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TO: Charlie Famuliner, Director, Multifamily Division,
Virginia State Office, 3FHM

FROM: Edward F. Momorella, District Inspector General for
Audit, Mid-Atlantic, 3AGA

SUBJECT: Oakmont North Apartments I, II, and III
Multifamily Mortgagor Operations
Norfolk, Virginia

We audited the operations of Oakmont North Apartments I, II, and III (projects), to determine whether the owner and identity-of-interest management agent (agent) operated the projects according to the terms and conditions of the Regulatory Agreement and applicable HUD requirements.

The report identifies that the owner used projects revenue to reduce advances when the mortgages were in default, and incurred ineligible and unsupported expenses. As a result the projects which are in financial distress lost the use of needed revenue.

Within 60 days, please give us, for each recommendation made in the 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.

If you have any questions, please contact Irving I. Guss, Assistant District Inspector General for Audit, at (215) 656-3401.

Executive Summary

We audited the operations of the projects to determine whether the owner operated the projects according to the terms and conditions of the Regulatory Agreement, and applicable HUD requirements.

Projects funds improperly applied to reduce overdrafts

The owner reduced the projects overdrafts during mortgage default contrary to HUD requirements. The overdrafts represented the owner's debt payable to the bank. The owner stopped making mortgage payments and projects revenue of \$298,281 was improperly applied against the outstanding overdrafts.

Projects paid questionable costs

The owner paid ineligible and unsupported expenses which totaled \$56,249 and \$2,390, respectively, contrary to HUD requirements. The owner and agent did not manage these cash disbursements properly. As a result the projects which are in financial distress lost the use of needed revenue.

We recommend the owner reimburse HUD the final overdraft amounts, repay the projects the ineligible costs and justify the unsupported costs.

We discussed the draft findings with owner/agent representatives during the audit and at an exit conference held on July 23, 1996. The draft findings were provided to the owner and responses received were considered in our report. The owner responses are included as Appendix B.

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Abbreviations

HUD Department of Housing and Urban Development

OIG Office of Inspector General

Introduction

Oakmont Associates, Phase I, II, and III, a Virginia Limited Partnership, owner, was organized on March 1, 1982 to acquire and operate Oakmont North Apartments I, II, and III. The general partner of Oakmont Associates is Great Atlantic Management Company, Inc., an identity-of-interest management agent owned solely by Edwin A. Joseph, a limited partner in Oakmont Associates.

The projects consist of 456 units located in Norfolk, Virginia. The mortgages were endorsed for insurance under Section 221(d)(3) of the National Housing Act. The owner executed five-year Housing Assistance Payment contracts beginning November 1, 1992 for 55, 30, and 50 units for Oakmont North I, II, and III, respectively.

The owner defaulted on the mortgages in October 1995. The mortgages were assigned to HUD in March 1996. The owner agreed to a deed in lieu of foreclosure transaction in June 1996. HUD took over management of the projects in June 1996.

Primary tenant records are maintained at the projects office. Financial records are maintained at the agent's office at 2 Eaton Street, Suite 1100, Hampton, Virginia.

Audit Objectives

The primary objective of the audit was to determine whether the owner/agent managed the projects in accordance with HUD regulations and requirements. Specific objectives were to determine whether the owner/agent: (1) established adequate internal controls to safeguard the projects assets, assure reliable accounting data and operating efficiencies, (2) complied with the terms and conditions of management certifications and regulatory agreements, and (3) assured HUD housing assistance payments and claims are correct.

Audit Scope

We reviewed HUD, agent and projects files and interviewed pertinent HUD and agent staff.

Audit Period

Our audit was performed between January 1996 and June 1996, and covered the activities from January 1995 through December 1995. The audit period was expanded when appropriate.

We conducted the audit in accordance with generally accepted government auditing standards.

The Owner Improperly Reduced Bank Overdrafts During Mortgage Default

The owner reduced the projects overdrafts during mortgage default contrary to HUD requirements. The overdrafts represented the owner's debt payable to the bank. The owner stopped making mortgage payments, and projects revenue of \$298,281 was improperly applied against the outstanding overdrafts.

HUD Handbook 4370.2 REV-1, dated 5/92, paragraph 2-11 A, prohibits the repayment of advances when the project is in a non-surplus cash position.

Bank overdrafts owner responsibility

In 1992, the projects operations did not generate sufficient revenues to cover the projects expenses. The owner and management company independently, on June 29, 1992, executed an indemnity agreement with the bank which permitted overdrafts to the projects accounts. Section 2 of the agreement states the owner "...hereby agrees to reimburse the Bank immediately upon demand by the Bank and without further action by it, for the full amount of any and all overdrafts resulting from time to time in the Deposit Accounts as the same shall occur..." The bank allowed the projects overdrafts to grow and did not demand payment.

Overdrafts reduced when mortgage payments stopped

In October 1995, HUD informed the owner that the overdrafts were owner advances and repayment could only be made when the projects were in a surplus cash position. The owner disagreed with HUD and discontinued making mortgage payments thereby allowing the overdrafts to be reduced.

The projects monthly accounting reports indicated that the last mortgage payments were made in September 1995 and the overdrafts decreased as follows:

Finding 1

<u>Project</u>	<u>Overdrafts After Sept 1995 Mortgage Payment</u>	<u>Overdrafts At Apr 30, 1996</u>	<u>Overdrafts Reduced During Mortgage Default</u>
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The owner agreed to a deed in lieu of foreclosure and HUD started managing the projects on June 3, 1996. We requested, and the owner refused to provide us with updated overdraft amounts when HUD took the projects. The owner stated that HUD agreed not to pursue the reduction of the overdrafts as a condition for the deed in lieu of foreclosure transaction. The HUD Virginia State Office Chief Counsel stated that HUD did not agree to release owner liability for repaying owner advances during mortgage default on the deed in lieu documents. In the absence of projects surplus cash, reduction of the overdrafts was the owner's responsibility not the projects'.

Auditee Comments

The owner's attorney stated this finding was not supported by law and did not violate the HUD Handbook provisions because the amount owed to the bank was a trade debt and not an owner advance. The overdraft funds were used to timely pay trade debts thereby providing the tenants with safe, clean and affordable housing.

The attorney stated that the overdrafts were projects debt owed to the bank. The owners merely used their credit worthiness to convince the bank to allow the projects overdrafts.

The attorney pointed out that the projects owed \$164,772 in management fees to the identity-of-interest management agent as of December 31, 1995. Further, if the owners do pay any portion of the overdraft, these funds should be used to pay the management company's unpaid fees.

The attorney stated that during the deed in lieu discussions, HUD told the owner that HUD would not pursue the overdraft issue.

**OIG Evaluation of
Auditee Comments**

The debt owed to the bank was not a project trade debt. We classified the overdrafts similar to the owner obtaining bank financing to advance funds to pay projects operating expenses. The owner/agent executed the indemnity agreement with the bank not the project entity. The bank permitted the overdrafts and repayment was the owner's responsibility.

The owner did not maintain units in decent, safe and sanitary condition as documented in the latest HUD inspection that failed 90 percent of the units inspected.

The owner benefitted from these overdrafts by delaying the mortgages default and protecting the owner's investment in the projects. In addition, the agent requested a ruling from HUD in January 1995 concerning interest payments to an owner who advances funds to a distressed property. In the request, the agent classified funds from the owner line of credit to keep the operating account current as an owner advance. The bank allowed the overdrafts to continue based on the owner's credit. HUD's decision stated that operating advances and interest, if HUD approved, are to be repaid from surplus cash. Based on the decision the agent decided not to classify overdrafts as owner advances.

The projects' monthly accounting reports for December 1995 and May 1996 signed by the agent indicated that the projects did not owe any management fees. The total payables at the end of December 1995 totaled \$78,539. Therefore, how the attorney established \$164,772 owed the agent for management fees is not known.

The attorney did not provide any written documentation that HUD agreed not to pursue the overdrafts.

Recommendation

We recommend the owner:

- 1A. Provide HUD the final overdraft amounts at June 3, 1996. Recalculate and pay HUD the amount of overdrafts (owner advances) reduced during

Finding 1

mortgage default through June 3, 1996 totaling at least \$298,281.

The Owner Paid Ineligible and Unsupported Expenses

The owner paid ineligible and unsupported expenses which totaled \$56,249 and \$2,390, respectively, contrary to HUD requirements. The owner and agent did not manage these cash disbursements properly. As a result the projects which are in financial distress lost the use of needed revenue.

The Regulatory Agreement paragraph 6b. states that the owner cannot pay out any funds for costs except for reasonable and necessary repairs. Paragraph 9b. states that payment for services, supplies or materials cannot exceed the amount ordinarily paid for such services, supplies, or materials in the area where the services are rendered or the supplies or materials furnished.

The Management Certification in paragraphs 3a. and 4a. provides that the agent will (1) comply with the project's Regulatory Agreement, and (2) assure that all project expenses are reasonable in amount and necessary to the operation of the projects.

A. Ineligible costs

The owner paid \$56,249 for: (1) servicing costs for tax-exempt bonds, (2) bond refunder transaction costs from project funds and (3) duplicate costs.

1. Servicing costs of tax-exempt bonds

The owner paid servicing costs for tax-exempt bonds secured by payments on the HUD insured mortgages of the projects. The agent disbursed \$50,605 from 1991 to 1995 for these costs from projects funds. According to the agent, records prior to 1991 were destroyed, and provided no comment why the costs were paid from projects funds. The Virginia State Office Chief Counsel advised us that these costs were not allowable project

Projects improperly paid owner's servicing and transaction costs

operating expenses and implied that these costs were owners' costs.

2. Bond refunder transaction costs

The owner improperly paid \$5,414 for bond refunder transaction costs from projects funds.

In a letter dated May 20, 1994, HUD provided the owner's attorney the terms and conditions of payment of bond refunder transaction costs. These transaction costs were to be funded by owner contributions and tax-exempt and taxable bonds issued by the bond refunder.

The owner incurred transaction costs of \$190,000 at settlement plus \$5,414 paid from projects funds for costs of a letter of credit posted by the owner related to the bond refunder. The \$190,000 was funded by tax-exempt and taxable bonds issued by the bond refunder. The bond refunder settlement statement did not include the \$5,414 and was not funded by the bonds. The \$5,414 was an owner cost not a project cost and ineligible. HUD did not approve bond refunder costs to be paid from projects funds.

3. Duplicate costs

The owner paid \$230 for duplicate bathroom floor work. The owner paid for the same bathroom floor work for a unit on two invoices dated 8/31/94 and 9/8/94. The owner paid both invoices on the same check. We were advised that the agent will seek reimbursement from the contractors.

Painting costs of \$420 previously presented were resolved based on the owner's response to the draft finding.

B. Unsupported costs

The owner paid \$2,390 to project employees for a Christmas bonus equal to one weeks pay. According to the agent, this was a common practice of the owner to pay employees Christmas bonuses. In our opinion such payments are questionable when the projects were in default.

Unsupported landscaping, roofing and miscellaneous costs previously presented were resolved based on the owner's response to the draft finding.

* * * *

By not properly managing cash disbursements, the owner paid ineligible and unsupported costs. This condition is alarming in view of the financial distress of the projects.

Auditee Comments

A. Ineligible Costs

1. Servicing costs of tax-exempt bonds

The owner stated that these costs were allowable project expense. The project received extensive benefits such as reduced costs from the owner obtaining financing from tax-exempt bonds, therefore, these costs were allowable.

2. Bond refunder transaction costs

The owner did not contemplate that these costs would be paid by the owner or funded by surplus cash. These costs were reasonable and necessary in order to maintain the HUD mortgages in a current position.

3. Duplicate costs

The owner believed that painting units more than once a year was not unreasonable.

The owner agreed with the duplicate costs for the bathroom floor work and was requesting reimbursement from the vendor.

B. Unsupported costs

The Christmas bonuses incurred were necessary and reasonable to obtain the highest quality employees. The costs were considered part of the employees compensation package.

OIG Evaluation of
Auditee Comments

A. Ineligible costs

1. Servicing costs of tax-exempt bonds

These costs were not eligible to be paid from project operations. HUD Handbook 4370.2 REV-1, dated 5/92, Chapter 4, Section 4-4 describes the 7000 account series. Account 7700 (Trustee) is an account to record expenses paid to an independent third party to manage long term debt and protect both the interests of the lender and the borrower. Expenses recorded to these accounts are applicable to the mortgagor entities distinguished from expenses necessary and reasonable to the operation of the project. Owners may charge expenses included in the 7000 series against project operations only with the prior written approval of HUD. HUD has not approved the servicing costs.

2. Bond refunder transaction costs

As stated in the finding transaction costs were to be funded by owner contributions and tax-exempt and taxable bonds issued by the bond refunder. The \$5,414 was an owner cost not a project cost and remains ineligible.

3. Duplicate costs

We accept the owners rationale and the painting cost of \$420 is resolved. The \$230 requires repayment to the project.

B. Unsupported costs

As stated in the finding we question paying Christmas bonuses when the projects were in default. However, if such bonuses are part of a written compensation package for the employees, it should be provided to HUD for determining the eligibility of the costs.

Recommendations

We recommend the owner:

- 2A. Reimburse the projects the ineligible \$56,249.
- 2B. Provide a copy of the employees compensation package to HUD. HUD will evaluate and render a decision on the eligibility of the questionable Christmas bonuses of \$2,390.

Internal Controls

In planning and performing our audit, we considered the internal control systems of the management of Oakmont North Apartments I, II, and III in order to determine our auditing procedures and not to provide assurance on internal control.

Internal control is the process by which an entity obtains reasonable assurance as to achievement of specified objectives. Internal control consists of interrelated components, including integrity, ethical values, competence, and the control environment which includes establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Internal controls assessed

We determined that the following internal control categories were relevant to our objectives:

- Accounting records and reports
- Cash receipts and disbursements
- Tenants security deposits
- Section 8 Housing Assistance Payments
- Procurement

Significant weaknesses found

A significant weakness exists if internal control does not give reasonable assurance that the entity's goals and objectives are met; that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports. Based on our review, we believe the following items are significant weaknesses:

- Cash receipts and disbursements

These weaknesses are detailed in the findings in this report.

Follow Up On Prior Audits

This is the first OIG audit of Oakmont North Apartments I, II, and III.

Schedule of Ineligible and Unsupported Costs

<u>Finding Number</u>	<u>Ineligible 1/</u>	<u>Unsupported 2/</u>
1	\$298,281	
2	<u>56,249</u>	<u>\$2,390</u>
	<u>\$354,530</u>	<u>\$2,390</u>

- 1/ Ineligible amounts are clearly not allowed by law, contract, or HUD policies or regulations.
- 2/ Unsupported amounts are not clearly eligible or ineligible, but warrant being contested for various reasons, such as the lack of satisfactory documentation to support eligibility.

Auditee Comments

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