



Issue Date	February 14, 1997
Audit Case Number	97-FW-249-1001

TO: Katie S. Worsham
Director, Office of Community Planning
and Development, 6AD

FROM: D. Michael Beard
District Inspector General for Audit, 6AGA

SUBJECT: Community Development Block Grant Program
Procurement for Rehabilitation of Multifamily Projects
Houston, Texas

We have performed a review of the City of Houston's use of Community Development Block Grant Program funds to rehabilitate two multifamily properties. During our audit of the HUD-funded HOME Program, it came to our attention that the City may not have followed proper procurement procedures in contracting for the use of grant funds to rehabilitate two multifamily properties the City acquired from the Resolution Trust Corporation.

Within 60 days please give us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of this review.

We have provided a copy of this audit report to the Grantee. Please call Darrel Vaught, Assistant District Inspector General for Audit, at (817) 978-9309, if you have any questions.

(THIS PAGE LEFT BLANK INTENTIONALLY)

Executive Summary

We have performed a review of the City of Houston's (City) use of Community Development Block Grant Program (Grant) funds to rehabilitate two multifamily properties it acquired from the Resolution Trust Corporation. Our objectives were to determine whether the City's acquisition, rehabilitation, and sale of Belfort Southwest III and Belfort Southwest IV & V: (1) met grant eligibility requirements; (2) was done in accordance with grant requirements for procurement; and (3) resulted in proper recording of sales proceeds as program income. We determined the City's use of grant funds did meet eligibility requirements and that program income from the sale of the properties was properly recorded. However, the City did not follow proper procurement policies and procedures in awarding contracts for construction management services and rehabilitation contracts.

Sole Source and Fee
Payments were Technical
Procurement Violations

The City's Department of Housing and Community Development awarded a consultant a contract for property and construction management services. In so doing, the City committed a technical violation as the award resulted in a sole-source contract. Instead of awarding a new contract, the City should have amended its existing contract with the consultant. In addition, the new contract used a prohibited pricing method for determining the consultant's construction management fees.

Contract Not Monitored
and Consultant Violates
Contract Terms

The City allowed the consultant to handle most aspects of the rehabilitation construction but did not properly monitor the consultant. As a result, the City did not detect the contractor's violation of key provisions of the contract; including, the consultant's award of construction contracts without free and open competition.

\$353,761 of
Subcontractor's Cost
Questioned

The consultant hired three subcontractors to perform 91 percent of the \$1.1 million in rehabilitation work. The three were related and were involved in questionable transactions. Based on available documentation, only \$559,758 of \$777,007 paid to one subcontractor consisted of acceptable costs, and only \$77,633 of \$102,000 paid to the second was adequately supported. Further, although the contracts with the first two subcontractors included all labor and materials, the third subcontractor collected \$112,145 to furnish materials.

Possible Davis-Bacon Violation

The City apparently relied on the consultant's erroneous representation that Davis-Bacon Act prevailing wage requirements did not apply to the construction contracts.

Recommendations

This report contains recommendations to improve internal controls over consultant contracts, recover ineligible costs, review questioned costs and recover those determined ineligible, and determine if the Davis-Bacon Act was violated.

The City Disagreed with Report Conclusions

A draft report was provided to the City's Housing and Community Development Director on October 3, 1996. The draft was discussed with the Director and a member of her staff at an exit conference held on October 15, 1996. Based on this conference, we performed additional work and provided the Director with a revised draft on December 12, 1996, for review and comment. The Director responded in writing on January 28, 1997. In that response the City essentially disagrees with this report. We have summarized the City's response with the finding, and included it entirety as Appendix D.

Introduction

The City bought two Resolution Trust Corporation (RTC) apartment complexes under the RTC's Affordable Housing Disposition Program. The two projects are:

- **Belfort Southwest III, a 96-unit project bought for \$250,000 on November 10, 1993 and**
- **Belfort Southwest IV & V, a 345-unit project bought for \$1,117,480 on November 15, 1993.**

The City used Community Development Block Grant funds and Resolution Trust Corporation (RTC) loans to acquire and rehabilitate the properties. In November 1994, the City used Grant funds to pay off the \$310,000 and \$1,385,675 loans owed to RTC. In May 1995, the City sold Belfort Southwest III for \$960,000 and Belfort Southwest IV & V for \$3,450,000. The City deposited the sales proceeds in its Grant program income account.

Objective and Scope

Our objectives were to determine whether the City's acquisition, rehabilitation, and sale of the two properties: (1) met grant eligibility requirements; (2) was done in accordance with grant requirements for procurement; and (3) included proper recording of any sales proceeds as grant program income.

To accomplish our objectives, we:

- Reviewed appropriate sections of HUD Regulations governing project eligibility (24 CFR 570, Subpart C); procurement of goods and services (24 CFR 570.502 and 24 CFR 85.36); and program income (24 CFR 570.500 and 504);
- Reviewed the City's written procurement policies and compared them to HUD requirements in 24 CFR 85.36;
- Reviewed the documentation for procurement of construction management services and compared the procedures used and contract awarded to HUD procurement requirements;
- Reviewed and evaluated contracts and related documentation, including applications for payments,

canceled checks, bank statements and invoices at the City and at the consultants;

- Reviewed contracts, invoices, canceled checks, and bank statements for the three vendors paid in excess of \$100,000 each by the Consultant for doing rehabilitation work or providing contract services;
- Interviewed five contractors of one company (Gulfcon) to determine nature of rehabilitation work completed and receipt of payment; and
- Interviewed the City staff, Consultant's construction manager, and two owners of subcontractors regarding work done, materials furnished, and subcontractors used.

The review covered the period from April 1992 to May 1995. We performed the field work between July and December 1995. We performed some additional field work during October and November 1996.

Table of Contents

Management Memorandum	i
Executive Summary	iii
Introduction	1
Finding	
City Did Not Properly Procure and Monitor its Contract for Rehabilitating Multifamily Properties	3
Internal Controls	23
Appendices	
A Schedule of Questioned Costs	25
B Schedule of Questionable Construction Costs	27
C Schedule of Questioned Gulfcon Construction Costs	29
D Auditee Comments	31
E Distribution	43

Abbreviations

HUD	U. S. Department of Housing and Urban Development
OIG	Office of Inspector General
RTC	Resolution Trust Corporation

City Did Not Properly Procure and Monitor its Contract for Rehabilitating Multifamily Properties

The City did not properly follow HUD requirements for procurement of construction management services from a consultant and used a percentage of cost pricing method which is specifically prohibited by HUD. Further, because the City's Department of Housing and Community Development (Department) relied almost totally on the consultant to handle all aspects of the rehabilitation work, the Department was apparently not aware that the Consultant violated its contract in several areas including: (1) not preparing cost estimates based on detailed plans and specifications; (2) not obtaining formal competitive bids from contractors; and (3) not preparing written construction contracts containing required clauses for contractors to follow certain Federal laws and Executive orders. Without adequate specifications for and competitive award of construction contracts, neither the City nor HUD has any assurance that the cost to rehabilitate the two multifamily properties was reasonable. Further, the Department erroneously relied on the Consultant's representation that subcontractors were not required to meet Davis-Bacon Act requirements to pay prevailing wages established by the Department of Labor. As a result, HUD may determine the \$1,122,000 of Community Development Block Grant (Grant) funds used to pay rehabilitation costs to be ineligible.

HUD Requirements

HUD Regulations¹ require grantees, in procuring goods and services, to follow specific procurement standards and procedures, including:

- (1) Maintaining a contract administration system which ensures that contractors perform in accordance with the terms, conditions, and specifications of their contracts or purchase orders; (2) making awards only to responsible contractors possessing the ability to perform successfully under the terms and conditions of a proposed procurement; and (3) maintaining records sufficient to detail the significant history of a procurement, including

¹ Title 24, Code of Federal Regulations, Part 570, Community Development Block Grants, Subpart J, Grant Administration (24 CFR 570.502) refers to the applicability of 24 CFR 85, Administrative Requirements for Grants and Cooperative Agreements to State, Local and Federally Recognized Indian Tribal Governments (24 CFR 85.36 covers Procurement).

rationale for the method of procurement, selection of contract type, contractor selection or rejection, and the basis for the contract price.

- Providing competition by conducting all procurement transactions in a manner providing full and open competition consistent with the required procurement standards and having written selection procedures for procurement transactions including a clear and accurate description of the technical requirements for the goods or services to be procured, identify all requirements which the offerors must fulfill and all other factors to be used in evaluating bids or proposals.
- Using sealed bids, which are shown as the preferred method for procuring construction, making a public solicitation, and awarding a contract on the basis of a firm fixed price to the lowest responsible bidder.
- Not using prohibited cost plus a percentage of cost and percentage of construction cost pricing methods.
- Requiring bonds for construction or facility improvement contracts that exceed \$100,000 including the minimum requirements of a bid guarantee from each bidder equivalent to 5 percent of the bid price, and performance and payment bonds on the part of the contractor for 100 percent of the contract price.
- Incorporating specific clauses in all or certain types of contracts including: compliance with the Copeland "Anti-Kickback" Act for all contracts for construction or repair, the Davis-Bacon Act for construction contracts in excess of \$2,000 when required by the Federal grant program legislation, Sections 103 and 107 of the Contract Work Hours and Safety Standards Act for construction contracts in excess of \$2,000, and applicable standards, orders, or requirements of specific sections of the Clear Air Act, Clean Water Act, Executive Order 11738, and Environmental Protection Agency regulations for contracts in excess of \$100,000.

The Grant Administration Regulations also require grantees to follow OMB Circular No. A-87, Cost Principles for State and Local Governments. This Circular requires costs, to be allowable charges to grant programs, be necessary and reasonable for proper and efficient administration of the grant programs. Further, the Circular requires cost conform to any limitations or exclusions set forth in other governing limitations as to types or amounts of cost items.

Grant Regulations² covering labor standards states that Section 110 of Title I of the Housing and Community Development Act of 1974 as amended requires that all laborers and mechanics employed by contractors or subcontractors on construction work shall be paid wages in accordance with the Davis-Bacon Act.

City Withdraws First Draft
of Contract for
Construction Management

In 1992, the City issued a request for proposals for real estate acquisition and property management services to obtain assistance in acquiring and managing multifamily projects from the Resolution Trust Corporation (RTC). Based on these competitive proposals, in March 1993, the City drafted a contract to be jointly awarded to three companies for the following services:

² Title 24, Code of Federal Regulations, Part 570, Community Development Block Grants, Subpart K, Other Program Requirements (24 CFR 570.603).

Company	Services	Compensation
Duddlesten Realty Advisors, Inc.	Financial Analysis, Physical Inspection, Market Study, Value Determination and Negotiation Strategies.	\$50,000
Duddlesten Management Corporation (Consultant)	Management Leasing, Financial Reporting, and Budget Preparation for each property.	Greater of 4 percent of collections or \$10 per month per unit
	Rehabilitation Construction Management services.	Minimum of \$3,000 per property for 20 hours and \$150 per hour for any additional time approved by City.
The Manley Companies	Program Analysis, Representation and Negotiations with RTC and Financing Structures for Acquisition, Rehabilitation, and/or Permanent Financing.	\$40,000

However, because of concerns expressed by the City Controller, the City deleted the leasing and construction management services contract for Duddlesten Management Corporation. The Department Director said the City Controller was concerned about the possibility of a conflict of interest in allowing the same company to both assist in acquisition and to manage the properties. As a result, the City issued another Request for Proposals for property and construction management services. Duddlesten Management Corporation did not submit a proposal on this later request.

Second Round of Proposals Rejected

Eight companies submitted proposals for property and construction management services. However, the City did not award the contract to any of the eight. Departmental staff members reviewed and evaluated the proposals: three were deemed not responsive because they did not include all required documentation; one company withdrew; and the remaining four were deemed inadequate.

Consultant Gets Contract

According to the Department Director, the City Controller withdrew his previous concerns. Thus, she recommended the City Council award the contract to Duddlesten Management Corporation (Consultant), as originally planned. Based on this recommendation, the City awarded the contract to the Consultant 8 months after it deleted the Consultant from the

original award. The Contract provided for compensation as follows:

Management Services	Compensation Fee	Source of Funds
Property	4% of Collections	Property Rents
Construction	3% of Construction Cost	Grant and RTC

Contract Award Technically Violated Competitive Rules and the Consultant's Fee Used a Prohibited Pricing Method

The City committed a technical violation of HUD's procurement requirements. The City's award of a new contract, rather than amending the original contract to reinstate the deleted services, resulted in a "sole source" award because the Consultant had not submitted a proposal under the Request for Proposals, which was the basis for the new contract award. Also, because the City changed the pricing method in the new contract to the Consultant to be a percentage of the rehabilitation construction costs, the City violated HUD's prohibition against percentage of cost pricing.

City Did Not Adequately Monitor Contract Activity

The Department did not adequately monitor contract activity, thereby not ensuring its Consultant followed the terms of the contract. As a result, the Consultant hired by the City to manage construction did not follow its contract with the City to: (1) provide cost estimates based on detailed plans and specifications; (2) conduct pre-bid conferences and obtain bids from contractors for various phases of construction; (3) ensure the contractors provided appropriate performance and payment bonds; and (4) prepare addendum to standard contracts to incorporate several Regulatory required clauses, including paying prevailing wage requirements.

The Consultant did not actually perform any service; instead, it used an affiliated company, Cornerstone Constructors, Inc. (Cornerstone) to perform the construction management services. Cornerstone, without any written contract with the City, billed and received payment from the City as the construction contractor for over \$1 million in rehabilitation work. This, despite the following terms and conditions in the Consultant's contract that Cornerstone did not perform:

- Site inspection, planning, conceptual cost, and specifications - physical inspection to identify deficiencies, scope of work, and preparation of line item budget

estimate to establish cost and scope of work; and prepare complete written specifications as to material and application methods best suited for work to be performed.

- Preconstruction bid conference, bid opening and award, and award phase - pre-bid conference with all vendors associated with scope of work; three bids to be taken on each line item pertaining to scope of work; all contractors to be prequalified; establishing bid day and time for all vendors; review bids and spread by category and qualified bidder; and selection to be based upon the lowest and most complete bid of qualified bidder; and notify contractors of award.
- Contract Award - Contracts to be issued with AIA³ standard contract form, executed and notarized with contractor and the City named as additional insured; the AIA standard contract form to contain an addendum setting forth certain contractual requirements pursuant to 24 CFR 85.36(i).⁴

Responsibility to Monitor
Contract Not Clearly
Assigned

The Department's Assistant Director, Administrative Manager, and Planner all had false assumptions about who was to monitor the contract. The Assistant Director noted that the Department used the City's purchasing procedures for "routine" goods and services, which do not apply to all City contracts. Further, he noted the Department's contract administration system consists of several distinct and separate procedures and policies. The Assistant Director referenced copies of the Department's Procedure for Contract and Subrecipient Payables⁵ to describe the Department's procedures for contracts developed outside of the purchasing system. He further noted that the Department assigns staff to monitor contract performance in order to ensure contract requirements are met and that the City's Legal Department

³ American Institute of Architects.

⁴ 24 CFR 85.36(i) sets forth clauses grantees are required to place in all or certain types of contracts, including meeting requirements for prevailing wages if required by Grantor agency.

⁵ Paragraph 3.b. notes that a "Contract Reviewer" is a Department staff member designated to review contractor/subrecipient reports and payment requests to ensure compliance with contract provisions and Federal regulations and Paragraph 3.c. notes that a "Contract Manager" is a Department manager who directly supervises Contract Reviewers and approves requests for payment and resolves payment issues with the contractor and other Departmental staff.

assigns staff attorneys to ensure the contracts include provisions that bring applicable laws and regulations into effect through the contract document. The Department's Assistant Director noted that an Administrative Manager had the responsibility to ensure the consultant complied with the terms and specifications of the contract.

The Administrative Manager stated:

- His role was to interact with the consultant for acquisition of RTC properties under the direction of the Department Director.
- He was not familiar with HUD's requirements for procurement of goods and services.
- It was not his function to ensure that the Consultant properly contracted for construction services and he did not know who else within the Department had that responsibility.
- A Departmental Planner had the responsibility to ensure the rehabilitation work was done properly.
- Cornerstone and the Consultant were considered to be one and the same and Cornerstone handled the construction work. He did not know if the Consultant had a written contract with Cornerstone to perform the construction management services.

The Planner said:

- The Department handled the RTC properties differently than other multifamily projects the Department had him inspect.
- Although he usually inspected properties for each phase of construction, for the RTC properties he inspected only once when construction was about 80 percent complete.
- He did not have, nor did he use, any drawings or detailed written specifications for making the inspection.

The Consultant Does Not Perform in Accord with Contract Terms

- He reported inspection results orally to the Administrative Manager and did not keep any documentation of the inspection.

The Cornerstone Vice President, acting as the Consultant's construction manager, was not familiar with the tasks to be performed under the contract between the City and the Consultant. Further, he was apparently not aware of HUD requirements, although referenced in and required by the Consultant's contract with the City, for preparing detailed specifications and cost estimates for the work to be done, obtaining bids for construction work, determining qualifications of contractors, and incorporating specific clauses into the construction contracts.

The Cornerstone Vice President said:

- He was not aware of any written contract or agreement for Cornerstone to provide the Consultant's construction management services to the City. He stated that Cornerstone was not the general contractor but acted as the construction manager.⁶
- He could not recall whether he had read the contract between the City and the Consultant setting forth the scope of services the Consultant was to provide to the City.
- He was not familiar with or aware of HUD regulations and requirements for procurement including the requirement for full and open competition.
- Cornerstone did not formally advertise for competitive sealed bids for doing the rehabilitation work on the two properties.
- Cornerstone did not use any general contractors to do the work, but he made sure that the work was done properly.

⁶ The scope of services for the Consultant's contract did include a provision to hire a construction manager to: work with the architect in setting up job specifications, develop pre-qualification criteria for bidders, conduct pre-bid conferences, and evaluate bids, etc.

- He assembled a group of people they knew and trusted and negotiated the price of work with them.

The Consultant/Cornerstone did not have evidence they performed an inspection of the properties for the purpose of developing a more detailed scope of work, plans and specifications, and line item cost estimates. The only evidence of any inspection, scope of work, or cost estimate was a very brief cost estimate prepared by Cornerstone.⁷ Cornerstone's letter to the consultant noted these inspections were preliminary in nature and based upon visual examination which did not include any penetration of walls, tests of air conditioning units or appliances, or inspection of any occupied units.

The City's contract required the Consultant to obtain at least three bids and contemplated awarding contracts to general contractors for various phases and to incorporate other HUD requirements into an addendum to the contract(s). The City's contract is not clear on whether the Consultant was to enter into construction contracts in the City's name or to represent the City in the City's contracting with construction companies. However, Cornerstone:

- Did not adequately solicit or obtain formal bids from general contractors for performing the different phases of construction work.
- Procured both materials and contractors to carry out the rehabilitation work on the two properties through use of Cornerstone "subcontracts" and "purchase orders."
- Billed the City, as "contractor,"⁸ a total of \$292,000 and \$830,000 for work done on Bellfort Southwest III and Bellfort Southwest IV & V, respectively.

⁷ Provided to the Consultant by Cornerstone Constructors, Inc., letter dated December 8, 1992, noting the inspections were for the purpose of identifying physical deficiencies and cost estimates to correct the deficiencies (a required task of the Consultant's acquisition services contract (Exhibit A.1.(c)) of the scope of professional services, contract authorized by City Council Resolution 92-1604, December 9, 1992).

⁸ Used AIA Document G702, *Application and Certificate for Payment*, along with a *Departmental Request for Payment*, showing either Duddlesten Management Corporation or Cornerstone as a subcontractor.

- Used the funds received from the City, less the construction management fee, to pay the contractors and material suppliers performing work on the properties.⁹
- Did not provide the City with any payment or performance bonds, which are required by HUD Regulations, and did not use written contract(s) incorporating clauses requiring the contractor(s) to follow specific Federal laws and Executive Orders relating to labor and environmental requirements.¹⁰

Consultant's Violations of Contract Do Not Ensure Reasonableness of \$1,092,115 Price City Paid for Rehabilitation

The Department had only the billings from Cornerstone to support the cost of construction which showed \$1,092,115 paid for rehabilitation. Cornerstone billed costs based on Cornerstone's estimate of the cost of rehabilitation plus the 3 percent construction management fee. Cornerstone's billings equaled the City budget for rehabilitation and construction management for these two properties. Therefore, the City paid out the amount budgeted without determining prices were based on competitive bids and that these prices were evaluated through use of detailed specifications and cost estimates.

To support the costs incurred, Cornerstone provided OIG with contracts, purchase orders, invoices, and canceled checks, which showed the following payments for rehabilitating the two properties:

Contractor/Supplier	Bellfort III	Bellfort IV & V	Amount
Gulfcon	\$203,417	\$573,590	\$ 777,007
Gulf Coast Building Supply		102,000	112,145
Buffalo Steel Company	64,414	47,731	102,000
Ken Hammet Company, Inc.	5,000	40,000	45,000
Class Cuts	7,000	27,800	34,800

⁹ Although Cornerstone's periodic billings to the City could not be reconciled specifically to Cornerstone's payments to contractors and vendors, the total of all billings and invoices did reconcile to funds paid to contractors and material suppliers (see Attachment B).

¹⁰ Required from Cornerstone if acting as a contractor or from other contractors doing the work if Cornerstone was acting as construction manager on behalf of the City.

Contractor/Supplier	Bellfort III	Bellfort IV & V	Amount
JW Gray Electric Co., Inc.	4,875	15,485	20,360
Miscellaneous Items	150	653	803
Totals	\$284,856	\$807,259	\$1,092,115

Cornerstone used written subcontracts for Gulfcon and Buffalo Steel. Cornerstone used purchase orders for the other vendors and contractors. Because Cornerstone did not use competitive bids to establish price, OIG selected Gulfcon, Gulf Coast Building Supply, and Buffalo Steel Company to review their documents supporting costs incurred for the rehabilitation work.

Cornerstone Deals with Related Companies

Review of public records and other documentation showed an apparent relationship between the Gulf Coast Building Supply, Inc., Buffalo Steel, and Gulfcon. These three companies represent 91 percent of the price paid for rehabilitation and were awarded contracts without competition. The apparent relationship is based on the following information:

- Gulf Coast Building Supply, Inc., charter filed February 23, 1982, located at 901 Houston Boulevard, South Houston, Texas. President of the company is also sole proprietor of Buffalo Steel. The address is also the address of Gulfcon. Records showed Cornerstone's \$112,145 in payments to Gulf Coast were apparently transferred by Gulf Coast to Gulfcon's bank account.
- Buffalo Steel assumed name certificate, filed November 12, 1993, shows the sole proprietor as the same person who is President of Gulf Coast Building Supply, Inc. Records showed that \$90,908 of Cornerstone's payments to Buffalo Steel were transferred to Gulfcon's bank account.
- Gulfcon assumed name certificate, filed August 18, 1993, shows the company to be a sole proprietorship. Although it lists a different owner than the other two companies, Gulfcon's business address is shown to be the same as Gulf Coast Building Supply. Further, Gulfcon's owner signed

Companies have Inadequate or Questionable Supporting Documentation for Costs Incurred

Buffalo Steel's checks totaling \$90,908 made payable to Gulfcon.

A review of Gulfcon, Buffalo Steel, and Gulf Coast Building Supply, Inc.'s records raises questions as to the reasonableness of the prices paid by Cornerstone for the rehabilitation work. As a result, OIG could verify only \$637,392 (64.3%) of the \$991,152 as being incurred for rehabilitation work on the two properties.

Gulfcon's Costs Related to Rehabilitation.

Cornerstone executed two subcontracts with Gulfcon, both on January 3, 1994, for lump sum amounts. The subcontract for Bellfort Southwest III was for \$203,417 to furnish and pay for all labor, services and materials and perform all work necessary. A similar contract for Bellfort Southwest IV & V was for \$573,590. The subcontracts showed the following work to be performed:

Category	Bellfort III	Bellfort IV & V	Totals
Finishes	\$ 37,000	\$ 99,360	\$136,360
Carpentry	38,390	130,410	168,800
Gutters	11,950	24,380	36,330
Roofs	62,000	167,370	229,370
Concrete	45,357	83,350	128,707
Foundations	8,720	33,390	42,110
Masonry		35,330	35,330
Totals	\$203,417	\$573,590	\$777,007

Cornerstone paid Gulfcon the full amount of the two contracts during February and March 1994.

Gulfcon's owner did not have any employees on his payroll. Gulfcon contracted out all the work, including materials and labor, to subcontractors. OIG examined canceled checks, reviewed available invoices, and where warranted, confirmed

the work and payments with the contractors that did the work. Gulfcon did not have invoices or other documentation to support all costs. Further, certain transactions appeared questionable because the checks were either made out to Gulfcon's owner or jointly to Gulfcon's owner and an individual. As shown on Attachment C, Gulfcon could support only \$559,758 of the \$777,007 incurred.

Materials purchased from Gulf Coast Building Supply, Inc.

Although Cornerstone's subcontracts with Gulfcon provided that Gulfcon would supply all materials and labor, Cornerstone issued purchase orders to Gulf Coast Building Supply, Inc. for a total of \$112,145 in materials. The Cornerstone Vice President said the contract with Gulfcon did not include lumber and that he purchased materials for the properties as they always did to ensure quality materials were used.

However, the payments for materials appear highly questionable for the following reasons:

- Gulfcon's proposal, dated December 16, 1993, submitted to Cornerstone stated:

"We hereby propose to furnish the materials, labor, and insurance to complete the scope of work . . ."

- The subcontract, dated January 3, 1994, between Gulfcon and Cornerstone stated:

"Subcontractor shall furnish and pay for all labor, services and materials and perform all the work necessary or incidentally required for the completion . . . The Subcontractor and the Contractor agree that the materials and/or services to be furnished and the work to be done by the Subcontractor are:

To properly complete all
Finishes, Carpentry, Gutters, Roofs, Concrete, Foundations . . ."

- The Cornerstone checks paid to Gulf Coast for materials were deposited in Gulf Coast's account; but on the same day, Gulfcon's bank accounts shows identical deposits to Gulfcon, as follows:

Gulf Coast Building Supply Deposit of Checks from Cornerstone		Corresponding Deposits to Gulfcon's Bank Account	
Date Endorsed	Amount	Date	Amount
1/19/94	\$ 64,414.00	1/19/94	\$ 64,414.00
2/10/94	37,934.42	2/10/94	37,934.42
3/28/94	9,796.97	3/28/94	9,796.97
Total	\$112,145.39	Total	\$112,145.39

The President of Gulf Coast said he could provide no explanation on why Gulf Coast was apparently transferring funds received from Cornerstone to Gulfcon. The owner of Gulfcon said the transfers were based on his borrowing funds from the owner of Gulf Coast, a long time friend.

- In the absence of detailed plans and specifications the necessity for purchasing the materials cannot be supported by Cornerstone.
- Materials included \$11,760 for 58 metal doors and 40 solid core doors at \$120 each. The brief description of work prepared by Cornerstone does not indicate metal doors were needed. Physical inspection of the properties did not disclose the presence of the metal doors. A maintenance supervisor at the projects, who was there when the work was done, said no metal doors were installed. He did not recall how many wooden doors were installed. Cornerstone's Vice President said he believed the billing for metal doors should have also been for solid core wooden doors. However, without detailed plans and specifications, the records do not show the number of doors required to be and actually installed.

Buffalo Steel's work overpriced by \$24,367.

Buffalo Steel was formed in November 1993, about 6 weeks before Cornerstone executed a January 3, 1994 contract with the Buffalo Steel for \$88,000. Subsequent change orders by

Cornerstone raised the price to \$102,000. Buffalo Steel's records show the deposit of the payments received from Cornerstone, with subsequent transfers of a portion to Gulfcon, as follows:

Buffalo Steel Deposit of Checks from Cornerstone		Corresponding Deposits to Gulfcon's bank account	
Date Endorsed	Amount	Date	Amount
2/1/94	\$ 13,000.00	2/4/94	\$13,000.00
2/18/94	42,275.00	2/25/94	42,183.20
3/28/94	46,725.00	3/28/94	35,725.00
Total	\$102,000.00	Total	\$90,908.20

The Buffalo Steel checks made out to Gulfcon were signed by the owner of Gulfcon. The owner of Buffalo Steel stated that the fence and gates at the Bellfort Southwest properties was the only contract done by Buffalo Steel. Further, the owner stated that since he could not get to the work, he subcontracted it to Gulfcon for \$90,908, making about \$10,000 profit on the deal. Buffalo Steel's bank account shows the owner issued and signed a check made payable to himself for \$10,000. Buffalo Steel's owner said he allowed Gulfcon's owner to sign his company checks because he had let the contract to Gulfcon. Gulfcon's owner explained his signing the checks by saying he was a long time friend of the owner of Buffalo Steel and that he had also authorized Buffalo Steel's owner to sign Gulfcon checks (records provided did not indicate that Buffalo Steel's owner signed any Gulfcon checks).

Gulfcon records show that Gulfcon subcontracted the work to two companies for a total cost of \$77,633. Therefore, had there been bidding, the companies actually doing the gates and fences could have bid the work at a much lower price. As a result of not bidding, the gates and fence work exceeded actual cost by \$24,367.

City Needs to Determine Reasonableness of Costs

Based on OIG review of the three companies, questionable costs totaled:

Contractor	Questioned Amount
------------	-------------------

Gulfcon	\$217,249
Gulf Coast	112,145
Buffalo Steel	24,367
Total	\$353,761

Cornerstone paid out another \$100,160 to three other contractors. Based on the results of OIG's review of the top three vendors, the City needs to take similar steps to ensure the propriety of costs paid to these other three contractors.

City Does Not Ensure Contractors Follow Davis-Bacon Prevailing Wage Requirements

The City had no assurance that subcontractors complied with labor standard requirements. Cornerstone's Vice President advised the City that Cornerstone's exclusive use of independent contractors avoided any violation of the Davis-Bacon Act. HUD Regulations require grantees to ensure construction contractors follow Davis-Bacon Act requirements for paying laborers employed by subcontractors, whether first, second, third, or subsequent subcontractors.

The contract with the Consultant required the consultant to include a clause in all contracts requiring contractors pay prevailing wages in accord with the Davis-Bacon Act. On December 2, 1993, Cornerstone's Vice President wrote the Department Director a letter stating:

"As I explained during our discussion of the Davis Bacon Act as it relates to the Bellfort projects, our exclusive use of sub contractors avoids any violation of this act."

The letter further notes that Cornerstone's Vice President had discussed the issue with the U.S. Department of Labor, and that this individual agreed that they should not experience any problems. In a March 24, 1994 letter to the Department's Administrative Manager, the Cornerstone Vice President said:

"In response to your question regarding the Davis Bacon Act as it applies to the work on these two projects, we are in full compliance. There were no salaried or hourly employees on the project. All work was performed by independent contractors and fell

under the guidelines for work performed by independent contractors."

The Department apparently relied on these statements without making inquiry with the City's legal counsel or HUD staff. HUD Grant Regulations specifically require construction contractors and subcontractors meet Davis-Bacon Act requirements for the payment of prevailing wages. The use of independent contractors, when they use their own labor force, requires they pay prevailing wages as established by the Department of Labor. Therefore, the Act was applicable to all such subcontractors and their subcontractors.

The City will need to take action to have Cornerstone obtain the necessary payroll information to ensure that all salaried employees of the subcontractors or their subcontractors were or are paid the required amount for Federally assisted projects.

Auditee Comments

The City notes that it is in the process of formalizing its policies and procedures regarding professional services (consultants) contracts including assigning of responsibility to monitor such contracts.

The City's response, while acknowledging some violations of HUD requirements, generally disagrees with the findings and recommendations apparently because it was a unique one-time activity. The City believes the audit should acknowledge the role of RTC in the process and address the fact that the properties were in need of rehabilitation, which was accomplished with the use of \$341,750¹¹ of RTC and \$780,250 of HUD funds. The City also asserts that it is not the City's responsibility to ascertain the reasonableness of the costs paid by the consultant to the various subcontractors that did the work. The City also believes that the audit should have verified whether the subcontractors complied with Davis-Bacon Act provisions.

¹¹ As noted in the background, the City obtained RTC loans and used a portion of the loan proceeds to pay for rehabilitation; the City repaid the loans using HUD Community Development Block Grant funds.

OIG Evaluation of
Auditee Comments

The audit did not question that the properties acquired by the City were in need of rehabilitation or state that the City did not rehabilitate the properties. RTC is not charged by statute or regulation to oversee or otherwise ensure that a recipient of their assistance also complies with another Federal funding agency's requirements. HUD places the responsibility on the City to ensure it is administering the program in accordance with HUD requirements.¹²

It appears the City, while acknowledging a need to improve its administration of consultant contracts, does not wish to take responsibility or remedial actions for its Consultant's violation of provisions contained in the Consultant's contract with the City. As a governmental entity, the City has a public trust to ensure that government funds are not only used for the purpose intended but also within reason for the goods or services obtained. The City partially met this responsibility by including contract provisions, that had they been followed, would have ensured the reasonableness of the Grant funded rehabilitation costs and compliance with HUD requirements. However, the City did not properly monitor and supervise its Consultant to ensure these contract provisions were followed. Thus, the City abdicated its responsibility to ensure proper and economic use of public moneys.

Although the City wants to claim it is not responsible for determining the reasonableness of the rehabilitation cost, the City placed \$1,092,115 of government funds in the hands of its Construction Management Consultant and allowed the Consultant to spend these funds with no contractual control and little or no oversight by the City. Further, the City's response shows a significant lack of concern about the irregular financial transactions between the three ostensibly separate companies that received \$991,152 of the \$1,092,115 the City gave to its Consultant.

Recommendations

We recommend the Fort Worth Office of Community Planning and Development require the City to:

¹² HUD Regulation, 24 CFR 570.501(b), states recipients are responsible for ensuring that all Grant funds are used in accordance with all program requirements.

-
- 1A. Ensure that laborers and mechanics employed by subcontractors at all tiers were paid prevailing wages in accord with the Davis-Bacon Act or repay to the Grant Program from non-Federal sources all funds expended on such subcontracts;
 - 1B. Repay the Grant Program from non-Federal sources \$24,367 the amount paid for gates and fencing in excess of the amount actually incurred by the contractors that did the work;
 - 1C. Obtain adequate and verifiable documentation to support the propriety of costs paid to Gulfcon or repay the Grant Program \$217,249 from non-Federal sources;
 - 1D. Obtain adequate and verifiable documentation to support the propriety of costs paid to Gulf Coast Building Supply, Inc. or repay the Grant Program \$112,145 from non-Federal sources;
 - 1E. Obtain adequate and verifiable documentation to support the propriety of the \$100,160 costs paid to the three other contractors and repay from non-Federal sources any amount not adequately supported; and
 - 1F. Establish and implement specific procedures to monitor all consultant contractors to ensure they perform all tasks in accord with their contracts and Grant regulations.

(THIS PAGE LEFT BLANK INTENTIONALLY)

Internal Controls

In planning and performing our audit, we considered internal systems of the management of the Department of Housing and Community Development, City of Houston, Texas, to determine our auditing procedures and not to provide assurance on internal control. Internal control is the process by which an entity obtains reasonable assurance as to achievement of specified objectives. Internal control consists of interrelated components, including integrity, ethical values, competence, and the control environment which includes establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Multifamily Properties

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

Eligibility of Acquisition and Improvement of Multifamily Properties
Procurement of Consultant Services
Monitoring of Consultant Contracts
Payment of Consultant Contracts
Accounting for Program Income from Sale of Real Multifamily Properties

We evaluated all relevant control categories identified above by determining the risk exposure and assessing control design and implementation.

A significant weakness exists if internal control does not give reasonable assurance the entity's goals and objectives are met; resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data are obtained, maintained, and fairly disclosed in reports.

The City Department of Housing and Community Development's management generally did not exercise adequate control over procurement, monitoring, and payment for consultant services. Based on our review, we believe the following item is a significant weakness:

- Department officials have not established adequate controls for monitoring of consultant contracts as more fully discussed in the Finding.

(THIS PAGE LEFT BLANK INTENTIONALLY)

Schedule of Questioned Costs

Recommendation Number	Ineligible ¹	Unsupported ²
B	\$24,367	
C		\$217,249
D		112,145
E		<u>100,160</u>
TOTALS	<u>\$24,367</u>	<u>\$429,554</u>

¹ Ineligible Costs - Costs clearly not allowed by law, contract, HUD, or local agency policies or regulations.

² Unsupported Costs - Costs not clearly eligible or ineligible but which warrant being contested (e.g., lack of satisfactory documentation to support the eligibility of the cost, etc.)

(THIS PAGE LEFT BLANK INTENTIONALLY)

Schedule of Questionable Construction Costs

Bellfort Southwest III			
	Costs		
	Paid	Supported	Questioned
Gulfcon	\$203,417	\$137,819 ¹	\$ 65,598
Gulf Coast Building Supply, Inc.	64,414	0	64,414 ²
HCI Hammet	5,000	0	5,000 ³
Class Cuts	7,000	0	7,000 ³
JW Gray Electric	4,875	0	4,875 ³
Other	150	150	0
Total Construction	\$284,856	\$137,969	\$146,887
Bellfort Southwest IV & V			
	Costs		
	Paid	Supported	Questioned
Gulfcon	\$573,590	\$421,939 ¹	\$151,651
Buffalo Steel	102,000	77,633	24,367 ⁴
Gulf Coast Building Supply, Inc.	47,731	0	47,731 ²
HCI Hammet	40,000	0	40,000 ³
Class Cuts	27,800	0	27,800 ³
JW Gray Electric	15,485	0	15,485 ³
Others	653	653	0
Total Construction	\$807,259	\$500,225	\$307,034
Total Costs	\$1,092,115	\$638,194	\$453,921⁵

¹ See Attachment C for description.

² Funds paid to this company were apparently transferred to Gulfcon.

³ City needs to verify reasonableness of price.

⁴ Amounts paid to contractor in excess of actual cost incurred by independent contractor.

⁵ Questioned costs represent amounts paid by the Consultant to the subcontractors less amounts OIG considered as adequately supported.

(THIS PAGE LEFT BLANK INTENTIONALLY)

Schedule of Questioned Gulfcon Construction Costs

Belfort Southwest III subcontractors	Paid	Questioned	Supported
Brinkman ¹	\$41,415	\$ 0	\$41,415
Phil Knight Construction ¹	26,000	0	26,000
Apartment Rehab Maintenance ¹	22,172	0	22,172
Advanced Systems	6,820	0	6,820
J. Hill Trucking	4,975	0	4,975
Gutter Man, Inc	6,800	0	6,800
Individual A	35,700	35,700 ²	0
Individual B ¹	30,632	1,500 ³	29,132
Various vendors	2,027	1,522 ³	505
Totals	\$176,541	\$38,722	\$137,819
Belfort Southwest IV & V subcontractors	Paid	Questioned	Supported
Brinkman ¹	\$148,600	\$ 0	\$148,600
Apartment Rehab Maintenance ¹	89,926	1,130 ³	88,796
John Concrete Contractor ¹	45,149	0	45,149
Advanced Systems	16,940	0	16,940
J. Hill Trucking	6,200	0	6,200
Gutter Man, Inc.	19,115	415 ³	18,700
Individual A	185,700	185,700 ²	0
Individual B ¹	93,039	0	93,039
Various vendors	10,005	5,490 ³	4,515
Totals	\$614,674	\$192,735⁴	\$421,939
Totals for both properties	\$791,215	\$231,457⁴	\$559,758

¹ OIG also contacted contractor to confirm work done and method of payment.

² Two checks paying draw requests from the individual, totaling \$125,250, were made out to the owner of Gulfcon. Two other checks made out to the individual, totaling \$96,150, contained a second endorsement by the owner of Gulfcon. OIG could not locate individual to interview about the transactions.

³ Gulfcon's owner did not have supporting invoices or contracts.

⁴ Amounts questioned on Attachment B were calculated by deducting the supported costs from the amounts paid to Gulfcon by the Consultant.

(THIS PAGE LEFT BLANK INTENTIONALLY)

Auditee Comments

Distribution

Secretary's Representative, 6AS

Director, CPD, 6AD (4)

Comptroller, 6AF

Director, Accounting, 6AAF

Assistant to the Deputy Secretary for Field Management, SDF (Room 7106)

CPD/ALO, DG (Room 7214) (3)

Associate General Counsel, Office of Asstd. Housing & Comm. Dev., CD (Room 8162)

Acquisitions Librarian, Library, AS (Room 8141)

Chief Financial Officer, F (Room 10166) (2)

Deputy Chief Financial Officer for Operations, FO (Room 10166) (2)

Director, Housing & Community Dev. Issue Area, US GAO, 441 G St. NW,
Room 2474, Washington, DC 20548

Attn: Judy England-Joseph

Auditee