



Issue Date
June 6, 2005

Audit Report Number
2005-PH-1012

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

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

SUBJECT: The Lycoming County Housing Authority, Williamsport, Pennsylvania, Risked
HUD Assets for the Benefit of Its Affiliated Nonfederal Entity

HIGHLIGHTS

What We Audited and Why

We audited the Lycoming County Housing Authority (Authority) in response to a referral from the U.S. Department of Housing and Urban Development's (HUD) Pennsylvania State Office, Office of Public Housing. Our audit objective was to determine whether the Authority properly used HUD funds to develop and support its affiliated nonfederal entity.

What We Found

Although the Authority properly allocated direct and indirect costs to its nonfederal entity, it violated its annual contributions contract with HUD by guaranteeing a \$3.5 million line of credit with HUD assets to help support the nonfederal entity. As of March 2005, the Authority owed \$2.9 million on this line of credit, placing significant HUD assets at risk. This occurred because the Authority erroneously believed that a disposition agreement approved by HUD granted it permission to use HUD funds to support its affiliated nonfederal entity.

What We Recommend

We recommend that the Director, Office of Public Housing, Pennsylvania State Office, notify the Authority that it has improperly encumbered annual contributions contract assets and direct it to provide evidence within the next 30 days that the financial instruments encumbering the assets have been changed to exclude the assets and, thereby, put \$2.9 million to better use. We further recommend that if the Authority does not withdraw its encumbrances of annual contributions contract assets, the Director, Office of Public Housing, Pennsylvania State Office, should advise HUD Headquarters that the Authority is potentially in substantial default of its annual contributions contract and request that it send a notice of default to the Authority.

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 Authority waived our formal exit conference on May 26, 2005, and provided written comments to our draft report on May 27, 2005. The Authority agreed to review the financial instruments the audit determined encumbered HUD assets and stated it would make changes required to ensure that HUD assets are not at risk. The complete text of the Authority's response can be found in Appendix B of this report.

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BACKGROUND AND OBJECTIVES

The Lycoming County Housing Authority (Authority) was established in 1948 under the Municipal Authorities Act of the Commonwealth of Pennsylvania to provide affordable housing for qualified individuals in accordance with the rules and regulations prescribed by the U.S. Department of Housing and Urban Development (HUD). A five-person board of directors appoints the Authority's executive director and governs the Authority. The executive director during the audit, who had been serving in this position for more than five years, was Elizabeth Turner. The Authority's main administrative office is located at 1941 Lincoln Drive, Williamsport, PA.

The Authority currently owns and operates 362 public housing units under its annual contributions contract with HUD. The annual contributions contract defines the terms and conditions under which the Authority agrees to develop and operate all projects under the agreement. HUD authorized the Authority the following financial assistance from fiscal years 2002 to 2004:

- \$880,000 operating subsidy to operate and maintain its housing developments,
- \$1.9 million Public Housing Capital Fund program to modernize public housing units, and
- \$3 million to provide housing assistance through tenant-based Section 8 vouchers.

In 1997, the Authority created a nonfederal entity known as the Lycoming Housing Finance, Incorporated. The Authority formed this nonprofit corporation in an effort to increase housing opportunities to low-income families throughout Lycoming County. A board of directors, consisting of three members who also serve on the Authority's board of directors, presides over the corporation. The Authority shares management and office space with the corporation. The Authority's executive director also serves as the chief executive officer of the Lycoming Housing Finance, Incorporated, and is the nonvoting board secretary of both organizations.

Federal regulations¹ allow HUD to approve the disposition of real property of a project in whole or in part. In accordance with federal regulations, the Authority proposed to transfer 138 of its public housing units to the Lycoming Housing Finance, Incorporated, instead of rehabilitating the units and continuing to maintain them. HUD approved the Authority's request to dispose of the 138 units in April 2000. The Lycoming Housing Finance, Incorporated, currently owns and operates 216 units of low-income housing.

The overall objective of our audit was to determine whether the Authority properly used HUD funds to develop and support its affiliated nonfederal entity.

¹ 24 CFR [*Code of Federal Regulations*] 970.9

RESULTS OF AUDIT

Finding 1: The Authority Improperly Guaranteed a \$3.5 Million Line of Credit with HUD Assets to Support Its Nonfederal Entity

The Authority improperly encumbered HUD assets and violated its annual contributions contract by using HUD assets to guarantee a \$3.5 million line of credit to support its affiliated nonfederal entity known as the Lycoming Housing Finance, Incorporated. This occurred because the Authority erroneously believed that a disposition agreement approved by HUD granted it permission to use HUD assets to secure the line of credit it used to support its affiliated nonfederal entity. By withdrawing its encumbrances of annual contributions contract assets, the Authority can ensure that HUD assets valued at \$2.9 million² are not at risk.

The Authority Improperly Guaranteed \$3.5 Million with HUD Assets

The Authority violated its annual contributions contract by guaranteeing a \$3.5 million line of credit starting in September 2000. The Authority obtained this line of credit from a bank and used it to support its affiliated nonfederal entity known as the Lycoming Housing Finance, Incorporated. In so doing, the Authority placed federal funds at risk by improperly encumbering assets covered by its contributions contract without prior approval from HUD. As of March 2005, the Authority owed \$2.9 million on the bank 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.³ 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 contributions contract.⁴ Nevertheless, we found the Authority improperly encumbered and placed HUD assets at risk.

We discussed these problems with the executive director during the audit, and she informed us that she believed the disposition agreement approved by HUD granted the Authority permission to use HUD assets to secure the line of credit. However, we found that nothing in the agreement granted the Authority permission to use HUD assets to guarantee the line of credit it used to support the Lycoming Housing Finance, Incorporated. By withdrawing its encumbrances of annual contributions

² Balance on bank loan as of March 1, 2005

³ Part A, section 7, of the annual contributions contract, Covenant against Disposition and Encumbrances

⁴ Part A, section 17, Notices, Defaults, Remedies

contract assets, the Authority can ensure that HUD assets valued at \$2.9 million are not at risk.

Recommendations

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

- 1A. Notify the Authority that it has improperly encumbered annual contributions contract assets and direct it to provide evidence within the next 30 days that the financial instruments encumbering the assets have been changed to exclude the assets and, thereby, ensure that HUD assets valued at \$2,888,300 are not at risk.
- 1B. If the Authority does not withdraw its encumbrances of annual contributions contract assets, advise HUD Headquarters that the Authority is potentially in substantial default of its annual contributions contract and request that it send a notice of default to the Authority.

SCOPE AND METHODOLOGY

We performed an audit of the Lycoming County Housing Authority, located in Williamsport, Pennsylvania. The audit was conducted from December 2004 through April 2005 in accordance with generally accepted government auditing standards and included tests of internal controls that we considered necessary under the circumstances.

The audit covered transactions representative of operations current at the time of the audit and included the period January 2002 through September 2004. We expanded the scope of the audit as necessary. We reviewed applicable guidance and discussed operations with management and staff personnel at the Lycoming County Housing Authority and key officials from HUD's Pennsylvania State Office.

To determine whether the Authority properly used HUD funds to develop and support its affiliated nonfederal entity, we

- Reviewed all documentation provided by the Authority related to our audit objective, including partnership agreements, legal documents, financial statements, general ledgers, bank statements, bank loan agreements, related correspondence, payment vouchers, and minutes from board meetings.
- Reviewed the Authority's and the Lycoming Housing Finance, Incorporated's available independent auditor's reports for fiscal years 2002 and 2003.
- Reviewed HUD and Authority correspondence related to the audit and results of monitoring reviews HUD's Pennsylvania State Office conducted.
- Obtained and reviewed the legal opinion of the counsel to the inspector general regarding issues identified during the audit.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

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

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- The Authority did not prevent annual contributions contract assets from being encumbered or risked without HUD approval.

Appendixes

Appendix A

FUNDS TO BE PUT TO BETTER USE

Recommendation Number	Funds to Be Put to Better Use 1/
1A	\$2,888,300

- 1/ “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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION



1941 Lincoln Drive • Williamsport, PA 17701
(570) 323-3755 • Fax (570) 323-5230

May 27, 2005

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

RE: Draft Audit Report

Dear Mr. Temme:

I have reviewed the copy of the Lycoming County Housing Authority draft audit report dated May 23, 2005 furnished by your office.

It is our position that we have not inappropriately encumbered HUD assets. We will, however, within the next 30 days, review all loan and other documents under discussion. Should we find that the documents contain language that could potentially risk or be perceived to risk HUD assets, we will take the following steps to correct those documents:

1. We will review the documents with our legal staff and the legal staff of the lender.
2. We will have any language that could potentially risk HUD assets removed from said documents.
3. We will ensure that all documents have been changed and no HUD assets are encumbered presently or in the future.
4. We will ensure the only collateral for said loans is the physical property by which the mortgage(s) are secured.

Further, all of the physical property units referred to in the draft report were removed from our Annual Contributions Contract (ACC) in August 2000. Therefore, the physical property no longer is classified a HUD asset.

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Draft Audit Response
Lycoming County Housing Authority
May 27, 2005

Thank you for your consideration. We will keep you informed of our progress in correcting any deficiencies we find.

Sincerely,



Elizabeth A. Turner
Executive Director

Cc: John P. Buck, Assistant District Inspector General for Audit
Debra A. Braun, Auditor
John Bonner, Esq., Solicitor for Lycoming County Housing Authority
Henry Frey, Jr., Chairman, Lycoming County Housing Authority Board