AUDIT REPORT

ONE MCKNIGHT PLACE
REVIEW OF PROJECT DISBURSEMENTS

ST. LOUIS, MISSOURI

2001-KC-1002

MAY 11, 2001

OFFICE OF AUDIT, GREAT PLAINS
KANSAS CITY, KANSAS

Issue Date
May 11, 2001
Audit Case Number
2001-KC-1002

TO: Herman S. Ransom, Director, Office of Multifamily Housing, Kansas City Hub, 7AHM

Roger E. Niesen

FROM: Roger E. Niesen, District Inspector General for Audit, 7AGA

SUBJECT: One McKnight Place - #085-36602
St. Louis, Missouri

We have completed an audit of One McKnight Place's use of project funds to determine if the owners complied with the terms of their regulatory agreement. We conducted the audit in response to a request from your office.

Our report contains four findings with recommendations requiring action by your office. The four findings address premature distributions of surplus cash to the owners, excessive withdrawals from the replacement reserve account, deficiencies relating to the management agreement, and the use of the project's funds for other than reasonable and necessary project expenses.

Within 60 days please give us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or you staff have any questions, please contact me at (913) 551-5871.

Executive Summary

We have completed an audit of One McKnight Place. The objective of our audit was to determine whether the owners used project funds according to their regulatory agreement. That is, were funds used for purposes other than reasonable operating expenses, necessary repairs, or allowable distributions from surplus cash. The audit was conducted in response to a HUD request.

One McKnight Place prematurely distributed surplus cash to its owners, did not appropriately request funds from its reserve fund, did not execute an adequate management contract with its identity-of-interest management agent, and did not always spend funds only for reasonable operating expenses and necessary repairs.

These actions were in violation of the Regulatory Agreement. As a result, the owners owe $31,708 to the project's reserve fund and must change their procedures to prevent further violations. Although the violations have had no determinable effect on the project at this point, future compliance with the Regulatory Agreement is necessary to protect the Department's interests and the mortgage insurance fund.

Distributions to Owners

One McKnight Place prematurely distributed $908,920 in surplus cash to its owners. One McKnight generated sufficient surplus cash to cover the amount of the premature distribution. However, surplus cash cannot be distributed until it has been substantiated by a surplus cash calculation. Since all cash had been distributed per the most recent surplus cash calculation, the excess distribution was in violation of the regulatory agreement. HUD only allows distributions to be made after a surplus cash calculation has been completed. This helps ensure owners and agents fulfill their responsibilities to properly maintain projects.

Management Fees

One McKnight Place used $31,708 from its Reserve for Replacement account for items that were routine maintenance costs of the project, rather than capital expenses; for items that were also charged to the tenants; and for items that were not expenses of the project. HUD directives say Reserve for Replacement Funds provide cash for the replacement of capital items and are not intended to cover routine maintenance costs. As a result, the improperly used Reserve for Replacement funds will not be available in later years to help defray the costs of required capital improvements. One McKnight Place received a management fee that exceeded the amount allowed by its management agreement. The management agreement between the mortgagee, One McKnight Place, and the identity of interest management agent allowed for the payment of a 4 percent management fee. The actual

management fee taken by the management agent was 5 percent. A letter from the mortgagee had a hand written note added that indicated the management fee was increased to 5 percent and said an additional 2 percent could be paid to the management agent for food service management. The management agreement was not updated or amended to reflect these changes, and there was no analysis to show the fees for the food service were reasonable when compared with an arms length transaction. As a result HUD lacks assurance that project funds are only being used for reasonable and necessary expenses.

Ineligible Expenses

The owners of One McKnight Place paid project funds for other than reasonable and necessary operating and maintenance expenses of the project. These expenses included employee benefits, political and charitable contributions, non-project expenses subsequently reimbursed to the project, and purchases for the benefit of the owner/management agent.

Using funds for these expenses violated the Regulatory Agreement. The Agreement requires all project funds be used for reasonable and necessary operating and maintenance expenses of the project, with the exception that distributions for other purposes can be made from surplus cash. Using project funds for other than reasonable and necessary expenses increases the risk to HUD's mortgage insurance fund.

Recommendations

We recommend that the Director, Office of Multifamily Housing, Kansas City Hub ensures One McKnight Place makes future distributions only out of surplus cash, establishes and implements procedures to ensure future requests for use of reserve funds are properly prepared, repays the reserve funds for excessive withdrawals, executes a management agreement stating the duties to be performed and the appropriate fees to be paid, and accounts for its funds in such a way that it can be shown all non-project expenses are paid from surplus cash.

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Introduction

The Department of Housing and Urban Development coinsured, under the 221(d)(4) program, a $21,621,300 mortgage to construct One McKnight Place. The owner of One McKnight Place is McKnight Place Partnership I, L.P. The general partners of the ownership are One McKnight Place Management Company (48.75 percent), and D.A. Smith Family Partnership (48.75 percent). The limited partners are Charles Deutsch (1.25 percent) and David and Elana Smith (1.25 percent). On September 21, 1987, the owners signed their Regulatory Agreement with the coinsuring mortgagee, and on August 31, 1995, the Regulatory Agreement was modified as a result of a loan modification that lowered the interest rate.

One McKnight Place's mortgage was originated by a coinsuring lender. HUD delegated to coinsuring lenders certain responsibilities that HUD Field Offices generally perform for projects with fully insured and HUD-held mortgages. The responsibilities included reviewing monthly and annual financial statements; reviewing management agents and fees; authorizing withdrawals from the replacement reserve; conducting on-site reviews of project operations; and negotiating workout agreements and mortgage relief.

Subsequent to constructing the coinsured portion of the property, the owners, under a different corporate identity, constructed phases II and III of the property without HUD assistance. Phases II and III are known as McKnight Place Extended Care. Phase IV was recently constructed through use of HUD's 241 supplemental loan program in the amount of $14,076,400. The Regulatory Agreement for this phase was dated July 14, 1999. One McKnight Place (phase I) generated gross revenue of $9.8 million in 2000. It has 221 units and is located in St. Louis County, Missouri.

Audit Objective

The overall audit objective was to determine whether project officials used project funds for purposes other than reasonable operating expenses, necessary repairs, or allowable distributions from surplus cash.

Audit Scope and Methodology

To achieve our objective, we reviewed the project's bank statements, canceled checks, general ledgers, invoices, and management agreement. We also interviewed project management and owners.

We performed audit work from February 2001 through March 2001. The audit covered the period January 1, 1998 through December 31, 2000. We extended the review, where necessary, to include other periods. The Audit was conducted in accordance with generally accepted government auditing standards. We provided draft findings to One McKnight on April 3, 2001 and received the owners' responses to our findings on April 20, 2001. We provided a copy of this report to the owners of One McKnight Place.

Surplus Cash Was Prematurely Distributed

One McKnight Place prematurely distributed $908,920 in surplus cash to its owners. The project generated sufficient surplus cash to cover the amount of the premature distribution. However, surplus cash cannot be distributed until after it has been substantiated by a periodic surplus cash calculation. Since all cash had been distributed per the most recent surplus cash calculation, the excess distribution was in violation of the regulatory agreement. HUD only allows distributions to be made after a surplus cash calculation has been completed to ensure owners and agents fulfill their responsibilities to properly maintain projects.

Program Requirements

One McKnight Place is governed by a Regulatory Agreement that says distributions can only be paid out of surplus cash that existed as of the end of a semi-annual or annual fiscal period. It also says that distributions may be paid only after the end of the fiscal period in which the surplus cash is generated.

Premature Distributions

One McKnight made distributions to its owners that exceeded the amount of surplus cash that was calculated to be available as of the end of the fiscal period prior to the distribution.

The December 31, 1998 surplus cash calculation showed the project had surplus cash in the amount of $565,850. One McKnight distributed the $565,850 to its owners between January 1 and February 4, 1999. However, One McKnight distributed another $400,000 on March 18, 1999 and $306,920 on May 7, 1999 to its owners. At these times no surplus cash was available. The June 30, 1999 surplus cash computation showed One McKnight had surplus cash totaling $659,485. The project distributed the $659,485 to its owners between July 1 and July 15, 1999. On December 21, 1999, One McKnight made payments totaling $202,000 to its owners. Again, at this time no surplus cash was available. The next surplus cash computation date was not until December 31, 1999.

Since the Regulatory Agreement only allows distributions to be made to the extent of surplus cash available as of the end of the prior period, and the project had already fully disbursed its surplus cash before making these distributions, the payments violate the Regulatory Agreement. One

McKnight should have kept the funds in the project until the next surplus cash date, at which time they would have been eligible to distribute the funds as part of surplus cash. For example, if the project had not made the extra distributions in March and May, the project would have had that $706,920 in cash when the June 30, 1999 surplus cash computation was done, making the total surplus cash available for distribution $1,366,405 rather than $659,485.

The project's improper distribution of funds was a timing issue that self-corrected when new surplus cash calculations were made. Therefore, we are not making recommendations for repayment of funds. However, since the future financial position of a project can vary, HUD only allows distributions to be made after a surplus cash calculation has been completed. This helps ensure owners and agents fulfill their responsibilities to properly maintain projects.

Auditee Comments

Excerpts from One McKnight's comments on our draft finding follow. Appendix B, page 25, contains the complete text of the comments.

In 1999, One McKnight made distributions from replacement reserve funds to reimburse the owners for project expenses paid between 1992 and June 30, 1999. These distributions were in addition to regular surplus cash distributions as a result of the owners' understanding of how the regulations applied and the nature of the circumstances. If these funds had been applied for in the surplus cash period in which the work was done, then a corresponding amount of cash equal to these distributions would have been available as surplus cash. The owners assumed that these refunds from the replacement reserve account did not have to be part of a new surplus cash calculation. In the future, any refund from the replacement reserve account will be part of a surplus cash calculation for a prescribed period.

OIG Evaluation of Auditee Comments

All distributions may only be paid out of surplus cash calculated as of the end of the prior fiscal period. The regulatory agreement defines a distribution as the outlay of any cash or asset of the project excluding outlays for

mortgage payments, reasonable expenses necessary for the proper operation and maintenance of the project, and repayment of owner advances authorized by HUD's administrative procedures. The payments described above meet the definition of distributions.

One McKnight's promise to distribute any future replacement reserve account releases only after the surplus cash calculation for a prescribed period should prevent recurrence of this issue, if followed.

Recommendations

We recommend the Director, Office Multifamily Housing, Kansas City Hub, ensure the owners of One McKnight Place:

1A. Pay future distributions for other than reasonable and necessary operating expenses only to the extent of surplus cash that was calculated to be available per the last surplus cash calculation.

Reserve Funds Were Not Properly Used

One McKnight Place used $31,708 from its Reserve for Replacement account for items that were routine maintenance costs of the project, rather than capital expenses; for items that were also charged to the tenants; and for items that were not expenses of the project. This amount was included in the premature surplus cash distribution to the owners outlined in Finding 1. HUD directives say Reserve for Replacement Funds provide cash for the replacement of capital items and are not intended to cover routine maintenance costs. As a result, the Reserve for Replacement funds will not be available in later years to help defray the cost of needed capital improvements.

Program Requirements

One McKnight Place is governed by a Regulatory Agreement that says the project should apply for withdrawals from the reserve fund in accordance with chapter 5 of HUD Handbook 4566.2. Handbook 4566.2 says the reserve provides cash for the replacement of capital items and is not intended to cover routine maintenance costs. The Handbook lists items that are specifically eligible for reimbursement from the reserve. Exterior painting is on the list, but interior painting is not.

HUD Handbook 4350.1, applicable to multifamily housing projects but not specifically referenced in One McKnight's Regulatory Agreement, was used as a guideline by the mortgagee when reviewing the project's request for release of reserve funds. The Handbook says a reserve fund is established to help ensure that the physical life of buildings and structures extend to the assumed 55-year economic lives.

It was not the original purpose of a reserve fund to provide for a complete, dollar for dollar, capability of replacing all the building structural components and equipment as they wear out but rather to provide a readily available source of capital that will help defray replacement costs in the latter years of amortization of a mortgage note. Owners should make reimbursement requests during the same fiscal year in which the expenditure occurs, preferably at least sixty days prior to the close of the project's fiscal year. Some of the items traditionally contemplated as ineligible for draws from a Replacement Reserves Fund are repainting of interior areas, minor repairs to gutters and downspouts, caulking and sealing.

One McKnight applied for and was granted releases from the reserve fund for claims totaling $31,708 that were inappropriate to charge to the reserve fund. The claims were not eligible for reimbursement from the reserve fund because the improvements were: not for the project, claimed more than once or in an amount greater than the project paid, also billed to the resident, or routine maintenance including service, repairs, cleaning, caulking, and interior painting.

The $31,708 was part of One McKnight's withdrawals from its reserve fund of $75,000 in 1998 and $709,379 in 1999. The amount of the releases was large because the project requested reimbursement from the reserve fund for capital improvements that were not claimed dating back to 1992. The project should have made timely applications for release of the reserve funds, rather than saving six years of project improvements for one request. One McKnight's Chief Financial Officer said the former Chief Financial Officer neglected to request draws from the reserve for replacement account for all the capital improvements that were made.

One McKnight should not have made application to the mortgagee for the release of the $31,708 of reserve for replacement funds. One McKnight's Chief Financial Officer said a temporary employee helped prepare the request and may have made some mistakes. He also said he was unaware that interior painting was not normally paid from reserve for replacement funds.

Since the $31,708 was inappropriately withdrawn from the reserve for replacement account, and since funds that exceeded the surplus cash calculation were distributed to the owners during the same period (see Finding 1), the owners need to repay the reserve for replacement account $31,708. A properly funded reserve for replacement account helps ensure the future health of a project.

Auditee Comments

Excerpts from One McKnight's comments on our draft finding follow. Appendix B, page 25, contains the complete text of the comments.

The $31,708 that the OIG identified as inappropriate to charge to the reserve fund consisted of certain amounts due

to clerical error and certain amounts due to interior painting of common areas within the building which One McKnight does not classify as routine maintenance. This is an extensive common area unique in character to a senior housing community and, therefore, this work would be classified as a capital expenditure. One McKnight certainly agrees to refund any amounts mistakenly taken from the Replacement Reserves due to clerical errors. If your conclusion, after getting input from our co-insured lender and fund administrator, results in a final determination that the items you refer to as "routine maintenance", including interior painting, were not eligible for reimbursement, then we will refund that portion as well.

OIG Evaluation of Auditee Comments

The regulatory agreement requires that withdrawals from the replacement reserve be applied for in accordance with HUD Handbook 4566.2. This Handbook says that the replacement reserve funds may generally only be used to pay for replacement of those items listed in Appendix 16. HUD expects that lenders will rarely approve withdrawal for other than the uses listed in Appendix 16. Reserve funds may be used for purposes other than those itemized in Appendix 16 only if the lender determines that the project's cash flow is not sufficient to cover the outlay and such uses would be the best use of reserve funds. One McKnight Place did not meet this condition of insufficient cash flow. The list contained in Appendix 16 does not include painting under the Interior Decorating heading. Painting only appears under the Exterior heading. Therefore, use of replacement reserve funds for interior painting would have had to fall under the acceptable exceptions outlined in the Handbook, which it did not.

Further, the Handbook states that if the owner is requesting a withdrawal for other than the uses listed in Appendix 16, the owner must explain why other project funds cannot be used as well as prepare an analysis of the reserve's ability to cover future replacement costs. The owners of One McKnight Place did neither of the above. Therefore, we conclude the owners should reimburse the $31,708 that was inappropriately withdrawn from the reserve fund.

Recommendations

We recommend the Director, Office of Multifamily Housing, Kansas City Hub, ensure the owners of One McKnight Place:

2A. Establish and implement procedures that ensure future reserve for replacement fund withdrawal requests comply with HUD's guidelines and are completed timely (during the fiscal year when the improvements are made).

2B. Repay the reserve for replacement fund $31,708 from non-project funds.

Management Fees Were Not Paid According To The Management Agreement And May Not Be Reasonable

One McKnight Place received a management fee that exceeded the amount allowed by the management agreement. The management agreement between the mortgagee, One McKnight Place, and the identity of interest management agent allowed for the payment of a 4 percent management fee. The actual management fee taken by the management agent was 5 percent. A letter from the mortgagee said an additional 2 percent could be paid to the management agent for food service management. Additionally, the letter had a hand written note on it initialed by one owner that indicated the management fee was increased to 5 percent. The management agreement was not updated or amended to reflect these changes, and there was no analysis to show the fees for the food service were reasonable when compared with an arms length transaction. As a result, HUD lacks assurance that project funds were only used for reasonable and necessary expenses.

Program Requirements

Chapter 4 of HUD Handbook 4566.2 states that after the lender approves a management agent, the project owner and any identity-of-interest or independent fee manager must execute a management agreement. The agreement establishes the management fee and the conditions in which that fee is to be paid. The regulatory agreement requires that the management fees be reasonable in amount.

Chapter 4 further says the owner has a responsibility to shop and compare. The regulatory agreement requires owners to obtain contracts and services on terms most advantageous to the project and at costs not in excess of amounts normally paid for such contracts and services in the area in which the services are rendered. Project owners, therefore, are required to shop and compare management fees, as necessary, to determine that the fee proposed by the owner does not exceed the amount normally paid on similar projects, except as justified by special conditions existing at that project.

A Letter Established Fees

The owners/management agent of One McKnight Place believed that a letter, dated July 25, 1995, from the mortgagee to One McKnight Place was sufficient to establish the 5 percent management fee and the additional 2 percent for the management of food services. The letter

from the mortgagee said an additional 2 percent could be paid to the management agent for food service management. Additionally, the letter had a hand written note on it initialed by one owner that indicated the management fee was increased to 5 percent.

The owner said the 2 percent special distribution/food service management fee was for running the daily operations and oversight of the food service department. This included hiring and oversight of the menus.

Competitive Bids and Comparable Studies Were Not Performed.

When One McKnight Place opened in 1988, they contracted with Marriott in St. Louis for food service manangement. Marriott was paid approximately $40,000 per year, which equated to about 0.8 percent of gross receipts. Because One McKnight Place wanted to serve a quality and style of food that Marriott was not able to provide, the owners did not renew Marriott's contract and took over the food service responsibilites. In 1995, the owners began paying themselves 2 percent of gross revenues for their services. From 1998 through 2000, this 2 percent fee ranged from $181,683 to $196,411 per year. Since the current payment is substantially greater than the amount the project previously paid for food service management, we believe it may be excessive. There were no bids let or studies completed to determine what was a reasonable fee for the services rendered.

As a result, HUD lacks assurance the fees paid for project management and food service were reasonable and necessary.

Auditee Comments

Excerpts from One McKnight's comments on our draft finding follow. Appendix B, page 25, contains the complete text of the comments.

One McKnight believes that a 5 percent general management fee and a 2 percent food management fee is extremely reasonable. Management fees at standard garden apartment projects begin at 5 percent and do not include the varied and extensive number of service components that One McKnight oversees. However, One McKnight owners believe that it would not be easy to find meaningful competitive prices for

the management services that they provide due to the uniqueness of their project. Therefore, they propose to enter into a standard 5 percent management contract with a related identity of interest and submit it to their lender for approval. Under these circumstances, they are willing to fund the 2 percent food service management fee out of their regular semi-annual Surplus Cash distributions since they already self-manage these operations.

OIG Evaluation of Auditee Comments

One McKnight's planned actions should correct the problem we identified with the management contract if the actions are approved by the lender and properly implemented.

Recommendations

We recommend the Director, Office of Multifamily Housing, Kansas City Hub, ensure the owners of One McKnight Place:

3A. Execute a current management agreement with the management agent and the mortgagee, and

3B. Either pay food service management fees out of regular semi-annual surplus cash distributions; or solicit bids for the food service management fees and execute a contract for food management with the most competitive bidder, or limit the amount paid to the amount of the lowest competitive bid.

One McKnight Place Made Purchases That Were Not Reasonable or Necessary

The owners of One McKnight Place paid project funds for other than reasonable and necessary operating and maintenance expenses of the project. These expenses included employee incentives, political and charitable contributions, non-project expenses subsequently reimbursed to the project, and purchases for the benefit of the owners/management agent. Using funds for these expenses violated the Regulatory Agreement. The Agreement requires all project funds be used for reasonable and necessary operating and maintenance expenses of the project, with the exception that distributions for other purposes can be made from surplus cash. Using project funds for other than reasonable and necessary expenses increases the risk to HUD's mortgage insurance fund.

Unallowable Purchases

The Regulatory Agreement says that project funds must be used to pay amounts required by the mortgage, make required reserve deposits, pay reasonable expenses necessary to the operation and maintenance of the project, and repay owner advances authorized by the Secretary's administrative procedures and approved by the mortgagee. Any other distributions can only be paid out of surplus cash that existed as of the end of a semi-annual or annual fiscal period. The owners of One McKnight Place used project funds for employee incentives, political and charitable contributions, non-project expenses subsequently reimbursed to the project and purchases for the benefit of the owners/management agent.

One McKnight made expensive purchases for the benefit of its employees. During the 3 years we reviewed, the project paid approximately $15,000 for tickets to the St. Louis Cardinals baseball games. Additionally, the project paid thousands of dollars for gift certificates at the Galleria shopping mall, for personal trainers for its top staff, holiday parties, and employee bonuses. For example, during the 3 years we reviewed, holiday parties at the Ritz Carlton hotel cost $23,635 and bonuses for 21 employees totaled $401,405.

The owners also used project funds for an assortment of political and charitable contributions. In 1999, the owners contributed $3,333 to Harmon for Mayor and $1,667 to the Senate Majority Fund. The owners also contributed to the

Children's Miracle Network, Yes to Schools school bond donation, the Vaad Hoeir of St. Louis, The Symphony Fund and many other causes. Although some of the project's charitable contributions also provided One McKnight Place with advertising, the payment still included a donation. For example, One McKnight paid $900 to Sha'arei Chesed Shul. This payment was toward a $1,800 platinum membership, the cost of which was split with another McKnight organization. Although the payment provided an advertisement and 2 dinner tickets, an advertisement could have been purchased for a lesser amount. For a contribution of $360, the project could have purchased a full-page advertisement, which included dinner tickets valued at $160, making the value of the advertisement $200.

Further, One McKnight Place funds were used to pay for non-project expenses that were subsequently reimbursed to the project. Even though the funds were reimbursed, project funds should not be used for non-project expenses or to make loans for non-project expenses. The project had house accounts for its employees where tabs that were deducted from paychecks were kept. Often when an employee would submit a personal credit card statement, the balance was paid in full and then the total of the purchases that were deemed personal was charged back to the employee. Also, certain employees and owners had extra cell phones or pagers for family members or used their official phones for personal reasons. The project paid for these bills upfront and then billed the personal portions to the house account.

Finally, in some instances the owners used project funds to pay expenses that were for the owners' benefit or used project resources in a way that did not benefit the project. For example, the Project paid $1,031 to purchase airfare for one of the owners to travel to the project to attend an award ceremony, used the Chief Financial Officer to perform the accounting for the partnership, and used another employee to provide services for another business of one owner. Additionally, one of the owners' secretary and another owners' assistant were paid employees of the project. These expenses would have more appropriately been paid out of the partnership account or the management agent account.

The owners believe that since the project was very profitable

and always generated surplus cash, there was no problem in offering great employee benefits. Offering employee benefits and making contributions to the community allowed the property to be of high caliper. The Chief Financial Officer believes these payments just reduced the amount of the next surplus cash computation and caused no harm.

We agree with the Financial Officer that no harm has occurred to date due to the profitability of the project. The payments only reduced the next period's surplus cash amount available for distribution to the owners. The project is in excellent physical condition and is current on its mortgage payments. However, the project could be less profitable in future periods. The Regulatory Agreement's requirements related to spending are in place to protect the Department's interest and reduce risk to HUD's Mortgage Insurance fund. The surplus cash computation requirement and procedures allow owners of profitable projects to withdraw an appropriate amount of funds from the project while still protecting the insurance fund.

Auditee Comments

Excerpts from One McKnight's comments on our draft finding follow. Appendix B, page 25, contains the complete text of the comments.

"Based on our project being somewhat unique and its successful operating history, we respectfully disagree with your interpretation of the Regulatory Agreement on this point. The expenses you identified represent a very small portion of our overall operating expenses (perhaps with the exception of employee bonuses), were reasonable and were necessary for the operation and maintenance of the project at the superior level at which it operates. We believe each item you identified can be substantiated as beneficial to our project's ongoing success….. Most of these expenses would still be necessary for employee retention, even if the project was not in a surplus cash position. However, if our overall profitability and available Surplus Cash were to change in the future, we would review these practices at that time and we would further assume that the mortgagee would do the same. A less desirable, more cumbersome and costly alternative would be to pay for such reasonable employee incentives, political and charitable contributions from a partnership

account funded from Surplus Cash. We do not believe this to be either reasonable or in the best interest of the project and sincerely hope that you will reevaluate your position on this issue."

OIG Evaluation of Auditee Comments

We commend One McKnight on its successful operating history, but emphasize that past performance is not a guarantee of continued future success. This successful operating history does not relieve the project of accountability to HUD through compliance with the Regulatory Agreement. HUD cannot allow One McKnight a different standard than other projects. The Regulatory Agreement must be enforced regardless of the project's current wealth. The best solution is to fund the expenditures described in our finding from a separate partnership account, funded from surplus cash. This would allow the owners a means to make these expenditures while still holding them to the same standard for direct use of operating funds as other projects.

Recommendations

We recommend the Director, Office Multifamily Housing, Kansas City Hub, require the owners of the One McKnight Place to:

4A. Stop paying non-project type expenses from project funds.

4B. Take administrative action against the owners if they continue to pay non-project expenses using non-surplus cash project funds.

Management Controls

In planning and performing our audit, we considered the management controls of One McKnight Place to determine our auditing procedures, not to provide assurance on the controls. Management controls include the plan of organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Management Controls

We determined the following management controls were relevant to our audit objectives:

- Assuring appropriate expenditure of project funds.
- Assuring compliance with laws and regulations.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- One McKnight Place prematurely distributed surplus cash (see Finding 1).
- One McKnight Place did not appropriately use its reserve for replacement funds (see Finding 2).
- One McKnight Place did not have an adequate management agreement in place (see Finding 3).
- One McKnight Place spent project funds for other than reasonable and necessary expenses (see Finding 4).

Follow Up On Prior Audits

This is the first audit of One McKnight Place performed by the Office of Inspector General.

Schedule of Questioned Costs

Recommendation Number	Type of Questioned costs Ineligible 1/	Unsupported 2/
2B	$31,708	

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 costs charged to a HUD-financed or HUD-insured program or activity and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the costs. Unsupported costs require a future 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.

Auditee Comments

APR 2 5 2001

April 20, 2001

Mr. Roger E. Niesen
District Inspector General for Audit
U.S. Department of Housing and Urban Development
400 State Avenue
Gateway Tower II – Fifth Floor
Kansas City, KS 66101-2406

Dear Mr. Niesen:

We are in receipt of your April 3, 2001 letter outlining your four draft audit findings. Please consider the following responses in preparing your final conclusions.

Preliminary Finding 1 – Surplus Cash Was Prematurely Distributed

In 1999, we made three distributions from Replacement Reserve Funds totaling $908,920 to reimburse the Owners for project expenses paid in earlier periods. These distributions were made in addition to regular Surplus Cash distributions for prescribed periods. These amounts were distributed as the result of our understanding of how the regulations applied and the nature of the circumstances characterizing the source of these distributions. These distributions were based on refunds from Replacement Reserve accounts dating back as far as 1992. The first two distributions were received for work performed and funded from the project prior to December 31, 1998. The third distribution was received for work performed and funded from the project prior to June 30, 1999. The project has had a long history of providing Surplus Cash according to the standard Surplus Cash calculation. If these funds had been applied for in the Surplus Cash period in which this work was done, then a corresponding amount of cash equal to these distributions would have been available as Surplus Cash. Therefore, we assumed that these refunds from the Replacement Reserve account did not have to be part of a new surplus cash calculation. In the future, any refund from the Replacement Reserve account will be part of a Surplus Cash calculation for a prescribed period.

One McKnight Place △ Saint Louis, Missouri 63124 △ (314) 993-0111

Auditee Comments

Mr. Roger E. Niesen
April 20, 2001
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Preliminary Finding 2 – Reserve Funds Were Not Properly Used

In 1999, $908,920 was refunded to the project from the Replacement Reserve account. Of this amount, you identified $31,708 that was inappropriate to charge to the reserve fund. This amount consisted of certain amounts due to clerical error and certain amounts due to interior painting of common areas within the building which we do not classify as routine maintenance. This is an extensive common area unique in character to a senior housing community and, therefore, this work would be classified as a capital expenditure. You have advised us that common area interior painting is routine maintenance and not eligible for refund from the Replacement Reserve account. For this extensive interior painting, Patrician Mortgage Company, our co-insured lender, processed and approved the refund. As part of your preliminary findings, we would appreciate you contacting Ms. Cary Brownley at Patrician Mortgage Company to see how she interprets this. Her telephone number is 301-718-2000. We certainly agree to refund any amounts mistakenly taken from the Replacement Reserves due to clerical errors. If your conclusion, after getting input from our co-insured lender and fund administrator, results in a final determination that the items you refer to as "routine maintenance", including interior painting, were not eligible for reimbursement, then we will refund that portion as well.

Preliminary Finding 3 – Management Fees Were Not Paid According To The Management Agreement And May Not Be Reasonable

We believe that, based on the complexity of the management required to successfully administer a senior housing community with a superior level of results, a 5% general management fee and a 2% food management fee is extremely reasonable. Common industry practice supports our position. Management fees at standard garden apartment projects begin at 5% and do not include the varied and extensive number of service components that we oversee and which are necessary to operate a successful senior housing community. However, we believe that it would not be easy to find meaningful competitive prices for the management services that we provide due to the uniqueness of our project. Therefore, we propose that we enter into a standard 5% management contract as a party with a related identity of interest and submit it to Patrician Mortgage Company for their approval. Under these circumstances, we would be willing to fund the 2% food service management fee out of our regular semi-annual Surplus Cash distributions since we as owners already self-manage these operations.

Auditee Comments

Mr. Roger E. Niesen
April 20, 2001
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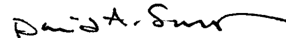
Preliminary Finding 4 – One McKnight Place Made Purchases That Were Not Reasonable Or Necessary

Based on our project being somewhat unique and its successful operating history, we respectfully disagree with your interpretation of the Regulatory Agreement on this point. The expenses you identified represent a very small portion of our overall operating expenses (perhaps with the exception of employee bonuses), were reasonable and were necessary for the operation and maintenance of the project at the superior level at which it operates. We believe each item you identified can be substantiated as beneficial to our project's ongoing success. For instance, of approximately 250 Cardinal home games that you questioned, less than 5% were attended by owners. Over 95% were given to employees mainly for weekly incentive performance programs, as were movie tickets, gift certificates and the like. Our annual holiday party at the Ritz Carlton is an important management function that builds significant moral and teamwork across a broad spectrum of management departments that employ over 150 people. The employee bonuses are necessary to attract and retain high quality and skilled employees in a very competitive employment marketplace. Charitable and political contributions were relatively nominal payments. Nevertheless, they serve an important role in building community awareness and good will at a time when community involvement and government regulation play ever increasing roles. Most of these expenses would still be necessary for employee retention, even if the project was not in a surplus cash position. However, if our overall profitability and available Surplus Cash were to change in the future, we would review these practices at that time and we would further assume that Patrician Mortgage Company would do the same. A less desirable, more cumbersome and costly alternative would be to pay for such reasonable employee incentives, political and charitable contributions from a partnership account funded from Surplus Cash. We do not believe this to be either reasonable or in the best interest of the project and sincerely hope that you will reevaluate your position on this issue.

Sincerely,

Charles Deutsch



David A. Smith

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