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Audit Report Number	2011-SE-1003
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TO: Douglas P. Carlson, Director, Portland Field Office, Office of Community Planning and Development, OED

FROM: //signed//
Ronald J. Hosking, Regional Inspector General for Audit, Seattle, Region X,
OAGA

SUBJECT: Oregon Housing and Community Services Allowed a Developer To Use Neighborhood Stabilization Program Funds for Ineligible Purposes

HIGHLIGHTS

What We Audited and Why

We audited Oregon Housing and Community Services (OHCS) to determine whether it obligated Neighborhood Stabilization Program (NSP) funds in a timely manner, adequately monitored subgrantee and contractor performance, properly maintained NSP records, and reasonably ensured that NSP funds were spent for eligible activities. We selected OHCS because it received \$19.6 million in NSP funds.

What We Found

OHCS generally obligated NSP funds in a timely manner, adequately monitored subgrantee and contractor performance, properly maintained NSP records, and reasonably ensured that NSP funds were spent for eligible activities. However, it allowed a developer to use \$5,000 for ineligible reserve accounts.

What We Recommend

We recommend that the Director, Portland Office of Community Planning and Development, require OHCS to reallocate or repay the funds, ensure that subgrantees and developers understand the program requirements for reserves, and check for similar issues in other projects.

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

Auditee's Response

We requested a response to the draft report on February 11, 2011. OHCS provided written comments on February 11, 2011 and generally agreed with the report.

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

TABLE OF CONTENTS

Background and Objective	4
Results of Audit	
Finding 1: Oregon Housing and Community Services Allowed a Developer To Use NSP Funds To Fund Ineligible Reserve Accounts	5
Scope and Methodology	7
Internal Controls	8
Appendixes	
A. Schedule of Questioned Costs	9
B. Auditee Comments and OIG's Evaluation	10
C. Subrecipient and Developer Project Sample Selection	14

BACKGROUND AND OBJECTIVE

Oregon Housing and Community Services

Oregon Housing and Community Services (OHCS) acts as Oregon's housing finance agency and works to create and preserve opportunities for quality, affordable housing for low- and moderate-income families. Governed by a seven-member council, OHCS promotes affordable housing through grants and tax credits, the construction or rehabilitation of multifamily developments, and the financing of single-family homes. Additionally, OHCS manages Federal and State funds for antipoverty, homelessness, energy assistance, and community service programs.

Neighborhood Stabilization Program

The Housing and Economic Recovery Act of 2008 (HERA) appropriated \$4 billion to stabilize communities through the purchase and redevelopment of foreclosed-upon and abandoned residential properties. Commonly called the Neighborhood Stabilization Program (NSP), these formula grant funds are considered to be Community Development Block Grant (CDBG) funds. Eligible uses are

- Establishing financing mechanisms to purchase and redevelop foreclosed-upon homes and residential properties,
- Purchasing and rehabilitating abandoned or foreclosed-upon homes and residential properties,
- Establishing and operating land banks for foreclosed-upon homes and properties,
- Demolishing blighted structures, and
- Redeveloping demolished or vacant properties.

OHCS allocated its \$19.6 million share of NSP funds to nine local government organizations (subrecipients) and seven nonprofit organizations (developers). It also retained funds to assist home buyers in areas not served by the subrecipients and developers. The subrecipients and developers carry out NSP activities, and OHCS reimburses them upon receipt of adequate documentation.

Our objective was to determine whether OHCS

- Obligated NSP funds in a timely manner,
- Adequately monitored subgrantee and contractor performance,
- Properly maintained NSP records, and
- Reasonably ensured that NSP funds were spent for eligible activities.

RESULTS OF AUDIT

Finding 1: Oregon Housing and Community Services Allowed a Developer To Use NSP Funds To Fund Ineligible Reserve Accounts

OHCS allowed a developer to use NSP funds to fund ineligible reserve accounts. This noncompliance occurred because OHCS was unaware that the use of program funds for operating deficit or capital needs reserves was ineligible. As a result, \$5,000 was not available for other program purposes.

OHCS Provided Funds for Ineligible Operating and Replacement Reserves

OHCS provided a small amount of NSP funds for ineligible operating and replacement reserves. An OHCS subgrantee provided NSP funds to a non-profit developer to purchase and rehabilitate a house to use the house as a rental unit. As part of the transaction, the developer requested and received \$5,000 for replacement reserves “. . . to cover capital needs replacements as well as operating deficits.” However, program requirements prohibit using NSP money to fund reserve accounts.

Appendix B, paragraph 9 of Office of Management and Budget Circular A-122, Cost Principles for Non-Profit Organizations prohibit contingency reserves or similar provisions made for events, the occurrence of which cannot be foretold with certainty as to time or intensity or with an assurance of their happening. In addition, section 2301(e)(1) of HERA provides that NSP funds be treated as CDBG funds under the Housing and Community Development Act of 1974 (1974 Act). Neither HERA, the implementing NSP Federal Register notices, nor the 1974 Act include operational deficit or replacement reserves as eligible activities.

OHCS Was Not Aware That NSP Funds Could Not Be Used for Reserves

OHCS was unaware that using NSP funds for operating deficit or capital needs reserves was ineligible. The responsible OHCS manager stated that he considered the \$5,000 reserve fund as reasonable and customary based on his experience in managing maintenance and capital improvements.

Since OHCS permitted the developer to use the \$5,000 for an ineligible reserve account, these funds were not available for other program purposes.

Recommendations

We recommend that the Director, Portland Office of Community Planning and Development, require OHCS to

- 1A. Require the developer to repay or reallocate the ineligible funds to an eligible NSP purpose.
- 1B. Ensure that its subgrantees and developers are aware that using NSP funds for operating reserves is prohibited.
- 1C. Determine whether similar instances of using NSP funds for operating reserves have occurred and correct them.

SCOPE AND METHODOLOGY

Our audit period covered October 2008 through September 2010. We performed our fieldwork in October and November 2010 at OHCS’ office located at 725 Summer Street NE, Salem, OR, and at the following subrecipients and developers:

Subrecipient/developer	City
City of Portland – Portland Housing Bureau	Portland
Clackamas County – Office of Community Development	Oregon City
Washington County – Office of Community Development	Hillsboro
Community Connections of Northeast Oregon	La Grande
Umpqua Community Development Corporation	Roseburg

To accomplish our objective, we interviewed OHCS’ staff and reviewed its contracts with subrecipients, financial information, and individual NSP-funded project files at OHCS and subrecipient and developer offices.

Sample Selections

We reviewed OHCS records for 6 of 54 randomly selected financing mechanism projects it administered.

For projects administered by subrecipients and developers, we selected three of nine subrecipients and four of seven developers on the basis of funding amount, number of units, amount of program income, and distance from OHCS. Appendix C shows the sample selection by entity and activity for our file review at OHCS for subrecipient and developer projects.

We reviewed files for NSP-funded projects at the offices of all three subrecipients and at two of the four developers. We did not visit the Housing Authority of Jackson County and Habitat for Humanity because of travel considerations.

We used HUD’s Line of Credit Control System and Disaster Recovery Grant Reporting system for background information only and did not rely on the data to base our conclusions. We relied on computer-processed data maintained by OHCS for tracking program activities. Based on our assessment and testing of these data, we concluded that the data were sufficiently reliable for our objective.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

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

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our objective:

- OHCS' policies implemented to reasonably ensure that subgrantees and developers follow NSP rules.
- OHCS' policies implemented to reasonably ensure that NSP funds are used in accordance with HERA, Federal Register notices, and HUD guidance.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

We assessed the relevant internal controls above and found no significant deficiencies.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation Number	Ineligible 1/
1A	\$5,000


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



Oregon
John A. Kitzhaber, MD, Governor

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February 11, 2011

Ronald J. Hosking
Regional Inspector General for Audit
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909 First Avenue, Suite 126
Seattle, WA 98104-1000

Dear Mr. Hosking:

Oregon Housing and Community Services (OHCS) would like to take the opportunity to comment on the HUD Office of the Inspector General's (OIG) draft audit report on the administration of Oregon's Neighborhood Stabilization Program (NSP).

We are pleased that the report finds that our agency has successfully administered this program according to HUD regulations and we generally agree with the report. It has been an honor to work with your staff and HUD's during this audit.

We would like to offer a few comments on the one finding in your audit that may put the report in the context of our program operations.

The finding on page 5 of the draft report states:

"Oregon Housing allowed a developer to use NSP funds to fund ineligible reserve accounts. This noncompliance occurred because Oregon Housing was unaware that the use of program funds for operating deficit or capital needs reserves was ineligible. As a result, \$5,000 was not available for other program purposes."

OHCS clearly agrees with the finding's conclusion that "Oregon Housing was unaware that the use of program funds for operating deficit or capital needs reserves was ineligible," as stated in Appendix B, paragraph 9 of OMB Circular A-122. However, OHCS based its decision to allow the developer to establish replacement reserves in compliance with guidance from HUD and industry practices.

First, the NSP program funds are governed by the requirements of many federal programs and directives – Community Development Block Grant, HOME Program, Federal Register Notices, HUD webinars with frequently asked questions, and various OMB Circulars, and the HUD sponsored NSP Resource Exchange – many of which provide conflicting, contradictory and shifting guidance.

What We Do Matters!

Comment 1

For example:

Comment 2

Comment 3

Comment 4

Comment 4

Comment 4

Comment 5

Comment 4

1. **24CFR570.207, Ineligible Activities:** CDBG regulations do not specifically prohibit the use of NSP funds for operating or capital reserves;
2. **24CFR570.201, Eligible Activities:** CDBG regulations do not specifically mention the permitted use of NSP for operating or capital reserves;
3. **HUD's NSP FAQ # 33:**
Question to HUD (4-28-2010): Can NSP1 funds be used for operating reserves if the mortgage lender requires that funds be allocated for operating reserves as a condition of funding for a multifamily housing project?
Answer from HUD: Yes. NSP1 funds can be used for operating reserves if the NSP1 grantee can demonstrate that such a requirement is consistent with industry practices and the dollar amount of the required reserves is consistent with local industry standards.
4. **ICF INTERNATIONAL, INC -NSP Open Forum Question and Answer (05-13-10) # 3481025:**
NSP HUD experts David Noguera and John Laswick (transcript, page 10): "Okay, so you cannot subsidize a rental property on an ongoing basis. You can subsidize a rental property up front if the lender requires a replacement reserve to be established or a loan loss reserve or other reserves that are customary in your market place and that are sized appropriately and are not \$1 million for a four unit project."
5. **Meeting the 25% Set-Aside for Low Income Persons Webinar-Presentation Slides (5-18-2010):**
Typical Uses of NSP FUNDS
 - Rental projects
 - 100% financing of development costs or in combination with other loans and subsidies
 - NSP funds can be used to pre-fund replacement reserves required by lenders
6. **NSP Resource Exchange Sample NSP Single-Family Development and Rental Program Manual (December 2010):**
Single-Family Rental Toolkit (Page 9):
 2. Complete a Project Development and Operating Budget that includes all proposed NSP-funded expenses for acquisition, site work, rehab/construction, holding costs, marketing costs, initial lease-up costs and reserves, developer fee, and other soft costs; as well as a cash flow projection showing projected rent collections and expenses over at least a five-year period.

The replacement reserve does not violate prohibitions (HUD's 9-8-2010 NSP FAQ # 485) against rental subsidies. It is not an ongoing subsidy.

Second, replacement reserves are customary practices in the low-income housing industry, especially for housing benefiting very low-income tenants. These developments do not yield adequate cash flow to build reserves. Because NSP required us to set aside 25 percent of the program funds to serve populations earning less than 50 percent of area median income, the developer needs subsidized financing so it can charge low rents. NSP made it possible to serve a high needs population.

Ronald J. Hosking
Regional Inspector General for Audit
February 11, 2011
Page 3

Comment 6

In the midst of these circumstances of ambiguous guidance, and the extremely ambitious timelines established by HUD to obligate funds, OHCS followed the customary practice of the industry with respect to replacement reserves.

Comment 7

Given these circumstances, OHCS respectfully requests that the Office of the Inspector General reconsider its recommendation to require the developer to repay the funded replacement reserve of \$5,000 or reallocate the funds to an eligible NSP purpose. Avoiding a financial hardship for the housing development and the developer is part of OHCS's request. In light of the NSP1 audit finding and the language of OMB Circular A-122, for future rounds of NSP funding OHCS will disallow the use of NSP funds for ineligible development reserve accounts.

Thank you for the opportunity to provide comments and we appreciate the successful completion of the NSP1 Audit from the Office of the Inspector General.

Respectfully,



Victor Merced
Director

OIG Evaluation of Auditee Comments

- Comment 1** OHCS states it based its decision to allow the developer to establish a replacement reserve in compliance with industry practices and guidance from HUD. However, OHCS does not give any examples of guidance on the use of NSP funds for reserves from HUD that was available prior to the November 2009 closing of the purchase of the house in the finding.
- Comment 2** 24 CFR 570.207, Ineligible Activities, states "The general rule is that any activity that is not authorized under the provisions of §§ 570.201–570.206 is ineligible to be assisted with CDBG funds." Neither operating nor replacement reserves are authorized in §§ 570.201–570.206.
- Comment 3** 24 CFR 570.201, Basic Eligible Activities, states that "CDBG funds may be used for the following activities." Neither operating nor replacement reserves are listed among these activities.
- Comment 4** The 2 Frequently Asked Questions, the Open Forum question, and the Webinar all refer to operating reserves required by a lender. All of this guidance was dated after the November 2009 closing of the purchase of the house in the finding. The lender for the purchase of the house in the finding is the NSP subgrantee. In its grant agreement with OHCS, this subgrantee agreed to comply with Office of Management and Budget cost principles. Office of Management and Budget Circular A-122, Cost Principles for Non-Profit Organizations, prohibit contingency reserves or similar provisions made for events, the occurrence of which cannot be foretold with certainty as to time or intensity or with an assurance of their happening.
- Comment 5** This manual states that it is not an official HUD document.
- Comment 6** OHCS states it followed customary industry practice with respect to the replacement reserves in the midst of ambiguous guidance and pressure to obligate its NSP grant funds. However, as noted above, OHCS does not give examples of any ambiguous guidance that was available when the property in the finding was purchased with NSP funds. NSP funds are considered to be CDBG funds and CDBG funds cannot be used for reserves.
- Comment 7** Office of Inspector General audit reports inform HUD program officials of, among other things, ineligible costs arising from alleged violations of requirements governing program funds. In the case of ineligible costs, the reports also recommend action to program officials to require repayment of the ineligible costs. The program officials then make the management decisions regarding the recommendation, including whether to require repayment of ineligible costs.

Appendix C

SUBRECIPIENT AND DEVELOPER PROJECT SAMPLE SELECTION

Entity	Activity	Number in sample	Number in universe	Selection method
City of Portland	Financing mechanism	3	17	Randomly
City of Portland	Purchase and rehabilitation	2	5	Amount of funds
City of Portland	Redevelopment	1	1	100 percent
Clackamas County	Financing mechanism	3	12	Randomly
Clackamas County	Purchase and rehabilitation	2	6	Amount of funds
Washington County	Financing mechanism	3	10	Randomly
Washington County	Purchase and rehabilitation	3	9	Amount of funds
Community Connections of Northeast Oregon	Purchase and rehabilitation	2	2	100 percent
Housing Authority of Jackson County	Land bank	1	1	100 percent
Habitat for Humanity	Purchase and rehabilitation	2	8	Amount of funds
Habitat for Humanity	Redevelopment	1	1	100 percent
Umpqua Community Development Corporation	Purchase and rehabilitation	2	7	Amount of funds and program income