Issue Date
January 10, 2006
Audit Report Number
2006-PH-1005

TO: James D. Cassidy, Director, Office of Public Housing, Pittsburgh Field Office, 3EPH

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

SUBJECT: The Housing Authority of the County of Butler, Butler, Pennsylvania, Used HUD Assets Improperly to Develop and Support Its Nonfederal Entities

HIGHLIGHTS

What We Audited and Why

We audited the Housing Authority of the County of Butler's (Authority) administration of its affiliated nonfederal entities. We performed the audit as part of our fiscal year 2005 audit plan. Our audit objective was to determine whether the Authority properly used HUD assets to develop and support its affiliated nonfederal entities.

What We Found

The Authority used HUD assets improperly to develop and support its affiliated nonfederal entities. It violated its annual contributions contract with HUD by improperly using HUD assets as collateral to obtain two lines of credit totaling $1.1 million. As of August 2005, the Authority owed $888,792 on the lines of credit, placing significant HUD assets at risk. The Authority also did not properly record these loans in its financial records. These problems occurred because the

Authority erroneously believed it could use HUD assets to support and develop its affiliated nonfederal entities.

Additionally, the Authority did not properly allocate all applicable salary costs to its nonfederal entities, contrary to its annual contributions contract. As a result, from January 2002 to May 2004, the Authority improperly paid salaries estimated at $205,875 from federal funds for work its employees performed for its nonfederal entities. This occurred because the Authority did not have adequate internal controls in place to ensure it properly identified the source and allocation of its funds.

What We Recommend

We recommend that the director, Office of Public Housing, Pittsburgh field office, notify the Authority that it improperly encumbered annual contributions contract assets and direct it to modify the financial instruments to exclude the assets. If the Authority does not withdraw the encumbrances of annual contributions contract assets, we recommend that the director 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. We also recommend that HUD require the Authority to accurately and completely record its loans in its financial records.

Additionally, we recommend that HUD require the Authority to recover $205,875 from its nonfederal entities for employee expenses not properly allocated to its nonfederal entities and to develop a reasonable method for allocating future salaries and expenses.

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 December 15, 2005. The Authority provided written comments to our draft findings on December 22, 2005. The Authority generally agreed with our recommendations to remove the encumbrance of HUD assets and to properly allocate costs but disagreed with portions of our questioned costs. 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 Housing Authority of the County of Butler (Authority) was established in 1965 under the Housing Authorities Law of the Commonwealth of Pennsylvania. The Authority entered into an annual contributions contract in 1966 with the U.S. Department of Housing and Urban Development (HUD) and agreed to provide affordable housing for qualified individuals in accordance with the rules and regulations prescribed by HUD. The Authority's main administrative office is located at 114 Woody Drive, Butler, Pennsylvania.

The Authority owns and operates 466 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:

- $1.6 million operating subsidy to operate and maintain its housing developments,
- $1.7 million Public Housing Capital Fund program to modernize public housing units, and
- $17 million to provide housing assistance through tenant-based Section 8 vouchers.

The Authority reported nine affiliated nonfederal entities in its financial statements. The Authority's chairman and executive director also serve as officers for eight of these entities. The Authority formed these corporations in an effort to increase affordable housing opportunities throughout Butler County and it provides management and consulting services for the entities. In addition, the Authority is the developer, management agent, and service provider for the 139 housing units associated with these entities.

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

RESULTS OF AUDIT

Finding 1: The Authority Improperly Used HUD Assets as Collateral on Lines of Credit of $1.1 Million

The Authority violated its annual contributions contract[1] with HUD by improperly acquiring two lines of credit totaling $1.1 million with HUD assets. As of August 2005, the Authority owed $888,792[2] on the lines of credit, placing significant HUD assets at risk. The Authority did not record these loans on its books and used the lines of credit to develop and support its affiliated nonfederal entities without HUD's approval. These problems occurred because the Authority erroneously believed it could use HUD assets as collateral on debt used to support and develop the affiliated nonfederal entities.

The Authority Put $1.1 Million in HUD Assets at Risk

The Authority violated its annual contributions contract by securing two lines of credit totaling $1.1 million with HUD assets. It obtained these lines of credit from a bank and used them to support seven affiliated nonfederal entities. It used its administrative offices as collateral for a $554,000 line of credit in October 2003 and obtained a second $580,000 line of credit on its offices in March 2005, increasing the amount of HUD assets used as collateral to $1.1 million. Since the offices were purchased using HUD funds, the Authority placed federal funds at risk by improperly encumbering assets covered by its contributions contract. As shown below as of August 2005, the Authority owed $888,792 on the bank loans, placing significant HUD assets at risk.

Nonfederal entity	Property	Loan balance
Historic Lafayette Associates Historic Lafayette, Inc.	Historic Lafayette Apartments	$333,292
Rolling Road Regency L.P.; Regency Associates, LLC; Butler Area Housing and Community Development Corp.	Rolling Road Apartments	$145,000
Redevelopment Authority of the County of Butler	Vacant lot	$310,000
Butler County Homeownership Corporation	Two single family homes for resale	$100,500
Total		**$888,792**

[1] Annual contributions contract, part A, section 7, "Covenant against Disposition and Encumbrances."
[2] Balance on bank loan as of August 2005.

The annual contributions contract prohibits the Authority from encumbering or pledging its HUD assets without HUD's prior approval. 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[3]. Also, the annual contributions 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 HUD[4]. The Authority failed to file a declaration of trust when it acquired its administrative offices, and it later improperly encumbered and placed significant HUD assets at risk.

We discussed these problems with the executive director and he stated that based on the advice of the Authority's counsel, he believed that the Authority was permitted to use its administrative offices as collateral on the lines of credit. However, he acknowledged that he now concurs that the Authority's administrative offices were encumbered as collateral for the lines of credit. He further stated he would take actions necessary to remove the encumbrances.

The Authority Did Not Properly Record the Loans in Its Books

As previously discussed the Authority owed $888,792 on two lines of credit that it used to develop and support its nonfederal entities, placing significant HUD assets at risk. In addition to placing HUD assets at risk, the Authority failed to record these loans in its financial records.

The Authority violated 24 CFR [*Code of Federal Regulations*] 85.20[5]and its annual contributions contract with HUD by failing to report these loans on its books. It is required to maintain complete and accurate books and to maintain effective control and accountability for all grant cash, real and personal property, and other assets to safeguard and assure they are used solely for authorized purposes. The Authority did not ensure the lines of credit it obtained and used for development of its nonfederal entities were properly recorded or disclosed to HUD.

When we discussed these problems with the Authority, the comptroller informed us that the funds from the lines of credit were used for a program that pays all principal and interest. He stated that since that program guarantees the repayment, the Authority makes no entries in its financial records. However, our audit showed that the Authority violated 24 CFR 85.20 and its contributions contract

[3] Annual contributions contract, part A, section 17, "Notices, Defaults, Remedies."
[4] Annual contributions contract, part A section 8, "Declaration of Trust."
[5] 24 CFR [*Code of Federal Regulations*] 85.20, "HUD's Standards for Financial Management Systems."

with HUD by not properly disclosing the loans in its financial statements and by improperly risking HUD assets.

Recommendations

We recommend that the director, Office of Public Housing, Pittsburgh field office

1A. Notify the Authority that it has improperly encumbered 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 $888,792 to better use.

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.

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

1D. Require the Authority to accurately and completely record loans in its financial records and properly report its loan balances in its financial statements.

Finding 2: The Authority Did Not Properly Allocate All Relevant Salary Costs to Its Affiliated Nonfederal Entities

The Authority used federal funds improperly to support its affiliated nonfederal entities. It did not properly prepare personnel activity reports or equivalent documentation to support services provided by its executive director, management staff, accounting personnel, and staff members contrary to its consolidated annual contributions contract[6] and Office of Management and Budget Circular A-87[7]. These improper practices occurred because the Authority did not have adequate internal controls in place to ensure it properly identified the source and allocation of its funds. As a result, the Authority improperly paid $205,875 from federal funds from January 2002 through May 2004 for salary and benefits for Authority employees who worked to support its nonfederal housing developments.

The Authority Improperly Used $205,875 in Federal Funds

The Authority improperly paid $205,875 from federal funds from January 2002 through May 2004 for salary and benefits of Authority employees who worked to support its nonfederal housing developments. The improper payments occurred because the Authority's internal controls did not ensure that it properly prepared personnel activity reports or equivalent documentation to support services provided by the executive director, management staff, accounting personnel, and staff members. This practice was contrary to the Authority's consolidated annual contributions contract and Office of Management and Budget Circular A-87.

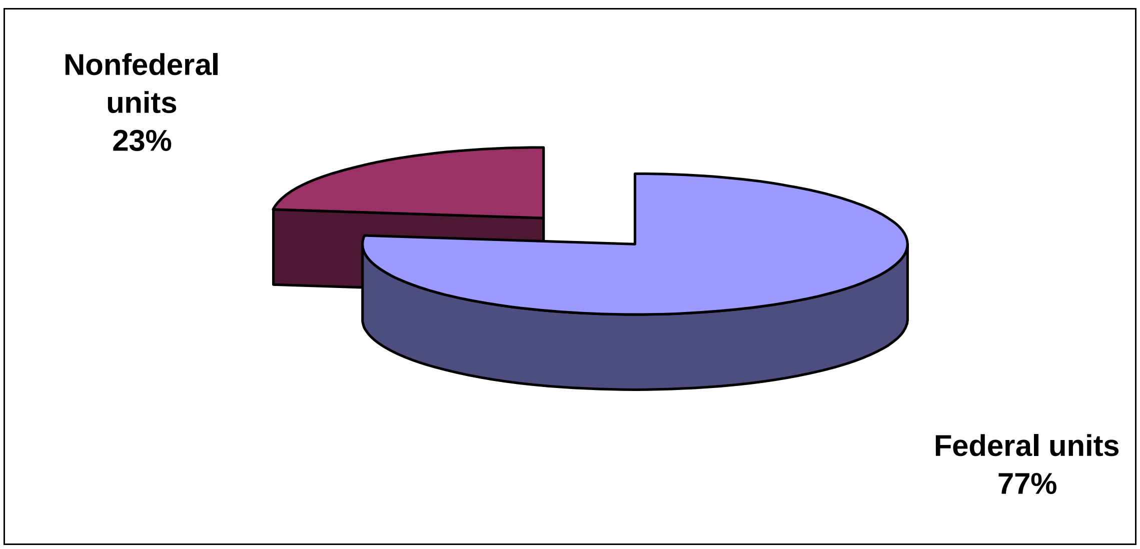
The Authority's annual contributions contract with HUD requires it to maintain records that identify the source and allocation of its funds. This key management control is critical to ensuring the Authority spends federal funds, provided through its annual contributions contract, only in accordance with the regulatory requirements of each specific federal program. Further, the contract specifies that the Authority can only withdraw federal funds for the payment of costs associated with the development and operation of projects under its annual contributions contract or other projects specifically approved by HUD. Thus, when employees work on multiple programs, a distribution of salaries should be supported by personnel reports or equivalent documents.

The Authority's cost allocation procedures from 2002 through 2004 consisted of allocating costs to each program based on a budgeted estimate of the time spent

[6] Annual contributions contract, part A, section 9, "General Fund" – The Authority may withdraw funds from the general fund only for projects covered under the annual contributions contract.
[7] Office of Management and Budget Circular A-87 revised May 4, 1995, as further amended, August 29, 1997, attachment B, paragraph 11 (h) (5), "Personnel Activity Reports."

by each employee on a particular program. A total of $96,290 was budgeted in 2002 and 2003 for employees performing services for the nonfederal entities. However, the Authority could not provide support for its budget estimate and its procedures were not in accordance with Office of Management and Budget Circular A-87, which requires a distribution of salaries or wages to be supported by personnel activity reports or equivalent documentation. The circular further states that budget estimates do not qualify as support other than on an interim basis, and that quarterly budgets should be compared to actual costs based on monthly activity reports. The monthly activity reports must account for the total activity for which the employee is compensated.

In this regard the Authority could not provide personnel activity reports or other equivalent documentation to support its budget estimates and did not perform quarterly reconciliations. Since the Authority could not provide documentation to support services provided by the executive director, management staff, accounting personnel, and staff members, we estimated the total salary and fringe benefits that the low-income housing fund paid to support the nonfederal entities. Our estimate was calculated by multiplying the total salary and benefits costs paid to 12 individuals we identified as having worked on both the federal and the nonfederal programs by the percentage the nonfederal units comprised of the total units under the Authority's management. We found the Authority managed 605 low-income housing units and that 139 of these units were not covered by its annual contributions contract. As illustrated below, the percentage of employee salaries that should have been allocated to the nonfederal entities was 23 percent (139 nonfederal units divided by 605 total units).



The Authority's accounting records showed that total salaries and benefits paid to the applicable individuals from January 2002 through May 2004 totaled $1,313,761. We calculated the unsupported payments to be $302,165 because the nonfederal units under management accounted for 23 percent of the Authority's total units. However, since the Authority allocated $96,290 in 2002 and 2003 to its nonfederal entities, we reduced the unsupported payments to $205,875. Additionally, by ensuring it allocates and settles expenses related to its nonfederal affiliated entities on a quarterly basis, the Authority would put $85,190 to better use annually[8].

The Authority's executive director was aware of the requirements for allocating costs in Office of Management and Budget Circular A-87. However, he acknowledged the Authority's recordkeeping was not adequate to properly allocate costs to its nonfederal entities. He assured us that the Authority would take steps to ensure it did not use HUD funds to support non-HUD projects.

Recommendations

We recommend that the director, Office of Public Housing, Pittsburgh field office

2A. Direct the Authority to provide adequate documentation to support the $205,875 identified in the report or reimburse its public housing program from nonfederal sources.

2B. Require the Authority to develop a reasonable method for allocating salaries and expenses to its nonfederal affiliated entities and ensure that they are allocated and settled at least on a quarterly basis and, thereby put $85,190 to better use.

[8] The $85,190 in funds to be put to better use was calculated by dividing the $205,875 by 29 months and multiplying by 12 months for fiscal year 2005 since no allocation of nonfederal entity expenses was recorded.

SCOPE AND METHODOLOGY

We performed an audit of the Authority, located in Butler, Pennsylvania. The audit was conducted from June through October 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 August 2005. We expanded the scope of the audit as necessary. We reviewed applicable guidance and discussed operations with management and staff personnel at the Authority and from HUD's Office of Public Housing, Pittsburgh field office.

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

- Reviewed all documentation provided by the Authority related to our audit objective, including partnership agreements, legal documents, financial statements, general ledgers, bank loan agreements, related correspondence, time sheets, journal entries, salary expenses, operating budgets, and minutes from board meetings.

- Reviewed the Authority's, Historic Lafayette Associates' and Chicora Commons Limited Partnership's available independent auditor's reports for fiscal years 2003 and 2004.

- Reviewed HUD and Authority correspondence related to the audit and results of monitoring reviews HUD's Pittsburgh Office of Public Housing 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.

- Proper allocation of costs to affiliated nonfederal entities.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

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

- The Authority did not properly allocate costs to its affiliated nonfederal entities.

- The Authority did not record these loans on its books.

Appendixes

Appendix A

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

Recommendation number	Unsupported costs 1/	Funds to be put to better use 2/
1A		$888,792
2A	$205,875	
2B		$ 85,190
Total	$205,875	$973,982

1/ 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.

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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

HOUSING AUTHORITY COUNTY OF BUTLER

EXECUTIVE DIRECTOR:
PERRY O'MALLEY

COMMISSIONERS:
ROBERT J. HARTNETT, CHAIRMAN
MARGARET M. CLAWSON, VICE-CHAIRWOMAN
ERMA J. MOWRY
GEORGE MICHAEL KELLY
ELIZABETH ESCHENFELDT

December 22, 2005

Mr. John Buck, RIGA
Department of Housing & Urban Development
Office of Inspector General/Office of Audit
The Wanamaker Building
100 Penn Square East - Room 1005
Philadelphia, PA 19107-3380

RE: Draft Audit 2006-PH-xxxx

Dear Mr. Buck:

As discussed during the exit conference conducted by telephone on December 15, 2005 regarding the Draft Audit report for the Housing Authority of the County of Butler, I am taking this opportunity to address the findings for your consideration prior to the issuance of the final Audit Report.

Finding 1 –

Comment 1 Page 4. – Please be advised while our independent auditor mistakenly identified nine non-federal entities, we again bring to your attention that we have only five (5). Attached you will find correspondence to your Auditors.

Comment 2 Page 5 – Two Lines of Credit. We did in fact use our administrative offices as collateral. We did this due to the fact that 60% of the cost of the administrative office were non-HUD funds or approximately $800,000.

We are in the process of terminating both lines of credit and will remove the encumbrance of this asset.

The Authority will request permission from HUD to use our administrative office for affordable housing development purposes.

Page 7 – 1d. The Authority will record all loans and report balances in future financial statements.

114 WOODY DRIVE • BUTLER, PA 16001

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www.housingauthority.com • e-mail: bcha@housingauthority.com

Mr. John Buck
Page Two
December 22, 2005

Finding 2 -

Comment 3

Page 8 - The Authority does not agree it improperly used federal funds to support affiliated non-entities for the following reasons:

Comment 4

In addition to the information supplied to your auditors, we are researching extensive documents with regard to work orders and other various documentation that will eliminate this amount.

In any case, we dispute the formula used to determine the ineligible amount. Please consider the following for your final report calculations:

Comment 5

Chicora Commons – DOFO – April 2000, 27 units
Historic Lafayette – DOFO – February 2003, 62 units
Rolling Road - DOFO – December 2004, 50 units

The total unit months are substantially less during your audit period. We believe your auditors inadvertently used all three developments as being on line.

Our calculations indicate (using your auditor's formula) that a total reimbursement to the Housing Authority would be $145,419 less actually paid $96,290 showing a worse case scenario of $49,129.

Comment 6

Additionally, your audit indicates 12 staff members. Please note and consider the following:

During the development stage (pre-occupancy) only four (4) staff consisting of the Executive Director, Comptroller, Executive Secretary and Resident Initiatives/Planning Development Coordinator are involved in non-HUD affordable housing development initiatives and for relatively insignificant amounts of time.

After occupancy, as noted above, the Executive Director and Comptroller have minimal involvement. While the Operations Manager and maintenance staff's involvement is documented by work orders and have non-HUD charge offs.

It should also be pointed out that the Authority Board of Directors has adopted OMB Circular A-87 on July 8, 2005.

Finally, we appreciate the professionalism and courtesy extended by your staff during this audit and look forward to your consideration of the above in your final audit report.

Sincerely,

HOUSING AUTHORITY OF
THE COUNTY OF BUTLER

Perry O'Malley

Perry O'Malley
Executive Director

POM/kd

enclosures

HOUSING
AUTHORITY
COUNTY OF
BUTLER

MEMORANDUM

To Debra Braun, Office of OIG
Amy Edison, Office of OIG

From Perry O'Malley, Executive Director

Date June 28, 2005

Re Requested Information

Attached you will find a listing with an explanation of the non-federal entities discussed with you on June 24, 2005:

Please advise me immediately of any deficiencies with regard to your request and this response.

10/File

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Comment 1

Non-Entities
Housing Authority of the County of Butler

1. **Butler Area Housing Rehabilitation, Inc. (501 c 4 non-profit)**
   - Chicora Commons Limited Partnership

2. **Butler Area Homeownership Corporation (501 c 3 non-profit)**

3. **Butler Area Housing and Community Development Corporation (501 c 3 non-profit)**

   Two subsidiaries:

   - **Regency Associates, LLC (** the General Partner**)**
     - Rolling Road Regency Limited Partnership
   - **Historic Lafayette, Inc. (**the General Partner**)**
     - Historic Lafayette Associates (the Limited Partner)

OIG Evaluation of Auditee Comments

Comment 1 The Authority does not dispute that it reported nine affiliated nonfederal entities in the audited financial statements it submitted to HUD. The Authority is now stating however, that its independent auditors mistakenly identified nine nonfederal entities when in fact it has five. Our review of documentation provided by the Authority such as partnership agreements, tax credit applications, bylaws, and board minutes also identified nine affiliated nonfederal entities, confirming the findings of the independent auditors.

Comment 2 We are encouraged that the Authority has agreed to remove the encumbrance of this asset and that it has agreed to record all loans and report balances in its future financial statements. However, the Authority could not substantiate its statement that 60 percent of the cost of its administrative offices was paid with non-HUD funds.

Comment 3 The audit showed and the Authority acknowledged in its written response to the audit findings, dated October 24, 2005, that management did not clearly ensure that the Authority's recordkeeping system precisely recorded and calculated the cost of services and the required detail of payments received by the affiliated nonfederal entities.

Comment 4 We requested and reviewed documentation to support these costs during the audit. Since the Authority states it is now reviewing additional documentation it did not provide us during the audit, we cannot comment on this additional documentation.

Comment 5 The Authority was the developer, management agent, and service provider for the three nonfederal properties associated with the 139 units during the audit period of January 2002 through May 2004. As such, Authority personnel did substantial work related to the properties during the audit period. Therefore, we used 139 units in our calculation to estimate unsupported costs.

Comment 6 During the audit we specifically asked the Authority's executive director and the comptroller to provide a list of employees working on the Authority's affiliated nonfederal entities. They stated they couldn't provide a list because the housing authority had 37 employees and all of them have put some time in performing work for the nonfederal entities. However, we took a conservative approach and determined that only 12 employees would have been substantially involved with the nonfederal entities due to the nature of their positions.