OFFICE OF AUDIT
REGION 5
CHICAGO, IL

Stark Metropolitan Housing Authority
Canton, OH

Public Housing Program

2013-CH-1003 **JULY 15, 2013**

Issue Date: July 15, 2013

Audit Report Number: 2013-CH-1003

TO: Shawn Sweet, Director of Public Housing Hub, 5DPH
Craig T. Clemmensen, Director of Departmental Enforcement Center, CACB

Kelly Anderson

FROM: Kelly Anderson, Regional Inspector General for Audit, 5AGA

SUBJECT: The Stark Metropolitan Housing Authority, Canton, OH, Did Not Follow HUD's Requirements and Its Own Policies Regarding the Administration of Its Program

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), final audit report of our audit of the Stark Metropolitan Housing Authority's public housing program.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8L, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at (312) 913-7832.

July 15, 2013

The Stark Metropolitan Housing Authority, Canton, OH, Did Not Follow HUD's Requirements and Its Own Policies Regarding the Administration of Its Program

Highlights

Audit Report 2013-CH-1003

What We Audited and Why

We audited the Stark Metropolitan Housing Authority's public housing program as part of the activities in our fiscal year 2012 annual audit plan. We selected the Authority based upon our previous audit of the Authority and an anonymous complaint received by the Office of Inspector General's hotline. Our objective was to determine whether the Authority followed the U.S. Department of Housing and Urban Development's (HUD) requirements and its own policies regarding the administration of its program.

What We Recommend

We recommend that the Director of HUD's Cleveland Office of Public Housing require the Authority to (1) reimburse its operating and capital fund more than $6.3 million from non-Federal funds, (2) provide support or reimburse its operating and capital fund nearly $4.2 million from non-Federal funds, (3) charge and collect more than $263,000 in appropriate market rent, (4) deobligate more than $57,000 in capital funds, and (5) provide support that more than $356,000 in proceeds was not derived from the encumbrance of public housing property. We also recommend that HUD considers a declaration of substantial default based on the issues cited in this audit report.

What We Found

The Authority, under the direction of its former executive directors, inappropriately used more than $6.3 million in public housing operating and capital funds to pay ineligible expenses for its commercial development, Metropolitan Centre, and two nonprofit developments, Ruthe and Isadore Freed Housing Corporation and Stark Metropolitan Federal Credit Union. Further, it did not (1) provide documentation to support that nearly $4.2 million in public housing operating and capital funds used to pay expenses such as salaries, utilities, and maintenance costs for its developments was from fees earned by its cost center for managing its projects or engaging in business activities, (2) charge and collect more than $263,000 in appropriate market rent from its developments, and (3) ensure that it obligated more than $57,000 in capital funds for eligible expenditures. As a result, HUD and the Authority lacked assurance that more than $10.5 million in public housing operating and capital funds was used to benefit low- and moderate-income residents and more than $320,000 was available for eligible public housing purposes.

Additionally, the Authority inappropriately executed an oil and gas lease with Chesapeake Exploration that encumbered project assets without HUD's approval. It received more than $356,000 in proceeds from the agreement. As a result, HUD lacked assurance that its interests in the Authority's project assets were protected.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVE

The Canton Metropolitan Housing Authority was created in 1939 in accordance with the provisions of the Ohio Revised Code. Its name was changed to the Stark Metropolitan Housing Authority in 1970. It is a public nonprofit organization, chartered by the State of Ohio, funded in part through the U.S. Department of Housing and Urban Development (HUD). The Authority was established to provide eligible residents of Stark County with quality affordable housing in decent, safe, and nourishing neighborhoods. The Authority administers 2,546 public housing units, and 1,639 units under its Section 8 program.

The Authority is operated by a five-member board of commissioners. These members are appointed to a 5-year term and are not compensated for their services. The mayor of Canton, OH, the largest city in Stark County, appoints two members. The Stark County commissioners, the Stark County Court of Common Pleas, and the Stark County Court of Common Pleas Probate Division each appoint one member.

The Authority's former executive director retired on December 31, 2012. The board selected a new executive director, effective February 25, 2013. The Authority's former deputy director became the controller under the current executive director.

The Authority receives public housing operating funds to operate public housing units under its annual contributions contract with HUD. It also receives Public Housing Capital Fund grants from HUD for capital and management activities, including the modernization and development of its public housing. The grant can be used for financing activities, such as payments of debt service and customary financing costs in standard public housing agency developments and mixed-finance developments.

In 2005, HUD required public housing agencies with 250 or more units to convert to asset management and establish a central office cost center. The cost center generates revenue by using a fee-for-service approach and engaging in business activities. In April 2007, the Authority established its cost center.

Further in May 2005, HUD amended the Authority's annual contributions contract to include the Canton Senior Center under its Cherrie Turner Tower project. The Center was established to provide services such as computer training; cleanup, and litter pickup; library books for the children; facilitating meetings with other agencies for the residents; meeting space for the neighboring communities; community activities; maintenance space; and training.

In addition to managing its public housing and Section 8 programs, the Authority operates two nonprofit developments, Ruthe and Isadore Freed Housing Corporation and Stark Metropolitan Federal Credit Union. Ruthe and Isadore Freed Housing Corporation was formed on December 5, 1996, and is a legally separate, nonprofit organization, served by a board composed of local officials and community representatives. Freed Housing is responsible for advancing, encouraging, and promoting housing and related services to low- and moderate-income persons in the Stark County area. Freed Housing does not develop, administer, or manage projects that contain public housing.

Stark Metropolitan Federal Credit Union is a nonprofit, legally separate entity regulated by the National Credit Union Administration. The credit union is a Federal credit union chartered on May 5, 2000, under the laws of the United States. The purpose of the credit union is to provide public housing and Section 8 housing authority residents, credit union employees, and Authority employees and their families sound and affordable financial services and products. The credit union does not develop, administer, or manage projects that contain public housing.

Our objective was to determine whether the Authority followed HUD's requirements and its own policies regarding the administration of its program funds. Specifically, we wanted to determine whether the Authority appropriately (1) used operating funds, (2) drew down and disbursed capital funds, (3) obligated capital funds, and (4) obtained HUD approval before encumbering project assets.

RESULTS OF AUDIT

Finding 1: The Authority Inappropriately Used Public Housing Operating and Capital Funds To Support Its Developments and Home Ownership Program

The Authority inappropriately used nearly $2.8 million in public housing operating and $3.6 million in capital funds to support the operations of its developments and homeownership program, which were not self-sufficient. Further, it failed to provide documentation to support that more than $4 million in operating funds and $162,000 in capital funds were not used to support its developments. The Authority also did not (1) ensure that it obligated more than $57,000 in capital funds for eligible expenditures and (2) charge and collect more than $263,000 in appropriate market rent from its developments. The weaknesses occurred because the Authority lacked adequate procedures and controls to ensure that it appropriately managed its operating and capital funds and the previous executive director believed the funds were being spent appropriately. As a result, HUD and the Authority lacked assurance that more than $10.5 million in operating and capital funds was used to benefit low- and moderate-income residents and more than $320,000 was available for eligible public housing purposes.

The Authority's Developments Were Not Self-Sufficient

From April 1, 2010, through September 30, 2012, the Authority's cost center earned more than $4 million in management and accounting fees. However, in reviewing the Authority's accounting records, we determined that cost center's expenses totaled more than $5 million, $1 million more that it earned. Despite this shortfall, the Authority continued to provide financial support to its developments and homeownership program, which were not self-sufficient, by transferring public housing operating funds to its cost center and drawing down capital funds.

The Authority's Metropolitan Centre

In 2007, the Authority reestablished the Canton Senior Center and changed its name to the Metropolitan Centre. The Centre is a nonresidential commercial development property that contains a medical center, conference rooms, business offices, a jazz club, and a renovated grand ballroom for weddings and other events. Although this property contains commercial businesses, the revenue generated from leasing office space was not enough to maintain its operations, including the property. Since this property was under its contract with HUD, the Authority included the Centre in its annual plans to receive operating and capital funding. However, the Authority failed to notify HUD that the Centre was not a senior center and did not provide services for low- and moderate-income households. Further, the Authority operated a homeownership program using one of the office spaces in the Centre. The program was established in 2001 to provide HUD-certified housing counseling services for the community, not just low- and moderate-income households. The Authority's employees managed the operations of this program. However, the program did not generate sufficient income to support its own operations.

The Authority's Nonprofit Developments

In 1996 and 2000, respectively, the Authority created two nonprofit developments, Ruthe and Isadore Freed Housing Corporation and Stark Metropolitan Federal Credit Union. These two developments were not self-sufficient and relied on funds earned by the Authority's cost center to maintain their operations. However as previously mentioned, the Authority's cost center did not maintain sufficient funds to support the operations of the developments.

The Developments' Expenses Were Ineligible

Contrary to HUD regulations,[1] the Authority inappropriately encumbered program assets when it made 55 transfers totaling more than $2.5 million in operating funds to its Centre and expended more than $3.5 million in capital funds (a total of 111 check payments) to pay the Centre's and credit union's expenses. The ineligible expenditures included annual contributions to its credit union as well as expenses for the Centre, including but not limited to the following:

- Debt service payments for the nonprogram loans,
- Renovations (including general construction; heating, ventilation, and air conditioning; plumbing; electrical; and fire protection),
- Architect and engineering fees,
- Salary expenses for the contracted manager,
- Advertising and marketing,
- Utilities, and
- Maintenance supplies.

Further, the Authority's cost center paid salaries and benefits for the credit union employees. However, the Authority's cost center did not have funds available to make these payments. Therefore, the Authority inappropriately allocated

[1] United States Housing Act of 1937, as amended, sections 9(d)(1) and 9(e)(1); further sections 7 and 9(c) of the Authority's contract with HUD

$190,547 in salaries and benefits for the credit union's employees to its asset management projects.

In 2000, the Authority purchased a non-interest-bearing certificate of deposit for $100,000 from the credit union. However according to the Authority's general depository agreement, all funds deposited by the Authority with the depository must be credited to the Authority in a separate interest-bearing deposit or interest-bearing account. On May 2, 2009, the Authority reduced its deposit to $50,000. We reviewed other market rate certificates of deposit held by the Authority and determined the annual fair market rate for certificates of deposit for the period July 8, 2005, through December 31, 2012. Had the Authority purchased interest-bearing certificates of deposit at market rate, it would have earned $15,754 in interest income as of December 31, 2012.

The Developments' and Homeownership Program's Expenditures Were Unsupported

The Authority failed to provide sufficient documentation in accordance with HUD's requirements[2] to support that more than $4 million in operating funds and $162,000 in capital funds were not used to support its developments and homeownership program. The expenditures included $3.6 million in salaries and benefits for the employees of its developments and homeownership program as well as time allocated to each development's business activities by the Authority's

- Executive staff,
- In-house legal counsel,
- Accounting staff,
- Security guards,
- Maintenance personal, and
- Information technology staff.

The unsupported expenditures also included (1) $111,856 for lawn maintenance and snow removal, (2) $39,189 for utility expenses, (3) $227,500 in annual contributions, and (4) $14,472 for the credit union's manager to attend a 3-year training program at the Community Development Credit Union Institute. The following table shows the total amount of unsupported expenses incurred by the Authority's developments and homeownership program.

[2] Section 9(c) of the Authority's contract with HUD

Expenses	Freed Housing	Credit union	Homeownership program	Centre	Totals
Salaries and benefits	$2,039,044	$1,170,364	$246,081	$155,177	$3,610,666
Annual contributions	-	227,500	-	-	227,500
Operating	-	-	-	162,156	162,156
Lawn and maintenance	-	18,423	-	93,433	111,856
Utility	6,919	32,270	-	-	39,189
Training program	-	14,472	-	-	14,472
Totals	$2,045,963	$1,463,029	$246,081	$410,766	**$4,165,839**

Further, the Authority inappropriately obligated $57,410 in capital funds for the Centre's expenses; however, these funds had not been drawn down.

The Authority Failed To Charge and Collect Market Rate Rents From Its Developments

From January 1, 2001, through December 31, 2012, the Authority leased its maintenance and management office building, Gage Gardens, to the credit union, along with an adjoining parking lot, for $1 dollar per year for a total of $12. We contacted a local realtor and determined that the average fair market rent for the credit union's building would have been approximately $10 per square foot per year. However in determining a reasonable fair market value for the office, we conservatively used $8 per square foot per year instead of $10. Therefore, we estimated the fair market rent for a 2,306-square-foot building to be $1,537 per month. We determined that the Authority could have earned $225,939 ($1,537 * 147 months) in rental income as of December 31, 2012, if it had charged its credit union fair market rent.

Freed Housing leased office space at the Authority's central office. From April 1, 2010, through December 31, 2012, the Authority charged Freed Housing a total of $11,269 in fees for the office space, utilities, and staffs' salaries that were allocated to Freed Housing's business activities. However, the Authority was unable to provide documentation to support that Freed Housing paid the fees. We contacted a local realtor and determined that the average fair market rent for the space occupied by Freed Housing would have been $10 per square foot per year. However in determining a reasonable fair market value for the space, we conservatively used $8 per square foot per year instead of $10. From January 1, 2005, through December 31, 2009, Freed Housing occupied 240 square feet for an annual rent of $1,920 (240*8). From January 1, 2010, to December 31, 2012, Freed Housing occupied 1,148 square feet for an annual rent of $9,184 (1,148*8). Therefore, had the Authority charged Freed Housing fair market rent, it could have earned $37,152 (($9,184*3) + ($1,920*5)) in rental income as of December 31, 2012.

HUD Identified Similar Deficiencies

On September 20, 2012, HUD issued a letter to the Authority regarding its independent auditor report for its fiscal year ending March 31, 2011. The letter to the Authority stated that public housing operating and capital funds are not fungible. In the event that a program cannot cover its bills, public housing funds are not to be used to cover that expense. HUD also stated that the movement of Federal money between programs is a violation of part a, section 10(c), of the Authority's contract with HUD and that the Authority must immediately cease such transactions.

Additionally, the letter stated that the Authority had violated HUD's regulations by using public housing operating funds to pay debt services associated with the Centre. HUD said that these funds must be repaid from non-Federal funds.

Further, the letter stated that the Authority was using operating funds to pay the credit union employees' salaries and this was not an eligible program expense. The letter also stated that the Authority must immediately reimburse its public housing program and charge the credit union for its salaries. Operating funds are to be used only to pay for necessary and reasonable low-income housing expenses, not to assist other programs if they are unable to operate.

Although HUD's letter stated that the Authority must immediately cease the transactions and repay its program, the Authority continued to (1) distribute Federal funds among programs for the Centre and (2) support its credit union and Freed Housing. As of December 31, 2012, the Authority had failed to repay its program.

The Authority's Procedures and Controls Had Weaknesses

The weaknesses described above occurred because the Authority lacked adequate procedures and controls to ensure that it appropriately managed its operating and capital funds. In addition to supporting its developments and homeownership program, the Authority's previous executive directors made written commitments to the credit union stating that the Authority would (1) pay the credit union employees' salaries and benefits, (2) provide annual financial assistance and pay all of the utilities and maintenance costs associated with the credit union's building, (3) lease a building and adjoining parking lot to the credit union for $1 per year, and (4) purchase a certificate of deposit that would earn interest below the market rate.

The Authority's controller said the original intent for the developments was to provide the Authority with an additional source of revenue outside HUD's operating subsidy. However, the developments had not been able to operate without the Authority's support.

The controller said he was aware that the Authority was using operating and capital funds for ineligible activities. However, the former executive director made the final decisions on how the funds should be used, and he believed the funds were being used appropriately and the funded activities were eligible expenditures. The Authority's accounting supervisor said the previous executive director believed anything that might benefit public housing residents in any way was considered an eligible use of funds. The accounting supervisor also said that the Authority's employees believed the board of directors knew that Federal funds were being used to support the Centre. Our review of the monthly board meeting minutes confirmed that the board approved the expenditures for the Centre.

Conclusion

The Authority lacked adequate procedures and controls to ensure that it appropriately managed its operating and capital funds. As a result of the weaknesses discussed above, HUD and the Authority lacked assurance that more than $10.5 million in operating and capital funds was used to benefit low- and moderate-income residents and more than $320,000 was available for eligible public housing purposes.

Recommendations

We recommend that the Director of HUD's Cleveland Office of Public Housing require the Authority to

1A. Reimburse its capital fund $3,569,942 ($3,319,942 + $250,000) from non-Federal funds for the ineligible drawdowns and disbursements cited in this finding.

1B. Reimburse its operating reserve fund $2,773,976 ($2,583,429 + $190,547) from non-Federal funds for the inappropriate transfers to its cost center and salary and benefit payments cited in this finding.

1C. Reimburse its operating reserve fund $15,754 from non-Federal funds for the ineligible deposit of funds in a non-interest-bearing account.

1D. Provide supporting documentation or reimburse its operating reserve fund $4,003,683 ($3,610,666 + $227,500 + $111,856 + $39,189 + $14,472) from non-Federal funds for the unsupported salary and benefit payments; operating contribution payments; and lawn maintenance, snow removal, utility, and training costs for the developments and program cited in this finding.

1E. Provide supporting documentation or reimburse its capital fund $162,156 from non-Federal funds for the Centre's operating expenses cited in this finding.

1F. Deobligate the $57,410 in capital funds cited in this finding and ensure that the Authority uses the funds for eligible purposes.

1G. Charge and collect market rate rents on its buildings and facility spaces to ensure that $263,091 ($225,939+$37,152) is available for other eligible public housing purposes.

1H. Develop and implement adequate procedures and controls to ensure that all operating funds received and capital funds drawn and disbursed are expended for eligible activities and follow HUD's requirements.

1I. Discontinue the use of operating and capital funds for ineligible activities.

We recommend that the Director of HUD's Cleveland Office of Public Housing

1J. Determine whether additional operating and capital funds were used to inappropriately support the Centre, credit union, Freed Housing, and the homeownership program after December 31, 2012. Funds determined to be inappropriately used should be reimbursed by the Authority to its operating or capital fund as appropriate.

1K. Inform the Deputy Assistant Secretary for Field Operations of the Authority's actions that led to encumbrances of program funds and project assets, and in accordance with section 17 of its contract recommend considering a declaration of substantial default (see findings 1 and 2).

1L. Identify the funding year of the Capital Fund grants used for the ineligible and unsupported expenditures to determine whether the reimbursement, if appropriate, should be to HUD or the program.

We recommend that the Director of HUD’s Cleveland Office of Public Housing in conjunction with HUD’s Departmental Enforcement Center

1M. Pursue appropriate administrative sanctions against the former executive directors for failing to comply with HUD’s requirements.

Finding 2: The Authority Inappropriately Entered Into an Oil and Gas Lease

The Authority inappropriately executed an oil and gas lease with Chesapeake Exploration, which encumbered project assets without HUD's approval. The weakness occurred because the Authority's previous executive director and board lacked a sufficient understanding of HUD's requirements. As a result, HUD and the Authority lacked assurance that (1) the lease did not inappropriately encumber Program assets and (2) HUD's interests were protected. Further, HUD and the Authority lacked assurance that more than $356,000 in proceeds was used appropriately.

Program Assets Were Encumbered Without HUD Approval

On January 20, 2012, the Authority executed an oil and gas lease with Chesapeake Exploration for a minimum of 10 years, which encumbered its projects without HUD's approval.[3] It received $356,295 from Chesapeake Exploration for 158.36 net acres of its properties' mineral interests. The lease included properties under its contract with HUD.

On December 20, 2012, the Authority purchased a First Merit Bank certificate of deposit using the funds received from its leasing agreement. It had a maturity date of April 1, 2013. The Authority allocated the funds to its public housing asset management projects. After the certificate of deposit matured, the Authority purchased another First Merit Bank certificate of deposit for $356,393 ($356,295+ $98 in interest earned on the previous certificate of deposit).

The Authority Lacked Sufficient Understanding of HUD's Requirements

The weakness described above occurred because the previous executive directors and the board of commissioners lacked a sufficient understanding of HUD's requirements regarding the encumbrance of program assets to ensure compliance with the Authority's contract. The Authority's board adopted a resolution authorizing the previous executive director to negotiate a price per acre and terms for the oil and gas lease on the Authority's properties with Chesapeake Exploration and authorized the previous executive director to sign all of the necessary documents to execute the lease. Further, according to the Authority, it

[3] Section 7 of the Authority's contract with HUD

believed that the funds received under the leasing agreement should be recorded as a non-Federal source of revenue since the funds were received from a private entity, not HUD. However, the Authority failed to seek guidance from HUD.

Conclusion

As a result of the weaknesses discussed above, HUD and the Authority lacked assurance that the Authority's lease with Chesapeake Exploration did not inappropriately encumber program assets and HUD's interests were protected. Further, HUD and the Authority lacked assurance that more than $356,000 in proceeds was used appropriately. In addition, HUD lacked assurance that its interests in the Authority's project assets were protected.[4]

Recommendations

We recommend that the Director of HUD's Cleveland Office of Public Housing require the Authority to

2A. Provide documentation to support that the $356,393 ($356,295+$98) in proceeds from the lease was not derived from the encumbrance of public housing property under its contract with HUD or ensure that the funds are used in accordance with HUD's regulations for program revenue.

2B. Implement procedures and controls to ensure that the Authority complies with HUD's requirements when entering into leasing and other agreements involving properties under its contract.

2C. Implement procedures and controls to ensure that the Authority follows HUD's requirements regarding the use of revenue generated from its public housing program.

We recommend that the Director of HUD's Cleveland Office of Public Housing

2D. Obtain and review the Authority's Chesapeake Exploration oil and gas lease to determine whether the agreement violates its contract with HUD and if so, pursue corrective actions as appropriate.

2E. Determine whether the Authority's other leasing and similar arrangements encumber program assets under its contract and if so, pursue corrective actions as appropriate.

[4] Further, the Ohio Revised Code states that the oil and gas lease has priority over claims and other encumbrances on the leased property.

SCOPE AND METHODOLOGY

We performed our onsite audit work at the Authority's office at 400 East Tuscarawas Street, Canton, OH, between October 23, 2012, and March 27, 2013, and HUD's Cleveland field office. The audit covered the period September 1, 2010, through August 31, 2012, but was expanded as determined necessary.

To accomplish our objectives, we reviewed

- Applicable laws; regulations; HUD program requirements at 24 CFR (Code of Federal Regulations) Parts 85, 905, 941, and 970; Public and Indian Housing Notices 2007-9, 2007-9 Supplement, 2007-15, and 2007-28; HUD Guidebook 7485.3G; HUD Handbooks 7460.8, 7475.1, and 7510.1G; The United States Housing Act of 1937 as amended; 42 U.S.C. (United States Code), chapter 8, subchapter I, 1437g; the Ohio Revised Code, section 1509; and Office of Management and Budget Circulars A-87, A-102, and A-110.

- The Authority's accounting records, bank statements, 5-year annual plan, annual statement performance and evaluation reports for fiscal years 2005 to 2012, declaration of trust, public housing annual contributions contract with HUD, employee earning history register, computerized databases, policies and procedures, organizational chart, general depository agreement, lease agreement with Chesapeake Exploration, and main office rent and utility costs.

- The Authority's board meeting minutes pertinent to the program, the credit union's board meeting minutes, and Freed Housing's board meeting minutes.

- Independent auditors' reports on the Authority for fiscal years 2009, 2010, 2011, and 2012.

- HUD's files for the Authority.

We also interviewed the Authority's employees, HUD staff, and a local realtor.

<u>Finding 1</u>

We reviewed the Authority's disbursement of operating funds to determine whether the costs were necessary and reasonable low-income housing expenses and whether the funds were used to provide and operate cost-effective, decent, safe, and affordable dwellings for lower income families. We also reviewed the disbursement of capital funds to determine whether the funds were used for capital and management activities, including the modernization and development of public housing. Further, we reviewed the Authority's cost center transactions to determine whether its expenses exceeded its revenues before accounting for costs associated with its developments and homeownership program.

We reviewed the Authority's 5-year public housing agency plans and annual statement of performance and evaluation reports for the years 2005 through 2012 to identify the Centre's expenses. Next, we reviewed the Authority's draws and disbursements of capital funds related to its Centre as of December 31, 2012. Lastly, we reviewed the Centre's (1) debt service payments, (2) accounts payable, and (3) disbursements related to the architect and engineering fees and renovation of tenant space within the Centre.

We reviewed the Authority's homeownership program, snow removal, and lawn maintenance expenses for the Centre. We also reviewed the Authority's employee salaries and benefits allocated to Centre's business activities by the Authority's executive staff, security guards, accounting department, legal department, and maintenance staff.

We reviewed the Authority's disbursements of operating and capital funds for the credit union and Freed Housing as of December 31, 2012. We also reviewed (1) the Authority's salary and benefit files and files pertaining to the credit union and Freed Housing, (2) contributions made by the Authority to the credit union and certificates of deposit held at the credit union, (3) lawn maintenance and snow removal costs associated with the credit union, and (4) rental leases and utility costs for the credit union and Freed Housing for the use of office space.

We provided our review results and supporting schedules to the Director of HUD's Cleveland Office of Public Housing and the Authority's executive director during the audit.

Finding 2

We reviewed the Authority's (1) oil and gas lease with Chesapeake Exploration, (2) certificate of deposit with First Merit Bank, and (3) general ledger allocating lease proceeds to its public housing asset management projects.

We provided our review results and supporting schedules to the Director of HUD's Cleveland Office of Public Housing and the Authority's executive director during the audit. We also provided our discussion draft audit report to the Authority and HUD's staff during the audit. We held an exit conference with the Authority on June 26, 2013.

We asked the Authority's executive director to provide written comments on our discussion draft audit report by July 2, 2013. The executive director chose not to comment on the report.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective(s).

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

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

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Reliability of financial reporting – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

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

- The Authority lacked adequate procedures and controls to ensure compliance with Federal and its own requirements regarding (1) the expenditure of its operating funds, (2) the drawing and disbursing of its capital funds, and (3) ensuring that capital funds are obligated for eligible expenditures (see finding 1).

- The Authority lacked a sufficient understanding of HUD's requirements regarding the encumbrance of program assets (see finding 2).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A	$3,569,942		
1B	2,773,976		
1C	15,754		
1D		$4,003,683	
1E		162,156	
1F			$57,410
1G			263,091
2A		356,393	
Total	$6,359,672	$4,522,232	$320,501

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 the 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 Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified.

Appendix B

FEDERAL AND AUTHORITY REQUIREMENTS

Finding 1

The United States Housing Act of 1937, as amended, section 9(d)(1), states: "The [HUD] Secretary should establish a Capital Fund for the purpose of making assistance available to public housing agencies to carry out capital and management activities, including:

(A) The development, financing, and modernization of public housing projects;
(B) Vacancy reduction;
(C) Addressing deferred maintenance needs and the replacement of obsolete utility systems and dwelling equipment;
(D) Planned code compliance;
(E) Management improvements;
(F) Demolition and replacement;
(G) Resident relocation;
(H) Capital expenditures to facilitate programs to improve the empowerment and economic self-sufficiency of public housing residents and to improve resident participation;
(I) Capital expenditures to improve the security and safety of resident; and
(J) Homeownership activities, including programs under section 32."

Section 9(e)(1) of the Act states: "The Secretary should establish an operating fund for the purpose of making assistance available to public housing agencies for the operation and management of public housing, including:

(A) Procedures and systems to maintain and ensure the efficient management and operation of public housing units;
(B) Activities to ensure a program of routine preventative maintenance;
(C) Anticrime and antidrug activities, including the costs of providing adequate security for public housing residents;
(D) Activities related to the provision of services, including service coordinators for elderly persons or persons with disabilities;
(E) Activities to provide for management and participation in the management and policy making of public housing by public housing residents;
(F) The cost of insurance;
(G) The energy costs associated with public housing units, with an emphasis on energy conservation;
(H) The costs of administering a public housing work program under section 12, including the costs of any related insurance needs;

(I) The costs of repaying, together with rent contributions, debt incurred to finance the rehabilitation and development of public housing units, which must be subject to such reasonable requirements as the Secretary may establish; and
(J) The costs associated with the operation and management of mixed finance projects, to the extent appropriate."

HUD Handbook 7475.1, chapter 1, section 5, states that public housing agencies are responsible for operating their public housing projects in compliance with the contract and applicable regulations and procedural requirements. The contract, among other things, requires public housing agencies to operate their housing projects solely for the purpose of providing decent, safe, and sanitary housing within the financial reach of lower income families and in such a manner as to promote serviceability, efficiency, economy and stability. Among the specific responsibilities of public housing agencies are the following:

a. Properly managing Federal funds without waste, fraud, or mismanagement;
b. Operating projects for the benefit of lower income families;
d. Maintaining the accounting books and records in accordance with HUD requirements and submitting required six month/year-end financial statements (see Chapter 6);
e. Operating projects with maximum efficiency and economy; and
f. Submitting an annual operating budget and all related, supporting documents in accordance with the annual contributions contract (see Chapter 2).

The Supplement to HUD Handbook 7475.1, section 6.3, states that the following uses of excess cash are not permitted: the central office cost center may not be loaned or transferred excess cash except through asset management fees, and proceeds from asset disposals of an asset management project are considered to be assets of the asset management project and not the central office cost center. With HUD approval, certain proceeds may be transferred to the central office cost center but may still be governed by other restrictions.

HUD Guidebook 7485.3(G), paragraph 12-11(A)(5), states that if the public housing agency uses funds for ineligible purposes, the field office may use an order to require the public housing agency to repay HUD from nonprogram funds. If such repayment is not forthcoming, the field office may recommend withholding a portion of the public housing agency's next year's grant.

HUD's Public and Indian Housing Low Rent Technical Accounting Guidebook 7510.G, chapter 2, section 2, states that the books and accounts must be complete and accurate. The books of original entry must be kept current at all times, and postings must be made at least monthly to ledger accounts. All records and files must be stored appropriately, and all supporting documentation must be maintained in a safe and accessible location.

HUD's Public and Indian Housing Low Rent Technical Accounting Guidebook 7510.G, chapter 2, section 6, states that the public housing agency must maintain source documents and files that support the financial transactions recorded in the book of accounts and that provide an adequate audit trail. This includes such items as documents identifying the source of cash receipts, canceled checks, paid bills, payrolls, time and attendance records, tenant rent rolls, housing assistance payment registers, investment registers, insurance policies, inventory records, contracts, grant award documents, and the approved program budgets and revisions.

HUD's Public and Indian Housing Low Rent Technical Accounting Guidebook 7510.1G, chapter 2, section 7, states that funds provided by HUD are to be used by the public housing agency only for the purposes for which the funds are authorized. Program funds are not fungible, and withdrawals should not be made for a specific program in excess of the funds available on deposit for that program. A public housing agency does not "commingle" funds by pooling funds or by making expenditures for various programs from a single account used to pool funds. Unless there is a specific legal requirement to maintain separate bank account for a specific purpose, the prohibition against "commingling of funds" does not mean that the public housing agency is required to physically segregate program funds in multiple bank accounts.

HUD's regulations at 24 CFR 941.205(a) state that to be considered as eligible project expenses, all development-related contracts entered into by the public housing authority must provide for compliance with the provisions of the annual contributions contract.

Section 9(A) of the Authority's contract states that the Authority must deposit and invest all funds and investment securities received by or held for the account of the Authority in connection with the development, operation, and improvement of the projects under an annual contributions contract with HUD in accordance with the terms of the general depository agreement(s). The general depository agreement must be in the form prescribed by HUD and must be executed by the Authority and its depository.

Section 9(C) of the Authority's contract states that the housing authority must maintain records that identify the source and application of funds in such a manner as to allow HUD to determine that all funds are and have been expended in accordance with each specific program regulation and requirement. The housing authority may withdraw funds from the general funds only for (1) the payment of the cost of development and operations of the project under annual contributions contract with HUD, (2) the purchase of investment securities as approved by HUD, and (3) such other purposes as may be specifically approved by HUD. Program funds are not fungible; withdrawals should not be made for a specific program in excess of the funds available on deposit for that program.

Section 10(C) of the Authority's contract states that the housing authority must not withdraw from any of the funds or accounts authorized under this section amounts for the projects under annual contributions contract or for the other projects or enterprises in excess of the amount then on deposit in respect thereto.

Finding 2

HUD’s regulations at 24 CFR 970.5 state that disposition means the conveyance or other transfer by the public housing agency, by sale or other transaction, of any interest in the real estate of a public housing development, subject to exceptions.

The Authority’s annual contributions contract with HUD, section 7, states that the Authority must not “demolish or dispose of any project or portion thereof, other than in accordance with the terms of this annual contributions contract and applicable HUD requirements. With the exception of entering into dwelling leases with eligible families for dwelling units in the projects covered by this annual contributions contract and normal uses associated with the operations of the project, the Authority must not in any way encumber any such project or portion thereof without the prior approval of HUD.”

Section 8 of the Authority’s contract states that the Authority should execute and deliver an instrument (which may be in the form of a declaration of trust, a trust indenture, or such other document as may be approved by HUD), confirming and further evidencing, among other things, the covenant of the Authority not to convey or encumber the project except as expressly authorized in the annual contributions contract.

The Authority’s declaration of trust states that the government requires the Authority to remain “seized of the title to the property and to refrain from transferring, conveying, assigning, leasing, mortgaging, pledging, or otherwise encumbering or permitting or suffering any transfer, conveyance, assignment, leasing, mortgage, pledge or other encumbrance of the property or any part thereof appurtenances, thereto, or any rent, revenues, income, or receipts therefrom or in connection therewith, or any of the benefits or contributions granted to it by or pursuant to the annual contributions contract.”

Ohio Revised Code 1509.31(d) states that “if a mortgaged property that is being foreclosed is subject to an oil or gas lease, pipeline agreement, or other instrument related to the production or sale of oil or natural gas and the lease, agreement, or other instrument was recorded subsequent to the mortgage and if the lease, agreement, or other instrument is not in default, the oil or gas lease, pipeline agreement, or other instrument, as applicable, has priority over all other liens, claims, or encumbrances on the property so that the oil or gas lease, pipeline agreement, or other instrument is not terminated or extinguished upon the foreclosure sale of the mortgaged property. If the owner of the mortgaged property was entitled to oil and gas royalties before the foreclosure sale, the oil or gas royalties should be paid to the purchaser of the foreclosed property.”

The Authority’s lease with Chesapeake Exploration states that “Chesapeake Exploration will also pay royalties and additional funds for the equal to 1/8 of the net revenue realized for all oil and gas produced and marketed from the lease.” The lease also states that “if Chesapeake Exploration receives evidence that the Authority does not have all title to all or any part of the rights in the lease, it may withhold payments until the adverse claim is fully resolved. In the event that the leased land is encumbered then Chesapeake should have the right to suspend the payment of royalties due until the claim is fully resolved.” The lease also states that there should be leasehold forfeiture, termination, expiration, or cancellation for failure to comply with covenants. The covenants should not be subject to termination, forfeiture of rights, or damages due for failure to comply with the obligations if compliance is effectively prevented by Federal; State; or local law, regulation, decree, or third parties over whom Chesapeake Exploration has no control.