AUDIT REPORT

JESTER TRAILS APARTMENTS
MULTIFAMILY PROJECT

HOUSTON, TEXAS

2004-FW-1002

FEBRUARY 26, 2004

OFFICE OF AUDIT, REGION 6
FORT WORTH, TEXAS

Issue Date
February 26, 2004
Audit Case Number
2004-FW-1002

TO: Raynold Richardson
Director, Multifamily Housing Program Center, 6EHM

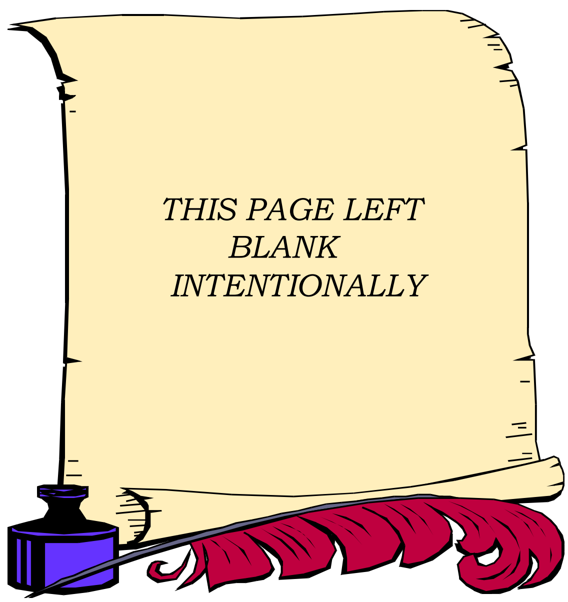
FROM: D. Michael Beard
Regional Inspector General for Audit, 6AGA

SUBJECT: Jester Trails Apartments
Project Number FW 03 0014
Houston, Texas

We completed an audit of Jester Trails Apartments, a Section 221(d)(4) insured multifamily housing project. The objective of our audit was to review the operations of the owner-managed project and determine whether the project's owner complied with the Regulatory Agreement and HUD regulations. The audit resulted in five findings.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide us, for each recommendation without a management decision, 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. Additional status reports are required at 90 days and 120 days after report issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact Theresa Carroll, Assistant Regional Inspector General for Audit, at (817) 978-9664, or me at (817) 978-9309.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Executive Summary

We completed an audit of Jester Trails Apartments, a Section 221(d)(4) insured multifamily housing project. The objective of our audit was to review the operations of the owner-managed project and determine whether the project's owner complied with the Regulatory Agreement and HUD regulations.

Owner failed to comply with Regulatory Agreement and other HUD requirements.

Although the owner maintained the property in satisfactory condition, it did not comply with several provisions of the Regulatory Agreement and other HUD regulations. Specifically, the owner failed to maintain the books and records of the project. Thus, the owner cannot show it deposited rental receipts intact. In addition, the owner paid $55,475 for ineligible and unsupported personal expenses with the project's operating funds. The owner also improperly obtained and used project funds to pay $42,431 for a personal promissory note. Further, the owner received $32,254 in excess of the allowed management fee. Finally, the owner misused $24,127 in tenant security deposit funds. All of these violations occurred because the owner disregarded HUD's requirements.

Project is in default.

The owner's payments of ineligible and unsupported expenses depleted the project's operating funds. Currently, the project is in default. However, the lender has indicated it wishes to prepay the mortgage to avoid a claim.

Recommendations.

We recommend HUD allow the lender to prepay the mortgage freeing the $2.13 million loan balance for better use. Further, HUD should require the owner to reimburse the project for the ineligible use of project funds totaling $140,073. HUD should also obtain documentation for the unsupported expenses of $14,214 and recover from the owner for the project any costs determined to be unallowable. If the owner does not repay the project for improper diversions of property funds, HUD should take civil action and other prescribed remedies. In addition, HUD should take administrative action against the owner and its members to prevent them from managing this or another HUD property.

Owner Response.

We presented our draft audit report to the owner and HUD's staff during the audit. We held an exit conference with a member of the owner on February 13, 2004. That member provided written comments to our draft report.

We summarized her comments with each finding. The complete text of her comments is at Appendix B.

Overall, the owner agreed with the findings and admitted a member improperly took project funds. The owner stated the project's books and records are fully compliant and procedures are in place for the current period, but records for previous periods cannot be corrected. The owner expressed confusion regarding the promissory note issues and indicated it wished to clear the finding by refinancing the property. The owner did not address the recommendations of repaying the funds or HUD taking administrative action against the members.

Table of Contents

Abbreviations

CPA	Certified Public Accountant
FHA	Federal Housing Administration
HUD	U. S. Department of Housing and Urban Development
OIG	Office of Inspector General
OMB	Office of Management and Budget

Introduction

Jester Trails Apartments (the project) is located at 2006 West 43rd Street in Houston, Texas. We're Rockin, L.L.C. (the owner) owns and operates the project. In February 1998, the owner purchased and began rehabilitating the project with over $2.2 million in financing provided by Arbor National Commercial Mortgage, L.L.C. and insured by the Federal Housing Administration (FHA) of the Department of Housing and Urban Development (HUD). Once it completed renovations, the owner began initial rental operations on January 5, 1999.

At closing, HUD approved the owner, consisting of four members and their ownership percents as follows:

- David Murray - 38.75%,
- Linda Murray - 38.75%,
- Ursula Cano - 15%, and
- Key Partners, L.L.C., - 7.5%.

According to the project's records, David Murray acquired the combined 22.5 percent member interests of Ursula Cano and John Getrost in 2000. As a result, David Murray's ownership interest increased from 38.75 percent to 61.25 percent, making him the majority member. However, the owner did not notify HUD when this change in ownership occurred and HUD never approved this transfer. In addition, the two members filed a suit concerning the transfer of these shares and the ownership of the property.

On June 3, 2003, Ms. Poole[1], submitted documents to HUD showing the ownership of We're Rockin, L.L.C. consisted of:

- Faith Ventures, Unlimited, Managing Member 1%,
- Linda Poole, Member 41%, and
- David Murray, Member 58% nonparticipating ownership.

Further, the owner indicated it had selected Sandersen, Knox and Belt, L.L.P., as the current management agent. However, HUD did not approve this transfer of ownership or the new management agent. HUD also questioned the validity of the previous transfer.

Audit Objective.

The objective of our audit was to review the operations of the owner-managed project and determine whether the project's owner complied with the Regulatory Agreement and HUD regulations.

Audit Scope and Methodology.

To accomplish our audit objectives, we interviewed:

- HUD's Houston Office Multifamily staff;
- HUD's Fort Worth Office Enforcement Center staff;
- HUD's Houston Office Legal Counsel;

[1] Ms. Linda Poole was previously known as Linda Murray and is a member of the owner.

- A Texas Secretary of State's representative;
- A Texas Comptroller of Public Accounts' representative;
- A partner at the CPA firm of Gainer, Donnelly, & Desroches, L.C.;
- A member of We're Rocking, L.L.C.;
- Staff at Jester Trails' current management agent, Sandersen, Knox and Belt, L.L.P; and
- Jester Trails' maintenance personnel and property manager.

We also reviewed:

- The 1999 and 2000 audited financial statements;
- The 2001 draft financial statements;
- The 1999 and 2000 audit engagement letters;
- HUD Enforcement Center's review of the 2000 audited financial statements referral and the owner's response;
- HUD Real Estate Assessment Center's comments on the 1999 and 2000 audited financial statements;
- HUD's Physical Inspection Report dated August 21, 2001;
- The Regulatory Agreement and owner certification between HUD and We're Rockin, L.L.C.;
- HUD's program participant files for the project;
- HUD's Handbooks;
- HUD's management review dated February 18, 2003;
- The by-laws and other documents relating to the previous and current ownership/management of the project; and
- The project's general ledgers, bank statements, copies of canceled checks, and invoices for the audit period.

In addition for 2002, we:

- Tested the available rental records to determine if the owner deposited rental receipts into the project's operating bank account intact.
- Tested project disbursements to determine if the owner made any unauthorized distributions or improper loans to other properties. We selected a statistical sample from the check register of 200 out of 470 disbursements to determine if the owner made disbursements in accordance with the Regulatory Agreement and HUD Handbooks.
- Reviewed the Tenant Security Deposit account to determine whether the owner underfunded the account

and/or used the account for other than the return of tenant deposits. We reviewed 100 percent or 24 of the checks written on the tenant security deposit account.
- Inspected the physical condition of the project's exterior and the interior of a few non-statistically selected units.

We expanded our review to include the year 2001 and the period of January 1, 2003, to July 31, 2003, because of the problems found in 2002. However, we only covered the four problem areas discovered in 2002: personal expense payments, promissory note payments, management fee payments, and misuse of tenant security deposits funds. Plus, we reviewed the 3 months of available rental receipts records for 2003. We also expanded our review to include the 1998 promissory note and associated closing documents.

Scope Limitation.

The owner did not maintain the books and records in compliance with the Regulatory Agreement. The owner and the current management agent possessed only a few project records for 2001; mainly a few vouchers and invoices misfiled in the 2002 records. In accordance with Government Auditing Standards, we relied on information maintained in an independent CPA's workpapers for 2001 testing. Complete financial records for 2002 and 2003 also did not exist. In addition, the owner did not maintain the records for these years in an organized or logical manner. Because the owner failed to maintain the records, we could not audit rental receipts and revenue.

We also found the owner did not maintain reliable computerized information. Thus, we mostly relied on third party or source information like bank statements, canceled checks, vouchers, and invoices to conduct the audit. However, we had to rely on data in the unaudited financial statements for 2001 and the general ledgers for 2002 and 2003 to determine rental revenue since the owner did not have any other sources of information available. Further, we had to estimate the management fee based on the unverified rental revenue amount for the same reason.

We conducted the audit at HUD's Houston Field Office, the project, and the office of the current management agent in Sugar Land, Texas. We performed the audit work from July through November 2003. The audit covered the period January 1, 2001, through July 31, 2003. The audit was conducted in accordance with Generally Accepted Government Auditing Standards.

Owner Failed to Maintain the Project's Books and Records

In violation of the Regulatory Agreement, the owner failed to maintain the books and records of the project. As a result, the owner cannot show it deposited rental receipts intact. In addition, the owner's mismanagement has led to the project not producing sufficient revenue to keep it viable. Currently, the project is in default. The lender has indicated it wishes to prepay the mortgage. HUD should allow the lender to prepay and avoid a claim, which would free the $2.13 million loan balance for better use.

Criteria.

The Regulatory Agreement and a HUD Handbook require the owner to keep the books and records in reasonable condition for a proper audit. The HUD Handbook also requires the books and accounts to be kept current, complete, and accurate.[2]

Owner failed to maintain books and records.

The owner did not maintain the books and records in compliance with the Regulatory Agreement or HUD's Handbook. The owner and the current management agent possessed only a few project records for 2001; mainly a few vouchers and invoices misfiled in the 2002 records. The independent Certified Public Accountant (CPA) possessed the most complete records available for 2001 in its working papers. However, HUD also had a few bank statements in its files. The owner did not have complete financial records for either 2002 and 2003. In addition, the owner did not maintain the records for these years in an organized or logical manner. The management agent believed that the CPA firm will have to render a disclaimer on the 2001 and 2002 financial statements because of the condition of the records.

Rental receipts are unauditable.

The owner only had rent rolls and rental receipt logs for 7 months out of the 31 months audited. The owner also did not have deposit slips showing tenant unit or amount paid for any month, which prevented confirmation of rental deposits and receipts. For the 7 months reviewed, the owner apparently did not deposit all of the receipts for 2 months. However, the owner's lack of records prohibited

[2] Paragraph 9(c) of the Regulatory Agreement and HUD Handbook 4370.2, REV-1, Financial Operations and Accounting Procedures for Insured Multifamily Projects, Chapter 2-3A&B.

an audit and a determination that the owner took rental receipts for its members' personal use.

Owner previously took rental receipts.

The audited financial statements for 1999 and 2000 cited the owner for diverting rental receipts to the members' personal needs. In our opinion, the owner intentionally kept poor records to prevent an audit from determining if it took receipts during 2001, 2002, and 2003. Since the lack of records appears intentional, HUD should take administrative action to prevent the owner and its members from managing this or another HUD property.

Project is not viable.

Jester Trails Apartments is currently in default of its July, August, September, October, and November mortgage payments and is pending assignment to HUD. The defaulted mortgage principal balance is $2,133,843**.** The principal and interest outstanding since the last payment made in June is $70,101. Late fees total $1,122. The total amount owed on the mortgage as of November 13, 2003, is $71,223.

On October 10, 2003, the lender, Arbor Commercial Mortgage, L.L.C., requested an extension of an assignment of the project to HUD. The lender along with it sister company, Arbor Realty Trust, seek to prepay the Jester Trails Apartments' mortgage to avoid an insurance claim against HUD. The project owner agreed with this solution. HUD's Directors' of Multifamily in Houston and Fort Worth have approved the mortgagor's prepayment of the mortgage in lieu of an assignment to HUD. Final approval is pending at HUD Headquarters in Washington, D.C.

Auditee Comments

The owner agreed with the content of this finding. According to the owner, it cannot correct the records prior to June 2003. Further, the independent CPA will probably issue disclaimers for 2001, 2002, and 2003, due to the lack of records. However, the owner indicated the records are now fully compliant and procedures are now in place. The owner did not address the recommendations concerning the prepayment of the mortgage or HUD taking administrative action against the owner and its members. Yet, the owner indicated it is seeking refinancing of the property.

OIG Evaluation of Auditee Comments

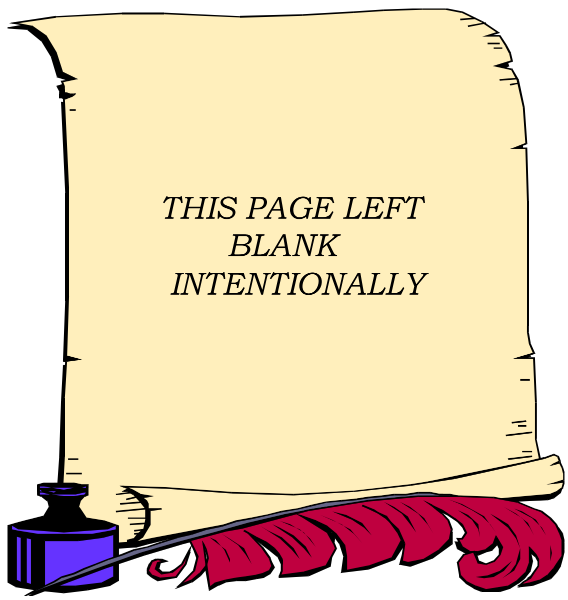
We appreciate the owner admitting the finding was correct. Further, we commend the minority member for establishing controls and correcting the condition of the project's books and records after she took control of the project. However, we still believe HUD should protect its interests and seek prepayment of the mortgage and take action against the owner and/or its members.

Recommendations

We recommend HUD:

1A. Obtain final approval from HUD Headquarters to allow the lender to prepay the mortgage to avoid a claim against HUD, resulting in $2.13 million funds being put to better use by making the funds available for another multifamily project.

1B. Take administrative action against the owner and its members to prevent them from managing this or another HUD property in the future.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Owner Paid Personal Expenses with Project Funds

The owner paid $55,475 for ineligible and unsupported personal expenses with the project's operating funds. HUD limits the payment of project funds to reasonable operating expenses and necessary repairs. In addition, HUD also requires an invoice, bill, or other supporting documents to support all project disbursements. Even though the owner knew of these requirements, it disregarded them. Since the project's operating account funded these personal expenses, the project lacks operating funds and is currently delinquent on its mortgage payments.

Criteria.

The Regulatory Agreement prohibits the owner from receiving project funds when a project does not have surplus cash. Specifically, the agreement says: "Owner shall not without the prior written approval of the Secretary: Assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs." In addition, HUD requires approved invoices, bills, or other supporting documentation for all disbursements from the Regular Operating Account.[3]

Owner paid majority member's personal expenses.

In violation of HUD's requirements, the owner paid a total of $45,525 for ineligible and unsupported personal expenses of the majority member from 2001 to 2003. The majority member had the project pay $38,261 for ineligible and $6,264 in unsupported expenses charged to five different business and personal credit cards. In addition, the project also directly paid $1,000 for automobile expenses of the majority member.

Owner paid ineligible and unsupported legal fees.

In 2001, the owner used project funds to pay a total of $4,500 in ineligible and unsupported legal fees. HUD requirements prohibit the project from paying costs that are not supported project related expenses. According to the independent public accountant, the owner paid ineligible personal legal fees totaling $2,000. The owner also paid an additional $2,500 for unsupported legal fees. The owner could not provide supporting documentation to show the project incurred these legal fees.

[3] HUD Handbook 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*, Chapter 2, Section 2-6E.

Owner lacks support for additional expenses.

The owner lacks support (such as an invoice or bill) for an additional $5,450 paid by the project from 2002 to 2003. The project wrote checks to such payees as a Circuit City account, "reimbursements" to the majority member, a doctor, and cash. In a few cases, the owner did not even document the payee. Since HUD requires all disbursements to be supported, the owner should either prove these items are project expenses or repay the project for these unsupported disbursements.

Project did not have surplus cash.

The owner and/or its members should not have received any disbursements from project funds because the project did not have any surplus cash available at any time during the 3 years reviewed. Jester Trails audited financial statements showed a negative surplus cash balance of $88,020 at the end of 2000. Although audited financial statements do not exist for 2001 and 2002, based on available information Jester Trails did not have surplus cash available for those 2 years.

Owner disregarded HUD's regulations.

The owner knew personal expenses could not be paid with project funds. The minority member stated she was aware it was against HUD regulations to pay personal expenses with project funds. In fact, she believed it was a common business practice to keep personal expenses separate from business expenses. She also stated she tried to explain this practice to the majority member. However, according to her, the majority member believed it was his business and "the government had no business in his business." Further, in March 2001, the owner stated they had been provided "the proper HUD rules and regulations needed to operate the project." Thus, the owner merely disregarded HUD's regulations.

Project is delinquent on its mortgage.

The owner's improper payments put the project in default. As of November 2003, the project is 4 months' delinquent on its mortgage. Currently, the owner owes $71,223, including late fees and penalties. In addition, the project is short of operating funds for reasonable expenses and necessary repairs.

Auditee Comments

The owner agreed with this finding. The owner took steps to prevent the managing member from having control or access to the assets of the property. In addition, the owner stated no further violations occurred since the minority member established control in June 2003. However, the owner did not address repaying the project for ineligible disbursements, supporting questionable expenses or potential civil actions by HUD.

OIG Evaluation of Auditee Comments

We appreciate the owner did not dispute this finding. Since the owner did not dispute the finding, HUD should seek recovery of the improper disbursements. Further, if the owner does not repay the funds, HUD should take civil action.

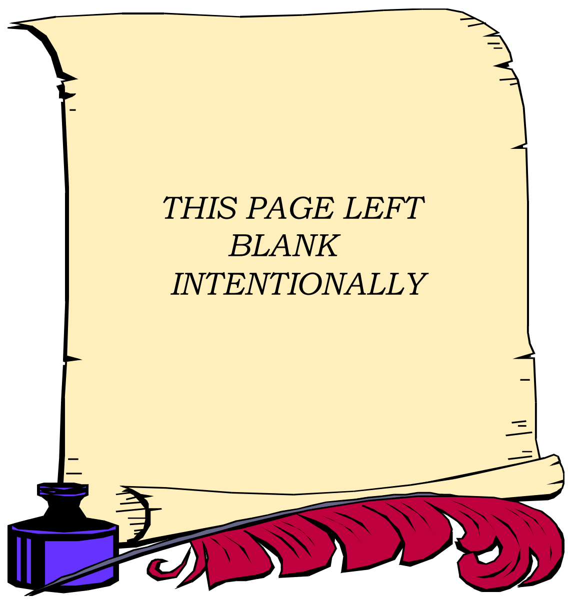
Recommendations

We recommend HUD:

2A. Require the owner to repay the project $41,261 for improper use of project funds.

2B. Obtain documentation or justification for $14,214 unsupported expenses and recover for the project any costs determined to be unallowable.

2C. Take appropriate civil action and HUD prescribed remedies if the owner does not repay HUD for improper diversion of property funds.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Owner Improperly Obtained and Paid for a Promissory Note

In violation of the Regulatory Agreement and without HUD approval, the owner obtained and used project funds to pay $42,431 for a personal promissory note. The owner claimed that HUD was aware of the note and stated they did not have sufficient personal funds to pay the note. However, HUD was not made aware of this 1998 note until 2001. Plus, HUD did not receive the full promissory note until 2003. Once aware of the project's payments on the note, HUD told the owners in 2001 they could only use surplus cash to make payments. Yet, the owner continued to pay on the note with project funds even though the project did not have surplus cash. As a result, the payments contributed to the depletion of the project's operating funds causing the project to default.

Criteria.

The Regulatory Agreement prohibits the owner from assigning their right to manage or receive rents and profits from the mortgaged property without obtaining the prior written approval of HUD's Secretary.[4] In addition, the owner shall not, without prior written approval, make or receive and retain any distribution of assets or any income of any kind of the project except surplus cash.[5]

Owners obtained note without HUD approval.

One day prior to closing in February 1998, the owner obtained a promissory note without informing HUD or obtaining HUD's approval. HUD required the owner to fund initial operating and working capital escrow accounts. To fund the escrow accounts, the owner pledged its ownership interests as collateral on the promissory note. The owner also assigned to the lender the right to receive all dividends, other distributions, and other property and interests, which is a violation of the regulatory agreement.

Owner improperly used project funds to pay the note.

From 2001 to 2003, the owner improperly used $42,431 of project funds to pay the promissory note. The owner's note payments are improper because the project did not have surplus cash available. Since this is a personal note, the owner was prohibited from using project funds to make the payments.

[4] The Regulatory Agreement, Paragraph 6(c).
[5] The Regulatory Agreement, Paragraph 6(e).

Owner believed HUD approved the note.

The owner stated HUD had full knowledge of the promissory note and did approve it. Further, the owner stated that it used project funds to pay the note because it did not have sufficient personal funds to make the payments on the note.

HUD unaware of the note.

Prior to 2001, HUD appears to be unaware of the note. The promissory note was not included in the project's closing file, not signed by HUD, and not recorded. HUD first became aware of the note in 2001 when the owner filed its delinquent 1999 and 2000 financial statements. Upon reviewing the financial statements, HUD questioned the note. Further, HUD told the owner it could only use surplus cash to make payments on the note. To further complicate matters, when HUD conducted its review in 2001, the owner did not provide the full note including the pledge agreement. Thus, HUD did not know until our audit in 2003 what the owner pledged as security for the note.

Improper payments contributed to the project's default.

Since the owner received $42,431 of project funds it was not entitled to receive, the project had less funds to operate. As of November 2003, the owner is 4 months behind on the mortgage because the project lacks sufficient funds to make the payments. As a result, the improper payments contributed to the project's default.

Auditee Comments

The owner expressed confusion regarding this finding. According to the owner, the bank stated the note was proper and the local HUD representative recollects some mention of its approval. The owner hopes to resolve the issue by refinancing the property. Yet, the owner did not address repaying the project for the ineligible disbursement of project funds.

OIG Evaluation of Auditee Comments

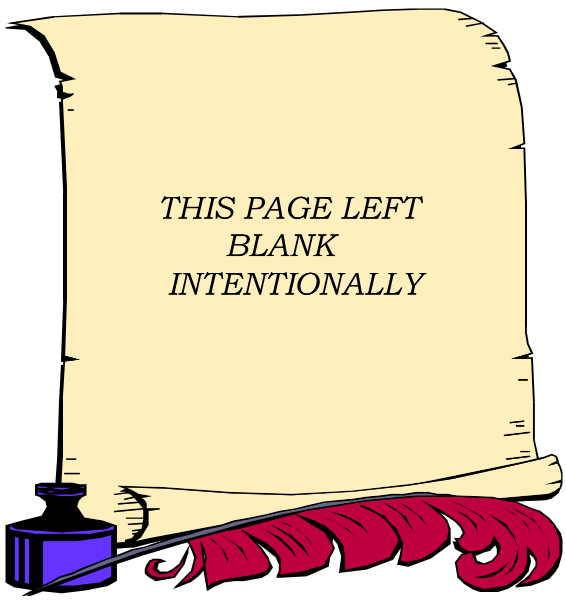
We understand the confusion surrounding the complicated nature of this finding. The owner did not provide any evidence HUD was aware of the note at closing. HUD was not aware and did not approve of the note at closing. In addition once aware of the note, HUD prohibited the owner from making any payments on the note unless the project had surplus cash. Since the project did not have surplus cash, HUD should seek recovery of the improper disbursements. Further, if the owner does not reimburse the project, HUD should take civil action.

Recommendations

We recommend HUD:

3A. Require the owner to repay the project $42,431 for improper used of project funds.

3B. Take appropriate civil action and HUD prescribed remedies if the owner does not repay HUD for improper diversion of project funds.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Owner Received Excessive Management Fees

The owner received $32,254 in excess of the allowed management fee. Although the owner only billed the project $42,215 for management fees, the majority member of the owner also received a salary of $62,534 for overseeing operations. However, HUD requires the salary of supervisory employees to be included in the management fee. Including the salary, the owner received a total of $104,749 in management fees. For the years reviewed, the owner was only entitled to receive an estimated management fee totaling $72,495.

Criteria.

The Project Owner's Certification for Owner Managed Multifamily Housing Projects sets the management fee an owner can receive to self-manage a project. In the case of Jester Trails, the owner's management fee was set at 6 percent of residential rental income. According to HUD's Management Agent Handbook, the owner was required to cover the cost of supervising and overseeing project operations out of the management fee.[6] In addition, if other individuals are performing the front-line operations of the project, the salary of supervisory personnel may not be charged to the project account. Instead, their salary must be paid out of the management fee.[7]

Owner paid both a management fee and salary.

As the following table shows, the owner was paid a management fee and the majority member received a salary. However, the owner did not include the member's salary in the management fee as required. As a result, the owner received $32,254 more in management fees than the Project Owner's Certification allowed.

[6] HUD Handbook 4381.5, REV-2, Section 3.1.
[7] HUD Handbook 4381.5, REV-2, Sections 6.38 and 6.39.

Excessive Management Fees				
	2001	**2002**	**2003**	**TOTALS**
Type of Expenses				
Salary/Contract Labor	$23,584	$29,000	$9,950	$62,534
Management Fee	22,475	13,600	6,140	42,215
Total Owner Received	**$46,059**	**$42,600**	**$16,090**	**$104,749**
Less 6% Estimated Fee[8]	31,373	31,035	10,087	72,495
Totals Excessive Fee	**$14,686**	**$11,565**	**$6,003**	**$32,254**

Owner did not follow requirements.

The owner either was aware or should have been aware of the requirements but did not follow them. The majority member, who received all the fees, would not return calls to explain the excessive fees he received. The minority member said she was aware of HUD's regulations, but she did not know the majority member was being paid both fees.

Auditee Comments

The owner did not dispute the finding.. The owner has ensured that the managing member no longer has access to the assets of the property. However, the owner does not fully address repaying the project indicating instead that any loss of funds is the managing member's responsibility.

OIG Evaluation of Auditee Comments

While we appreciate that the owner did not dispute the finding, the owner is ultimately responsible for repaying the project, regardless of who made the improper disbursements. Thus, HUD should seek recovery of the improper disbursements and take civil action if the project is not repaid.

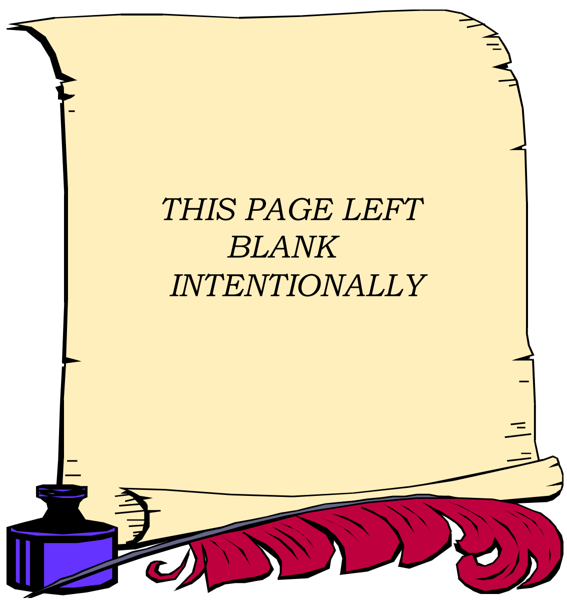
8 The estimated management fee is calculated based on the net rental revenue for 2001 and gross potential rent revenue for 2002 and 2003 since the owner did not maintain sufficient books and records to allow rental revenue to be verified to the rental receipts.

Recommendations

We recommend HUD:

4A. Require the owner to repay the project $32,254 for the excessive management fees.

4B. Take appropriate civil action and HUD prescribed remedies if the owner does not repay HUD for improper diversion of property funds.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Owner Misused Tenant Security Deposit Funds

In violation of HUD's requirements, the owner misused $24,127 in tenant security deposit funds. Instead of fully funding and separately maintaining the account as required, the owner used $15,406 to pay for project operations and $8,721 for personal expenses. Even though the owner knew the account should be fully funded, it used the tenant security deposit funds for project operations because the project's financial condition was precarious. In addition, the owner knew paying personal expenses was prohibited. However, it continually used project assets to pay them.

Criteria.

The Regulatory Agreement and a HUD Handbook requires the owner to keep tenant security deposit funds separate from all other funds of the project in an amount equal to or exceeding all outstanding tenant security deposit obligations.[9] Further, all payments from the account must be for refunds to tenants or for expenses incurred by tenants.[10]

Owner used tenant security deposit funds for project operating expenses.

By inappropriately transferring $15,406 in tenant security deposit funds to the project's operating account, the owner avoided using its funds for project operations. For June 2003, even though the general ledger showed the tenant security deposit liability was $24,627, the tenant security deposit bank account balance was only $500. Therefore, the owner underfunded the tenant security deposit account $24,127.

Owner paid $8,721 for personal expenses.

The owner also used $8,721 of tenant security deposit funds to pay for expenses like repairing the majority member's personal automobile. From 2002 to 2003, the owner wrote 37 checks on the tenant security deposit account. The owner wrote 3 of the 37 checks for the majority member's personal expenses.

[9] Paragraph 6(g) of the Regulatory Agreement and HUD Handbook 4370.2, REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects,* Chapter 2-9A.

[10] HUD Handbook 4370.2, REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects,* Chapter 2-9B.

Owner disregarded HUD's regulations.

Even though the owner knew of HUD's requirements regarding tenant security deposits, the owner disregarded them. In its response to a 1999 independent audit finding submitted to HUD, the owner admitted the tenant security deposit account was underfunded. The owner also stated it would not remove any funds out of the account. In addition, in a December 2001 letter to HUD, the owner said it would fully fund the account during 2002. Despite all of these assurances to HUD, the owner did not fully fund the account and continued taking funds out during 2002 and 2003.

Project lacks funds to return tenants' deposit.

The project does not have sufficient operating funds available to return every deposit to each tenant. In addition, the improper payments contributed to project's default by further reducing the amount of liquid assets available to the project. Thus, HUD should seek recovery of the $24,127 from the owner.

Auditee Comments

The owner attributed this finding to abuse by the managing member. The owner stated that all previous residents entitled to a refund were fully paid and no resident was denied a refund of their deposit because of this abuse. However, the owner did not address repaying the project.

OIG Evaluation of Auditee Comments

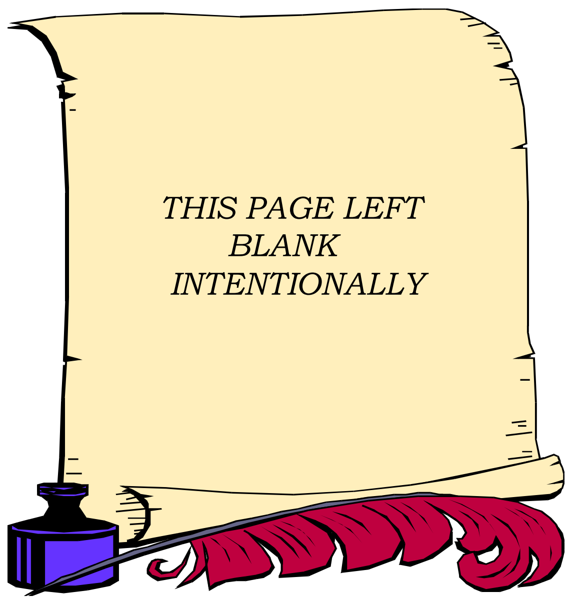
We applaud the owner for taking action including restricting the managing member's access to the project assets. However, the owner needs to repay the tenant security deposit fund or HUD should seek civil action to recover the improper disbursements.

Recommendations

We recommend HUD:

5A. Require the owner to fully fund the project's tenant security deposits by replacing the $15,406 used to fund project operations and repaying the $8,721 spent on personal expenses.

5B. Take appropriate civil action and HUD prescribed remedies if the owner does not fully fund tenant security deposits and does not repay the project for improper diversion of funds.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Management 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

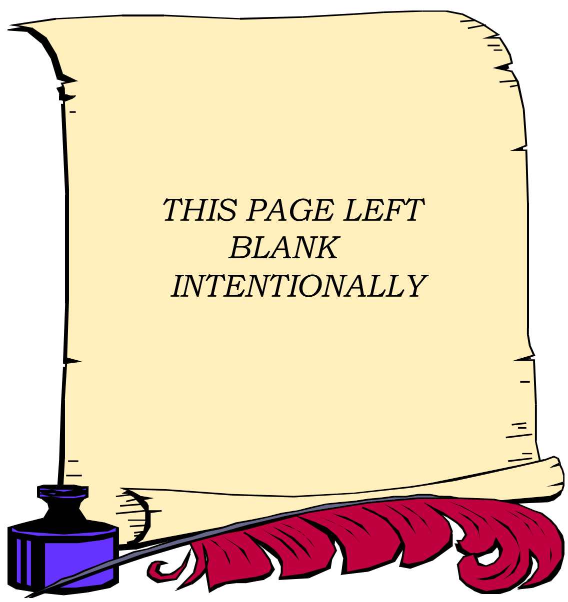
We determined the following management controls were relevant to our audit objectives:

- Program Operations - Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Validity and Reliability of Data - Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with Laws and Regulations - Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding Resources - Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

Significant Weaknesses

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

We determined that none of We're Rocking's management controls were reliable so we did not rely on them. We covered the significant weaknesses in our findings and recommendations.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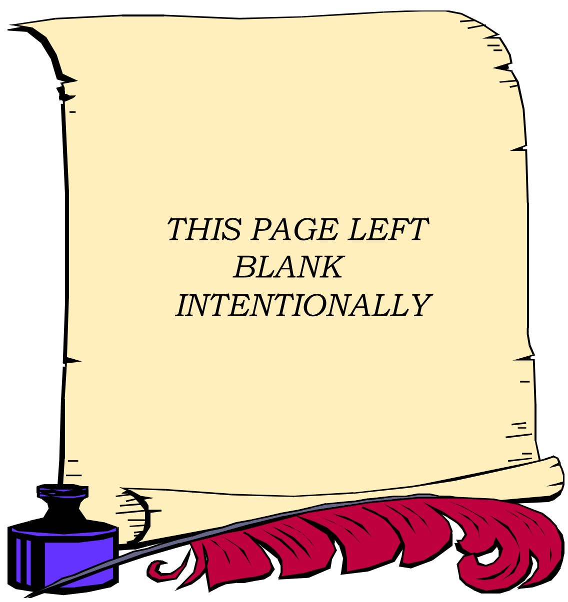
Follow-Up on Prior Audits

This is the first audit of the Jester Trails Apartments, Houston, Texas, by the Office of Inspector General.

Gainer, Donnelly, & Desroches, L.C, an independent audit firm, issued the 1999 and 2000 audited financial statements of the project on March 27, 2001, and August 30, 2001, respectively. In the 1999 and 2000 audited financial statements, Gainer, Donnelly, & Desroches, L.C. expressed a qualified opinion for the Report on Compliance – Major Program. In 1999 audit, the audit firm cited two findings: unauthorized distribution of project assets and insufficient funds in the tenant security deposit fund. In the 2000 audit, the audit firm cited one finding: unauthorized distribution of project assets. The audit firm had not cleared these outstanding findings at the time of our audit. We included these issues in our audit objectives. In addition, our report includes findings and recommendations covering these issues. The owner has not submitted audited financial statements for 2001, 2002, and 2003 to HUD.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Schedule of Questioned Costs

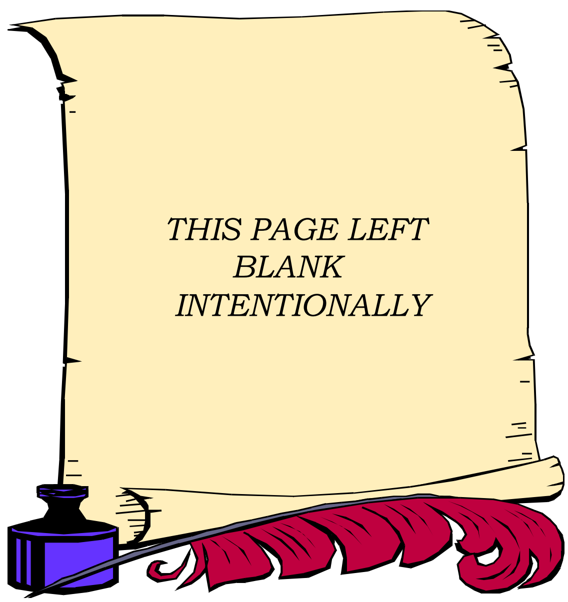
Recommendation Number	Ineligible Costs [1]	Unsupported Costs [2]	Funds To Be Put To Better Use [3]
1A			$2,133,843
2A	$ 41,261		
2B		$14,214	
3A	42,431		
4A	32,254		
5A	24,127		
Totals	$140,073	$14,214	$2,133,843

Total Questioned Costs and Funds Put To Better Use $2,288,130

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.

3 Funds to be put to better use include quantifying savings that would be used more effectively if OIG recommendations were implemented. The Inspector General Act specifically provides that future monetary savings should be reported under the category "recommendations that funds be put to better use."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Auditee Comments

02-17-04 12:23 From-LARRY LIKOVER MD 7134657334 T-705 P 01/02 F-952

February 16, 2004

Linda Poole
2006 West 43rd Street
Houston, Texas 77018

D. Michael Heard
Regional Inspector General for Audit, 6AGA
Fort Worth, Texas

Dear Mr. Beard:

This letter is being offered in response to your audit report of Jester Trails Apartments dated 2004. As was explained to your auditors, I was a minority member of the company holding title to this property and was not in a position to effectively control its operations during the period, which your audit focuses. In June 2003, I successfully applied legal pressure on Mr. Murray, the controlling member of the company, to relinquish his control of operations. Since that time, I have devoted all my energies to address and correct the problems associated with the property. The conditions that I inherited were deplorable, to say the least, but we have made great strides in correcting a multitude of problems. At the time I took control of the property over half the residents were delinquent in their rents and the property was rife with criminal activity. The property was in serious disrepair and all the maintenance equipment was either damaged or inoperable. Finally, all the bank accounts were barren and nothing but a multitude of bills existed.

Since that time, we have hired a professional staff to oversee the property, the bills, with the exception of the mortgage are under control and the property has been restored to operational condition. We have implemented a new marketing strategy and the property is currently being rented up with expectations of reaching a breakeven point very soon. We are in constant communication with the mortgage company and are anticipating renegotiating our note in the near future that will allow us to be current once again. Under this scenario, the HUD would be released from its obligation to the property and all potential losses would be mitigated.

Your report has cited five specific findings in regard to the property. I offer the following response to each:

Finding 1: Owner failed to maintain the project's books and records.

This finding is correctly stated, however, this problem is no longer applicable to the period subsequent to June 2003. We now have proper records and financial information available. Though we cannot correct the conditions of the records prior to that time, we have fully compliant records and procedures in place. To fully comply with HUD regulations, we are having audits performed for 2001, 2002 and 2003. Though these reports will likely result in disclaimed opinions, they will be completed in the next few weeks and appropriately filed under the HUD REAC system. We are confident that the 2004 reports will be filed with clean opinions and under the statutory requirements of HUD.

Finding 2: Owner paid personal expenses with project funds.

We do not dispute this finding. Yet, Mr. Murray no longer has any control over the assets of the property and no such further violation has occurred since June 2003.

Finding 3: Owner improperly obtained and paid for a promissory note.

This finding is the most confusing of all findings. This note was consummated under the understanding that the HUD would allow it. The bank assured the owners that it was proper and even the local HUD representative recollects some mention of its approval. It is very unlikely the bank would have issued the note if they did not believe it was fully secured and under the auspices of HUD regulations. Despite the misunderstandings associated with this note, we anticipate resolving this matter with the future refinancing of the property.

02-17-04 12:24 From-LARRY LIKOVER MD 7134657334 T-705 P.02/02 F-852

Finding 4: Owner received excessive management fees.

This finding is actually related to the second finding. As the managing member no longer has access to the assets of the property, this finding has been corrected. Any loss of funds due to this finding is his responsibility.

Finding 5: Owner misused Tenant Security Deposit Fund

As with findings two and four these abuses are related to the previous managing member's abuses. It should be noted, however, that all previous residents that were entitled to a refund of their deposit have been fully paid. No resident was denied a refund of his or her deposit because of this abuse.

Sincerely,

Linda Poole

Linda Poole.