



U.S. Department of Housing and Urban Development

District Office of the Inspector General  
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September 17, 1997

Audit-Related Memorandum  
No. 97-AT-255-1818

MEMORANDUM FOR: Jeanie E. Smith, Director, Community Planning and  
Development Division, 4GD

FROM: Nancy H. Cooper  
District Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: State of Mississippi HOME Program  
New Construction Activities  
Jackson, Mississippi

We have completed a limited review of new construction activity in the HOME Program administered by the State of Mississippi Department of Economic and Community Development (DECD). Our review was in response to concerns you expressed.

The objectives of our review were to evaluate whether DECD and subgrantees awarded HOME funds for new construction in a fair and impartial manner, and to determine whether a conflict of interest existed between DECD managers and a HOME developer.

Our review concentrated on the competitive application process and award of HOME funds. The purpose of this report is to provide you information on related issues requiring corrective action by DECD. Our review included interviews of HUD and DECD staff, review of DECD records, and review of vehicle purchases by DECD managers from a HOME developer.

We conducted the on-site review in May and June 1997. Our audit work focused on new construction awards and activities for the 1995 and 1996 HOME grants, but included limited work on all grant years back to 1992.

## BACKGROUND

The purpose of the HOME Investment Partnerships Program is to expand the supply of affordable housing for low income Americans and to strengthen public-private partnerships in providing affordable housing. The State of Mississippi first received an allocation of HOME funds in 1992. DECD's Community Services Division is responsible for awarding HOME funds to local governments and Community Housing Development Organizations (CHDOs), and for managing the grants. From 1992 through 1996, DECD funded 54 new construction applications, 31 to local governments and 23 to CHDOs, totaling \$22,363,059.

Developers generally engage a consultant to assist in preparing and submitting applications submitted by CHDOs and/or local governments for specific projects. DECD accepts and grades the applications annually, and ranks them by grade. A tie-breaker is used to decide multiple applications with the same grade, usually the annual unemployment rate for the respective community. The application rating factors for the 1995 new construction applications were as follows:

<u>Element</u>	<u>Points</u>
Leveraging of Other Funds	30
Period of Affordability	20
Energy Conservation Features	20
Site Plan/Unit Design	30
Minority/Women Business Participation	20
Repayment Plan	20
Verification of Need	<u>20</u>
Total	<u>160</u>

After DECD awards the funding, local governments provide low interest loans to the developers. Community Planning and Development (CPD) policy in such project-specific applications where the local government does not procure the services, is that competition is unnecessary and Federal procurement requirements are not applicable. CHDOs grantees are generally the developer. DECD provides technical assistance and monitoring until the project is completed and the grant is closed out.

DECD's Community Services Division and its HOME program records are located at 301 West Pearl Street in Jackson, MS.

## SUMMARY

### Award of HOME Funds

DECD consistently applied its ranking process, and fairly and impartially awarded HOME funds

to local governments and CHDOs. We did not review local government loans to developers, or owner procurement of contractors, since Federal procurement requirements were not applicable.

However, two DECD managers responsible for awarding HOME funds purchased vehicles from an automobile dealership which has an identity-of-interest with a HOME developer. Although DECD had no direct dealings with the developer, and we found no evidence of actual wrongdoing, questions of favoritism and gratuities were raised after the vehicle purchases. The State of Mississippi requires employees to avoid conduct which creates public suspicion or mistrust. DECD needs to develop guidelines and policies to help prevent such allegations in the future.

#### Financial Feasibility Review Needs Improvement

DECD does not perform adequate analytical reviews of the financial viability of proposed HOME projects. As a result, it cannot conclude with reasonable certainty that the proposed project will be financially sound and thus able to provide affordable housing for the required period of time. DECD recognized the weakness and sought to add an underwriter to its staff; however, budget restraints hindered those efforts.

\* \* \* \*

Details of these issues are in Attachment 1. We discussed the draft findings with DECD staff. The DECD Manager of Grants Management generally concurred in the findings and agreed to implement adequate corrective actions. Her written comments are in Attachment 2 and are summarized in Attachment 1 following each finding.

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

We provided a copy of the report to the auditee.

Should you or your staff have any questions, please contact Rudy E. McBee, Assistant District Inspector General for Audit, at (423) 545-4368.

Attachments:

- 1 - Results of Review
- 2 - Auditee Comments
- 3 - Distribution

## RESULTS OF REVIEW

### **FINDING 1 - PROCEDURES SHOULD BE DEVELOPED TO PREVENT CONDUCT WHICH CREATES PUBLIC MISTRUST**

Two DECD managers responsible for awarding HOME funds to local governments purchased vehicles from an automobile dealership which had an identity-of-interest with a HOME developer. Although DECD had no direct dealings with the developer, and we found no evidence of actual wrongdoing, questions of favoritism and gratuities were raised after the vehicle purchases. The State of Mississippi requires employees to avoid conduct which creates public suspicion or mistrust. We believe DECD should take steps to try to prevent such allegations in the future.

Section 25-4-101 of the Mississippi Code Annotated states:

"The legislature declares that elective and public office and employment is a public trust and any effort to realize personal gain through official conduct, other than as provided by law, or as a natural consequence of the employment or position, is a violation of that trust. Therefore, public servants shall endeavor to pursue a course of conduct which will not raise suspicion (underline added) among the public that they are likely to be engaged in acts that are in violation of this trust and which will not reflect unfavorably upon the state and local governments."

The two managers who purchased vehicles are responsible for the final review of HOME applications and award to subgrantees (local governments). Generally, developers are identified in subgrantee applications and, after grants are awarded, the developers receive low interest second mortgages from the local governments to construct affordable housing. Even though DECD did not contract directly with the developer, the DECD managers were aware the developer was building HOME units and had an identity-of-interest with the automobile dealership from which they purchased vehicles. Adding to the appearance of a conflict of interest, was the fact that the managers live approximately 230 miles from the automobile dealership. The first vehicle was purchased in December 1996, and the second was purchased in March 1997. Soon after the second vehicle purchase, the HUD Mississippi State Office received allegations that the majority of its HOME funds went to the developer from whom the vehicles were purchased.

We reviewed DECD awards of HOME funds from 1992 through 1996 to determine if DECD gave preferences in the ranking and award of HOME applications to subgrantees who selected this developer. We also examined the vehicle purchases to determine if the managers received gratuities in the form of unusually low-cost transactions. We found no evidence of favoritism by DECD toward the subgrantees, and no apparent gratuities in the vehicle purchases.

Both managers stated they did not consider the purchases conflicts of interest because they were so removed from the everyday activity of their jobs and because DECD was not a party to contracts with the developer. However, since DECD met with the developers during site reviews and at pre-construction conferences, a business relationship existed between them. In hindsight, the managers acknowledged it was reasonable for the public to perceive the transactions as conflicts of interest; however, they maintained there was no favoritism and they did not receive gratuities.

The transactions prompted allegations of favoritism and improper transactions. Because of the business relationship between DECD and the developer, DECD should have recognized the potential conflict of interest and disclosed the transactions prior to public inquiry. When in question about the propriety of a transaction, DECD should obtain an opinion from the Mississippi Ethics Commission, the authoritative body responsible for advisory opinions on state ethics provisions (Mississippi Code Annotated, Section 25-4-17).

### **AUDITEE COMMENTS**

DECD concurred with the finding and agreed to implement the recommendations.

### **RECOMMENDATIONS**

We recommend that you require DECD to:

- 1A. Develop guidelines to define situations that have the appearance of conflicts of interest, and procedures for reporting such actual or potential situations to the appropriate level of management.
- 1B. Establish a policy outlining circumstances that necessitate an opinion from the Mississippi Ethics Commission about the propriety of actions taken or contemplated.

## **FINDING 2 - FINANCIAL FEASIBILITY REVIEW NEEDS IMPROVEMENT**

DECD does not perform adequate analytical reviews of the financial viability of proposed HOME projects. As a result, it cannot conclude with reasonable certainty that the proposed project will be financially sound and thus able to provide affordable housing for the required period of time. DECD recognized the weakness and sought to add an underwriter to its staff; however, budget restraints hindered those efforts.

All HOME funds used for constructing rental housing must be used to assist low income persons at reduced rents for a minimum period of 20 years (24 Code of Federal of Regulation (CFR ) 92.216(a) and 92.252(a)). The developer must take into consideration the lower rental income when projecting income to determine if the proposed project is financially feasible. If a project fails financially, affordability restrictions may terminate upon foreclosure.

DECD accepts applications for HOME funds annually. As part of the application evaluation , DECD reviews financing plans and proforma budgets prepared by the applicant, but applies no analytical reasonableness tests to the projections. DECD should test the projections to determine if the applicants are adequately disclosing debt service costs and if the projects are financially sound. Some funding depends on awards from other organizations and is subject to change if, for instance, applications for tax credits were rejected. Again, DECD does not have adequate review procedures in place to analyze the effects on debt service cost. Since the applicant is not required to submit a revised proforma budget disclosing changes to debt service costs, DECD's assurance that the project will be financially viable is further diminished.

In one file reviewed, the subgrantee was unable to get all proposed financing, resulting in conventional bank financing increasing from \$65,000 to \$190,000. The file included no revised proforma or documentation that DECD had determined if the project was still financially viable based on the new loan commitment terms. In this instance, due to the extended term of the new loan, the difference in debt service was negligible. However, the change in loan amount and terms should have prompted DECD to reexamine the project's financial viability and the availability of construction funds. The lack of financial analysis increases the risk that HOME funds will be expended on a project that will not remain affordable to low income families for the required 20 years. Had the developer not obtained comparable financing, the affordability of the project could have been jeopardized and the grant subsequently deemed ineligible. DECD would have difficulty recovering ineligible funds from a local government with limited financial resources.

DECD recognized the need to strengthen its financial review procedures. Since the staff did not have the expertise or time to adequately analyze the financial components of HOME proposals, DECD sought and received approval to hire an underwriter. However, budget restraints prevented them from filling the position. If the restraints continue, DECD should try other methods of obtaining assistance. For example, DECD's Financial Resources Division already has staff with the financial expertise needed to review proforma budgets, which DECD could possibly

use for the HOME Program.

**AUDITEE COMMENTS**

DECD agreed the financial review should be improved, but contended HOME funds had not been jeopardized, noting that no HOME projects had failed. Officials stated they had changed the grant contract terms to require recipients to document leveraged funds and to submit a revised proforma when debt service costs change. They stated they plan to hire an underwriter.

**RECOMMENDATION**

We recommend that you require DECD to:

- 2A. Develop and implement a plan to provide sufficient competent analytical review of the financial feasibility of proposed HOME financing plans.

**AUDITEE COMMENTS**





**DISTRIBUTION**

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