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SECRETARY
DOUGLAS APPLE
GENERAL MANAGER

To: Doug Apple, General Manager
From: Tino Hernandez, Chairman *TH*
Date: October 9, 2008
Re: Audit Committee Findings and IGO Investigation of NYCHA's CM/Build Program

The Board is in receipt of the September 17, 2008 Memorandum ("OIG Memorandum") issued by the Inspector General concerning its investigation of NYCHA's CM/Build Program. A copy of the OIG Memorandum is annexed for your reference.

As the OIG Memorandum makes clear, NYCHA's Audit Committee, Internal Audit Department and the OIG have all identified serious and recurring deficiencies in the management of the Capital Program's Construction Management Build Program ("CM Build Program") in terms of both financial accountability and regulatory compliance. These findings of significant deficiencies have a direct and adverse impact on NYCHA's financial statements and on its current and future ability to preserve its physical infrastructure.

The Board acknowledges that Senior Management in both the Capital and Finance Programs has taken certain steps to correct the deficiencies identified by the various audits and investigations undertaken by the Internal Audit Department, OIG and HUD. In fact, we were pleased to see that twelve of the thirteen CM Build projects bid in 2007-08 were within 20% of their cost estimates, representing a decrease from prior years. Nevertheless, these steps, though commendable, have yet to adequately address all of the significant deficiencies identified in the OIG Memorandum.

As we discussed in the Capital Board briefing on September 23, 2008, the Board remains concerned about these deficiencies and accordingly, directs you, as the General

Manager, to ensure that the Capital Projects Division fully implement the following recommendations.

- You are to finalize procedures for oversight of the CM Build Program by December 15. A draft manual of such procedures dated September 3, 2008 has already been circulated. Please ensure that the appropriate departments have also reviewed the procedures to ensure compliance with all applicable legal, regulatory and program requirements.
 - Procedures for oversight must require that appropriate staff fully document and record all transactions to ensure that the required audit trail exists for all transactions.
 - Procedures for oversight must require that all staff be compliant with all regulations and financial reporting requirements and that supervisors be held accountable for failure to comply with such regulations and requirements
- Earlier this year, Louie Rueda, Deputy General, reorganized the Capital Projects Division. By December 15, 2008, you are to provide the Board with an organizational chart that identifies all employees (at all levels) who are responsible for monitoring the activities of each Construction Manager and their sub-contractors. The organizational chart should also include a detailed description of the roles and responsibilities of staff. In addition, you are to provide a step-by-step description of the process and documentation required to establish cost estimates, approval of task orders, approval of change orders, and any other financial transaction related to the CM Build Program.
- By January 15, 2008, you are to provide the Board with an assessment of the costs which should be recouped from Construction Managers and/or sub-contractors.

The Board emphasized that reforms must be implemented without further delay and that staff at all levels shall be held accountable. The Board will be meeting with you and your senior staff a minimum of every other month to review your progress in carrying out the Board's instructions.

cc: Earl Andrews, Board Member
Margarita López, Board Member
Robert McSweeney, Inspector General



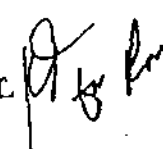
The City of New York
Department of Investigation

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MEMORANDUM

TO: NYCHA BOARD OF DIRECTORS

FROM: ROBERT J. MCSWEENEY, INSPECTOR GENERAL 

DATE: SEPTEMBER 17, 2008

SUBJECT: IGO INVESTIGATION OF NYCHA'S CM/BUILD PROGRAM

The following is a summary of recommendations made by NYCHA's Audit Department and Committee as well as the findings and recommendations of an investigation conducted by the Inspector General's Office ("IGO"), initiated in March 2007, regarding NYCHA's \$780 million CM/Build program, including construction projects funded over the past three years by the \$300 million bond offering. My colleagues and I would be happy to meet with you at your earliest convenience to discuss these findings and recommendations.

Summary of Audit Committee and IGO's Findings

1. NYCHA's Audit Department and Audit Committee identified a number of internal control weaknesses and communicated strong concerns about those deficiencies to senior management in mid-2005 and again in early 2006.
 - On May 31, 2005, Vice Chairman and Audit Committee Chairman Andrews sent a memorandum to Chairman Hernandez indicating that the Audit Committee had directed the Audit Department to assess internal controls regarding expenditures in the CM/Build program, and communicated the Audit Committee's concern that supervisory procedures "have yet to be finalized" that are "paramount to achieve adequate and consistent control of capital construction activities particularly those conducted by our CM/Builders."
 - Audit reports issued on August 3 and 31, 2005 identified concerns regarding insufficient validation of change order payments; a significant percentage (44%) of audited contracts that were awarded based on fewer than three subcontractor bids; and the wide disparity between CM firms' estimates and contract costs.

- The Audit Committee directed the Audit Department to conduct an audit of CM firms' cost estimates as a follow-up to the August 31, 2005 report. The Audit Department's January 23, 2006 report concluded that: CM firms' documentation lacked sufficient detail to validate the accuracy of any of the four cost estimates audited; the Capital Projects Division ("CPD") significantly relied on CM firms' cost estimates; and there were no written guidelines for third-party verification of cost estimates.

- As a result of those findings, the Audit Committee interviewed CPD staff on February 3, 2006 and learned that CPD's cost estimates used for bond-funded CM/Build projects were significantly outdated and that CPD lacked the necessary procedures and internal controls to validate CM firms' cost estimates. The Audit Committee's concerns continued prompting them to send an additional memo to Chairman Hernandez on February 8, 2006, which communicated the need for clear and complete procedures to manage the CM/Build program, as well as its conclusion that there were "material deficiencies" in procedures relating to evaluating CM firms' cost estimates and subcontractors' bids.

- As a result of Vice Chairman Andrews' memorandum of February 8, 2006, Chairman Hernandez sent a memorandum to GM Apple on February 22, 2006 directing him to "establish a corrective action plan." On or about March 3, 2006, a corrective action plan was submitted to the Board that was intended to "take a fresh look at NYCHA's internal controls, to assess its risk of fraud, and to make changes where needed to reduce the organization's overall exposure," including "finalizing the draft procedures" relating to: "Cost Estimating Procedures;" "Reconciling CM Cost Estimates for Bid Analysis Recommendations to Award;" as well as formalizing uniform and consistent processes for managing CM firms and document management. As a result, new standardized forms were introduced and edits were made by CPD to its draft CM/Build procedures manual requiring use of an escalation factor for A/E estimates that are more than twelve months old.
 - Generally, the IGO's investigation found no documented use of an escalation factor and few reconciliations of pre-bid cost estimate variances in the 39 bond-funded projects, even those prepared in 2008. Over two and a half years later, the draft procedures manual still has not been finalized, including those related to cost estimates.

- * A July 20, 2006 Audit Department report, sent to the Audit Committee on October 2, 2006 regarding CM/Build cost estimates in the first quarter of 2006, once again called for "executive management attention" and the need for "more accurate cost estimates by CM/Builders;" the need to increase bid responses, with more than half of the bids audited having less than three bids; and the need for CPD involvement in CM firms' negotiations with subcontractors on bids. Those concerns were reiterated in a January 31, 2007 Audit Department report on CM firm Tetra Tech's contracts which found that the CM firm's cost estimates, in three of the six contracts awarded, were substantially lower than the bids and contracts awarded, and that payments to the CM firm for staffing expenses were made without an approved staffing plan.

- Notwithstanding repeated Audit Department findings calling for corrective action and concerns communicated by the Audit Committee, significant internal control deficiencies persisted through 2007 and 2008. Audits of change orders approved from May 2006 to April 2007 for M.A. Angeliades/Hudson Meridian and approved from May 2007 to August 2007 for PMS detailed in the Audit Department's reports issued on September 19, 2007 and February 1, 2008 respectively, found "significant deficiencies and management control weaknesses that undermine the confidence that NYCHA is getting the most reasonable price for work." The Audit Department found that even "cursory reviews" of change orders were not documented.

- 2. CPD generally has not conducted contemporaneous independent cost estimates of CM/Build construction projects to validate construction costs over the past four years.
 - In many instances, there have been multimillion-dollar differences between NYCHA's cost estimates, the related CM firms' cost estimates and the construction contract costs; and for many there is no documented reconciliation.
 - * CM firms negotiated numerous sole-bid contracts; five of them totaling over \$55 million.

- 3. CPD generally has not conducted audits prior to the approval of change orders to validate the additional construction expenses, totaling over \$17 million paid to contractors over the past four years.
 - The reorganization of CPD in 2004 eliminated the pre-approval audit function conducted by the Quality and Cost Control Unit and replaced that important internal control mechanism with a "cursory review" of proposed change orders.
 - The IGO investigation also was unable to document the validity of scope change costs due to a lack of documentation.
 - CPD intends to begin detailed validation of change order proposals by January 2009. Approval to fill all necessary staff positions has met with unanticipated delays according to CPD management.

- 4. CPD's supervision of CM/Build projects has been inadequate over the past four years and, as noted above, a detailed procedures manual for the administration of the CM/Build program has not been finalized. A number of CPD staff testified that the environment created by DGM Farro was one where they were encouraged to take a "hands-off" approach to supervising CM firms. (Farro, on advice of counsel, refused to voluntarily cooperate with this investigation.)

- A number of CPD staff testified that the lack of supervision, generally entailing only weekly construction site visits during 2004 - 2006, resulted in CM firms using inexperienced staff to supervise subcontractors and poor construction quality on many projects.
 - * ▪ Poor construction and site conditions were documented frequently by Operations' Technical Services Department, notwithstanding payment of CM firms' staffing fees costing NYCHA over \$57 million to-date.
 - Several CPD senior staff members testified about a lack of sufficient resources, training and technical skills within their staff to adequately supervise CM/Build construction projects. CPD management acknowledges that, as of September 2008, staff training has been inadequate and will be an on-going focus of its attention.
 - CPD intends to finalize its procedures manual by December 2008, and the section pertaining to cost estimation procedures by the end of September. ^{Date.}
5. In 2005, approval from HUD for a \$300 million bond offering was conditioned on NYCHA using those proceeds to complete a minimum of 100 scheduled projects; most relating to exterior brick and roofing repairs. NYCHA published a "Performance Outcome Schedule" as part of the offering's Official Statement that projected the completion of 100 construction projects and agreed to a quarterly timetable of obligation and expenditure targets with associated penalties for noncompliance.
- CPD's cost estimates for bond-funded projects were significantly outdated. Many were two to three years old; one was ten years old; and many were taken from budget projections based on preliminary walk-through field surveys.
 - Rather than fund 154 planned projects, or the guaranteed minimum of 100, the bond proceeds will finance only 39 projects.
 - Although senior management knew in 2005 that the CM firms' cost estimates and subcontractors' bids would continue to be significantly higher than CPD's outdated cost estimates, estimates were not adequately refreshed to sufficiently validate the CM firms' cost estimates and change orders from 2005 through 2008.
6. GM Apple hired DGM Rueda in June 2006 and implemented several initiatives to improve supervision of construction projects and their costs, two years after the launch of the CM/Build program.
- Rueda testified that he was surprised to find on his arrival at NYCHA the absence of full-time supervision of CM firms as is done at DDC, his previous

employer, and so by February 2007 they implemented full-time on-site CPD supervision of CM firms' and their subcontractors.

- In September 2006, Rueda initiated detailed reviews and negotiation of CM firms' staffing plans used to establish the fee NYCHA paid for CM supervision. According to Rueda, just two of these reviews saved NYCHA \$700,000 in CM staffing fees.
- They identified a process for the reconciliation of pre-bid cost estimate variances. However, the IGO's investigation found that the reconciliation process has not been utilized consistently by CPD staff.
- Rueda initiated a Borough-based organizational realignment in January 2008, and created a Technical Support Program Unit responsible for change order quality assurance, cost-estimating and management of close-outs. However, over six months have passed without the effective implementation of many of the planned internal controls and supervisory procedures.
- For new CM/Build task orders, NYCHA plans to have CM firms compete for the task orders, and they have expanded the solicitation of subcontractors' bidding.

Summary of Audit Committee and IGO's Recommendations

- ✓ 1. Implement effective supervisory and cost-control measures to ensure: independent and up-to-date cost estimates; validation and negotiation of change orders; and appropriate records management.
- ✓ 2. Ensure internal supervisory and cost-control measures have been fully-implemented and audited to confirm their effectiveness before the second bond offering proceeds.
- ✓ 3. Hire an independent construction consultant to audit CM/Build contracts and related change orders from 2004 to 2008, as well as CM firms' staffing plans, to identify any recoupment from CM firms that NYCHA might be advised to pursue.
4. Last month NYCHA agreed to retain Ernst & Young in response to its audit *Observation and Recommendation* that "the Authority should consider a thorough review of its CM Build functions possibly through the assistance of an independent construction firm or personnel with construction audit expertise as discussed with the Audit Committee and management." That review should include particular focus on NYCHA's independent cost estimate validation, change order negotiation and bid solicitation procedures. In addition, the Ernst & Young consultants should report quarterly to the IGO the status of its review and NYCHA's progress over the next year.

5. Revise and finalize CPD's CM/Build procedures manual with detailed functional expectations similar to those utilized by New York City's Department of Design and Construction.
6. Conduct a CPD staff skills assessment and initiate any necessary staff reassignments or training to ensure that all CPD staff has the requisite skills for their responsibilities.
7. Conduct a cost-benefit analysis to determine whether the CM/Build program provides commensurate value for the incremental expense of CM firms' fees. (While CPD reports that on-time performance has improved, it is still below the industry norm described by NYCHA staff, and construction quality problems persist.) 8/3/6
8. Supplement the Audit Committee with at least one independent member who has construction management expertise.

cc: Commissioner Rose Gill Hearn
Deputy Commissioner Kim Berger
Associate Commissioner Richard Sullivan