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Audit Case Number	98-PH-241-1001

TO: Joseph K. Aversano, Director, Community Planning and Development Division, Virginia State Office, 3FD

FROM: Edward F. Momorella, District Inspector General for Audit, Mid-Atlantic, 3AGA

SUBJECT: City of Virginia Beach  
Community Development Block Grant Program  
Virginia Beach, Virginia

We audited selected activities of the City of Virginia Beach (Grantee) Community Development Block Grant (CDBG) Program. The purpose of the audit was to determine whether the activities were administered in accordance with HUD regulations and requirements and Grantee policies.

The report identifies the Grantee needs to follow HUD requirements in its management of the (1) replacement housing loan and grant program and (2) use of grant funds to pay-off homeowner debts.

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

A copy of the report has been provided to the Grantee.

If you have any questions, please contact Irving I. Guss, Assistant District Inspector General for Audit, at (215) 656-3401.

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# Executive Summary

The purpose of the audit was to determine whether the City of Virginia Beach administered selected CDBG Program activities according to HUD regulations and requirements and Grantee policies.

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Grantee funded questionable construction of new housing

Our audit identified that the Grantee generally administered an effective program. However, problems were disclosed in the replacement housing loan program that require corrective action.

The Grantee did not properly follow HUD requirements for the construction of new residential housing. The Grantee established a replacement housing loan program as part of its neighborhood rehabilitation program and relocation plan and has constructed 90 new homes since 1982. Although the program was approved as a CDBG eligible activity by HUD, the Grantee failed to adequately consider applicable regulations and did not fully substantiate the program's authority. As a result, the Grantee established a questionable CDBG activity and awarded unsupported loans and grants totaling \$3,167,566.

Grantee improperly funded homeowner debts

The Grantee used CDBG funds to pay-off or refinance liens and judgements on homeowners' property contrary to HUD regulations. The Grantee misinterpreted regulations and improperly used CDBG funds to pay homeowners' personal debts including income and property tax liens, unpaid medical expenses, delinquent water and sewer bills, and department store debts. As a result, the Grantee used CDBG funds totaling \$63,827 for ineligible activities and reduced the amount of grant funds available for eligible program activities.

We recommend: (1) You evaluate the Grantee's administration of its replacement housing program, given the guidance provided by your office, and determine the eligibility of the questioned \$3,167,566; and (2) the Grantee repay the CDBG Program \$63,827 for ineligible loans/grants, and discontinue using CDBG funds to fund homeowners' non-mortgage related personal debts.

We discussed the draft findings with Grantee officials during the audit and at exit conference held on October 22, 1997. The draft findings were provided to the Grantee and the response received was considered in our report. The Grantee's response is included as Appendix B, exclusive of exhibits.

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## Abbreviations

CDBG	Community Development Block Grant
CFR	Code of Federal Regulations
GPR	Grantee Performance Report
HUD	Department of Housing and Urban Development
OIG	Office of Inspector General
URA	Uniform Relocation Assistance and Real Property Acquisition Policies Act

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# Introduction

For Fiscal Years 1995 and 1996, the City of Virginia Beach received \$3,297,000 and \$3,219,000, respectively, in CDBG funds. The Grantee is governed by City Council and administers the CDBG Program through the City Manager and the Department of Housing and Neighborhood Preservation. Mr. Andrew Friedman is the Director of Housing and Neighborhood Preservation.

CDBG Program records are maintained at the Department of Housing and Neighborhood Preservation Building, 2424 Courthouse Drive, Virginia Beach, Virginia.

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## **Audit Objectives**

The primary objective of the audit was to determine whether the Grantee administered its CDBG Program in accordance with HUD regulations and requirements, and local policies. The audit focused on selected program activities covering rehabilitation activities, code enforcement, subrecipient activities, and administrative and indirect costs.

## **Audit Scope**

We reviewed HUD, Grantee, and subrecipient records and interviewed staff responsible for program activities. We reviewed 26 rehabilitation and replacement housing project files. We inspected 16 rehabilitated and replacement housing properties.

## **Audit Period**

Our audit was performed between April 1997 and September 1997, and covered the activities from April 1996 through March 1997. The audit period was expanded when appropriate.

We conducted the audit in accordance with generally accepted government auditing standards.

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# CDBG Funds Were Improperly Used To Finance New Residential Housing Construction

The Grantee did not properly follow HUD requirements for the construction of new residential housing. The Grantee established a replacement housing loan program as part of its neighborhood rehabilitation program and relocation plan and has constructed 90 new homes since 1982. Although the program was approved as a CDBG eligible activity by HUD, the Grantee did not meet the regulatory criteria necessary to make this an eligible program. As a result, the Grantee established a questionable CDBG activity and awarded unsupported loans and grants totaling \$3,167,566.

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24 CFR 570.207(b)(3) states that CDBG funds may not be used for the construction of new permanent residential structures or for any program to subsidize or assist such new construction except for three specific circumstances. In our opinion, the existing conditions did not fall within the scope of these 3 exceptions. See Appendix B for allowable exceptions to the new construction prohibition.

## Replacement housing loan program

Program provided for demolition and new construction of a house

In 1982, the Grantee implemented a replacement housing loan program as part of its neighborhood rehabilitation and relocation plan. According to the Grantee's local policies, the program was designed to provide assistance to eligible homeowners whose house was located in a target neighborhood, was dilapidated, and was unfeasible for rehabilitation. Through code enforcement, the program involved the condemnation and demolition of an owner's existing house and the subsequent construction of a new dwelling, generally on the same lot. Grantee officials told us that the activities conducted under its replacement housing program "displaced" people; therefore, the Uniform Relocation Assistance and Real Property Acquisition Policies Act (URA) provisions were applicable and relocation assistance was authorized. In 1982, the URA was implemented by 24 CFR 42. The assistance provided by the Grantee generally included a CDBG funded replacement

housing grant and loan to finance the construction of a new replacement house. Our review of Grantee Performance Reports (GPR) and replacement housing program files from July 1982 to June 1996 showed that the Grantee used CDBG funds totaling \$3,231,393 to construct 90 new houses under the program. However \$63,827 of these costs were covered in Finding 2. To eliminate duplication this amount was reduced from replacement housing program costs to a net of \$3,167,566.

The program's initial authority was questionable

Replacement housing program not subject to URA

The establishing authority of the Grantee's replacement housing program was questionable. The program was initially identified and established in the 1982-83 CDBG application and GPR. The GPR cited 24 CFR 42 as the authority for the program. Under 24 CFR 42, grantees may construct housing of last resort subject to the provisions of the URA as an exception to the 24 CFR 570.207(b)(3) prohibition against constructing new residential structures. Under housing of last resort provisions, grantees are limited to constructing housing for displaces of a CDBG project when the project is prevented from proceeding because comparable replacement housing is not otherwise available. The cited authority was questionable since it appeared that the Grantee's replacement housing program, as it was implemented, never was subject to the URA. In 1982, according to 24 CFR 42.49(d)(5), a person is not displaced if he/she is an owner-occupant who voluntarily agrees to move for a temporary period and the Grantee does not acquire the property or require the owner to move from the property. Because program participants owned their homes, elected to relocate temporarily, and the Grantee did not acquire the property, they did not appear to be displaced as defined by regulations. Accordingly, the Grantee's replacement housing program was not subject to URA provisions. HUD regulations prohibiting new residential construction were therefore applicable.

Program authority revised in 1989

Application of CFR covering other relocation assistance does not justify new construction

The Grantee changed the authority for its replacement housing program in the 1988-89 GPR. Because HUD questioned the use of URA provisions as the basis for the program, the Grantee revised the program's authority to 24



CFR 570.606(d). This regulation allows grantees to provide optional relocation payments and other relocation assistance to persons displaced by activities that are not subject to the URA. Additionally, the regulation permits relocation payments in excess of prescribed URA limits, subject to a written determination that the assistance is appropriate. HUD approved the change and recognized the cited authority as appropriate in a 1989 monitoring review report of the Grantee's CDBG Program. Grantee and HUD officials told us that the CDBG funds used for the replacement housing program met the criteria of "other relocation assistance" as described in 24 CFR 570.606(d) and therefore was an eligible expenditure of grant funds. In our opinion, the activity conducted under the program did not involve the relocation of the homeowner. In addition, HUD regulations specifically prohibit use of CDBG funds for new residential construction except under specific circumstances. "Other relocation assistance" is not one of the exceptions. Accordingly, the Grantee's replacement housing program was not authorized under 24 CFR 570.606(d).

#### Program authority revised again in 1993

The Grantee once again revised the authority for its replacement housing program in the 1992-93 GPR. In a 1993 substantive review of the Grantee's 1992-93 GPR, HUD reviewed the activity conducted under the replacement housing program and questioned its cited authority. HUD determined that the activity was not subject to "optional relocation" provisions established at 24 CFR 570.606(d) because no relocation occurred. HUD suggested that the authority citation be changed to "substantial reconstruction" as described in section 105(a)(19) of Title 1 of the Housing and Community Development Act. The citation allows grantees to:

"... facilitate substantial reconstruction of housing owned and occupied by low and moderate income persons (A) where the need for the reconstruction was not determinable until after rehabilitation had commenced, or (B) where the reconstruction is part of a neighborhood rehabilitation effort and the grantee (i) determines the housing is not suitable for rehabilitation, and (ii) demonstrates to the satisfaction of the Secretary that the cost of substantial reconstruction is significantly less than the cost of new construction and less than the fair market value of the property after substantial reconstruction."

Under the Act Grantee used substantial reconstruction to justify new construction

Discussions with Grantee officials and physical observations of in-progress and completed units revealed that the activity conducted under the replacement housing program was

undoubtedly the construction of new housing. Additionally, a review of replacement housing files for work initiated during July 1994 through June 1996 showed that the required cost analyses were not performed and approved by HUD. In our opinion, the Grantee's replacement housing program was not authorized by the substantial reconstruction provisions.

The replacement housing program needs to be reevaluated

The activity conducted under the Grantee's replacement housing program is clearly questionable, given the previously discussed history of the program's cited authority and eligibility under CDBG regulations. The program appears to have been established and implemented without adequate consideration to applicable HUD directives prohibiting the use of CDBG funds for the construction of new residential housing. The Grantee, with HUD approval, continues to use grant funds for the program. In our opinion, the program should be reevaluated considering the facts we presented above, and a determination made as to its eligibility. Because the Grantee cannot adequately justify the use of CDBG funds for its replacement housing activity, loans and grants totaling \$3,167,566 is questionable.

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Auditee Comments

Grantee decisions based on HUD guidance

The Grantee stated that the record clearly shows that the Grantee was held to a high standard of diligence in making its decisions, over the course of many years, to carry out and continue the replacement housing activity. Both direct determinations of eligibility, and failure to note ineligibility, provided the Grantee with ongoing guidance from HUD that this was an eligible activity. The Grantee used the system of relying on HUD for guidance as it was and is in place, and used it openly and continually to help make its decisions. There is no reasonable way to go back and question the results of all those decisions at this point. We believe that based on these facts alone, the finding should be abandoned.

Relocation benefits

The Grantee believes that the replacement housing program is clearly eligible as a relocation benefit since the persons who received this benefit were living in houses that were unsafe

and subsequently condemned by code enforcement. With or without the program, they would have been required to relocate. The program was created to lessen the adverse effects that relocation would have had on the residents and the neighborhoods. The fact that the program allows a person to obtain a new housing unit on the same lot does not eliminate the fact that relocation would have been required absent the program. The program met the intent of the relocation requirements in the most cost effective and beneficial way available.

1993 revision of cited authority

The Grantee commented that the justification for changing the authority for the program in 1993 was because they were told by HUD to use it. If the Grantee had been asked to change the program, rather than simply use a revised eligibility citation, they would have done so.

Because of the questions raised by the audit report, effective July 1, 1997 the Grantee no longer conducts this activity with CDBG funds.

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OIG Evaluation of  
Auditee Comments

City decisions based on HUD guidance

We acknowledge HUD's role in providing guidance to the Grantee relative to its replacement housing activity. However, as stated in the finding, the new housing construction performed by the Grantee was explicitly prohibited under CDBG guidelines. Because HUD provided guidance to the contrary and failed to identify the questionable nature of the program does not negate the apparent ineligibility of the replacement housing program.

Relocation benefits

We are not questioning the requirement to relocate persons whose house is condemned and demolished due to code enforcement. However, contrary to the Grantee's stated position, the new housing construction performed under the replacement housing program was not an eligible CDBG activity. As stated in the finding, regulations prohibit the construction of new permanent residential structures except

under specific circumstances. In our opinion, the activity conducted under the replacement housing program did not fall within the scope of these exceptions.

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OIG Comment

OIG requested Headquarters CPD and your office to provide guidance as to the eligibility of the replacement housing program administered by the Grantee. Headquarters did not respond although their request for a time extension was approved by our office. Your office responded and recognized involvement with the Grantee's development of its replacement housing program and its application of the regulations. During the exit conference the Grantee advised there is nothing more to describe the basis for the establishment and continuance of the program that hasn't been uncovered and disclosed by the OIG during the audit.

In our opinion, given the facts presented, your office must evaluate the legislation, regulations and guidance provided the Grantee and determine the eligibility of the program.

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Recommendation

We recommend you:

- 1A. Evaluate the Grantee's administration of its replacement housing program, given the guidance provided by your office, and determine the eligibility of the questioned \$3,167,566. To accomplish this determination review as many of the 90 cases processed by the Grantee, as necessary, the decisions made and justification provided.

## CDBG Funds Were Improperly Used To Pay-off Homeowners' Liens And Judgements

The Grantee used CDBG funds to pay-off or refinance liens and judgements on homeowners' property contrary to HUD regulations. The Grantee misinterpreted regulations and improperly used CDBG funds to pay homeowners' personal debts including income and property tax liens, unpaid medical expenses, and delinquent water and sewer bills. As a result, the Grantee used CDBG funds totaling \$63,827 for ineligible activities and reduced the amount of grant funds available for eligible program activities.

24 CFR 570.202 (b) (3) provides that CDBG funds may be used to make loans for refinancing existing indebtedness secured by a property being rehabilitated with CDBG funds if such financing is determined by the recipient to be necessary or appropriate to achieve the locality's community development objectives.

HUD declares pay-off of liens and judgements is ineligible

A January 2, 1992 memo from the Deputy Assistant Secretary for Grant Programs clarified the term "existing indebtedness" used in CFR 570.202 (b) (3). According to the memo, the intent of this provision is to permit the consolidation of any existing secured loan (typically a mortgage) with a CDBG loan. The memo further states that the use of CDBG funds to pay existing liens and judgements is not reasonable and is therefore ineligible.

A review of rehabilitation files for work initiated during the period July 1994 to June 1997 showed that CDBG funds totaling \$63,827 were improperly used to pay or refinance ineligible homeowner liens and judgements. These costs were identified in Finding 1. To eliminate duplication, these costs are presented here. Essentially, grant funds were used to relieve homeowners of their responsibility to pay their personal debts. Details follow:

Property	Homeowner Liability	Amount
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1	Fed Income Taxes	\$18,200
2	Medical Expenses	13,368
3	Medical Expenses	13,000
4	Real Estate Taxes	152
5	Medical Expenses	11,158
6	Real Estate Taxes	211
7	Real Estate Taxes	2,728
8	Real Estate Taxes	1,734
9	Real Estate Taxes	1,683
10	Water/Sewer Bills	643
11	Department Store Debt	950
	Total	\$63,827

Grantee claims program could not progress unless pay-off occurred

In one case, a portion of the debt had been outstanding for over twenty years. According to the Grantee, grant funds were used to pay-off liens and judgements attached to the properties so the owners could obtain clear title. The Grantee could not perform rehabilitation work on these properties unless clear title was obtained. The Grantee interpreted the "existing indebtedness" provision contained in CFR 570.202 (b) (3) to allow the use of CDBG funds to pay-off liens and judgements since this activity was necessary to achieve their community development objectives. Although the Grantee was not aware of the January 1992 memo that clarified "existing indebtedness", the regulation states that use of grant funds under these provisions must be reasonable and appropriate. In our opinion, using grant funds to relieve program participants of their financial responsibility is unreasonable and inappropriate. By misinterpreting the regulation, the Grantee allowed CDBG funds totalling \$63,827 to be used for ineligible activities and reduced the amount of CDBG funds available for eligible CDBG activities.

**Auditee Comments**

The Grantee stated that they should not be required to repay the CDBG Program \$63,827 for loans/grants used to pay-off or refinance homeowners' liens and judgements for the following reasons:

- Without knowledge of the 1992 HUD guidance letter, their interpretation of 24 CFR 570.202(b)(3) clearly

allowed the use of CDBG funds to provide loans for refinancing existing indebtedness because it was determined to be necessary and appropriate to achieve the objectives of providing decent, safe, and affordable housing and eliminating slum and blight in the target neighborhoods.

- The existing indebtedness was added to the total cost of the rehabilitation work done and all costs greater than the relocation grant were financed by the replacement housing loan. Accordingly, the existing indebtedness to another party became an existing indebtedness to the Grantee. The homeowner was not relieved of their obligation, it was simply transferred to a new obligation.

In response to the recommendations the Grantee stated if repayment is ultimately required that repayment out of program income be allowed. Further, the practice has been discontinued.

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## OIG Evaluation of Auditee Comments

We acknowledge the Grantee's lack of knowledge of the 1992 HUD guidance letter. However, as stated in the finding, using grant funds to pay-off or refinance homeowners' existing non-mortgage related debts was not an appropriate use of CDBG funds. The 1992 HUD guidance letter reiterates this point and, in part, used it to categorize non-mortgage related refinancing of homeowner existing debts as an ineligible use of CDBG funds. In our opinion, this clearly includes obligations transferred and made payable to the Grantee. Accordingly, the \$63,827 remains ineligible and payable to the CDBG Program.

The Grantee's alternative proposal, if repayment is necessary, be made from program income is unacceptable. Repayment to the program will be from non-Federal funds.

## Recommendations

We recommend the Grantee:

- 2A. Repay the CDBG Program from non-Federal funds, \$63,827 for ineligible loans/grants used to pay-off or refinance homeowners' liens and judgements.

We further recommend you:

- 2B. Assure the Grantee has discontinued using CDBG funds to pay-off or refinance homeowners' non-mortgage related personal debts in its program activities.



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# Internal Controls

In planning and performing our audit, we considered the internal control systems of the management of the Grantee in order 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.

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## Internal controls assessed

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

- Administrative controls over rehabilitation, and related activities
- Administrative controls over subrecipients
- Administrative and indirect costs

## Internal controls assessed

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

- Administrative controls over the replacement housing loan and grant program

This weakness is detailed in the findings in this report.

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# Follow Up On Prior Audits

This is the first audit of the Grantee by the OIG.

# Schedule Of Ineligible And Unsupported Costs

F	i	n	d	i	n	g	N	u	m	b	e	r
<u>Ineligible 1/</u>						<u>Unsupported 2/</u>						
				1								\$3,167,566
				2		\$63,827						

1/ Ineligible amounts are clearly not allowed by law, contract, or HUD policies or regulations.

2/ Unsupported amounts are not clearly eligible or ineligible, but warrant being contested for various reasons, such as the lack of satisfactory documentation to support eligibility.

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# Exceptions To Use Of CDBG Funds For New Housing Construction

In 1982, 24 CFR 207(f) allowed two exceptions to the prohibition against new housing construction. The regulation allowed new construction: (1) under the last resort housing provisions set forth in 24 CFR 42; and (2) when funds were used by neighborhood-based nonprofit organizations, small business investment companies, or local development corporations for community economic development or neighborhood revitalization.

In 1989, a third exception was added that allowed new construction when the property was to be used primarily for residential rental purposes.

As of August 1997, the three previously discussed exceptions were the only allowable circumstances in which CDBG funds could be used for new housing construction.

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# Distribution

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