, completing them Spring 2004. Future plans entail using the home at 2518 Tracy as the initial real estate sales office for the Beacon Hill project, while 2523 Tracy will continue to serve as a laboratory until the remaining owner-occupied homes on Tracy are renovated.

The eleven (11) unit project plan anticipates private developers purchasing the public investment in 2518, 2519 and 2523 Tracy and completing rehabilitation with private financing and state neighborhood tax credits. The estimated private investment is $1,430,000.00.

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C. Contracts authorized use of public funds to rehabilitate housing – page 25

D. HEDFC failed to repay the Section 108 loan for the Westside Business Park – page 25

The facts under this topic are misstated. HEDFC has never own the subject property. HEDFC made a loan to the Westside Industrial Park L.L.C. ("Redeveloper") which was secured by a deed of trust as well as other collateral. The Redeveloper then prepaid the loan to HEDFC as permitted under the loan documents on November 27, 2002. In response to the unanticipated prepayment of program income, HEDFC after consultation with the Director of the Department of Housing and Community Development ("DHCD') formally requested that these prepaid program income funds be used to fund a revolving loan fund instead of being returned to HUD. See our letter to the City dated December 4, 2002 attached as Exhibit 4. The City then made a similar request by a letter to HUD. See the letter to HUD dated January 7, 2003 attached as Exhibit 5. While awaiting a determination by HUD the acting Director of DHCD requested the funds be paid back to the City for repayment of the Section 108 Loan. However the Director did authorize HEDFC to use a portion of the funds to fund a portion of a loan made at the direction of the City to United Inner City Services for the construction of its St. Marks Child Development Center. The Corporation's requirement to repay these remaining funds is subject to the availability of CDBG program income. Accordingly HEDFC has at all time acted properly and in accordance with the direction of the City with regard to the proceeds of the 108 loan. At the City's request, HEDFC remitted $5.6 million to the City Treasurer on November 21, 2003. Of this amount, $174,010 represented interest earned on those funds during the period held. Of the resulting balance, $701,382 was remitted to the City Treasurer on January 6, 2004 and $897,388 was paid on behalf of United Inner City Services for the referenced project. To date, of the $7.2 million held, and after a payment to the City of $300,000 the remaining balance to the City stands at only $597,388..

E. Monitoring focuses on compliance not effectiveness – page 25

Monitoring should focus on compliance with contracts and federal regulatory requirements. All contracts between HEDFC and the City direct and control how public funds are spent. Again, the City does not cede decisions about the use of public funds to HEDFC because the expenditure is set out by contract between the two entities.

VIII. Unclear role prevents adequate assessment of HEDFC's effectiveness – page 26

HEDFC's role is defined by its contract with the City of Kansas City. Third party perceptions of HEDFC's role are a matter of personal preference and should not be construed as matters of fact. While HEDFC's primary mission is providing assistance to low income families in Kansas City's urban core, the Corporation does act as owner/predeveloper or developer for certain projects. In its role as predeveloper/developer the Corporations responsibilities as lender are mutually exclusive. Since one cannot loan money to oneself, the Corporation is simply converting one corporate asset (cash) to another asset (improved real estate).

All activities undertaken by HEDFC have been consistent both with the letter and spirit of the various contracts and cooperative agreements it has entered into with the City. HEDFC regularly provides reports outlining performance against contract goals, and all goals have been crafted with national housing objectives in mind. Although HEDFC is a private nonprofit corporation free to conduct whatever lawful business it chooses, it has made serving the needs of low income households residing in the urban core—and meeting national housing objectives—its primary focus.

A. HEDFC's primary role is lending – page 26

The statement that" HEDFC's primary role is lending" is inaccurate. As stated previously, HEDFC's corporate mission allows it to undertake a wide array of activities. **All** activities of the organization support and are consistent with its mission, and all funds expended are in furtherance of its mission, the City's goals, and national housing objectives. The notion of "system stakeholders" that HEDFC should act solely as a lender rather than a developer smells like paternalism, seeks to frustrate legislative intent, and, if imposed, would have prevented the successful completion of Renaissance Place, Brooklyn Infill, and Citadel–all projects started by developers and CDCs that had to be bailed out. Suffice it to say that the definition, interpretation and implementation of HEDFC's mission—including its policies and procedures for conducting development activities—is best left to HEDFC, a *private* nonprofit corporation. What activities it undertakes ***in partnership*** with the City is a contractual matter, and in no way limits HEDFC's authority as a lawfully organized Missouri corporation.

B. Most funding has been for development activities – page 26

While this statement may at first glance appear accurate, it is misleading . Development activities include single family new construction and multifamily construction activities which provide direct "housing" benefits to consumers. Economic development activities provide both direct and indirect benefits to consumers. Spending levels represent the policies and spending decisions of the leaders of the City of Kansas City, Missouri.

The City has not mandated that HEDFC develop specific policies and procedures for HEDFC to conduct development activities. As in the case of the $14.8 million Section 108 and the $4.5 million EDI grants, HEDFC has served as a lender to the private developers only.

In HEDFC's capacity as a lender, it follows its customary policies and procedures for underwriting and approving loans. On those rare occasions in which HEDFC does serve

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in a development role, HEDFC has used its in-house capacity to move projects to completion and protect the City's investment, using industry acceptable practices.

<u>Recommendations</u> – page 27

2A.See response to VII. A, above.

2B. HEDFC requests a reconciliation of accounts both payable and receivable, and if a determination is then made that any funds are due the City, HEDFC will pay such sums upon the receipt of program income.

2C. Existing contracts adequately address this recommendation.

<u>Finding 3: HEDFC's Operational Deficiencies Contribute to Poor System Performance</u> – page 28

See Note 1

HEDFC's management routinely monitors and evaluates the need for program implementation changes, process and procedural improvements as well as additional staff training. While some changes and improvements may be delayed because of competing demands or limited resources, none restrict or preclude the delivery of services. Although certain concerns identified in this report are accurate, the conclusions and recommendations are unsupported by the facts as reflected in our responses below.

IX. HEDFC operational controls and processes are deficient – page 28

There are several misstatements contained under this topic.

- **Financial Audit**. While the timeliness of the HEDFC Financial Audit at first blush appears to be way past due per its contract with the City it was not the fault of HEDFC. HEDFC was informed subsequent to year-end that its auditor from the prior year had decided not to do the audit for HEDFC's fiscal year ending 2003 after the auditor had already undertaken preliminary steps to conduct the audit. HEDFC then issued an RFP for the selection of a new auditor. The new auditors were selected in August 2003, and an engagement letter was signed on August 31, 2003. By the terms of the engagement letter the audit was to be delivered by October 31, 2003. In Early November 2003 the financial audit was substantially complete, however, the presence of the performance audit team consisting of the City Auditor and the HUD Inspector General appeared to slow the financial audit process. The financial auditor anticipated the release of the performance audit. The performance audit was negatively affected because audited financials were not available for the most recent fiscal year. A preliminary draft (absent the auditors' opinion) was provided for discussion purposes only. Audit responses were provided and a subsequent draft with a disclaimer of opinion was delivered to HEDFC on March 17, 2004. The auditors' rational for disclaiming an opinion was primarily based on the novel position that the assets of HEDFC were not its assets but were instead assets of the City. This position was

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advanced even though the assets were in the name of HEDFC, prior audits of the City and HEDFC had never questioned the ownership of the assets and a legal opinion had been delivered by a law firm to specifically address that issue. It was not until after the City Attorney issued his opinion concerning this issue that the auditors issued their audit on June 30, 2004. The City was at all times advised of the status of the audit and on several occasions, granted extensions of time.

- **Computer Systems.** The comments are inaccurate and misleading. The Corporation maintains a Novell network system consisting of 3 servers, 30 workstations, 30 local printers and 4 network printers. The system uses Microsoft Office (Word, Excel, Access etc.), MIP non-profit accounting, Dataflex (Dos based loan servicing database), LoanLedger (windows based loan servicing software), Genesis (loan processing software currently not in use).

  Competing demands and high turnover have delayed the conversion from the Dos based servicing system to the windows based system. While the current network system is adequate at least. Some aspects of the system are progressive and up to date with current technology. Additional training and improved skill levels can however enhance performance and improve implementation of existing components. For example implementation of the Genesis loan processing software may aid in data interface, and management tracking and reporting. However, some duplicative efforts will continue to exist until conversion or implementation of a completely integrated system. Cost analyses performed in prior years revealed that implementation of a totally integrated software system would be prohibitive. Recent estimates indicate that such a system would cost in excess of $150,000 excluding training and conversion expenses. Allocation of additional resources could ameliorate all the stated concerns, however, management believes that such a use of funds, at present, would not be the best use of limited resources.

- **Policies and Procedures.** This statement is inaccurate. The database manual documents procedures for collecting, tracking and reporting a large array of information about each loan or project. However, improved training and implementation will enhance the data collection process. A copy of the database manual is available for reference.

- **Supporting Documents.** This statement is both inaccurate and misleading. All loan documents for projects currently under construction are located in the HEDFC offices while loan documents for projects that have been completed are either in the HEDFC offices or in off-site storage at the HEDFC owned building at 6285 The Paseo. Each permanent file is given a file number and its location is listed in the file directory contained in the computer system.

- **Reports.** Minor errors sometime occur because of address changes, multiple homeowners/borrowers, etc. These types of errors can not normally be screened through system quality control reviews and may require a more subjective review.

Audit Response continued

Management will endeavor to subject reports to a higher degree of review prior to submission.

- **Board Reports.** Reports are given to the Board each month to provide information on each part of HEDFC's operations, including financial, lending, operations and development reports. Over the last 2 years, the formats of these reports seldom vary from month to month. Their content will vary since they are structured to update the Board on current activity. The multifamily report gives detail information about each project that is under application or under construction including the name of the project, source of funds, amount, and status which states percentage of completion if applicable. In addition a specific written update on all economic development projects is provided each month.

See Note 1

- **Detailed Program Budgets.** HEDFC does not use detailed program budgets, but instead uses "project" budgets, which are maintained in each project file, and which track and report actual project budgets to fund allocations. See the sample project budget attached as Exhibit 6.

See Note 2

- **Grants Funds Commingled.** This statement is both inaccurate and misleading. As discussed and documented previously, the funds in question were in fact HOME funds paid to reimburse the CDBG account for a portion of administrative expenses allocated to HOME. Although the receipt of said funds was appropriately recorded and documented as a reduction in HOME receivables, the actual deposit represented a reduction in the HOME Funds owed to CDBG. Moreover, federal regulations require separate "accounts", the regulations do not speak specifically to separate "bank accounts". HEDFC does in fact maintain separate bank accounts, and separate income accounts for HOME and CDBG funds. Management contends (and the regulations support this contention) that no commingling occurred for the reason stated above.

- **On-Site Inspections.** This statement is both inaccurate and misleading. On-site inspections are performed on a regular and consistent basis. In fact, observation reports are required to be submitted with each draw request to support payments to contractors. In the future, consideration will be given to filing observation report chronologically in the project file for easier reference.

- **Monitoring Reports.** This statement is vague, and HEDFC is without sufficient information or understanding to respond.

- **Inventory of Assets.** The accounting system currently tracks all additions and disposals. In addition, separate schedules are maintained by staff persons responsible for asset management. However, procedural improvements have previously been identified which will allow all physical assets to be logged and maintained in the fixed asset database. The system will allow for photograph as well as cost, maintenance and other relevant information. Implementation of improved procedures will depend largely on availability of additional staff and or financial resources.

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Audit Response continued

- **Benchmarks.** HEDFC compares its performance to its contract requirements.

- **Competitive Bidding**. All projects in which HEDFC has responsibility for development have documentation of competitive bidding, including a copy of the public advertisement or other written form of solicitation, in the project file.

See Note 3

- **Program Marketing**. This statement is inaccurate. HEDFC does market its programs to targeted users. It conducts periodic workshops for lenders, realtors and CDCs. In addition it participates in work shops presented by HUD, CDC's and other nonprofit organizations to the public for housing programs. The fact that HEDFC uses its entire HOME funds budget for the past fiscal years clearly indicates that sufficient marketing has and is occurring.

- **Accounting Principles.** HEDFC accounting system using the accrual basis of accounting. Without a specific reference, management believes this comment to be without basis.

X. Previous studies have noted similar operational problems – page 29

Recent trends show that groups of auditors/reviewers perform similar or redundant procedures resulting in a grossly ineffective use of funds. Furthermore, funds which may have been expended to solve problems or improve process and procedure are instead used to reiterate simple, sometimes obvious conclusions.

NCCED prepared an "action plan" in 2001 (at the City's expense) to present a "detailed professional objective assessment of the efficiency and effectiveness of the City's current operations and to identify specific steps to enhance the City's capacity to provide affordable housing". HEDFC was the primary focus of the review.

Baird Kurtz and Dobson (BKD) issued a draft report in April 2002 (at HEDFC's expense) to "review internal procedures and current information technology". The scope of the review changed and no new observations were made. In fact, the BKD report was based primarily on conversations with employees and others. As such, the information "was never intended to be a complete review of all procedures". The reviewer's comments and recommendations were based less on fact and more on opinions and subjective observations. Much of the information presented was a reiteration of those aspects of the organizations management and employees had previously identified as needing improvement. The report stated as fact broad subjective conclusions not supported by fact. The credible recommendations were reiterations of known facts or regurgitation of prior comments made by others. Moreover, the report was prepared without substantial input by some executive staff members at the time.

- HEDFC completed its annual financial audit in accordance with federal regulations. Audit fieldwork began in late 2003 and was concluded in early 2004.

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- HEDFC was subjected to a performance audit conducted by the City Auditor and the HUD Inspector general. Audit field work for the performance audit overlapped the fieldwork for the annual financial audit during 2003 and 2004.
- DHCD routinely conducts monitoring reviews of HEDFC to examine and monitor compliance during 2003 and 2004.
- KPMG performed a program audit of DHCD in 2004. Some aspects of HEDFC's processes and procedures were also reviewed.
- HEDFC is currently scheduled to receive a HUD HOME program audit in 2004.

It is important to note that no additional funds or resources were provided to implement any of the recommendations presented.

XI. HEDFC's financial condition has declined – page 30

Although the statements as presented are substantially accurate, the omission of facts makes the conclusion misleading.

A. Ability to cover short-term needs declined since 2000 – page 31

HEDFC was formed in 1970 to assist the City as previously discussed. <u>HEDFC is by design financially dependant on the City and/or assets it manages contractually for the City</u>. In the past, City representatives and HEDFC officials have stressed the importance of HEDFC's primary responsibility, to focus on the needs of the City. In fact, the decreased liquidity ratios, increased debt ratios and negative cash flow are the direct result of City policies and federal regulations. More specifically, cash on hand is required to be used before entitlement (new money) can be drawn down from the City. In recent years, the City has required that cash on hand be used to a greater extent. As a result, cash balances have declined in relationship to prior years.

HEDFC receives program income from its loan portfolio. The program income makes up a portion of the funds required by the Consolidated Plan to meet established goals. Additional funds are budgeted from CDBG and HOME entitlements. Therefore, it is accurate that HEDFC's operations budget expends more cash than it generates.

B. Ability to cover long-term obligations has declined since 2000 – page 31

In order to facilitate more timely payments to contractors and borrowers, HEDFC obtained a commercial line of credit to be used for certain types of transactions. Moreover, HEDFC entered into agreements with participating banks to fund HEDFC second mortgage loans in the short term. These decisions have in fact increased interest expenses, bank fees and debt ratios over prior years. However,

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these decisions have not weakened HEDFC's financial position since entitlement receivables and program income receipts have not been affected.

XII. The City failed to meet affordable housing production goals – page 32

The statement that the "City, HEDFC and local community development corporations failed to meet housing production goals for the year ending May 31, 2003", is accurate. However, the statement that "the system achieved less than a third of its housing production goals and multi-family housing was not completed", is inaccurate.

A. The City's housing system achieved less than a third of its housing production goals – page 32

Housing production goals have historically been defined as units of work beginning when HEDFC receives an Application for Financial Assistance and ending when a housing unit is occupied by a renter or homebuyer. The units of work are tracked and recorded for reporting purposes on the City's Housing Production Reporting form. The "housing system" method of tracking housing production starts at "category 8 acquisition date", as stated on Housing Production Reporting forms submitted monthly to DHCD by CDCs and private developers. The actual production goal achieved was 124 "work units". This number corresponds with the auditors' statement in part on page 32 of their report.: "according to HEDFC's Single Family Production report, the agency, working with local CDCs, completed 54 houses. The report lists an additional 37 addresses where construction is underway; 12 addresses with a status of planning and development; and 1 site acquisition." It should also be noted that as provided for in our contract, the goals are dependent upon loan or grant applications received during each fiscal year.

B. The number of days until sale is long – page 33

The number of days it takes to sell homes in distressed urban core neighborhoods is not at odds with the experience of many communities throughout the region. Given market dynamics since 9/11, coupled with negative perceptions relative to public infrastructure, public schools, safety and the like, it is not surprising to see an impact on the number of days a home is on the market.

C. Public funding per unit varied – page 34

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Audit Response continued

HEDFC does track and report the public funding used to construct and rehabilitate houses.

Housing development in distressed urban core neighborhoods is not "cookie-cutter." Each parcel and development project is unique, and the funding or investment required varies with the costs of acquisition, abatement of environmental hazards and unusual site conditions, etc.

D. Multi-family housing not completed – page 35

The statement is both misleading and inaccurate.
Under the contract with the City, HEDFC was required to **provide funding** for the multifamily projects, specifically 2 loans with 99 units—not to complete the projects within the contract year. As required by the contract, the loans were in fact made. The construction/rehabilitation of the multifamily units usually takes 12 to 18 months depending on the type and amount of construction. The Chambers and Hanover projects referenced in the contract had an estimated twelve month schedule. These projects were completed 4-28-03 and 7-1-03 respectively. In addition, HEDFC financed the Finance Building for 32 units downtown on 5-1-03 and the Twin Elms project for 54 units on 12-30-02. Accordingly, HEDFC once again exceeded its contractual goals for that contract year.

See Note 4

In this lending role, however, HEDFC is responsible for underwriting the loan, monitoring construction completion, lease-up and loan conversion of the multifamily projects.

XIII. HEDFC met the target for number of home ownership assistance loans but not for rehabilitation loans – page 35

Although the target for rehab loans was not met, consideration of market dynamics must be taken into account. All loan products are driven by demand, as evidenced by the fact that more home ownership assistance loans were requested to be funded by the City through HEDFC. As has been seen in the home ownership assistance market, however, many times those who desire these public-funded loan products have credit challenges which impede their ability to qualify for a loan or grant. An additional impediment is the availability of CDBG dollars.

Many persons who are inclined to request rehab loans qualify for CDBG, since their incomes exceed 80% of AMI, yet these funds have been reduced by the City at an alarming rate. These persons, whose incomes make them ineligible for HOME financing, are constantly turned away for lack of CDBG funding availability.

HUD's FY2000-FY2006 Strategic Plan, Objective 2.2 seeks to minimize the geographic isolation of minorities and low-income persons. One method it employs is the flexible

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use of CDBG and HOME programs to revitalize distressed neighborhoods to make them attractive to middle-income families. The City's failure to allow greater use of CDBG dollars for housing—both new construction and rehab—frustrates HUD's intent to create more mixed-income neighborhoods, and frustrates HEDFC's ability to lend to a wider market, especially one that needs incentives to choose to live in distressed communities when they have options to live elsewhere in the metropolitan area.

A. *Contract doesn't define loan servicing performance goals – page 35*

This statement is incorrect. The contract specifically requires loan collections, investment of principal and interest repayments, the exercise of necessary and appropriate forbearance arrangements and foreclosures. It would be unrealistic to require a minimum delinquency rate since such would be contingent upon events outside HEDFC's control. Earlier HOME loans beginning in June 1, 1996 through May 31, 2001 were deferred for five years but were repayable over 25 years. The HOME loans should be included in any consideration since the loans are serviced for insurance, program compliance, prepayments and regular principal payment for some of the loans. These types of loans make up over half of the entire portfolio. If the HOME loans are included in the calculation of delinquency rate for 90 days and over the rate is only 4.5%. See Table below. Such a low delinquency rate is a very good example of the professional competency of the staff's underwriting and servicing capabilities. The different loan programs each require their own unique servicing since the terms vary from program to program.

	Number of Days Delinquent						
Type of Loan	30	60	90	120	150	180 & over	Total 90+
Rehabilitation	5.15%	2.37%	0.92%	0.60%	0.72%	2.27%	4.51%
Second Mortgage	10.63%	3.25%	1.50%	0.69%	0.57%	15.83%	18.58%
HOME Mortgage	.84%	.60%	.44%	.07%	.12%	1.62%	2.25%
Overall	3.25%	1.47%	.70%	0.31%	0.84%	3.15%	4.54%

Recommendations – page 36

The City's Comprehensive Housing Plan clearly sets forth the housing services that the City Council has determined should be provided by the City. The contracts between the City and HEDFC clearly provides for the services required by HEDFC to carry out the approved plan. The recommendations are without merit since the facts clearly indicate that HEDFC has exceeded its performance goals under its contracts and has carried out the objectives of the Plan and the Contracts. If the City Council should decide to change how it wants to provide housing services to its citizens HEDFC will continue to carry out the intent of the City as it has since its inception.

Audit Response continued

HEDFC is a unique organization that has been structured to provide the services demanded by the City. It has the professional expertise, institutional memory, and qualified staff to respond to the directions of the City. To believe that further out-sourcing these services would be beneficial to the citizens of Kansas City is to ignore HEDFC's vast knowledge of federal regulations and City requirements needed to carry out the City's housing program services, HEDFC's responsiveness to the special ongoing requests of the City, and the special relationship HEDFC has had with the City.

See Note 5

Furthermore, for the last 3 years HEDFC **has** competitively bid to perform services for the City, and will continue to be responsive to the City's needs as requested.

Significant Weaknesses – page 39

- See the earlier response on this Finding. The City's system is responsive to its approved Consolidated Plan, and it meets the needs of the City's constituencies within the confines of the federal regulations.

- The contract does clearly state the obligations of HEDFC under the contracts with the City.

Follow-Up on Prior Audits – page 41

Reference is made to reports (not audits)—BKD and NCCED—that are at best two (2) years old, and have little relevance to HEDFC's current structure. A new President/CEO was hired 9/02, General Counsel and Director of Lending hired 11/02, full-time CFO hired 1/03, Director of Economic Development 1/03, and two additional senior staff promoted to director level positions. Additional support staff was added in both the lending and finance divisions since 1/03, and the organization held a highly successful staff retreat 5/03. While giving no credence to either report, HEDFC is obviously a different organization today than when the reports were generated.

Schedule of Questioned Costs and Funds Put to Better Use – page 45

2A. Not ineligible by contract or federal regulations.

2B. Not ineligible by contract or federal regulations.

If you have any questions or comments about our response please call me at your convenience.

Very truly yours,

HEDFC

Kenneth T. Bacchus
President & CEO

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Auditor's Evaluation of Auditee

The President and Chief Executive Officer of HEDFC recommended that all conclusions and many of the recommendations of the audit report be disregarded. While we did not address any recommendations to HEDFC, we did provide a draft audit report to HEDFC management for review and comment since we discuss HEDFC's role within the city's housing system as well as certain aspects of its performance. We did not request that they specifically respond to the findings that deal directly with the City's housing system (findings 1 and 2). However, HEDFC provided extensive comments on those findings. In those comments, HEDFC disagreed with most of the content of the findings and reflected a strong desire to see the City maintain its program as it existed during our audit period. It is important to note that those comments come from the perspective of the recipient of most of the city's housing funds. If implemented, the recommendations in this report will enable the City to exercise significantly more control over its program, and its program participants, including HEDFC. As a program participant, HEDFC has participated in Kansas City's system for implementing housing programs under annual contractual agreements, but has no authority to speak for the city. The City Manager generally agreed with the findings and recommendations. We have included his response in Appendix C.

Therefore, we focused our review on HEDFC's response to the third finding, which deals with HEDFC's financial viability and performance. We looked for assertions of fact in HEDFC's response that contradict facts in our report. As such, we are not specifically responding to assertions that our statements were inaccurate without explanation. We are also not responding to assertions that our statements were inaccurate when there was also implicit acceptance (e.g. where the response said that they would try to improve in this area).

For the most part, HEDFC's response states that the findings are inaccurate and misleading, but does not provide facts that contradict our report. We noted the following assertions that contradict the facts in our report:

Note 1

We did see project budgets in our review of a sample of files. However, we distinguish between individual project budgets and detailed annual program or operating budgets. The project budgets do not cover a specified time-period and the source of funds is not clear. We did not see any roll-up of individual project budgets that would clearly identify the planned source and use of funds overall for a given time period.

Note 2

Both HUD and the City (the parties with regulatory authority) cited the commingling as a problem. HUD regulations require participating jurisdictions to maintain separate accounts for CDBG and HOME trust funds. The city contract defines these accounts as separate bank accounts (the definitions CDBG Program Income Depository Account and HOME Trust Fund Account state that each is "a single account, at a FDIC insured financial institution"). HEDFC does maintain separate bank accounts for the different funds and in the instance described deposited HOME funds into the CDBG account.

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Note 3

When we say HEDFC doesn't market its programs to users, we mean all people who are eligible for the programs. We agree that HEDFC's participation in HUD workshops would educate some eligible people about the programs. However, an adequate marketing effort would ensure that as many eligible people as possible know about the programs and how to participate in them. The fact that HEDFC spent all of the money has no bearing on whether people eligible for the programs know they exist.

Note 4

HEDFC's response says that the Chambers project was completed in April 2003. We say in our report that Board minutes did not provide information on multi-family housing completed in contract year 2003. These two statements are not contradictory. This point reinforces our conclusions that annual performance goals are vague and it is hard to tell what the city is getting for its significant spending on housing.

Note 5

The annual contracts refer to HEDFC as a designated subrecipient, which is the term HUD uses to describe agencies, authorities, or organizations receiving funds from the grantee to undertake eligible activities. The primary distinction between a contractor and a subrecipient is the method used for selecting the agency – contractors are selected through a competitive process. City staff told us that HEDFC is not required to submit an application to receive funding. Staff told us that in the past, HEDFC submitted "Pro Forma Statements" that described the sources and uses of funds for activities planned during the year. We asked for and reviewed an example pro forma statement – it is not a response to an RFP. HEDFC's President agreed that HEDFC is not required to submit an application to receive funding but said that in the last couple of years HEDFC has done so.

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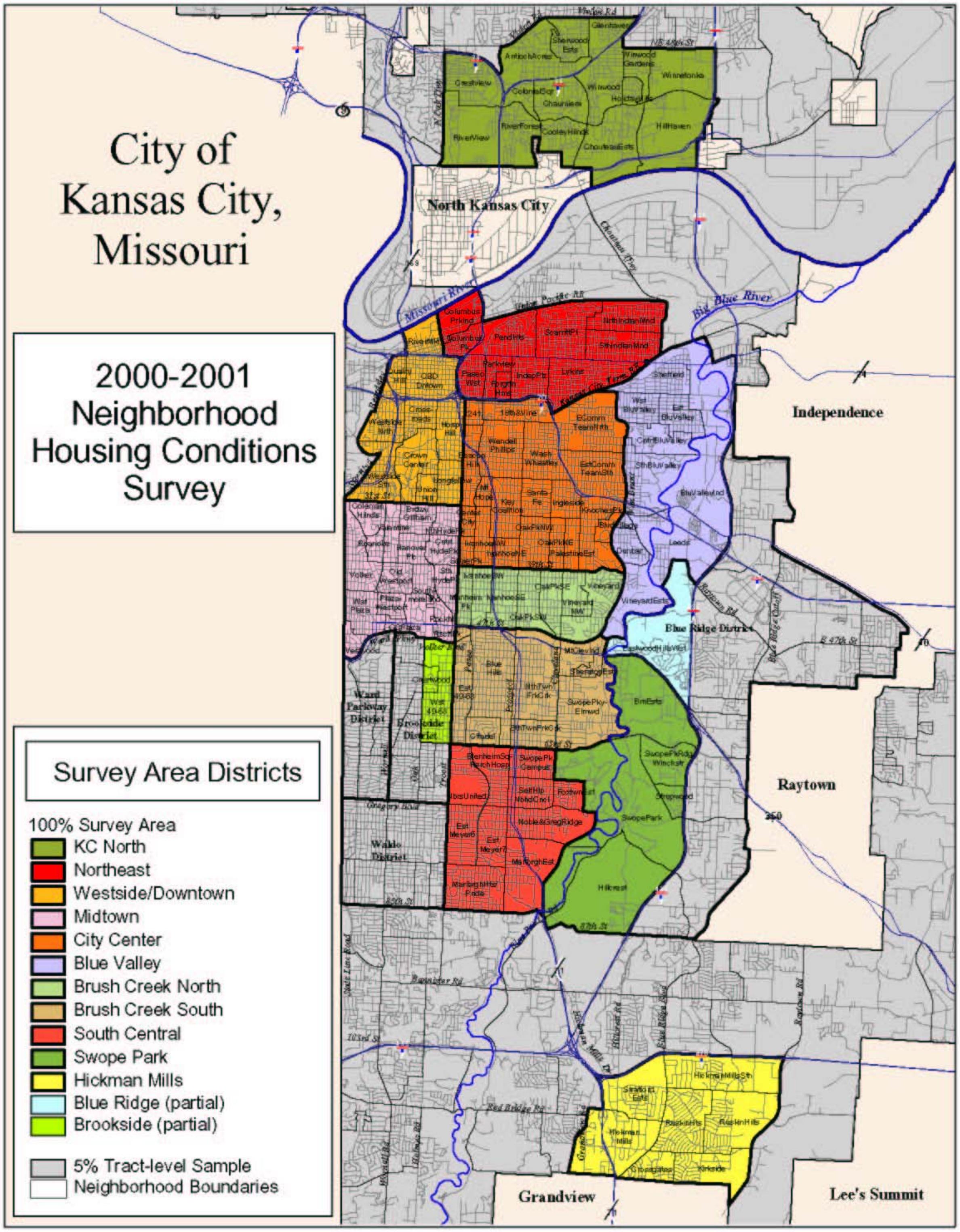
Kansas City, Missouri, Housing Survey Map



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Payments to HEDFC by Fund, Contract Year Paid, and Calendar Year Funds were Encumbered

Year Paid	FUND	Calendar Year Funds Were Encumbered									
HEDFC Contract Year		<>	1996	1997	1998	1999	2000	2001	2002	2003	Total
1	Economic Development Initiative-HUD Grant					1,775,329					1,775,329
1	HOME Investment Fund				21,400						21,400
1	HUD Section 108 Loan Fund	250,000		668,367			2,531,470				3,449,837
1	Community Development-26th Yr						989,096				989,096
1	Community Development-23rd				104,926						104,926
1	Community Development-24th				212,283						212,283
1	Community Development-25th					377,101					377,101
1	HOME Investment Fund 94		250,000		17,627	1,798,950	530,551				2,597,128
2	Economic Development Initiative-HUD Grant			1,845,100		1,127,811					2,972,912
2	HUD Section 108 Loan Fund			2,130,060		4,371,980	397				6,502,437
2	Community Development-26th Yr						810,404				810,404
2	Community Development-27th Yr			26,544				859,254			885,798
2	Community Development-22nd			118,283							118,283
2	Community Development-23rd			720,379	455,627			447,000			1,623,006
2	Community Development-24th				648,873			500,000			1,148,873
2	Community Development-25th					66,542					66,542
2	HOME Investment Fund 94						1,770,453	2,364,789			4,135,242
3	Economic Development Initiative-HUD Grant			3,670,576		837,096					4,507,672
3	HUD Section 108 Loan Fund			3,200,880		871,173	8,324,636			2,500,000	14,896,689
3	Community Development-27th Yr							750,500			750,500
3	Community Development-28th Yr	350,000							416,343		766,343
3	Community Development-23rd				198,386				547,351		745,737
3	HOME Investment Fund 94			80,400				35,152	2,636,847		2,752,399
	Total	600,000	250,000	12,460,589	1,659,122	11,225,983	14,957,007	4,956,695	3,600,541	2,500,000	52,209,937

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