audit report
OFFICE OF INSPECTOR GENERAL

Issue Date December 24, 1996	
Audit Case Number 97-SF-212-1001	

TO: William F. Bolton, Director, Multifamily Division, Sacramento Area Office, 9GHM

FROM: Mark Pierce, Senior Auditor, 9AGA

SUBJECT: Shade Tree Apartments
Multifamily Mortgagor Operations
Sacramento, California

We reviewed financial activities of the multifamily project known as Shade Tree Apartments (project number 136-35541) located in Sacramento, California. We found that project cash was improperly used to make payments on a second deed of trust and to reimburse the management agent for unsupported and excessive costs. Also, the owner improperly retained some project cash. The misused monies contributed to the project's financial weakness and deferred maintenance.

BACKGROUND

The objective of HUD's mortgage insurance programs for multifamily housing is to assist in the construction, rehabilitation or preservation of rental or cooperative housing. In consideration for the mortgage insurance, the owner agrees to various controls over the housing's operations. These requirements are contained or referenced in a contract known as a regulatory agreement. Some requirements include limits on use of project assets, proper project upkeep, and maintenance of accounting records.

In 1978 HUD's Federal Housing Administration insured a 6.8 million dollar mortgage loan for the project, known then as Little Oak Apartments, under Section 221(d)(4) of the *National Housing Act*. On December 31, 1984 College Oaks, a general partnership, purchased the project from Little Oak Apartments Investors, a limited partnership. In addition to cash, the seller accepted a promissory note for $1,160,000 from the buyer, who assumed the HUD-insured mortgage loan with a balance of $6.6 million.

The new owner consists of four different general partnerships or joint ventures: College Oaks, Campbell Associates, Woodland Associates, and Westgate Associates. The entities had entered into a "Little Oaks Apartments Operations Agreement" in December 1984 to acquire the project, which they subsequently renamed. In 1990 the Campbell Associates partnership divided into two partnerships, with interest in Shade Tree given to Campbell Associates II. Several individuals or couples have interest in at least three of the entities. One investor, Doris Davis, has the responsibility for management and control of the routine business activities for all the entities.

The project is located on 16 acres in Sacramento, California and is adjacent to the American River Junior College. The project includes 296 apartments and has amenities such as a recreation room, tennis courts, a jacuzzi, and several pools. The owner has contracts with HUD for subsidizing rents of qualified low-income residents, under the Section 8 program, for 210 of the housing units. The first contract was effective in 1979 and covers 60 units. A second contract covering 150 more units began September 1993. The contracts require the owner to maintain the units and related facilities so as to provide decent, safe and sanitary housing.

Doris Davis, Inc., located in San Jose, California, provided management agent services to the project for the new owner. In 1992 the independent firm of Porta Management Group, a California corporation located in Sacramento, began managing the project. (Porta had its name changed to PMG Real Estate Management & Consulting in September 1995.)

The project has experienced high vacancy rates as well as significant maintenance and financial problems. A January 1993 physical inspection by HUD identified a vacancy rate of 25 percent. Fifty vacant units (17 percent) required substantial repair before they could be made ready for occupancy. Three years later and over two years since the second Section 8 contract award, a HUD inspection showed 26 vacant units. This was equivalent to a vacancy rate of nearly nine percent. The inspector observed that, while major improvements had been made, the project was still affected by age obsolescence and deterioration. There was much deferred maintenance that affected curb appeal and vacancy.

For many years the project has experienced significant "surplus cash" deficiencies due to high levels of project payables relative to available cash.

Objective and Methodology

The purpose of our review was to determine whether any improper use of project assets contributed to the project's financial and physical problems. The review generally covered the period January 1, 1991 through May 31, 1996.

We conducted the review in accordance with generally accepted government auditing standards The primary methodologies for this work included:

- Analysis of audited financial statements of the project, discussions with the public accountant performing the audits, and review of the accountant's working papers prepared during those audits.
- Interviews of multifamily asset management staff at the HUD Sacramento office and review of documents there that concerned the project.
- Interviews of the owner's principal Doris Davis and various employees of the management agent.
- Consideration of the project's internal control structure and assessment of risk exposure to determine review procedures. We did not evaluate control effectiveness because of the limited nature of the review.
- Examination of accounting records and supporting documentation for selected financial activities and transactions.
- A visit to the project to observe its condition.

We also obtained and considered comments on our preliminary conclusions from Doris Davis, the management agent, and HUD asset management staff. Written comments obtained from Ms Davis's attorney and the agent are included as appendices to this report.

RESULTS OF AUDIT

FINDING - Improper Use of Assets Contributed To the Project's Financial Weakness and Deferred Maintenance

Project assets of $114,292 were used in violation of the regulatory agreement between January 1, 1991 and May 31, 1996. These consisted of $79,989 disbursed to an ownership entity on a deed-of-trust note, $11,024 paid for excess interest paid on personal lines of credit used to finance owner advances, $3,492 cash account taken by the partners, and $19,787 of excessive and unsupported costs charged by the management agent. Owner advances made through 1994 and agent refunds mitigated a small fraction these acts. Nevertheless, improper use of project assets since then contributed to its financial weakness and deteriorated physical condition. As a result, some residents were exposed to substandard conditions and HUD's insurance risk was raised. This occurred because the owner and management agent disregarded the regulatory agreement.

LIMITS ON USE OF PROJECT FUNDS. In consideration for the insurance endorsement of the project's mortgage loan, the owner agreed to be bound by a regulatory agreement with HUD. The agreement states that the owner will not, without HUD approval:

- Pay out any project funds for other than the insured loan and for reasonable operating expenses and necessary repairs, except from surplus cash, and

- Receive any distributions of project assets unless from surplus cash. A distribution is defined as the withdrawal of any project assets for all but necessary and reasonable expenses to operate and maintain the project.

HUD publications help define reasonable operating expenses and necessary repairs, principally in handbook 4381.5 REV-2, *The Management Agent Handbook* (and its predecessor 4381.5 REV-1) and handbook 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*.

For the period covered by our audit, *distributions were prohibited* because the project consistently had surplus cash *deficiencies* as shown below.

As of Dec. 31	Deficiency
1990	$79,466
1991	$105,231
1992	$119,431
1993	$100,313
1994	$97,081
1995	$104,153

SECOND DEED OF TRUST. The current owner partially financed its purchase of the project on December 31, 1984 with a second deed-of-trust note of $1,160,000 to the seller. This second deed was replaced in January 1992 with a $1½ million loan from Campbell Associates II, a part owner of the project. Consistent with the regulatory agreement and as required by HUD, the loan agreement prohibit making payments with project funds unless from surplus cash.

Nevertheless, the public accountant engaged to audit the project's 1995 financial statements identified improper payments of $79,989 (consisting of seven monthly payments of $11,427) made on the Campbell note. The owner stopped making the payments when the public accountant advised that they were in violation of the regulatory agreement. We identified no other project payments on this note, but the owner has not repaid the amount.

EXCESS INTEREST. On March 1, 1993 HUD authorized the use of project funds to pay for the interest expenses on personal lines of credits by three principals of the owner.+ The lines of credit were ostensibly for the purpose of funding needed repairs. For the period from November 1991 to February 1996, the project paid $87,416 in interest on the lines of credit.

Although the project paid the interest due on these personal accounts, we found that not all of the draws on these accounts during this period were for the project. Some of these draws were used by owner principals to fund other projects or activities. Only $282,569 of the draws went to the project while the draws totaled $633,188.

Nevertheless, the interest paid by the project of $87,416 was not based on a proper allocation. Entire monthly interest payments were charged to the project on a "hit-or-miss" basis: some months the project was not charged for interest paid, and some months the project was charged for the entire interest charge. Based on the amounts of the draws actually advanced to the project, we determined that the project should only have been charged $76,392, or $11,024 less than the amount paid.

CASH ACCOUNT TAKEN. Doris Davis, Inc. did not turn over the $3,492 balance in the project operating account to Porta when it took over management of the project. Instead Davis commingled non-project funds in the account and used it for joint financial activities of several principals of the owner. The project accounting records show the transaction as a reduction of owner advances.

ASSET MANAGEMENT FEES. In December 1992 Doris Davis, Inc. turned over management agent responsibilities for the project to Porta Management Group. Porta subsequently provided the full range of services normally provided by an agent. From January 1993 to December 1995, however, Davis received $40,872 for asset management fees.

The asset management fees were for such functions as making onsite inspections, reviewing and authorizing proposed weekly cash disbursements and follow-up of repairs, and review of monthly profit and loss statement and annual financial reports. These functions are associated with managing and protecting assets of the ownership entity and overseeing the management agent's performance. According to section 6.41 of handbook 4381.5 REV-2, such costs may only be paid from funds available for distribution in accordance with the regulatory agreement. The payments for these fees stopped after December 1995 when the HUD Sacramento office notified Doris Davis, Inc. that the asset management fees violated the regulatory agreement.++

+ This authorization was rescinded February 16, 1996.

++ The asset management fees were disclosed in audited financial statements submitted to HUD. The HUD Sacramento office noted the disclosure in the 1995 financial statements, and on February 16, 1996 notified Doris Davis to discontinue the payments.

Nevertheless, HUD was previously aware of and had condoned these fees, thus we are not taking exception with the fees paid through 1995. A former HUD official responsible for monitoring the project said that the fee arrangement was considered acceptable because Porta was inexperienced with HUD requirements, and it was thought that Davis's assistance would be useful. However, this was intended to be a short-term arrangement only.

EXCESSIVE AND UNSUPPORTED AGENT COSTS. In addition to obtaining reimbursement for necessary products and services for the project and collecting the management fee, HUD permits the agent to use project funds to pay for "front-line" management activities. However, the management certification form (contained in handbook 4381.5 REV-2) requires the agent to: not impose surcharges or administrative fees in addition to actual costs; ensure all expenses are reasonable and necessary; obtain materials, supplies and services on terms most advantageous to the project; and have records available to support the reasonableness of charges by identity-of-interest entities.

An identity-of-interest company of the agent, BOSS Service and Supply, Inc., provides all "front-line" employees for the project as well as some of its services and materials. The management agent, however, used project funds to pay BOSS $19,787 for the following excessive and unsupported costs.

Cost Item	Amount Billed	Excessive	Not Supported
Credit reports	$9,232		$7,630
Printed forms	2,791		706
Photocopies	2,368		2,368
Postage	2,472		2,472
Payroll-related costs	106,124	$6,611	
Total	$122,987	$6,611	$13,176

Credit reports. The project was charged $20 for credit reports. The agent provided us with an invoice from the credit report company to BOSS that supported costs of $3.47 per credit check. This only supports $1,602 of the charges. The agent claimed that additional costs are involved, including equipment, software, and staff time reviewing the report. However, the agent staff did not have documentation supporting these additional costs.

Printed forms. In addition to forms directly ordered and paid for by the project, the agent billed the project $1,262 for forms purchased by BOSS and ostensibly provided to the project. Each month BOSS would prepare an invoice itemizing the quantity and unit price of the forms. The unit prices, however, were arbitrary amounts and the quantities were based on estimates. The agent provided us records that showed the actual costs of recent purchases of forms by BOSS. These records showed that the unit prices charged by BOSS were higher than its costs. Based on the average markup, we estimate that the excessive costs charged to the project were $706. The agent claimed there were other costs involved such as taxes and freight but provided no documentation to support these costs. While the method used to determine the quantities was not adequate, we considered the quantities to be reasonable and took no exception with them.

Photocopies. Photocopies were charged based on arbitrary quantities and a unit cost of 20¢ which the agent could not support. While it was evident that some photocopying was done for the project (such as monthly accounting reports sent to the owner), the unsupported quantities did not seem reasonable and the per-unit charge seemed well above cost.

Postage. Postage was arbitrarily charged at the rate of 20¢ per dwelling. The agent could not document the actual costs. These monthly charges were in addition to itemized (and supported) postage and freight charges paid by the project.

Payroll-related costs. During its 1994 and 1995 audits, the public accountant found that BOSS had overcharged the project for payroll taxes, workmen's compensation and health insurance. As a result, the owner negotiated a cost reduction of $6,611 consisting of $3,760 for 1994 and $2,851 for 1995. These excess costs have been *reimbursed* to the project.

MITIGATING EFFECT OF OWNER ADVANCES. The above misuses of project assets occurred from 1991 to 1996; however, the owner advanced substantial funds ($282,569) to the project through 1994 which mitigated all the misuse through that year, after which advances ceased. Nevertheless, the effect of any offset reduces the allocable interest of the lines of credit that were the source of the advances. Thus, the offset reduces the amount of exceptions from $114,292 to $101,934.

Issue	Amount of Exception	Less Offset	Net of Offset
Second deed of trust	$79,989		$79,989
Excess interest	11,024	-$3,958	14,982
Cash account taken	3,492	3,492	0
Excessive/unsupported agent costs	19,787	12,824	[+]6,963
Total	$114,292	$12,358	$101,934

EFFECTS. The asset misuse contributed to the project's weak financial condition and reduced funds available to make necessary repairs despite advances made by the owner and the increase in Section 8 subsidies.

As noted earlier, the project consistently experienced significant surplus cash deficiencies, and the average working capital deficit was $176,000 for the last seven years. Long-vacant apartments contributed to this weak financial position. On June 21, 1996 we observed the interiors for 8 of the 26 vacant units (9% vacancy).[++] Five of these units were being readied for occupancy, but the other three had been vacant for several years because rehabilitation work had not been done. The resident manager told us that completion of repair work depends on the availability of funds. In August 1996 the resident manager told us that several units that had been vacant for years had finally been made ready for occupancy.

[+] This includes $2,851 of excessive payroll-related costs already reimbursed to the project.

[++] The project's vacancy had improved from 50 to 26 units between July 1993 (two months before the second Section 8 contract that increased the number of potential subsidized units from 60 to 210) and June 1996. The January 1996 HUD inspection also noted 26 vacancies, which was still considered high.

The project is 27 years old and has been affected by age obsolescence. In addition, the physical deterioration of the building components and equipment is apparent. HUD's January 1996 physical inspection concluded that the project's overall physical condition was "satisfactory"; however, significant maintenance and replacement was necessary such as replacing roofs and gutters, repaving parking lot, and replacing carpets and appliances. The old appliances had marginal performance and were missing parts. An October 1996 HUD inspection gave the project a "below average" rating. Although the inspection noted some effort to improve the project, it still had much deferred maintenance. The inspector estimated repair costs totaling over $212,000, including $154,000 for roofs and $22,000 for rehabilitation of vacant units.
As a result, of these conditions some residents were subjected to substandard conditions. Further, HUD's insurance risk was raised since the value of the mortgaged property was lessened by the obsolescence and deferred maintenance.

CAUSE OF THESE ACTS. The violations to the regulatory agreement occurred generally because of disregard of HUD requirements. Davis Doris told us that she believed that payments on the second mortgage were appropriate if the HUD-insured mortgage was current. Also, neither Davis nor Porta had set up proper systems to allocate interest and certain payroll-related costs to the project. Further, Porta did not recognize the need for setting up a system to track actual costs for purchases made on the project's behalf by its BOSS affiliate.

OWNER/AGENT COMMENTS AND OIG EVALUATION. This report reflects our final conclusions after obtaining and considering comments from the owner, the management agent, and HUD asset management staff. Appendices A and B contain written comments on our preliminary conclusions obtained from the owner's attorney Levy, Levy & Levy, and the agent.

While the HUD staff indicated concurrence with us, the responses from the owner's attorney and agent were often contentious.

> **Second deed of trust.** The attorney states that the second deed of trust loan provided funds to improve and benefit the project. The owner mistakenly believed that the project had a positive cash flow that could be used to pay the interest. However, the owner contends there was no harm to the project.
>
> The loan proceeds were not available for the project because they were needed to pay of the loan arising from the project's purchase. The project was harmed because needed maintenance was deferred to make prohibited payments with project funds on the new second.
>
> **Excess interest.** The attorney states that the proceeds from the lines of credit were used to pay for project repairs.
>
> Only part of the proceeds obtained from the lines of credit were used for project purposes. The audit takes exception with only the excess interest charges related to the borrowed funds not used for project purposes.
>
> **Cash account taken.** The attorney states that the cash in the account kept by Doris Davis had been retained in project accounts.
>
> The owner never provided records to us showing the disposition or status of the funds from this account. The bank statements provided with the attorney's response do not include the account in question. We concluded that the funds in the account were improperly handled based principally on information provided by the owner's public accountant who performed the audits of the annual financial statements. The accountant stated that the amount of

owner contributions in the 1994 statements was reduced by the $3,492 because ". . . this account was no longer used as a project operating account, but as a partnership account."

Asset management fees. The attorney states that the HUD officials were aware of the joint-management.

HUD intended that the arrangement be temporary. Port told us that they have been providing full management services, and we concluded that the services provided by Doris are principally asset management in nature.

Excessive/unsupported agent costs. The agent claims that the charges were fair and based on standard industry practice. The cost per credit report is $20 when including hardware, software, and employee time obtaining and reviewing each report. Costs of printed forms is based on actual costs. Photocopy costs at $59 are reasonable. As for the payroll-related costs, the problem with its reconciliation process was corrected in 1996.

The agent has already reimbursed the excessive payroll-related costs of 1994 and 1995. The agent, however, still has not provided evidence that the charges for credit reports, printed forms, and photocopies are reasonable. The agent has the burden for maintaining documentation showing that the charges were reasonable and necessary.

RECOMMENDATIONS. We recommend that HUD:

A. Obtain compensation from the owner and agent and determine what portion may be returned to the project, and what conditions or restrictions will be imposed for use of those funds, to cure its financial and physical needs.

B. If the owner will be authorized to resume using project funds to reimburse for interest on the lines of credit, require the owner to establish a proper system for determining the amount of interest allocable to the project.

C. Not approve a resumption of fees for Doris Davis, Inc.

D. Instruct the agent to stop all unsupported charges for reimbursements until it has established systems to properly document actual costs and agrees not to charge the project surcharges or administrative fees.

If you have any questions, please contact senior auditor Mark Pierce at 415-436-8101.

APPENDIX A

OWNER COMMENTS

APPENDIX A

APPENDIX A

APPENDIX A

APPENDIX B

MANAGEMENT AGENT COMMENTS

APPENDIX B

APPENDIX B

APPENDIX B

APPENDIX C

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December 24, 1996

TO: DISTRIBUTION BELOW

FROM: Mark Pierce, Senior Auditor, 9AGA

SUBJECT: Shade Tree Apartments
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Sacramento, California
Memorandum Report 97-SF-212-1001

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( )	Central Records, GF (room 8266)	4
( )	Pacific/Hawaii, 9AGA: Albright, McCargar, Bahr, Warner, Lovell, Pierce, Cembrano (2)	8
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	Total	48