

INTERNAL AUDIT REPORT

DATE: July 14, 2020

TO: Linda Gorton, Mayor

CC: Sally Hamilton, Chief Administrative Officer
Glenn Brown, Deputy Chief Administrative Officer
Aldona Valicenti, Chief Information Officer
William O'Mara, Commissioner of Finance and Administration
Susan Speckert, Commissioner of Law
Phyllis Cooper, Director of Accounting
Charlie Lanter, Director of Grants and Special Programs
Susan Straub, Communications Director
Urban County Council
Internal Audit Board

FROM: Bruce Sahli, CIA, CFE, Director of Internal Audit
Trey Wilburn, CFE, Internal Auditor

RE: Affordable Housing Program Audit

Background

Lexington's Affordable Housing Program was created in 2014 to help provide affordable housing for households at or below 80% of area median income (i.e. \$56,100 for a family of four). The purpose of the Fund is to leverage public and private investment to provide, produce and preserve safe, quality affordable housing. Housing is considered affordable when rent and utility costs are no more than 30% of gross



household income. The goal of the Office of Affordable Housing is that every household in Fayette County will have access to safe, quality, and affordable housing.

Developments funded all or in part with Affordable Housing Fund dollars must be permanent housing that serves households at or below 80% of the Fayette County area median income. More specific targets may be established by the Board. These targets shall reflect awareness of the need to ensure that a portion of the Fund's resources serve the housing needs of households at or below 50% of area median income and households at or below 30% of area median income. Permanent housing is defined as housing where there is no time limit on how long a household can reside in a unit.

In order to meet its mission and goals, LFUCG has allocated \$2,000,000 to the Affordable Housing Fund in Fiscal Year 2021.

Loans and grants from the Fund are not intended to be the sole source of funding for a development; therefore, developments must leverage other public and private dollars. The development's financing plan must demonstrate Fund dollars will assist in reducing development costs, and thereby reduce or eliminate debt that must be serviced from rental income. Energy efficient construction is required to ensure reduced utility costs. It is expected that reduced debt service and utility costs will correspond to lower rents charged to the tenants. In addition, all developments receiving resources from the Fund will be deed restricted to ensure long term affordability.

Scope and Objectives

The general control objectives for the audit were to provide reasonable assurance that:

- The underwriting process is being followed on each of the loan, grant, and deferred/forgivable notes
- The loan principle and interest amounts are credited to projects correctly
- There is consistent compliance with ordinance-related program requirements

Audit results are based on observations, inquires, transaction examinations, and the examination of other audit evidence and provide reasonable, but not absolute, assurance controls are in place and are effective. In addition, effective controls in place



during an audit may subsequently become ineffective as a result of technology changes or reduced standards of performance on the part of management. The scope of the audit included activity from January 1, 2015 through January 1, 2020.

Statement of Auditing Standards

We conducted our audit in accordance with the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to afford a reasonable basis for our judgments and conclusions regarding the organization, program, activity or function under audit. An audit also includes assessments of applicable internal controls and compliance with requirements of laws and regulations when necessary to satisfy the audit objectives. We believe that our audit provides a reasonable basis for our conclusions.

Audit Opinion

In our opinion, the controls and procedures provided reasonable assurance that the general control objectives were mostly being met. Opportunities to improve controls are included in the Summary of Audit Findings.

Priority Rating Process

To assist management in its evaluation, the findings have been assigned a qualitative assessment of the need for corrective action. Each item is assessed a high, moderate, or low priority as follows:

High - Represents a finding requiring immediate action by management to mitigate risks and/or costs associated with the process being audited.

Moderate – Represents a finding requiring timely action by management to mitigate risks and/or costs associated with the process being audited.

Low - Represents a finding for consideration by management for correction or implementation associated with the process being audited.



SUMMARY OF AUDIT FINDINGS

Finding #1: Insurance Coverage Needed for Affordable Housing Program Projects

Priority Rating: High

Condition:

The current balance of outstanding loans as of April 30, 2020 was \$7,792,729. Our examination of Ordinance 101-2014 and the Program's Loan Underwriting Policies and Procedures noted there is no requirement for insurance coverage on the loans. This leaves LFUCG at risk for losses as the second lienholder.

Effect:

In the absence of insurance coverage for each Affordable Housing Program project, LFUCG has limited protection from loss on these community investments.

Recommendation:

The Affordable Housing Program needs to add binding insurance coverage on every project for the entirety of the mortgage. This needs to be inserted into the Affordable Housing Program's Loan Underwriting Policies and Procedures.

Director of Grants & Special Programs Response:

While not in the Affordable Housing Program's Loan Underwriting Policies and Procedures, the Program's Loan Agreement and Mortgage documents include language that requires insurance coverage with LFUCG as a loss payee. For an additional level of security, the Affordable Housing Program's Loan Underwriting Policies and Procedures will be updated to include language related to insurance coverage requirements. Further, compliance guidelines will be updated to include an annual review of insurance maintained by each development to ensure the developments are adhering to the insurance requirements included in the Loan Agreement and Mortgage.

Chief Administrative Officer Response:

I concur.



Finding #2: Single Point of Failure Exits Within the Program
Priority Rating: High

Condition:

The Affordable Housing Program Manager is retiring. He has been the only person responsible for the day-to-day operation of this program since its inception in 2014. His retirement represents a significant loss of Program knowledge and industry contacts that have provided an important component in the successful administration of the Affordable Housing Program, and there is no defined succession plan in place.

Effect:

A single point of failure exists within the Affordable Housing Program due to the fact only one LFUCG employee is trained to administer this complex program, which has been allocated \$2,000,000 for Fiscal Year 2021.

Recommendation:

The Affordable Housing Manager position was created by Ordinance and is thereby assigned the day-to-day management of the Affordable Housing Fund. However, in-house back-up support should be available in the event the Affordable Housing Manager position is vacated or if the Manager is otherwise unable to perform the administrative duties. A possible source of this additional in-house support might be someone within the Division of Grants & Special Programs. During the audit, the Affordable Housing Manager mentioned that the compliance part of the program could be serviced by a third party, and the feasibility of this should be considered by senior management.

Director of Grants & Special Programs Response:

The Affordable Housing Manager has recently been assigned to the Division of Grants and Special Programs and this allows for back-up support in the areas of administration, compliance and underwriting. However, as the Affordable Housing portfolio continues to add units, it will eventually become necessary to expand staffing in order to meet compliance requirements of the ordinance. This will add an additional layer of security and institutional knowledge to the program.

Chief Administrative Officer Response:

I concur.



Finding #3: Improved Security and Storage of Affordable Housing Files Needed

Priority Rating: High

Condition:

All of the Affordable Housing Program electronic files are stored on the Affordable Housing Manager's work computer C:Drive, with no file backup process in place. The Affordable Housing Manager also has paper documents for all loans in his office. The paper documents are stored in a filing cabinet which does not provide protection from fire or theft. Some of the documents contain confidential personal financial information.

Effect:

Affordable Housing Program files and documents are not properly backed up or secured.

Recommendation:

All Affordable Housing Program information contained on the Affordable Housing Manager's work computer C:Drive should be moved to a secured shared program drive on the LFUCG network. The Affordable Housing Manager informed us during the audit that this is in the process of being completed. The Program's paper documents should be stored in a locked file cabinet in order to secure the confidential information.

Director of Grants & Special Programs Response:

All electronic data has been moved to the shared I-Drive maintained by the Division of Grants & Special Programs. This drive is backed up nightly. All paper files will be moved to a more secure location.

Chief Administrative Officer Response:

I concur.



Finding #4: Deferred/Forgivable Loan Promissory Note Criteria not Addressed in Ordinance
Priority Rating: High

Condition:

In the Promissory Note Language for Deferred/Forgivable Loans it states “However, so long as the Maker ensures the Affordability Period of a minimum of fifteen (15) years from the date Funds are first expended on the Project as defined in Section 3.3 of the Loan Agreement AND that no Breach or Event of Default as defined in Section 5.1 and 5.2 of the Loan Agreement has occurred without cure or continues to occur without cure, then LFUCG may in its sole discretion elect not to require payment on its Maturity Date.”

There is no guidance in Ordinance 101-2014 or Affordable Housing’s Policies and Procedures that mentions LFUCG waiving required payment or who would have the power to waive such payment.

Effect:

The absence of guidance regarding loan forgiveness could result in inappropriate or inconsistent loan forgiveness decisions.

Recommendation:

The Ordinance should be amended to address loan forgiveness.

Director of Grants & Special Programs Response:

This language exists on some housing credit transactions and is in place to ensure Affordable Housing Funds allocated to these developments adhere to the requirements of Section 42 of the Internal Revenue Code, which governs the Low Income Housing Credit. Deferred loans, with no repayment requirements, are a tool used to comply with Section 42 and when allocated by the Board there is no expectation of repayment at the end of the 15 year loan term. Instead of placing forgiveness language in an Ordinance, the Program’s Rental Guidelines should be revised to clarify that the Board must approve forgiveness at the end of the loan period.

Chief Administrative Officer Response:

I concur.



Finding #5: Annual Report of Affordability Requirement is not Being Enforced
Priority Rating: High

Condition:

Section 2-483.(E) of Ordinance 101-2014 states, “An annual report of affordability shall be submitted by the applicant to the Board”. We found no evidence that annual reports of affordability were being submitted for Board review. The Board of Affordable Housing is supposed to receive these reports every year for every funded project.

Effect:

An ordinance requirement is not being complied with by the developer/owner.

Recommendation:

The Affordable Housing Governing Board should enforce this annual requirement on a consistent basis as required by Ordinance.

Director of Grants & Special Programs Response:

The Affordable Housing Manager is performing this function by conducting annual reviews of each funded development to ensure units are leased to income eligible tenants and the rents remain affordable to the population being served. The Ordinance should be revised to read “An annual report of each funded development’s adherence to affordability requirements shall be submitted by the Affordable Housing Manager to the Board.”

Chief Administrative Officer Response:

I concur.

Finding #6: Inconsistencies Noted Between Board’s Practices and Ordinance Requirements

Priority Rating: High

Condition:

We noted two inconsistencies between the Board’s practices in application review and the related ordinance that governs the Affordable Housing Fund. Ordinance 101-2014 Sec. 2-479.5 states that the board should annually review, rank, prioritize, and approve funding proposals from eligible applicants. The audit determined that the Affordable Housing Manager is reviewing, ranking, and prioritizing the applications and the Board is only approving funding.



In addition, Ordinance 101-2014 Section 2-479.8 states the Board should submit annual reports on the activities of the Affordable Housing Fund to the Mayor, the Urban County Council, and the community. We found no evidence that this is being performed by either the Board or the Affordable Housing Manager.

Effect:

Two of the Board's duties required by Ordinance 101-2014 are not being complied with. This could raise questions about the proper governance and reporting of the Affordable Housing Fund activities.

Recommendation:

The ordinance requirements should be consistently complied with. Consideration should be given to possibly changing the ordinance to allow the Affordable Housing Manager to review, rank, and prioritize the applications, after which the Manager would be required to give a full report to the Board for final approval of the application ranking and prioritization. The Board would still decide whether to approve funding.

Consideration should also be given to allowing the Affordable Housing Manager to prepare the Affordable Housing Fund annual report for the Board's review and approval, after which either the Manager or the Board should present the report to the Mayor, Council, and community.

Director of Grants & Special Programs Response:

The Ordinance should be amended to reflect the current process whereby the Affordable Housing Manager makes funding recommendations to the Board after underwriting each application to ensure it adheres to the Board's evaluation criteria and funding priorities. Additionally the Ordinance should be amended to require the Affordable Housing Manager to prepare and present reports on Affordable Housing Fund activities to the Mayor, City Council and Community. The Affordable Housing Manager has made two presentations to the City Council, the last being in June 2017 and on several occasions has made presentations to community groups. If approved by the Chief Administrative Officer work on the amendments will begin immediately.

Chief Administrative Officer Response:

I concur.



Finding #7: Reserve for Replacement Requirement is not Being Enforced
Priority Rating: Moderate

Condition:

The Affordable Housing Fund Guidelines' Reserves for Replacement requirement states, "The Fund requires a minimum reserve for replacement deposit of \$400 per unit per year for new construction developments. The minimum amount for rehabilitation developments will be determined by the capital needs assessment, but in no case be less than \$400 per unit per year, unless waived by the Board." We found no evidence that this is being done for any of the projects.

Effect:

The absence of Reserve for Replacement accounts increases the risk that funding for the replacement of short-lived building components will not be available if needed.

Recommendation:

The Reserve for Replacement requirement should be consistently enforced in order to set aside funds to provide for the periodic replacement of short-lived building components. The Affordable Housing Manager should ensure that every project has the reserve fund in place.

Director of Grants & Special Programs Response:

Annual compliance reviews will include a review of a development's Reserve for Replacement Account. The Board has waived this requirement or lowered the required deposit amount on several smaller transactions. In the future, the minutes will reflect these actions.

Chief Administrative Officer Response:

I concur.

Finding #8: Posting Error Not Corrected in a Timely Manner
Priority Rating: Moderate

Condition:

AmeriNat services nine loans for the Affordable Housing Program. Each month AmeriNat sends a loan revenue report and related check to a Division of Grants and Special Programs Manager. The report indicates how much principal and interest were



posted to each of the nine accounts serviced by AmeriNat. From January 2019 through May 2019, AmeriNat posted all payments for account #1000099317 to principal only. These five months of accounting errors were identified during the Affordable Housing Manager's June 2019 account reconciliation, resulting in \$957.78 being transferred from account principal to account interest.

Effect:

Incorrect posting of interest payments effect the reporting of interest income.

Recommendation:

Care should be taken to correctly complete the monthly reconciliation.

Director of Grants & Special Programs Response:

The Affordable Housing Manager performs monthly financial reconciliations to ensure all loan payments are received and the records maintained by the Manager reconcile with data provided through LFUCG's accounting and budget system. However, the Manager failed to timely report the misclassification of loan payments on the above mentioned loan. Future errors will be corrected in a timely manner.

Chief Administrative Officer Response:

I concur.

