audit report

Issue Date December 13, 2006
Audit Report Number 2007-PH-1002

TO: Malinda Roberts, Director, Office of Public Housing, Philadelphia Regional Office, 3APH

Margarita Maisonet, Director, Departmental Enforcement Center, CV

John P. Buck

FROM: John P. Buck, Regional Inspector General for Audit, Philadelphia Regional Office, 3AGA

SUBJECT: The Montgomery County Housing Authority, Norristown, Pennsylvania, Improperly Used HUD Funds to Purchase, Renovate, and Maintain Its Main Office

HIGHLIGHTS

What We Audited and Why

We audited the Montgomery County Housing Authority (Authority) because of complaints we received concerning the propriety of the Authority's purchase, renovations, and operation of its main administrative office and regarding its Section 8 Housing Choice Voucher program. Our audit objective was to evaluate whether the Authority properly used U.S. Department of Housing and Urban Development (HUD) funds to purchase, renovate, and maintain its main administrative office. We also reviewed the adequacy of the Authority's administration of its Section 8 Housing Choice Voucher program.

What We Found

The Authority complied with HUD regulations and adequately administered its Section 8 Housing Choice Voucher program. However, it violated its consolidated annual contributions contract[1] by improperly acquiring a $1.2 million loan using HUD assets as collateral. It further improperly used HUD funds to pay the interest and principal on the loan, which it used to renovate its main office building. The Authority also violated its annual contributions contract by improperly using HUD funds to purchase, renovate, and maintain its main office. It improperly used $975,900[2] in Public Housing Homeownership (Homeownership) program proceeds and $609,363[3] in capital funds to purchase, renovate, and maintain the building, much of which is vacant, or which the Authority has been attempting to lease commercially for several years, or has leased to the Redevelopment Authority of Montgomery County (Redevelopment Authority).

The Authority improperly used another $9,257 in Homeownership program proceeds to pay the utilities of the Redevelopment Authority. The Authority's improper use of HUD funds contributed to a significant increase in its operating expenses and caused it to delay and cancel needed repairs at public housing units in Montgomery County.

What We Recommend

We recommend that the director of the Philadelphia Office of Public Housing notify the Authority that it has improperly encumbered annual contributions contract assets and direct it to provide evidence that the financial instruments encumbering the assets have been changed to exclude the assets and, thereby, put $1.1 million to better use. We further recommend that if the Authority does not withdraw its encumbrances of annual contributions contract assets, the director should advise HUD Headquarters Office of Field Operations that the Authority is potentially in substantial default of its annual contributions contract (ACC) because it has improperly encumbered ACC assets and provide all the relevant information. Further, the Philadelphia Office of Public Housing should request to be advised on Headquarters' disposition of the "Notice of Default" to the Authority. We also recommend that the Department's Enforcement Center initiate appropriate sanctions against Authority officials responsible for encumbering annual contributions contract assets to secure a loan.

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[1] Annual contributions contract, part A, section 7, "Covenant against Disposition and Encumbrances."
[2] $975,900 = ($325,000 used to purchase building + $428,021 used for renovations + $222,879 used to supplement budget shortfalls).
[3] Only $142,812 (6 percent) of the $2,380,196 total renovation costs for the building was eligible to be paid for with capital funds. Since the Authority spent $752,175 in capital funds to renovate the building, the use of $609,363 of the funds was ineligible.

In addition, we recommend that HUD require the Authority to properly support its use of $975,900 in Homeownership program proceeds or repay the program unsupported amounts from nonfederal funds. The Authority should also repay from nonfederal funds $609,363 in ineligible capital funds spent to be returned to the United States Treasury. We further recommend that the Authority reimburse the Homeownership program $9,257 for improperly paying its tenant's utility bills. Lastly, we recommend that the Authority begin paying future debt service on the $1.2 million loan attributable to activities unrelated to its consolidated annual contributions contract from nonfederal funds and provide adequate support for $119,139 in interest payments it made on the loan or repay HUD any unsupported amounts.

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 November 14, 2006. The Authority provided written comments to our draft report on November 29, 2006. The Authority generally disagreed with our findings but expressed willingness to work with HUD to resolve the issues noted in our report. The complete text of the Authority's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

The Montgomery County Housing Authority (Authority) is a governmental, public corporation created through a resolution of the County of Montgomery, Pennsylvania. It was organized as a public housing authority. The Authority owns and operates approximately 617 public housing units and issues approximately 2,597 housing choice vouchers. The annual contributions contract defines the terms and conditions under which the Authority agrees to develop all projects under the agreement. The Authority is governed by a board of five members who are appointed locally. The governing board is essentially autonomous but is responsible to the U.S. Department of Housing and Urban Development (HUD). The Authority's main administrative office is located at 104 West Main Street, Norristown, Pennsylvania.

HUD authorized the Authority the following financial assistance for fiscal years 2004 through 2006:

- $1,878,902 in operating subsidies to operate and maintain its housing developments,
- $1,492,360 in Public Housing Capital Fund program funding to modernize public housing units, and
- $21,208,915 to provide housing assistance through tenant-based Section 8 vouchers.

In February 2005, an anonymous complaint was received via the Office of Inspector General (OIG) Hotline alleging that the Authority was not using federal funds in accordance with applicable regulations.

The objectives of the audit were to evaluate whether the Authority properly used HUD funds to purchase, renovate, and maintain its main administrative office and to evaluate the adequacy of the Authority's administration of its Section 8 Housing Choice Voucher program.

RESULTS OF AUDIT

Finding 1: The Authority Improperly Used HUD Assets as Collateral on a $1.2 Million Loan

The Authority violated its consolidated annual contributions contract[4] with HUD by improperly acquiring a $1.2 million loan using HUD assets as collateral. This occurred because the Authority erroneously believed that its main administrative office was not a project asset covered by its consolidated annual contributions contract. As of August 2006, the Authority owed more than $1.1 million[5] on the loan, placing significant HUD assets at risk. The Authority used the loan to renovate its main administrative building, much of which it is attempting to rent or has rented for activities unrelated to its consolidated annual contributions contract with HUD.

The Authority Put $1.2 Million in HUD Assets at Risk

The Authority violated its annual contributions contract by obtaining a loan totaling $1.2 million in January 2002 using HUD assets as collateral. It assigned its main office building (including its rents, leases, and profits) as collateral. The building serves as the main office for the Authority's executive staff and Section 8 department. The Authority purchased the building in November 1999 with $325,000 in Homeownership program proceeds, and later obtained the $1.2 million loan to renovate the building. As of August 2006, the Authority owed more than $1.1 million on the loan, placing significant HUD assets at risk. The annual contributions contract prohibits the Authority from encumbering or pledging its HUD assets without HUD's prior approval. Section 7 of the contract states that the Authority shall not in any way encumber any such project, or portion thereof, without prior approval of HUD. In addition, the Authority cannot pledge as collateral for a loan the assets of any project covered under the contract.

The Authority Did Not File a Required Declaration of Trust

In violation of its consolidated annual contributions contract, the Authority failed to file a declaration of trust when it purchased its administrative office building. The contract requires that promptly upon acquisition of any project, the Authority should execute and publicly file a declaration of trust evidencing the covenant of the housing authority not to encumber the project to protect the interests of

[4] Annual contributions contract, part A, section 7, "Covenant against Disposition and Encumbrances."
[5] The balance on the bank loan as of August 2006 was $1,102,012.

HUD.[6] Essentially, the Authority acquired project assets and did not confirm or evidence its covenant not to encumber the project assets, and it later improperly encumbered and placed significant HUD assets at risk. In this regard, the contract further states that encumbering annual contributions contract assets as collateral for a loan constitutes grounds for declaring the Authority in substantial default of its annual contributions contract.[7]

The Authority Misinterpreted the Definition of Project Asset

The Authority mistakenly believed that its main administrative office was not a project asset covered by its consolidated annual contributions contract. The Authority believed that since the office building did not constitute public housing, it was not covered by the Authority's consolidated annual contributions contract. The Authority believed, therefore, that it was not required to file a declaration of trust evidencing its covenant not to encumber the project to protect the interests of HUD. As a result, the Authority also incorrectly believed that it was permitted to use its administrative offices as collateral on the $1.2 million loan without prior approval of HUD.

The Authority's interpretation of "project assets" was incorrect. Section 2 of the consolidated annual contributions contract specifically states that the term "project" includes all real and personal property, tangible and intangible, which is acquired or held by the Authority in connection with a project under the consolidated annual contributions contract. The Authority purchased the building at 104 West Main Street, Norristown, Pennsylvania, to be used as the main office of its executive staff and Section 8 department. Since the building is being held by the Authority in connection with a project under its consolidated annual contributions contract (office of its executive staff and Section 8 department), it is clearly a project asset. Further, the Authority used a significant amount of HUD funds to maintain, operate, and renovate the building in connection with a project under its consolidated annual contributions contract.

Recommendations

We recommend that the director of the Philadelphia Office of Public Housing

1A. Notify the Authority that it has improperly encumbered consolidated annual contributions contract assets and direct it to provide evidence that the financial instrument encumbering the assets has been changed to exclude the assets and, thereby, put more than $1.1 million to better use.

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[6] Annual contributions contract, part A, section 8, "Declaration of Trust."
[7] Annual contributions contract, part A, section 17, "Notices, Defaults, Remedies."

1B. If the Authority does not withdraw its encumbrances of annual contributions contract assets, advise HUD Headquarters Office of Field Operations that the Authority is potentially in substantial default of its annual contributions contract (ACC) because it has improperly encumbered ACC assets and provide all the relevant information. Further, the Philadelphia Office of Public Housing should request to be advised on Headquarters' disposition of the "Notice of Default" to the Authority.

1C. Require the Authority to implement adequate procedures, including obtaining a required declaration of trust on its administrative offices, to ensure it does not encumber HUD assets without HUD approval.

We also recommend to the Department's Enforcement Center that

1D. Appropriate sanctions be initiated against Authority officials responsible for encumbering annual contributions contract assets to secure a loan.

Finding 2: The Authority Improperly Used HUD Funds to Purchase, Renovate, and Operate Its Main Office Building

The Authority improperly used $975,900[8] in Public Housing Homeownership (Homeownership) program proceeds and $609,363[9] in capital funds to purchase, renovate, and maintain its 104 West Main Street office building, much of which has remained vacant for several years or is leased to the Redevelopment Authority of Montgomery County (Redevelopment Authority). It improperly used another $9,257 in Homeownership program proceeds to pay the utilities of the Redevelopment Authority, which is a tenant in its building. Further, the Authority improperly used HUD funds to pay the interest and principal on the $1.2 million loan (discussed under Finding 1) which it used to renovate the building. These problems occurred because the Authority misinterpreted applicable requirements and failed to develop and implement adequate internal controls to ensure that HUD funds were used in accordance with its consolidated annual contributions contract and with the applicable requirements. Consequently, the additional expense of renovating and maintaining the building caused delays in the Authority's needed capital fund projects. In addition, the significant increase to the Authority's operating expenses could have a detrimental effect on its ability to operate HUD programs in the future.

The Authority Improperly Used $975,900 in Homeownership Proceeds

The Authority improperly used $975,900 in Homeownership program proceeds to purchase, renovate, and maintain its 104 West Main Street office building. Regulations at 24 CFR [*Code of Federal Regulations*] 906.31(a) require that the Authority use any net proceeds of any sales under a homeownership program remaining after payment of all costs of the sale for purposes relating to low-income housing and in accordance with its homeownership plan.

The Authority is using only one-third (10,000 of 30,000 square feet) of the building it purchased to be used as its main administrative office. It is leasing about 3,000 square feet of office space on the second floor to the Redevelopment Authority. The remaining 17,000 square feet of office space has remained vacant since the Authority purchased the building in November 1999. Since May 2003, the Authority has been attempting to lease out at least 4,800 square feet of the vacant office space in the building using commercial real estate brokers. The Authority's listing agreement for the property with its commercial real estate broker stated that the Authority will pay a broker's fee if a ready, willing, and able tenant or buyer is found by the broker or by anyone, including the owner, during the term of the contract. The agreement defined a willing tenant as one

[8] See footnote 2.
[9] See footnote 3.

who will pay the listed rent or more for the property, and it did not restrict use of the property to low-income housing-related activities.

The Authority purchased this 30,000-square-foot building for $325,000 using its Homeownership program proceeds. It later used $428,021 in Homeownership program proceeds to help renovate the building. In addition, since October 2002, the Authority has used $222,879 in Homeownership program proceeds to make up for budget shortfalls created by the upkeep of the building. Overall, the Authority used $975,900 in Homeownership program proceeds to purchase, renovate, and maintain its main office building. The Authority's homeownership plan, submitted to HUD for review and approval, did not identify the purchase, renovation, and upkeep of this office building as one of its intended uses. However, the plan stated that proceeds could be used for activities to support housing for low-income families. Since only about one-third of the building is now used to support the Authority's executive and Section 8 administrative staff, only one-third of the purchase, renovation, and maintenance of the building could potentially be funded with Homeownership program proceeds if the Authority can properly justify this use in its homeownership plan. Nevertheless, there is currently no evidence to indicate that HUD approved the Authority's use of $975,900 in Homeownership program proceeds for the purchase, renovation, and maintenance of its main office building, or that the Authority used the funds solely for purposes relating to low-income housing. Therefore, it needs to adequately justify and obtain approval from HUD to support its use of $975,900 in Homeownership program proceeds or repay any unsupported amounts from nonfederal funds.

The Authority Improperly Used $609,363 in Capital Funds to Renovate the Building

The Authority improperly used $609,363 in capital funds to renovate its 104 West Main Street office building when it did not ensure that the capital funds spent directly benefited its public housing program. According to 24 CFR [*Code of Federal Regulations*] 968.112, public housing modernization funds can only be used when the costs can be directly attributed to public housing. The regulation states that when the physical or management improvement including administrative cost will benefit programs other than public housing, such as Section 8 or local revitalization programs, eligible costs are limited to the amount directly attributable to the public housing program.

We estimated the Authority used approximately 1,800 square feet or 6 percent of the 30,000-square-foot building for public housing purposes. Our estimate was based on information obtained from the Authority's operating budgets for 2003, 2004 and 2005. The Authority's operating budgets for those years indicated it prorated square footage between its Section 8 and public housing programs in order to allocate office rent. On average, the Authority allocated 81 percent to Section 8 and 19 percent to public housing over the three years. In 2005, 82 percent and 18 percent were allocated to Section 8 and public housing respectively. Considering this information, and based on the fact that the Authority only occupied one-third of the office building, we estimated it used approximately 1,800* of the 30,000-square-foot building for public housing purposes. Therefore, only $142,812 (6 percent) of the more than $2.38 million total renovation costs for the building was eligible to be paid for with capital funds. Since the Authority spent $752,175 in capital funds to renovate the building, the use of $609,363 of the funds was ineligible. The Authority stated that it had approval from HUD to spend the $752,175 to renovate the building. However, in a letter, dated May 17, 2001, HUD advised the Authority that the use of capital funds is prohibited for non-related public housing program use. Therefore, the 28,200 square feet in this building that were not related to public housing program use should not have been renovated using capital funds.

The Authority's use of ineligible capital funds to renovate its office building diverted funds from planned public housing repair projects. These repairs included potential health and safety issues such as gas line replacement, sidewalk repairs, and handrail replacement in a senior citizen complex. Some of these projects are still not complete, and some have been cancelled due to lack of available funding.

As discussed above, the Authority improperly used capital funds that did not benefit its public housing program to renovate its 104 West Main Street office building. Since the $609,363 in capital funds improperly spent will not meet the 24-month time frame for obligating capital funds as required by Section 9J of the United States Housing Act, the Authority must repay the funds to the United States Treasury.

The Authority Improperly Paid Its Tenant's Utility Costs of $9,257

The Authority improperly used Homeownership program proceeds to pay the utilities of the Redevelopment Authority. Regulations at 24 CFR [*Code of Federal Regulations*] 906.31(a) require that the Authority use any net proceeds of any sales under a Homeownership program remaining after payment of all costs of the sale for purposes relating to low-income housing and in accordance with its homeownership plan. In addition, the Authority's lease agreement with the Redevelopment Authority required it to pay its own utilities. Nevertheless, from November 2002 to May 2006, the Authority paid the utilities of the Redevelopment Authority at a cost of $9,257, using Homeownership program proceeds. The Authority's homeownership plan, submitted to HUD for review

* 1,800 square feet = 18% x10,000 square feet (one third of 30,000 square feet)

and approval, did not identify the use of Homeownership program proceeds to pay the utilities of the Redevelopment Authority as one of its intended uses, and this use does not support low-income housing.

If the Authority develops and implements procedures to preclude these improper payments from recurring, it will put $2,583[10] to better use annually. Although this will be a recurring benefit, our estimate reflects only the initial year of these benefits. After we brought this matter to the Authority's attention, the Authority took immediate action and provided us support to show that it had obtained reimbursement from the Redevelopment Authority for its Homeownership program. Authority officials also stated that the Authority would develop and implement procedures to preclude these problems from recurring. Since the Authority has provided adequate support to show that it obtained reimbursement from the Redevelopment Authority for its Homeownership program, we consider recommendation 2C on page 13 closed.

The Authority Improperly Used HUD Funds to Pay Debt Service on a $1.2 Million Loan

In addition to the issues discussed under Finding 1, the Authority is improperly paying the principal and interest on the $1.2 million loan it used to renovate its 104 West Main Street office building with HUD funds. As previously discussed, the Authority used only 10,000 square feet of its 30,000-square-foot office building for HUD or low-income housing-related purposes. The Authority's comparative financial statement showed that the future interest and principal payments on the Authority's $1.2 million loan, which it used to renovate the building, are more than $1.86 million. Since the Authority only used one-third of the building for purposes related to its consolidated annual contributions contract, it should only use HUD funds to pay one-third of the debt service on the loan.

Part A, section 9(C), of the contract states that the Authority may withdraw funds from the general fund only for the payment of the costs of development and operation of the projects under the annual contributions contract with HUD, the purchase of investment securities as approved by HUD, and such purposes as may be specifically approved by HUD. In this regard, we estimated that the Authority plans to use more than $1.2 million[11] in future HUD funds to pay the debt service on this loan for purposes unrelated to its consolidated annual contributions contract with HUD. Therefore, the Authority should either begin using the remaining office space for purposes related to its consolidated annual contributions contract or begin paying the prorated future debt service on this loan from nonfederal funds.

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[10] $9,257/43 months = $215.28 x 12 months (to annualize).
[11] $1,866,319 multiplied by two-thirds.

We reported the outstanding principal on the loan in Finding 1, and, therefore, are reporting only the prorated future interest payments of $511,135 (two-thirds times $766,703) in the chart in appendix A. In addition, the Authority should provide support and obtain approval from HUD for paying $119,139[12] in prior interest payments with HUD funds or repay the program from nonfederal funds.

Recommendations

We recommend that the director of the Philadelphia Office of Public Housing require the Authority to

2A. Properly justify and obtain approval from HUD to support its use of $975,900 in Homeownership program proceeds to purchase, renovate, and maintain its main office building or repay the program unsupported amounts from nonfederal funds.

2B. Repay from nonfederal funds $609,363 in ineligible capital funds spent to renovate and maintain its main office. These funds should be returned to the United States Treasury because they were not properly obligated within 24 months.

2C. ** Obtain reimbursement from the Redevelopment Authority for improperly paying its utility costs and reimburse the Homeownership program $9,257.

2D. Develop and implement procedures to preclude improper utility payments, thereby putting $2,583 to better use annually.

2E. Use the remaining office space in its 104 West Main Street office building for purposes related to its consolidated annual contributions contract or begin paying future debt service on the $1.2 million loan attributable to activities unrelated to its consolidated annual contributions contract from nonfederal funds, thereby putting $511,135 to better use.

2F. Properly justify and obtain approval from HUD to support its use of $119,139 for interest payments it made on the $1.2 million loan used to renovate space in its 104 West Main Street office building not currently related to consolidated annual contributions contract activities or repay any unsupported amounts from nonfederal funds.

2G. Develop and implement adequate internal controls to ensure that HUD funds are used in accordance with its annual contributions contract and with applicable regulations.

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[12] $178,708 total interest payments for 2003, 2004, 2005, and 2006 multiplied by two-thirds.
** This recommendation is closed.

SCOPE AND METHODOLOGY

To accomplish our objectives we

- Reviewed the Authority's internal control structure.
- Reviewed the Authority's independent auditor's reports for fiscal years 2002, 2003, 2004, and 2005.
- Reviewed minutes of the Authority's board of commissioners meetings.
- Interviewed Authority and Philadelphia Office of Public Housing officials.
- Reviewed records related to the purchase and renovations of the Authority's main office, such as contractor records, funding allocations, sales agreements, lease agreements, loan agreements, real estate contracts, financial records, and other related correspondence between the Authority and HUD officials.
- Reviewed HUD and Authority correspondence related to the audit objectives and the results of a hotline investigation conducted by HUD's Philadelphia Office of Public Housing.
- Obtained a legal opinion from the OIG Office of General Counsel regarding the Authority's actions to obtain a $1.2 million loan it used to renovate its main office building. Counsel opined that the Authority encumbered HUD assets and violated its annual contributions contract.
- Reviewed records related to the Section 8 Housing Choice Voucher program to include the Authority's administrative plan, quality control plan, year-end settlement statements, Section 8 Management Assessment program certifications, and a random sample of 10 tenant files.
- Reviewed applicable HUD regulations, handbooks, public housing notices, and consolidated annual contributions contracts.

To achieve our audit objectives, we relied in part on computer-processed data in the Authority's database. Although we did not perform a detailed assessment of the reliability of the data, we did perform a minimal level of testing and found it to be adequate for our purposes.

The audit generally covered the period from January 1999 to December 2005. This period was expanded to include the most current data while performing our audit. We conducted our fieldwork from March through May 2006.

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 control was relevant to our audit objectives:

- Allowable uses of federal funds – Policies and procedures that management has in place to reasonably ensure that the use of federal funds complies with HUD program requirements.

We assessed the relevant control 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 item is a significant weakness:

- The Authority lacked adequate internal controls to ensure that HUD funds were used in accordance with its annual contributions contract and with applicable regulations. The deficiencies are discussed in detail in the Results of Audit section of this report.

APPENDIXES

Appendix A

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

Recommendation number	Ineligible costs 1/	Unsupported costs 2/	Funds to be put to better use 3/
1A			$1,102,012
2A		$ 975,900	
2B	$609,363		
2C	$ 9,257		
2D			$ 2,583
2E			$ 511,135
2F		$ 119,139	
TOTAL	**$618,620**	**$1,095,039**	**$1,615,730**

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/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. In these instances, if the Authority implements our recommendations, it will cease improperly encumbering consolidated annual contributions contract assets, cease improperly using HUD funds to pay the utility costs of its tenants, and cease paying interest on portions of a loan used for renovations unrelated to its consolidated annual contributions contract with HUD.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

WP WISLER PEARLSTINE

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November 29, 2006

VIA ELECTRONIC AND FIRST CLASS MAIL
Mr. John P. Buck, Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General
100 Penn Square East, Suite 1005
Philadelphia, PA 19107

Re: Comments to the OIG Audit Report on the Montgomery County Housing Authority

Dear Mr. Buck:

This correspondence constitutes the official comments of the Montgomery County Housing Authority (the "MCHA") in response to the draft Audit Report prepared by the Office of Inspector General (the "OIG") regarding the MCHA's acquisition, renovation and maintenance of the property located at 104 West Main Street (the "Housing Center").

The MCHA remains totally committed to working cooperatively with HUD to the benefit of their mutual constituencies and looks forward to working with HUD to clarify any misunderstandings and correct any perceived concerns in a timely and efficient manner. In this response, the MCHA proposes resolutions that it believes will satisfy the concerns of the OIG without negatively affecting the MCHA's ability to serve low-income families.

Comment 1 For the record, however, the MCHA does not agree with the findings of the OIG that the MCHA violated its Annual Contributions Contract ("ACC") or any applicable regulation in the acquisition, renovation and maintenance of 104 West Main Street the Housing Center.

Specifically, the MCHA disputes the conclusions in the Report because:

Comment 2 (1) the Homeownership Program Regulations, MCHA's Homeownership Plan, and the Implementing Agreement between the MCHA and HUD permitted the MCHA to use Homeownership Program proceeds for the acquisition and renovation of the Housing Center;

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Comment 3

Comment 4

Comment 5

Comment 4

Comment 4

Comment 2

Comment 2

WP WISLER PEARLSTINE

(2) the Housing Center is not a "project" as defined by applicable regulations and the ACC; therefore, the MCHA was not prohibited from pledging that property or the rents obtained from the rental of the property as collateral for a loan;

(3) the MCHA's use of its capital fund to renovate the Housing Center was expressly permitted by applicable regulations because the MCHA obtained HUD approval of its Annual and Five Year Plans detailing the expenditures; and

(4) the MCHA did not use HUD funds to pay interest and principal on the $1.2 million loan.

A. Introduction

As the MCHA reviewed its options for relocating its administrative offices and ultimately as it pursued its plans to purchase and renovate the Housing Center, the MCHA acted openly, publicly and in good faith. Activities of the MCHA relating to the purchase, renovation and leasing of the Housing Center were undertaken after thoughtful evaluation and rigorous due diligence. In determining that the acquisition and renovation were appropriate, the MCHA relied upon the advice of its consultants, who were regarded as experts on HUD statutory and regulatory requirements, as well as its communications with HUD.

Throughout its analysis, acquisition and renovation of the Housing Center, the MCHA regularly consulted with HUD representatives as to operational matters generally and as to the purchase and renovation of the Housing Center in particular. The MCHA openly communicated its intentions to HUD in its Annual Plans, which the MCHA filed with HUD and which HUD approved.

Also, during the course of the audit, the MCHA fully cooperated with the OIG, allowing access to all of its employees and frequently collecting and compiling information at the request of the auditors.

B. The Homeownership Regulations, MCHA's Homeownership Plan, and the Implementing Agreement Between MCHA and HUD Permitted the MCHA to Use the Proceeds from that Program to Acquire, Renovate and Maintain the Housing Center.

The Report incorrectly concludes that the MCHA was not authorized to use Homeownership Proceeds to acquire, renovate and maintain the Housing Center. The MCHA's use of Homeownership Proceeds is governed by (1) the Homeownership Regulations, (2) the MCHA's Homeownership Plan, which was developed in conjunction with HUD, and (3) the Implementing Agreement between the MCHA and HUD, all of which permitted the MCHA to use the Program proceeds for the acquisition, renovation and maintenance of the Housing Center.

Comment 2

WISLER PEARLSTINE

Comment 2

1. The Homeownership Regulations permitted the MCHA's use of Program proceeds for the acquisition and renovation of the Housing Center.

Comment 2

The MCHA used proceeds exclusively from its Section 5(h) Homeownership Program (the "Homeownership Proceeds") to cover the purchase price and other closing costs, as permitted by the Homeownership Regulations and the terms of MCHA's Homeownership Plan. The Homeownership Regulations certainly do not preclude the use of Homeownership Proceeds for these purposes, and read literally support the use of such proceeds to protect the interests of the MCHA. Indeed, the Homeownership Proceeds applied to the Housing Center were correctly utilized to ensure the success of MCHA's housing assistance for low-income families generally, and for the success of MCHA's Homeownership Plan specifically.

Comment 2

The use of MCHA's Homeownership Proceeds at the time the funds were applied to the Housing Center was governed by 24 C.F.R. § 906.15,[1] which provided that the net sale proceeds "be retained by the PHA and used for housing assistance to low-income families." 24 C.F.R. § 906.15(a). The regulation further provided that the Homeownership Proceeds may be used, at the discretion of the PHA and in accordance with the HUD-approved ownership plan, "for purposes that are justified to ensure the success of the plan and to ***protect the interests*** of the homeowners, ***the PHA***, and any other entity with responsibility for carrying out the plan." 24 C.F.R. § 906.15(b)(1) (emphasis added). Moreover, the regulation makes clear that such proceeds may be appropriately utilized not solely for the Homeownership Program, but also "[i]n connection with the PHA's other public housing that remains under ACC, for any purposes authorized for the use of operating funds under the ACC ...." 24 C.F.R. § 906.15(b)(4).

Comment 2

In sum, the regulations do not specifically preclude the use of Homeownership Proceeds for the acquisition and maintenance of the Housing Center, as the expenditure of these funds "ensure the success of the plan and ... protect the interests of ... the PHA ...." The purchase of the Housing Center was for the express purpose of allowing MCHA to better assist low-income families with housing, and served to ensure the success of MCHA's efforts in implementing its Homeownership plan as well as other public housing programs under the ACC. The MCHA purchased the Housing Center to (a) provide a greater amount of office space to accommodate its growing staff; and (b) reduce its operating expenses attributable to renting office space, which had increased to almost $100,000 per year. In addition, the MCHA wanted to better achieve its mission, goals and objectives by establishing a centrally located housing resource center, which would assemble under one roof other public and non-profit agencies providing housing and economic development services and assistance. Clearly, the expenditure of Homeownership Proceeds on the Housing Center for these purposes is within both the spirit and the text of the applicable regulations.

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[1] The current regulation controlling use of Homeownership Proceeds is 24 C.F.R. § 906.31. Significantly, the current regulation permits a PHA to use net sales proceeds "for purposes relating to low-income housing and in accordance with its PHA plan," which arguably encompasses an even broader range of permissible uses than under the prior regulation.

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2. The MCHA's Homeownership Plan and the Implementing Agreement between the MCHA and HUD permitted the MCHA's use of Program proceeds for the acquisition and renovation of the Housing Center.

The MCHA's Homeownership Plan was submitted to HUD for its review on July 7, 1994 and was approved by HUD as meeting the requirements of 24 C.F.R Part 906, Section 5 (h) on June 1, 1995. The MCHA prepared its Homeownership Plan proposal with the assistance of Mr. Ken Davis, a HUD employee in its Philadelphia Field Office who spent a week with Ms. Carol Navon at the MCHA's office developing the Homeownership Plan. Mr. Davis advised the MCHA to use broad language when addressing the use of sales proceeds in order to maximize the range of activities to which the proceeds could permissibly be applied. Accordingly, the approved Homeownership Plan provided that sales proceeds would be used for:

> housing related activities as follows:
>
> . . . 5. Activities to support housing for low-income families ***which may include, but are not limited to . . . any other purpose authorized for use of operating funds*** under the ACC and federal regulations, as included in the HUD approved operating budgets.

(emphasis added). Thus, the approved Homeownership Plan expressly allowed MCHA to utilize Homeownership Proceeds for authorized operating funds under the ACC. At the time HUD approved the MCHA's Homeownership Plan, the MCHA rented the space for its administrative offices and used its operating funds to make those rental payments. The MCHA reasonably believed, therefore, that the acquisition of property for the administrative offices, which over time would result in an overall reduction of the MCHA's operating expenses, would be treated similarly as a proper operating fund expenditure.

In addition, the Implementing Agreement between the MCHA and HUD stated that "[s]ale proceeds shall be used in an economical and efficient manner (without excessive administrative costs), so as to provide the maximum housing assistance at a reasonable cost to low-income families." (Exhibit 2). Thus, the Implementing Agreement expressly permitted the use of Homeownership Proceeds for administrative overhead costs, provided they were not excessive. The MCHA's acquisition, renovation and maintenance of administrative offices qualify as administrative overhead costs that allow the MCHA to perform its duties in a more economical and efficient manner and therefore provide maximum assistance to low-income families. Moreover, the MCHA's expenditures on the Housing Center provided the MCHA with an asset which generates revenue that will eventually help to offset the administrative costs. If the MCHA is permitted to rent and is ultimately successful in renting the remaining office space, then it will further reduce the administrative cost of operations which will also benefit low-income families served by the MCHA.

Finally, the MCHA's independent auditor, Mr. O'Neill, knew the Homeownership Proceeds were to be used to purchase the Housing Center, audited the purchase, and prepared an Audit Report of the MCHA for the twelve months ended December 31, 1999 in which he described the purchase of the Housing Center and concluded, without qualification, that the MCHA's expenditures and other operations were in compliance in all material respects with all

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applicable federal program requirements. (Exhibit 9) Thus, at that time, the MCHA had a good faith basis to believe, and continues to believe, that the proceeds of its successful Homeownership Program were correctly utilized for the Housing Center.

3. Response to Recommendations

With respect to the Audit Report Recommendations, to the extent that HUD determines that the use of Homeownership Proceeds to purchase the Housing Center was not in accordance with the Homeownership Plan, the MCHA requests that HUD permit the MCHA to submit a revised Homeownership Plan and that HUD approve the use of Homeownership proceeds retroactively to the date of the purchase.

C. The Housing Center Is Not a "Project" as Defined by the Annual Contributions Contract; therefore, the MCHA Was Not Required to File a Declaration of Trust and Was Permitted to Encumber the Property.

1. The Housing Center is not a "Project".

The finding that the MCHA failed to properly file a declaration of trust and improperly pledged a HUD asset flows from the OIG's incorrect interpretation of the Annual Contributions Contract between the MCHA and HUD. Section 8 of the ACC requires the filing of a declaration of trust "promptly upon the acquisition of any project". (Exhibit 3 at §8)[2]. Section 7 of the ACC prohibits the MCHA from pledging "as collateral for a loan the assets of any project covered under this ACC." (Exhibit 3 at §7).

Section 2 of the ACC defines a "project" as:

> Project - public and Indian housing developed, acquired, or assisted by HUD under the Act, other than under section 8 of the Act, and the improvement of such housing. The term shall include all real and personal property, tangible and intangible, which is acquired or held by a HA in connection with a project covered under this ACC.

(Ex. 3 at § 2). Thus, the clear text of the ACC defines a "project" thereunder as (a) a housing development, (b) the improvement of a housing development, or (c) property held in connection with a specific housing development (e.g. easements, parking lots).

The Housing Center does not meet the definition of "project" under the ACC because it clearly is not "housing" of any kind, and the use of the Housing Center as administrative offices for the MCHA is not an acquisition in connection with any particular housing. The MCHA did not, for example, acquire the Housing Center to serve as a rental office or community room for any housing project, nor did it acquire the Housing Center for parking or access roads to a housing project. Rather, the MCHA acquired the Housing Center as an administrative necessity for its daily operations. The Audit Report does not identify any "public or Indian housing

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[2] Exhibit numbers refer to the separately bound Exhibit Packet that the MCHA previously provided to the OIG.

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developed, acquired, or assisted by HUD under the Act" in connection with which the MCHA acquired the Housing Center.

The Report appears to conclude that the use of HUD money to maintain, operate and renovate the Housing Center somehow brings the Housing Center under the definition of a "project"; however, HUD chose not to define a "project' in that manner in the ACC. If HUD intended housing authorities to file a declaration of trust for any property upon which the MCHA engaged in any activities that in any way related to public or assisted housing, then it could have used language expressly so indicating in the ACC. Instead, HUD defined "projects" as a public housing development and the property acquired or held in connection with a public housing development.

2. Response to Recommendations

With respect to the Recommendations in the Audit Report, if HUD were willing to retroactively approve the loan and allow the encumbrance, then the MCHA would be willing to execute a declaration of trust. To the extent that the concerns surround the pledging of rents to secure the loan, the MCHA will discuss alternatives with the lender. Additionally, effective January 1, 2006, contributions from the Section 8 Program will be treated as rental income to the MCHA and those payments, along with the income from the Redevelopment Authority, will pay the interest and principal on the debt.

Furthermore, even if HUD concludes that there was a violation of the ACC, it is unclear why any "sanctions" would be recommended because, by the OIG's own acknowledgement, this issue related to a difference of interpretation, not one where the MCHA or any of its agents or representatives sought to defraud or mislead HUD. Sanctions were not referenced in the initial outline provided to the MCHA and no basis for imposing sanctions was disclosed to the MCHA. Also, the MCHA at all times kept HUD advised of its actions and no HUD official ever raised this issue.

D. The MCHA Properly Used Its Capital Fund to Renovate the Housing Center.

The MCHA's use of its capital fund to renovate the Housing Center was in accordance with the applicable regulations because the MCHA had express authority to use the funds for the renovation of the Housing Center and the Report incorrectly allocates only 6% of the space in the Housing Center to Public Housing.

1. The MCHA's use of its capital fund to renovate the Housing Center was expressly permitted by applicable regulations because the MCHA obtained HUD approval of its Annual and Five Year Plans detailing the expenditures.

The applicable regulations, specifically, 24 C.F.R. §968.112, permit the MCHA to use public housing modernization funds for "eligible costs", which include "[u]ndertaking activities described in its approved Annual Statement under §968.325 and approved Five-Year Action Plan under §968.315(e)(5)." The MCHA included the work on the Housing Center and budgeted capital fund expenditures for the renovation of the Housing Center in its 2002, 2003 and 2004 Five Year Plans. (Exhibits 14, 17 and 21, respectively). Each year, HUD approved the MCHA's Plan. (Exhibits 15, 19 and 22, respectively).

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Specifically, the 2002 Annual Plan Executive Summary provides a lengthy discussion about the Housing Center, describes the intended uses of the building, states clearly that the MCHA will occupy one-third of the usable office space, and includes a schedule of estimated rehabilitation costs projected to come from the Capital Fund Program as follows: $245,375.00 in FY 2002, $182,174.00 in FY 2003, $150,000.00 in FY 2004, $150,000.00 in FY 2005, and $150,000.00 in FY 2006. (Exhibit 14). The 2003 Annual Plan includes a schedule of estimated rehabilitation costs projected to come from the Capital Fund Program as follows: $195,375.00 in FY 2003, $182,174.00 in FY 2004, $150,000.00 in FY 2005, $150,000.00 in FY 2006 and $150,000.00 in FY 2007. (Exhibit 17).

Because the MCHA included $922,924 of capital fund expenditures for the renovation of the Housing Center between FY 2002 and FY 2006[3] and because HUD approved those expenditures, the same regulation that the OIG claims disallowed the expenditures actually expressly permitted the MCHA's expenditure of $922,924 of capital funds in accordance with the plans. As the MCHA only used $752,175 from the capital fund for the renovations, all of the expenditures were expressly permitted under the applicable regulations.

2. The allocation of the cost of renovating the Housing Center to the Public Housing Department should be at least 30%, not 6%.

Although the Report does not explain the allocation of cost to the Public Housing Program, the OIG's allocation of the Housing Center space to the MCHA's Public Housing Department was apparently based upon incorrect accounting principles and not based upon the actual space allocated to the MCHA's Public Housing Department or the direction given to the MCHA by HUD regarding use of capital funds.

Prior to allocating any of its capital fund to the Housing Center, the MCHA sought guidance as to the appropriate use of the capital fund for the renovation of the Housing Center. The HUD advised the MCHA on two issues related to the Housing Center. First, with respect to the area on the second floor to be rented to other entities, the May 17, 2001 letter stated "the use of CGF is prohibited for non related public housing program use." Second, the letter stated that the MCHA should "pro-rate that portion of its ***space that Section 8 would occupy*** ...." (Exhibit 12). The HUD letter did not require that common areas, which are clearly used by the Public Housing Program or storage areas being used by Public Housing be excluded, nor did it require

[3] In addition, the Authority received specific approval from Ms. Boram Lee, Public Housing Revitalization Specialist at HUD, to apply unused Capital Funds for $434,881.00 from its 2001 Capital Fund Grant to Housing Center renovation expenses incurred in 2002, as reflected in a memorandum to the file prepared by Paul Fisher on March 21, 2003. (Exhibit 23, pp. 3 and 4). As a result, Capital Fund expenditures for fiscal year 2001 relating to the Housing Center for $434,881.00 were included on the Authority's Actual Modernization Cost Certificate submitted to and approved by HUD on August 26, 2004. (Exhibit 23). Finally, HUD approved the use of $29,700.00 for renovation costs for the Housing Center from the 2003 Capital Fund Grant, as reflected in a Final Performance and Evaluation Report for Capital Fund Grant by letter dated July 3, 2006. (Exhibit 27).

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the pro-ration of space occupied by Public Housing employees for any work that employee performed that was attributable to Public Housing.

Comment 9

Based upon the foregoing communication, the MCHA allocated thirty percent (30%) of the Capital Fund for renovation costs determined according to the amount of usable office space in the Housing Center used by Public Housing in relation to the total amount of usable office space in the building. (Exhibit 13). An allocation based upon square footage is consistent with the May 17, 2001 letter issued by HUD and accounting principles typically applied to fixed assets, including capital improvements.

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Comment 11

The MCHA's allocation of space was reviewed with the MCHA's auditor and was consistently followed and reflected in the 2002, 2003 and 2004 Annual Plans submitted to and approved by HUD. (Exhibits 14, 17, 21, and 15, 19 and 22, respectively). The MCHA allocated the actual office space to be occupied by Public Housing employees, Section 8 Program employees and its tenant, the Redevelopment Authority and 30% of that space was attributable to Public Housing. However, the proper allocation to capital fund, per HUD's direction was to take the building square footage, reduce the area that was not related to Public Housing Program use and divide that number by the total square footage.

Comment 11

Total Space	30,000
Section 8 Space	-4,128
RDA Space	-3,070
Basement - Maintenance	-968
Basement - Section 8 storage	-1,380
Other Rental Space	-4,823
Total Space Allocation for Public Housing	15,631

Comment 11

Total Space Allocation for Public Housing	Total Square Footage	Percent of Renovation Allocable to Capital Fund
15,631	30,000	52.1%

Comment 11

Total Renovation Cost	Percent Allocated to Public Housing	Allowable Cost from Capital Fund
$2,380,196	52.1%	$1,237,701.90

Comment 11

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Consequently, while the MCHA could have allocated fifty-two percent (52%) of the renovation cost or $1,237,701.90 to Public Housing, it only allocated thirty percent (30%) of the renovation cost or $752,175.00 to its capital fund because approximately 30% of the usable office space in the building was to be occupied by Public Housing staff. The OIG's allocation of only 6% of the space to the MCHA is simply not based in reality or upon appropriate accounting principals.

Comment 10

The six percent the OIG allocated to Public Housing appears to be based upon apportioning the individual salaries of those employees who divide their work time between

Comment 10

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Public Housing and Section 8 and then adding those apportioned sums to other Public Housing/Section 8 cost allocations. Although this may be an appropriate method for attributing general operating expenses to different HUD programs, the MCHA's method of accounting for capital expenditures was based upon accounting principles relating to fixed assets (including depreciation of those assets) and not on principles relating to allocation of operating expenses, which are the appropriate principals applied by the MCHA and reviewed by its independent auditor on an annual basis.

Comment 12

3. Response to Recommendations

The MCHA maintains that its use of capital funds for renovation of the Housing Center was both authorized and appropriate. The MCHA hopes that through discussions with HUD the parties can agree to an alternative resolution of this issue; however, the MCHA sees repayment to the U.S. Treasury of funds that were properly committed and expended on approved uses in a timely manner as an unreasonable proposal.

Comment 5

E. The MCHA Did Not Use HUD Funds to Pay Interest and Principal on the $1.2 Million Loan.

The MCHA has used a portion of its operating funds for monthly principal and interest payments on a loan for the cost of improvements to a building it owns and occupies. The OIG incorrectly and summarily concludes that all payments from the operating fund are HUD funds. Because these payments are no different legally or practically from rental payments that the MCHA made for its previous administrative offices, they should be permitted in the same manner.

Comment 5

1. The operating fund does not consist solely of HUD funds.

The MCHA's general operating funds include rental payments received from the RDA pursuant to its lease, and indirectly, from the Section 8 Program through the payment of its proportionate share of the principal and interest payments on the expense side of the ledger. In other words, the general fund does not consist solely of HUD funds, as the OIG Audit Report implies.

Comment 5

The RDA's rental payments have been, and continue to be, used to make principal and interest payments under the loan. The RDA leases 3,070 square feet on the second floor and pays an annual rent of $46,736.88. Over the four years of the lease to date, the RDA has paid the MCHA approximately, $186,947.52, which is more than the total interest payments on the loan to date, which the OIG calculated to be $178,708.[4]

Comment 5

2. Debt service payments should be treated the same as rental payments.

Additionally, the debt service payments being made by the MCHA are no different from the rental payments that it made for its prior offices, which were paid using a portion of its operating funds. If the MCHA were leasing space as a tenant rather than paying principal and

[4] Draft Audit Report at p. 12 n.12.

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interest as the property owner, funds for those rental payments would come from the MCHA's general operating fund. There is no rational or legal basis for treating debt service payments differently than rental payments.

3. The MCHA's independent auditor properly treated such payments separately from HUD funds and found no reportable conditions with the MCHA's payment of debt service on the loan.

Beginning with the MCHA's 2002 Audit Report, Mr. O'Neill discussed the mortgage debt for the Housing Center, identified the property as a business activity (rather than as a Public Housing activity), and created a "business activity" category on the financial reports prepared and furnished to HUD. (Exhibit 20). In that Audit Report, Mr. O'Neill issued his unqualified opinion that there were no reportable conditions in the MCHA's financial matters for 2002 and that those records complied with applicable statutory and regulatory requirements. Further, Mr. O'Neill had encouraged the MCHA to undertake the purchase as an advantageous business decision because of the ongoing expense for leasing space and the benefits of owning the real estate as a capital asset. (Exhibit 30).

4. Response to Recommendations

In addition to the RDA's rental payments, the Section 8 Program provides another source of payments for the debt service on the Commerce Bank loan. To date, the MCHA has been billing the Section 8 Program for its pro-rata portion of the loan payments using journal vouchers. As a result, that allocation has been reducing the monthly operating expenses of the MCHA. The MCHA could treat the Section 8 Program payments as rental payments for the space it occupies in the building, just as the RDA pays rent for its space, and then allocate some of that rental income towards the payment of debt service on the Commerce Bank loan.

F. The MCHA's Public Housing Program Has Not Suffered Because of Expenditures on the Housing Center.

The MCHA's Public Housing Department has been and continues to be a successful program and has not been adversely affected by the purchase, renovation and maintenance of the Housing Center. The MCHA has continued to serve its Public Housing residents well and has obtained funding from non-federal sources to perform numerous renovation projects over the past several years. In fact, the HUD recently awarded the MCHA's Public Housing Department with its ***thirteenth consecutive "High Performer"*** rating.

Additionally, since 2002 the MCHA has obtained (1) $617,848 in Community Development Block Grants from Montgomery County to waterproof the exterior of and replace 209 windows at Robert Smith Towers, one of the MCHA's elderly high rises, to replace 228 windows at Golden Age Manor, another of the MCHA's elderly high rises and to install a laundry facility at Bright Hope, one of the MCHA's family developments and (2) $631,540 from the Affordable Housing Trust Fund to remove and replace a rooftop HVAC unit and to install ductwork to increase ventilation and improve air quality on resident floors of Smith Towers and to replace windows and waterproof and repair the exterior of Marshall Lee Towers, another senior high rise.

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G. Conclusion

In sum, the MCHA, its directors, officers and administrators have at all times acted openly and in the best interests of the MCHA and the communities that it serves. The MCHA is confident that it has not breached any contractual or regulatory obligation and that any perceived issue with respect to use of funds will be resolved upon further discussion with the Department. The MCHA looks forward to resolving this matter in an amicable and expeditious manner.

Very truly yours,

KENNETH A. ROOS
Solicitor

cc: MCHA Board of Directors
Ronald Jackson, Executive Director

OIG Evaluation of Auditee Comments

Comment 1 The audit was performed in accordance with generally accepted government auditing standards and the conclusions in the report are supported by relevant and substantial evidence documented in the audit workpapers. As such, the audit team collectively possessed adequate professional proficiency for the tasks required and was properly supervised. The audit evidence showed that the Authority violated its consolidated annual contributions contract by improperly acquiring a loan using HUD assets as collateral and by improperly using HUD funds to purchase, renovate and maintain its 104 West Main Street office building. Overall, the Authority's written reply submitted by its legal counsel contains numerous inaccuracies concerning the audit results and conclusions discussed in the audit report. As such, it raises serious concerns as to whether the Authority is truly committed to correcting the problems the audit identified.

Comment 2 Counsel's response regarding the Authority's use of Homeownership proceeds is inaccurate and contrary to the audit evidence. Counsel correctly cites HUD regulations which provide that net sales proceeds be used for purposes related to low-income housing and in accordance with its Homeownership Plan. However, in its response counsel ignores relevant and substantial audit evidence, which showed that the Authority violated the same regulations it is citing. The audit evidence showed the Authority's Homeownership Plan and the Implementing Agreement between the Authority and HUD did not in any way identify the purchase, renovation and upkeep of the 30,000-square-foot office building as one of its intended uses. Further, counsel's assertion that the Authority always intended to use the entire building to assist low-income families is contrary to the audit evidence. The audit evidence clearly showed the building has been mostly vacant since the Authority purchased it in November 1999 and the Authority has been unsuccessfully attempting to lease at least 4,800 square feet of the property commercially. The Authority's counsel confirmed this fact in a May 2005 letter to HUD in which it was responding to an annonymous complaint regarding issues surrounding the appropriateness of the Authority's purchase of the property. In the letter counsel stated that since at least May 2003, the Authority was attempting to lease out vacant office space in the building using commercial real estate brokers. We reviewed the Authority's listing agreement for the property with its commercial real estate broker, and the agreement succinctly stated that the Authority would pay a brokers fee if a ready, willing and able tenant or buyer was found by the broker or by anyone, including the owner during the term of the contract. The agreement defined a willing tenant as one who would pay the listed rent or more for the property and it did not restrict use of the property to low-income housing related activities.

Comment 3 As explained in the audit report, the Authority is incorrect in its assertion that its main administrative office was not a project asset covered by its consolidated annual contributions contract. As counsel correctly states in its reply, Section 2 of the consolidated annual contributions contract specifically states that the term "project" includes all real and personal property, tangible and intangible, which is acquired or held by the Authority in connection with a project under the consolidated annual contributions contract. In this regard, the Authority purchased 104 West Main Street, Norristown, Pennsylvania, to be used as the main office of its executive staff and Section 8 department, clearly holding the property in connection with a project under its consolidated annual contributions contract. Further, the Authority used a significant amount of HUD capital funds to renovate the building. Since capital funds have been heavily invested in the building and it is clearly being held by the Authority in connection with a project under its consolidated annual contributions contract, it is clearly a project asset. It is important to reemphasize that as of August 2006, the Authority owed more than $1.1 million on the loan, placing significant HUD assets at risk as a result of this violation.

Comment 4 HUD did in fact approve the Authority's annual plans, which included some rehabilitation of the Main Street building, which it listed in the plans as its Resource Center. However, the approval was contingent upon the Authority complying with applicable HUD regulations. In this regard, regulations at 24 CFR [*Code of Federal Regulations*] 968.112 require that public housing modernization funds only be used when the applicable costs can be directly attributed to public housing. HUD regulations also provide that net Homeownership proceeds be used for purposes related to low-income housing and in accordance with its Homeownership Plan. The audit evidence showed however, that the Authority did not comply with these applicable HUD regulations in regard to its usage of HUD funds. Further, HUD's approval letters to the Authority explicitly stated that the approval of the plans did not contitute an endorsement of the Authority's strategies and policies.

Comment 5 The Authority could not provide support showing that its payments for principal and interest on this loan were made from nonfederal funds. The audit did not summarily conclude that all payments from the operating funds are HUD funds as the Authority's counsel mistakenly asserts. If the Authority's operating funds also contained rental payments from the Redevelopment Authority, it could not provide support to substantiate this or that its payments for principal and interest on this loan were made from these funds or any other non-HUD funds. Since the Authority only used one-third of the building for purposes related to its consolidated annual contributions contract we estimated it should only use HUD funds to pay one-third of the interest on the loan. In calculating our estimate we multiplied total interest paid of $178,708 by two-thirds. Therefore, the audit conservatively estimated that the Authority could not support that it properly paid $119,139 in prior interest payments with non-HUD funds. Additionally, it is important to note, the Authority also paid an additional $151,904 in prior principal on the loan from the operating funds which reasonably, the Authority also should be able to support. Nevertheless, unsupported costs may require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, may involve a legal interpretation or clarification of departmental policies and procedures.

Comment 6 The audit evidence showed that the Authority violated its consolidated annual contributions contract by improperly acquiring a loan using HUD assets as collateral and by improperly using HUD capital funds and homeownership proceeds to purchase, renovate and maintain its 104 West Main Street office building. The intent of this particular audit was not to perform a detailed review of the work of the Authority's independent auditors. However, as part of our continuing charter to perform Quality Assurance Reviews of Independent auditors performing work for housing authorities receiving HUD funds, we respectfully reserve the right to do so in the future.

Comment 7 The audit determined that the Authority could not support that it used $975,900 in Homeownership program proceeds for purposes related to its low-income housing or its homeownership plan in accordance with HUD regulations. Unsupported costs may require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, may involve a legal interpretation or clarification of departmental policies and procedures.

Comment 8 We have made our recommendations to the Philadelphia Office of Public Housing based on our evaluation of relevant and substantial audit evidence. Nevertheless, we will consider approving alternative suggestions meeting the intent of our recommendations after they are fully evaluated and provided the alternatives are agreed to and proposed by the Philadelphia Office of Public Housing.

Comment 9 Counsel's response regarding the Authority's use of its capital funds is inaccurate and contrary to the audit evidence. HUD did in fact approve the Authority's annual plans, which included some rehabilitation of the Main Street building, which it listed in the plans as its Resource Center. While HUD did in fact approve the Authority's annual plans, the approval was contingent upon the Authority complying with all applicable HUD regulations. In this regard, regulations at 24 CFR [*Code of Federal Regulations*] 968.112 state that public housing modernization funds can only be used when the costs can be directly attributed to public housing. The regulation specifically states that when the physical or management improvement, including administrative cost, will benefit programs other than public housing, such as Section 8 or local revitalization programs, eligible costs are limited to the amount directly attributable to the public housing program. Further, in a letter, dated May 17, 2001, HUD stated that it understood the Authority was planning to rent to other housing agencies in Montgomery County. HUD warned the Authority at that time that the use of capital funds is prohibited for nonrelated public housing program use. As such, the space in the building that was not related to public housing program use should not have been renovated using capital funds.

Comment 10 As stated in the audit report, the building is in fact a project asset and therefore, capital funds may therefore be used to renovate portions of the building relating to public housing. That being said, counsel's assertion that the audit report does not explain the allocation of cost to the public housing program is not quite accurate and is contrary to the audit evidence and the facts presented in the audit report. As detailed in the audit report, the Authority improperly used $609,363 in capital funds to renovate its 104 West Main Street office building when it did not ensure that the capital funds spent directly benefited its public housing program. The Authority's operating budgets for 2003, 2004, and 2005 indicated that it prorated square footage between its Section 8 and Public Housing programs for allocation of office rent. On average, the Authority allocated 81 percent to Section 8 and 19 percent to Public Housing over the three years. In 2005, 82 percent and 18 percent were allocated to Section 8 and Public Housing respectively. Considering this information, and based on the fact that the entire Authority only occupied one-third of the office building, we estimated the Authority used approximately 1,800[*] square feet or 6 percent of the 30,000-square-foot building (including applicable common areas) for public housing purposes. Therefore, only $142,812 (6 percent) of the more than $2.38 million total renovation costs for the building was eligible to be paid for with capital funds. Since the Authority spent $752,175 in capital funds to renovate the building, the use of $609,363 of the funds was ineligible. We have revised and included additional wording in the report to further clarify how we determined the capital funds eligible to be used for the Authority's renovation costs.

Comment 11 Counsel's calculations that 52 percent of the building could be allocated for the public housing program is erroneous and not supported by the audit evidence. Additionally, counsel's assertion that the Authority had approval from HUD to spend the $752,175 in capital funds to renovate the building is also not supported by the audit evidence as detailed in the audit report.

Comment 12 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. We have classifed these funds as ineligible expenditures because the Authority violated regulations at 24 CFR [*Code of Federal Regulations*] 968.112 which require that public housing modernization funds can only be used when the costs can be directly attributed to public housing. The regulation specifically states that when the physical or management improvement, including administrative cost, will benefit programs other than public housing, such as Section 8 or local revitalization programs, eligible costs are limited to the amount directly attributable to the public housing program.

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[*] 1,800 square feet = 18% x10,000 square feet (one third of the total 30,000 square feet)

Comment 13 As stated in the audit report, the audit evidence showed that the Authority's use of ineligible capital funds to renovate its main office building diverted funds from planned public housing repair projects. These repairs included potential health and safety issues such as gas line replacement, sidewalk repairs, and handrail replacement in a senior citizen complex. Some of these projects are still not complete, and some have been cancelled due to lack of available funding.