

Schedule of Audit Findings and Responses

King County Housing Authority January 1, 2010 through December 31, 2010

1. **Other auditors reported that related entities of the Housing Authority do not have adequate internal controls over accounting.**

Background

Housing Authority management, taxpayers, bondholders, creditors, banks, the state Legislature, and state and federal agencies rely on the information in financial statements and reports to make decisions. It is the responsibility of Housing Authority management to design and follow effective internal controls to provide reasonable assurance regarding the reliability of financial reporting.

Government Auditing Standards, prescribed by the Comptroller General of the United States, require the auditor to communicate internal control deficiencies, as defined below in the Applicable Laws and Regulations section, as a finding. Auditing guidance also allows the auditor to report significant deficiencies identified by other auditors. Therefore, these findings have been included in our report.

Description of Condition

Tax Credit Partnerships

Housing authorities create tax credit partnerships as separate limited liability partnerships or limited liability companies to obtain private funding for low-income housing projects. The Housing Authority is the general (or managing) partner and the investor is the limited partner. The King County Housing Authority had 23 such partnerships in 2010. Because they have a significant operational or financial relationship with the Housing Authority, they are included in its financial reporting. As private companies, the partnerships are audited by auditors other than those at the State Auditor's Office. The audited financial statements are combined and presented in the Housing Authority's financial statements.

The other auditors identified significant deficiencies in internal controls for 11 of the 23 Tax Credit Partnerships, as follows:

Sixth Place Apartments Limited Liability Partnership:

Not all construction costs incurred were recorded, resulting in work in progress, contractor's payable, and retention being understated by \$789,521

Salmon Creek Housing Limited Liability Partnership:

Depreciation expense was not recorded, resulting in depreciation expense and accumulated depreciation being understated by \$1,000,871.

Soosette Creek Limited Liability Company:

- Retained earnings did not include the total amount of prior year losses, resulting in retained earnings being understated by \$486,728.
- Depreciation expense was recorded for more than a reasonable amount, resulting in depreciation expense and accumulated depreciation being overstated by \$1,934,123.

Seola Crossing Limited Liability Partnership:

Depreciation expense was not recorded in accordance with the depreciable lives stated in the financial statements, resulting in depreciation expense and accumulated depreciation being overstated by \$278,908.

Colonial Gardens Limited Partnership:

Depreciation expense was not recorded, resulting in depreciation expense and accumulated depreciation being understated by \$169,441.

Woodridge Park Liability Partnership:

Transfer of property to KCHA was not recorded, resulting in fixed assets, and non-recourse debt being overstated, and gain on transfer at fair market value being understated by \$471,160.

Seatac Limited Partnership:

- Additions to fixed assets were not capitalized, resulting in fixed assets being understated and net loss being overstated by \$121,412.
- Involuntary conversions of fixed assets and the gain on the involuntary conversion from the fire that occurred were not recorded, resulting in fixed assets being understated and net loss being overstated by \$653,082.

Cones Limited Partnership:

Excessive depreciation expense was taken on fixed assets, resulting in depreciation expense and accumulated depreciation being understated by \$93,112.

Nia Apartments Limited Liability Company:

Depreciation expense was not recorded accurately, resulting in depreciation expense and accumulated depreciation being understated by \$682,895.

Eastbridge Apartments Limited Liability Company:

- Depreciation expense was not recorded, resulting in depreciation expense and accumulated depreciation being understated by \$759,867.
- ASC 835 (FAS 62) assets on bonds were not capitalized, resulting in fixed assets being understated and interest expense being overstated by \$281,175.

Egis Housing Limited Partnership:

Additions to building were not capitalized, resulting in fixed assets being understated and net loss being overstated by \$216,740.

Effect of Condition

The tax credit partnerships corrected all of the errors listed above in their accounting records and financial statements.

Recommendation

The other auditors recommended the tax credit partnerships take the following actions, which include improvements to their internal controls over financial reporting:

- Record all the costs incurred for construction projects
- Record depreciation and amortization expense in accordance with the methods listed in their notes to the financial statements
- Record all prior year's net loss into retained earnings
- Record the transfer of property made to the King County Housing Authority
- Capitalize material additions to fixed assets
- Record involuntary conversions when they occur
- Record the interest incurred on bonds during the construction period to fixed assets.

Housing Authority's Response

The King County Housing Authority strenuously disagrees with the SAO in its classification of these SAS 115 letters as a finding. Our disagreement is based on the following issues:

- 1) *The outside auditors clearly state in their correspondence to the management of the limited partnerships "this communication is intended solely for the information and use of management, the Partnership, and others within the organization, and is not intended to be and should not be used by anyone other than these specified parties." This language exists for a very explicit reason: to allow private auditors to convey issues to management in an educational manner. While it is common for the SAO to rely on the work of component unit private auditors for attestation purposes, it is not commonplace to include such management letters as a finding for the primary government. Indeed, the wording above makes it*

clear that the private auditors are not expecting or allowing others to rely on their management letter.

- 2) The management letters are discussing deficiencies that do not even rise to the level of a "material weakness". Instead, they are categorized as a "significant deficiency" which is "less severe than a material weakness". It is inconsistent for the SAO to report these lower-level management letter items as findings, the SAO's most serious reporting level.*
- 3) Notwithstanding the above, we disagree with the private auditor's assertion that the issues they identified even rise to the level of being a significant deficiency. It has been the strategy of the partnerships to have the CPA firm suggest final closing entries rather than having the management companies make them, as the CPA firm has the necessary technical background. Indeed, this procedure is part of the internal control process, not a deficiency.*
- 4) Although such management letters existed during the 2009 audit, the SAO chose to not include such letters in their 2009 report, and they gave no indication they had any issues with the letters. It was only after the time had passed for KCHA to make the objection listed in (3) above to the private auditor that the SAO changed their position on the management letters. This is inherently unfair.*

Auditor's Remarks

The Washington State Auditor's Office performs its audits in accordance with *Government Audit Standards*, issued by the Comptroller General of the United States. As stated below, these standards require us to include information about significant deficiencies in internal control that were noted during the audits of the Housing Authority and its related entities. We reaffirm our finding.

Applicable Laws and Regulations

Government Auditing Standards, July 2007 Revision – Section 5.11, states that auditors should report significant deficiencies and material weaknesses in internal control.

Statement on Auditing Standards No. 115, issued by the Auditing Standards Board of the American Institute of Certified Public Accountants, defines material weakness and significant deficiency as follows:

a. Material weakness:

A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

b. Significant deficiency:

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material

weakness, yet important enough to merit attention by those charged with governance.

State law (RCW 43.09.200) states:

The state auditor shall formulate, prescribe, and install a system of accounting and reporting for all local governments, which shall be uniform for every public institution, and every public office, and every public account of the same class.

The system shall exhibit true accounts and detailed statements of funds collected, received, and expended for account of the public for any purpose whatever, and by all public officers, employees, or other persons.

The accounts shall show the receipt, use, and disposition of all public property, and the income, if any, derived therefore; all sources of public income, and the amounts due and received from each source; all receipts, vouchers, and other documents kept, or required to be kept, necessary to isolate and prove the validity of every transaction; all statements and reports made or required to be made, for the internal administration of the office to which they pertain; and all reports published or required to be published, for the information of the people regarding any and all details of the financial administration of public affairs.

Budgeting, Accounting and Reporting System (BARS) Manual, Part 3, Accounting, Chapter 1, Accounting Principles and General Procedures, Section B, Internal Control, states in part:

Internal control is a management process for keeping an entity on course in achieving its business objectives, as adopted by the governing body. This management control system should ensure that resources are guarded against waste, loss and misuse; that reliable data is obtained, maintained, and fairly disclosed in financial statement and other reports; and resource use is consistent with laws, regulations and policies.

Each entity is responsible for establishing and maintaining an effective system of internal control throughout their government.