AUDIT REPORT

Harris Health Center, East Providence, Rhode Island, Did Not Ensure That Renovations Were Properly Completed, Paid $21,729 for Unnecessary and Nonproject Costs, and Did Not Calculate Management Fees Properly

2007-BO-1004

March 22, 2007

OFFICE OF AUDIT, REGION 1
Boston, Massachusetts

.

Issue Date: March 22, 2007	
Audit Report Number 2007-BO-1004	

TO: Ellen Connolly, Director of Housing, Boston HUB, 1HMLA

FROM: For John Dvorak, Inspector General for Audit, Boston Region, 1AGA

SUBJECT: Harris Health Center, East Providence, Rhode Island, Did Not Ensure That Renovations Were Properly Completed, Paid $21,729 for Unnecessary and Nonproject Costs, and Did Not Calculate Management Fees Properly

HIGHLIGHTS

What We Audited and Why

We reviewed operations at Harris Health Center (Center), 016-43106, a 34-bed nursing home located in East Providence, Rhode Island, because the mortgage was delinquent and final endorsement of the U.S. Department of Housing and Urban Development (HUD)-insured loan was delayed. We examined whether project renovations were completed properly, only necessary interest and credit card fees were paid, and management agent fees were properly calculated and paid.

What We Found

The Center did not ensure that renovations were completed properly. It also paid unnecessary interest and non-project-related costs and did not properly calculate and pay fees to its related management agent. These conditions were caused by inconsistent supervision of the renovations and a misunderstanding of the HUD regulatory requirements. As a result, the Center did not receive the full benefits of its renovations and spent money on unnecessary expenses, all of which contributed to operating losses and cash flow shortfalls.

What We Recommend

We recommend that the director of HUD's Boston Multifamily Hub require the Center's owner to correct the renovation deficiencies, develop a repayment plan to reimburse the project $21,729 for unnecessary and non-project-related costs, and establish a consistent management agent structure and method for computing and paying management agent fees.

For each recommendation in the body of the report without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the owner of the Center with a draft audit report on February 27, 2007, and requested a response by March 14, 2007. We held an exit conference with the owner on March 5, 2007, to discuss the draft report, and we received the owner's written comments on March 14, 2007. The owner generally agreed with the facts, conclusions, and recommendations in this report, and will be working with HUD to implement corrective actions.

The complete text of the auditee's response can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

Harris Health Center (Center) is a 34-bed nursing home located in East Providence, Rhode Island. In 2003, Harris Health Center, LLC, the owner, obtained a U.S. Department of Housing and Urban Development (HUD)-insured mortgage of $1.6 million to renovate the nursing home. HUD provided the insurance for this mortgage under a program published in Section 232 of the National Housing Act. This program provides mortgage insurance through HUD-approved lenders to assist in the construction or rehabilitation of nursing homes. Harris Management, Inc., manages the Center for a monthly fee. The same principals own both Harris Health Center, LLC, and Harris Management, Inc.

Harris Health Center, 833 Broadway, East Providence, Rhode Island

Originally built in 1934, this nursing home consisted of a main two-story building with two wings. Using borrowed funds, the owners hired a general contractor to install an elevator, add two patient rooms, add a conference room, replace roofing, and install new flooring. Renovations began March 29, 2003. The renovation plans changed several times, and the Center exceeded its original budget. The Center obtained a revised certificate of occupancy in July 2006.

Our audit objective was to determine whether the Center was operated in accordance with its regulatory agreement. Specifically, we examined whether renovations were completed properly, the Center paid for only necessary project expenses, and the Center properly computed and paid management agent fees.

RESULTS OF AUDIT

Finding 1: Renovations Were Not Completed Properly

Renovations at the Center were not completed properly. We found eight deficiencies in the contractor-completed renovations. These deficiencies were caused by the contractor's poor workmanship and inconsistent supervision. As a result, the Center did not receive the full benefits of its renovations because facility conditions were not always improved. In addition, the owners took beds out of service. The delays in renovations kept these beds out of service for longer than planned, and contributed to operating losses and cash flow shortfalls.

Eight Deficiencies Were Found in Completed Renovations

Our review of the Center's renovations identified eight deficiencies[1] in the completed work:

- A pipe was venting gas into a conference room.
- Water had leaked through the roof into the patient room below.
- The shut-off valve for a boiler was embedded in fire-retardant caulking.
- Flooring tiles were not adhering and separating from the subflooring.
- A wheelchair ramp was splitting and cracking.
- Two patient rooms were not connected to the heating system.
- Three fascia boards that form the molding along the roofline were missing.
- The closet in one of the newly built patient rooms was unfinished.

Pipe from first floor water closet venting sewer gas into a second floor conference room

[1] In appendix C, we exhibit each deficiency of the renovations.

This photograph shows an example of the contractor's poor workmanship (other examples are shown in appendix C). The conference room is part of a new addition built on top of an existing wing. The floor in the photograph above is built on top of the former roof. The pipe leads to a bathroom on the first floor. The architectural drawings did not show this pipe. The contractor installed a new floor and walls around the pipe. We provided our photograph to HUD. HUD telephoned the contractor who vented this pipe through the ceiling, attic, and roof. The work was completed December 13, 2006. We found other deficiencies in the physical condition that were unrelated to the renovations. A management letter will be issued to HUD detailing the deficiencies that need corrective action.

Supervision of Renovations Was Inconsistent

The Center was one of three nursing homes that the owner was simultaneously renovating with the same general contractor. The owner acted as his own management agent for all three properties and as his own project manager for the construction at each project. In addition, the owner took beds out of service to facilitate construction. Due to the delays in renovation, these beds were out of service longer than planned. This decrease in the number of patients and corresponding decrease in revenue contributed to operating losses and cash flow shortfalls. Also, the general contractor changed its supervisors during the construction, and continuity of construction efforts was lost. The loss of continuity was compounded by multiple changes to the plans and changes in the building codes. Due to a February 2003 tragedy in which 100 people died in a nightclub fire, the state of Rhode Island has imposed stricter laws governing fire and building codes. The state implemented these changes while the project was under renovation, which further prolonged the construction to satisfy the new regulations.

HUD regulations allow HUD to determine whether latent defects exist within 12 months of completion of the construction. HUD should follow up on notices of latent defects to decide whether to release, extend, or make a demand on the guaranty.

Conclusion

Center renovations were not completed properly. We found eight deficiencies in the renovations. These conditions were caused by the general contractor's poor workmanship and inconsistent supervision. As a result, the Center did not receive the full benefit of the renovations because facility conditions were not always improved.

Recommendations

We recommend that HUD require the Center owner to

1A Ensure that the seven remaining identified deficiencies are corrected in accordance with the contract.

1B. Within 12 months of completion of the construction, consider pursuing latent defects against the contractor and/or the guarantor for the improperly completed renovations.

Finding 2: The Center Paid $21,729 for Unnecessary and Nonproject Costs

The Center paid $20,975 in unnecessary interest and fees on credit cards and leases. In addition, it paid $754 for non-project-related expenses. The Center operated in a regulated business environment with inherent cash flow challenges. However, it did not fully implement controls to manage its cash flow and use its line of credit, which had lower interest rates than its credit cards. As a result, it had fewer funds available, which contributed to its operating losses and cash flow shortages.

The Center Paid Unnecessary Interest

Between January 1, 2004, and September 30, 2006, the Center had six credit cards. Banks issued two cards, and stores issued the other four. On September 30, 2006, the total balance for these cards was $42,312. Each credit company charged interest at a variable rate of 6.9 to 52.78 percent. Credit companies designed the temporary, lower rates to attract customers. Sometimes the Center paid the credit company late or skipped the payment. Interest rates rose with each late payment and each skipped payment. A summary of credit card interest follows:

Name	Balance on September 30, 2006	Actual interest
Bank card 1	$21,277	$ 12,303
Bank card 2	$ 8,142	$ 4,287
Store card 1	$ 3,788	$ 634
Store card 2	$ 1,432	$ 564
Store card 3	$ 3,666	$ 594
Store card 4	$ 4,007	$1,407
Total	**$42,312**	**$ 19,789**

The Center Had a Line of Credit With Lower Interest Rates

The Center also had a line of credit with lower interest rates. The $40,000 line of credit had a variable interest rate. While the bank initially charged 5.25 percent interest, this rate had risen to 9.25 percent by September 2006. The Center did not use its line of credit to reduce the balances of its higher interest credit cards. If the Center had used its line of credit, it could have avoided $13,074 in interest calculated as follows:

Name	Actual interest	Interest at 9.25%	Projected savings
Bank card 1	$12,303	$4,036	$8,411
Bank card 2	$4,287	$1,589	$2,698
Store card 1	$634	$415	$219
Store card 2	$564	$188	$395
Store card 3	$594	$172	$422
Store card 4	$1,407	$510	$929
Total	**$ 19,789**	**$6,910**	**$ 13,074**

The "projected savings" reflects that the credit companies charged the Center interest on its interest. It also reflects that in some months, the interest rate was below 9.25 percent.

The Center Paid Unnecessary Fees

In addition, the Center did not always pay the minimum amounts on time each month, which also led to late fees. For one credit card, the payments were less than the interest and fees charged. For several months, the outstanding balance for this card rose. Due to the combination of small payments, skipped payments, and interest, the project exceeded its limit for this card, which also led to over limit fees. The Center recorded $4,200 in fees between January 1, 2004, and September 30, 2006.

From April 1, 2004, to September 30, 2006, the project leased furniture for patient use at $1,670 each month. The Center sometimes paid this lease late and skipped some payments. Each time this occurred, the leasing company charged a fee of $231. These fees totaled $3,701 between April 1, 2004, and September 30, 2006. The leasing statement did not list these fees until two months after the fee was incurred.

The regulatory agreement between the Center owner and HUD requires that expenses be necessary to the project's operations. If the Center had used its line of credit, it could have saved on the interest and fees. As a result, we calculated that $13,074 was paid in unnecessary interest and $7,901 in unnecessary fees.

The Center Paid Non-Project Expenses

The Center paid $366 to file the annual limited liability corporation report with the state. These expenses benefited the owner of Harris Health Center, LLC, not the Center. The Center also expended $388 for a monitor for a related nursing home. This expense benefited another of the owner's nursing homes, not the Center. These errors were caused by less than adequate accounting controls.

Conclusion

The Center paid $20,975 in unnecessary interest and fees on credit cards and leases. The Center operated in a regulated business environment with inherent cash flow challenges. However, it did not fully implement controls to manage its cash flow and use its line of credit, which had lower interest rates than its credit cards. In addition, it paid $754 for non-project-related expenses. These errors were caused by less than adequate accounting controls. As a result, the Center had fewer funds available, which contributed to its operating losses and cash flow shortages.

Recommendations

We recommend that HUD require the Center owner to

2A. Reimburse or offset management fees[2] for $20,975 in unnecessary interest.

2B. Reimburse the project $754 for nonproject services and costs.

2C. Implement stronger controls over cash flow and accounting to avoid unnecessary interest, fees, and non-project expenses.

[2] In Finding 3, we note that the project prioritized payments other than the management fees. As a result, the project owed management fees to the owner/management agent.

Finding 3: Management Agent Fees Were Not Properly Calculated

The Center did not correctly calculate the management fees to be paid to its related management agent, Harris Management, Inc. In addition, it paid an employee for services that were to be provided under the management agent's contract. When we informed the Center of this error, it reduced the management agent fees. These errors occurred because the Center's owner misunderstood HUD's regulatory requirements. As a result, management fees were misstated.

Management Agent Fees Were Not Properly Calculated

The management agent fees recorded by the Center were not always calculated in the same way. The fee recorded in the accounting records differed from the fee stated in the contract for the management agent and from the fees stated in management agent certification submitted to HUD. The contract identified a fee of five percent of net patient revenue plus expenses, while the management agent certification identified a fee of five percent of gross patient revenue. However, the amounts expensed in the Center's accounting system did not reflect an expense based on the fees identified in either the certification or the contract. The Center recorded management fees based on estimates provided by the management agent. The different fee calculations for January 2004 to September 2006 were as follows:

Calculation of management fees	Amount
Management certification at 5% of gross patient revenue	$221,182
Management agent contract at 5% of net patient revenue	$12,951
Recorded in accounting system	$98,172

The Regional Business Manager Was Paid Directly by the Center

The contract between the Center and the management agent provided for specific services. The Center's owner, acting as the management agent, and a regional business manager performed these services. In 2006, the owner transferred the regional business manager from the management agent to the Center without adjusting the management agent contract to reflect this change. As a result, the Center temporarily overstated the management fees. In November 2006, based on our audit, the Center reversed $15,905 in management fees[3] for the services it paid directly to the regional business manager.

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[3] The table showing the management fees reflects the reversal of $15,905.

The Owner Misunderstood HUD Regulatory Requirements

A regulatory agreement governs the relationship between the Center's owner and HUD. As a nursing home, the Center was also subject to regulatory requirements established by the Rhode Island Department of Health, the administrator for the federal Medicaid program. These two regulatory environments differed. HUD requires that expenses be reasonable in price and necessary to the operations, while Medicaid defines a per diem reimbursement rate to represent full and total payment for services. The Center's owner did not fully understand how the HUD regulatory requirements differed from the Medicaid requirements. This misunderstanding led the Center to accept estimates for the management fees.

Conclusion

The Center inappropriately recorded estimated management agent fees that were not supported by its contract or certification. The owner also inappropriately transferred an employee from the Center's related management agent to the Center without adjusting the management agent contract. Although there were inconsistencies in calculating and recording the management fees and that employee's salary, the project was not overcharged overall and the Center reversed $15,905 in management fees for the services it had paid directly to the regional business manager.

Recommendations

We recommend that HUD require the Center owner to

3A. Revise the management agent contract to reflect an appropriate method for calculating management fees.

3B. Determine which entity should employ the regional business manager and, if needed, adjust the management agent contract accordingly.

We recommend that HUD

3C. Verify that the Center owners properly accounted for the $15,905 reversal of management fees.

SCOPE AND METHODOLOGY

Our audit primarily covered the period January 1, 2004, to September 30, 2006, and included operational expenditures during this period. We conducted our work from August 2006 to January 2007. We primarily carried out our work at the nursing home and at the HUD Providence, Rhode Island, field office. We focused our review on renovations, management agent fees, credit card expenditures, and leases.

To achieve our objectives, we identified, reviewed, and obtained relevant regulations, handbooks, and agreements pertaining to the development (renovation) of the project and management of the loan, including handbooks and the regulatory agreement between the owner and HUD.

We relied on data from the auditee's computer system. We interviewed staff on how they entered and used data within this system and performed sufficient tests to determine whether the data were reliable. Based on our assessment we determined that the data were sufficiently reliable for our purposes.

In addition, we interviewed the owner, project staff, and HUD staff about the renovation process, management procedures, and expenditures. We reviewed and analyzed construction documents, including the construction binder, the drawings, the contracts, the change orders, and correspondence. We reviewed and analyzed expenditures; including credit card statements, the leasing statement, and invoices.

We selected a nonstatistical sample of 24 credit card charges for detailed review. We selected this sample due to the large number of items in the universe and the fact that risk for each item is not uniform. We only reviewed items that were unusual in nature. Charges may be unusual due to the vendor, the account to which the charge is assigned, or the type of business paid. These 24 items had at a total dollar value of $63,460. The results of our testing apply only to our selection and may not be projected to the universe or population.

We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Policies and procedures that management has implemented to reasonably ensure that the HUD-insured project is administered in accordance with the regulatory agreement.
- Polices and procedures that management has implemented to reasonably ensure that sufficient funds are available to pay project expenses in a timely manner.

We assessed the relevant controls identified above.

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

Significant Weaknesses

Based on our review, we believe the following item is a significant weakness:

- The project did not implement effective controls to manage its cash flow (see finding 2).

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Unreasonable or unnecessary 2/
2A		$20,975
2B	$754	
3C	$15,905	

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 polices or regulations.

2/ Unreasonable/unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, and/or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

HUD - OIG
OFFICE OF AUDIT
BOSTON, MASSACHUSETTS
2006 MAR 14 AM 10: 44
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HARRIS HEALTH CENTER

March 12, 2007

John A. Dvorak
Regional Inspector General for Audit
US Department of Housing and Urban Development
Office of the Inspector General for Audit, Region 1
Thomas P. O'Neill Building. Room 370
Boston Massachusetts, 02222-1039

Dear Mr Dvorak:

Below you will find our response to Draft Report of the audit conducted of Harris Health Center that was discussed at our conference with HUD staff at Harris Health Center on March 5, 2007.

Results of the Audit:

Finding 1: We agree with most parts of finding #1 and will work with the Providence, Rhode Island HUD Office and the contractor to remedy these deficiencies. One of which is already been corrected.

The oversight of the construction was not only the responsibility of the management but also the responsibility of the architect hired by HUD to also oversee the project this would be evidenced by the attendance sheets for the construction meetings.
Beds were taken out of service by necessity to demolish the first floor rear wing. This wing consisted of four two bed units a full bath and two ½ baths. We were promised (verbally) by the project manager that the rooms would be down a maximum of two weeks. The wing remained closed for eight months. When the contractor was at a dead end because of the changes in the fire code I assisted with the local and state Fire Marshals to agree on a plan that allowed maximum safety for our residents, remain within the new code and be most cost effective.

A. We respectfully request that HUD consider the seven deficiencies as latent defects. We will work with HUD to ensure that the remaining seven deficiencies are corrected within the scope of the contract.

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AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	**Auditee Comments**

Finding 2: We agree with the conclusion of Finding #2.

A. We respectfully request that the unnecessary interest and fees of $20,975.00 be allowed to be offset by a portion of the uncollected management fees.

B. Retrieve the computer monitor that is located at Harris Manor and can be used by Harris Health Center thereby reducing the amount necessary to reimburse Harris Health Center. This would eliminate the necessity for repayment of $388.00.

C. Reimburse the Center for the annual LLC Report of $366.00

D. We will implementing stronger controls over cash flows and accounting.

Finding 3: We agree in concept with the findings of #3.

A. We will work with the local HUD office to enact a management contract that reflects an appropriate method for calculating management fees.

B. The regional office manager will remain an employee of the facilities who will equitably split her salary and benefits and adjust the management company accordingly.

C. We will provide documentation to the local HUD office that the $15,905.00 was reversed from the management fees.

Sincerely,

Charles L. Harris, member

Charles L. Harris, Member
Harris Health Center, LLC

CC: Joe Crisafulli

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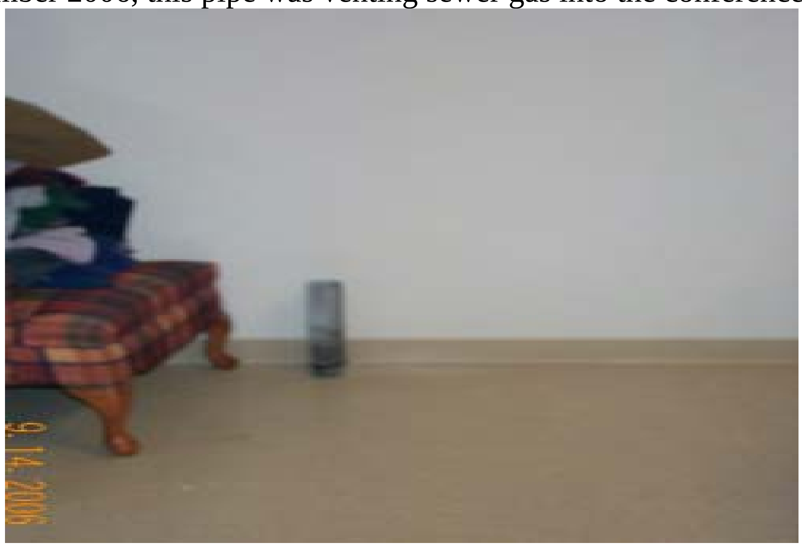
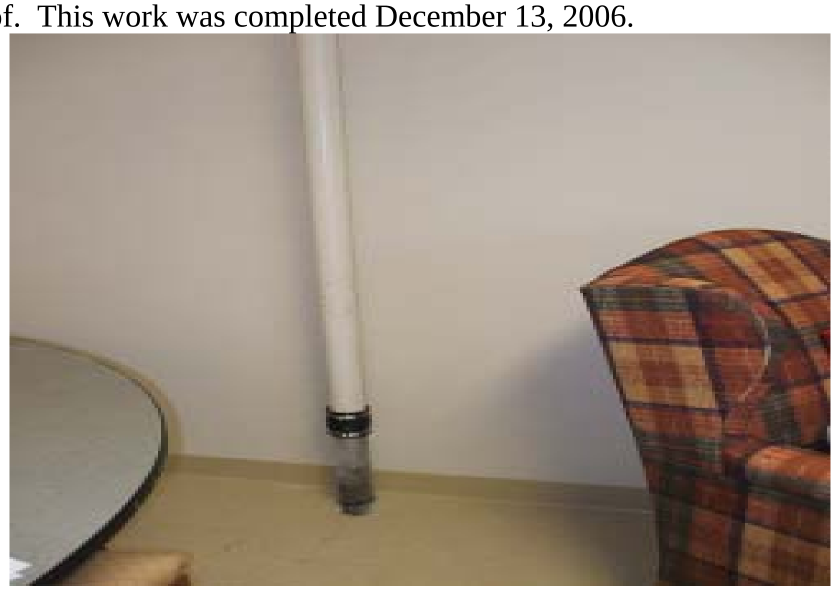
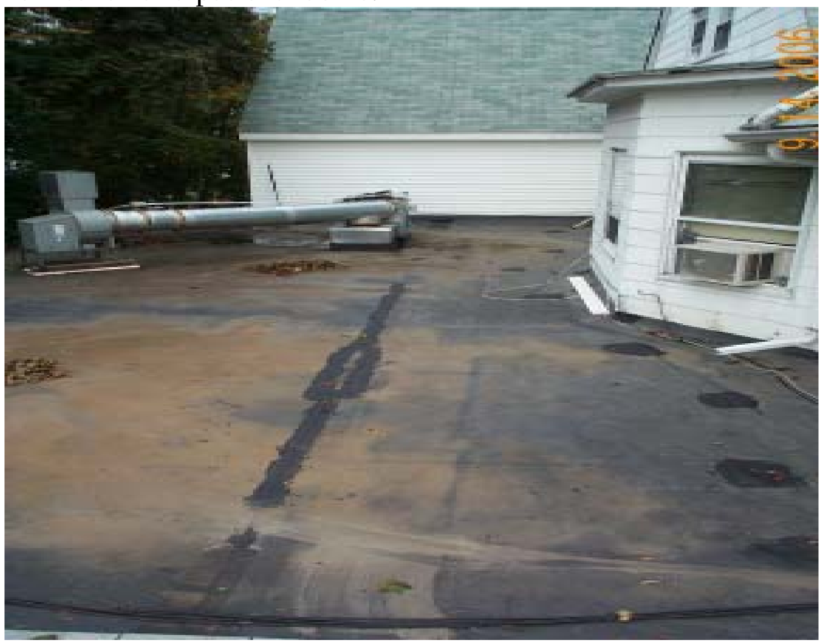
Appendix C

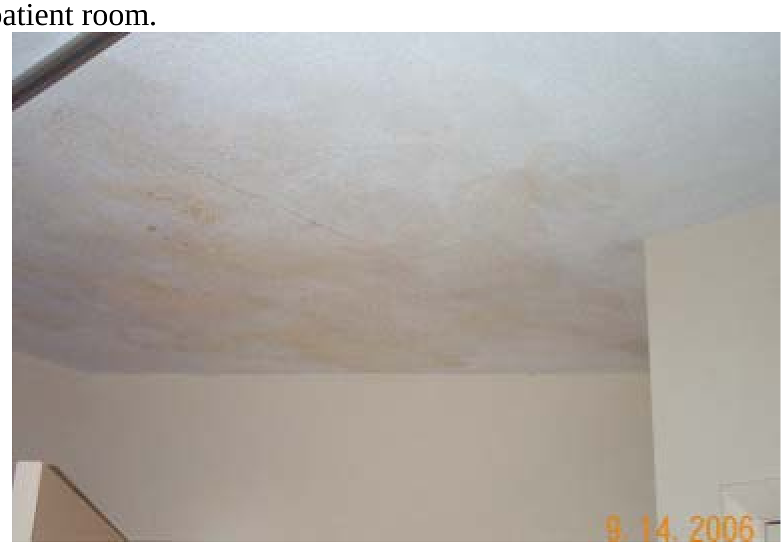
SCHEDULE OF RENOVATION DEFICIENCIES

Element	*Photograph and Description*
(continued from page 6) **A pipe was venting gas into a conference room.**	In September 2006, this pipe was venting sewer gas into the conference room.  HUD telephoned the contractor who vented this pipe through the ceiling, attic, and roof. This work was completed December 13, 2006. 

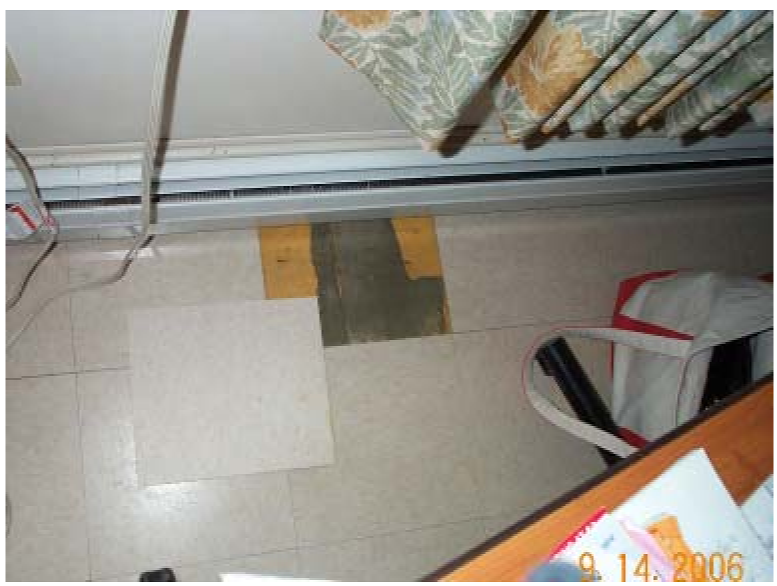
<table>
<tr><th>Element</th><th>Photograph and Description</th></tr>
<tr><td>Water leaked through roof into the patient room below.</td><td>
The contractor installed a membrane roof over the back wing. This wing houses the kitchen and patient rooms.

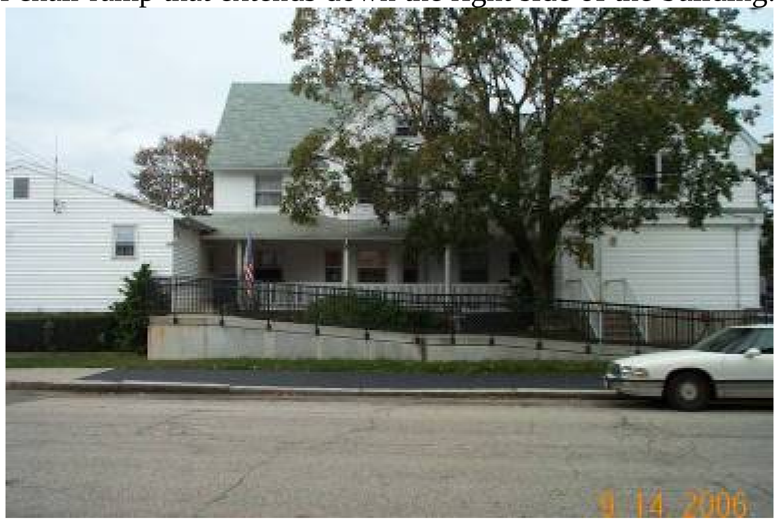
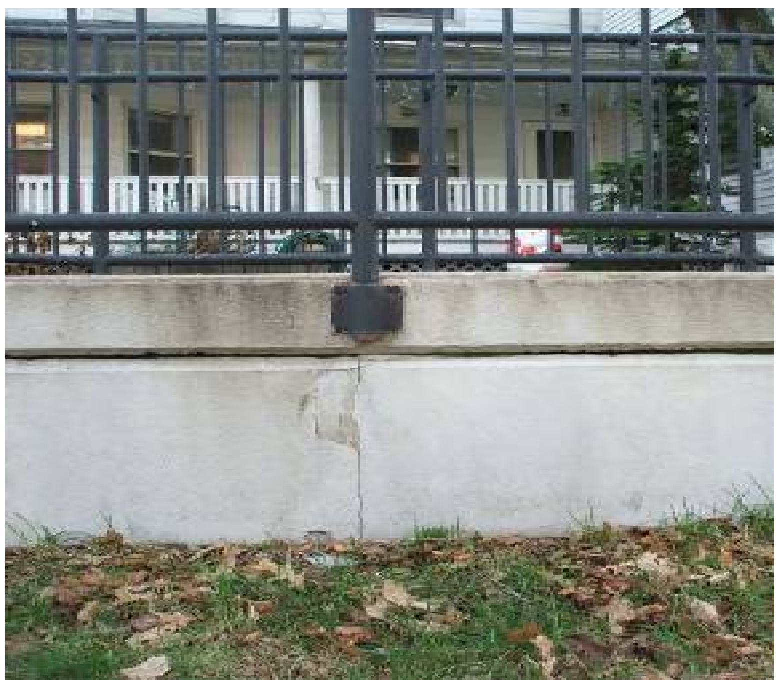


Water leaked through the roof into the patient room underneath. The photograph below shows the ceiling of that patient room. After the leak was discovered, the project added the black caulking to the roof to stop the leaking into the patient room.



</td></tr>
</table>

Element	*Photograph and Description*
The shut-off valve for a boiler was embedded in fire retardant caulking.	This shut off valve was in the boiler room next to the elevator. It was embedded in red fire-retardant caulking 
Flooring tiles were not adhering and were separating from the sub flooring.	The flooring tiles in the patient rooms and water closets on the first floor were separating from the subflooring. The underside of the tile is visible. There was very little glue on either the subflooring or the tile. The hallway in the second floor addition also experienced this issue 

Element	*Photograph and Description*
A wheelchair ramp was splitting and cracking.	The wheel chair ramp that extends down the right side of the building.  The photograph below is a closer view of the ramp, which is splitting and cracking.  *(continued next page)*

Element	*Photograph and Description*
(continued from previous page) **A wheelchair ramp was splitting and cracking.**	The decay was more evident at the corner of the ramp where the cement was cracking to expose the interior fill.