Issue Date October 15, 2004	
Audit Report Number 2005-PH-1001	

TO: Malinda Roberts, Director, Office of Public Housing, Pennsylvania State Office, 3APH

FROM: Daniel G. Temme, Regional Inspector General for Audit, Philadelphia Region, 3AGA

SUBJECT: The Lehigh County Housing Authority, Emmaus, PA, Risked HUD Assets for the Benefit of Nonfederal Entities

HIGHLIGHTS

What We Audited and Why

We performed an audit at the Lehigh County Housing Authority (Authority) in response to a complaint. The complainants alleged the Authority used HUD funds improperly to benefit its affiliated nonfederal entity known as Valley Housing Development Corporation. Our audit objective was to determine whether the Authority improperly used HUD funds to develop and support its affiliated nonfederal entities. This is the first of two audit reports we will issue on this audit. The second report will address problems identified regarding disbursement of HUD funds to the Authority's General Fund.

What We Found

The Authority improperly used HUD funds to develop and support its affiliated nonfederal entities. In this regard, it violated its Consolidated Annual Contributions Contract with HUD by guaranteeing tax credits and debt, estimated at $4.4 million for its affiliated nonfederal entities, and by improperly providing its affiliated entities $95,634. [1] We found that $3.0 million of the $4.4 million in HUD assets the Authority has pledged since 1988 remained at risk and that the entities owed the Authority $93,834. Further, our audit identified an apparent conflict of interest regarding the Executive Director's relationship with the Authority's affiliated nonfederal entities.

These problems occurred because the Authority's Board of Commissioners did not provide adequate oversight over the Authority's management, nor did it ensure adequate internal controls were in place to detect and prevent these problems from occurring. The control deficiencies created an environment that allowed the Authority to put HUD funds at risk for the benefit of its affiliated nonfederal entities.

What We Recommend

We recommend that HUD take action, if appropriate, to declare the Authority in substantial default of its Consolidated Annual Contributions Contract and direct the Authority to take immediate action to remove its remaining improper pledges of $130,000 in HUD assets. We also recommend that HUD require the Authority to recover the remaining $13,100, which it improperly provided its affiliated entities, or repay it from nonfederal funds. Lastly, we recommend HUD direct the Authority's Board of Commissioners to create internal controls to prevent, detect, and resolve the improper pledging of HUD assets and conflict of interest situations.

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 discussed the report with the Authority during the audit and at an exit conference on September 1, 2004. The Authority provided written comments to our draft report on September 29, 2004. To its credit, the Authority was proactive, and provided documents showing it had either removed, or was in the process of removing the majority of its improper pledges of HUD assets. The Authority also provided documents showing it had recovered all but $13,100 of the funds it improperly provided its affiliated entities. The Authority's Board of Commissioners further passed a Board resolution to create internal controls to prevent, detect, and resolve improper pledging of HUD assets, and apparent conflict of interest situations. The complete text of the Authority's response, excluding the aforementioned documents, can be found in Appendix B of this report.

[1] $13,100 of the $95,634 was improperly given to two entities that were considered federal entities.

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BACKGROUND AND OBJECTIVES

The Lehigh County Housing Authority was established in 1975 under the Housing Authorities Law of the Commonwealth of Pennsylvania to provide affordable housing for qualified individuals in accordance with the rules and regulations prescribed by HUD. A five-person Board of Commissioners appoints the Authority's Executive Director and governs the Authority. The Executive Director during the audit was John Seitz. The Executive Director and his Deputy Executive Director had been serving in their respective positions for more than 20 years. The Authority's main administrative office is located at 635 Broad Street, Emmaus, Pennsylvania.

The Authority owns and manages 289 public housing units under its Consolidated Annual Contributions Contract with HUD. The Consolidated Annual Contributions Contract defines the terms and conditions under which the Authority agrees to develop and operate all projects under the agreement. HUD authorized the Authority the following financial assistance from Fiscal Years 2000 to 2003:

- $2.3 million Operating Subsidy to operate and maintain its housing developments.
- $1.6 million Capital Fund Program to modernize public housing units.
- $28.9 million to provide housing assistance through tenant-based Section 8 certificates and vouchers.

In 1982, the Authority created a nonfederal entity known as Valley Housing Development Corporation. The Authority formed this nonprofit corporation to provide low- and moderate-income households opportunities for low cost rental housing. A Board of Commissioners, consisting of 11-21 members, governs the corporation. As of December 2003, the Valley Housing Development Corporation held an interest in 46 limited partnerships in which it served as the general partner. It primarily funded its limited partnerships through a combination of private investment (in exchange for federal housing tax credits), commercial loans, and loans the corporation made using funds it received in exchange for 1-year state tax credits. In total, these partnerships operate more than 1,300 units of low-income housing.

Since November 1990, the Authority has assisted Valley Housing Development Corporation, for a fee, to enable it to develop and operate its housing projects for low- and moderate-income households. The Authority also shares common management with the corporation. In July 2003, however, several complainants alleged the Authority used HUD funds improperly to benefit the Valley Housing Development Corporation. Given the complaints, the overall objective of our audit was to determine whether the Authority improperly used HUD funds to develop and support its affiliated nonfederal entities.

RESULTS OF AUDIT

Finding 1: The Authority Improperly Pledged $4.4 Million in HUD Assets and Improperly Provided Its Affiliated Entities $95,634

The Authority violated its Annual Contributions Contract with HUD by guaranteeing $4.4 million of its affiliated nonfederal entities' tax credits and debt and improperly providing its affiliated entities $95,634. It also allowed apparent conflicts of interest to exist regarding its Executive Director's relationship with its affiliated nonfederal entities. We estimate that $3.0 million, of the $4.4 million in HUD assets the Authority has pledged since 1988, remained at risk, and the entities owed the Authority $93,834.

This occurred because the Authority's Board of Commissioners did not ensure adequate internal controls were in place to detect and prevent these problems from occurring. The control deficiencies created an environment that allowed the Authority to put HUD funds at risk for the benefit of its affiliated nonfederal entities.

The Authority Improperly Pledged $4.4 Million in HUD Assets

The Authority violated its Consolidated Annual Contributions Contract by guaranteeing its Development Corporation's tax credits and debt, estimated at $4.4 million. In so doing, the Authority placed federal funds at risk by improperly pledging assets covered by its contributions contract without prior approval from HUD. We estimated that $3.0 million, of the $4.4 million in HUD assets that the Authority improperly pledged since 1988, remained at risk. The Consolidated Annual Contributions Contract prohibits the Authority from encumbering or pledging its HUD assets without HUD's prior approval.[2] The contract further states that encumbering assets or pledging Consolidated Annual Contributions Contract assets as collateral for a loan constitutes grounds for declaring the Authority in substantial default of its contributions contract.[3] Nevertheless, we found the Authority improperly pledged and placed HUD assets at risk as follows:

- During 1989 and 1990, the Authority's Board Chairman and its Executive Director indemnified four limited partnerships against possible losses totaling $1.7 million in low-income housing tax credits. These agreements remain in

[2] Part A, Section 7, of the Consolidated Annual Contributions Contract, Covenant Against Disposition and Encumbrances

[3] Part A, Section 17, Notices, Defaults, Remedies

effect and do not identify specific assets the Authority will use to cover this contingent liability.

- In August 2002, with approval of the Authority's Board of Commissioners, the Authority's Executive Director signed an agreement obligating it to guarantee $1.2 million for construction of a housing project for one of Valley Housing Development Corporation's limited partnerships. We found that the Authority's guarantee of this $1.2 million construction project no longer poses a risk to HUD assets because the limited partnership completed the project in April 2004. However, the Authority's Executive Director signed a related agreement in August 2002, whereby it continued to pledge $30,000 to guarantee payment of the project's operating expenses.

- During the 10-year period from October 1989 to June 1999, the Authority's Executive Director signed at least six guarantees for lines of credit totaling $500,000 for the Development Corporation. All of the credit lines were in place as of June 2004. The guarantees did not identify specific assets the Authority would use in the event it was required to pay off the debt.

- In April 1988, the Authority's Board Chairman signed an agreement obligating the Authority to guarantee two loans totaling $1.0 million from the Pennsylvania Housing Finance Agency to one of the Development Corporation's limited partnerships. By signing this absolute and unconditional guarantee, the Chairman created a potentially large contingent liability and placed the Authority's assets at substantial risk. According to the latest statement from the Pennsylvania Housing Finance Agency, as of May 2004, the total outstanding balance on the loans was $754,500.

The Authority's Executive Director could not tell us or provide documentation showing the specific assets the Authority would use to cover these contingent liabilities. In the absence of documents identifying the funds to pay these contingent liabilities, there is substantial risk to the Authority's Consolidated Annual Contributions Contract assets if the entities go into default. Further, Board resolutions were not available showing that the Authority's Board of Commissioners had approved these agreements.

We discussed these problems with the Executive Director during the audit, and he began taking immediate action to withdraw the Authority's improper pledges of HUD assets. In July 2004, after we completed audit fieldwork, the limited partnerships and the Finance Agency released the Authority from its guarantees for the $1.7 million in low-income housing tax credits and the outstanding loan amount of $754,500. Also, the Authority allowed a $250,000 guaranteed line of credit to expire without renewal. On October 12, 2004, the Authority provided documentation showing that a bank released the Authority from its guarantees for a $150,000 line of credit. As a result, the Authority put to better use $2,853,711, of the $2,983,711, of HUD funds that were at risk. The Authority needs to complete corrective actions on the remaining $130,000 of funds still at risk.

The Authority Improperly Provided Its Affiliated Entities $95,634

We reviewed the 2003 general ledgers and bank statements for the Authority's affiliated entities and found that it improperly provided the entities $95,634. The Consolidated Annual Contributions Contract limits the use of HUD funds to paying development and operation costs of the projects under the Contract with HUD, and purchasing investment securities and other purposes specifically approved by HUD.[4] Contrary to the terms of the Contract, the Authority improperly provided funds to its Development Corporation and other affiliated entities from its General Fund[5] without approved loan agreements or appropriate entries in its accounting system.

For example, in October 2001, the Executive Director began reviewing the financial condition of the Valley Housing Development Corporation and its limited partnerships on a biweekly basis. In accordance with the Limited Partnership agreements, he instructed staff to transfer funds from the Valley Housing Development Corporation to the limited partnerships, as needed. If the Development Corporation lacked sufficient funds to cover its limited partnerships' cash shortages or to pay its own bills, he directed staff to use the Authority's General Fund to cover the shortfalls. Although the transactions were recorded as loans from the General Fund, we found that the Authority recouped only $1,800 of the $95,634 as of April 2004. However, since approved loan agreements and appropriate entries did not exist in the Authority's accounting system, it was unlikely that the Authority would recoup the remaining $93,834. Therefore, since the Consolidated Annual Contributions Contract limits the use of HUD funds, and the Authority did not differentiate between federal and nonfederal funds in its General Fund, the disbursement of $93,834 is ineligible.

Minutes from meetings of the Authority's Board of Commissioners provided no indication that the Board was aware that the Executive Director was directly transferring cash from the Authority's General Fund to support its affiliated entities. However, the Authority did not have policies and procedures to prevent such transfers from occurring.

By improperly providing funds to its affiliated entities, the Authority reduced the amount of funds available for its own operating expenses and weakened its

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4 Part A, Section 9, Depository Agreement and General Fund

5 The Authority's General Fund contained both federal and nonfederal funding but did not differentiate between the two. A subsequent audit report will address this problem in further detail.

financial position. After we discussed these problems with the Executive Director, he took immediate action to recoup some of the funds. As of September 30, 2004, the Authority had recouped $80,734 of the $93,834 that was outstanding. Therefore, the Authority still needs to collect the remaining $13,100. Additionally, we estimated the Authority could put $95,634 to better use over a 1-year period by implementing procedures to preclude the Authority from improperly transferring funds to its affiliated entities.

The Authority Allowed Apparent Conflict of Interest Situations to Exist

The Authority's Executive Director violated the Consolidated Annual Contributions Contract conflict of interest restrictions by improperly pledging HUD assets to guarantee debt and tax credits of the Valley Housing Development Corporation, in which he also served as the Executive Director and Assistant Vice President, and its limited partnerships. The Consolidated Annual Contributions Contract prohibits the Authority from entering into any contract or arrangement in connection with any project under the Contract with any Authority employee who formulates policy or who influences decisions with respect to the project(s). [6] Employees must disclose their interest or prospective interest to the Authority and HUD. We found that the Authority's Board of Commissioners did not establish controls to detect, prevent, and resolve these conflict of interest situations from occurring.

We found that from 1990 to 2002 the Authority's Executive Director signed at least ten agreements, pledging up to $2.3 million in HUD assets for the benefit of the Authority's nonfederal entities. We believe an apparent conflict of interest existed because most of the pledged assets guaranteed debt and tax credits of the Valley Housing Development Corporation, in which he also served as the Executive Director and Assistant Vice President, and its limited partnerships. Despite the apparent conflict of interest, the Executive Director created large contingent liabilities and placed the Authority's assets at substantial risk.

In addition, we found that the Executive Director did not disclose to HUD a financial interest he had with an outside business affiliated with the Authority's nonfederal entities, which we believe was also an apparent conflict of interest. The Consolidated Annual Contributions Contract requires employees to disclose their interest or prospective interest to the Authority and HUD. While HUD can waive this requirement for good cause, the Executive Director did not disclose the relationship to HUD or request a waiver.

[6] Part A, Section 19, Conflict of Interest

Recommendations

We recommend that the Director, Office of Public Housing, Pennsylvania State Office:

1A. Review issues contained in this audit report, and if appropriate, initiate action to declare the Authority in substantial default of its Consolidated Annual Contributions Contract and take appropriate administrative action as detailed in Section 17 (Notices, Defaults and Remedies) of the Contract.

1B. Require the Authority to take immediate action to withdraw its remaining pledges of Consolidated Annual Contributions Contract assets and, thereby, put $130,000 to better use.

1C. Require the Authority's Board of Commissioners to pass Board resolutions approving the development and implementation of procedures that ensure the Authority does not encumber or pledge HUD assets without HUD approval, and the Authority properly reports and resolves apparent conflict of interest situations.

1D. Direct the Authority to recover all of the $13,100 remaining that it improperly provided its affiliated entities during 2003 or repay it from nonfederal funds.

1E. Require the Authority's Board of Commissioners to pass a Board resolution approving procedures to ensure the Authority does not improperly provide HUD assets to its affiliated entities and, thereby, put $95,634 to better use annually.

SCOPE AND METHODOLOGY

We performed an audit from November 2003 through September 2004 of the Lehigh County Housing Authority, located in Emmaus, Pennsylvania. The audit was conducted in accordance with generally accepted government auditing standards and included tests of internal controls that we considered necessary under the circumstances.

The audit covered transactions representative of operations current at the time of the audit and included the period January 2001 through December 2003. We expanded the scope of the audit as necessary. We reviewed applicable guidance and discussed operations with management and staff personnel at the Lehigh County Housing Authority and key officials from HUD's Pennsylvania State Office.

To determine that the Authority improperly used HUD funds to develop and support its affiliated nonfederal entities we:

- Reviewed all documentation provided by the Authority related to our audit objective, including partnership agreements, financial statements, general ledgers, bank statements, cashbooks, bank loan agreements, related correspondence, payment vouchers, and minutes from Board meetings.

- Reviewed the Authority's available Independent Auditor's Reports for Fiscal Years 2001 and 2002.

- Reviewed HUD and Authority correspondence related to the audit and results of monitoring reviews HUD's Pennsylvania State Office conducted.

INTERNAL CONTROLS

Internal Control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Policies, procedures, control systems, and other management tools implemented to prevent the inappropriate use of HUD funds for nonfederal purposes.

- Policies, procedures, controls, and other management tools implemented to detect, prevent, and resolve conflict of interest situations.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

Based on our review, we believe the following items are significant weaknesses:

The Authority did not

- Prevent Consolidated Annual Contributions Contract assets from being encumbered, disbursed, or risked without HUD approval.

- Establish adequate controls to prevent, detect, and resolve apparent conflict of interest situations.

Appendixes

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation Number	Ineligible 1/	Funds to Be Put to Better Use 2/
1B		$2,983,711 (1)
1D	$93,834 (2)	
1E		$ 95,634
Total	$93,834	$3,079,345

(1) The Authority took action to remove its guarantees for $2,853,711 of this amount. The Authority needs to take action on the remaining $130,000 still at risk.

(2) The Authority collected $80,734 of this amount. The Authority needs to collect the remaining $13,100.

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.

2/ "Funds to be put to better use" are quantifiable savings that are anticipated to occur if an Office of Inspector General (OIG) recommendation is implemented, resulting in reduced expenditures during subsequent period for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

Appendix B

AUDITEE COMMENTS

Auditee Comments

Lehigh County Housing Authority

EQUAL HOUSING OPPORTUNITY

635 Broad Street
Emmaus, PA 18049

Phone 610/965-4514 • TDD 610/433-2312 • Fax 610/965-9820

John C. Seitz, EXECUTIVE DIRECTOR
Robert P. Forney, CHAIR
Kent H. Herman, SOLICITOR

September 29, 2004

Mr. Daniel G. Temme
Regional Inspector General for Audit
United States Department of Housing and Urban Development
OIG-Audit
The Wannamaker Building, Suite 1005
100 Penn Square East
Philadelphia, PA 19107

Dear Mr. Temme:

Enclosed please find a response to the draft audit report prepared by our counsel on behalf of the Lehigh County Housing Authority. I have also enclosed evidence of repayment of all but $13,100 of the $95,634. Finally, we have received notification that American Bank will release the Lehigh County Housing Authority guaranty on its line of credit. We will provide the written release as soon as it is executed.

Sincerely,

Daniel C. Beers
Acting Executive Director

enclosure

Auditee Comments

KING, SPRY, HERMAN, FREUND & FAUL, LLC
ATTORNEYS & COUNSELORS
ALLENTOWN · BANGOR · BETHLEHEM · STROUDSBURG

September 29, 2004

Mr. Daniel G. Temme
Regional Inspector General for Audit
United States Department of Housing and Urban Development
OIG-Audit
The Wanamaker Building, Suite 1005
100 Penn Square Street
Philadelphia, PA 19107-3380

RE: Lehigh County Housing Authority

Dear Mr. Temme:

I am writing this correspondence to you on behalf of my client, the Lehigh County Housing Authority ("LCHA"). The purpose of this letter is to respond to a draft Audit Report from your office titled "Risked HUD Assets for the Benefit of Nonfederal Entities". I first want to provide a background of LCHA and its affiliated "nonfederal entity", Valley Housing Development Corporation ("VHDC"), a Pennsylvania Non-Profit Corporation.

LCHA was organized by Lehigh County, Pennsylvania in the mid 1970's. It began providing affordable housing in 1979. Its first activity consisted of 100 units of Section 8 assisted housing. Throughout the next 25 years LCHA consistently sought available public funding for a variety of affordable housing programs. Currently LCHA assists over 1,660 families through its Section 8 voucher, moderate rehab and family unification programs. It also serves 225 elderly households and 64 families in 9 developments through its public housing program. LCHA operates a shelter plus care program which provides housing for homeless persons with mental illness. Currently this program serves 37 individuals. It provides management services for Interstate Realty, the owners of three affordable projects totaling 93 units in Whitehall Township.

LCHA has been an active participate in the 5(h) Home Ownership program providing 20 public and assisted housing residents first time home buying opportunities in the Boroughs of Emmaus and Fountain Hill. The LCHA acquisition with rehab program allowed an additional 6 lower income families to become first time home owners in Whitehall Township. LCHA has been and continues to be the administrator for numerous housing rehabilitation grants

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awarded to Lehigh County and other local municipalities. Finally, LCHA has provided administration for the Act 137 Lehigh County Recording Fee program which has provided down payment and closing cost assistance, home ownership counseling and housing rehabilitation services for low income home buyers.

In the 1980's LCHA created VHDC. VHDC's primary purpose has been to promote and advance decent, safe and sanitary housing for persons of low income including families, elderly and disabled individuals. LCHA and VHDC have separate Board of Directors. They meet separately. A contract exists between LCHA and VHDC. Under the terms of the contract VHDC pays LCHA for administrative, management and social service functions delivered to VHDC projects by LCHA employees.

VHDC has created over 1,360 affordable housing units in 48 different scattered site developments throughout Lehigh and Northampton Counties. These developments service a wide array of housing needs for lower income individuals. Thirty developments containing 1,060 units house elderly families. Two developments containing 22 units are designated as transitional housing for homeless families. Twelve developments provide 141 units of low income family housing. Two developments with 40 units house persons with mental illnesses. One development provides 15 units of independent living to families who have severe physical disabilities. Another project provides 8 units of low income family housing to families who are victims of domestic violence. More than 2,200 low income individuals are housed in these developments.

These developments were created utilizing a federal program, Section 42 of the Internal Revenue Code, the Low Income Housing Tax Credit ("LIHTC"). The LIHTC is allocated by a State agency, the Pennsylvania Housing Finance Agency. The creation of this housing by VHDC has generated over $75 million in construction activity. This work has consisted of new construction as well as the renovation of numerous old and obsolete factory buildings, schools, or other commercial buildings. Financing of over $25 million has been provided for these projects, and these projects have generated more than $52 million in private equity investment. All these projects are subject to local taxes. They generate in excess of $1,300,000.00 of local, county and school real estate taxes on an annual basis.

LCHA currently employs approximately 70 individuals providing administrative, management, maintenance and social services for the housing provided by both LCHA and

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VHDC. LCHA and VHDC projects also provide on-going economic activity for a variety of outside vendors required for property maintenance and other services. VHDC has provided a host of other management services to other local non-profit groups. It also has provided home ownership opportunities for over fifty (50) low income first time home buyers.

This background of accomplishments is important in fully understanding the responses to each of the draft findings of the OIG. The following represents the responses of LCHA.

1. Finding #1: The Authority Improperly Pledged $4.4 million in HUD Assets and Improperly Provided its Affiliated Nonfederal Entities $95,634.

   A. The Authority Improperly Pledged $4.4 million in HUD assets.

Response: At the time of the preparation of this response all guarantees with the exception of guarantees with the face amount of $280,000.00 have been released. In order to properly consider this issue a few important points should be noted. First, at no time has there been any payment of any federal funds as a result of any of the guarantees noted in the OIG report. Second, the original request for a guarantee in a LIHTC project was made by the Pennsylvania Housing Finance Agency (PHFA), a State agency which has had the responsibility of administering the LIHTC allocation process and provides funding for affordable housing projects throughout Pennsylvania. LCHA, and apparently PHFA, did not believe this action was prohibited. Third, some of the guarantees were collateralized with VHDC assets. Finally, LCHA is endeavoring to obtain releases of the remaining guarantees. In fact, as part of this process, LCHA identified a $50,000.00 line of credit of VHDC from American Bank guaranteed by LCHA. American Bank has agreed to release this guarantee.

The vast majority of the obligations identified by the OIG were readily released by creditors. Of what remains, $150,000.00 is collateralized by VHDC real estate. The remaining guarantees, if not released, expect to be satisfied by the sale of other VHDC assets within the next few months. LCHA has and will fully comply with this request. LCHA will also provide HUD with a Board resolution which will direct that LCHA will not encumber or pledge HUD assets without HUD approval. Finally, LCHA had audits completed and submitted to HUD on an annual basis since its inception. This issue was never raised by LCHA's auditors.

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B. The Authority Improperly Provided it's Affiliated Nonfederal Entities $95,634.

Response: As noted in the report of the OIG $31,800.00 of this amount has been repaid. It is expected that the balance except as noted below will be repaid as of the date of this letter. The source of these funds is the disposition of VHDC assets. LCHA, however, needs guidance with respect to the amount of $13,100.00. This $13,100.00 consists of payments on behalf of two other LCHA federally funded projects, $7,100.00 to Catasauqua Apartments and $6,000.00 to Macungie Apartments. Catasauqua Apartments is a low income family housing project which is a Section 8 Substantial Rehab project identified as contract no. PA 26-0052-001, FHA No. 034-35188. This federally funded program is owned by LCHA. The project consistently incurs operating deficits. The project contains reserves held by HUD. LCHA administrators have requested appropriate representatives of HUD to release these reserves to cover operating deficits. LCHA has not been permitted, however, to access these project reserves. In conclusion, the funds for Catasauqua Apartment project were not provided to an "Affiliated Nonfederal Entity". On the contrary, funds for the Catasauqua Apartment project were provided to LCHA to pay operating deficits for another federal program. LCHA wishes to repay this obligation but needs guidance from HUD on this issue. LCHA believes that the obligation should be paid from project reserves. LCHA understands and agrees that HUD ACC funds will be repaid from non-ACC sources.

The sum of $6,000.00 was provided for Macungie Apartments. Macungie Apartments is owned by LCHA. Macungie Apartments is a United States Department of Agriculture Rural Housing Development, identifying no. 44-39-23200653, project no. 022. At times Macungie Apartments incurs operating deficits. Macungie Apartments has substantial project reserves. Requests have been made by LCHA administrators to utilize project reserves for operating deficits. Representatives of the United States Department of Agriculture have not permitted a release of these reserves. This funding of $6,000.00 was not provided to another "Affiliated Nonfederal Entity" and guidance from HUD is requested by LCHA with respect to this issue. LCHA understands and agrees that the ACC funds will be restored but believes that payment should be authorized from project reserves.

In the last year the following structural changes have taken place at LCHA. The accounting employee responsible for these erroneous transfers has resigned. A new position of Controller has been created. The Controller, who reports directly to the LCHA Board of

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Directors, has the responsibility of insuring that these sorts of erroneous transfers do not re-occur. Finally, the Executive Director of LCHA has resigned.

C. The Authority Allowed Apparent Conflict of Interest Situations to Exist

Response: As noted above, LCHA and VHDC have separate Boards of Directors. Both entities meet separately. A written contract controls the relationship between the two entities and provides that LCHA will provide administrative, management and maintenance services to VHDC. VHDC is billed by LCHA for this service. In early 2004 LCHA hired a Controller in order upgrade its financial department. The Controller reports directly to the LCHA Board of Directors. The Executive Director of LCHA has recently resigned. All these steps were designed to prevent and resolve conflicts of interest between LCHA and VHDC.

The relationship between LCHA and VHDC is not fundamentally flawed. Congress has provided specific authorization for a public housing authority such as LCHA to create and operate affiliated entities. See, Section 515 of the Public Housing Reform Act of 1998 (QHWRA) which states in part:

> (b) JOINT VENTURES. - (1) IN GENERAL. - Notwithstanding any other provision of law, a public housing agency may - (a) form and operate wholly owned or controlled subsidiaries (which may be entity corporations) and other affiliates, any of which may be directed, managed, or controlled by the same persons who constitute the board of directors or similar governing body of the public housing agency, or who serve as employees or staff of the public housing agency; or (b) enter into joint ventures, partnerships, or other business arrangements with, or contract with, any person, organization, entity, or governmental unit - (I) with respect to the administration of the programs of the public housing agency, including any program that is subject to this title; or (ii) for the purpose of providing or arranging for the provision of supportive or social services.

It is the position of LCHA that there is nothing inherently wrong with its relationship with VHDC. In fact, it is extremely doubtful that VHDC could have created much, if any, of the affordable housing opportunities outlined above without this relationship. There is no indication that any of the actions taken by LCHA or VHDC have provided any private benefit

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to any member of the staff of LCHA or any member of the Board of Directors of LCHA or VHDC. The relationship between the two entities has been fully disclosed to both the Boards of LCHA and VHDC. LCHA will enact resolutions approving the implementation of procedures ensuing that it does not encumber or pledge HUD assets. LCHA will enact resolutions to ensure that HUD assets are not provided to its affiliated nonfederal entities. LCHA will enact conflict of interest policies to insure full disclosure and non-participation by any officers, directors or employees in any formal decisions concerning a transaction in which he or she may have a conflict of interest. LCHA will enact a policy disclosing any employee conflict of interests to HUD.

The successes resulting from the relationship between LCHA and VHDC have been outlined above. This effort has provided decent jobs for over 70 employees. It has provided millions of dollars of economic activity to the Lehigh Valley. It has provided safe, clean and affordable housing for thousands of people. This work has been accomplished by the employees of LCHA, and by the volunteer Boards of Directors of LCHA and VHDC who have spent hundreds of hours guiding and enabling housing opportunities for low income individuals.

Concluding Comments: With respect to the issue of guarentees, after the OIG advised LCHA that the guarantees, which never resulted in any expenditure by LCHA, should be removed over 90% of the face amount of the guarantees were removed immediately by creditors of VHDC. LCHA expects to obtain the removal of the remaining guarantees. The vast majority of the remaining guarantees of VHDC debt are secured by other VHDC assets. LCHA has repaid all but $13,100.00 of the $95,634.00 improperly provided to affiliated Nonfederal Entities. $13,100.00 of this amount was provided to LCHA for operating deficits on other federally funded projects. These projects have reserves and LCHA believes that consent should be granted for payment from these reserves. LCHA agrees to repay the $13,100.00 from non ACC sources in the event project reserves can not be used. Guidance is requested from HUD with respect to this issue. The relationship between LCHA and VHDC is subject to a written contract. LCHA has recently hired a Controller and restructured its accounting department to ensure that policies are followed to avoid "the inappropriate use of HUD funds for nonfederal purposes". The Executive Director of LCHA has recently resigned. Finally, LCHA will enact conflict of interest policies as outlined above.

LCHA is proud of its accomplishments over the last 25 years. All LCHA and VHDC affordable housing assets are well maintained and have made better lives for thousands of low

Auditee Comments

KING, SPRY, HERMAN, FREUND & FAUL LLC

Mr. Daniel G. Temme
Regional Inspector General for Audit
United States Department of Housing and Urban Development
September 29, 2004
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income Lehigh Valley residents. LCHA has consistently fully cooperated with the efforts of the OIG and has done everything possible to respond as rapidly as possible to the findings contained in the OIG's report. LCHA will continue its efforts to fully comply with the OIG recommendations.

Very truly yours,

Kent H. Herman, Esquire

KHH/dm