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MEMORANDUM NO:
2003-FW-1806

July 3, 2003

TO: Raynold Richardson,
Director, Multifamily Housing Program Center, 6EHM

FROM: //S//
D. Michael Beard,
Regional Inspector General for Audit, 6AGA

SUBJECT: Colonial Oaks
Project Number 114-11132
Houston, Texas

INTRODUCTION

Based on a recommendation from Houston Multifamily staff, we conducted a review of Colonial Oaks Apartments (Colonial Oaks). The objective of the review was to determine whether Colonial Oaks' owners operated the project in accordance with HUD requirements. Specifically, we determined whether the owners (1) established and maintained adequate written policies, procedures, financial books and records; (2) used project funds appropriately; and (3) maintained the property in a satisfactory physical condition.

METHODOLOGY AND SCOPE

To accomplish our objective, we:

- Reviewed the project's regulatory agreement, the Owner's Certification, and HUD's Handbook Requirements;
- Reviewed the HUD Houston Multifamily Program Center's Colonial Oaks project files;
- Reviewed the purchase closing statement and the Assumption Agreement;
- Interviewed the HUD Houston Multifamily Program Center's staff;
- Interviewed Colonial Oaks' owners and site personnel;
- Interviewed staff at other apartments in the general vicinity and obtained information on their vacancy rates;
- Interviewed the two contract Certified Public Accountants employed by the owners; and

- Obtained and reviewed the project's accounting records and supporting operating information.

We also:

- Tested rental receipts to determine whether the owners deposited rental receipts intact to the project's operating bank account. We tested 100 percent of the rent receipts from January 2002 through May 2002. We also traced the receipts for May 2002 to the individual tenant ledger cards.
- Reviewed 100 percent of the tenant lease files for the 72 units occupied in July 2002 to determine if tenants had leases.
- Tested project disbursements to determine whether the project had supporting documentation for payments and whether amounts paid were reasonable and necessary to project operations. Our initial test included 100 percent of contract labor payments for the entire review period. We also tested an additional 43 payments out of a universe of 641 payments totaling \$50 or more.
- Inspected the exterior and a non-representative sample of seven occupied and five vacant units out of the 79 units in July and August 2002.

Our review covered Colonial Oaks' operations from June 1, 2000, through May 31, 2002. We performed the fieldwork between July 12, 2002 and November 14, 2002. We performed additional review work and reviewed information provided by the HUD Houston Multifamily Program Center in April 2003.

Management comments are attached and include management decisions, planned actions and planned action dates. No further action is required.

Should you or your staff have any questions, please contact Theresa Carroll, Assistant Regional Inspector General for Audit at (817) 978-9309.

BACKGROUND

Colonial Oaks is a 79 unit, two story brick, garden-type apartment built in 1972. The current owners of Colonial Oaks are Mr. Sherjeet S. Grewal and Mr. Hargopal Sidhu. They assumed the project's mortgage on June 1, 2000. At that time, they agreed to comply with the project's Regulatory Agreement the previous owners signed in 1994 when HUD issued FHA insurance under Section 223(f). However, the owners declined to attend a pre-occupancy meeting with HUD to learn about HUD's expectations, the Regulatory Agreement, and the Project's Management Certification.

HUD approved the owners' self-management of project operations and agreed the owners could receive a management fee of 4 percent of project revenue for project management. HUD's approval was subject to the terms of the Owner's Certification to comply with the Regulatory Agreement and HUD requirements. During the review period, the owners did not pay themselves a management fee. Colonial Oaks' mortgage was current as of November 2002. Colonial Oaks does not receive project based Section 8 assistance and does not have Section 8 tenants. The owners also own and manage Summerfield Apartments, a conventional 110-unit property located in Southwest Houston.

RESULTS OF REVIEW

The owners are not adequately managing the project. Although the owners have kept the mortgage current, they did not establish or maintain controls, procedures or financial records that met HUD's requirements because they are either not familiar with HUD's requirements or they said HUD required too much paperwork for such a small property. As a result, the owners:

- 1) Did not maintain the project's physical condition;
- 2) Did not properly collect, record, and deposit rental receipts;
- 3) Lacked leases for 43 percent of their tenants;
- 4) Lacked support for payments totaling \$9,262;
- 5) Improperly paid management costs from project operating funds;
- 6) Did not submit audited financial statements to HUD timely; and
- 7) Did not prepare an affirmative marketing plan.

Thus, the owners are in technical default of their mortgage. Since the problems are of an on-going nature dating from the owners' assumption of the project, we recommend HUD terminate the owner's self-management and require them to obtain the services of an independent property management agent. In addition, we recommend HUD require the owners to reimburse the project for any improper or unsupported disbursements. Further, HUD should require the owners to submit audited financial statements or seek appropriate sanctions against the owners.

CRITERIA

HUD required the owners to comply with a Regulatory Agreement as a condition to receive HUD insurance for a loan. The Regulatory Agreement, among other things, establishes requirements for project management and administration. Provisions in the Regulatory Agreement specified the owners must:

- Maintain the property in good repair and condition,
- Ensure expenditures are reasonable and necessary to the operation of the property,
- Ensure all project income is deposited to a project bank account,
- Maintain property books and records in a manner to permit timely audit, and
- Timely submit audited financial statements to HUD annually.

In addition, HUD requires owners who decide to manage a project themselves to certify they will comply with HUD's management requirements contained in the Project Owner's Certification for Owner-Managed Multifamily Housing Projects. By signing the Certification, the owners agreed to:

- Comply with HUD's requirements;
- Comply with the project's Regulatory Agreement and HUD's Handbooks;
- Establish and maintain project accounts, books, and records in a condition that will facilitate audit; and
- Exert a reasonable effort to maximize project income.

The Certification also gives HUD the right to terminate the owners' self-management arrangement for failure to comply with the provisions contained in the Certification or for other good cause.

HUD has issued The Financial Operations and Accounting Procedures for Insured Multifamily Projects.¹ The Handbook is HUD's principle guide for financial and accounting operations for HUD insured multifamily projects. HUD has also issued the Management Agent Handbook.² This Handbook provides guidance regarding most aspects of HUD's relationship and interaction with owners and management agents of HUD-insured properties. HUD's Multifamily Asset Management and Project Servicing Handbook defines technical default.³ A technical default is failure by the mortgagor to perform any covenant due under the provisions of the Regulatory Agreement.

¹ HUD Handbook 4370.2, REV-1, CHG-1, issued January 26, 1996.

² HUD Handbook 4381.5, REV-2, CHG-2, issued September 15, 1997.

³ HUD Handbook 4350.1, REV-1, CHG-9, issued January 23, 1996.

Owners lack adequate controls, procedures, and financial records

The owners have not established sufficient controls, policies, and procedures or financial records to adequately manage the project. The owners lack controls and written policies over operating and managerial functions like leasing, rental collection, maintenance, and disbursements. Further, they lack financial records that meet HUD's requirements. The project's Regulatory Agreement and Owner's Certification required the owners to follow the requirements in HUD's Handbooks. HUD's Handbooks required that owners establish controls and accurate books and records in order to safeguard the project's assets. The owners have not established such items because they are not familiar with HUD's requirements and they said HUD required too much paperwork for managing such a small property.

HUD previously told the owners to correct their deficient practices. In a Management Review Report (Report) dated December 21, 2001, HUD told the owners to establish procedures for several areas including maintenance, disbursements, and rental collection practices. Further, HUD's Report criticized the owners for not having accounting and bookkeeping records available on-site for review.⁴ In early 2002, the owners' newly hired Certified Public Accounting (CPA) firm sent several faxes to HUD concerning HUD's Report. The CPA firm told HUD they had provided the owners with four binders of operating procedures and guidelines. In addition, the owners, through the CPA firm, said they were in the process of posting the project's financial data in accordance with HUD's requirements. However, none of the responses specifically addressed day-to-day maintenance, disbursements, or rental collections.

In our opinion, the owners still have not established written policies and procedures to the detriment of the project. The four binders prepared by the CPA firm are on-site, but they are merely a collection of various HUD Handbooks. Further, when asked, the on-site manager stated he did not refer to them. In fact, he stated he did not have written operating procedures.

Owners did not adequately maintain the project

The project has failed two out of the last three inspections performed by HUD's Real Estate Assessment Center (REAC). REAC's most current inspection performed on March 4, 2003, cites systemic deficiencies in the building's exteriors, the building's electrical systems, appliances, and bathroom fixtures. Failure to maintain the project is a violation of the Regulatory Agreement. The owners did not make exterior repairs because they mistakenly believed HUD would not permit them to use Reserve for Replacement funds for the repairs. Since the owners did not maintain the project's exterior, its appearance suffered, which has apparently affected its marketability. Vacancies increased during 2002 from five vacant apartments in the early months of 2002 to 14 vacancies in September 2002.

Our inspection found similar problems to the ones identified by REAC in March 2003. As the following pictures show, we noted problems with rotted soffit and fascia boards, missing or damaged gutters, and missing covers in electrical breaker boxes.

⁴ HUD's Project Manager sent a letter to the owners two months prior to the review and requested that information be available on-site for the review.



Missing gutter and rotted fascia boards outside unit 68.



Missing gutter, rotted fascia and soffit boards, and peeling paint on soffit and ceiling of breezeway outside unit 74.



Missing breaker box cover and exposed wiring for unit 19.

During the review, the owners indicated they wanted to use Reserve for Replacement funds to perform exterior repairs. The owners wanted to purchase materials and skilled labor to perform the exterior repairs rather than hire a contractor to save money. The owners stated the local HUD office would not permit them to do the exterior repairs in this way. However, they did not make a written request and there was no written HUD refusal. Thus, the owners' lack of knowledge of HUD requirements to obtain the Reserve for Replacement funds delayed HUD's approval of such funds and, ultimately, the repairs.

We informed the owners about obtaining Reserve for Replacement funds. During the review, the HUD project manager agreed to the owners' request. The owners started the repair of the gutters in September 2002. However, REAC's most current inspection still showed that all the building exteriors needed paint, over one-half of the buildings still had rotted soffit or fascia boards, over one-half lacked electrical breaker box covers, and almost half had missing gutters. Thus, overall, Colonial Oaks is not in good repair or condition.

Owners did not properly collect, record, or deposit rental receipts

For the five months reviewed, the owners or manager either spent or could not otherwise account for \$1,365 in rents they collected. In addition, on a few occasions, the manager collected rent

but did not record it on the rental receipts journal and, in one case, recorded different amounts on the journal and a tenant's ledger card. The manager also held receipts for several days and did not always deposit funds on-hand when he made a deposit. HUD requires, in so far as possible, that rental receipts be deposited on the date received. Further, HUD requires that there be a segregation of duties between the rental receipt function and the accounts receivable function.⁵

The current manager collects, records, and deposits all rental receipts. Tenants pay by cash, check, and money order. The lack of segregation of duties in rental receipts exposes the owners to the risk that theft of cash rents might occur. Since the owners do not have a fidelity bond, they would be liable to the project for any theft that might occur.

Owners lacked leases for a significant number of tenants

For the month of July 2002, the project manager could not provide a lease for 31 of the 72 occupied units (43 percent). The Regulatory Agreement does not specifically require leases. However, owners should have them to prove they are not overcharging for security deposits and are not leasing for less than 30 days.⁶ Further, without a lease, the responsibilities of the owner and tenant are not clearly spelled out. As a result, both parties lack a firm and, perhaps, enforceable understanding of the consequences of failing to meet an obligation like paying rent on time or the penalties for paying late. A written lease also provides the owners and tenant with a clear statement of their rights and duties, which the owners can enforce in the event of any violation or illegal activity.⁷

Owners cannot provide support for payments totaling \$9,262

The owners lacked support for payments to small contractors totaling \$9,262. HUD requires adequate supporting documentation (i.e. vendor invoice) for payments out of project operating funds.⁸ The owners could not provide an invoice for 28 payments totaling \$8,262, which were categorized as Contract Labor. In addition, one owner, Mr. Grewal, wrote a check to himself for \$1,000. He asserted that he cashed the check to pay a contractor for air conditioning repairs. The memo field on the check named a contractor and identified apartment numbers. The owner stated the contractor was unable to cash another check in his name due to a lack of identification. Although he was able to provide a voided check dated the same date to that contractor, Mr. Grewal could not provide an invoice. Mr. Grewal agreed that he had not insisted on invoices from contractors. He stated he would start requiring them.

⁵ HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects, Chapter 2, section 2-12. A. General Controls number five and A. Receipt Controls number three.

⁶ Both of these items are a Regulatory Agreement requirement. Length of rental period is covered by paragraph 4(a). Security deposits are covered by paragraph 6(g).

⁷ In April 2003, federal officials arrested 10 individuals in an apartment, which was apparently being used as part of an illegal alien smuggling ring.

⁸ HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects, Chapter 2, section 2-12, B. Disbursement Controls number 1.

Owners improperly paid management costs from operating funds

The owners improperly used operating funds to pay their wives to oversee project operations and their CPA firm to set up a HUD approved accounting system and internal controls. According to HUD's Management Agent Handbook,⁹ such costs should be paid from the management agent fee. The CPA firm's bills did not differentiate between auditing fees, which are an allowed project expense, and the cost of establishing accounting systems and controls, which are not a valid project operating expense. Thus, the total amount of ineligible costs could not be determined. The owners admitted they paid their wives a total of \$4,000 in July 2000 to oversee project operations when there was already a full time on-site manager. Mr. Grewal agreed that the payments to their wives should have been a management cost paid from the project management fee. Since the owners have not been paid a management fee, HUD should offset these ineligible costs against the fee owed to the owners.

Owners did not submit audited financial statement timely

The owners have not provided HUD audited financial statements on time since they took over the project in mid-2000. Further, the owners have not submitted audited financial statements for 2002. The Regulatory Agreement required the owners to submit annual audit financial statements. The owners resisted having audits performed. The owners told HUD's Project Manager during the Management Review that an audit was too costly for this size project.

The owners finally employed a CPA firm on January 2, 2002, after HUD's Project Manager insisted they submit their annual audits. Even though the owners hired the CPA in January 2002, the owners delayed the CPA's audit by not providing a signed engagement agreement until June 2002. As a result, the CPA firm stopped audit work in March 2002. By the time the owners returned the agreement, the CPA did not immediately return to this audit because they were working with other clients. When the audit restarted, the owners further delayed it by not answering the CPA firm's August request for financial and other documents. The owner's CPA submitted the project's 2000 audit in December 2002 and the 2001 audit in June 2003. However, the owners still need to submit their delinquent 2002 financial statements.

Owners lack an Affirmative Marketing Plan

The owners have not completed an Affirmative Fair Housing Marketing Plan (Plan).¹⁰ The owners agreed in their Owners Certification that they would not discriminate and would furnish HUD any reports and information required to monitor the project's compliance with fair housing and affirmative marketing requirements. HUD's 2001 Management Review Report required the owners to complete the Plan. However, the owners did not know how to complete the Plan and even asked us how to complete it. Although the project appears to be appropriately marketed, the owners lack a basic understanding of HUD's rules and are thus not able to comply with HUD's requirements. Since failure to complete the Plan is a major program compliance

⁹ HUD Handbook 4381.5, REV-2, CHG-2, section 6.38 issued September 15, 1997.

¹⁰ HUD Form 935.2.

violation,¹¹ HUD should consider it a factor in terminating the owner's self-management of the project.

We held an exit conference with one owner and HUD Houston Multifamily staff on June 9, 2003. At the exit conference, Mr. Sidhu did not disagree with the facts in the memorandum. Even though their reply was due by June 27, 2003, the owners did not submit a written response. We subsequently contacted the owners on more than one occasion requesting their written response. The owners promised to send the information via facsimile. However, as of the date of this report, we have not received their reply. Thus, we are issuing this memorandum without their comments. The HUD Houston Multifamily Program Center agreed with our memorandum and its recommendations. Their comments are included in their entirety in Appendix B.

RECOMMENDATIONS

We recommend that the HUD Houston Multifamily Program Center:

1A. Terminate the owners' self-management of the project and require the owners to hire an independent management agent that is acceptable to HUD to operate the project.

1B. Require the new management agent to establish and implement written policies and procedures for general operations, rent collections, disbursements, maintenance, and financial reporting.

1C. Require the owners to correct the physical deficiencies cited in REAC's March 2003 inspection or declare the owners in default of the mortgage.

1D. Require the owners to either repay the project the following amounts or offset the management fee owed to the owners by the following amounts:

- a) \$1,365 collected but not deposited,
- b) \$4,000 paid to the owners' wives for overseeing project operations in 2000, and
- c) \$9,262 paid to Sherjeet Grewal and other contractors but not supported by invoices.

1E. Require the owners to determine the amount paid to their CPA for costs other than their annual audit. HUD should then require the owners to either repay the project or offset the management fee owed to the owners for that amount.

1F. Require the owners to complete audited annual financial statements for 2002 or seek civil penalties against the owners for failure to submit the financial statements.

1G. Require the new management agent to complete an Affirmative Fair Housing Marketing Plan.

¹¹ HUD Handbook 4381.5, Chapter 7, section 7.3(b)(5).

Management comments are attached and include management decisions, planned actions and planned action dates. No further action is required. Should you or your staff have any questions, please contact Theresa Carroll, Assistant Regional Inspector General for Audit, at (817) 978-9309.

MANAGEMENT CONTROLS

In planning and performing our review, we considered the management controls relevant to the HUD insured Multifamily Housing program to determine our review 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.

We determined that the following categories contained management controls relevant to our review objectives:

- General operations,
- Disbursements,
- Maintenance,
- Rental Collections, and
- Financial Reporting.

It is a significant weakness if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet an organization's objectives. Based on our review, we believe the following item is a significant weakness:

- Owners lack written policies and procedures for general operations, disbursements, maintenance, rental collections, and financial reporting.

SCHEDULE OF QUESTIONED COSTS AND FUNDS PUT TO BETTER USE

<u>Recommendation Number</u>	<u>Type of Questioned Cost</u>	
	<u>Ineligible¹²</u>	<u>Unsupported¹³</u>
1D. a)	\$1,365	
1D. b)	\$4,000	
1D. c)		\$9,262

¹² 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.

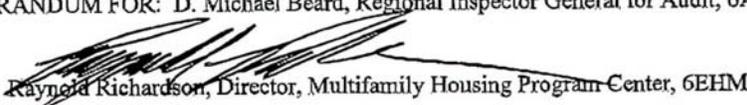
¹³ Unsupported costs are costs charged to a HUD-financed or HUD-insured program or activity and eligibility cannot be determined at the time of review. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the costs. 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.



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June 30, 2003

MEMORANDUM FOR: D. Michael Beard, Regional Inspector General for Audit, 6AGA

FROM:  Raymond Richardson, Director, Multifamily Housing Program Center, 6EHM

SUBJECT: Audit Memorandum on Colonial Oaks Apartments
Houston, Texas

This is in response to your memorandum dated June 11, 2003, relative the draft findings for the subject audit.

We agree with the OIG findings and recommendations with the exception of one change to recommendation 1F. The REMS system indicates the Audited Financial Statement for FYE 2001 has been received and reviewed by FASS. Therefore, recommendation 1F should reflect that only the 2002 financial statement remains outstanding.

In addition, we are providing you with our management decisions on the recommendations at this time as follows:

IG RECOMMENDATIONS

1A. Corrective Action Taken: Letter forwarded to owner dated June 30, 2003, directing owner to hire an independent management agent that is acceptable to HUD to operate the development.

Proposed Corrective Action and Proposed Completion Date: Proposed completion date is August 1, 2003.

Why Action is Considered Unnecessary: N/A

1B. Corrective Action Taken: Letter forwarded to owner dated June 30, 2003, directing owner to hire an independent management agent that is acceptable to HUD to operate the development.

Proposed Corrective Action and Proposed Completion Date: Once new agent is selected by the Owner, this office will communicate to agent to establish and implement written policies and procedures for general operations, rent collections, disbursements, maintenance, and financial reporting. Proposed completion date is August 1, 2003.

Why Action is Considered Unnecessary: N/A

1C. Corrective Action Taken: Notice of Regulatory Agreement was forwarded by the Fort Worth Multifamily HUB and the Departmental Enforcement Center dated April 21, 2003, regarding the March 4, 2003, REAC inspection score of 31c*.

Proposed Corrective Action and Proposed Completion Date: Owner response was due June 21, 2003. This office is waiting on the re-inspection of development that is in accordance with the protocols with the DEC and REAC.

Why Action is Considered Unnecessary:

1D. Corrective Action Taken: Letter will forwarded to owner directing owner to repay (a) \$1,365 collected but not deposited; (b) \$4,000 paid to owners' wives for overseeing project operations in 2000; and (c) \$9,262 paid to Sherjeet Grewal and other contractors but not supported by invoices.

Proposed Corrective Action and Proposed Completion Date: Proposed completion date is August 1, 2003.

Why Action is Considered Unnecessary: N/A

1E. Corrective Action Taken: Letter forwarded to owner instructing owner to determine the amount paid to their CPA for costs other than their annual audit. HUD will require owners to offset the management fee owed to the owners for that amount.

Proposed Corrective Action and Proposed Completion Date: Proposed completion date is August 1, 2003.

Why Action is Considered Unnecessary: N/A

1F. Corrective Action Taken: Letter forwarded to owner dated requiring owners to complete annual audit financial statements for 2002. The REMS system indicates that the audited financial statement for 2001 has been received and reviewed by FASS.

Proposed Corrective Action and Proposed Completion Date: Proposed completion date is August 1, 2003.

Why Action is Considered Unnecessary: N/A

1G. Corrective Action Taken: Letter forwarded to owner dated June 30, 2003, directing the hiring of new management agent.

Proposed Corrective Action and Proposed Completion Date: Once new agent is selected, this office will require the submission of an updated Affirmative Fair Housing Marketing Plan. Proposed completion date is August 1, 2003.

Why Action is Considered Unnecessary: N/A

If you need additional information, please contact me at (713) 313-2274 extension 7063.

Cc: Payne-McGuigan, 6EHMA
Carter, 6EHMA
Davis, 6EHMA

DISTRIBUTION

Colonial Oaks Apartments, Houston, Texas

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