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AUDIT REPORT

MARION SCOTT REAL ESTATE, INC.
MANAGEMENT AGENT
NEW YORK, NEW YORK

2003-NY-1001

February 12, 2003

OFFICE OF AUDIT
NEW YORK/NEW JERSEY

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audit report

Issue Date
February 12, 2003
Audit Case Number
2003-NY-1001

TO: Deborah VanAmerongen, Director, New York Multifamily HUB, 2AHM

Alexander C. Malloy

FROM: Alexander C. Malloy, Regional Inspector General for Audit, 2AGA

SUBJECT: Marion Scott Real Estate, Inc.
Management Agent
New York, New York

We completed an audit of the books and records of Marion Scott Real Estate, Inc., (hereafter referred to as the Agent). The objective of the audit was to determine whether the Agent complied with (1) U.S. Department of Housing and Urban Development (HUD) regulations and requirements pertaining to the use of projects funds, which can only be used to pay necessary and reasonable operating expenses and repairs; and (2) its Management Certifications when purchasing from or contracting for goods and services with its IOI Companies. This audit report contains six findings and recommendations for corrective action.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please give us, for each recommendation without management decisions, 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 you staff have any questions, please contact Edgar Moore, Assistant Regional Inspector General for Audit, or me at (212) 264-8000, extension 3976.

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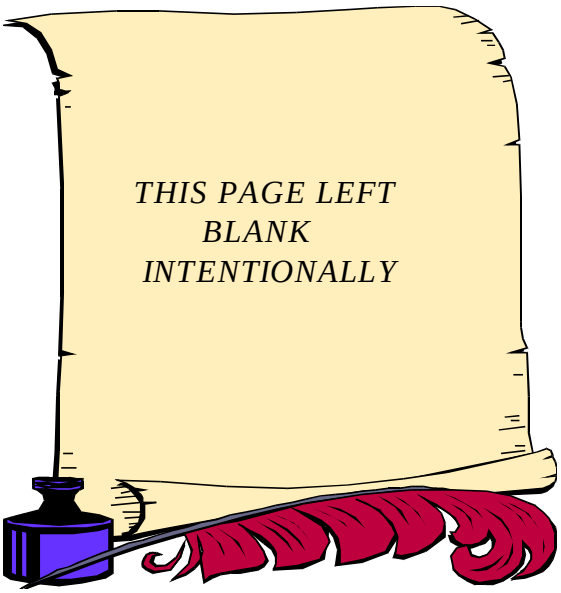
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Executive Summary

We conducted an audit of the books and records of Marion Scott Real Estate, Inc. (the Agent). The objective of the audit was to determine whether the Agent complied with: (1) HUD regulations and requirements pertaining to the use of project funds, which can only be used for necessary and reasonable operating expenses and repairs, and (2) its Management Certifications when purchasing from or contracting for goods and services with its IOI Companies.

Results

We concluded that the Agent did not always comply with HUD regulations and requirements pertaining to the use of project funds nor did it always comply with its management certification when purchasing from or contracting with its IOI Companies. Specifically, we found that the Agent: (1) used project funds to pay for ineligible, unsupported, and unnecessary/unreasonable expenses, (2) collected unauthorized and excessive management fees and improperly charged front-line expenses to projects, (3) allowed its IOI Company employees to occupy rent free apartment units in the projects, (4) allowed its IOI Company to mark-up subcontractor's invoices prior to billing the projects, (5) entered into a questionable arrangement for legal services to the HUD projects, and (6) did not comply with the terms of the Drug Elimination Grant Agreement. Details pertaining to these items are provided in the findings, and are summarized below:

The Agent used projects funds to pay for ineligible, unsupported, and unnecessary/unreasonable expenses.

Contrary to HUD regulations, the Agent used project funds to pay various expenditures that are either ineligible, unsupported, or unnecessary/unreasonable. These expenditures were associated with: (a) the preparation, filing and payment of general partners' corporate tax returns and tax liabilities; (b) acquisition and mortgage loan restructuring; (c) payments of fines, penalties, and interest; (d) personal vehicle expenses; (e) general consulting services; and (f) various other ineligible, unreasonable, and unsupported expenses. Consequently, the projects may have been deprived of $185,967 in funds that could have been used for reasonable and necessary operating expenses and repairs. This occurred because officials of the Agent believed that all expenses were project related and chargeable to projects.

The Agent collected unauthorized and excessive management fees and improperly charged front-line expenses

During the period between January 1, 1999 and December 31, 2001, the Agent collected unauthorized and excessive management fees from some projects and improperly charged front line expenses to other projects. As such, the projects were deprived of $76,802 that could have been used for reasonable and necessary operating expenses. This occurred because the Agent did not follow HUD requirements that limit the amount of management fees that can be earned; and because the Agent failed to comply with its Management Certifications that delineate the fees it is entitled to collect from the projects.

Agent allowed IOI employees to occupy rent-free units

Our review disclosed that during the period between January 1, 1999 and March 31, 2000, the Management Agent allowed employees of an Identity-of-Interest (IOI) Company to occupy rent-free apartment units in three of the HUD-subsidized projects. As such, the projects were deprived of $55,050 in rental revenue, which could have been used for reasonable and necessary operating expenses. This occurred because the representatives of the Agent believe that since HUD approved a rent-free apartment unit for the superintendent at each of the projects, it did not matter that the superintendents were employees of the IOI Company. However, we believe that HUD's intent is to provide rent-free apartment units only to employees of the projects.

Agent allowed its IOI Company to mark-up amounts on a subcontractor's invoices prior to billing the projects

Our review disclosed that between September 1997 and September 1999, the Agent made payments to an IOI Company that included questionable mark-ups of amounts on invoices from a third party subcontractor. Specifically, we determined that the IOI Company marked-up the amounts on at least 87 invoices, totaling $92,970, from a third party subcontractor by 57 percent or $52,857, and billed the projects a total of $145,827. Also, we noted an additional 130 invoices, totaling $142,228, for which we were unable to determine the percentage or amount of mark-up by the IOI Company. Nonetheless, we question the need for an IOI Company to serve as merely an intermediary company between the Agent and a subcontractor. Accordingly, we question the eligibility of costs charged to projects that represent the IOI mark-up of amounts on the subcontractor's bills. In this regard, we consider the cost of $193,210 as unreasonable/ unsupported, which represent $50,982 ($52,857 less $1,875 refunded) of identified mark-up cost, which we believe is

unreasonable, and $142,228 of unsupported costs that we believe contains an undetermined percentage of marked-up costs. This occurred because of the Agent's contention that since the IOI Company provided supervisory and quality control services over the work performed by the third party subcontractor, it was therefore entitled to mark-up the invoices. However, we question the need for such services since it is the Agent's responsibility to ensure that contractors adequately perform the work outlined in their contracts.

The Agent entered into a questionable arrangement for legal services to the projects

Contrary to HUD regulations, the Agent did not solicit written cost estimates or obtain competitive bids prior to obtaining legal services. Instead, the Agent entered into a questionable arrangement with an IOI attorney for legal services to the projects. As a result, the Agent cannot assure HUD that it obtained legal services at the most reasonable and economical price. This occurred because the Agent failed to follow HUD regulations when arranging for legal services for the HUD subsidized projects. Accordingly, we questioned cost of $257,223, which represents payments to the IOI attorney during the period January 1, 1999 through December 31, 2000.

The Agent did not comply with the terms of the Drug Elimination Grant Agreement

Contrary to HUD regulations, the Agent did not comply with the terms of the Drug Elimination Grant Agreement. During the period between May 5, 2000 and September 30, 2001, the Agent expended a project's funds for expenses related to the Drug Elimination Grant (DEG) and did not submit timely requests for draw-downs to reimburse the project's operating account. Also, we noted that the Agent may not have expended grant funds in accordance with the line items in the program's approved budget. Because of the Agent's failure to comply with the terms of the grant agreement and failure to draw down grant funds on a monthly or quarterly basis, the project was deprived of $134,177 that could have been used for reasonable and necessary operating expenses.

Management Controls

Our review also disclosed weaknesses in the Agent's management controls that relates to the above findings (see the "Management Controls" section of this report).

Issues needing further study and consideration

In addition, our review disclosed that there are certain practices and conditions that need further review by HUD management to bring the Agent closer to full compliance

with HUD regulations and requirements. These areas are discussed in the "Issues Needing Further Study and Consideration" section of this report and involve: (1) leasing of commercial space at the projects to affiliates at less than fair market rent; (2) employees of IOI Companies residing in apartment units, but their incomes are not reported on the Section 8 re-certification forms, and (3) the administration of a Network Learning Center.

Recommendations

We recommend that HUD, the Director, New York Multifamily HUB, require the Agent/owners to reimburse the projects for all amounts considered to be ineligible, and submit supporting documentation for those disbursements considered to be questionable and/or unsupported, so that HUD can determine the eligibility of these questioned/unsupported costs. In addition, we made recommendations that will improve the Agents internal controls and encourage compliance with HUD regulations.

Exit conference

On December 13**,** 2002, we held an exit conference with officials of the Agent to discuss the results of our draft audit findings and recommendations. Based on the results of the discussion we removed one finding from our draft report since it pertained to an issue that relates to the Mortgagor entity and not the Agent. The issue pertains to the fact that the Mortgagor entity neither obtained cost estimates nor solicited bids under the Mark-to-Market Program prior to selecting their IOI Company to be the General Contractor. Nevertheless, this issue was addressed in a separate memorandum to the New York State Office (NYSO). On December 20, 2002, Agent officials provided us with their final written response to the findings, which we included in its entirety as Appendix D of this report. We also provided a summary and an evaluation of their responses at the end of each finding.

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Appendices

Abbreviations:

DEG	Drug Elimination Grant
HUD	U.S. Department of Housing and Urban Development
IOI	Identity-of-Interest
NJSO	New Jersey State Office
NOFA	Notice of Funding Availability
NYSO	New York State Office
OIG	Office of Inspector General
PUPM	Per Unit Per Month
REAC	Real Estate Assessment Center

Introduction

Marion Scott Real Estate, Inc. (Agent) managed ten HUD-insured and subsidized projects in New York City in 1999 and 2000. In the year 2000, it added two HUD-insured and subsidized projects located in Newark, New Jersey to its inventory of properties.

Mr. Marion Scott is the President of Marion Scott Real Estate, Inc. and the books and records of the company are maintained in its offices at 107-129 East 126th Street, New York, New York.

The Agent has identity-of-interest relationships with the following companies or individuals that provided services to the projects during the audit period:

Name of Company	Service Provided
• Aargo Services Inc.:	Security services.
• Servotech Two, Inc.:	Plumbing, heating, HVAC and repairs.
• Eastside Plumbing Specialties, LLC:	Plumbing supplies.
• Planned Building Services, Inc.:	Janitorial and maintenance.
• Aargo Support Organization, Inc.:	Credit checks and support.
• Herbert Freedman, Esq.:	Legal services and collections.
• GAP Restoration & Maintenance Inc:	Repairs, maintenance, painting, decoration and rehabilitation.

The principals of Marion Scott Real Estate, Inc., have ownership interests in the HUD insured and subsidized projects managed by the Agent. These individuals are also the principals of the corporations that are the general partners of the HUD-subsidized projects.

In March 2000, HUD awarded a Multifamily Housing Drug Elimination Grant (DEG) in the amount of $200,000 to three projects managed by the Agent (1775 Houses, MS Houses, and AK Houses). The purpose of the Drug Elimination Program is to assist property owners to reduce or eliminate drug-related criminal activity in and around their developments and to provide programs to prevent or eliminate drug use and abuse among their residents. The Agent used an organization called Centering Associates, to administer the DEG for these projects and elected to pay all the expenses related to the DEG from the operating account of the 1775 Houses project, prior to requesting reimbursement from HUD.

Audit Objectives

The objective of the audit was to determine whether the Agent complied with: (1) HUD regulations and requirements pertaining to the use of projects funds, which can only be used for necessary and reasonable operating expenses and repairs, and (2) its Management Certifications when purchasing from or contracting for goods and services with its IOI Companies.

Audit Scope and Methodology

To accomplish our objectives, we interviewed HUD NYSO officials as well as officials and staff members of the Agent. We obtained an understanding of the Agent's internal control system, and reviewed and verified cash receipt and cash disbursement transactions for the period between January 1999 and December 2000, related to three of the projects managed by the Agent. The mortgages for three test projects, 1775 Houses, MS Houses, and AK Houses, were all current during the period we reviewed. In certain instances we expanded the scope to include other periods and projects.

In addition, we examined the financial statements of all the projects, and examined the reports submitted to HUD for the three test projects. We also reviewed the records of two of the Agent's IOI Companies relative to billings for work performed at the projects. We conducted inspections at the three test projects to determine their physical condition, and to examine the repair work performed at the projects by the IOI Companies and other vendors. This was done to ensure that the repair work billed by the IOI Companies and other vendors was actually performed. The projects that we inspected were in good physical condition and the repairs that we inspected were performed.

Audit Period

The audit generally covered the period between January 1, 1999 and December 31, 2000, and where appropriate was extended to cover other periods. We performed our audit fieldwork between July 2001 and June 2002.

The audit was conducted in accordance with Generally Accepted Government Auditing Standards.

We provided a copy of this report to the Auditee.

Ineligible, Unsupported, And Unnecessary/Unreasonable Costs Were Charged To The Projects

Contrary to HUD regulations, the Agent used project funds to pay various expenditures that are either ineligible, unsupported, or unnecessary/unreasonable. These expenditures were associated with: (a) the preparation, filing and payment of general partners' corporate tax returns and tax liabilities; (b) acquisition and mortgage loan restructuring; (c) payments of fines, penalties, and interest; (d) personal vehicle expenses; (e) general consulting services; and (f) various other ineligible, unreasonable, and unsupported expenses. Consequently, the projects may have been deprived of $185,967 in funds that could have been used for reasonable and necessary operating expenses and repairs. This occurred because officials of the Agent believed that all expenses were project related and thus not the responsibility of the Owner/Agent. However, since we believe some of the expenses are ineligible, we recommend that the Agent/owners be instructed to reimburse the projects the amount of those expenses, which totaled $103,625 from non-project funds. In addition, we recommend that the Agent submit to HUD, supporting documentation for $82,342 in expenses that we considered either unsupported or unreasonable, and that HUD, the Director, New York Multifamily HUB make an eligibility determination of those expenses.

Criteria

The Regulatory Agreement provides that the: "Owners shall not without the prior written approval of the Secretary: (b) 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."

Paragraph 2-6(e) of HUD Handbook 4370.2 REV-1, Financial Operations and Accounting Procedures for Insured Projects, provides that "all disbursements from the regular operating account (including checks, wire transfers and computer generated documents) must be supported by approved invoices/bills or other supporting documentation…"

Chapter 6, paragraph 6.41(c) of the Management Agent Handbook No. 4381.5 REV-2, provides that "Reasonable expenses for preparing the ownership entity's tax return, and Schedule K-1, if the entity is a partnership, may be charged to a project's operating account."

Project funds used to pay for questionable services and items

Our audit disclosed that during the period between January 1, 1999 and December 31, 2001, the Agent disbursed funds totaling $ 185,967, from various projects' operating accounts to pay for questionable services and items. The details are as follows:

(a) Payment for the preparation of corporate tax returns

CPA firm prepared corporate tax returns for the General Partners

Our audit disclosed that during the period reviewed, the Agent engaged the services of a Certified Public Accounting (CPA) firm to prepare audited financial statements for all HUD-subsidized projects managed by the Agent. In the engagement letters with the projects, the CPA firm stated that as a part of the engagement, it would also prepare the projects' Federal and State tax returns. We noted that the CPA firm addressed all of its invoices to the owners of the projects (the partnerships) for work related to the audits of the financial statements. We also noted that in addition to conducting the audits of the financial statements of the projects, the CPA firm prepared the corporate tax returns for the General Partners of nine of the projects (1775 Houses, MS Houses, AK Houses, Harlem Gateway, Lexington Gardens, Los Tres Unidos, Dunwell Plaza, Mother Zion, and Washington Heights Site A).

Our review disclosed that for the nine projects listed above, the CPA firm addressed its invoices for the corporate tax returns to the General Partners of the projects at the Agent's mailing address. The invoices provide that the billings are for professional services rendered in the preparation of Federal, New York State, and New York City Corporation income tax returns, as well as for computer processing and out-of-pocket expenses. We found that although the General Partners are different entities than the Partnership entities that own the projects, the Agent recorded these billings in the general ledgers of the respective projects as "Audit Expense", and used funds from the projects' operating accounts to pay the invoices.

It should be noted that Chapter 6, paragraph 6.41 (c), of Handbook 4381.5, REV-2, provides that reasonable expenses for preparing the ownership entity's tax return, and Schedule K-1, if the entity is a partnership, may be charged to a project's operating account. It should be further noted that the ownership entity for each of the nine

projects previously listed is a Limited Partnership and the preparation of the partnerships' tax returns were already included in the regular auditing fees. Thus, we believe that the expenses associated with the preparation of the General Partners' corporate tax returns are not eligible project expenses; rather they are expenses of the General Partners. As such, we believe that costs, which totaled $22,918, charged to the projects for the preparation of the General Partners corporate tax returns are ineligible, and that the amount of the ineligible costs should be reimbursed to the projects by the General Partners with non-project funds. (See Appendix B for the details of the payments by project).

The General Partners' corporate tax return preparation fees totaling $22,918 are considered ineligible

In addition to the above, the Agent used $11,042 of project(s) funds to pay the General Partners' corporate tax liabilities due to New York State and the City of New York. We believe that these payments represent an ineligible use of project funds because the General Partners' corporate taxes are the responsibility of the General Partners, and thus are not eligible project expenses. Therefore, the General Partners should reimburse the amounts of the ineligible expenses, which totaled $11,042, to the respective projects with non-project funds. (See Appendix B for the details of the payments by project).

General Partners' corporate tax payments of $11,042 are considered ineligible

(b) <u>Acquisition and Mortgage Loan Restructuring</u>

Our review disclosed that the Agent disbursed $25,000 of project(s) funds to a CPA firm for services related to the acquisition of two projects in New Jersey, and for mortgage loan restructuring. Our determination was based on an invoice dated November 30, 1999, from the CPA firm, which was addressed to an ownership acquisition entity in care of the Agent. The invoice was written as follows:

> " Billing on account of services rendered in connection with proposal acquisition of Lock Street and Fairview Apartments, including preparation of financial projections; meetings, and discussions with attorneys and principals.
>
> Mortgage loan restructuring and acquisitions of Limited Partnership interests in 1775 Houses, MS Houses Associates, and AK Triangle Housing Associates."

We noted that a group, which included the principals of the Agent, acquired the ownership interests in the two projects,

Lock Street Apartments and Fairview Apartments on January 28, 2000. As such, the Agent took $25,000 from five projects, AK Houses, MS Houses, 1775 Houses, Lock Street Apartments and Fairview Apartments, based on the number of units in each project; and in May 2000, issued checks from the operating accounts of those projects to pay the invoice from the CPA firm.

We believe that the expenses for the property acquisition, mortgage loan restructuring, and acquisition of Limited Partnership interests in the projects were the obligation of the owners and not a necessary and reasonable expense of these projects. Accordingly, we consider the payment of the owners' expenses an ineligible use of the project's funds. Therefore, we believe that the $25,000 should be reimbursed to the projects by the ownership entities of the various projects with non-project funds. (See Appendix B for the details of the payments by project).

$25,000 in property acquisition and mortgage loan restructuring costs are considered ineligible

(c) Payments for Fines and Penalties

Our audit disclosed that during the period reviewed the Agent disbursed project(s) funds totaling $15,201 to pay fines, penalties and interest, which are ineligible project expenses. A review of the supporting documentation disclosed that the fines were levied by government agencies for various violations; and the penalties and interest were for late payment of taxes. We believe that had the Agent complied with applicable laws and regulations these costs would have been avoided. Consequently, the projects were deprived of $15,201 that could have been used for necessary and reasonable operating expenses. As a result, we take exception to the total amount, and believe that the Agent should reimburse the amount to the respective projects with non-project funds. (See Appendix B for the details of the payments by project).

$15,201 in payments for fines and penalties are considered ineligible

(d) Vehicle Expense

Our audit disclosed that the Agent disbursed checks totaling $4,000, from the operating account of 1775 Houses project, to its superintendent for automobile payments that we believe are ineligible expenses. Based on our examination of the project's disbursement reports, we noted that during the period between May 2000, and December 2000, the Agent

$4,000 in reimbursements to superintendent for vehicle expenses is considered ineligible

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issued 10 checks in the amount of $400 each to the superintendent of the 1775 Houses project with the notation "vehicle expense" or "vehicle reimbursement." The Agent charged the disbursements to the project's general ledger account number 659000, entitled "Miscellaneous Maintenance and Operating Expense".

Our examination of the supporting documentation for the payment(s) disclosed that they were monthly billings in the amount of $353, from a financial institution, to the superintendent for automobile payments. The Agent's representative informed us that prior to April 2000, the superintendent was an employee of the IOI Company that provided the janitorial services to the project, and that the IOI Company paid the superintendent $400 per month for these charges ($353 was for the automobile payments and $47 was for incidental expenses such as gasoline). The representative also stated that in April 2000, when the Agent stopped using the IOI Company for janitorial services and made the individual an employee of the project, the Agent continued making the monthly $400 payments to the superintendent. Initially, the Agent's representative informed us that the monthly $400 payment was included in the superintendent's compensation, but later the statement was retracted.

In our opinion, these payments do not have a proper relationship to the operations of the project. Accordingly, we consider the amount of $4,000 as ineligible project cost, and we recommend that the Agent be instructed to reimburse the amount to the 1775 Houses project with non-project funds.

(e) Consultant Services

$20,685 in unnecessary consultant's costs are considered ineligible

Our audit also disclosed that the Agent disbursed project(s) funds totaling $20,685 to a consulting company for services that related to the Agent's responsibilities. The consulting firm performed services such as developing a proposal for a Drug Elimination Grant from HUD, and preparing a response to a REAC Inspection. We believe that these services relate to the normal responsibilities of the Agent, therefore, they should not have been charged to the projects. In this regard, the Agent should have paid for these expenses from its management fees. Therefore, we consider the associated cost as ineligible, and recommend that the Agent be instructed to reimburse the amount of

$20,685, to the respective projects from non-project funds. (See Appendix B for the details of the payments by project).

(f) Other Ineligible, Unreasonable and Unsupported Expenses

(1) Other Ineligible Costs

$3,545 in charges for parties, a scholarship and bank charges are considered ineligible

During the period reviewed we noted various other expenses totaling $4,779 that we consider ineligible. In this regard, we found that the Agent disbursed project funds totaling $3,545 to pay for: holiday and block parties ($2,535); a scholarship grant to a resident of one of the projects ($1,000); and a reimbursement to a superintendent for a bank charge related to a check issued on a closed account ($10). We believe that these expenses were not necessary and reasonable to the operation of the projects, and that the Agent should have been responsible for them. Therefore, we recommend that the Agent be instructed to reimburse the amount of $3,545 to the projects for these expenses from non-project funds. (See Appendix B for the details of the payments by project).

Payment of $1,234 to an IOI for a replacement worker is considered ineligible

In addition, the Agent disbursed $1,234 from the operating account of the MS Houses project to an IOI Company for a replacement worker. The payments were made because one of the regular maintenance workers assigned to the project did not show up for work. We noted that although the IOI Company was under contract to provide janitorial services at the project at a stated monthly fee; the IOI Company did not reduce its monthly fee to the project for the employee who did not come to work. Instead, the IOI Company billed the project for the additional replacement worker. We believe that based on the terms of the contract, the IOI Company had a fiduciary responsibility to provide the staff to perform the work at the project; therefore, no additional charges should have been made. As a result, we believe that since the IOI Company was under contract to perform these services, the charges for the additional replacement worker are ineligible. Accordingly, we recommend that the amount of $1,234 be reimbursed to the MS Houses project from non-project funds.

(2) Other Unreasonable/ Unsupported Expenses

We noted that various other expenses, totaling $70,323 were charged to the projects that appear to be unreasonable/unsupported. These expenses consisted of payments to IOI Companies to prepare the projects for inspections; a payment to a Public Adjuster for a fire insurance loss; using one project's funds to pay the expenses of another project, as well as, expenses for unknown services which, we consider unsupported. Details pertaining to these expenses are as follows:

Costs to Prepare for Inspections

The Agent disbursed $62,354 from the operating funds of the projects, 1775 Houses, AK Houses and MS Houses, to three IOI Companies. The payments were made to the companies to prepare the projects for REAC Inspections. The Agent's representative contends that "REAC Inspections are very intense, the inspector will look at everything, and will take issue for every little thing that is found wrong. Since the results of these inspections are very important to the Management Agent, extra efforts are taken to prepare the projects for them."

$62,354 in costs to prepare the projects for inspections is considered unreasonable

However, we noted that at the time these expenses were incurred, the Agent had contracts with one of its IOI Companies to provide janitorial services to the three projects. Repairs are normally a reasonable cost; however, in our opinion, the cost of numerous last minute repairs to prepare for a HUD inspection are not reasonable. We believe that had the Agent and the IOI Company properly maintained the projects, there would not have been a need for additional/extra effort to prepare the projects for the REAC inspections. It is our opinion that the funds should have been used to pay reasonable and necessary operating costs. Accordingly, we are questioning the $62,354 paid to the three IOI Companies pending a determination of the eligibility of these expenses by HUD, the Director, New York Multifamily HUB. (See Appendix B for the details of the payments by project).

Public Adjuster

The Agent used project funds, totaling $7,030, to pay a Public Adjuster to prepare a claim for a fire insurance loss. The payment was made with funds from the operating account of the 1775 Houses project, in connection with a claim for losses sustained from a fire at the project on July 21, 2000. According to a representative of the Agent, the Agent engaged the services of the Public Adjuster to estimate the fire loss damage and submit an insurance claim to the Insurance Company. The representative also stated that this is a standard industry practice; and it is preferable to have the Public Adjuster on-site when the Insurance Company sends its representative to perform its estimation/investigation of the fire loss. The representative added that having a Public Adjuster present when the Insurance Company's representative performs the estimate usually results in a higher insurance loss paid out to the claimant. However, we believe that the preparation of an insurance claim is a normal responsibility of the Agent and that the fee paid to the Public Adjuster may be an unreasonable/unnecessary project expense. Accordingly, we are questioning the $7,030 paid to the Public Adjuster pending a determination of the eligibility of the costs by HUD, the Director, New York Multifamily HUB.

The $7,030 payment to the Public Adjuster is considered unreasonable

Use of One Project's Funds To Pay Expenses of Another Project

The Agent made payments totaling $939 from the account of the 1775 Houses project to pay expenses of other projects. Specifically, $293 represented legal fees related to the AK Houses project and $646 represented clean-up costs related to the Mother Zion project. HUD regulations prohibit the use of one project's funds to pay expenses of another project. Accordingly, the Agent should reimburse $939 to the 1775 Houses project from the operating accounts of the AK Houses projects and the Mother Zion project for these expenses.

$939 due to 1775 Houses project from the AK Houses and Mother Zion projects

Unsupported Expenses

Our audit also disclosed that the Agent was unable to provide adequate documentation to support disbursements totaling $12,019 from projects' operating accounts. The

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unsupported disbursements consisted of $11,549 to an outside vendor to pay invoices with the inscription: "Pursuant to the terms of the Partnership Administrative Services Agreement with Omni Partnership Services Inc.; enclosed please find quarterly invoices for the following limited partnerships". The Agent's representative was not able to provide us with the Services Agreement nor advise us as to what services were performed for the projects. We were advised that these agreements existed prior to the Agent assuming management of the projects. Accordingly, we consider the $11,549 in costs to be unsupported, and recommend that HUD, the Director, New York Multifamily HUB make a determination of the eligibility of these charges.

Charges, totaling $11,549 for unknown services are considered unsupported

We also noted a payment of $470 to the New York City (NYC) Department of Finance that was not supported by the Agent. Accordingly, since the Agent did not furnish adequate documentation to demonstrate that the expenditure was a reasonable and/or necessary operating expense, we classified the amount as being unsupported, pending a HUD NYSO eligibility determination of the costs (See Appendix B for the details of the other ineligible, unreasonable and unsupported expenses by project).

$470 paid to the NYC Department of Finance is considered unsupported

Auditee comments

Agent officials (a) contend that the general partners are single purpose entities, established and operated for the sole purpose of directing the actions of the limited partnership owners. Accordingly, they believe that the payments for the preparation of the general partners' corporate tax returns and tax liabilities are reasonable and necessary project operating costs; (b) contend that the invoice that supports the payments for acquisition and mortgage loan restructuring expenses reviewed by the auditors was poorly worded and does not reflect the services provided, as such they believe that these payments related primarily to costs associated with the Mark-to-Market Program and are proper project expenses; (c) concur that it was inappropriate for the projects to pay fines and penalties that could have been avoided by management and will reimburse the properties accordingly. However, they do not agree with $310 of the $12,501 that we classified as ineligible expenses; (d) consider the payments for vehicle expenses to the superintendent of the 1775 Houses project, as

a part of his employment arrangements. In this regard, the Agent is reviewing our position on this issue with its tax advisors; (e) consider the payments for consultant services for the preparation of the Drug Elimination Grant proposal, to be reasonable and appropriate expenses of the projects. Agent officials believe that the preparation of these types of applications is not an obligation of the management company; (f) agree with the items deemed ineligible: holiday and block parties, as well as the scholarship grant, bank charge for bad check and payments for replacement workers. The Agent will ensure that the appropriate owners reimburse the respective projects.

In addition, Agent officials contend that the amount of project funds of 1775 Houses project that was used to pay the expenses of another project has been reimbursed to the 1775 Houses project's operating account. The Agent will provide the appropriate documentation to the field office. Agent officials also consider the costs to prepare the projects for REAC inspections and the payment to the public adjuster, as reasonable and necessary operating expenses of the projects. Furthermore, the Agent will provide the field office with the documentation for the $12,019 in unsupported costs.

OIG evaluation of auditee comments

Our evaluation of the auditee's comments are as follows: (a) as mentioned in the Agent's response, the HUD Handbook provides that the preparation of the ownership entity's tax return may be charged to the project's operating account. However, the payments in question represent costs associated with the general partners who are separate non-ownership entities, therefore, these costs are ineligible; (b) OIG's position is based on the invoice from the CPA firm that states that the billing is for services rendered in connection with proposal acquisition of two properties and mortgage loan restructuring, which are owner expenses; (c) we consider all payments for fines and penalties to be ineligible use of project funds, therefore, all payments for fines and penalties should be reimbursed with non-project funds; (d) the payments to the superintendent of the 1775 Houses project, which are classified as vehicle expenses, are ineligible because they do not have any relation to the operations of the project. In addition, these expenses are not a part of the superintendent's compensation because they were not included on the employee's IRS Form W-2,

nor on a Form 1099 issued to the employee by the Agent; (e) we believe that the preparation of grant proposals is a normal responsibility of the Agent and the payments to the consultant should be reimbursed to the projects with non-project funds; (f) the field office should obtain documentation from the Agent to ensure that the reimbursements of other ineligible costs were made to the projects with non-project funds. In addition, the field office needs to determine the reasonableness and eligibility of the costs associated with obtaining the public adjuster, as well as the costs incurred to prepare the projects for REAC inspections. Also, the field office should obtain documentation from the Agent for the items deemed as unsupported and make a determination as to the reasonableness of those costs.

Recommendations: We recommend that HUD, the Director, New York Multifamily HUB:

1A. Instruct the Agent to develop procedures to ensure compliance with all terms and conditions of the Regulatory Agreement and HUD rules and regulations that require project funds to be expended only for reasonable and necessary expenses. The procedures should also ensure that adequate supporting documentation for expenses are obtained and maintained.

1B. Instruct the Agent to reimburse the applicable projects the $103,625 in ineligible costs that were used to pay for: a) the preparation of the general partners corporate tax returns and tax liabilities; b) property acquisition and mortgage loan restructuring; c) fines and penalties; d) the reimbursement of a superintendent's vehicle expenses, e) consulting services; and f) holiday and block parties, a scholarship grant, and bank charges. The reimbursements are to be made from non-project funds.

1C. Make an eligibility determination of the $81,403 in unnecessary/unreasonable and unsupported charges for: (1) the preparation of the projects for inspections; (2) a payment for a Public Adjuster; and (3) payments of other unsupported costs.

1D. Instruct the Agent to reimburse $939 to the 1775 Houses project from the operating accounts of the AK Houses and the Mother Zion projects, which was used for legal fees and clean-up costs respectively, and stop the practice of using one project's funds to pay the expenses of another project.

The Agent Collected Unauthorized And Excessive Management Fees From Some Projects And Improperly Charged Others Front Line Expenses

Contrary to HUD requirements, during the period between January 1, 1999 and December 31, 2001, the Agent collected unauthorized and excessive management fees from some projects and improperly charged front line expenses to other projects. As such, the projects were deprived of $76,802 that could have been used for reasonable and necessary operating expenses. This occurred because the Agent did not follow HUD requirements that limit the amount of management fees that can be earned; and because the Agent failed to comply with its Management Certifications that delineate the fees it is entitled to collect from the projects. Accordingly, we recommend that HUD, the Director, New York Multifamily HUB, instruct the Agent to reimburse the amount of ineligible excessive fees to the respective projects with non-project funds.

Criteria

The Management Certification between the Management Agent and the owner provides that the Agent's compensation or monthly management fee should equal an approved percentage of gross rents collected during the prior month. However, HUD has limited the management fees that can be earned.

On December 5, 1997, the HUD, New York State Office (NYSO) issued a memorandum to all Owners, Agents and Contract Administrators within the HUD, New York State Office Jurisdiction, which provided that residential management fees paid by projects should not exceed a cap of $44 PUPM (Per Unit Per Month). This memorandum also stipulated that front-line expenses (i.e. the cost of taking applications, recertifying residents, maintaining the project, and accounting for project income and expenses) could be charged to the projects. It was mandatory that all owners implement this new management fee policy within one year of the January 1, 1998 effective date.

In addition, the HUD New Jersey State Office (NJSO) issued a memorandum on June 25, 1997, to all Owners, Agents and Contract Administrators within the HUD New Jersey State Office Jurisdiction, which provided that

residential management fees should not exceed a cap of $56 PUPM. The New Jersey policy does not allow the charging of front line expenses to the projects.

If any other fees were allowed it would be specified in the management certification (in paragraph 1b, or in paragraphs 3 or 4 of attachment 1) as either miscellaneous or special fees, which must be approved by HUD.

Our review disclosed that the Agent collected from some projects excessive and/or unauthorized asset management and residential management fees. It also disclosed that other projects were improperly charged front-line expenses. These matters are discussed as follows:

Asset Management Fees

Agent collected unauthorized asset management fees of $52,275 from NY and NJ projects

The Agent began charging a $5 per unit asset management fees to three of the New York projects in April 2000 and continued charging these fees until July 2001. During this period the Agent collected a total of $40,185 in asset management fees from the three New York projects as follows: 1775 Houses $20,400, AK Houses $9,305, and MS Houses $10,480. In addition, our review disclosed that when the Agent assumed management of two projects in New Jersey, the Agent began collecting asset management fees from the New Jersey projects. We determined that the Agent collected a total of $12,090 in asset management fees from the New Jersey projects (Lock Street Apartments $3,250 and Fairview Apartments $8,840) during the period from February 2000 until February 2001. It should be noted that in February 2001, the management of the New Jersey projects was transferred to another identity of interest (IOI) management agent that is controlled by one of the principals of the Agent.

Representatives of the Agent assert that the Agent began charging the asset management fees on the advice of its attorneys when HUD approved the projects for the Mark-to-Market Program. However, we advised the Agent's representative that since these fees are not included on the management certification nor authorized and approved by HUD, the Agent should not have collected them from the projects. The Agent concurred with our position and used non-project funds to refund the $52,275 ($40,185 +

Although funds were reimbursed a HUD review is needed

$12,090) it collected from these projects. Although these fees have been reimbursed, we believe that the HUD field office needs to conduct further examination in this area to ensure that unauthorized asset management fees are not being collected from other HUD projects managed by the Agent.

Front Line Expenses

Our review disclosed that the Agent assumed the management of two New Jersey projects, Fairview Apartments and Lock Street Apartments, at the end of January 2000, and managed these properties until February 2001. We found that upon assuming management of the New Jersey projects, the Agent began charging front line expenses to the projects on a monthly basis. However, as mentioned above, the NJSO management fee policy does not allow front line expenses to be charged to the New Jersey projects. We learned that during the period the Agent managed the New Jersey projects, the Agent charged $67,555 in front line expenses to the two projects as follows: Lock Street Apartments $18,819 and Fairview Apartments $48,736. As a result, we believe these expenses are ineligible. Therefore, the amount of the expenses should be reimbursed, by the Agent from non-project funds.

Agent collected unauthorized front-line expenses of $67,555 from two New Jersey project

Residential Management Fees

During our review we learned that a rental unit at the 1775 Houses project (a New York project) has not been available for rent since July 1995 because of chronic plumbing problems. We also learned that the Agent allowed one of its IOI Companies to use the unit for storage. Because the unit was not available for rent we believe that the Agent was not entitled to collect a management fee for the unit. As a result, we take exception to the residential management fees collected by the Agent for the unavailable unit at the 1775 Houses project during the period we reviewed (1/1/1999 through 12/31/2001). The fees amounted to $1,584 ($44 per month x 36 months) and are considered ineligible; therefore, the Agent should reimburse the amount of the fees with non-project funds.

Excessive management fees related to an apartment unit not under lease is considered ineligible

In addition, we learned that the Agent did not perform periodic analyses, as required by the management

certification, to determine if collecting the residential management fees at the $44 PUPM rate was resulting in the collection of excessive management fees from projects.

Pursuant to the management certification, the Agent is entitled to a residential management fee based on the amount of rental income collected. To determine the monthly residential management fee, the Agent is to apply an approved rate, per the management certification, to the amount of rental income collected. However, the amount of management fee collected cannot exceed $44 PUPM for NY projects and $56 PUPM for NJ projects, pursuant to the respective management certification and the policy of the respective HUD field office. Instead of determining its monthly fee in the stated manner, we found that the Agent determined its monthly residential management fees by multiplying the number of units in each project times $44 PUPM.

Because the fees were determined using the rate of $44 PUPM, the Agent should have prepared periodic analyses to compare the fees earned based on actual income collected with the fees collected based on the maximum rate. Because this was not done, we determined, by performing a comparative analysis, that the Agent over collected residential management fees from some projects by $7,662 (AK Houses $6,947, 1775 Houses $473, and Lock Street Apartments $242).

The total excessive residential management fees collected of $9,246 is ineligible

Accordingly, we determined that the overall excessive residential management fees collected by the Agent from these projects (related to the above unit not under lease and to the Agent not performing the comparative analysis) amounts to $9,246 ($1,584 plus $7,662). This amount is considered to be ineligible and should be reimbursed to the applicable projects with non-project funds.

In summary, we determined that for the period 1999 through 2001, the Agent collected unauthorized asset management fees ($52,275) and excessive residential management fees ($9,246) from some projects. Also, the Agent improperly charged $67,555 of front line expenses to two New Jersey projects. As previously stated, the Agent concurred with our position regarding the $52,275 of unauthorized asset management fees it collected ($40,185

from the three New York projects and $12,090 from the two New Jersey projects), and reimbursed the amounts to the respective projects with non-projects funds. Nevertheless, it is our belief that by collecting the excessive fees from the projects, the Agent deprived the projects of funds that could have been available for necessary and reasonable operating expenses**.** As such, we believe that the Agent should be required to reimburse the net amount of $76,802, to the applicable projects with non-project funds. (See Appendix C, which details the ineligible fees collected from the projects by year and the asset management fees refunded by the Agent).

Auditee comments

Agent officials contend that they are not aware of anything that prohibits charging front-line expenses to the New Jersey projects. In addition, Agent officials believe that they are entitled to all the residential management fees from the AK Houses project. They contend that the rental revenue decreased because of the reduced rents when the project entered into the Mark-to-Market Program and the program provided that the monthly management fees will not be reduced because of the rent reductions.

OIG evaluation of auditee comments

We believe that the Agent should charge front-line expenses in accordance with the policy of the field office under whose jurisdiction the project is located. In addition, management fees should be collected in accordance with the HUD-approved management certification. Furthermore, if there are any fee adjustments as a result of changes in rental revenue due to the Mark-to-Market Program, HUD should take them into consideration when determining the final unauthorized fees to be repaid by the Agent.

Recommendations

We recommend that HUD, the Director, New York Multifamily HUB:

2A. Instruct the Agent to reimburse the net ineligible costs of $76,802 to the respective projects from non-project funds (see Appendix C for the applicable projects).

2B. Instruct the Agent to develop procedures to ensure that only HUD-authorized and approved management fees that are stipulated in the projects' management certifications are collected from the projects. In addition, only the fee policy of the HUD field office with jurisdiction over applicable projects should be used to calculate and collect management fees from those projects.

2C. Advise the NJSO Multifamily HUB to monitor the current management agent to ensure that the Agent is not collecting unauthorized front-line expenses and asset management fees from the New Jersey projects.

2D. Instruct the Agent to cease collecting a residential management fee for the apartment unit that is not under lease at the 1775 Houses project.

The Agent Allowed IOI Employees To Occupy Rent-Free Units At Various Projects

Our review disclosed that during the period between January 1, 1999 and March 31, 2000, the Management Agent allowed employees of an Identity-of-Interest (IOI) Company to occupy rent-free apartment units in three of the HUD-subsidized projects. As such, the projects were deprived of $55,050 in rental revenue, which could have been used for reasonable and necessary operating expenses. This occurred because representatives of the Agent believe that since HUD approved a rent-free apartment unit for the superintendent at each of the projects, it does not matter that the superintendents are employees of the IOI Company. However, we believe that HUD's intent is to provide rent-free apartment units only to employees of the projects, not to employees of an IOI Company under contract with the projects. Accordingly, we recommend that HUD, the Director, New York Multifamily HUB evaluate and make a determination on whether to instruct the Agent to pay $55,050 to the respective projects with non-project funds for allowing its IOI employees to occupy rent-free apartments.

Criteria

The HUD Approved Rent Schedule, HUD form 92458, Part D, entitled "Non-Revenue Producing Space", provides that a rent-free apartment unit is available for the superintendents of the 1775 Houses, AK Houses, and MS Houses projects.

Paragraph 4-4, of HUD Handbook 4370.2 REV-1, Financial Operations and Accounting Procedures for Insured Projects provides that Account No. 6331, entitled "Manager's or Superintendent's Rent Free Unit" should be used to record the contract rent of any rent-free apartment unit provided to a resident manager or superintendent, which would otherwise be considered revenue producing.

Agent contracted with an IOI Company for janitorial services and allowed IOI employees to occupy rent-free apartment units.

A representative of the Agent informed us that prior to March 31, 2000, three projects: 1775 Houses, AK Houses, and MS Houses did not have any onsite employees. However, when the Agent contracted with an IOI Company to provide the janitorial services at these projects, the janitorial staff included superintendents, porters and handymen. In this regard, during the period that the IOI Company provided the janitorial services, from January 1999 to March 2000, the Agent allowed its IOI employees to occupy rent-free apartment units at each of the three

projects. Consequently, these projects were deprived of rental revenues.

We believe that when HUD approved a rent-free apartment unit in each project, its intent was to provide rent-free units to employees of the projects and not to employees of third party contractors. Since these employees were not project employees, we believe that they should have paid rent for those units. By not paying rent, we believe that the IOI employees received compensation over and above their salaries in the form of free apartment units. Further, it should be noted that discussions with HUD, NYSO officials revealed a similar viewpoint.

Agent's IOI Company receives over $1.5 million for janitorial services rendered.

In conjunction with the above, we learned that after March 2000, the IOI employees became employees of the projects and although the IOI Company stopped providing the janitorial services, they continued to receive payments for back services until December 2000. Specifically, during the period between January 1999 and December 2000, the IOI Company was paid $1,525,103 for janitorial services ($639,297 from 1775 Houses, $565,312, from AK Houses, and $320,494 from MS Houses), which we believe was market cost for the janitorial services. Therefore, we believe that the Agent should not have contracted with its IOI Company for janitorial services at market prices during the period it allowed employees of the IOI Company to occupy rent-free units. However, since it occurred, we consider $55,050, which represents the rental value of the rent-free units during the period the IOI employees occupied them (January 1999, through March 2000), to be lost income that should be paid by the Agent.

The value of the rent-free apartment units is questioned

Auditee comments

Agents officials disagree with OIG and contend that since each of the projects are authorized an administrative rent-free unit it did not matter that non-project employees occupied them.

OIG evaluation of auditee comments

We believe that it was not a reasonable act for employees of an IOI Company to occupy rent-free units while the projects pay market prices to an IOI Company for janitorial

services. In this regard, we believe that the IOI Company should have at least reduced its janitorial prices to the projects by the cost of the rent-free units.

Recommendations

We recommend that HUD, the Director, New York Multifamily HUB**:**

3A. Determine whether the Agent improperly allowed non-project employees to occupy rent-free units. If so, the Agent should be (a) instructed to cease the practice of allowing IOI employees to occupy rent-free units intended for use by resident/onsite project employees; and (b) required to pay the projects loss rents totaling $55,050 ($16,785, to 1775 Houses, $21,360 to AK Houses, and $16,905 to MS Houses), which represents the rental value of the rent-free units that were occupied by employees of the IOI. The payments are to be made with non-project funds.


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The Agent's IOI Company Marked-Up Subcontractor Costs

Our review disclosed that between September 1997 and September 1999, the Agent made payments to an IOI Company that included questionable mark-ups of invoices from a third party subcontractor. Specifically, we determined that the IOI Company marked-up the amounts on at least 87 invoices, totaling $92,970, from a third party subcontractor by 57 percent or $52,857, and billed the projects a total of $145,827. Also, we noted that there was an additional 130 invoices, totaling $142,228, for which we were unable to determine the percentage or amount of mark-up by the IOI Company. Nonetheless, we question the need for an IOI Company to serve as merely an intermediary company between the Agent and a subcontractor. Accordingly, we question the reasonableness of costs charged to projects that represent the IOI mark-up of amounts on the subcontractor's bills. In this regard, we consider the cost of $193,210 as unreasonable/unsupported, which represent $50,982 ($52,857 less $1,875 refunded) of identified mark-up costs and $142,228 of unsupported costs that we believe contain an undetermined percentage of marked-up costs. This occurred because of the Agent's contention that since the IOI Company provided supervisory and quality control services over the work performed by the third party subcontractor, it was therefore entitled to mark-up the invoices. However, we question the need for such services and recommend that HUD, the Director, New York Multifamily HUB determine the eligibility of the services and all associated costs.

Criteria

The hyphenated word "mark-up" as used in this finding means that the IOI contractor took the amount of costs submitted on a subcontractor's invoices and added additional amounts to create the amounts on the invoices that the IOI Contractor subsequently submitted to the Agency for payment.

Paragraph 3(d) of the Project Owners and Management Agent's Certification for Projects with Identity-of-Interest or Independent Management Agents provides that the Owner and the Agent agree to "Refrain from purchasing goods or services from entities that have an identity-of-interest with us unless the costs are as low or lower than arms-length open market purchases."

Additionally, Paragraph 4 of the Management Certification provides that the Agent agrees to: (a) assure that all expenses of the project are reasonable and necessary; (b) exert reasonable effort to maximize project income and to take advantage of discounts, rebates and similar money-saving

techniques, and (c) obtain contracts, materials, supplies and services.... on terms most advantageous to the project

IOI Company billed projects for work performed by third party subcontractor

For the period between September 1997, and September 1999, we identified 217 invoices that were submitted to the projects by an IOI Company primarily for plumbing work performed by a third party subcontractor. The Agent disbursed $288,055 from the project(s) funds, to the IOI Company, to pay the amount on the 217 invoices. Our review disclosed that the IOI Company served as a pass through contractor and that the third party subcontractor actually performed the work at the projects. The third party subcontractor billed the IOI Company and the IOI Company marked up the amounts on the subcontractor invoices and submitted billings to the projects as if the IOI Company performed the work.

IOI Company marked-up 87 of the third party subcontractor invoices by $52,857

We were able to reconcile 87 of the 217 invoices that the IOI Company submitted to the projects to the actual billings from the third party subcontractor. We determined that although the IOI Company billed the projects a total of $145,827 on these invoices, the third party subcontractor that actually performed the work only charged the IOI Company $92,970. Accordingly, the $145,827 on the IOI Company's invoices contain marked-up cost of $52,857 or 57 percent. We consider that amount questionable and/or unsupported since we question the need for an IOI Company to serve as an intermediary company between the Agent and a subcontractor.

Lack of documentation from third party subcontractor to support 130 invoices that the IOI Company billed to the projects

Regarding the remaining 130 invoices, the IOI Company billed the projects a total $142,228. However, the Agent was not able to provide us with the corresponding invoices that the third party subcontractor used to bill the IOI Company for the work performed. Accordingly, we were unable to perform any meaningful analysis to determine the amount of the mark-up that the IOI Company applied to the amounts on the subcontractor's invoices. Therefore, we consider the $142,228 to be unsupported pending a review and eligibility determination by HUD, the Director, New York Multifamily HUB.

In response to our questions pertaining to the reasonableness of the IOI Company's mark-ups of amounts

on the subcontractor's invoices, the Agent provided us with a letter stating the following:

Agent contends that the IOI Company mark-up of subcontractor invoices is reasonable

- When the IOI Company was formed it did not have any staff; therefore, it entered into an oral agreement with the subcontractor to provide plumbing services to the projects.

- The IOI Company was the prime plumbing contractor to the HUD-subsidized projects and provided oversight services to the third party subcontractor such as determining the scope of the work and monitoring the quality and timeliness of its work.

- The hourly rates billed by the IOI Company for plumbing services were at or below comparable billing rates in the New York metropolitan area.

- The Vice-President of the Agent, who is also the President of the IOI Company in question, was able to obtain the special lower hourly rate from the subcontractor, and

- The subcontractor's services were terminated after less than a year when the IOI Company hired its own staff, crew, trucks, supplies etc.

For the reasons stated above, the Agent believes that the IOI Company mark-ups of the amounts of the subcontractor's invoices were reasonable and justifiable.

IOI Company did not have staff to provide the plumbing services

We learned that the IOI Company was formed in 1997, and did not have any employees or a payroll until March 1998. Accordingly, the Agent's statement that the IOI Company provided oversight services to the subcontractor is questionable for any work performed by the subcontractor prior to March 1998, since the IOI Company did not have any staff members to provide oversight.

Furthermore, we learned that the plumbers that the IOI Company eventually hired were the same individuals who were doing the work at the projects as employees of the subcontractor. Accordingly, it appears that the IOI Company hired the subcontractor's plumbing staff to justify marking up the costs to the projects. Moreover, the fact that

employees of the Agent performed the administrative and billing services for the IOI Company, supports our belief that the Agent should have contracted with the subcontractor directly instead of going through an IOI Company. Consequently, we question whether the IOI Company provided any viable service or function other than those services that would have been normally provided by an Agent in fulfilling its HUD required management duties. Thus, we do not believe that the Agent provided adequate justification for allowing the IOI Company to mark-up the amounts on a subcontractor's invoices and subsequently bill the projects the marked-up amounts.

The Agent did not justify the reasonableness of IOI Company mark-ups of subcontractor invoices

IOI Company made partial reimbursement to the projects

Agent/IOI Company officials initially agreed with our computations of the IOI Company mark-ups of three subcontractor invoices. As a result, the IOI Company issued four checks totaling $1,875 to reimburse three of the projects. However, there is still an outstanding balance of $50,982 that should be reimbursed to the affected projects. The details of the questionable and unsupported IOI invoices are too voluminous for inclusion in this report; however, we can make them available upon request.

In summary, we determined that the Agent disbursed $52,857 from the projects' accounts to a IOI Company for unreasonable mark-ups of amounts on invoices of a third party subcontractor. The IOI Company reimbursed three of the projects a total of $1,875, leaving an outstanding balance of $50,982. Also, we believe that additional marked-up costs may be contained in the $142,228 that the IOI Company billed the projects for work actually performed by the same subcontractor. Therefore, this amount is considered unsupported until the Agent provides the corresponding subcontractor invoices so that a determination of the marked-up amount can be made and evaluated.

Consequently, we believe that HUD, the Director New York Multifamily HUB needs to determine the eligibility of all costs considered questioned/unsupported in this finding.

Auditee comments

Agent officials contend that its use of a related plumbing contractor (now discontinued) was appropriate under the

circumstances and met all of HUD's requirements including those set forth in the finding. They contend that the auditors miscalculated the size of the mark-up; nevertheless, they believe that the size of the IOI Company mark-ups is irrelevant as long as the cost of the services were as low or lower than arms-length open market purchases.

OIG evaluation of Auditee comments

OIG auditors computed the IOI Company mark-up by determining the difference between the amount of the invoice submitted to the projects by the IOI Company and the amount of the invoice submitted to the IOI Company by the subcontractor. As a result, OIG determined that the IOI Company marked-up the subcontractor's billings by 57%. Furthermore, it should be noted that at the time that the subcontractor provided the services to the projects, the IOI Company did not have any employees; accordingly, we question whether there was any added value provided by the IOI Company to justify its mark-ups.

Recommendations

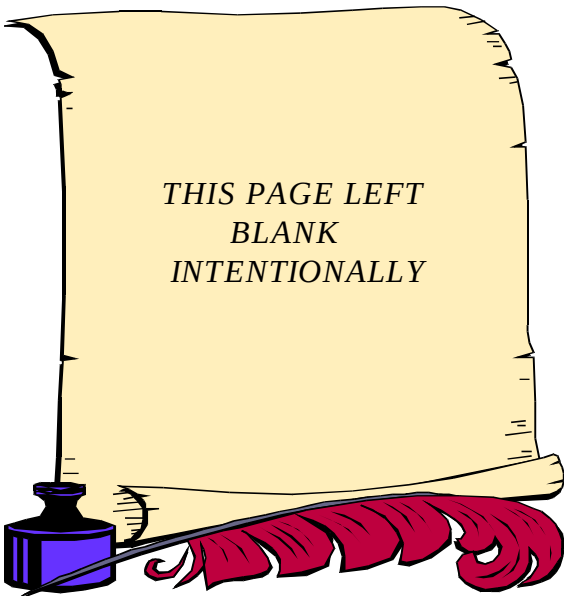
We recommend that HUD, the Director, New York Multifamily HUB:

4A. Determine the eligibility of the service provided by the IOI Company as discussed in the finding. If such service is allowable, then a determination needs to be made as to the reasonableness of the IOI Company's compensation, which was in the form of marked-up costs.

If the service of the IOI Company is considered ineligible or the compensation considered excessive, then HUD, the Director New York Multifamily HUB should instruct the Agent to:

4B. Reimburse all applicable projects the portion of the $193,211 that is considered excessive or ineligible. The reimbursement should be with non-project funds.

4C. Instruct the Agent to institute procedures to assure that the practice of allowing its IOI Companies to mark-up the amounts on invoices that are submitted by subcontractors for work performed at the HUD projects is discontinued.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The Agent Entered Into An Arrangement For Legal Services For The HUD-Subsidized Projects That Is Questionable

Contrary to HUD regulations, the Agent did not solicit written cost estimates or obtain competitive bids prior to obtaining legal services. Instead, the Agent entered into a questionable arrangement with an IOI attorney for legal services to the projects. As a result, the Agent cannot adequately assure HUD that it obtained legal services at the most reasonable and economical price. This occurred because the Agent failed to follow HUD regulations when arranging for legal services for the HUD subsidized projects. Accordingly, we are questioning $257,223 paid to this IOI attorney, pending HUD's, the Director, New York Multifamily HUB's determination of the reasonableness of these charges

CRITERIA

HUD Handbook 4381.5, The Management Agent Handbook, paragraph 6.50 provides that "…an Agent is expected to solicit written cost estimates from at least three contractors or suppliers for any contract, ongoing supply or service which is expected to exceed $10,000 per year..." "For any contract, ongoing supply or service estimated to cost less than $5,000 per year, the agent should solicit verbal or written cost estimates in order to assure that the project is obtaining services, supplies and purchases at the lowest possible cost. " In addition, "the Agent should make a record of any verbal estimates obtained…" and all documentation of estimates and/or bids should be retained as apart of the project records for three years following completion of the work.

Paragraph 3(d) of the Project Owners and Management Agent's Certification for Projects with Identity of Interest or Independent Management Agents provides that the owner and the Agent agree to "refrain from purchasing goods or services from entities that have an identity-of-interest with us unless the costs are as low as or lower than arms-length, open-market purchases."

Furthermore, paragraph 4 of the Management Certification provides that the Agent agrees to: "(a) Assure that all expenses of the project are reasonable and necessary", and

" (c) Obtain contracts, materials, supplies and services…on terms most advantageous to the project. "

Agent entered into questionable arrangement with one of its officers to provide legal services to HUD subsidized projects

Our audit disclosed that during the period between January 1, 1999, and December 31, 2000, the Agent entered into an arrangement with one of its officers (an attorney) to provide legal services to the HUD-subsidized projects, which we believe is questionable. The Agent did not demonstrate that it obtained the required price estimates or competitive bids before entering into the agreement for the legal services. Accordingly, the Agent cannot adequately assure HUD that the most economical price for these services was obtained and being charged to the HUD subsidized projects.

Agent officials contend that the fees charged by this attorney for legal services were reasonable based on the Agent's experience. However, because of the relationship that exists between the attorney, the Agent, the Agent's IOI Companies, and the projects, we cannot be certain.

During the review we learned that the attorney is an officer of the Agent and three of the Agent's IOI Companies, which provides repair and maintenance, plumbing and heating, and security services to the projects. In addition, this attorney is an owner of some of the projects managed by the Agent.

Although the attorney does not provide legal services for the Management Agent, the Agent informed us that the attorney, in his capacity as an officer of the Agent, has primary duties to assist the President in the proper running and management of the Agent's office, and has signatory authority that includes signing checks on behalf of the Agent. However, the Agent's President signs all checks written to the attorney.

Regarding the attorney's costs for providing legal services to the projects, officials of the Agent advised us that an employee of the Management Agent provides the administrative services related to the attorney's legal services. The attorney also does not pay any rent for space occupied within a project for his legal practice; accordingly, his overhead is apparently low.

The attorney acts as a pass-through and subcontracts most of the legal services

In addition, we learned that although the Agent managed other properties during the audit period, the attorney only provided legal services to the HUD-subsidized projects in the New York City area. The invoices submitted by the attorney indicated that services provided consisted of making court appearances, preparing warrants, eviction notices, petitions, and motions to restore. However, upon examining the attorney's files we noted that other legal entities were actually performing these services and the IOI attorney appeared to be functioning as an intermediary agent. As a result, we believe that the Agent should have contracted directly with the third party attorneys rather than going through its IOI attorney, who probably marked up the costs.

The Agent stated that the IOI attorney prepares the initial petition to start the legal process for a required action and accordingly is paid for this service. The attorney then subcontracts with other vendors to perform the follow-up court appearances and pays the vendors for their services. However, the Agent was unable to provide any documentation regarding the amount the attorney paid other sub-contracted legal entities to perform legal services. Furthermore, we were not provided any documentation showing how the attorney's time was distributed among his duties as a principal of the Management Agent, an officer of various identity-of-interest companies, and as the attorney providing legal services to the HUD-subsidized projects.

Attorney billed HUD subsidized projects for legal services while receiving salary compensation from the Agent

During the period reviewed, the IOI attorney received legal fees totaling $257,223 for services provided to the HUD-subsidized projects in New York City ($143,160 in 1999, and $114,063 in 2000). However, during the same period, the attorney also received salary compensation from the Management Agent of $397,466 ($196,930 in 1999, and $200,536 in 2000). We were not provided documentation showing the compensation the attorney received as an officer of the other IOI related entities.

Accordingly, based on the above facts, we believe there is a potential conflict of interest with this individual providing legal services to the projects. Since the attorney is an officer of the Agent and many of the IOI Companies, we are not certain whether the attorney actually provided the legal

services or just performed normal Agent responsibilities and sub-contracted the legal work to other law firms.

Furthermore, as mentioned above, since there were no time distribution records maintained to show how the attorney/Officer split his time between being an owner of some of the projects, a salaried employee of the Agent and an officer of various identity-of-interest companies, all while supposedly providing legal services to the projects, the use of this attorney is questionable. Accordingly, we question the $257,223 paid to this attorney for legal services to the projects pending a HUD NYSO determination as to the reasonableness and eligibility of the costs considering the relationship that exists between the IOI attorney, the Agent, and other IOI companies.

Payments to the attorney totaling $257,223 are questioned.

The chart below details the questioned legal fees paid by project and by year.

Project Name	1999	2000	Total
1775 Houses	$33,550.00	$18,830.00	$52,380.00
AK Houses	15,890.00	15,380.00	31,270.00
MS Houses	9,865.00	9,255.00	19,120.00
Dunwell Plaza	1,600.00	2,040.00	3,640.00
Harlem Gateway	18,363.00	11,285.00	29,648.00
Los Tres Unidos	6,735.00	11,585.00	18,320.00
Washington Heights-Site A	6,455.00	10,480.00	16,935.00
Lexington Gardens	15,635.00	13,395.00	29,030.00
Upaca	25,782.00	13,460.00	39,242.00
Mother Zion	9,285.00	8,353.00	17,638.00
Grand Total	**$143,160.00**	**$114,063.00**	**$257,223.00**

Auditee comments

Agent officials state that the use of the IOI Attorney is atypical (a practice now discontinued); however, it was employed because it was a way to save costs on landlord-tenant representation in New York City. They believe that bringing much of the work in-house and using outside lawyers for court appearances saved costs. They also contend that the auditors discounted the administrative costs of the full time personnel who prepared the legal paperwork for the IOI attorney.

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OIG evaluation of auditee comments

The Agent still has not demonstrated how the IOI attorney allocated his time between his various positions as an officer of the management agent, an officer of various IOI Companies, as well as, his legal practice for the projects. Furthermore, without knowing the terms of the agreement between the IOI attorney and the other subcontracted law firms, as well as the associated costs, the Agent cannot assure us that the IOI attorney's charges were reasonable. It should also be pointed out that the personnel who provided the full time administrative services to the IOI attorney, are listed as employees of the Agent, thus further supporting that a pass through relationship may exist.

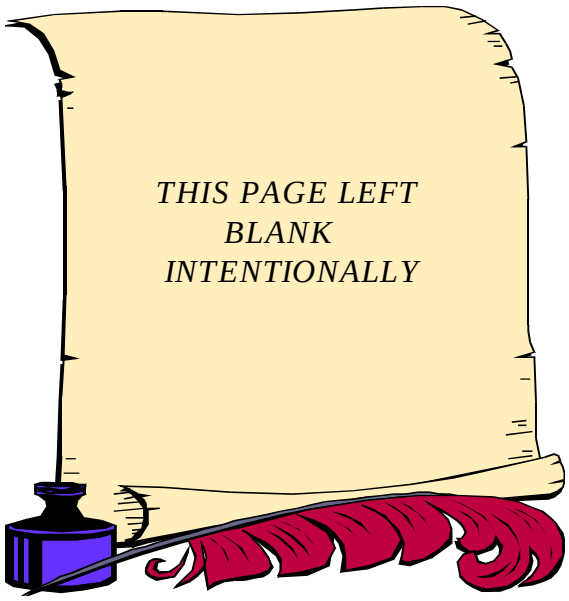
Recommendations

We recommend that HUD, the Director, New York Multifamily HUB instruct the Agent to:

5A. Develop procedures to ensure compliance with HUD regulations regarding the need to obtain written cost estimates or bids when contracting for goods and services in excess of $10,000 for the projects.

5B. Provide documentation to the NYSO so that HUD can determine whether the attorney's charges of $257,223 were reasonable and necessary. In this regard, documentation should show the amounts paid by the IOI attorney to the subcontracted legal entities along with an explanation of how the IOI attorney's time is distributed between his duties as an officer of the Agent and various IOI Companies, and as an attorney providing legal services to the HUD-subsidized projects. Any amounts determined to be unreasonable should be repaid to the projects from non-project funds.

5C. Refrain from using the IOI attorney to perform legal services to the projects since the attorney is an officer of many of the IOI Companies and a salaried employee of the Agent.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The Agent Did Not Comply With The Terms Of The Drug Elimination Grant Agreement

Contrary to HUD regulations, the Agent did not comply with the terms of the Drug Elimination Grant Agreement. During the period between May 5, 2000, and September 30, 2001, the Agent expended a project's funds for expenses related to a Drug Elimination Grant (DEG) and did not submit timely requests for draw-downs to reimburse the project's operating account. Also, we noted that the Agent may not have expended grant funds in accordance with the line items in the program's approved budget. Because of the Agent's failure to comply with the terms of the grant agreement and did not draw down grant funds on a monthly or quarterly basis, the project was deprived of $134,177 that could have been used for reasonable and necessary operating expenses. Accordingly, we recommend that HUD, the Director, New York Multifamily HUB instruct the Agent to draw down program funds for allowable expenditures and reimburse the project.

Criteria

The Drug Elimination Grant Agreement (No. NY36-HDE-0010-199) between HUD and the Grantee provides that the Grantee will use the Line of Credit Control System/Voice Response System (LOCCS/VRS) to draw down funds to reimburse its costs on a monthly or quarterly basis. The Grantee must choose the preferred frequency and notify the HUD field office staff, and continue with the frequency of drawdowns until the field office staff is notified of a change.

In addition, Article 1 of the Grant Agreement entitled "Grant Administration" paragraph E, provides that: "The Grantee is required to expend grant funds in accordance with the approved budget... unless an extension/ amendment is approved by HUD" .

Background

In a letter dated March 6, 2000, HUD, the New York State Office notified the Agent that a Multifamily Housing Drug Elimination Grant in the aggregate amount of $200,000 was awarded to three projects under its management (1775 Houses, MS Houses and AK Houses). On May 22, 2000, the Grant Agreement was signed by the Director, New York Multifamily HUB on behalf of HUD and by the Senior Vice President of the Management Agent on behalf of the projects on May 5, 2000. The grant award established strict budgetary line items of $50,000 for Drug Prevention and

$150,000 for Drug Intervention. The twelve-month grant term was extended for six months for a total allowable grant term of 18 months. The completion date was moved to September 2001.

The Agent used an organization called Centering Associates, to administer the DEG and elected to pay all the expenses related to the DEG from the operating account of the 1775 Houses project. The Agent established a receivable account - "Due from Centering Associates" - in the 1775 Houses project's accounting system to record DEG costs paid with project's funds. This was done with the intention of reimbursing the project's account when grant funds were drawn down.

The Agent's actions deprived the project of $134,177

Our audit disclosed that during the period between May 5, 2000, and September 30, 2001, the Agent disbursed $177,777 from the operating account of the 1775 Houses project, to pay expenses related to the DEG. Under the terms of the grant agreement the Grantee/Agent was authorized to draw down grant funds from the LOCCS/VRS to reimburse its costs. However, as of April 30, 2002, the Agent had only drawn down $43,600, from LOCCS, which was used to reimburse the operating account of the 1775 Houses project. We were not provided with an explanation as to why additional DEG funds were not drawn down. Consequently, the Agent's failure to timely draw down funds has deprived the project of $134,177 ($177,777 less $43,600), which could have been used for ordinary and necessary operating expenses.

Agent did not expend grant funds in accordance with the approved budget

In addition to the above, our review disclosed that at the end of the term of the grant (September 30, 2001), the Agent had spent $92,165 for drug prevention ($42,165 more than the budgeted amount of $50,000) and $85,612 for drug intervention ($64,388 less than the budgeted amount of $150,000). This is contrary to the Grant Agreement, which limits the line item charges to $50,000.00 for drug prevention and $150,000.00 for drug intervention unless HUD approves an extension/amendment. Since the Agent did not expend funds according to the approved budget, or obtain HUD's approval for any budget amendments, the Agent did not comply with the Drug Elimination Grant Agreement.

Agent's submission of second request for grant funds

On May 21, 2002, the Agent provided us with a copy of a May 9, 2002 request it submitted to HUD for a draw down of $146,952 of DEG funds. Combined with the initial draw, the breakdown of funds requested to pay incurred costs, as submitted to HUD, is as follows:

	Drug Prevention	Drug Intervention	Total
Draw #1	$ 3,796	$39,805	$43,600
Draw #2	$44,889	$102,062	$146,952
Total	$48,685	$141,867	$190,552

However, the requests, as submitted by the Agent, do not reflect the grant costs as recorded on the books and records. The Agent re-classified costs from Drug Prevention to Drug Intervention so it appears that the funds were expended in accordance with the line item budget. However, as mentioned above, our testing showed that more funds were spent on drug prevention than on drug intervention, which is contrary to the DEG Agreement.

HUD needs to review the eligibility for all of the Agents DEG expenditures drawn down.

We believe that it is not a prudent business practice for the Agent to submit vouchers that reflect program compliance, when it did not comply with the provisions that require funds to be expended in accordance with the strict line items in the budget. Furthermore, we became aware of correspondence between HUD and the Agent regarding the Agent's proposal for reimbursement of costs. HUD advised the Agent that under the Notice of Funding Availability (NOFA), one of the ineligible activities listed is " costs incurred prior to the effective date of your grant agreement." In addition, we reviewed correspondence between an outside consultant and the Agent, which indicated that the consultant also informed the Agent that there could be no change of grant scope or reallocation of budget monies without HUD's prior approval. Consequently, we believe that to ensure that the Agent has only requested reimbursement from HUD for eligible items in accordance with budget limits, the Agent should be instructed to submit to HUD all documentation that supports the amounts requested, so that HUD can determine the eligibility of the amounts requested.

In summary, for the period May 5, 2000, through September 30, 2001, the Agent used $177,777 from the operating

account of the 1775 Houses project to pay DEG expenses and only drew down $43,600, from the grant funds to reimburse the project. Accordingly, it is our belief that by using project funds for grant costs and not making timely draw downs to reimburse the project, the Agent deprived the project of $134,177 in funds that could have been used for necessary and reasonable operating expenses. In addition, we found that the Agent requested DEG funds from HUD, to pay expenses that were not incurred in accordance with the budgeted amounts in the grant agreement; therefore, we believe the Agent did not comply with the terms of the Drug Elimination Grant Agreement.

Auditee comments

Agent officials contend that they are working cooperatively with HUD to reconfigure the drug elimination grant work plan, and to draw down funds to reimburse the 1775 Houses project operating account.

OIG evaluation of auditee comments

The Agent's comments are responsive to our recommendations; as such, we agree with the action being taken by the Agent and believe that all funds expended from the project's operating account for the Drug Elimination Grant should be reimbursed.

Recommendations

We recommend that HUD, the Director, New York Multifamily HUB:

6A. Instruct the Agent to resubmit its draw down request for only allowable Drug Elimination Grant expenditures and immediately reimburse $134,177 to the 1775 Houses project with the funds drawn down.

6B. Instruct the Agent to submit to HUD, all supporting documentation related to DEG expenses for which funds have been drawn down, so that HUD can determine the eligibility of these expenses. If HUD determines that any expenses are outside of budget limits and/or are ineligible, these amounts should be reimbursed to the program from non-Federal/project funds.

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Management Controls

In planning and performing our audit, we considered the management controls of the Agent in order to determine our auditing procedures, not to provide assurance on the 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 that the following management controls were relevant to our audit objectives:

Program Objectives - 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.

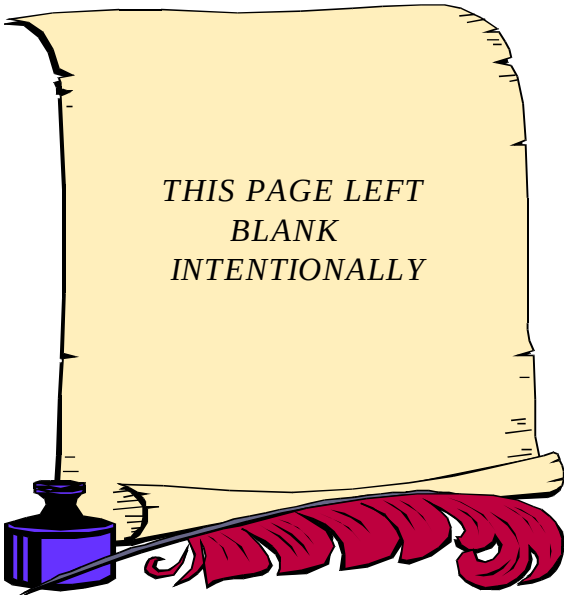
Safeguarding Resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss and misuse.

We assessed the relevant controls identified above.

It is a significant weakness if management controls do not provide reasonable assurance 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.

Significant Weaknesses

Based on our review, we found significant weaknesses in the areas of "Program Objectives" (see finding 6), "Validity and Reliability of Data" (see findings 1, 4, 5 and 6), "Compliance with Laws and Regulations" and "Safeguarding Resources" (see findings 1 through 6).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Follow Up On Prior Audits

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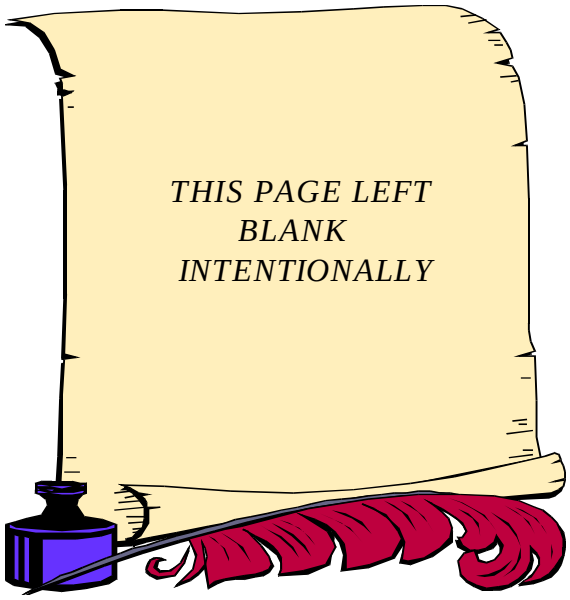
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Issues Needing Further Study and Consideration

During our review we noted certain practices or conditions that in our opinion require further review by HUD management. These areas involve: (1) the leasing of commercial space in the projects to affiliates at less than fair market rent; (2) employees of IOI Companies residing in apartment units but their incomes are not reported on the re-certification forms; and (3) the administration of the Network Learning Center. See below for details:

Project commercial space leased to affiliates below fair market rent

Our review disclosed that the Agent and its IOI Companies are occupying commercial space at two of the projects at below fair market rents. Accordingly, the projects are being deprived of valuable commercial rental income. We learned that the Agent occupies space at the 1775 Houses project under a five-year lease that expires at the end of February 2003, at an annual rent of $12,000 ($1,000 per month), including utilities. The estimated area of the space occupied by the Agent is 4,824 square feet; which yields a lease rate of approximately $.21 per square foot, which in our opinion is less than fair market rate. In addition, some of the Agent's IOI companies occupy commercial space at the AK Houses project under a five-year lease that expires at the end of February 2003, at an annual rent of $9,000 ($750 per month), including utilities. The estimated area of the space occupied by the IOI Companies is 2,300 square feet; which yields a lease rate of approximately $.33 per square foot, which in our opinion is less than fair market rent.

We believe this occurred because of the relationship between the Agent and its IOI Companies. Accordingly, we believe HUD, the Director, New York Multifamily HUB should examine this situation and determine whether more equitable leases can be initiated between the projects and the lessees.

IOI Company employees reside in apartment units but are not reporting their income on tenant re-certification forms

Our review disclosed that there are employees of an IOI Company, who are identified as residents living in apartment units of two of the HUD insured/subsidized projects. This information was confirmed by the Agent's Human Resources Department records and by the W-2 forms prepared for them. However, these IOI employees are not listed as residents of the respective apartment units and their income is not being reported on the HUD-50059 (annual Section 8 re-certification forms). As a result, the

household incomes reported by the members of those apartment units are understated, which result in higher HUD Section 8 subsidy payments for those units. Accordingly, we believe that HUD, the Director, New York Multifamily HUB needs to evaluate this situation and adjust the Section 8 payments accordingly.

Administration of Network Learning Center

On March 7, 2000, HUD authorized the mortgagee for the 1775 Houses project, to release $160,000 from the project's Residual Receipts Account to the Agent, for the purpose of establishing a Network Learning Center for the benefits of the tenants. Individuals affiliated with the Agent created a non-profit organization to administer the program and on March 31, 2000, the Agent issued a $160,000 check to the non-profit organization from the operating account of the 1775 Houses project. The non-profit organization expended $137,895.27 of the $160,000 for various items related to the establishment of the Network Learning Center. The expenditures were for items such as: repairs, computer supplies, computer hardware, computer software, furniture, telephone system, air conditioning, electrical wiring, and other expenses. However, we learned that the Network Learning Center was open for only six (6) weeks and now the furniture, computer hardware and computer software are sitting idle, thus the tenants are not realizing any tangible benefits from a program that was intended for their benefit. As a result, we believe that HUD, the Director, New York Multifamily HUB should evaluate this situation and consider advising the Agent to either re-open the program or salvage as much equipment as possible and return the funds realized from the salvage to the project's operating account.

Schedule of Questioned Costs

	Type of Questioned Cost		
Finding	Ineligible **1/**	Unsupported **2/**	Unreasonable **3/**
1	$103, 625	$12,019	$70,323
2	76,802	-	-
3	-	-	55,050
4		142, 228	50,982
5	-	-	257,223
6	-	-	134,177
Totals	**$180,427**	**$154,247**	**$567,755**

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/ Unreasonable costs are costs charged to a HUD-financed or HUD-insured program that exceed the costs that would be incurred by the ordinarily prudent person in the conduct of a competitive business.


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Marion Scott Real Estate, Inc.
New York, New York

Summary of Ineligible, Unsupported and Unreasonable Expenses – Finding 1

PROJECT	CHECK NUMBER	CHECK DATE	INELIGIBLE AMOUNT	UNSUPPORTED AMOUNT	UNREASONABLE AMOUNT
1775 Houses	817-003028	10/15/99	$1,000.00		
1775 Houses	817-003028	10/15/99	$178.00		
1775 Houses	815-001181	05/16/00	$1,178.00		
1775 Houses	815-001352	09/19/00	$1,187.00		
Los Tres Unidos	822-002352	1/14/99	$1,175.00		
Los Tres Unidos	821-001049	2/16/00	$1,000.00		
Los Tres Unidos	821-001049	2/16/00	$178.00		
Lexington Gardens	353-001169	7/18/00	$4,753.00		
Los Tres Unidos	821-001479	9/12/00	$1,187.00		
Lexington Gardens	353-001217	9/19/00	$1,187.00		
Dunwell Plaza	814-001222	9/19/00	$1,187.00		
Mother Zion	1321	12/19/00	$1,187.00		
Harlem Gateway	834-001149	2/15/01	$1,187.00		
M.S. Houses	357-001055	2/16/00	$1,000.00		
M.S. Houses	357-001055	2/16/00	$595.00		
M.S. Houses	357-001133	4/20/00	$1,000.00		
M.S. Houses	357-001133	4/20/00	$178.00		
AK Houses	853-001490	1/18/01	$1,000.00		
AK Houses	853-001490	1/18/01	$187.00		
AK Houses	853-001703	8/16/01	$1,000.00		
AK Houses	853-001703	8/16/01	$187.00		
Site A	297-001381	1/18/01	$1,187.00		
Total Corporate Tax Return Preparation Fees			**$22,918.00**		
Mother Zion		3/10/99	$300.00		
MS Houses	2367	3/10/99	$300.00		
1775 Houses	2831	03/10/99	$300.00		
1775 Houses	1086	03/09/00	$300.00		
Lexington Gardens		12/31/98	$300.00		
Los Tres Unidos	822-002389	3/10/99	$300.00		
Dunwell Plaza	814-001056	3/9/00	$300.00		
Lexington Gardens	353-001051	3/9/00	$300.00		
Los Tres Unidos	821-001065	3/9/00	$300.00		
Mother Zion		3/9/00	$300.00		
Harlem Gateway	834-001082	3/27/00	$300.00		
MS Houses	001077	3/9/00	$300.00		
AK Houses	854-004405	3/10/99	$300.00		
AK Houses	853-001091	3/9/00	$300.00		
Upaca Site 7		12/31/98	$2,500.00		

Marion Scott Real Estate, Inc.
New York, New York

Summary of Ineligible, Unsupported and Unreasonable Expenses – Finding 1

PROJECT	CHECK NUMBER	CHECK DATE	INELIGIBLE AMOUNT	UNSUPPORTED AMOUNT	UNREASONABLE AMOUNT
Site A	297-001069	12/31/99	$300.00		
1775 Houses	1085	03/09/00	$155.00		
Lexington Gardens		12/31/98	$380.00		
Los Tres Unidos	822-002388	3/10/99	$380.00		
Mother Zion		3/10/99	$380.00		
Dunwell Plaza	814-001057	3/9/00	$155.00		
Lexington Gardens	353-001050	3/9/00	$155.00		
Los Tres Unidos		3/9/00	$155.00		
Mother Zion		3/9/00	$155.00		
Harlem Gateway	834-001081	3/27/00	$155.00		
MS Houses	2366	3/10/99	$380.00		
MS Houses	001076	3/9/00	$155.00		
MS Houses	854-004404	3/10/99	$380.00		
AK Houses	853-001090	3/9/00	$155.00		
Upaca Site 7		12/31/98	$325.00		
Site A	297-001068	12/31/99	$155.00		
Lexington Gardens	353-001198	9/12/00	$130.00		
Lexington Gardens	1202	9/12/00	$258.00		
Lexington Gardens	353-001197	9/12/00	$34.00		
Total Payments for General Partners' Corp. Taxes			**$11,042.00**		
M.S. Houses	357-001162	5/16/00	$4,490.00		
1775 Houses	815-001181	05/16/00	$8,745.00		
AK Houses	854-001191	5/16/00	$5,385.00		
Lock Street	310-001067	5/16/00	$1,715.00		
Fairview	298-001117	5/16/00	$4,665.00		
Total Acquisition and Mortgage Loan Restructuring			**$25,000.00**		
1775 Houses	1315	08/23/00	$142.39		
AK Houses	853-001343	10/6/00	$2,000.00		
Mother Zion		10/20/00	$71.09		
Mother Zion		10/20/00	$80.58		
1775 Houses	1103	03/16/00	$1,500.00		
MS Houses	2493	8/12/99	$25.00		
AK Houses	853-001305	09/15/00	$1,000.00		
AK Houses	853-001439	12/12/00	$50.00		
AK Houses	853-001440	12/12/00	$50.00		
AK Houses	853-001441	12/12/00	$80.00		
AK Houses	854-004512	08/12/99	$25.00		
Harlem Gateway		11/27/00	$25.00		

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Marion Scott Real Estate, Inc.
New York, New York

Summary of Ineligible, Unsupported and Unreasonable Expenses – Finding 1

PROJECT	CHECK NUMBER	CHECK DATE	INELIGIBLE AMOUNT	UNSUPPORTED AMOUNT	UNREASONABLE AMOUNT
MS Houses	001129	04/20/00	$25.00		
MS Houses	2389	04/05/99	$50.00		
MS Houses	2390	04/05/99	$50.00		
MS Houses	2428	05/27/99	$25.00		
Harlem Gateway	835-006172	08/10/99	$318.00		
Dunwell Plaza	816-007545	08/19/99	$250.00		
Harlem Gateway	834-001097	04/03/00	$2,500.00		
Harlem Gateway	834-001366	10/12/00	$300.00		
Harlem Gateway	834-001364	12/15/00	$25.00		
Harlem Gateway	834-001365	10/16/00	$25.00		
AK Houses	854-004447	5/27/99	$25.00		
MS Houses	2388	4/5/99	$50.00		
Upaca Site 7 Assoc.		4/2/99	$4,125.00		
Lexington Gardens	354-005450	02/03/99	$30.00		
1775 Houses	1170	05/04/00	$100.00		
MS Houses	2341	02/03/99	$30.00		
MS Houses	2379	03/29/99	$168.48		
Dunwell Plaza	816-007382	02/04/99	$30.00		
Harlem Gateway	835-006035	02/04/99	$30.00		
Harlem Gateway	835-006034	02/04/99	$30.00		
Los Tres Unidos	822-002363	02/03/99	$30.00		
Mother Zion		02/03/99	$30.00		
AK Houses	854-004364	02/03/99	$30.00		
1775 Houses	2783	02/03/99	$30.00		
Harlem Gateway	835-006184	8/19/99	$205.41		
AK Houses	854-004476	6/15/99	$100.00		
Site A	299-005446	4/5/99	$300.00		
Site A	299-005502	3/1/99	$1,000.00		
Harlem Gateway	834-001235	08/17/00	$35.00		
1775 Houses	1472	12/08/00	$205.40		
Total Payments for Fines and Penalties			**$15,201.35**	@	
1775 Houses	1169	05/03/00	$400.00		
1775 Houses	1189	05/16/00	$400.00		
1775 Houses	1191	05/22/00	$400.00		
1775 Houses	1231	06/15/00	$400.00		
1775 Houses	1233	06/19/00	$400.00		
1775 Houses	1248	07/18/00	$400.00		
1775 Houses	1285	08/17/00	$400.00		
1775 Houses	1376	10/12/00	$400.00		

Marion Scott Real Estate, Inc.
New York, New York

Summary of Ineligible, Unsupported and Unreasonable Expenses – Finding 1

PROJECT	CHECK NUMBER	CHECK DATE	INELIGIBLE AMOUNT	UNSUPPORTED AMOUNT	UNREASONABLE AMOUNT
1775 Houses	1444	11/16/00	$400.00		
1775 Houses	1471	12/05/00	$400.00		
Total Payments for Vehicle Expense			**$4,000.00**		
MS Houses	2347	2/19/99	$1,050.00		
MS Houses	2485	7/15/99	$2,450.00		
MS Houses	1039	2/9/00	$1,125.00		
MS Houses	1039	2/9/00	$1,125.00		
AK Houses	854-004403	3/9/99	$1,050.00		
AK Houses	854-004480	6/15/99	$2,450.00		
AK Houses	853-001051	2/9/00	$1,125.00		
AK Houses	853-001051	2/9/00	$1,125.00		
AK Houses	853-001163	4/20/00	$2,625.00		
1775 Houses	2830	3/9/99	$1,050.00		
1775 Houses	2929	6/15/99	$2,450.00		
1775 Houses	3102	12/23/99	$810.00		
1775 Houses	815-001047	2/9/00	$1,125.00		
1775 Houses	815-001047	2/9/00	$1,125.00		
Total Consulting Services			**$20,685.00**		
			-		
1775 Houses	1410	11/01/00	$100.00		
AK Houses	853-001386	11/1/00	$100.00		
MS Houses	001359	11/1/00	$100.00		
1775 Houses	1319	08/31/00	$800.00		
AK Houses	853-001294	8/31/00	$200.00		
MS Houses	001290	8/31/00	$200.00		
1775 Houses	3041	10/28/99	$334.00		
AK Houses	854-004571	10/28/99	$334.00		
MS Houses	2549	10/28/99	$334.00		
1775 Houses	1331	09/11/00	$32.65		
Subtotal Holiday and Block Parties			**$2,534.65**		
1775 Houses	2789	02/03/99	$1,000.00		
Subtotal Scholarship Grant			**$1,000.00**		
			-		
1775 Houses	1169	05/03/00	$10.00		
Subtotal Bank Charges			**$10.00**		
			-		
MS Houses	001067	2/17/00	$246.81		

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Marion Scott Real Estate, Inc.
New York, New York

Summary of Ineligible, Unsupported and Unreasonable Expenses – Finding 1

PROJECT	CHECK NUMBER	CHECK DATE	INELIGIBLE AMOUNT	UNSUPPORTED AMOUNT	UNREASONABLE AMOUNT
MS Houses	001067	2/17/00	$246.81		
MS Houses	001067	2/17/00	$246.81		
MS Houses	001067	2/17/00	$493.62		
Subtotal Payments for Replacement Workers			**$1,234.05**		
Total Other Ineligible Costs			**$4,778.70**	@	
1775 Houses	817-003065	11/11/99			$1,000.23
1775 Houses	817-003095	12/16/99			$4,439.87
1775 Houses	817-003095	12/16/99			$3,996.59
1775 Houses	817-003095	12/16/99			$5,157.57
1775 Houses	817-003095	12/16/99			$1,677.33
1775 Houses	817-003095	12/16/99			$5,009.81
1775 Houses	817-003095	12/16/99			$5,066.10
1775 Houses	817-003095	12/16/99			$792.39
1775 Houses	817-003095	12/16/99			$154.26
1775 Houses	815-001010	1/5/00			$2,701.92
AK Houses	853-001077	2/17/00			$168.87
AK Houses	853-001077	2/17/00			$788.06
AK Houses	853-001077	2/17/00			$2,307.89
AK Houses	853-001077	2/17/00			$1,208.07
AK Houses	853-001077	2/17/00			$1,211.32
AK Houses	853-001077	2/17/00			$1,463.54
AK Houses	853-001077	2/17/00			$168.87
MS Houses	001062	2/16/00			$4,376.55
MS Houses	001062	2/16/00			$3,482.94
MS Houses	001067	2/17/00			$168.87
MS Houses	001246	7/19/00			$168.87
MS Houses	001246	7/19/00			$168.87
MS Houses	001217	7/18/00			$13,314.75
1775 Houses	817-002796	2/17/99			$1,440.00
AK Houses	854-004368	02/17/99			$800.00
MS Houses	2406	4/15/99			$1,120.00
Subtotal Payments to Prepare for Inspections					**$62,353.54**
1775 Houses	815-001480	12/19/00			$7,029.66
Subtotal Payment to Public Adjuster					**$7,029.66**
1775 Houses	1040	02/03/00			$266.62
1775 Houses	1044	02/03/00			$101.25

Marion Scott Real Estate, Inc.
New York, New York

Summary of Ineligible, Unsupported and Unreasonable Expenses – Finding 1

PROJECT	CHECK NUMBER	CHECK DATE	INELIGIBLE AMOUNT	UNSUPPORTED AMOUNT	UNREASONABLE AMOUNT
1775 Houses	1042	02/03/00			$85.80
1775 Houses	1041	02/03/00			$41.25
1775 Houses	1043	02/03/00			$70.95
1775 Houses	1039	02/03/00			$80.00
Subtotal Project Clean-up Costs					**$645.87**
1775 Houses	1363	09/29/00			$293.45
Subtotal Legal Fees					**$293.45**
Total Other Unreasonable Costs					**@ $70,322.52**
MS Houses	2439	6/10/99		$1,207.52	
MS Houses	2480	7/15/99		$150.94	
MS Houses	2543	10/15/99		$150.94	
MS Houses	001280	8/17/00		$150.94	
MS Houses	001353	10/17/00		$150.94	
MS Houses	001353	10/17/00		$150.94	
MS Houses	001387	11/17/00		$150.94	
AK Houses	854-004457	6/3/99		$1,167.28	
AK Houses	854-004500	7/15/99		$145.91	
AK Houses	854-004565	10/15/99		$145.91	
1775 Houses	3033	10/15/99		$176.10	
1775 Houses	2906	06/10/99		$1,408.80	
Mother Zion	3281	6/10/99		$1,006.24	
Mother Zion	3328	7/15/99		$125.78	
Mother Zion	3398	10/15/99		$125.78	
Mother Zion	1267	10/17/00		$251.56	
Mother Zion	1267	10/17/00		$125.78	
Mother Zion	1296	11/17/00		$125.78	
Dunwell Plaza	7487	6/10/99		$291.82	
Dunwell Plaza	7523	7/15/99		$145.91	
Dunwell Plaza	7611	10/15/99		$145.91	
Dunwell Plaza	1199	8/17/00		$145.91	
Dunwell Plaza	1223	9/19/00		$293.82	
Dunwell Plaza	1288	11/17/00		$145.91	
Los Tres Unidos	2474	6/10/99		$1,449.04	
Los Tres Unidos	2519	7/15/99		$181.13	
Los Tres Unidos	2604	10/15/99		$181.13	
Los Tres Unidos	1264	9/19/00		$181.13	
Los Tres Unidos	1292	10/17/00		$362.26	

Marion Scott Real Estate, Inc.
New York, New York

Summary of Ineligible, Unsupported and Unreasonable Expenses – Finding 1

PROJECT	CHECK NUMBER	CHECK DATE	INELIGIBLE AMOUNT	UNSUPPORTED AMOUNT	UNREASONABLE AMOUNT
Los Tres Unidos	1331	11/17/00		$181.13	
Harlem Gateway	6126	6/10/99		$231.44	
Harlem Gateway	6154	7/15/99		$115.72	
Harlem Gateway	6233	10/15/99		$115.72	
Harlem Gateway	1236	8/17/00		$115.72	
Harlem Gateway	1338	11/17/00		$231.44	
Harlem Gateway	1338	11/17/00		$115.72	
Subtotal Outside Vendor				**$11,548.94**	
Upaca Site 7 Assoc.	Not available	1/29/00		$469.94	
Subtotal Miscellaneous				**$469.94**	
Total Unsupported Charges				**$12,018.88**	
TOTAL			**@ $103,625.05**	**@ $12,018.88**	**@ $70,322.52**
Grand Total Ineligible, Unsupported & Unreasonable Expenses				**@ $185,966.45**	

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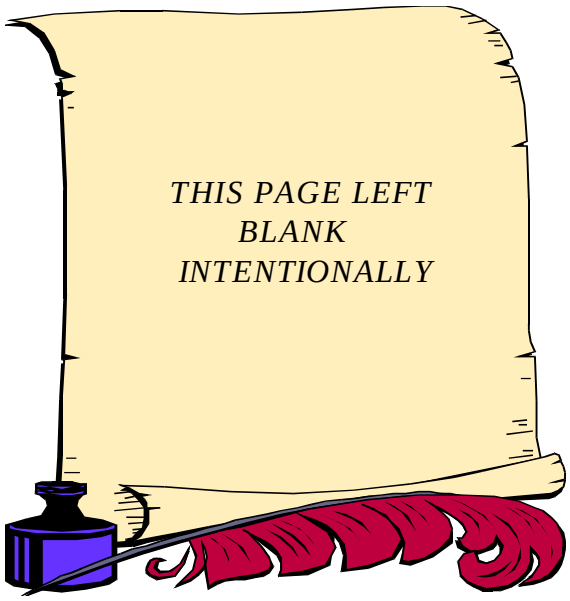
@ In the audit finding these amounts were rounded to the nearest dollar.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Marion Scott Real Estate, Inc.
New York, New York

Schedule of Net Ineligible Fees & Expenses – Finding 2

		TYPE OF FEES			
PROJECT NAME	**YEAR**	**FRONT-LINE EXPENSES**	**ASSET MANAGEMENT FEES**	**RESIDENTIAL MANAGEMENT FEES**	**TOTAL**
1775 HOUSES	1999			$528.00	$528.00
	2000		$11,475.00	$1000.95	$12,475.95
	2001		$8,925.00	$528.00	$9,453.00
SUBTOTAL			**@ $20,400.00**	**$2056.95**	**$22,456.95**
AK HOUSES	2000		$5,980.00	$6,947.26	$12,927.26
	2001		$3,325.00		$3,325.00
SUBTOTAL			**@ $9,305.00**	**$6,947.26**	**$16,252.26**
MS HOUSES	2000		$5,240.00		$5,240.00
	2001		$5,240.00		$5,240.00
SUBTOTAL			**@ $10,480.00**		**$10,480.00**
LOCK STREET APTS	2000	$13,582.00	$2,750.00	$242.28	$16,574.28
	2001	$5,236.92	$500.00		$5,736.92
SUBTOTAL		**$18,818.92**	**@ $3,250.00**	**$242.28**	**$22,311.20**
FAIRVIEW APTS	2000	$34,492.00	$7,480.00		$41,972.00
	2001	$14,244.44	$1,360.00		$15,604.44
SUBTOTAL		**$48,736.44**	**@ $8,840.00**		**$57,576.44**
GRAND TOTAL FEES		**$67,555.36**	**@ $52,275.00**	**$9,246.49**	**$129,076.85**
				@ LESS: REFUNDED ASSET MANAGEMENT FEES:	**1/ ($52,275.00)**
				AMOUNT TO BE REPAID TO PROJECTS	**2/ $76,801.85**

1/ This figure is comprised of refunded asset management fees in the amounts of **($20,400)**, **($9,305)**, **($10,480), ($3,250)** and **($8,840)** from the projects 1775 Houses, AK Houses, MS Houses, Lock Street Apartments and Fairview Apartments respectively.

2/ This figure is comprised of **$2,056.95** to be repaid to 1775 Houses, **$6,947.26** to be repaid to AK Houses, **$19,061.20** to be repaid to Lock Street Apartments, and **$48,736.44** to be repaid to Fairview Apartments.


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Auditee Comments

Marion Scott Real Estate Inc.

December 20, 2002

Mr. Alexander C. Malloy
Regional Inspector General for Audit
U.S. Department of Housing & Urban Development
26 Federal Plaza, Room 3430
New York, NY 10278

Dear Mr. Malloy:

Marion Scott Real Estate, Inc. ("MSI") is a property management company that currently has in its management portfolio eighteen different residential properties, containing 26,744 apartment units. The MSI managed properties are spread throughout New York City and northern New Jersey, and are comprised of market rate rental properties, cooperative apartments, and government subsidized rental properties. Some of the rental properties are owned by partnerships whose general partners are affiliated with MSI, others are owned by third parties.

Several properties are recipients of Section 8 assistance and have mortgages insured by the Secretary of HUD. Most of these properties present particular challenges to their managers by virtue of their location. A number of the MSI properties are in some of the most challenging neighborhoods of New York and Newark.

MSI prides itself on the quality of its management. Its paramount goal is, and always has been, to provide decent, safe and sanitary housing for the residents of its properties, including the residents of all of its Section 8 properties. MSI believes that it has to date succeeded in its mission. This can be seen, among other ways, by a review of the HUD Real Estate Assessment Center ("REAC") inspections of the properties and by the superior ratings our developments have received from New York Quadel management review team.

The HUD Office of the Inspector General ("OIG") has provided MSI with a draft audit (the "Draft") of its Section 8 properties, and afforded us the opportunity to review it and comment upon it. An exit conference was held on December 13, 2002, during which each of the findings was discussed in detail. The MSI representatives in attendance found the conference to be very helpful, and trust that the OIG representatives also benefited from the discussion. At the exit conference, we requested an additional seven days to revise our written response to the Draft. The OIG representatives agreed to our request.

107-129 EAST 126TH STREET, NEW YORK, NY 10035 TEL: 212 996-0200 FAX: 212 289-0598

Marion Scott Real Estate Inc.

This letter, therefore, provides you with the comments of MSI on the Draft. The Draft contained seven separate findings. We questioned whether or not the seventh finding should be included in this audit. You agreed to examine this question. For this reason, we are providing our comments to the seventh finding in a separate letter, which we are delivering to you simultaneously with this letter. If the OIG decides to include the seventh finding in the final audit, please consider that separate letter as our response to that finding, and publish it with the final audit. If, on the other hand, the OIG determines to handle the recommendations of the seventh finding outside of this audit, we would request that our response not be published with the final audit.

As we have told you, there are some facets of the Draft with which we are in agreement. MSI plans to repay any funds which were distributed from properties in error, and where this has been correctly pointed out in the Draft. In some instances, this has already been done. This will be clear from the specific comments below. On the other hand, there are other findings with which we disagree, or where we find the relevant HUD procedures to be ambiguous or subject to differing interpretations. In addition, some of the findings relate to actions taken in connection with HUD's interim mark to market demonstration program (the "Demonstration Program"). This program was just that – a demonstration program – without fully developed rules and requirements, and must be viewed as it was being operated at the time, and not with the hindsight of a fully developed mark to market program, which had not yet come into existence.

With regard to some issues, guidance was received from advisors and attorneys representing the company and/or the project owners, and such guidance relied upon. Further, with regard to some matters, guidance was sought from the appropriate HUD field offices. We understand that because of the work demands on the field offices, and also because of the ambiguities and other programmatic uncertainties referenced above, we were unable to come to an understanding on certain issues. We can say forthrightly, however, that all actions were taken by MSI in good faith, and without any intent to violate any rules or procedures, and all were undertaken with the best interests of the properties in mind.

We also wish to note that, during the entire year long period when the audit was underway, MSI staff did everything possible to provide the OIG auditors with everything they requested, and to respond to all interim requests. Further, during this period, as it became apparent or advisable for MSI to change any of its own procedures, we did so,

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without waiting for the audit results. We believe that the OIG agrees that our staff was continually cooperative with your auditors.

We understand that, once the audit is issued in final form, it will be up to the New York HUD Multifamily HUB (the "HUB") to resolve the findings with MSI. We understand that we will have, at that time, the opportunity to provide additional material to the HUB to document and support the positions that we are taking, and that the HUB will have the responsibility to determine whether the material we present to them are sufficient to sustain our positions. We understand that the HUB will confer with the OIG in connection with its responsibilities and that, to the extent the OIG and the HUB disagree on any issue, there are internal mechanisms within the Department to resolve those disputes. We understand that, in any event, the final decisions shall be those of the HUB officials, and trust that they will be asked to review our positions with an open mind.

The most serious matters raised by the Draft relate to the use of identity of interest ("IOI") companies by MSI. The Draft fluctuates between hinting that the use of IOI companies is per se improper, or that the particular means by which MSI employed these companies was wrong. We do not believe there were any violations of the rules with regard to the use of IOI companies, but understand that this is a particularly sensitive area within HUD. We would hope that the final audit will not reflect the position of the OIG on the subject in its "ideal world", but rather address the question of whether there were any violations of existing rules or regulations. We should add, however, that, in part because we now recognize the suspicion with which HUD tends to view the use of IOI companies (something that we had previously not been aware of), MSI has ceased using all but one of its IOI entities.

Finding 1A – Payment for the Preparation of Corporate Tax Returns. This finding states that HUD's procedures permit the preparation of tax returns of an owning partnership to be a project expense, but do not accord the same treatment to the corporate tax returns of the general partners of these partnerships. The Draft takes the same position with regard to the filing fees of the State of New York and New York City that are required to maintain the good standing of these entities. As a basis for this, the Draft cites HUD handbook provisions that talk about the partnership tax returns, but do not mention the general partner expenses.

We understand that the handbooks only refer to the owning entity, but we point out that the handbooks do not directly preclude general partner expenses being paid by the

Marion Scott Real Estate Inc.

properties in appropriate situations. Presumably, the standard would be whether or not these costs are reasonable and necessary for the operation of the property.

In this regard, we do not see the difference between the two levels of tax preparation costs and filing fees for the properties subject to this finding. The partnerships are all, as required by HUD, single asset entities, established to own and operate their respective properties. Clearly, the existence and good standing of these entities are crucial, as no owner-partnership can exist without a general partner. If partnership expenses are reasonable and necessary to the ongoing operation of a property, logic states that the expenses of the general partner are equally so. This is particularly the case where, as here, the general partners are also single purpose entities, established and operated for the sole purpose of directing the actions of the limited partnership owners.

We understand that precedent may not favor this position, but believe that it is the correct one, and suggest that the OIG rethink its findings in this regard, and perhaps suggest to the HUD program officials that general partner tax and filing fees are determined to be reasonable and necessary project operating costs.

Finding 1B – Acquisition and Mortgage Loan Restructuring. This finding relates to five properties and two different types of expenditures. With regard to the three New York properties, it relates to various fees related to the Demonstration Program. The Draft claims that these fees were for the benefit of the owner, and not the properties. We disagree.

The owners of the three New York properties were solicited to enter this program by HUD, which was desirous of having one or more New York properties in the Demonstration Program. There were no rules or procedures in effect at the time, to our knowledge, that would have required the owners to absorb the costs required to position the properties for the Demonstration Program. Thus, we believe them to be proper project expenses, reasonable and necessary for the operation of the properties.

The two New Jersey properties raise additional issues, because the wording of the questioned invoices make it appear that the services were provided to enable the general partners to determine whether an attempt should be made to buy-out the current limited partners, something that clearly would not appear to be a project expense. MSI takes the position that these invoices were poorly worded and not reflective of the services provided, however. As we discussed at the exit conference, we will attempt to locate

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additional documentation that supports this position, and present that material to you or the HUB, as appropriate.

Finding 1C – Payments for Fines and Penalties. MSI agrees with the Draft with regard to the inappropriateness of the projects paying fines and penalties that could have been avoided by management, and will reimburse the properties accordingly. We do not, however, agree that $310 of these charges was appropriately categorized as fines or penalties, and believe that they are reasonable and necessary operating expenses. They include costs for obtaining printouts from the Commissioner of Finance, and payment of two tickets for litter that were issued in the early morning hours, before a management company could be expected to clean the exterior of the premises. We will provide this documentation to the HUB.

Finding 1D – Vehicle Expenses. This finding relates to a unique situation where, following the termination of the properties' contracts with an affiliated janitorial maintenance company, certain of the properties engaged the staff of this company as project employees. In each instance, the salary and benefit terms of the individual employee were retained, but paid as direct project expenses, rather than through the maintenance contract. With regard to one individual, his employment arrangements *included the payment of his automobile expenses on a monthly basis.*

The Draft challenges the appropriateness of the properties picking up these vehicle expenses, stating that they had not been part of the compensation package to this individual. As we understand the OIG position, the expenses would not have been challenged had they been considered part of his compensation, and the determination that they were not compensation was based on the lack of a 1099 or IRS form W-2, showing these payments as income to the individual in question. We are reviewing this position with the company's tax advisors at this time to determine the correctness of the OIG position.

Finding 1E – Consultant Services. The vast majority of the payments questioned under this finding relate to the costs of consultants who were engaged to prepare drug rehabilitation program grant applications. The OIG believed that these costs should have been borne by the MSI under its management contract.

We disagree. For one thing, there is nothing that we can find that states that a management company must absorb the costs of this type of service, as it is neither in the

Marion Scott Real Estate Inc.

HUD handbooks nor other issuances, nor in the Manager's and Owner's Certification or the management contract.

Nevertheless, at first, two officials of the management company did attempt to put together these applications. In each such instance, the applications were denied and the programs not funded, and it became apparent that the development of an appropriate drug elimination submission required specific types of experience and talent. It was determined to bring in that outside expertise. This is standard in all businesses and, with regard to drug elimination grants, understand it to be a common phenomenon not only in privately owned housing, but in public housing as well. And, the proof is in the pudding because, when the consultants prepared the applications, they were funded, all to the benefit of the properties and their residents.

Finding 1F – Other Questioned Costs. With regard to this finding, MSI agrees with the OIG as to the items deemed ineligible by the OIG (as opposed to those deemed only "unsupported"), when viewed in light of standard HUD requirements. Therefore, MSI will ensure that the appropriate partnership owners are reimbursed for the costs of the holiday and block parties, as well as the scholarship grant, bad check charge, and replacement workers' salaries.

In addition, as to one of the items deemed unsupportable by the OIG, we agree with the OIG that the partnership owning 1775 Houses paid some small bills, which were rightfully the responsibility of other owners. Each of these bills was paid in error.

It does not appear, however, that the Draft findings correctly identify the proper parties who were responsible to pay these invoices. In fact, the legal bills related to labor negotiations involving AK Houses, 1775 Houses, and MS Houses; all reimbursements and adjustments have already been made. The janitorial costs involve emergency fire clean up work at Mother Zion; reimbursement here was also made within two weeks of the event. We will supply the appropriate documentation to the HUB.

On the other hand, MSI strongly disagrees with the conclusion of the OIG that $62,354 paid to prepare the properties for the successful REAC inspections was unjustified. The position of the Draft appears to be that expenses to specifically prepare for physical inspections should not be permitted project expenses, as they show a lack of appropriate upkeep year-round. MSI is of the opinion that this type of inspection preparation is expected by HUD as a part of the REAC inspection process, and that it benefits the

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Marion Scott Real Estate Inc.

properties and their residents. In fact, we believe that one of the advantages of the REAC system is to encourage additional expenditures, to the extent of available funds, to enable the properties to meet the strict REAC requirements, and that, if these costs are not permitted as property expenses, the REAC system will be harmed, to the detriment of the HUD portfolio.

As to the conclusion of the Draft that these expenditures should have been paid by the maintenance company and not project, we also disagree. Some of these expenditures were for materials, which are clearly a project expense. Others, while for labor, are for labor above and beyond that required for the scope of work covered by the maintenance contract. Thus, MSI is in total disagreement with the OIG on this point, and would anticipate that the HUB officials will be in agreement with us.

Similarly, MSI believes that the use of a public adjuster is extremely common in New York properties, and that the benefits of the results obtained by the adjusters far outweighs the costs. The use of adjustors leads to much more efficient negotiations with the insurance carrier, and results in a quicker repair of the property. In many years of managing properties in New York, this is the first time that MSI personnel have ever seen these costs questioned.

As to the $470 payment to the Department of Finance, this related to a check that was timely sent but never received, or lost, by the Department, which nevertheless refused to waive the interest charges. As this did not involve a failure by management to send the check in a timely fashion, MSI does not believe that management should bear this cost.

Finally, as to Omni Partnership Services, we will provide documentation to show that these costs related to limited partner K-1s and tax preparation, and were therefore appropriately charged to the properties. This material will be presented to the HUB during audit resolution.

Finding 2. This finding deals with various payments for management services by the properties. MSI agrees with the Draft findings that asset management fees are not appropriate project expenses. No such fees are currently being charged to the properties, and all past asset management fees have been reimbursed, as the Draft correctly reflects.

On the other hand, MSI does not understand the position being taken that properties in New Jersey are not entitled to pay for any "front line expenses", as are permitted in what

appears to be every other state of the union. MSI has never seen anything that prohibits their payment from project funds in New Jersey, and believes that any such determination would be violative of HUD Handbook 4381.5. MSI asserts that it never received notification of any such policy, prior than receiving the Draft findings, and that the fees taken were consistent with those approved by HUD under the management and owners' certification and management agreement. We have agreed with the OIG to study this matter further, and request that the OIG does the same, so that there can be an agreement as to whether the payments made for these front line expenses are appropriate. We believe, in this instance, that the burden should be upon the auditors to provide us with documentation to show us that MSI was wrong in paying these costs from project funds; no such documentation has as of yet been forthcoming.

As to the finding that excess management fees were paid by AK Houses, MSI disagrees, and believes that the apparent difference of opinion stems from the fact that, as a result of the Demonstration Program, the Section 8 contract rents were reduced, and that the program provides that the property manager's monthly management fee will not be reduced as a result of the rent reductions. The question was raised as to whether such a hold-harmless was automatic, or whether it had to be requested. We, and we believe the OIG, will examine this question.

Finding 3. This finding relates to the rent-free occupancy of employees of an identity of interest company at 1775 Houses, AK Houses and MS Houses. MSI disagrees with the conclusions of the OIG that this rent free occupancy was impermissible.

We take this position for a number of reasons. First, the underwriting for the properties assumed that there would be one rent-free unit in each property. Second, city law requires that a superintendent live in properties of this type, or within 200 feet of the building under his supervision. Third, the position of the OIG appears to be that rent free use of the apartment would be appropriate if the employee was a direct employee of the owning partnership, but is not appropriate for an employee of a third party entity performing the same services.

MSI believes that the position of the OIG is one of form over substance and that it is standard practice for non-owner employees to serve as building superintendents and live in rent-free units. We do not believe that the OIG could find support for its position to the contrary.

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Marion Scott Real Estate Inc.

Mr. Alexander C. Malloy
Regional Inspector General for Audit
U.S. Department of Housing & Urban Development
December 20, 2002
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Finding 4. This finding was titled "The Agent's IOI Company Marked-Up Subcontractor Costs". We believe that the title of the finding shows the bias of the OIG with regard to the use of IOI subcontractors in general, and in this situation is particular, and we disagree with it.

MSI maintains that its use of a related party plumbing contractor (now discontinued) was appropriate under the circumstances and met all of HUD's requirements, including those requirements which are set forth in the first part of the draft finding. The costs of the services provided were as low or lower than arms-length open market purchases, all expenditures were for reasonable and necessary purposes, there were no discounts, etc., that were not passed on to the properties, and the contract was on terms most advantageous to the project.

MSI believes this to be so for a number of reasons. First, the hourly rates were determined based upon a survey of market plumbing rates and the experience of MSI with regard to a number of properties it manages. Second, the use of an IOI company was beneficial because, in light of the level of rents then being obtained at the properties, it was not possible to assure an independent plumber that funds would always be available for payment for needed or requested services. Only through a contract between the subcontractor plumbing companies and the IOI company, which guaranteed regular payment to the subcontractors, was it possible to procure steady service for the properties.

There is no restriction on a bona fide identity of interest company subcontracting out work, and there is no restriction on the size of the mark ups permitted that company, as long as the above-related HUD-mandated criteria are met. If HUD wished to abolish or otherwise control IOI companies, it presumably has the ability to do so, but it has not chosen to do so, although we know this is a subject under constant discussion.

On this basis, the size of any mark up should be irrelevant to the auditors. Nevertheless, the draft finding does not state that the existence of the mark up is improper, only its size, which the auditors conclude to be 57%. In fact, this is a miscalculation. The arrangement with the subcontractor had the IOI contractor advancing $40 per hour to the subcontractor, irrespective of the ability of the property to pay for the services. This, the IOI company did on a regular basis. Additional amounts were to be paid the subcontractor at a later date. At the end of the arrangement with the subcontractor, it became necessary to settle up with the subcontractor. This was done, and a total of

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$122,500 was paid to the subcontractor, as evidenced by a settlement agreement that was provided to the auditors during the audit period. This brought the amount paid to the subcontractor to approximately $65 per hour, not the $40 per hour set forth in the audit. It should also be noted that, after the arrangement with the subcontractor was terminated, the IOI plumbing contractor hired its own personnel, did the work directly, at the same hourly rate. The hourly rate for these services has not been challenged by the auditors.

Finding 5. This finding deals with the handling of landlord-tenant legal matters through a lawyer who was also an officer and part owner of the management company (a practice now discontinued). The finding states that this arrangement is "questionable". We agree that this arrangement is atypical, but state that it was employed because it was a way to hold down the very high costs of landlord-tenant representation in New York City.

MSI is very familiar with the cost of legal services in New York City, and recognized that the properties could not support the level of services required to enforce the lease obligations of the properties' residents. MSI had dealt (and continues to deal) with most of the New York housing court lawyers (a relatively limited group of individuals), and realized that there would be a way to save costs considerably by bringing much of that work "in-house", and using the outside lawyers only for court appearances, where their experience would be well worth the cost of their services.

The draft finding appears to discount this, but we believe this is because the auditors are not sufficiently familiar with landlord-tenant legal process in the city. Further, determining how much the affiliated attorney was paid for his services, the audit finding discounted the administrative costs of the full time personnel who prepared most of the paperwork, and did not take into account the various filing and service fees that were incurred in the process. MSI provided a good deal of this information to the auditors during the course of the audit, and will provide more to HUB officials during the resolution process. We are certain that these officials will recognize the economic efficiency of the work as it was handled. MSI would also point out that the use of a related attorney was disclosed to HUD throughout, both on management entity profiles, and on management certifications.

Finding 6. This finding deals with the implementation of the drug elimination grant at 1775 Houses, MS Houses and AK Houses. Its main thrust relates to the failure of MSI to draw down the grant funds, and instead to have advanced project funds for grant fund

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purposes. It also alluded to changes in the grant program that would require a different budget configuration for grant expenses.

Suffice it to say that, while MSI agrees with some of what the OIG concluded in this draft finding, the company is working cooperatively with the HUB to reconfigure the drug elimination grant work plan, and close out the grant through a draw down of remaining funds and reimbursement of project accounts.

As a final point on this matter, please be advised that Centering Associates, described in the Draft as an alter ego of the management company, is in fact an independent venture with no relationship to MSI.

Issues Needing Further Study and Consideration

Project commercial space leased to affiliates represents office space that was never designed as commercially rentable space due to the lack of access from the outside of the building. Additionally, we believe it is a benefit to the tenants to have the managing agent centrally located so close to several of the properties. We believe the rent paid for the office space is reasonable given the circumstances.

As for the space occupied at AK Houses, this area was just storage before it was modified to be office space. Also, there is absolutely no access to the outside of the building, making it unusable as commercial space. Again, it is only good as project office space, and we believe that due its location, the amount of rent paid is reasonable.

Our understanding of the circumstances of the IOI employees who showed their addresses as residing in two of our projects is that they did not actually live in the apartments, but rather just had relationships with some of the individuals residing in those units. Since we were unaware that these employees had used our properties' addresses as home addresses, we did not check to see if their income had been reported on those unit's annual Section 8 re-certification forms.

The network learning center was plagued with problems from the beginning, including lack of interest from tenant association members and outside resources that did not live up to expectations. The program is currently being modified to expand the use of the previously purchased resources as well as adding additional resources from the remainder of the funds from this program and the remaining funds from the grant program mentioned in finding 6. As of this writing, the Neighborhood Networks Computer Center's doors have been reopened with the assistance of the Harlem Partnership Center.

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We have dedicated the space for use by a program, underwritten by the Beaumont Foundation, where the children work on laptops and desktop computers.

We are very excited about the strides we are making with respect to this learning center and HUD has been brought up to date on the current status of the center's new activities. As a matter of fact, HUD has been very instrumental in helping us to revitalize this program.

Conclusion. MSI is most interested in resolving any audit findings in as speedy and efficient manner as possible, so as to retain its strong relationship with HUD, and to ensure that there is no detrimental effect on the company, its properties and their residents.

We trust that the Draft will be revised based on our comments and, after the audit is issued in final form, we look forward to resolving any open issues with the HUB officials.

Sincerely yours,

Marion Scott
President

cc: Deborah Van Amerongen, Director, NY Multifamily HUB
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