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Audit Report Number 2009-AT-1007

TO: Charles T. Barnett, Director, Nashville Program Center, Office of Public Housing, 4LPH

//signed//

FROM: James D. McKay, Regional Inspector General for Audit, Atlanta Region, 4AGA

SUBJECT: The Chattanooga Housing Authority Mismanaged Its Finances

HIGHLIGHTS

What We Audited and Why

We audited the Chattanooga Housing Authority's (Authority) financial operations after the U.S. Department of Housing and Urban Development (HUD), Office of Public Housing, Tennessee State Office, informed us of the Authority's deteriorating financial condition. We began with a review of the Authority's development activities but expanded the review based on our survey results.

What We Found

The Authority, with the exception of $49,316 in ineligible expenses, generally complied with HUD requirements with respect to its development activities. However, its deteriorating financial condition led its management to use restricted funds to cover excessive general operating expenses. In addition, management unnecessarily expended scarce resources during a time of financial crisis and failed to provide adequate financial reporting to its board. Authority management

(1) Used more than $788,000 in Section 8 housing assistance funds for Authority operating expenses in violation of Section 8 regulations,
(2) Used $1.2 million in restricted Fannie Mae loan proceeds to cover operating expenses in violation of the executed loan agreement,
(3) Paid employee bonuses of more than $210,000 and a cost of living adjustment of more than $180,000 in conflict with its own policies,
(4) Approved more than $193,000 in excessive severance payments during two 2008 reductions in force in conflict with its own policies,
(5) Used $49,316 in public housing operating funds to pay non-HUD expenses in violation of annual contributions contract requirements, and
(6) Liquidated more than $4 million in investments without adequately informing the board, in violation of both HUD and Authority requirements.

As a result, the Authority misused more than $1 million in funding that could have been used to carry out its mission of providing families with decent, safe, and sanitary housing.

What We Recommend

We recommend that you require the Authority to

- Repay more than $1 million in ineligible costs,
- Support or repay from non-federal funds excessive performance-based compensation and cost of living adjustment payments totaling $402,862, and
- Develop and implement internal controls over the use of HUD funds to ensure that funds are expended only for eligible 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 finding with Authority officials during the audit. We provided a copy of the draft report to the Authority on May 19, 2009, for its comments and discussed the report with Authority officials at an exit conference on May 26, 2009. The Authority provided its written comments to our draft report on June 1, 2009. The Authority generally agreed with the contents of the report. However, the Authority asked that it not be required to reimburse its program for ineligible costs since it had very limited non-federal funds.

The complete text of the auditee’s response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVE

The Chattanooga Housing Authority (Authority) was chartered in 1938 pursuant to the Tennessee Housing Authorities Law. Its primary objective is to provide low-income housing to the citizens within Chattanooga, Tennessee, and the surrounding area in accordance with its annual contributions contract with the U.S. Department of Housing and Urban Development (HUD).

As of December 31, 2008, the Authority administered 2,756 occupied public housing units and 2,781 housing choice vouchers in the city and vicinity of Chattanooga. The Authority received HUD public housing grants totaling more than $28.9 million in 2007 and $27.5 million in 2008.

A seven-member board of commissioners appointed by the mayor of Chattanooga governs the Authority. Eddie Holmes is the board chairman, and Elizabeth McCright is the executive director. HUD's Nashville, Tennessee, Office of Public Housing is responsible for overseeing the Authority.

During 2008, the Chattanooga Times Free Press ran a series of newspaper articles related to the Authority's financial troubles. The articles highlighted the Authority's ongoing financial difficulties leading up to the resignations of both the executive director and the chief financial officer. At the request of HUD's Nashville, Tennessee, Office of Public Housing, HUD's Real Estate Assessment Center (REAC) conducted a review of the Authority's financial condition. REAC issued a financial recovery plan on July 3, 2008, detailing the Authority's troubling financial condition and made recommendations as to how it could be improved, including

- Further staff reductions,
- Additional reductions in administrative expenditures,
- Repaying or gaining a repayment waiver from HUD for misused Section 8 funds, and
- Selling its excess properties to generate working capital.

The Authority's last audited financial statements were for the fiscal year ending December 31, 2006. The Authority's independent public accountant is in the process of completing the 2007 and 2008 audits. According to a September 17, 2008, HUD waiver request, the Authority delayed obtaining the 2007 audit, because it terminated the contract with its former auditor. HUD denied the waiver request on October 16, 2008.

Our audit objective was to determine to what extent funds subject to an annual contributions contract were used to benefit non-HUD development activities or were otherwise inappropriately disbursed.

RESULTS OF AUDIT

Finding 1: The Authority Mismanaged Its Finances

The Authority mismanaged its finances. To cover excessive low income public housing operating expenses, Authority management misused Section 8 housing assistance funds and proceeds from a Fannie Mae development loan. In addition, management (1) paid excessive amounts to its employees for performance-based compensation and cost of living adjustments, (2) paid excess severance to laid-off employees, (3) used restricted program income to pay employee separation pay, and (4) paid ineligible expenses from its general fund for non-HUD development activities. Management also failed to inform its board regarding the liquidation of more than $4 million in investments or provide the board other financial detail that could have alerted it to the impending financial crisis. These conditions occurred because management failed to follow HUD and its own requirements. As a result, the Authority misused more than $1 million in funding that could have been used to carry out its mission of providing decent, safe, and sanitary housing for low-income families.

There Were Signs of Impending Financial Crisis

During the period covered by our audit, there were clear signs that the Authority was headed for a financial crisis. Because management failed to rein in out-of-control operating expenses, the Authority's financial condition steadily deteriorated. When the Authority's financial condition became critical during 2007, management misused both HUD funds and proceeds from a Fannie Mae development loan to keep the Authority functioning.

Low-Income Housing Operating Deficits Ballooned

From 2003 through 2007, the Authority's low-income housing program operated at an average annual loss of $1.55 million. This condition occurred despite fairly constant operating subsidy and operating revenue (see table 1). In 2007, the Authority experienced its highest level of both operating subsidy and operating revenue, yet it also experienced its largest operating deficit, more than $2.6 million (see table 2).

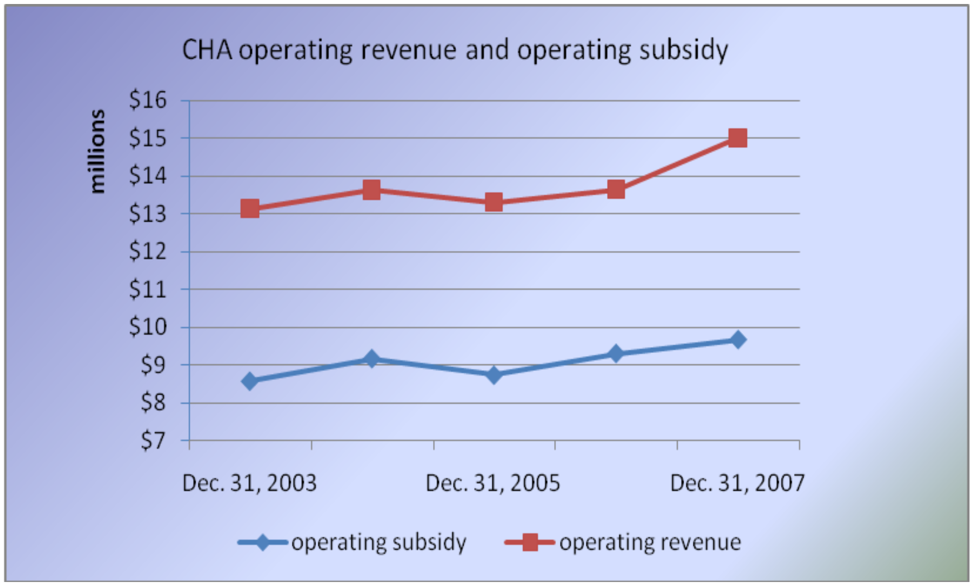

Table 1

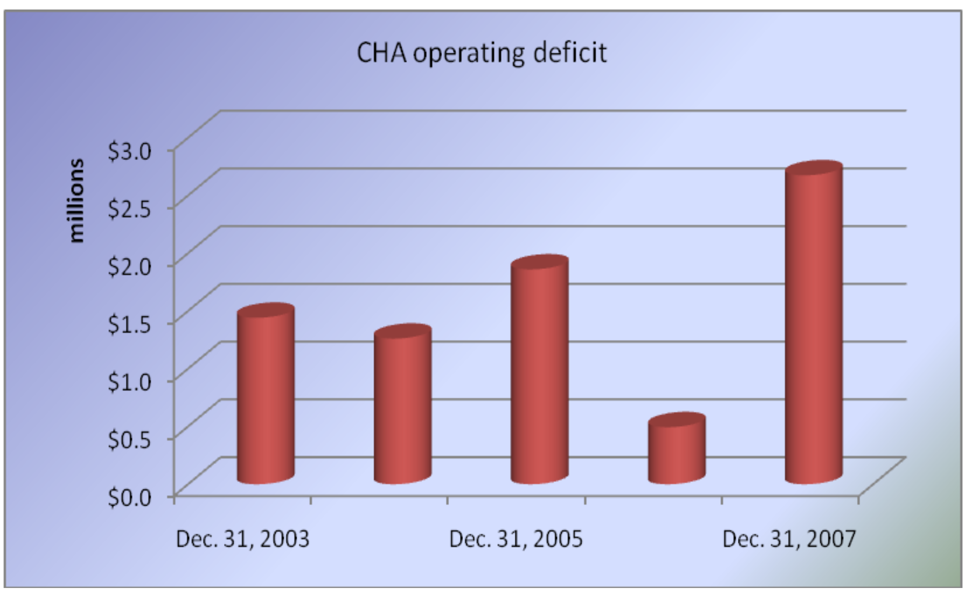

Table 2

As the Authority's operating deficits increased, management depleted all of its low-income public housing reserves, liquidating more than $4 million between December 2003 and December 2007 (see table 3). As the table also shows, during 2007, the Authority liquidated its remaining reserves to cover operating expenses, while its operating deficit increased dramatically.

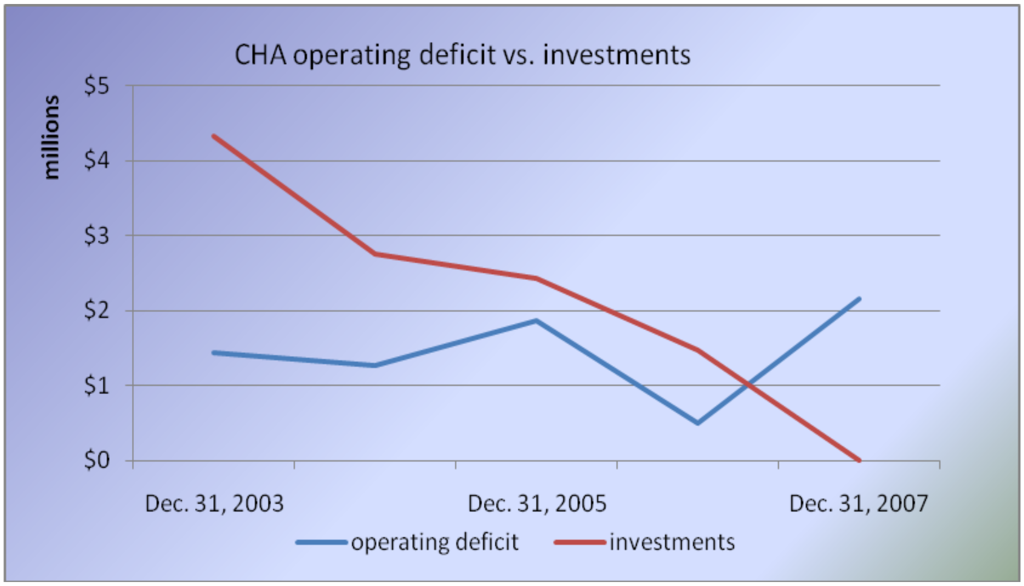

Table 3

Management Raided Additional Funding Sources

With its reserves completely depleted by the end of July 2007, the Authority needed another source of funds to cover its operating expenses. Authority records show that management reacted by making substantial ineligible transfers of Section 8 housing assistance funds to the general fund. In total, management transferred more than $788,000 during 2007, most of which was transferred from August through December. After discontinuing the ineligible transfer of Section 8 funds, management began to cover operating expenses using restricted proceeds from a Fannie Mae development loan. In early 2008, management made three transfers totaling $1.2 million from the Fannie Mae development loan to its general fund.

Management Eventually Took Action to Address Out-of-Control Costs

With all available funding sources exhausted, management finally took action to address escalating administrative expenses, a significant cause of its financial problems (see table 4). The Authority conducted two reductions in force in 2008, laying off 59 full-time employees. The Authority later reduced its staff by an additional five full-time employees, bringing the total reductions in force to 64. The Authority estimated that it saved more than $2.9 million in annual salaries and benefits via the staff reductions. It is clear that escalating administrative cost was a preventable yet major factor in mounting operating deficits.

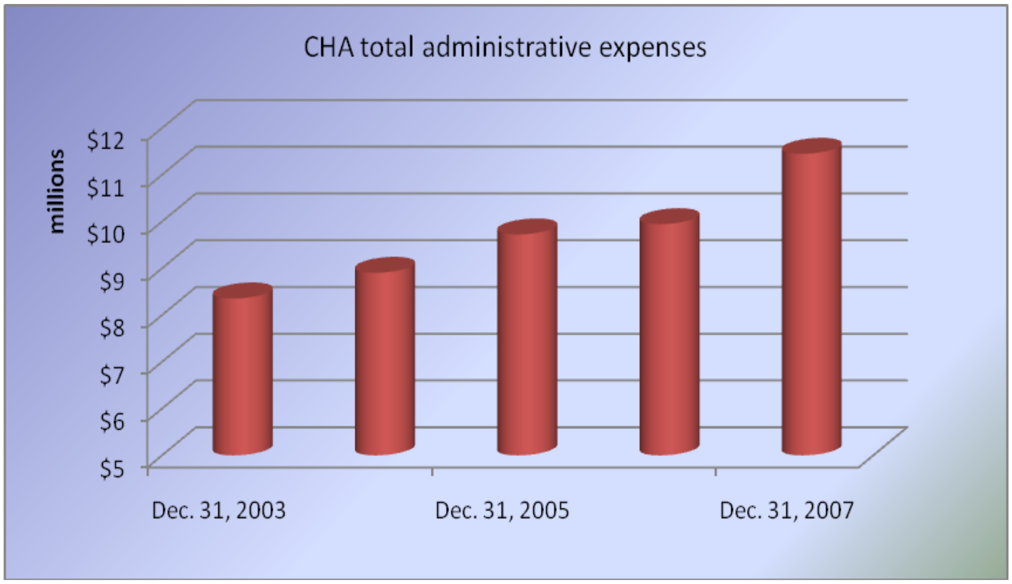

Table 4

Management Misled the Board as to the Use of Its Low Income Public Housing Reserves

As table 3 shows, the Authority liquidated all of its low-income public housing reserves, more than $4 million from 2003 through 2007. From June 30, 2006, through July 24, 2007, it liquidated more than $2.5 million in reserves. As a result, it had no reserves for future unforeseen expenses or funding shortfalls.

During the November 13, 2007, board meeting, the former chief financial officer reported to the board, “The bottom line shows a loss of $2.5 million, which represents a deliberate use of operating reserves to bring the sites up to REAC standards rather than risk having HUD recapture the funds.” However, Authority documentation indicated that management used the majority of the reserve funds for operating expenses (see appendix C). Although this is an eligible use of reserves, it contradicts the information management provided to the board.

Management also admitted that reserve funds were used for operating expenses. The former executive director stated that he authorized the use of only $1 million in reserves for bringing units up to REAC standards and was taken by surprise when the reserves were completely liquidated to cover other operating expenses. When asked for what the reserves were used, the former chief financial officer stated, “Because we didn’t have money to pay bills and meet payroll,” contradicting statements made to the board.

Management Misused Section 8 Housing Assistance Funds

The Authority administers HUD's Section 8 Housing Choice Voucher program. The program allows the Authority to provide housing choice vouchers to eligible families. The families use the vouchers to obtain housing from participating qualified landlords. Each year, HUD provides funds to the Authority to pay housing assistance to the selected landlords on behalf of the family covered by a particular voucher. In addition, HUD pays the Authority an administrative fee for administering the program.

Section 1.4(b) of the Authority's executed Section 8 annual contributions contract requires that HUD's annual contribution be used to cover housing assistance payments made by the Authority and the amount of Authority fees for program administration. In addition, 24 CFR (*Code of Federal Regulations*) 982.157(b)(1) requires that Section 8 program receipts only be used for housing assistance payments and Authority administrative fees.

During 2007, management used a portion of its Section 8 housing assistance funds to help cover non Section 8 program operating expenses. The Authority had no Section 8 administrative fee reserves at the time. In August 2007, with its low-income public housing reserves totally liquidated, management's use of Section 8 housing assistance funds accelerated. In addition to the Section 8 administrative fees allowed by HUD, the authority transferred more than $788,000 in restricted Section 8 housing assistance funds to the general fund to pay non Section 8 program operating expenses. The bulk of the transfers took place between August and December of 2007.

The Authority's former executive director stated that he was unaware that Section 8 funds were being used by the former chief financial officer to cover the Authority's low- income public housing operating expenses. The Authority's current executive director, who was the Authority's chief operating officer at the time, informed the former chief financial officer that using Section 8 funds in this manner was ineligible. The former executive director stated that if the chief operating officer had not intervened, he believed that the Authority would have "spent it all."

The chief financial officer contacted HUD regarding the eligibility of such use of Section 8 funds. On February 25, 2008, HUD responded that the Section 8 funds in question were restricted to paying housing assistance and could not be used for other programs. It is unclear whether the chief financial officer was aware that the funds were restricted, yet intentionally used them, or simply lacked adequate program knowledge to ensure that the Section 8 funds were used as required.

As a result of management's misuse of Section 8 funds, it had fewer funds with which to carry out its mission of providing rental subsidies on behalf of families to acquire decent, safe, and sanitary housing.

Management Claimed to Have Repaid Some Misused Section 8 Funds

During our review, the Authority claimed to have repaid a portion of the misused Section 8 funds. While attempting to determine the amount of repayment, we found that the Authority did not account for its various voucher programs as required.

In addition to the Section 8 Housing Choice Voucher program, the Authority participated in HUD's Shelter Plus Care, Disaster Voucher, and Moderate Rehabilitation Single Room Occupancy programs.

The Authority deposited all of the programs' respective administrative fees into one account, thus losing their individual identities. The commingled administrative fees were then transferred to the general fund and used for Authority operating expenses, which made it difficult to determine the exact amount of administrative fees that were eligible to be used to repay the Section 8 Housing Choice Voucher program. For example, HUD requires (PIH (Office of Public and Indian Housing) Notice 2007-26(r)) that Disaster Voucher program funds not be used for other activities or costs. HUD further requires that these funds remain separate and distinct from the Authority's regular voucher program in terms of the source and use of funding. Thus, since the various Section 8 programs have differing requirements, it is vital that the Authority separately account for the programs.

Due to the accounting method used by the Authority with respect to its administrative fees, at the time of our review, neither we nor Authority staff could determine the exact amount of funds that the Authority had repaid its Section 8 program.

Management Misused $1.2 Million in Fannie Mae Loan Proceeds

In 2007, the Authority entered into a development agreement to partner in a non-HUD development referred to as Mayfair on Market. The project was designed to be a $15.9 million mixed-use development consisting of 58 residential units, above-ground floor retail space, and underground parking. The agreement required the Authority to obtain a $3.65 million loan from Fannie Mae and loan these funds to the developer entity. The developer was to repay the loan with interest and make available to the Authority 18 of the completed residential units at a reduced cost. In December 2007, the Authority obtained the $3.65 million loan from Fannie Mae. The loan documents restricted use of the funds to this development only.

As discussed above, the Authority's financial condition deteriorated during 2007, becoming critical in early 2008. Operating expenses were mounting, the Authority had used all of its reserves, and bills were going unpaid.[1] Instead of addressing the cause of the problem, management used the restricted proceeds from the Fannie Mae loan to cover low-income public housing operating expenses. In February 2008, management made three wire transfers totaling $1.2 million from the Mayfair on Market account to the Authority's general fund.

The former executive director stated that he knew it was wrong to use the Fannie Mae loan proceeds for operating expenses but intended to repay the loans with anticipated operating subsidy and capital fund program grant funds. Given the Authority's dire financial condition, it was not reasonable to assume that it could have repaid the $1.2 million loan and continued to operate.

Since the Authority breached the terms of the loan and security agreement, Fannie Mae found it to be in default. As of March 2009, it was negotiating with Fannie Mae regarding how to cure the default.

[1] From December 31, 2006, to December 31, 2007, the Authority's accounts payable account grew from $491,285 to $710,542, an increase of 44.6 percent.

Management Paid Excessive Employee Compensation at a Time of Financial Crisis

Despite the financial condition of the Authority, management took action that unnecessarily increased employee compensation costs. In late November of 2007, management increased its costs by $402,862 when it approved performance-based compensation payments and a 2.5 percent cost of living adjustment. This action was taken at a time when the Authority had liquidated all of its low-income public housing investments and was raiding its Section 8 program to cover operating expenses. Shortly thereafter, during March and May of 2008, management found it necessary to reduce full-time employees by 59 to continue operating. Management then paid these employees $193,821 in excessive severance payments. These conditions occurred because management failed to follow its own policies and procedures, and its Annual Contributions Contract with HUD, before authorizing these expenditures.

Among other requirements, Section 4 of the Authority's Annual Contributions Contract requires it to operate its low income housing projects in an economical and efficient manner. Management's decision to incur these unnecessary costs at a time of financial crisis did not promote economy and efficiency and placed the Authority in a state of non-compliance with its Annual Contributions Contract.

<u>Performance-Based Compensation</u>
In late November 2007, the former executive director authorized $213,684 in performance-based compensation payments for Authority staff. He justified this action by stating that the one-time performance-based compensation payments were made instead of merit pay increases to save on future salary and benefit expenses.

The Authority's policies and procedures did not require it to pay either merit pay increases or performance-based compensation payments, and given the Authority's financial condition neither option was appropriate. The Authority's personnel policy provided for payment of performance-based compensation but only after the executive director had determined that funds were available. The former executive director stated that he approved the payments after the chief financial officer told him that the funds were available. However, the former chief financial officer stated that the executive director told her to make the funds available, because the payments were going to be made. In either case, management failed to follow policy and made unnecessary compensation payments while it was in the midst of a financial crisis.

Cost of Living Adjustment

The executive director authorized $189,178 in cost of living adjustments for January 2008. The Authority's personnel policy provided for employees to receive a cost of living adjustment effective the first payroll period of the calendar year provided sufficient budget authority was available.

When we asked why, at a time when the Authority was in such dire financial condition, he authorized the 2008 cost of living adjustment, the former executive director stated that he was told by other management staff that the adjustment was "kind of a guaranteed thing and that you can't really not give them." He further stated that he had authorized the cost of living adjustment because the chief financial officer had told him that the funds were available. He performed no further determination of the availability of funds. In addition, Authority staff was unable to locate the written authorization for the payments required by the personnel policy. Again, the former chief financial officer stated that the executive director told her to make the funds available because the payments were going to be made. In either case, management failed to follow policy and unnecessarily increased costs at a time of financial crisis.

Excessive Severance Payments

The Authority's financial condition continued to deteriorate, and in early 2008, management began cutting staff to reduce operating expenses. Management cut full-time staff by 26 in March and an additional 33 in May. Although this was supposed to be a cost-cutting measure, management paid the affected employees $193,821 in excessive severance pay. Instead of the maximum two weeks' severance pay specified in the Authority's personnel policy,[2] management paid affected employees a minimum of six weeks.

There is no provision in the Authority's policies for the executive director to exceed the two weeks cited in the personnel policy. In addition, there is no indication that the board voted on the excessive severance payments, although the former executive director stated that some board members were aware of the nature of the severance payments. The former executive director further stated that the decision to pay more than the policy required was made to provide the affected employees a "soft landing."

[2] Section 8.1 of the Authority's personnel policy, dated May 1, 2007, reads in part, "Generally, at least two (2) calendar weeks' notice prior to discharge due to a reduction in force will be given unless federal or state law requires otherwise. Employees who are terminated due to a reduction in force and who do not receive at least two (2) calendar weeks' notice will receive pay for each day in lieu of notice up to a maximum of two (2) weeks."

The Authority Used HUD Funds to Pay Ineligible Expenses Related to Non-HUD Activities

The Authority used $49,316 in HUD funds to pay ineligible expenses for two non-HUD activities, the Grove Street Center and Mayfair on Market. Section 9(C) of the Authority's low-income public housing annual contributions contract limits the use of low-income housing funds to the HUD projects covered by the contract. Staff time spent working on non-HUD activities or expenses paid on behalf of these activities must be paid from sources other than HUD funds.

The Authority paid an estimated $20,442 for staff salaries and benefits and $28,874 for legal expenses associated with these non-HUD activities, using funds from the low-income housing general fund. This condition occurred because Authority staff did not allocate time and expenses to the non-HUD activities. Management either intentionally misused HUD funds or was unaware of the applicable requirements.

Management Used Restricted Program Income for Employee Separation Pay

On November 20, 2007, as part of an existing employment contract, the Authority paid a separated employee more than $49,000. Although the payment appeared valid, the chief financial officer directed that it be made with restricted program income. The program income consisted of development fees the Authority had earned in connection with Greenwood Terrace, a HUD mixed-finance development.

Developer fees are considered by the regulations (24 CFR 85.25(a)) to be program income, and the Authority's mixed-finance amendment to its consolidated annual contributions contract specified how it could be used. According to exhibit H of the amendment, program income earned as developer fees was to have been used either for the project or for later project phases defined in the revitalization plan. Upon completion of the entire revitalization plan, program income could be used for affordable housing purposes.

Management Failed to Provide the Board with Adequate Financial Information

Authority management failed to provide the board with adequate financial information. For example, during our audit period, management liquidated more than $4 million in investments without reporting required financial transaction detail to the board. This condition occurred because management (1) failed to follow its own procedures and (2) may have intentionally withheld negative financial information from the board. As a result of management's lack of financial disclosure, the board's ability to anticipate and deal with the financial crisis that ultimately overtook the Authority was most likely severely diminished.

<u>Reporting on Investments</u>

From January 2004 through July 2007, management liquidated more than $4 million in low-income public housing reserves. These reserves were in the form of various bank certificates of deposit. Management failed to follow HUD requirements or its own policies and procedures for keeping the board informed regarding Authority investments. In addition, management failed to maintain an investment register and failed to timely execute an accurate general depository agreement.

PIH Notice 96-33(6)(f), extended indefinitely by PIH 02-13, requires that investment transactions be authorized by the housing authority's governing board and documented in the board minutes. This notice also requires the authority to maintain an investment register to document investment transactions.

Authority policies and procedures relating to investments also require the board to approve investments and for the chief financial officer to maintain an investment register and present any change in investments to the board. Failing to maintain such a register and inform the board of specific changes eliminated a significant level of control over the Authority's investments.

Contrary to the above requirements, the Authority's board minutes showed that the chief financial officers, employed at the time the investments were liquidated, gave general statements regarding the investment balances or described the use of investments as bringing units up to REAC standards. At no time during the period in question did the minutes show that the chief financial officers complied with the requirements for keeping the board informed regarding specific changes in Authority investments.

In addition, at the time the Authority executed its latest financial management contract, it failed to execute a general depository agreement as required by

Section 9(A) of the annual contributions contract. The only general depository agreement found between the Authority and its financial institution was incomplete and executed more than 15 months after the contract was executed. Section 3(b) of HUD's general depository agreement requires that a written directive be signed on behalf of the Authority by an officer or member designated by resolution or member of the board to sell the Authority's securities. The incomplete agreement had a date of August 1, 2007, eight days after the last low-income public housing investment was liquidated. Authority staff indicated that liquidation of the investments was handled via telephone calls to its financial institution. Management was either unaware of the requirements or intentionally delayed the execution of the agreement to circumvent a key internal control. Not having an executed general depository agreement in place served to circumvent a control which could have alerted the executive director or the board that all of the low-income public housing reserves were being liquidated.

Reporting on Authority Finances

The former chief financial officer was hired on October 31, 2005. The former executive director stated that he hired the chief financial officer because she was formerly a HUD auditor and as a former HUD Office of Public Housing employee, had acted as the Authority's HUD financial analyst. He stated that he relied upon her knowledge and experience with respect to financial and program matters.

During the March 2006 board meeting, after receiving the chief financial officer's financial report, a board member commented that it was a vast improvement over what they had previously received. However, soon thereafter, the board minutes showed that financial reporting began to be delayed and the chief financial officer gave various reasons for the delays. For example, according to the board minutes, quarterly financial reporting was delayed from July 2006 to August 2006, and during the September 2006 board meeting, the chief financial officer stated, apparently without explanation, that there was no financial report. During the October 2006 board meeting, the chief financial officer informed the board that no quarterly financial report would be given due to moving to new offices and the Authority's audit. The next financial report was given during the December 2006 board meeting, and that report was not completely accurate. The chief financial officer reported that the low-income public housing program operated at a surplus of about $1.4 million for the year. However, contrary to this positive report, the Authority's 2006 audit showed that the program actually operated at almost a half-million-dollar deficit.

During 2007, the board minutes showed that the financial reporting became even more erratic and incomplete. No significant financial reporting was presented to the board during five of the first seven months of 2007. More troubling was the fact that at no time during 2007 did the former chief financial officer inform the board that the Authority was (1) totally liquidating its low-income public housing investments, (2) transferring Section 8 housing assistance funds to the general fund to cover operating expenses, (3) hiring a consultant to perform an analysis of the Authority's finances (or the results of the analysis), or (4) paying its employees performance-based compensation and a 2008 cost of living adjustment. In addition, the 2008 minutes showed that neither the executive director nor the chief financial officer informed the board that Fannie Mae development loan proceeds were being used to cover operating expenses.

The consolidated statement of revenue and expenses used by management to report the Authority's financial condition to the board tended to mask the deterioration of the Authority's low-income public housing program during 2007. Because the revenue line item inaccurately reported restricted housing assistance funds as unrestricted cash and cash equivalents, it erroneously appeared as though both programs were financially healthy. The Authority's low-income public housing program ran a deficit of more than $2 million in fiscal year 2007, yet there was no indication of an impending financial crisis from what management was reporting to the board.

The April 2008 board minutes highlighted the board's ignorance of the Authority's financial condition, as well as management's failure to properly financially manage the Authority. During the meeting, the chief financial officer split apart the statements of revenue and expenses to show where each program stood financially. When told that the low-income housing program was operating at a $5.3 million loss (including depreciation), one commissioner asked how the Authority had gotten into that situation and why the board had not been made aware of the situation. Without further explanation, the chief financial officer responded, "We are just living month to month."

Financial Consultant Hired

Upon being hired in October 2007, the current executive director, the chief operating officer at the time, became concerned about the Authority's financial health. She requested that a consultant be hired to analyze the financial condition of the Authority. The former executive director agreed, and in late November 2007, a financial consultant was hired. In mid-December 2007, the consultant reported that the Authority had been out of money since July 2007 and that to get its operating expenses under control, it needed to reduce the number of full-time employees by 66. The former executive director stated that he chose to ignore the consultant's suggestions after the former chief financial officer told him that the consultant's figures were incorrect.

A review of the board minutes showed that there was no mention of the Authority's having hired the financial consultant or any mention of the results of the consultant's financial analysis. It should also be noted that the former executive director was aware of the consultant's analysis before the implementation of the 2008 cost of living adjustment.

As a result of management's failure to report critical financial information, the board lacked specific information needed to make the significant changes necessary to ensure the financial health of the Authority.

Management Was Making Improvements

The current Authority management had taken action to improve operations. These actions included

- Reducing its staff by 64 full-time employees via three separate reductions in force,
- Complying with its personnel policy during the most recent reduction in force to allow for appropriate severance pay,
- Reporting more detailed financial information during board meetings, and
- Obtaining HUD approval for the sale of Authority-owned surplus properties to generate additional funds.

Conclusion

The Authority's financial condition had steadily declined over the past few years, because management failed to adequately address the cause of the decline. Instead, it misused HUD and Fannie Mae funds to cover excessive operating expenses. Management used more than $788,000 in Section 8 funds in conflict with HUD's requirements and an additional $1.2 million in proceeds from a Fannie Mae development loan in conflict with the executed loan agreement.

Management also paid hundreds of thousands of dollars to its employees for performance-based compensation and cost of living adjustments in conflict with its policies, gave excess severance pay to laid-off employees in conflict with its policies, used restricted program income to pay employee separation pay, and paid ineligible expenses from its general fund for non-HUD development activities. In addition, management failed to adequately report the Authority's deteriorating financial condition to its board.

These conditions occurred because Authority staff either intentionally misused HUD funds or were unaware of HUD requirements as well as the Authority's own policies with respect to eligible uses of HUD funds. In addition, management either intentionally kept financial information from the board or was unaware of

HUD's and its own requirements for reporting financial information to the board. As a result, the Authority had fewer funds with which to meet its mission of providing decent, safe, and sanitary housing.

Although recent improvements will assist the Authority in improving its operations, internal controls over its financial operations must be strengthened. Policies and procedures must be put in place to ensure that all Authority employees are made aware of the controls and follow them.

Recommendations

We recommend that you

1A. Require the Authority to repay its Section 8 program $788,639 from its low-income public housing program and provide adequate documentation as evidence of repayment.

1B. Require the Authority to identify the source of the funds used to pay the 2007 performance-based compensation payments and the 2008 cost of living adjustment. For any such expenditure for which the source of funds was not a portion of the $788,639 cited in recommendation 1A, require the Authority to repay its low-income public housing program up to $402,862 from non-federal funds.

1C. Require the Authority to repay its low-income public housing program $193,821 from non-federal funds for the excessive severance payments made during the 2008 reductions in force.

1D. Require the Authority to repay its low-income public housing program a total of $49,316 from non-federal funds for the payment of ineligible non-HUD expenses.

1E. Require the Authority to repay its Greenwood Terrace program income account $49,480 for the ineligible separation pay.

1F. Require the Authority to not only follow current program requirements, but also develop and implement internal controls to ensure that HUD funds are expended only for eligible uses.

1G. Require the Authority to account for its individual programs in a manner that permits an accurate determination of the status of specific program funds.

1H. Require the Authority to follow its personnel policy when deciding to approve any future performance-based compensation payments, cost of living adjustments, and/or separation payments.

1I. Require the Authority to begin accounting for all expenses related to non-HUD activities separately and pay these expenses with other than HUD funds.

1J. Require Authority management to accurately report the Authority's financial condition to give the board an opportunity to take appropriate and timely action as conditions dictate.

1K. Require the Authority to execute a complete general depository agreement with its financial institution to ensure that required internal controls are in place with respect to its financial management.

SCOPE AND METHODOLOGY

Our audit objective was to determine to what extent funds subject to an annual contributions contract were used to benefit non-HUD development activities or were otherwise inappropriately disbursed. To accomplish our objective, we

- Reviewed applicable laws, regulations, and other HUD program requirements, including applicable sections of the *Code of Federal Regulations*, the Authority's annual contributions contract, and public housing notices.
- Interviewed HUD and Authority staff (former and current).
- Reviewed agency accounting data, invoices, payroll records, financial audits, REAC financial recovery report, and related documents.

We conducted our audit from October 2008 through March 2009 at both the Nashville, Tennessee, HUD office and the Authority's central office located at 801 Holtzclaw Avenue, Chattanooga, Tennesse. Our audit period was from October 1, 2004, through September 30, 2008. We expanded our audit period as needed to accomplish our objective.

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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

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

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They 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 objectives:

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

- Safeguarding of resources - Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- The Authority did not have adequate internal controls in place to ensure that HUD funds were expended as required (finding 1).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/	Unsupported 2/
1A	$788,639	
1B		$402,862
1C	193,821	
1D	49,316	
1E	49,480	
Total	$1,081,256	$402,862

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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

CHATTANOOGA HOUSING AUTHORITY

ELIZABETH F MCCRIGHT
EXECUTIVE DIRECTOR

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June 1, 2009

James D. McKay
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Region 4 Office of the Inspector General
Office of Audit, Box 42
Richard B. Russell Federal Building
75 Spring Street, SW, Room 330
Atlanta, Georgia 30303-3388

Re: Chattanooga Housing Authority Draft Audit Response

Dear Mr. McKay:

This letter is in response to the Draft Audit dated May 19, 2009 relating to your Department's review of the Chattanooga Housing Authority's ["CHA"] development activities and financial condition during the period from October 1, 2004 through September 30, 2008.

On behalf of the CHA's Board of Commissioners and staff, I would like to thank you and your staff David Bucher, Charles Pagano and Shane Weaver for the time and effort dedicated to this review. We appreciative the collaborative and constructive approach with which this report was prepared.

I have reviewed the draft report in detail and agree that the CHA's financial condition has steadily declined over the past few years and that prior management staff failed to address the cause of the decline resulting in the use of funding from inappropriate sources to support increased operational expenses.

I have commented below on each of the recommendations noted in your report and look forward to the opportunity to work with HUD to develop a corrective action plan.

Recommendation 1A

Require the Authority to repay its Section 8 program $788,639 from its low-income public housing program and provide adequate documentation as evidence of repayment.

The CHA agrees that any funds borrowed from the Housing Choice Voucher Program to support Low Income Public Housing Program expense should be repaid and documented appropriately. In 2008, the CHA repaid a total of $72,000 to the Housing Assistance Payment Program Account, thereby reducing the debt to $716,639. The CHA proposes to submit a formal request for a repayment agreement to HUD Nashville, in which the CHA will document the $72,000 payment and will propose terms for continued repayment until the debt is satisfied.

Recommendation 1B

Require the Authority to identify the source of the funds used to pay the 2007 performance-based compensation payments and the 2008 cost of living adjustment. For any such expenditure for which the source of funds was not a portion of the $788,639 cited in Recommendation 1A, require the Authority to repay up to $402,862 from non-federal funds.

Comment 1

The CHA will attempt to identify the source of the funds used to pay the 2007 performance-based compensation payments and the 2008 cost of living adjustment by July 30, 2009. As discussed in the exit conference with Mr. Butcher, Pagano and Weaver of your staff, the CHA has very few non-federal resources, of nominal value. It is unlikely that the CHA will be able to comply with the recommended repayment requirement for years to come, and therefore requests a waiver of this repayment responsibility.

Recommendation 1C

Require the Authority to repay its low-income public housing program $193,821 from non-federal funds for the excessive severance payments made during the 2008 reductions in force.

Comment 1

As noted in its response to Recommendation 1B, the CHA has very limited sources of non-federal funds and it is unlikely that the CHA will be able to comply with the proposed repayment requirement for years to come, and therefore requests a waiver of the repayment responsibility.

Recommendation 1D

Require the Authority to repay its low-income public housing program a total of $49,316 from non-federal funds for the payment of ineligible non-HUD expenses.

Comment 1

As noted in its response to Recommendation 1B, the CHA has very limited sources of non-federal funds and it is unlikely that the CHA will be able to comply with the proposed repayment requirement for years to come, and therefore requests a waiver of the repayment responsibility.

Recommendation 1E

Require the Authority to repay its Greenwood Terrace program income account $49,480 for the ineligible separation pay.

In conjunction with Recommendation 1A, the CHA proposes to submit a formal request for a repayment agreement to HUD Nashville, in which the CHA will address the repayment to Greenwood Terrace, LLC in the amount of $49,480.

2

Recommendation 1F

Require the Authority to not only follow current program requirements, but also develop and implement internal controls to ensure that HUD funds are expended only for eligible uses.

The CHA has begun to implement internal control policies, but has more work to do in this regard. The CHA would request HUD's assistance in the development of written internal control policies and procedures that will address this Recommendation.

Recommendation 1G

Require the Authority to account for its individual programs in a manner that permits an accurate determination of the status of specific program funds.

The CHA is working closely with HUD Nashville to develop monthly financial reports that permit an accurate determination of the status of specific program funds. It is expected that the format of these reports will be completed by June 30, 2009.

Recommendation 1H

Require the Authority to follow its personnel and financial policies when deciding to approve any future performance-based compensation payments, cost of living adjustments, and/or separation payments.

The CHA Management Team is committed to following its policies with regard to performance-based compensation payments, cost of living adjustments, and/or separation payments. As evidenced by the most recent reduction in force, the CHA complied with all personnel policies related to severance payments.

Recommendation 1I

Require the Authority to begin accounting for all expenses related to non-HUD activities separately and pay these expenses with other than HUD funds.

The CHA will account for all expenses related to non-HUD activities separately and pay these expenses with other than HUD funds.

Recommendation 1J

Require Authority management to accurately report the Authority's financial condition to give the Board an opportunity to take appropriate and timely action in the future as conditions dictate.

The CHA reserves a time at each monthly Board meeting for a full financial report by staff for the previous month's financial activities. The CHA is working closely with HUD Nashville to revise its current financial reports to provide meaningful and comprehensive information to the Board of Commissioners.

Recommendation 1K

Require the Authority to execute a complete general depository agreement with its financial institution to ensure that required internal controls are in place with respect to its financial management.

Although the CHA had a general depository agreement with First Tennessee Bank, the document was missing the date of the instrument and the signature of a witness on the signatory page. The CHA will execute a general depository agreement with First Tennessee Bank that is complete in all aspects to ensure that required internal controls are in place with respect to its financial management.

If you have any questions, do not hesitate to contact me at 423.752.4188.

Sincerely,

Elizabeth F. McCright

Elizabeth F. McCright
Executive Director

cc: Charles Barnett, HUD-Nashville
CHA Board of Commissioners

<u>OIG Evaluation of Auditee Comments</u>

Comment 1 The Authority asked for a waiver from reimbursing its low-income public housing program from non-federal funds for ineligible expenditures. The Authority stated that it has very limited sources for non-federal funds. We do not agree that such a waiver is appropriate at this time. The Authority should work with the local office of Public Housing to determine the total amount of ineligible costs and consider the options for reimbursement.

Appendix C

SCHEDULE OF LIQUIDATED INVESTMENTS AND USE OF FUNDS – JUNE 30, 2006, THROUGH JULY 24, 2007

Date	**Amount of investment(s) liquidated**	**Authority comments**
June 30, 2006	$440,486.67	"3rd Payroll 6/30/06/ AP* checks dated 6/29/06 $437,476.88"
December 22, 2006	$578,554.03	"3rd Payroll 6/30/06/ AP checks dated 12/22-12/31/2006 $249,685.21"
February 28, 2007	$388,416.54	"AP checks dated 3/1/07 $614,913.91 (TML $166,261.00)"
April 23, 2007	$303,884.18	"AP checks dated 4/1-4/30/2007 $1,786,435.14"
July 24, 2007	$405,141.91	"AP checks dated 7/1-7/31/2007 $942,164.27"
July 24, 2007	$405,141.91	None
Total	$2,521, 625.24	

* AP = accounts payable