




Issue Date:
July 6, 2006

Audit Report Number:
2006-BO-1009

TO: Ellen R. Connolly, Director of Boston Multifamily Housing Hub, 1 AHMLA

FROM: 
John A. Dvorak, Regional Inspector General for Audit, New England, 1AGA

SUBJECT: The Rhode Island Housing and Mortgage Finance Corporation, Providence, Rhode Island, Incorrectly Made More Than \$1.8 Million in Section 8 Subsidy Payments and Released More Than \$900,000 from Restricted Residual Receipts Accounts.

HIGHLIGHTS

What We Audited and Why

At the request of the U.S. Department of Housing and Urban Development (HUD), we audited the Rhode Island Housing and Mortgage Finance Corporation (Corporation), a state housing agency located in Providence, Rhode Island. Our audit objectives were to determine whether the Corporation (1) correctly processed Section 8 housing assistance payment contract renewals and (2) released residual receipts to development owners and itself in violation of federal regulations.

What We Found

The Corporation incorrectly processed Section 8 housing assistance payment contract renewals for eight developments. It included debt service at incorrect levels and failed to reduce Section 8 contract rents. The inflated contract rents resulted in more than \$1.8 million in Section 8 subsidy overpayments to the development owners. In addition, the Corporation did not recover the overpayments due to the failure of the owners to submit repayment plans on the advice of their legal counsel and because it was awaiting the outcome of our audit.

The Corporation also violated federal regulations when it incorrectly interpreted those regulations and allowed two developments to use more than \$900,000 in restricted residual receipts to pay financing fees to the Corporation, the Corporation's affiliated Affordability Housing Trust, and one development owner. The Corporation believed using residual receipts in a refinancing transaction as an incentive to the owner to extend affordability use restrictions for another forty years was an appropriate use of project funds. It indicated that it had returned the funds with interest to the residual receipts accounts of the two developments.

What We Recommend

We recommend that HUD require the Corporation to (1) actively pursue and recover just under \$1.2 million in Section 8 subsidy overpayments from six development owners, (2) confirm that the Corporation returned more than \$657,000 in overpayments collected from two development owners to the appropriate accounts, (3) develop and implement procedures to ensure that HUD requirements governing the renewal of expiring Section 8 housing assistance payment contracts are followed, and (4) clarify its procedures to ensure residual receipts are restricted to authorized uses. Further, we recommend that HUD confirm that the Corporation returned more than \$945,000 to the appropriate restricted accounts.

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

Auditee's Response

We provided the Corporation with a draft report on June 8, 2006, and held an exit conference on June 20, 2006. The Corporation provided written comments on June 28, 2006, in which it generally agreed with the conditions cited in our report findings, and suggested revisions to the tone and presentation of the report. In consideration of their concerns, we revised our report where appropriate.

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

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BACKGROUND AND OBJECTIVES

The Rhode Island Housing and Mortgage Finance Corporation (Corporation) is the state of Rhode Island's principal housing agency, operating several business lines including loan origination, asset management, and loan servicing. The Corporation is a public entity established in 1973 by the Rhode Island General Assembly. The Corporation was created to expand the supply of housing available to persons of low and moderate income and to stimulate the construction and rehabilitation of housing and health care facilities in the state of Rhode Island. The Corporation is considered an operating unit of the state of Rhode Island.

The Corporation created the Affordability Housing Trust (Trust), a separate legal entity, pursuant to a trust agreement initiated by the Corporation. The Trust is a private-purpose trust, established to assist in activities that involve the creation and preservation of affordable housing in the state of Rhode Island. All Trust resources, including income on investments and other revenues, are held in trust for the benefit of private and not-for-profit organizations. There is no requirement that any portion of the Trust's resources be preserved as capital. The Trust administers its affairs through its trustees, records its assets in segregated accounts, and maintains financial records separate from the Corporation.

The U.S. Department of Housing and Urban Development (HUD) provides Section 8 rental subsidies to the owners of certain mortgaged properties pursuant to a housing assistance payment contract. The entity responsible for the administration of the Section 8 assistance pursuant to a particular contract is the designated contract administrator. As of December 2005, the Corporation acts as the contract administrator for 178 developments assisted under the Section 8 program.

Since its enactment, the Section 8 program has undergone several changes. Under one of those changes, effective February 29, 1980, housing assistance payment contracts are categorized as either old regulation or new regulation contracts. Developments with an initial application before February 29, 1980, are subject to one set of regulations (old regulations), while developments with a later initial application are subject to a separate set of regulations (new regulations). A key difference is that the old regulation contracts and the applicable federal regulations in effect for those pre-80 developments did not require the development owner to account for project funds, did not limit distributions, and did not require the owner to establish reserves to cover residual receipts and reserve for replacement accounts.

The audit objectives were to determine whether the Corporation (1) correctly processed Section 8 housing assistance payment contract renewals or (2) released residual receipts to development owners and itself in violation of federal regulations.

RESULTS OF AUDIT

Finding 1: The Corporation Incorrectly Processed Contract Renewals That Resulted in More Than \$1.8 Million in Section 8 Subsidy Overpayments

The Corporation incorrectly processed Section 8 housing assistance payment contract renewals for eight developments renewed under option four¹ of the Section 8 Renewal Policy Guidebook. This occurred because, during the budget processing for each development, the Corporation did not follow HUD regulations and included debt service at incorrect levels, which had the effect of inflating the applicable contract rents. This deficiency was further impacted by the Corporation's incorrect belief that the development's Section 8 contract rents could not be reduced below their current levels. As a result, the Corporation made Section 8 subsidy overpayments to the development owners totaling more than \$1.8 million. The Corporation did not recover the overpayments due to the failure of the owners to submit repayment plans on the advice of their legal counsel and because it was awaiting the outcome of our review.

Incorrectly Processed Renewals Resulted in More Than \$1.8 Million in Subsidy Overpayments

During a 2004 review, the HUD Rhode Island state office identified that the Corporation had made errors in the Section 8 contract renewals processed for six developments under option four. HUD asked that we review all developments the Corporation renewed under option four. We identified 14 developments with expiring contracts renewed under option four.

Our review of the 14 developments the Corporation renewed under option four showed that the Corporation had identified subsidy overpayments totaling more than \$1.7 million for the six developments with contract renewal errors. The errors occurred because the Corporation did not draft its own written policies and procedures detailing the procedures to follow, and was not proactive in seeking clarification from HUD regarding its own interpretation of HUD regulations. The corporation included debt service at incorrect levels, including adding expired debt service to the budget or including debt service for the entire year when it was scheduled to mature during budget processing for each development. In addition, the Corporation mistakenly believed that a development's Section 8 contract rents

¹ Option four is one of six renewal options available to development owners detailed in the Section 8 Renewal Policy Guidebook, developed to provide comprehensive guidance for renewing expiring Section 8 project-based contracts. Under option four, the initial renewal rents are set at the lower or the current rents adjusted by the published operating cost adjustment factor or the development's budget, which is defined as the rent level required to meet operating expenses.

could not be reduced below their current levels and allowed the contract rents for each development to remain in effect.

Our review of the other eight developments identified similar processing errors in two of those developments, resulting in Section 8 subsidy overpayments of \$101,389. For all eight developments with contract renewal errors, there was more than \$1.8 million in Section 8 subsidy overpayments, as detailed in the table below.

<i>Development contract number</i>	<i>Section 8 subsidy overpayment</i>
RI43H023023	\$654,460
RI43H023005	\$358,731
RI43H023021	\$326,290
RI43H023022	\$232,510
RI43H023052	\$160,082
RI43H023078	\$98,579
RI43H023032 and RI43H023040	\$20,967
RI43H023002	\$2,810
Total	\$1,854,429

Subsidy Overpayments Were Not Repaid

Beginning in December 2004, the Corporation sent letters requesting repayment to the six development owners identified by HUD. However, the Corporation stated that the development owners, on the advice of their counsel, refused to submit repayment plans and that the issue was further complicated by the initiation of our audit. Therefore, the Corporation had not received repayment from any of the development owners before this audit. Following our audit, in March 2006, the Corporation again sent requests for repayment to the two additional development owners identified with contract renewal errors. Additionally, in May 2006, the Corporation began to actively seek repayment from the other six development owners and sent revised requests for repayment of the overpayments to these six owners. As of May 23, 2006, the Corporation received repayments from two development owners of \$654,460, and \$2,810 respectively.

Conclusion

The Corporation incorrectly processed Section 8 housing assistance payment contract renewals for eight developments renewed under option four of the Section 8 Renewal Policy Guidebook. HUD identified overpayments that resulted from contract renewal errors for six developments, but the Corporation

did not recover repayment of the overpayments due to the owner's refusal to submit repayment plans pending completion of our audit and HUD's review. The audit identified two other developments with overpayments, and the Corporation again began to actively seek repayment from the development owners totaling more than \$1.8 million as a result of the audit.

Recommendations

We recommend that HUD

- 1A. Require the Corporation to actively pursue and recover the \$1,197,159 in Section 8 subsidy overpayments from the six development owners.
- 1B. Confirm that the Corporation returned \$657,270 (\$654,460 and \$2,810, respectively) to the appropriate accounts.
- 1C. Require the Corporation to develop and implement procedures to ensure that HUD requirements governing the renewal of expiring Section 8 housing assistance payment contracts are followed.

RESULTS OF AUDIT

Finding 2: The Corporation Violated Federal Regulations by Allowing Two Owners to Use Residual Receipts to Pay Financing Fees

In an effort to ensure the extension of affordability restrictions, the Corporation incorrectly allowed two developments to use residual receipts to pay financing fees to the Corporation, the Trust, and one owner in violation of federal regulations. This occurred because the Corporation incorrectly interpreted federal regulations and believed the use of residual receipts in a preservation refinancing transaction was an appropriate use of development funds. Consequently, these two developments had \$920,428 less in their residual receipts accounts. The Corporation acknowledged its errors and indicated that it had the funds returned with interest to the residual receipts accounts of the two developments.

Restricted Residual Receipts Incorrectly Used in Refinancing Transactions

Housing assistance payment contracts are categorized as either old regulation or new regulation contracts. Developments with an initial application before February 29, 1980, are subject to one set of regulations (old regulation contracts or pre-80 contracts), while developments with applications after this date are subject to a separate set of regulations (new regulation contracts or post-80 contracts). The old regulation contracts are far less restrictive and do not require residual receipts or replacement for reserve accounts. The new regulation contracts require that development owners establish residual receipts accounts and limit the use of funds within these accounts for reductions in housing assistance payments or for other project uses if the funds exceed the amount needed for project operations, reserve requirements, and permitted distributions.

We reviewed 17 new regulation (post-80) contracts administered by the Corporation and found that they permitted two development owners to use the restricted residual receipts as part of the two developments' refinancing transaction. The Corporation indicated that use of residual receipts for refinancing was an appropriate use because it provided an incentive to the two development owners to maintain the developments as affordable housing. Financing fees, however, are an expense of the ownership entity and not an appropriate project use. As part of these refinancing transactions, the Corporation allowed the release of residual receipts to pay \$534,767 in preservation fees to the Trust, \$291,802 in other financing fees, and \$93,859 to one owner in violation of federal regulations, as shown in the table below.

	RI43H023124	RI43H023113	Totals
Preservation fee to the Trust	\$149,106	\$385,661	\$534,767
Other financing fees		\$291,802	\$291,802
Payment to owner		\$93,859	\$93,859
Total ineligible expenditures	\$149,106	\$771,322	\$920,428

Conclusion

As part of a preservation transaction extending affordability restrictions, the Corporation incorrectly allowed two developments to use residual receipts to pay financing fees to the Corporation, the Trust, and one owner in violation of federal regulations. As a result of our audit, the Corporation indicated that it had the funds returned with interest to the residual receipts accounts of the two developments.

Recommendations

We recommend that HUD:

- 2A. Require the Corporation to clarify its procedures to ensure residual receipts are restricted to authorized uses.
- 2B. Confirm that the Corporation returned \$945,829² (repayment of \$920,428 and interest of \$25,401) to the appropriate accounts.

² Of this amount, the Corporation indicated that it returned \$149,106 in preservation fees plus interest of \$4,587 to the first development. The Corporation further indicated that it returned \$385,661 in preservation fees plus interest of \$9,550 and \$291,802 in other financing fees and \$93,859 paid to the owner plus interest of \$11,264 to the second development.

SCOPE AND METHODOLOGY

To achieve our audit objectives, we

- Identified, obtained, and reviewed federal regulations and HUD handbooks/guidebooks pertaining to the Section 8 program.
- Met with and interviewed Corporation personnel and local HUD personnel from the multifamily office in Providence, Rhode Island.
- Reviewed legal correspondence and opinions concerning the requirement and treatment of residual receipts for both pre-80 and post-80 developments and sought additional guidance from the HUD Office of General Counsel.
- Reviewed the housing assistance payment contracts, renewal contracts, loan files, accounting data, and other records for selected developments.
- Reviewed 31 developments, including the housing assistance payment contract renewal processing for 14 developments renewing their expiring contracts under option four and the use and treatment of residual receipts for 17 post-80 developments.
- Summarized our analyses.

We performed audit work at the Corporation's office and at the HUD multifamily office in Providence, Rhode Island, from October 2005 through April 2006. Our audit generally covered the period January 1, 2003, through June 30, 2005, and was expanded as needed to meet our objectives.

We performed our review 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. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Program operations. Policies and procedures that management implemented to reasonably ensure that the Section 8 contract renewal process complies with HUD requirements and that the intended objectives are met.
- Compliance with laws and regulations. Policies and procedures that management implemented to reasonably ensure that its administration of Section 8 developments is consistent with laws and regulations.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- Program operations. The Corporation does not have controls in place to ensure that expiring Section 8 housing assistance payment contracts are processed in compliance with HUD requirements and that the intended objectives were met (see [finding 1](#)).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/
1A	\$1,197,159
1B	\$657,270
2B	\$945,829

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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments



Rhode Island Housing
working together to bring you home

Michael V. Milito
Phone: 401 457-1173
Fax: 401 450-1371

By Electronic Mail and US Mail

June 28, 2006

Mr. Michael Motulski
Assistant Regional Inspector General for Audit
Department of Housing and Urban Development
Office of Inspector General for Audit
Thomas P. O'Neill, Jr. Federal Building
10 Causeway Street, Room 370
Boston, MA 02222-1092

Dear Mr. Motulski:

Thank you for giving Rhode Island Housing the opportunity to respond to the draft of the Audit Report prepared by your staff. We feel that our meeting on June 20th clarified many issues and we look forward to seeing the final version of the audit report.

This letter constitutes Rhode Island Housing's formal response to the draft audit report. I will address each of the specific items identified in the draft report in turn. However, in order to put our response in context, I will first provide some background information about Rhode Island Housing and our assisted housing preservation initiatives.

1. About Rhode Island Housing.

Rhode Island Housing's mission is to provide affordable housing opportunities to all Rhode Islanders. We provide mortgages to first-time homeowners, we finance the construction of affordable rental developments, we administer the Section 8 Voucher program for many towns in Rhode Island and we are involved in a wide array of programs to assist homeless and families and individuals in obtaining permanent housing. We work hard to increase the number of affordable homes throughout the state.

A key component of our effort to increase the number of affordable housing units in Rhode Island Housing is our focus on doing whatever we can to ensure that existing affordable units which might convert to market rate housing remain in the affordable housing inventory. Obviously, the first place to start in expanding the supply of affordable housing is making sure that existing housing not be lost.

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We are very proud of our success in preserving the at-risk, expiring Section 8 portfolio in Rhode Island. Over the last ten years, we have provided financing to 63 developments, preserving more than 7,000 units as affordable for years to come. As importantly, our efforts have resulted in more than \$65 million in necessary rehabilitation work at these developments, ensuring that they remain quality places to live.

We are equally proud of our record as Section 8 contract administrator in Rhode Island. We currently administer more than \$100 million annually in Section 8 subsidies at approximately 150 developments throughout the state. The work we do is complicated and we are always striving to do our best to serve the residents of Rhode Island.

2. The Audit and Proposed Findings

The audit objectives were to determine whether Rhode Island Housing (i) correctly processed Section 8 housing assistance contract renewals and (ii) improperly released residual receipts account funds. Both findings generally arose in the context of Rhode Island Housing's efforts to preserve the affected development as an affordable housing resource for an extended time period.

a. Finding 1: Incorrect Processing of Contract Renewals

1. Causation

The first finding in the report concerns the incorrect processing of Section 8 contract renewals. Rhode Island agrees that about half of the contracts that were renewed under Option 4 of the Section 8 Renewal Guide (the "Renewal Guide") were processed incorrectly; however, we disagree with the conclusion regarding the cause of the error, and also disagree with the evaluation regarding Rhode Island Housing's efforts to recover subsidy overpayments.

The draft finding correctly states that the errors occurred because incorrect debt service levels were included in the budget worksheets when calculating renewal rents. However, the finding does not put this error into context by failing to note that the developments at issue were potential "expiring use" developments that either had reached or were approaching the end of their original mortgage terms. As part of our effort to preserve these developments, we were working with the owners to renew the Section 8 contract and in some cases provide new financing for the development in order to complete needed improvements and extend the use restrictions.

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When this process was underway, in the early 1990s, the Section 8 Contract Renewal process was a relatively new initiative for both HUD and Rhode Island Housing. Staff from both organizations did not have any real experience in administering the program.

Comment 2

Compounding this mutual lack of experience was the fact that the Renewal Guide was less than clear about how debt service was to be included in the rent calculation under Option 4. For example, Section 16-3 of the Renewal Guide provides in establishing an initial budget based rent for "exception projects", the owner must use the debt service associated with the original mortgage. Section 6-1 of the Renewal Guide defines "exception projects" as projects for which the primary financing was provided by a unit of State government and the mortgage is not insured under a federal insurance program. Finally, a memo provided by the local HUD office detailing the process for calculating OCAF rent adjustments provided that in cases where a development does not have an insured mortgage the debt service to be used in determining the appropriate rent increase under the Renewal Guide is the "principal; and interest on the mortgage originally associated with the Section 8 contract." Copies of these materials were provided at our June 20th meeting. I have enclosed additional copies for your convenience. (See Attachments A – C)

Comment 3

Based on our best interpretation of these materials, Rhode Island Housing completed the Option 4 renewals using the original debt service, even though in some cases the debt service had or was about to expire during the term of the renewal. All of our submissions to HUD revealed that the original debt service was included in the budget worksheets, and HUD began paying on the renewals as submitted. It was not until approximately two years after these renewals were completed and submitted that the local HUD office indicated that there may have been errors in the contract renewal.

Comment 4

Following this communication and in effort to resolve some of the uncertainty surrounding the entire renewal process, there followed a series of meetings and correspondence between Rhode Island Housing staff and the local HUD staff. The entire process from contract renewal through clarification several years later was documented in the time line and accompanying documentation that were provided at our June 20th meeting. I have enclosed additional copies for your convenience. (See Attachment D)

Comment 5

In short, while we acknowledge that there were errors in the Option 4 contract renewal process, we suggest that the errors was more properly attributable to lack of clarity in the Renewal Guide and accompanying documents rather than Rhode Island Housing's failure to ensure that staff complied with HUD requirements. We attempted to follow those requirements; the real problem was that the requirements were susceptible of a

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reasonable but incorrect interpretation. Moreover, while not excusing the incorrect processing, it should be noted that the entire overpayment in question, which occurred over a period of several years, represents less than 2% of the subsidy payments we administer each year.

Comment 6

The draft audit also includes the assertion that Rhode Island Housing was less than cooperative in pursuing repayment of the overpayments. We disagree strongly with this conclusion, which is simply incorrect. Beginning in February of 2005 we actively pursued these repayments, proven out by our receipt of the overpayments from two of the developments earlier this year. Our efforts on the remaining developments have been on hold due to the involvement of owner attorneys who were awaiting the outcome of your office's investigation. Our efforts to recapture the overpayments are well documented in the timeline and materials provided at our June 20th meeting. I have attached an additional set of those documents for your convenience. (See Attachment E) In fact, as your report notes, two of the affected developments have already returned a total of approximately \$657,000 to HUD for overpayments due to the incorrect contract renewals. We will continue to diligently pursue return of the subsidy overpayments from the remaining six developments.

Comment 7

2. Response to Recommendations

Despite our belief that the processing error was caused in no small part due to the ambiguity and lack of clarity in the Renewal Guide and other HUD-issued materials, we have considered your recommendation and have taken several action steps to help prevent a similar processing error from occurring in the future. We are in the process of developing checklists which track all aspects of a renewal package through our process to ensure that all appropriate steps are followed for each renewal option. I have attached a sample checklist for an Option 1 renewal. (See Attachment F) In addition, we are cross-training staff to increase the number of people familiar with the renewal process. Finally, between one and two supervisors review all renewal packages before they are sent to HUD. We will diligently continue to pursue the Section 8 subsidy overpayments from the remaining six developments.

b. Finding 2: Incorrect Use of Residual Receipts

1 Causation

The second finding involved the use of residual receipt funds in preservation transactions. Specifically, the proposed finding states that Rhode Island Housing transferred a portion of the residual receipt funds to the Affordable Housing Trust

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("AHT"), a trust fund created by Rhode Island Housing to support affordable housing development in Rhode Island. In addition, the finding states that Rhode Island Housing permitted a portion of the residual receipts account in one of the properties to be used as a financing source in a preservation transaction to the benefit of the owner.

As I previously mentioned, Rhode Island Housing has been actively preserving Section 8 properties for the last several years. As the draft audit correctly notes, housing assistance payments ("HAP") contracts fall into two categories: those with initial application before February 29, 1980 ("Old Regulation") and those with applications after that date ("New Regulation"). Rhode Island Housing, as contract administrator, has virtually unlimited discretion to oversee use of residual receipt funds in Old Regulation developments; however, the use of residual receipt funds in New Regulation developments is limited by regulation to uses that benefit the development.

Comment 8

The two developments identified in the audit are some of the first New Regulation contracts to come through our preservation program. As such, we took the same approach with these developments as we typically do with those with old regulation contracts, and permitted a portion of the residual receipt account to be transferred to the AHT. This failure to identify that these were New Regulations developments was an oversight on our part, and we have returned the funds from the AHT to the residual receipt account for each development, with interest.

Comment 9

Regarding the finding that we permitted a portion of the residual receipts funds to be used as an additional source to benefit the owner in the new financing transaction, we acknowledge that this occurred. We intentionally permitted a portion of the residual receipt funds to be used in this way because we believe that this is an important and often necessary incentive to persuade owners to preserve the units as affordable housing for an additional 40 years. We believed that using funds for this purpose is consistent with the regulatory directive that residual receipts funds be used to benefit the development. Absent clear guidance from HUD on this topic, we moved forward as we thought appropriate in order to preserve the inventory of affordable housing.

Comment 10

In light of the contrary opinion expressed by the local HUD office and the draft audit findings, we will no longer permit residual receipt funds to be used for the benefit of project owners absent approval by HUD on a case-by-case basis. All funds that were used to benefit the owner of the development in question have been returned to the appropriate residual receipts account, with interest. However, we will continue to permit use of such funds as part of a preservation financing where the funds were used to benefit the development. An example of such a use would be for capital improvements to be undertaken at the development.

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2 Response to Recommendations

We are taking steps to implement your recommendations regarding this proposed finding. Staff of our Development Division has all been provided with a list of New Regulation developments. Standard policy when preserving these properties is to leave the residual receipts account untouched unless they are needed for eligible project purposes such as the establishment of new reserves or rehabilitation.

Comment 12

3. Conclusion

While we have accepted and acquiesced in certain of the findings in the draft audit, we must stress that any inadvertent oversights were the result of our efforts to administer programs with limited guidance, written or otherwise, in an effort to preserve as much of the inventory of at-risk Section 8 housing as possible. There is no suggestion, nor could there be, that our actions were taken in effort to deceive HUD or deliberately violate applicable regulations. At all times we used our best judgment to accomplish an important goal that we hope HUD shares.

We appreciate the opportunity to respond to the draft report and hope that the information provided in this letter and in our June 20th meeting provides some clarity as to how the actions occurred. Please feel free to contact me directly should you have any further questions.

Finally, I want to acknowledge the professionalism and consideration demonstrated by your staff during the audit process. Their willingness to maintain open lines of communication was very much appreciated.

Sincerely,



Michael V. Milito
Deputy Assistant Director for
Law and Human Resources

cc: Richard H. Godfrey, Jr.
 John H. Gordon
 Leslie McKnight

OIG Evaluation of Auditee Comments

- Comment 1** The Corporation acknowledged that errors occurred because incorrect debt service levels were included in the budget worksheets. Although we recognize and commend the Corporation's efforts to preserve affordable housing, we disagree that the report does not provide the proper context of the errors. The report continually states that the errors occurred during contract renewals and provides a footnote stating that option four is one of six renewal options available to development owners for renewing expiring Section 8 project-based contracts. The Corporation stated that, in the early 1990's, the Section 8 contract renewal process was a relatively new initiative for HUD and the Corporation. However, our audit period was between January 1, 2003 through June 30, 2005, and the contract renewals identified with errors in this report all took place within that period.
- Comment 2** The Corporation stated that, in addition to a mutual lack of experience, the renewal guide was less than clear about how debt service was to be included in the rent calculation under Option 4 and provided examples of sections where they felt the renewal guide was not clear. The Corporation had the opportunity to contact the local HUD office for clarification on how to properly process contract renewals if it found the renewal guide to be unclear.
- Comment 3** The Corporation stated that it completed the renewals based on their best interpretation of the materials and that their submissions to HUD revealed that the original debt service was included in the budget worksheets. Again, the Corporation had the opportunity to contact the local HUD office for clarification on how to properly process contract renewals. HUD relies on the Corporation, as the contract administrator, to properly renew expiring Section 8 contracts and set the new rent levels. HUD is only required to review and approve the new rents in instances where the rent increase is five percent or higher. Additionally, although there was a gap between the initial renewals and when HUD identified the errors, HUD identified the errors during a routine annual review. It is not unusual for HUD to identify errors during these reviews and that is why they are performed.
- Comment 4** We recognize the Corporation's efforts in working with the local HUD office in an attempt to resolve the uncertainty surrounding the contract renewal process. Nonetheless, the issues were not resolved after HUD's initial disclosure in 2004 and the local HUD office found it necessary to request our assistance in 2005.
- Comment 5** The Corporation acknowledged that there were errors in the Option 4 contract renewal process, but suggested that the errors were more properly attributable to a lack of clarity in the renewal guide and accompanying documents. Again, the Corporation had the opportunity to contact the local HUD office for clarification on how to properly process contract renewals if it found the renewal guide to be unclear. Suggesting that the requirements were susceptible of a reasonable but

incorrect interpretation does not relieve the Corporation of its responsibilities as Contract Administrator.

- Comment 6** Based on a review of the additional documentation provided at, and subsequent to, the exit conference, we amended the report to state that the Corporation did not recover the overpayments due to the owner's failure to submit repayment plans and because it was awaiting the results of our audit. Additionally, we appreciate the Corporation's diligence to pursue the return of the subsidy overpayments from the remaining six developments as recommended.
- Comment 7** We appreciate the Corporation's willingness to act on our recommendations and hope that the Corporation works with its local HUD office in reaching an acceptable management decision on our recommendations. The checklists and cross-training are both positive steps toward ensuring that expiring Section 8 contracts are correctly renewed in accordance with HUD requirements.
- Comment 8** We acknowledge that the Corporation recognized their error and that they returned the funds from their Affordable Housing Trust to the residual receipts account for each development, with interest. In accordance with recommendation 2B, HUD should confirm the repayment.
- Comment 9** The Corporation acknowledged that they permitted a portion of the residual receipts funds to be used as an additional source to benefit the owner in a financing transaction. We recognize that it is the Corporation's belief that using funds for this purpose is consistent with the regulatory directive that residual receipts funds be used to benefit the development. However, as detailed in finding 2, we disagree with their belief and stand by our conclusion that the use of residual receipts in a financing transaction does not benefit the development.
- Comment 10** We recognize that the Corporation will no longer permit residual receipt funds to be used for the benefit of development owners absent approval by HUD on a case-by-case basis. We also recognize that the funds, with interest, have been returned to the appropriate residual receipts account. In accordance with recommendation 2B, HUD should confirm the repayment.
- Comment 11** We appreciate the Corporation's willingness to act on our recommendations and hope that the Corporation works with its local HUD office in reaching an acceptable management decision on our recommendations.
- Comment 12** We agree that the Corporation's actions were not in an effort to deceive HUD or to deliberately violate applicable regulations. We recognize that errors and inadvertent oversights occur. We also recognize that, at times, these errors and inadvertent oversights do result in a violation of applicable regulations, as detailed in our report. We appreciate the Corporation's candor and willingness to change as it continues its efforts to preserve the inventory of at-risk Section 8 housing.