



U.S. Department of Housing and Urban Development

District Office of the Inspector General
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October 26, 1995

Audit-Related Memorandum
No. 96-AT-214-1804

MEMORANDUM FOR: Daniel A. McCanless, Director, Multifamily Division, 4FHM

FROM: Kathryn Kuhl-Inclan
District Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: HUD State Office Request
Essential Housing Management, Inc.
Review of Charges for Front-Line Expenses
Winston-Salem, North Carolina

We have completed a review of charges to HUD multifamily projects for front-line expenses by Essential Housing Management, Inc. (EHM), Winston-Salem, North Carolina, for the three years ended December 31, 1994. Our objective was to determine if EHM's charges for front-line expenses were reasonable and properly supported. We initiated the review based on a request from your former Housing Management Division for an audit of EHM because of possible excessive charges by EHM to projects it managed.

BACKGROUND

EHM is a management company based in North Carolina. EHM operated under the name MBG, Inc. from January 1, 1992 until November 22, 1994. At December 31, 1994, EHM managed 56 HUD assisted or unassisted multifamily projects, and 190 other Farmers Home Administration and conventional properties, in 7 states and the District of Columbia.

EHM's corporate records were located in Winston-Salem and Raleigh, North Carolina.

SCOPE

We interviewed EHM staff and reviewed EHM's records pertaining to charges to HUD projects for front-line expenses. We also reviewed the records documenting payments to EHM for front-line expenses by three HUD projects: Meadowbrook Apartments, Willow Creek Apartments, and

Oak Knoll Apartments. We conducted our review from January through August 1995.

SUMMARY

EHM charged an estimated \$317,245 in excessive front-line expense fees to 41 HUD projects. The fees were excessive because EHM duplicated costs for bookkeeping services in fees charged to the projects, reducing money available to the projects to pay operating expenses and mortgage payments. Eight of the projects defaulted on their HUD-insured mortgages, and the mortgages were assigned to HUD.

Details of our finding and recommendations are in Attachment 1. We discussed the finding and recommendations with EHM's President, Chief Operating Officer, and Manager of HUD Programs on August 24, 1995, and provided them a draft of the finding. The Chief Operating Officer's written comments are summarized following the finding and are included verbatim in Attachment 4.

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

We provided a copy of this memorandum to EHM's President.

We appreciate your cooperation during the audit. Should you or your staff have any questions, please contact Rudy E. McBee, Assistant District Inspector General for Audit, at (615) 545-4368 or Bruce Milligan, Senior Auditor, at extension 4056.

Attachments:

- 1 - Finding and Recommendations
- 2 - Schedule of Excessive Charges
- 3 - Schedule of Unsupported Costs
- 4 - Auditee Comments
- 5 - Distribution

FINDING AND RECOMMENDATIONS

EHM Charged Excessive Front-Line Expenses To 41 Projects

EHM charged an estimated \$317,245 in excessive front-line expense fees to 41 HUD projects it managed. The fees were excessive because EHM charged two different fees which both reimbursed EHM for the same bookkeeping services. The excessive charges reduced money available to the 41 projects to pay operating expenses and mortgage payments. Eight of the projects defaulted on the HUD-insured mortgages, and the mortgages were assigned to HUD. EHM's excessive fees included \$94,029 charged to the 8 projects and \$223,216 for the remaining 33 projects.

Actual, Reasonable Costs are Chargeable to Project

HUD allows management agents to charge reasonable expenses incurred for front-line management activities to the project operating account, in addition to costs paid out of the management fee. Examples of front-line activities are taking applications, screening tenants and accounting for project income and expenses. However, the charges may not exceed the amount normally paid for such services, and may not exceed the agent's actual costs (HUD Handbook 4381.5 REV-2, The Management Agent Handbook, Paragraph 6.38). Owners of projects with mortgages assigned to HUD must remit all remaining net cash to HUD each month after project operating expenses have been paid (HUD Handbook 4350.1 REV-1, Multifamily Asset Management and Project Servicing, Chapter 10).

Fees Charged Were Excessive

From January 1, 1992 through December 31, 1994, EHM charged three fees to 41 HUD projects it managed: a fee for general management services, a bookkeeping fee, and a fee for performing front-line services. The general management fees were based on a percentage of income collections. The bookkeeping and front-line fees were calculated on a per unit basis. The average annual bookkeeping and front-line fees charged by EHM were:

<u>Per Unit Month Fee</u>	<u>Year</u>		
	<u>1992</u>	<u>1993</u>	<u>1994</u>
Bookkeeping	\$ 3.27	\$ 3.29	\$ 3.27
Front-Line	5.98	6.00	3.44

The fees charged the 41 HUD projects by EHM were excessive by approximately \$317,245¹. The fees were excessive because the bookkeeping and front-line fees reimbursed EHM for the same services. EHM charged the front-line fees because it claimed to provide services chargeable to the project operating account. However, support for the calculation of the front-line fees for 1992 and 1993 listed only the costs of EHM's accounting department including salaries, payroll taxes, employee benefits, rent and supplies. The front-line fees were excessive by at least the amount of the bookkeeping fees because the bookkeeping fees reimbursed EHM for maintaining the project accounting records.

The excessive fees of \$317,245 are listed in Attachment 2 by project. For 1992 and 1993, the excessive fees are the bookkeeping fees which were less than the front-line fees. The excessive amounts for 1994 are the front-line fees because they were less than the bookkeeping fees for almost all of the projects.

The excessive charges reduced the money available to the 41 projects to pay operating expenses and mortgage payments. Eight of the 41 projects went into default from 1988 through 1992, and the project mortgages were assigned to HUD. EHM's excessive fees included \$94,029 charged to the 8 projects and \$223,216 for the remaining 33 projects.

HUD Required EHM to Stop Charging Front-Line Fees in 1995

The HUD North Carolina State Office reviewed front-line fees in a March 1995 management review of EHM. HUD required EHM to discontinue the front-line fees retroactive to January 1995 because the fees were duplicating charges to the projects for bookkeeping services. EHM agreed to stop charging the front-line fees and refunded 1995 fees, but did not reimburse the projects for the excessive fees it received for the previous three years.

EHM Comments

In a September 12, 1995 letter, EHM's Chief Operating Officer (COO) agreed that support for the fees charged seemed to include unallowable costs, but believed allowable costs were omitted from the calculations. She said front-line fees charged for 1992 and 1993 were calculated by persons no longer employed by EHM, and they had been unable to determine how the calculations were made. The COO said HUD approved the rate for front-line fees for 1994. She said they were recalculating front-line fees for each year.

In a letter dated October 16, 1995, the COO provided a summary and numerous schedules detailing front-line and bookkeeping charges they believe are allowable and their conclusions regarding overcharges. The summary indicated overcharges in 1992 and 1993, an undercharge in 1994, netting to a total overcharge of \$71,806. The COO then subtracted amounts the projects owed EHM (for unpaid management, bookkeeping and front-line fees) to arrive at

¹ EHM staff stated some projects may not have fully paid front-line, bookkeeping and management fees. Any such unpaid amounts would be recorded as accounts payable by the projects and accounts receivable by EHM, and could be used to reduce fee overcharges. It was not feasible for us to determine and verify such amounts for all projects.

\$45,303 she contended EHM owed the projects. She said she had a thick file of supporting documentation she would make available for review. The text of the COO's second letter, minus the attachments, is in Attachment 4. We provided the attachments separately to the HUD State Office.

Evaluation of EHM Comments

The HUD State Office approved EHM's front-line fee charges in 1994, but was unaware that salaries of the same EHM staff were duplicated in the front-line and bookkeeping fees. The State Office recognized the duplication during the March 1995 review, and required EHM to stop the practice.

Because of higher priority work, we did not return to EHM to review the supporting documentation for EHM's second response. The North Carolina State Office will need to review the methodology and documentation for EHM's computation, and determine whether to rescind its prohibition against EHM charging front-line costs.

Recommendations

We recommend that you review EHM's October 16, 1995 letter and supporting documentation and require EHM to:

- 1A. Repay to HUD the excessive fees paid by the projects whose mortgages were assigned to HUD, estimated at \$94,029.
- 1B. Reimburse the other projects the excessive fees paid by the projects, estimated at \$223,216.
- 1C. Assure that project records are appropriately adjusted to reflect payables netted against EHM overcharges, and no longer owed to EHM.

Schedule of Excessive Charges

<u>Project Name</u>	<u>Project Number</u>	<u>Excessive Charges</u>			<u>Total</u>
		<u>1992</u>	<u>1993</u>	<u>1994</u>	
Projects with mortgages assigned to HUD:					
Brookside	053-35536	\$ 2,040	\$ 2,040	\$ 346	\$ 4,426
Cinnamon Ridge	053-35492	1,200	-	-	1,200
Forest Hills	053-35389	5,712	5,712	5,549	16,973
Lakewood	053-35493	6,720	6,720	166	13,606
Longmeadow	053-35507	5,040	3,360	-	8,400
Meadowbrook	053-35473	6,384	6,384	814	13,582
Summertree	053-35472	6,048	6,048	5,875	17,971
Willow Creek	053-35489	<u>8,400</u>	<u>8,400</u>	<u>1,071</u>	<u>17,871</u>
Sub-totals		<u>41,544</u>	<u>38,664</u>	<u>13,821</u>	<u>94,029</u>
Other projects:					
Academy Village	053-35320	2,100	2,100	2,040	6,240
Balsom Grove	053-35438	840	1,680	1,632	4,152
Bay Tree	053-35451	2,100	2,100	2,040	6,240
Bramblewood	053-35378	5,760	2,880	-	8,640
Carriage House	053-35452	2,142	2,142	2,040	6,324
Casa Grande	053-35329	1,890	1,890	1,683	5,463
Cotton Dale	053-35417	1,008	1,008	979	2,995
Duplin	053-35366	1,785	3,570	3,468	8,823
Erwin Elderly	053-EH236	540	540	918	1,998
Greenacre Terrace	053-35336	2,100	2,100	2,040	6,240
Heritage Ct.-NC	053-35388	1,512	1,512	1,469	4,493
Heritage Ct.-SC	054-35514	6,258	6,258	6,079	18,595
Heritage Homes	053-EH199	1,500	1,500	2,040	5,040
Hoffman Assoc.	053-35338	1,701	3,402	3,305	8,408
Meadow Wood	053-35402	2,100	2,100	2,040	6,240
Melvid Court	053-11020	1,512	1,512	1,346	4,370
Mountainside	053-35015	3,000	3,000	4,080	10,080
Oak Knoll	053-44101	7,560	7,560	7,344	22,464
Old Farm	053-35360	2,940	2,940	2,856	8,736
Plaza	053-35286	2,604	2,604	2,530	7,738
Richmond Village	053-35420	1,680	1,680	1,632	4,992
Robin Ridge	053-35385	600	600	816	2,016
R.M. Wilson	053-35287	1,050	1,850	2,040	4,940

Schedule of Excessive Charges

<u>Project Name</u>	<u>Project Number</u>	<u>Excessive Charges</u>			<u>Total</u>
		<u>1992</u>	<u>1993</u>	<u>1994</u>	
Sandy Ridge	053-35403	1,092	1,092	1,061	3,245
Scotland Manor	053-35368	2,520	2,520	2,448	7,488
South Village	053-35424	1,680	1,680	1,632	4,992
Tanglewood	053-35364	2,226	2,226	2,162	6,614
Union Square	053-35552	720	720	979	2,419
University	053-35311	2,373	4,746	2,875	9,994
Virginia Dare	053-35371	2,856	2,856	2,774	8,486
Walnut West	053-35346	714	1,428	1,387	3,529
Woodland	053-35330	2,100	2,100	2,040	6,240
Yadkin Trail	053-35446	<u>1,008</u>	<u>2,016</u>	<u>1,958</u>	<u>4,982</u>
Sub-totals		<u>71,571</u>	<u>77,912</u>	<u>73,733</u>	<u>223,216</u>
Totals		<u>\$ 113,115</u>	<u>\$ 116,576</u>	<u>\$ 87,554</u>	<u>\$ 317,245</u>

SCHEDULE OF UNSUPPORTED COSTS

<u>Finding/Recommendation</u>	<u>Unsupported Costs</u> ²
1A	\$ 94,029
1B	223,216

² Unsupported amounts do not obviously violate law, contract, HUD or local agency policies or regulations, but warrant being contested for various reasons such as lack of satisfactory documentation and HUD approval.

AUDITEE COMMENTS

DISTRIBUTION

Secretary's Representative, 4AS
Comptroller, 4AF
Audit Liaison Officer, 4AFI
Director, Field Accounting Division, 4AFF
North Carolina State Coordinator, 4FS
Director, Multifamily Division, 4FHM (2)
Special Agent in Charge, Southeast/Caribbean, 4AGI
Chief Financial Officer, F (RM 10166) (2)
Director, Office of Internal Control and Audit Resolution, FOI (Room 10176) (2)
Associate Director, US GAO, 820 1st St., NE Union Plaza, Bldg. 2 ,
Suite 150,
Washington, DC 20002, (2)
Housing - Federal Housing Comptroller, HF, (Room 5132) (3)
Assistant to the Deputy Secretary for Field Management, SDR (Room 7106)
President, Essential Housing Management, Inc.