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TO: R. Edmond Sprayberry, Director, Office of Public Housing, 4CPH

*Sonya D. Lucas*

FROM: Sonya D. Lucas  
Acting Regional Inspector General for Audit, 4AGA

SUBJECT: The Jefferson County Housing Authority  
Birmingham, Alabama

## **HIGHLIGHTS**

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

We reviewed the Jefferson County Housing Authority's (Authority) administration of its housing development activities as part of our audit of the U.S. Department of Housing and Urban Development's (HUD) oversight of Public Housing Agency development activities with related non-profit entities.

Our primary objective was to determine whether the Authority had diverted or advanced resources subject to its low-income housing Annual Contributions Contract (Contract) or other low-income housing agreements or regulations to the benefit of the other entities without specific HUD approval. Our objective included determining whether the Authority's cost allocation method complied with provisions of Office of Management and Budget (OMB) Circular A-87.

### **What We Found**

The Authority inappropriately used funds in its Revolving Fund account to pay the expenses of its programs and nonprofit entities, including affiliated nonprofit corporations, in excess of the funds the programs or entities had on deposit. As of December 31, 2003, 19 programs or entities, including nonprofit corporations and other programs, owed the Revolving Fund account \$2.7 million. However, the programs and entities only had \$2 million on deposit. Therefore, the Authority

inappropriately used funds to pay the expenses for the programs or entities. In addition, the Authority violated its Contract with HUD by inappropriately advancing public housing funds for some of its activities and activities of the nonprofit entities. At the end of 2003, the Authority had advanced more than \$396,000 of public housing funds to other activities. These actions occurred because the Authority did not have adequate controls in place to monitor the Revolving Fund account.

The Authority did not support its payment of administrative and maintenance salary costs with activity reports or equivalent documentation as required. Thus, it did not have a record of the time spent on various activities and some activities may have paid a disproportionate share of the costs. For fiscal years 2000 through 2003, the Authority did not support \$3.3 million of salary costs allocated to Federal programs for employees dividing their time between several programs.

### **What We Recommend**

We recommend that HUD require the Authority to settle the \$771,076 or current balance owed to the Revolving Fund account, and repay the \$396,000 balance.

We also recommend that HUD require the Authority to provide documentation to justify the \$3.3 million of salary costs charged to Federal programs from 2000 through 2003.

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

### **Auditee's Response**

We discussed our review results with the Authority and HUD officials during the audit. We provided a copy of the draft report to the Authority officials on December 17, 2004, for their comments and discussed the report with the officials at the exit conference on December 20, 2004. The Authority provided written comments on January 3, 2005.

The Authority generally agreed with the findings and highlighted corrective actions being taken. However, the Authority expressed some concerns regarding the improper bonuses and officials serving in dual capacities. After considering the Authority's response and consulting with the Office of Inspector General's legal counsel, we deleted the audit issues relating to the improper bonuses and officials serving in dual capacities.

The complete text of the auditee's response, along with our evaluation of that response can be found in appendix B of this report.

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## **BACKGROUND AND OBJECTIVES**

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The Jefferson County Housing Authority (Authority) was organized pursuant to the Housing Act of 1937 and the laws of the State of Alabama. Its primary objective is to provide low-income housing to the citizens of unincorporated areas of Jefferson County, Alabama, in compliance with its Contract with HUD.

A five-member Board of Commissioners (Board) governs the Authority with members appointed by the Jefferson County Commission. Alice Durkee is the Board chairperson, Eric Strong is chief executive officer, Julia Reynolds is chief financial officer, and Lewis McDonald is the executive director.

The Authority's major program activities included administering 615 conventional low-income units, 1,670 Section 8 vouchers, and 450 Shelter Plus Care certificates. During the past 4-years, the Authority has expanded its projects and programs locally and state wide through the Jefferson County Assisted Housing Corporation, an affiliated not-for-profit corporation. Together the Authority and Jefferson County Assisted Housing Corporation own or manage over 2,500 units. Jefferson County Assisted Housing Corporation is also the participating administrative entity for the State of Alabama under HUD's Section 8 Mark-to-Market Program and is the Section 8 Contract Administrator for the states of Alabama and Mississippi. Another affiliated not-for-profit corporation, the Community Housing Development Corporation is the lead developer for 80 houses in the tornado stricken Edgewater section of Western Jefferson County.

HUD's Office of Public Housing in Birmingham, Alabama, is responsible for overseeing the Authority.

Our overall objective was to determine whether the Authority had diverted or advanced resources subject to its low-income Contract with HUD and other low-income agreements or regulations to the benefit of other entities without specific HUD approval. Our objective included determining whether the Authority's cost allocation method complied with provisions of OMB Circular A-87. Our objective did not include a review of the contracts administered by the Jefferson County Assisted Housing Corporation or the Community Housing Development Corporation.

## RESULTS OF AUDIT

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### Finding 1: The Authority Improperly Used and Advanced Its Funds

The Authority inappropriately used funds in its Revolving Fund account to pay the expenses of its programs and nonprofit entities, including affiliated nonprofit corporations, in excess of the funds the programs or entities had on deposit. As of December 31, 2003, 19 programs or entities, including nonprofit corporations and other programs, owed the Revolving Fund account \$2.7 million. However, the programs and entities only had \$2 million on deposit. Therefore, the Authority inappropriately used funds to pay the expenses for the programs or entities. In addition, the Authority violated its Contract with HUD by inappropriately advancing public housing funds for some of its activities and activities of the nonprofit entities. At the end of 2003, the Authority had advanced more than \$396,000 of public housing funds to other activities. These actions occurred because the Authority did not have adequate controls in place to monitor the Revolving Fund account.

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#### **The Authority Inappropriately Used Funds To Pay Expenses**

The Authority inappropriately used funds from its HUD funded activities and its nonprofit activities to pay expenses in excess of the funds on deposit. The funds were pooled into the Authority's Revolving Fund account. At December 31, 2003, various programs and entities owed the Revolving Fund account \$2.7 million. For example, one entity, Westchester Apartments owed the Revolving Fund \$1.1 million of the \$2.7 million balance, but only had \$17,000 on deposit as of December 31, 2003.

Part C, Section 10 of the Contract, Pooling of Funds, states that the Authority shall not withdraw from any of the funds or accounts authorized under this section amounts for the projects under Contract, or for the other projects or enterprises, in excess of the amount then on deposit in respect thereto.

The Authority did not have adequate internal controls for operating its Revolving Fund or monitoring its Revolving Fund activity. Instead of limiting payments from the Revolving Fund to amounts a specific program had on deposit, the Authority made payments in excess of funds the programs had on deposit. Therefore, the Revolving Fund deficit was paid by other programs. This resulted in programs loaning other programs funds. Since the Authority was using the Revolving Fund account to loan funds between programs and entities, all funds owed to the Revolving Fund should be settled.

At the end of 2003, the following 19 programs and entities owed the Revolving Fund \$2.7 million, resulting in \$771,076 more than the programs and entities had on deposit. The balances were not settled monthly and remained outstanding from month to month.

<u>Program / Activity</u>	<u>Amount due to Revolving Fund</u>
OSCA Grant	\$ 1,344
CFP Grant 2001	\$ 2,131
Home Inspection Services	\$ 3,825
Edgewater Rehab	\$ 4,800
Shelter Care C000005	\$ 5,193
S8 Service Coordinator	\$ 6,683
Shelter Care C100018	\$ 7,032
Housing Counseling	\$ 10,078
Eldergarden	\$ 12,862
Spring Gardens IV	\$ 20,164
ROSS Grant	\$ 21,513
Shelter Care C900002	\$ 52,388
CFP Grant 2002	\$ 59,766
Section 8	\$ 95,064
Spring Gardens I	\$ 104,746
Spring Gardens III	\$ 116,377
Spring Gardens II	\$ 163,879
Mississippi Contract Admin	\$ 960,850
Westchester Apartments	<u>\$ 1,122,382</u>
 Total Owed the Revolving Fund	 <u>\$ 2,771,076</u>

**Public Housing Funds Of \$396,000  
Were Improperly Used To Support  
Other Entities and Activities**

In 1999, the Authority started using and commingling funds from various programs and entities into a Revolving Fund account. Low-income housing funds in excess of funds needed to pay the housing expenses were advanced to the Revolving Fund, resulting in the Revolving Fund owing public housing amounts ranging from \$167,000 to more than \$737,800 for fiscal years ending 1998 to 2003. The loans between funds should have been settled each year. At December 31, 2003, the Revolving Fund owed public housing \$396,000, which should be repaid to the public housing program.

Section 9 (A) of the Contract, states the housing authority may withdraw funds from the general funds only for: (1) the payment of costs of development and operation of projects under Contract with HUD; (2) the purchase of investment securities as approved by HUD; and (3) such other purpose as may be specifically approved by HUD.

### **Recommendations**

We recommend that the Director of the Office of Public Housing:

- 1A. Require the Authority to settle the \$771,076 or current balance owed to the Revolving Fund account.
- 1B. Require the Authority to repay its Conventional Public Housing fund the \$396,017 or current balance owed from non-Federal sources.
- 1C. Ensure future transactions comply with the Contract and other HUD requirements. Specifically, the Authority needs to establish controls to ensure pooled funds are not withdrawn for a program/entity in excess of the amount of funds on deposit for that particular program/entity.



## Finding 2: The Authority Did Not Support Its Allocation of Costs

The Authority did not support its allocation of administrative and maintenance salaries and benefits with activity reports or equivalent documentation as required. Thus, the Authority did not have a record of the actual time spent on the various programs and some programs may have paid a disproportionate share of the costs. Of the \$11.8 million of salary cost charged to its various programs for fiscal years 2000 through 2003, the Authority allocated \$6.4 million to its Federal programs. From the \$6.4 million allocated to the Federal programs, \$3.3 million was for employees that were dividing their time between several programs and activities. The Authority's management was not aware allocations should have been based on activity reports. As a result, the allocation of \$3.3 million was unsupported.

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### **Chief Financial Officer's Estimates Were Used to Allocate Costs**

The Authority operated approximately 30 programs and entities, including conventional public housing, capital grant, Section 8, and a not-for-profit corporation. The Authority's Chief Financial Officer determined how salary costs were allocated. The Chief Financial Officer said that salaries were charged on a direct basis whenever possible. All other salaries were allocated based on either number of units, budgeted income, budgeted income adjusted for estimated time spent, or work assignments by the Maintenance Director.

The Authority's former Controller said that he and the other employees told the Chief Financial Officer how much time they thought they were spending on various activities and she determined the allocations. He did not know how she allocated the costs or what amounts were actually charged. No time allocation or activity records were kept; they simply estimated how their time was spent.

### **Circular A-87 Requires Activity Reports To Support Allocation**

The requirement to use activity reports to support the allocation of costs is included in OMB Circular A-87, Attachment B, paragraph 11 h (4). The paragraph states, in part, where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation. The activity reports must reflect an after the fact distribution of the activity of each individual employee.

Since the Authority did not support its allocation of costs, we are questioning \$3,361,785.

## Recommendations

We recommend that the Director of the Office of Public Housing:

- 2A. Require the Authority to obtain assistance in developing a justifiable method of supporting the allocated costs. The method could include daily activity reports prepared by its personnel and work orders to support the allocation of the costs.
- 2B. Require the Authority to provide documentation to justify the \$3,361,785 of salary costs allocated to Federal programs for years 2000 to 2003, and ensure the Authority makes appropriate adjustments to the various programs. In addition, require the nonprofit to reimburse the Authority for any of its salary costs allocated to Federal programs for years 2000 to 2003.
- 2C. Require the Authority to develop a reasonable method for allocating its future costs, to include daily activity reports for services performed by its staff.

## SCOPE AND METHODOLOGY

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To accomplish our audit objective we reviewed the following:

- Applicable laws, regulations, and other HUD program requirements;
- The Authority's Contracts; and
- HUD's and the Authority's program files.

We reviewed various documents including: financial statements, general ledgers, bank statements, minutes from Board meetings, check vouchers, invoices, loan documents, related guarantee agreements, management agreements, partnership agreements and reports from the independent public accountant. In addition, we obtained an understanding of the Authority's accounting system as it related to our review objective.

We also interviewed the HUD Birmingham Field Office Public Housing officials, and Authority management and staff.

We performed our audit from March through September 2004. Our audit covered the period from January 1, 1998, through December 31, 2003. As necessary we extended the period.

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

# INTERNAL CONTROLS

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

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

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

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## Relevant Internal Controls

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

- Compliance with laws, regulations, policies, and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding resources, policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

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

## Significant Weaknesses

Based on our review, we believe the following items are significant weaknesses:

- The Authority did not have a system to ensure that Federal funds were properly used and the funds were not put at risk (see finding 1).
- The Authority did not have a system to ensure that costs charged among its various programs were properly supported (see finding 2).

## APPENDIX

### Appendix A

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

Recommendation Number	Ineligible 1/	Unsupported 2/	Funds To Be Put To Better Use 3/
1A			\$ 771,076
1B	\$ 396,017		
2B		\$ 3,361,785	
Total	<u>\$ 396,017</u>	<u>\$ 3,361,785</u>	<u>\$ 771,076</u>

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law, contract or Federal, State or local policies or regulations.
- 2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. 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/ Funds to be put to better use are quantifiable savings that are anticipated to occur if an Office of Inspector General (OIG) recommendation is implemented. This includes costs not incurred, de-obligation of funds, withdrawal of interest, reductions in outlays, avoidance of premature rehabilitation, loans and guarantees not made, and other savings. In this report, this represents the additional funds that would be available to the Authority for preventive maintenance intended to reduce the accelerated deterioration of the Authority's capital assets.



## Appendix B

### AUDITEE COMMENTS AND OIG'S EVALUATION

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#### Ref to OIG Evaluation

#### Auditee Comments

 <b>JEFFERSON COUNTY HOUSING AUTHORITY</b>  3700 INDUSTRIAL PARKWAY BIRMINGHAM, ALABAMA 35217-5316  205.849.0123 FAX: 205.849.0137 FAX: 205.841.0676  ..... LEWIS D. McDONALD EXECUTIVE DIRECTOR  WILLIAM V. LEWIS, JR. DIRECTOR OF FINANCE  DAVID C. WILKINSON DIRECTOR OF MAINTENANCE   COMMISSIONERS  ALICE DURKEE CHAIRMAN  CLAUD E. THACKER VICE CHAIRMAN  CHRIS GIATTINA  LILLIAN HOWARD  BUNNY STOKES  ..... AN EQUAL OPPORTUNITY HOUSING AUTHORITY	<p>January 3, 2005</p> <p>James D. McKay Regional Inspector General for Audit U.S. Department of Housing and Urban Development Office of the Inspector General for Audit, Region 4 Richard B. Russell Federal Building 75 Spring Street SW, Rm 330 Atlanta, GA 30303-3388</p> <p>Re: Comments to Draft Audit of Jefferson County (Alabama) Housing Authority, 17 Dec 2004</p> <p>Dear Mr. McKay:</p> <p>We thank you and appreciate the opportunity to provide comments to the audit of the Jefferson County (Alabama) Housing Authority ("Authority"). As I am sure you are aware from the exit interview the Authority prospectively handled many of the issues addressed by your audit, and disagrees with IG's interpretation of other issues, most particularly the issues raised relative to conflict of interest by employees of the Authority.</p> <p>I have attached a copy of JCHA's comments.</p> <p>If we can be of any further assistance, please do not hesitate to contact me.</p> <p>Sincerely,  Lewis McDonald Executive Director</p>
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## **JEFFERSON COUNTY HOUSING AUTHORITY COMMENTS**

### **BACKGROUND AND ORGANIZATION**

The Jefferson County Housing Authority ("Authority") is organized pursuant to Housing Act of 1937 and the laws of the State of Alabama. It is governed by a five member Board of Commissioners who sets policy consistent with its stated purpose of providing housing to moderate and low-income individuals and families in Jefferson County, Alabama. The Board of Commissioners also makes policy decisions concerning employee welfare, compensation and benefits.

The Jefferson County Assisted Housing Corporation ("Corporation") is a subsidiary of the Authority. Likewise, it has also been deemed an "instrumentality" by HUD pursuant to 24 CFR part 811.105 and most recently in connection with several ACCs which the Corporation has entered into with HUD relating to Section 8 Contract Administration. In connection with this a) the Authority and HUD have approved the corporate charter and other organic documents of the Corporation, including any amendments thereto, b) the Authority has the right to control, direct and authorize the execution of any Annual Contribution Contracts (ACC) which the Corporation may enter, c) the Authority both directly and indirectly controls the operations of the Corporation, including final approval of any business plan of the Corporation as well as the annual operating budgets, borrowing and spending, and d) upon the dissolution of the Corporation, title to all property, real and personal, is transferred to the Authority.

HUD has reviewed and approved of the relationship between the Authority and the Corporation as evidenced by its approval of the charter documents of the Corporation, as well as several amendments thereto. Inclusive in this approval of the Corporation as the Authority's instrumentality is the approval of officers and employees of the Authority serving as directors or officers of the Corporation. See 24 CFR 811.105(7)(e).

In 1999, the Authority, through the Corporation, bid for and received its first ACC relating to Section 8 Contract Administration for the State of Alabama ("CA"). The Corporation utilized Authority employees, officers and facilities to fulfill its obligations under the ACC and used the ACC administrative proceeds and incentive fees to pay its allocated share of those costs borne by the Authority relative to its CA. Additionally, the Authority utilized the unrestricted excess funds generation by CA to fund activities, programs and personnel positions which underscore and support the Authority's mission to low and moderate income citizens living in Jefferson County, Alabama. Its handling of CA for the state of Alabama has received high marks from HUD and the arrangement has delivered additional services to the county's low and moderate-income clients without any additional taxpayer support from either the Jefferson County Commission or the federal government.

In 2002, the Authority, once again through the Corporation, bid for and received its second ACC relating to Section 8 Contract Administration for the state of Mississippi. It began administering this contract under the same model as was being used with its administration of CA for Alabama. In 2004, the Authority was awarded its third and

## Comment 1

fourth ACC relating to Section 8 Contract Administration for the states of Virginia and Connecticut. These last contracts both began in 2004, and, due to sheer volume, required the Authority to begin making organizational changes.

In response to the increase in the volume of work associated with CA, it became clear to both the Authority and the Corporation that the previous arrangement of employees and allocations needed to be changed, as space was limited at the Authority's complex and, further, to promote efficiency and effectiveness of all programs, while maintaining fiscal accountability. In January 2004, the CEO and CFO of the Authority were allocated completely to Corporation programs, including CA, and no longer performed functions associated with the Authority's traditional public housing programs. The work of these individual positions was replaced by the Authority Board of Commissioners with the hiring of an executive director and a finance director who were assigned all of the functions of the previous CEO and CFO relating to the Authority's traditional public housing programs.

At each step of the growth of the Authority and Corporation the officials and boards of each have sought HUD advice and consent.

### COMMENT ONE

#### THE AUTHORITY'S USE OF A REVOLVING FUND INVOLVED NO LONG TERM USE OF RESTRICTED CASH ON DEPOSIT PURSUANT TO ANY ACC

The use of a Revolving Fund is a common vehicle for handling the financial arrangements of housing authorities around the country. The use of a Revolving Fund by the Authority has been known and disclosed to HUD in each annual audit together with its intercompany balances owed at the end of the year. It reflects the practicalities of modern corporate practice in insuring that payments on all programs are timely paid. The timing of payments from various grants and programs does not always coincide with the timing of payments received from the various funding sources, nevertheless, the Authority is charged with the responsibility of making these payments on time. As a result, the amounts owed in the intercompany accounts vary and fluctuate month to month as funds become available to clear various balances. The practice has received no findings from the Authority's auditors, no comments or criticisms from HUD, and indeed receives no criticism from OIG, other than fund balances not being completely cleared at least annually. Report, p.7. The Authority views this criticism as unfair, in that while OIG cites a loan from Public Housing to the Revolving Fund of \$396,017 for FY 2003, Public Housing owed the Revolving Fund \$135,992 at year end FY 2002. Consolidated Audit FY 2002, Note 9.

It is true that Authority audits show Public Housing having advanced \$300,000 to the Revolving Fund, however, this money included \$80,000 from Public Housing and another \$220,000 from the sale of scattered site houses, which the Authority understood



did not have the same restrictions of Public Housing funds. The \$80,000 advanced reflected approximately one half of the monthly expenses of Public Housing. As to the money from the sale of the scattered site house, HUD was asked about the use of the money and it was permitted to be used in this manner and has been accounted for in each subsequent audit of the Authority. It was only recently that the Authority was made aware that it and HUD's understanding of the character of the \$220,000 was wrong. During the audit, the OIG informed the Authority that a very recent court case had determined the proper accounting of these funds required they take on the characteristics of the most restrictive funds. There was obviously, no intent to misuse government funds and the money has always been accounted for.

Further, it is true that a Corporation project, the Westchester Apartments, maintained a large debit in the Revolving Fund for a numerous years. However, in June of 2004, the Corporation and Authority sold the Westchester Apartment and netted proceeds sufficient to repay the revolving fund those amounts owed. This sum, \$1,168,475.27, together with an additional amount of \$48,904.59, was paid to the Authority's revolving fund in December of 2004 from the proceeds of the sale. This settling of the Revolving Fund cleared any and all annual amounts owed by the Corporation for its ongoing operations.<sup>1</sup>

While the practice of loaning money between funds certainly existed, the Authority has proactively limited the practice to further clarify its restricted fund accounting. In April of 2004, the Authority removed all Corporation accounts from its active Revolving Fund and began the process of clearing up any account balances that may have been owed. With the exception of amounts owed from the Westchester Apartments, only an additional \$48,904.59 was owed the fund by the Corporation, and was repaid. The Corporation, likewise, set up its own Revolving Fund, which remains in the oversight of the Authority.

## Comment 2

### COMMENT TWO

THE AUTHORITY HAS INSTITUTED NEW ALLOCATION RULES FOR EACH OF ITS PROGRAMS AND ENTITIES, AND IS INVESTIGATING THE MANNER OF ALLOCATION USED IN THE PAST.

OIG questions as unsupported some \$3.3 million for FY 2000-2003 for employees of the Authority dividing their time between various programs. These allocations were based on the CFO's estimates of costs and the Authority is working with her to determine the method and manner used. The Authority believes the allocations to have been made in good faith and upon a reasonable basis, in compliance with OMB

<sup>1</sup> In December 2004, the Authority officially transferred numerous employees to the Corporation as a part of restructuring its employees between the entities. However, the Authority still maintains several employees whose costs are allocated between the Authority and Corporation and remain on the Authority payroll. The Corporation will continue to reimburse the Authority its allocated share of these expenses.

### Comment 3

Circular A-87, Attachment B, paragraph 11 h (4).<sup>2</sup> During this period of time, the Authority had numerous employees whose sole responsibility was to the Corporation's ACCs for Section 8 Contract Administration, and several whose primary responsibility was to CA. The Authority will work with the former CFO to determine the basis and methods used and supplement this information when it is available.

In 2004 the Authority began using new cost allocation procedures based upon a direct labor burden allocation of indirect costs. The Authority has identified certain employees and departments who have a direct labor burden on the basis of function and defines all indirect costs as a percentage of the direct labor burden of the Authority. The Authority, further, will implement documentation procedures to further document the required allocations.

#### COMMENT THREE

##### NO CONFLICT OF INTEREST FOR BONUSES PAID TO HOUSING AUTHORITY OFFICIALS AND NO CONFLICTS FOR OFFICIALS WHO SERVED IN DUAL CAPACITY FUNCTIONS

We appreciate the fact that the operations and structure of the Authority and Corporation are complex and somewhat unusual. Accordingly, despite the great commitment of time that OIG made to the audit, we believe there may have been aspects of our operation, particularly with respect to the Corporation, that may have been confusing or misunderstood by the IG which has led to improper conclusions on what it claims are "conflicts of interest" bonuses to the Authority's Chief Executive Officer, Chief Financial Officer, and Director of Maintenance.

The OIG in the Draft report appears to take its standard approach in directing criticisms at any PHA, which operates in conjunction with an affiliated non-profit organization. See January 13, 2004 report of the OIG. However, the situation of the Authority and Corporation is markedly different from a legal and factual standpoint. The main Corporation activity relates to its service to HUD under various Section 8 Contract Administration ACC's.

The Authority has consistently sought new ways of providing the low and moderate income citizens of Jefferson County, Alabama more than just the bare bones services offered by other authorities. This is consistent with HUD's stated objectives, which, in the words of former Secretary Mel Martinez, is that "the strength of our economy lies in the unmatched enterprise, creativity, and hard work of the American people. That is why President George W. Bush believes that the federal government should create an environment that encourages and rewards these qualities. HUD is helping create that environment across the nation . . . ." U.S. Department of Housing and Urban Development, Daily Message, February 28, 2003. The Authority is exercising

<sup>2</sup> OMB Circular A-87 was revised effective June 9, 2004. OIG's comments are based upon the previously in place circular.

exactly that type of enterprise, creativity and hard work on behalf of the citizens of Jefferson County, Alabama that need it most.

It is with these principles in mind that the Authority first began looking at the possibility of performing Contract Administration services for HUD. Because the Authority cannot legally operate on its own outside of Jefferson County, Alabama, it designated its subsidiary and affiliated governmental unit the task of performing these operations under the Authority's oversight. The Corporation, created under other provisions of Alabama law, is not subject to this restriction.

The Corporation, as the Authority's Instrumentality, currently serves as the Section 8 administrator for the states of Alabama, Mississippi, Virginia and Connecticut ("CA"). The Corporation has long been a vehicle through which the Authority has sought to meet this objective. In connection with this, HUD has repeatedly recognized Corporation as an "instrumentality" of the Authority under 24 CFR Part 811 and particularly with respect to CA. As an instrumentality of the Authority, the Corporation is responsible for the Contract Administration Fund.

In its instrumentality status, the Corporation is in effect simply a separately incorporated program of the Authority. The Authority is designated as the "parent entity", and does in fact exercise the requisite control through various corporate charter documents. See Invitation for Submission of Application: Contract Administrators for Project-Based Housing Assistance Payments (HAP) Contracts (the "Contract Administration RFP"). In the Authority's books and records, the Corporation is treated as a component unit, and is booked like any another program, such as Public Housing or Section 8.

It is common practice for legal or liability reasons to create separate legal entities in this respect. The mere existence of such a separate legal entity does not create a conflict of interest or require separate officers. HUD has expressly and approved the arrangement between these entities and the dual function of the senior staff of the Authority as the senior staff of the Corporation. This arrangement is expressly permitted by 24 CFR 811.105(7)(e). For OIG to suggest otherwise, where there is no difference in the financial, policy or ultimate governance interests of the entities, would elevate form over substance and require elaborate, cumbersome and expensive organizational superstructures, defeating the very objectives outlined by HUD.

The OIG report seeks to create a conflict of interest by virtue of the dual capacity served by the CEO and CFO, and to which the Authority objects. However, it is curious that OIG finds the same conflict for the bonus given to the Authority's Director of Maintenance, in that he held no position whatsoever at the Corporation and his only contact with the Corporation was by virtue of taking directives from the Authority's CEO as to fulfilling the maintenance needs of the Corporation's projects. OIG does not show that the conflicted party(ies) exercised some control over the Authority to get them to contract with the Corporation. This is clearly not the case for any of the three purported conflicts.

The draft finding that the Authority's Chief Executive Officer, Chief Financial Officer and Director of Maintenance improperly served in "dual capacities" with the Authority and Corporation contradicts the HUD approved arrangements, 20 CFR part 811, modern corporate practice and notions of economy and scale.

With respect to such service in dual capacities, the OIG takes a very formalistic view. If extrapolated generally, it would largely preclude PHA's from utilizing instrumentalities or other subsidiary organizations unless it could afford the costs of separate executives for each as well as the implied agency costs working in such a bureaucratic structure. This flies in the face of the fact that HUD has authorized use of subsidiaries in a variety of contexts, such as under the Section 8 Contract Administration Programs, without ever raising this as an issue. In that context, and without proffering any legal basis for its position other than general conflict of interest rules aimed at limiting hidden private gain, OIG's position cannot bear close scrutiny. Instead, the structure of the Corporation as an instrumentality of the Authority and the corresponding service of individuals as officers of each reflects an effective and widely accepted means of corporate governance, and is expressly permitted. This permits the Authority to engage in an activity, viz. Section 8 Contract Administration on a nationwide basis, which would not otherwise be available to it.

In effect, the Corporation is a separately incorporated program of the Authority. Their budgets and practices clearly evidence this. Does OIG suggest that each program of the Authority need its own CEO or CFO regardless of size or scope? We think not. Instead, we believe that an important function of the board of commissioners is to determine the appropriate staffing and organizational structure. So long as the financial benefits are within one consolidated budget, all of which is reported to HUD through the annual audit, there seems no basis to *require* a multiplicity of officers.

Thus, as between the Authority and Corporation, there is no "contractor" relationship because they are part of the same functional organization. We are not aware of, and OIG does not cite, any regulation or guidance in force today which would assert a conflict of interest inherently exists between a parent PHA and its instrumentality or which prohibits service by individuals in dual capacities. Quite to the contrary, the law expressly permits this arrangement. Indeed, such service in dual capacities is the genesis for the need for cost allocations.

While the OIG challenges the documentation of cost allocations between Corporation and the Authority (as well as with respect to other programs) (see Draft report at page 11), there is no question that the Authority did in fact allocate costs on a good faith basis and one which was repeatedly reviewed by the HUD field office through the annual audit.

Because "financial interest or other interest in the firm" is a predicate of any finding of conflict of interest under 24 CFR 85.36(b) (the ACC in section 14a refers to a "direct or indirect interest"), a conflict cannot exist with respect to the CEO, CFO or

Director of Maintenance concerning any payments made by the Authority to the Corporation (or vice versa), on their behalf. Both the Authority and the Corporation are non-profit entities, for which no private person or entity, as a matter of law, has an ownership interest. In the case of Corporation, its beneficiary is the Authority, which is consistent with its status as a legal instrumentality. It is apparent on its face that payments of wages and benefits, including "bonuses", are not in themselves prohibited conflict transactions; otherwise, no PHA or its instrumentalities could have employees or share in the costs thereof, making moot the need for allocation rules under OMB A-87. Consistent with the foregoing, neither the CEO, the CFO, nor the Director of Maintenance has any financial interest in the neither the Corporation nor the Authority.

With respect to the "bonuses" referred to in the Draft report, these were never "solicited" by the CEO or CFO and not even discussed with them prior to having been made. The Board of Directors of the Corporation (of which neither the CEO or the CFO is a voting member) made all determinations with respect to those bonuses with the knowledge and concurrence of the Board of Commissioners of the Authority. That approval, and payment of the bonuses, occurred March 22, 2001, several months prior to the December 17, 2001 minutes cited by OIG. No HUD approval was necessary for these bonuses because they were authorized payments under the CA ACC and no public housing dollars were used to fund these bonuses. Moreover, these payments were shown in the audited statements customarily provided to HUD. OIG cites no language of the affected ACCs that prohibit these bonuses.

Because the bonuses were expressly approved by both boards this also removes any conflict of these individuals in receiving these bonuses.

Further, OIG's draft report fails to properly attribute the source of these bonuses. Contrary to the Draft report, the "bonuses" paid to the CEO, CFO and Director of Maintenance were paid solely from Corporation funds and not from the "Authority's" Contract Administration Fund. Such payment was expressly permitted under terms of the ACCs under which Corporation principally operates.<sup>3</sup> Under the Contract Administration RFP and related ACC, the Corporation "may use or distribute for any purpose administrative fees that [the Corporation] has earned under the ACC." ACC for Project-based Section 8 Contract Administration, Exhibit A, Section 4.5, dated July 31, 2000 (emphasis added).

Indeed, this mistaken belief that the bonuses were paid from the Authority's separate funds perhaps reflects the misapprehension of the OIG with respect to the nature of Corporation. The citation to the December 17, 2001 minutes of the Authority and Corporation by OIG in an effort to imply that the Authority and Corporation boards knew of, or suspected, impropriety in the payment of bonuses is misplaced. First, those minutes

<sup>3</sup> OIG cites "Part A, Section 19" of the ACC, in apparent reference to the Authority's public housing ACC. It is unclear whether OIG considered the existence of more than one ACC. It is clear that the OIG did not attempt to reconcile how actions which were permissible and expressly contemplated under one ACC (for the Contract Administration Programs) were violations of another ACC.

have no direct relation to the bonuses approved previously by requisite board action and paid to the CEO, CFO and Director of Maintenance earlier in 2001. Second, the merit pay practices (a/k/a "bonuses") of the Authority have been included on the face of the Authority's consolidated budget and this treatment has been specifically discussed with HUD's field office. Third, the objection raised in the minutes was with respect to whether Corporation would be required to pay a disproportionately large share of the bonuses for rank and file employees who wholly or principally provided services to the Authority.

Indeed, the December 17, 2001 minutes cited by OIG concern the general "merit pay" practices of the Authority / Corporation and only tangentially involve the questioned payments made to the CEO, CFO and Director of Maintenance. Clarification of the context of those minutes, which we believe the OIG has not previously understood, may be helpful in that regard.

Consistent with Corporation's status as an instrumentality of the Authority, it is the frequent practice that their respective boards to meet jointly. Thus all information is available to both constituencies and all board members are permitted to have open discussion. Because the Authority must review and approve the budgets of the Corporation, both the revised budget for the Authority containing the questioned bonuses and the subsequent allocations of money from the Corporation's CA budget were approved by the Authority's Board of Commissioners.

Resolution No. 1405 (authorizing budget revisions), for Fiscal Year 2001, was taken with respect to the Authority. Its principal purpose was to document and approve variances to date (12/17/2001) (the "Reconciling Budget") from the original 2001 budget, which original budget had been approved the prior year. The Authority and the Corporation each operate with a fiscal year ending December 31. It is important to note that, because the Authority and its various programs and entities, including the Corporation, operated as a typical "consolidated" entity, budgets included all entities, though for HUD purposes, various programmatic allocations were made. Bonuses for the CEO, CFO and Director of Maintenance were not in the original budget as it related to the Authority nor the Reconciling Budget which was the subject of resolution 1405 (insofar as the allocation of Authority costs was concerned).

On page 7 of the minutes, the meeting turns to Corporation and its president, Mr. Burns. He guided consideration of the Reconciling Budget insofar as allocations made therein to Corporation, including bonuses to the CEO, CFO and Director of Maintenance of the Authority. As noted above, pursuant to the ACCs under which the Corporation operates, it may use its funds for any purpose, including such bonuses.<sup>4</sup> However, the "bonuses" being discussed at this meeting related to the incentive payments made to rank and file employees from public housing money, which did require HUD approval because it involved public housing funds. The discussion by the CFO of the use of other

<sup>4</sup> It is interesting to note that the ACC under which the Corporation operates itself provides for incentive based compensation. The outstanding performance of the Corporation in its efforts under the ACC led to payments of such incentives to the Corporation.

funds, reflects, from the Authority's board's perspective, other legal sources of funds if the sources contained in the Reconciling Budget were not approved by HUD with respect to the Authority. However, after further discussion, the "Reconciling Budget", as originally proposed with Corporation's allocation of merit pay (bonus) expense, was approved in resolution No. 86, including the president's approval. Because HUD in fact approved the proposed allocations and sources of funding, no alternative sources of funding had to be used from neither the Authority nor the Corporation.

With respect to the recitation in the OIG draft report regarding pay periods, it is our understanding that the Authority's practice of budgeting for incentive pay by including an extra pay period to fund it – if awarded – was a practice approved by HUD's local office. This is especially the case where general incentive payments, like those at the Authority, are based on objective job reviews and have a fixed incentive amount (2 weeks pay) and are not merely splitting up a "bonus pool". With respect to the OIG statement that HUD did not approve the bonuses, it is in error in two ways. First, insofar as the rank and file bonuses discussed on December 17, 2001 were in the budget, HUD approved those budgets with the knowledge that it included the 27 pay period convention.

Second, with respect to the CEO, CFO and Director of Maintenance, those amounts were paid by the Corporation and such payments were duly authorized by the Board of Directors of Corporation, with the knowledge and non-objection and ratification of the Authority board, were not solicited by such officers, and were permitted under the ACC under which Corporation principally operates. There is no basis for the statement in the draft report that the bonuses to the CEO and CFO were inappropriately paid.

Finally, the OIG's Draft Report requires the Authority to seek appropriate sanctions against employees, namely the CEO, CFO and Director of Maintenance for their conflicts of interest in obtaining bonuses. The IG expects the Authority to discipline its employees for the actions of the board of commissioners and the board of directors. The responsibility of making personnel decisions, including the payment of bonuses to its employees, rightfully belongs to the boards and no employee should be penalized for the actions of the employer. There is no indication that any employee "solicited" bonuses from an Authority contractor. These employees rightfully received what the independent Boards gave them.

This arrangement between these entities has yielded great results for HUD in helping HUD move from its bureaucratic bounds, while likewise helping those persons served by the Authority. The money from CA has been poured back into the citizens of Jefferson County, Alabama and with the increase of CA activities, even more will be done. There is no doubt the Authority has experienced "growing pains" and has likewise sought to address those pains as they became apparent. The Authority and Corporation have already rearranged their respective organizational charts in a way consistent with OIG's position, mooting many of OIG's criticisms prospectively.

It is for these reasons that the Authority believes OIG's claim that Authority officials solicited bonuses is misguided, and not supported in law or in fact. Contrary to

the factual analysis, OIG asserts that the Corporation is a “contractor” for purposes of its application of conflict of interest rules, and this position belies a basic misunderstanding of the Corporation’s role as the Authority’s instrumentality. It is not a mere “contractor” for the Authority. It is the instrumentality and agency of the Authority. Further, neither the CEO, CFO nor the Director of Maintenance has any “financial interest” in either the Corporation or the Authority. With no financial interest, there can be no conflict of interest.

Based on the foregoing, we respectfully request that the findings and related recommendations (specifically items 1C1 and 1D and highlights) with respect to “Improper Bonuses were Solicited by Authority Officials” and “Authority Official Served in Dual Capacities” be deleted



## **OIG Evaluation of Auditee Comments**

### **Comment 1**

The Authority's practice of using its Revolving Fund account to loan money between funds and entities is not in accordance with HUD requirements. Although the Authority's Director agreed that the practice of loaning money between funds certainly existed and indicated corrections were in process and planned, the Authority does not want to eliminate the practice completely. Therefore, the Authority does not want to comply with recommendation 1C1, which provides for establishing controls needed to prevent the prohibited practice. The Authority, in Part C, Section 10 of its Annual Contribution Contract with HUD, agreed that it would not loan pooled monies between programs or enterprises in excess of amounts these programs or entities had on deposit. The Authority's practices violated this requirement and should be corrected.

### **Comment 2**

The Authority's methodology to determine what percentages of employees' salaries should be charged to Federal programs is not in accordance with the provisions of OMB Circular A-87. The Authority comments indicate that basing allocations on the Chief Financial Officer's cost estimates were in compliance with OMB Circular A-87. OMB Circular A-87 explicitly states that budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to Federal awards. It further provides that where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation. The activity reports must reflect an after the fact distribution of each employee's activity. The Authority's policies and procedures did not provide for any after the fact documentation to support its allocations.

### **Comment 3**

Based on the Authority's response relating to the improper bonuses and officials serving in dual capacities, we modified our report by deleting the issues and recommendations.