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Audit Report Number	2006-KC-1014
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TO: Debra L. Lingwall, Coordinator, Omaha Public Housing Program
Center, 7DPHO

Margarita Maisonet, Director, Departmental Enforcement Center, CV

//signed//

FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: The Columbus Housing Authority, Columbus, Nebraska, Improperly Spent and
Encumbered Public Housing Funds for Its Non-HUD Development Activities

HIGHLIGHTS

What We Audited and Why

We reviewed the development activities of the Columbus Housing Authority, Columbus, Nebraska (Authority), because the U.S. Department of Housing and Urban Development (HUD) reported that the Authority had improperly used public housing funds to subsidize a multifamily housing facility for senior residents. Our objective was to determine whether the Authority complied with HUD rules and regulations when operating and managing Crown Villa, a non-HUD multifamily development.

What We Found

The Authority inappropriately spent more than \$62,000 in public housing funds to operate its non-HUD development, Crown Villa. It also inappropriately signed Crown Villa loan documents that contained setoff provisions allowing the bank to take Authority deposits in the event of default. The Authority defaulted, and the bank seized more than \$88,000 in public housing funds to

satisfy the defaulted loans. The Authority still owes nearly \$112,000 on a remaining loan. It is now at significant risk of being unable to continue administering HUD housing programs.

What We Recommend

We recommend that HUD require the Authority to repay its public housing program from nonfederal sources, ensure that no additional HUD funds are used for nonfederal activities without prior HUD approval, terminate the bank agreement that is encumbering public housing funds, and implement controls to protect federal funds. We also recommend that HUD impose administrative sanctions against the Authority, its former executive director, and members of its board of commissioners for placing the Authority in its current position.

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

The Columbus Housing Authority agreed with our audit conclusions. We provided the report to the Authority on August 30, 2006, and requested a response by September 20, 2006. The Authority provided written comments on September 18, 2006.

The complete text of the auditee's response can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

The Columbus Housing Authority (Authority) is a small public housing authority located in Columbus, Nebraska. It is a municipal corporation created by state law and is funded almost exclusively by the U.S. Department of Housing and Urban Development (HUD). It owns and operates 84 units of public housing in Columbus and administers approximately 100 Section 8 housing vouchers for HUD's Housing Choice Voucher program.

To participate in HUD's public housing programs, the Authority executed an annual contributions contract with HUD on January 31, 1996. The contract defines the terms and conditions under which the Authority agreed to develop and operate all projects under the agreement. A project is any public housing developed, acquired, or assisted by HUD under the United States Housing Act of 1937, as amended. The Authority may withdraw public housing funds only for the payment of the costs of development and operation of the projects under the contract or other purposes approved by HUD. Further, the Authority cannot in any way encumber any project, or portion thereof, without the prior approval of HUD.

In accordance with its agency plan, a public housing agency may form and operate wholly owned or controlled subsidiaries or other affiliates. Such wholly owned or controlled subsidiaries or other affiliates 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, but remain subject to other provision of law and conflict of interest requirements. Further, a public housing agency, in accordance with its agency plan, may enter into joint ventures, partnerships, or other business arrangements with or contract with any person, organization, entity or governmental unit with respect to the administration of the programs of the public housing agency such as developing housing or providing supportive/social services subject to either Title I of the United States Housing Act of 1937, as amended, or state law.

Between 2000 and 2003, the Authority developed Crown Villa, a multifamily housing facility. HUD allowed the Authority to borrow \$50,000 from its public housing funds to assist in purchasing the land for Crown Villa, conditioned on repayment. HUD did not approve any additional use of HUD funds for the development. The Authority completed Crown Villa, retained direct ownership, and began managing its daily operations in September 2003.

In July 2004, HUD became aware that the Authority was spending public housing funds for Crown Villa expenses and formally forbade it from continuing to do so. Soon thereafter, the Authority defaulted on the Crown Villa construction loan, and the bank foreclosed. Crown Villa was sold at a trustee's sale at a loss to the bank of \$1.6 million. The Authority is currently the defendant in a lawsuit brought by the bank to recover its losses.

HUD designated the Authority as troubled for fiscal year 2004, based on its Public Housing Assessment System scores. In July 2005, HUD conducted an on-site review and identified problems significant enough to require the Authority to enter into a one-year memorandum of agreement meant to assist the Authority in improving its operations.

Our audit objective was to determine whether the Authority complied with HUD rules and regulations when operating Crown Villa, including staffing and managing the property and paying its operating expenses.

RESULTS OF AUDIT

Finding: The Authority Spent and Encumbered Public Housing Funds to Operate a Nonfederal Development

The Authority spent and encumbered public housing funds to operate Crown Villa, a nonfederal multifamily development. This occurred because the former executive director and board of commissioners mismanaged Crown Villa, disregarded HUD regulations, and had no controls in place to safeguard its federal assets. As a result, more than \$62,000 in public housing funds are no longer available for their intended purposes, and nearly \$112,000 more in public housing funds related to a defaulted bank loan are at risk. Overall, the Authority is at significant risk of being unable to continue administering HUD housing programs.

The Authority Used Public Housing Funds for Crown Villa Expenses

The Authority inappropriately spent and encumbered public housing funds for Crown Villa operations and has not repaid its public housing accounts. According to HUD regulations, the Authority may withdraw funds from the public housing general fund only for the payment of the costs of development and operation of the projects under an annual contributions contract with HUD. There was no annual contributions contract associated with the Crown Villa development.

The Authority spent more than \$12,000 in public housing funds for operating expenses of the development. The public housing money was used primarily for legal fees, water and phone service, and accounting fees. The Authority also used public housing funds to pay Crown Villa payroll expenses for October through December 2003, which totaled nearly \$19,000. Further, the Authority spent more than \$5,500 in public housing funds to pay unemployment expenses for former Crown Villa employees.

In addition, the former executive director of the Authority and his assistant spent significant time managing Crown Villa's operations. The Authority paid their full salaries and related benefits from public housing funds, but Crown Villa did not reimburse the public housing funds for time spent operating Crown Villa. In 2004, the Authority conducted a time study showing that the executive director spent 23 percent of his time and his assistant spent 8 percent of her time on the development. Based on the time study, Crown Villa failed to reimburse the public housing program more than \$25,000 for their salaries.

In another audit report on the Authority (2006-KC-1013), we identified similar misuse of HUD funds used to benefit Crown Villa. The Authority spent more than \$204,000 in public housing funds to plan and develop Crown Villa without HUD approval and did not repay the public housing accounts.

The Authority Encumbered Its Public Housing Funds

The Authority encumbered its public housing funds when its former executive director and board chairman signed two loan documents for Crown Villa that contained setoff provisions. These provisions allowed the bank to take the Authority's depository funds in the event of default on the loans. The annual contributions contract with HUD states that the Authority shall not in any way encumber any project without the prior approval of HUD. The Authority did not have approval from HUD to sign the loan documents containing setoff provisions.

The Authority defaulted on the loans, and the bank exercised its right of setoff when it seized public housing funds from the depository accounts of the Authority for payment on the debts. The bank used the funds to pay off one loan, but the Authority remains indebted to the bank for the remaining loan balance of nearly \$93,000 plus interest of nearly \$19,000 that had accrued as of September 30, 2005.

In the audit report mentioned previously, we identified more than \$88,000 in HUD funds that the Authority improperly encumbered and later forfeited when its bank seized deposited funds as repayment on the defaulted loans obtained for the benefit of Crown Villa. The Authority has not replaced the public housing funds, nor has it recovered these funds from the bank.

The Authority Mismanaged Crown Villa

Authority administrators did not properly manage Crown Villa, and the development failed. The development did not have sufficient cash flow or cash reserves from nonfederal sources to support operations. To pay the development's expenses, the Authority inappropriately used public housing funds. In addition, Crown Villa was unable to meet its construction loan repayment obligations so the bank foreclosed and sued the Authority in an attempt to recover its losses. The lawsuit had not been settled as of the end of our audit.

Real estate professionals familiar with Crown Villa told us that the Authority did not adequately market the property during construction to get the units

occupied quickly enough after opening to provide sufficient cash flow to pay Crown Villa's operating expenses. The development consultant told us that the property should have been marketed eight months before opening, but the former executive director did not begin marketing the development until three months before opening. When applying for bank financing for Crown Villa, the Authority estimated that it could have the property fully occupied within 12 months of completing construction. However, more than 19 months after opening, the Authority had leased only 21 of the 60 units.

Authority Management Ignored HUD Regulations

The former executive director and board of commissioners ignored HUD regulations, and the Authority lacked controls to prevent its administrators from spending federal funds on nonfederal activities.

The former executive director told us that he knew the Authority used public housing funds on Crown Villa expenses without HUD approval. The board chairman told us that the board knew it did not have approval to spend the public housing funds for Crown Villa. However, the Authority had Crown Villa debts that needed to be paid so it used public housing funds with the intention of repaying the funds when the development had a positive cash flow. Therefore, the former executive director and board of commissioners willfully failed to perform in accordance with the annual contributions contract when spending and encumbering public housing funds for the benefit of Crown Villa.

According to 24 CFR [*Code of Federal Regulations*] Part 24, HUD can impose administrative sanctions against the former executive director and the board of commissioners for willfully failing to comply with the annual contributions contract.

Conclusion

The Authority is at significant risk of being unable to administer HUD housing programs because of the improper, willful actions of the former executive director and board of commissioners. During the five years that the Authority planned, constructed, and managed Crown Villa, it repeatedly violated its annual contributions contract. It spent more than \$266,000 in public housing funds, lost an additional \$88,000 when the bank seized its bank accounts, and remains at risk of losing nearly \$112,000 more in public housing funds for amounts owed on a defaulted loan.

The \$466,000 in misspent and encumbered public housing funds is significant to the Authority. Considering that HUD provided the Authority with an average

of \$100,000 annually in public housing operating funds in recent years, the misused funds represent more than four years of funding.

Recommendations

We recommend that the coordinator of the Omaha Public Housing Program Center

- 1A. Require the Authority to repay its public housing program \$62,135 from nonfederal sources (\$12,279 in operating expenses and \$49,856 in salaries and unemployment expenses).
- 1B. Require the Authority to pursue terminating the bank agreements that encumber public housing funds for unpaid loan balances so that at least \$111,894 in HUD funds will not be at risk.
- 1C. Require the Authority to implement adequate procedures to ensure that it does not expend or encumber HUD assets without HUD approval.
- 1D. Impose administrative sanctions against the Authority for violating the annual contributions contract with HUD.

Based upon the results of this audit and our previous audit of the Authority (Report Number 2006-KC-1013), we recommend that the director of the Departmental Enforcement Center

- 1E. Impose administrative sanctions against the Authority's former executive director and members of its board of commissioners who placed the Authority in its current position.

SCOPE AND METHODOLOGY

Our review generally covered the period from September 2003 through May 2005. To achieve our audit objective, we conducted interviews with the Authority's current and former staff; members of its board of commissioners; and its fee accountant, attorney, bank representative, consultant, and property appraisers. Additionally, we conducted interviews with HUD staff at the Omaha, Nebraska, and Kansas City, Kansas, Offices of Public Housing.

We reviewed the Authority's policies and procedures, Crown Villa development files and marketing studies, time studies of Authority staff, general ledgers, and audited financial statements. We also reviewed board of commissioners meeting minutes, annual contributions contracts, bank statements, and bank loan documents. In addition, we reviewed federal regulations and HUD's monitoring reports.

We reviewed reports generated from the Authority's computerized accounting system for evidence of expending or encumbering public housing assets without prior HUD approval. We used the computerized data for background information purposes only. We did not conduct tests of the data or controls governing the data. We did not use the data to support audit conclusions but used only original source documents to reach our conclusions.

During the audit, we identified nearly \$112,000 in public housing funds that are currently at risk of not being used for the purposes intended. If HUD implements our recommendation for the Authority to pursue terminating the agreements that encumber public housing funds, those funds will be available for the purposes intended by HUD. The funds at risk relate to two loans that the Authority entered into for the benefit of Crown Villa. The agreements contained setoff provisions that the bank could seize Authority funds on deposit to satisfy the loans in the event of default. One loan was for \$81,000. The second loan was a line of credit for \$100,000 on which the Authority borrowed the full amount. When the Authority defaulted on the loans, the bank exercised the setoff provisions and seized \$88,000 that the Authority had on deposit. From the seized funds, the bank paid off the smaller loan and applied the remainder to the line of credit. After the setoff, the Authority still owed about \$93,000. As of September 30, 2005, the remaining balance had accrued about \$19,000 in interest, creating a total outstanding balance of nearly \$112,000, which is currently encumbering public housing assets.

We performed on-site work from March through June 2006 at the Authority's office located at 2554 40th Avenue in Columbus, Nebraska. We performed our review in accordance with generally accepted government auditing standards.

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:

- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding of resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

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 Weakness

Based on our review, we believe the following item is a significant weakness:

- The Authority did not have adequate controls in place to ensure compliance with the annual contributions contract and safeguard its federal resources (see finding).

FOLLOWUP ON PRIOR AUDITS

**The Columbus Housing
Authority of Columbus,
Nebraska, Improperly Expended
and Encumbered Its Public
Housing Funds, #2006-KC-1013**

Based on a related audit of the Authority's planning and development of Crown Villa, we reported that the Authority violated its annual contributions contract with HUD when it expended and encumbered more than \$204,000 in public housing funds for Crown Villa.

The Authority spent nearly \$151,000 in public housing funds for development start-up costs before and during construction of Crown Villa. It also spent at least \$53,000 for salary and related benefit costs of Authority personnel who spent significant time on Crown Villa but who had been paid from public housing funds.

In addition, the Authority improperly encumbered its public housing assets when its former executive director and former chairman of the board signed development loan documents containing setoff provisions that allowed the bank to take Authority bank account funds in the event of default on the loans. The Authority defaulted on the loans, and the bank seized more than \$88,000 in public housing funds from the Authority's depository accounts for payment of Crown Villa's development debt.

We recommended that HUD require the Authority to repay its public housing program from nonfederal sources for the misspent funds, pursue recovery of the funds seized from the Authority's bank accounts, and implement adequate procedures to ensure that it does not expend or encumber HUD assets without HUD approval. The deficiencies are not yet corrected because we recently issued the report and HUD has not had sufficient time to take corrective action.

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/
1A	\$62,135	
1B		\$111,894

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 polices 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 at a later time 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.

The \$111,894 represents the outstanding balance of principal and interest as of September 30, 2005, that the Authority owed on the defaulted loans that benefited Crown Villa. If HUD requires the Authority to follow through with the recommendation to pursue terminating the bank agreements that encumbered public housing funds, HUD funds will no longer be at risk and can be used for their intended purposes.

Appendix B

AUDITEE COMMENTS



Columbus Housing Authority

Phone: 402-564-1131

Fax: 402-564-1648

TDD: 402-564-1131

2554 40th Avenue
Columbus, NE 68601-8519

September 18, 2006

Mr. Ronald J. Hosking
Regional Inspector General for Audit
U.S. Department of Housing & Urban Development
Gateway Tower II – 5th Floor
400 State Avenue
Kansas City, Kansas 66101-2406

Dear Mr. Hosking:

Below are the written comments of the Columbus Housing Authority concerning the audit of the Columbus Housing Authority's management of Crown Villa:

1A. The Columbus Housing Authority will work with the U.S. Department of Housing and Urban Development to repay its public housing program, \$62,135, using nonfederal sources.

1B. The Authority will work with its attorney to resolve this issue.

1C. The Columbus Housing Authority ensures that it will not expend or encumber HUD assets for nonfederal purposes without HUD approval. To ensure control, the Executive Director and Board of Commissioners will acknowledge and follow all policies, as approved by HUD, of the Columbus Housing Authority.

1D. No response

1E. No response

If you have any questions, please contact me.

Sincerely,

A handwritten signature in cursive script that reads "Constance J. Foust".

Constance J. Foust
Executive Director

