



Issue Date June 29, 2006

Audit Report Number 2006-KC-1011

TO: Herman Ransom, Director, Office of Multifamily Housing,
Kansas City HUB, 7AHM

Margarita Maisonet, Director of the Departmental Enforcement Center, CV

//signed//

FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: The Owner of Wellston Townhouses in St. Louis County, Missouri, Violated Its
Regulatory Agreement

HIGHLIGHTS

What We Audited and Why

We audited Wellston Townhouses, a 63-unit project located in St. Louis County, Missouri. We selected this project for audit based on a request from the U. S. Department of Housing and Urban Development's (HUD) Office of Housing. Our audit objective was to determine whether the owner and management agent used project funds in compliance with the regulatory agreement and HUD's requirements.

What We Found

Wellston Townhouses' managing owner (owner) did not use project funds in compliance with the regulatory agreement. It also violated several other terms of the agreement. The owner violated the regulatory agreement because it viewed its projects as interdependent and not individually viable. These violations, totaling \$304,660, adversely affected the project's financial stability.

What We Recommend

We recommend that HUD take appropriate actions to correct deficiencies and ensure that these violations will not occur in the future.

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

Auditee's Response

The owner generally disagreed with our findings. We provided the draft report to the owner on May 9, 2006. The owner provided written comments on June 12, 2006. The complete text of the owner's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

Wellston Townhouses is a scattered-site project consisting of 63 Section 8 units located in St. Louis County, Missouri. Townhouses Ltd., a profit-motivated partnership, owns the project. The U.S. Department of Housing and Urban Development (HUD) insures the project under its Section 221(d)(4) mortgage insurance program.

The owner signed a regulatory agreement on December 5, 1978, that governs the project's operations. Majestic Management has managed the project since March 1, 2005. Before that, Human Development Community Development Corporation, a related entity, managed the project and two other HUD-insured projects, one of which was assigned in 2004.

On December 31, 2003 and 2004, the project was in a negative surplus cash position.

Our audit objective was to determine whether the owner/management agent of this property used project funds in compliance with the regulatory agreement and HUD's requirements.

RESULTS OF AUDIT

Finding: Owner's Actions Violated Regulatory Agreement

Wellston Townhouses' managing owner (owner) did not use project funds in compliance with the regulatory agreement. It also violated several other terms of the agreement. The owner violated the regulatory agreement because it viewed its projects as interdependent and not individually viable. These violations, totaling \$304,660, adversely affected the project's financial stability.

Regulatory Agreement Violations

The owner did not follow the regulatory agreement requirements (see appendixes C and D). The owner

- Allowed liens,
- Improperly allocated shared payroll expenses,
- Made unauthorized distributions,
- Paid itself unallowable management fees,
- Underfunded tenant security deposits,
- Retained tenant rent credits, and
- Withheld required financial reports and plans.

Liens

The owner allowed the sewer district to place liens on the project. As of December 31, 2005, the owner had not paid \$158,491 in sewer fees, interest, and penalties. The sewer bill consisted of \$101,338 for service and \$57,153 for late fees, filing fees, and interest. The late fees, filing fees, and interest accumulated because the owner did not pay the project's sewer expense. Penalties of this type are not ordinary or necessary for the project's operation.

Payroll Allocation

The owner did not properly allocate payroll expenses for maintenance and administrative staff. The owner did not require these employees to track the time they spent performing duties for other projects. The books and records did not

show that the \$88,784 in payroll expenses during our audit period was reasonable and necessary for project operation.

Asset Distributions

The owner, without prior HUD approval, distributed \$40,271 in project assets when there was no surplus cash. These distributions involved

- \$22,589 reimbursed to related entities for prior advances and deposit errors without HUD approval,
- \$8,817 in rents diverted by the owner after new management was in place and later repaid to the project, and
- \$8,865 consisting of \$5,453 in excess management fees paid in 2003, \$2,642 paid to the City of St. Louis for water at another project, and \$770 paid to the management agent for a board of directors' meeting.

Management Fee

The owner did not comply with HUD instructions in a timely manner. On September 12, 2003, HUD instructed the owner to obtain independent project management and not to pay itself management fees after November 1, 2003. The project did not obtain new management until March 1, 2005. The owner collected unallowable management fees totaling \$33,420 after the stated deadline. This amount includes \$2,220 paid by a related entity and booked as an account payable.

Tenant Security Deposits

The owner improperly used tenant security deposits. As of December 31, 2005, the tenant security deposit account was underfunded by \$12,056. This violation began in 2003 when the owner transferred security deposit funds to the project's operating account.

Rent Credits

The owner improperly retained tenant rent credits. When retroactive changes at recertification created rent credits the project manager did not issue refunds to tenants. As of December 31, 2005, the project owed \$3,034 to 26 tenants. Eleven of the tenants were owed between \$100 and \$400.

Financial Reports and Plans

The owner did not submit required monthly accounting reports, action plan and operating budget, or audited financial statements.

The owner did not comply with repeated requests for monthly accounting reports. The project manager prepared the required reports but stopped submitting them to HUD after being told to obtain a new management agent. HUD uses these reports to monitor the project's revenues, disbursements, and obligations. HUD did not receive these reports from August 2003 through February 2005.

The owner, as requested by HUD in April 2004, submitted both an action plan and current operating budget, but HUD rejected them. The owner did not resubmit the items. The action plan was intended to improve and/or correct financial, management, control systems, and operational deficiencies. HUD uses action plans and budgets to analyze the needs of the project and provide a means for monitoring its financial stability.

The owner did not provide audited financial statements for 2004 as required by the regulatory agreement. After a new management agent was obtained in 2005, HUD's Departmental Enforcement Center informed the owner that HUD was considering assessing civil money penalties of \$32,500. The certified public accountant completed the 2004 audit report on March 31, 2006.

Owner's Reasoning

The owner viewed its projects as interdependent and not individually viable. The owner did not establish effective written procedures and controls because it wanted fiscal flexibility to meet expenses. The owner

- Did not pay the sewer bills because this service could not be shut off like other utilities,
- Believed it was too time consuming and costly to accurately track employee time,
- Thought it was allowable to repay other entities without obtaining HUD approval,
- Had a standard practice of taking estimated monthly management fees,
- Felt entitled to management fees for work performed after HUD had requested termination of its services,
- Had a standard practice of using security deposits for operating expenses and then reimbursing the account upon receipt of reserve for replacement funds, and
- Thought it was allowable to delay notifying tenants who were due rent reimbursements.

Financial Stability Affected

The owner allowed the project's financial stability to deteriorate through these regulatory agreement violations totaling \$304,660, including unsupported payroll and liens on the property. (see appendix A). The owner repeatedly denied HUD access to financial reports needed to monitor the project's condition. These reports would have indicated to HUD that the owner used project funds for unauthorized purposes and allowed the project's financial stability to deteriorate.

Recommendations

We recommend that the director of HUD's Kansas City Multifamily Housing Hub require the owner to

- 1A. Develop and implement procedures and controls to ensure that future disbursements of project assets comply with the regulatory agreement and HUD's requirements, including a cost allocation plan to maintain adequate books and records.
- 1B. Pay \$57,153 in sewer fees and interest from nonproject funds and initiate action to pay \$101,338 from project funds to cure sewer liens.
- 1C. Provide documentation to support the \$88,794 in unsupported payroll costs or reimburse the project's reserve for replacement account the applicable portion that cannot be supported as necessary to the project.
- 1D. Deposit \$8,865 for improper owner distributions into the project's reserve for replacements or a restricted capital account which requires HUD approval for release of the funds.
- 1E. Deposit \$31,200 for disallowed management fees into the project's reserve for replacements or a restricted capital account which requires HUD approval for release of the funds and eliminate the \$2,220 account payable HDC Retirement Village.
- 1F. Properly fund the tenant security deposit account with \$12,056.
- 1G. Reimburse tenants from project funds \$3,034 for their prepaid rent.

We also recommend that HUD's director of the Departmental Enforcement Center

- 1H. Pursue civil money penalties and administrative sanctions, up to and including debarment as appropriate, against the owner, management agent, and/or their principals/owners for their part in the regulatory violations cited in this report.

SCOPE AND METHODOLOGY

Our review generally covered the period from January 1, 2004, through December 31, 2005. To achieve our objective, we conducted interviews with the project management staff, HUD Departmental Enforcement Center staff, and HUD Office of Multifamily Housing staff. We also reviewed federal laws, regulations, and requirements. We also reviewed sewer district records.

To determine whether the owner used project funds for reasonable operating expenses and necessary repairs as required by the regulatory agreement, we reviewed the project's

- Monthly accounting reports,
- Cash disbursements ledger,
- Bank statements,
- Check stubs,
- Supporting documentation,
- Audited financial statements, and
- Regulatory agreement.

We reviewed all disbursements that exceeded \$250. Because we identified problems with shared expenses, we also reviewed all payroll and office rent disbursements. During our audit period there were 289 operating account disbursements totaling \$339,238. We reviewed 203 of these disbursements totaling \$331,515.

As a result of this review, we identified the regulatory agreement violations addressed in the finding. We discussed our results with the owner, as well as HUD staff, to obtain clarification and agreement.

We performed audit work from October 2005 through March 2006, at Majestic Management's office, 3920 Lindell, St. Louis, Missouri. The audit was conducted in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Compliance with laws and regulations - policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

We assessed the relevant controls identified above.

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

Significant Weaknesses

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

- The owner did not have adequate procedures in place to ensure project assets and income were distributed in compliance with the regulatory agreement (see finding).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1B	\$57,153		\$101,338
1C		\$88,794	
1D	\$8,865		
1E	\$33,420		
1F	\$12,056		
1G			\$3,034
Totals	\$111,494	\$88,794	\$104,342
		Grand total	\$304,660

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local polices or regulations.
- 2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a 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/ “Funds to be put to better use” are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. Our estimate reflects only the initial year of these recurring benefits.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

June 12, 2006

Ronald J. Hosking
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Region 7 office of Audit
Gateway Tower II
Kansas City, Kansas 66101-2406

SUBJECT: THE ALLAGE ALLOCACATION ON WELLSTON TOWNHOUSES

Dear Mr. Hosking:

Response to an audit report of Wellstone Townhouses, issued by the Regional Office of the Inspector General on regulatory agreement violations.

Comment 1

1. Filing of a lien by MSD – It is true that a lien was filed and is currently in place. However, management could not have prevented this lien from being filed by an independent agency, without adequate rent increases for which the Department of Housing and Urban Development did not approve or offer any assistance in resolving. If the Department of Housing and Urban Development wanted to protect its interest in the development it would have provide the funding that could have prevented the filling of a lien. Management has a plan for paying off the assessment and then to negotiate a reduction of late fees and penalties. MSD has continued to provide service to the project and has not threatened any other type of legal action.

Comment 2

2. Payroll Allocation – Management disagrees with the improper assessment of payroll allocation. Management believes that work performed is proof that all needed repairs and administrative duties required were provided to the project on an as needed daily basis and that employees of the project provided equal time to each project. This can be certified by employee work records. Personnel were allocated based on the agreed budget and workers were assigned to each project according to the budget. If special needs arose at another development efforts were made to allocate the cost back to that development. Statements made by the inspectors concerning the staff are false and should not be included in this report. The audit finding does not suggest that any lack of care was evident or that time cards were not maintained for each employee. Management does not believe that time cards would have changed any of the service received by the project. Time card allocation alone does not substantiate proper distribution of cost and is not currently used in many business practices. Staff assignments and allocations of resources is the responsible of the management agency and does not violated the management agreement. Management also disagrees with any outside entities trying to define the best method of allocating the use of staff and the way it is reported.

We strongly disagree of any inclusion of any employee wages being in this report.

Comment 3

3 Unauthorized Distributions – We disagree with the finding. Management admits that prior approval was not always obtained from HUD, but does not agree that this action put the project at risk. No funds of the development were use for any purpose other than the maintenance of the project. The owners appealed the request to change management and felt that it was entitled to manage the project and receive fees until a new management firm was in place. Management was making effort to hire and put in place a new management agency. Two local agents turned down a request to manage the project because it was evident that HUD was not supportive of us in managing the property, by not granting necessary rent increases and delaying the release of replacement reserves to the project. Budget submission to HUD showing the true cost for meeting the needs of the development were submitted and they were rejected by the Department of Housing and Urban Development with no offers of assistance to bring the development into compliance. Management is not shifting its responsibilities for any delays in insuring both the success and viability of a new management agency and the project. St. Louis HUD office promised to assist the project if management was changed. To date no assistance from HUD have been forth coming. The founder and Executive Director of the project was ill and we requested HUD’s understanding and assistance in trying to obtain a new management agent. During this transition Mr. Brown was more ill than first perceived by the Board of HCDC, as later confirmed by hospital stays and his death. We want to commit to HUD that we are taking steps to ensure future compliance.

Comment 4

3. Management fee – We strongly disagree with the finding. It is our position that until a new management agency was in place and properly functioning that management fees were properly paid to the management agency doing the work. Someone had to keep the project going and respond to the needs of tenants, collect rents and pay bills for the project. This work was done by HCDC while a search was being made to find and put into place a new management agency. No management fees were paid after a new agent was employed. It would not be expected that any one would manage the project without compensation for its time and efforts. Any amount listed as management fees should be excluded from this report and it would be improper to not pay for services received by the project.

Comment 5

4. Tenant Security Deposits – We agree that security deposits were temporarily used to meet the every increasing demands of the project, while we waited for the release of funds by HUD from our reserves. It should be noted that request for funds out of the replacement reserve were often delayed by the department of Housing and Urban Development without any explanation. The project underwent an increased number of inspections and delays in the release of funds could have resulted in the project not passing the inspections.

Comment 6

We have repaid the security account and steps have been taken to insure their protection in the future.

5. Prepaid Rents – We disagree with the finding. Management conducted an annual review of each tenants account and to make any adjustments needed to balance tenant rents with amounts due. Also when a tenant moved out the final adjustment in terms of rent due or owed was balanced against damage claims and or other factors in their rental agreement. Management never used or misused tenants accounts. Most of the funds in this account were owed to the development when the tenants moves out and was refunded if it was due to the tenant. Often this is the only way to maintain the unit if a tenants moves out without proper notification.

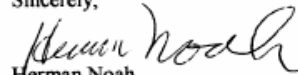
Comment 7

7. Financial Reporting – Financial reports were prepared and forwarded to the holder of the projects mortgage and The Board of Directors were not aware that these reports were not being received by HUD, due to Mr. Browns failing health that resulted in his death. Monthly reports and accounting records were prepared and maintained by the management agency. Until HUD released funds to the new management firm for the payment of the past due audit we could not contract with a new firm to produce the report.

It should be noted that the owner/manager did employ a new management agency and the project is in compliance with all current agreements. The owners have taken steps to dispose of the property and will no longer manage it or any other HUD projects once the sell is completed. HUD'S interest in the project will be protected and any outstanding obligations of the development will be disposed of.

We request that no action be taken that could jeopardize the sell of the project and result in the sale not being completed which will truly jeopardized HUDS security interest and put the welfare of the tenants of the Wellston Townhouses at risk.

Sincerely,



Herman Noah,
Chairman of the Board

OIG's Evaluation of Auditee Comments

Comment 1

The owner should have prevented local sewer company liens by properly paying the project's sewer bill. The owner indicates that this nonpayment was the result of inadequate HUD funding. HUD was not responsible for paying the project's sewer bill. It is the owner's responsibility to properly pay the sewer bill. If the owner had paid this expense, it would have met its contractual obligation to keep the property free of liens and avoided violating the regulatory agreement.

Comment 2

The owner indicates that "... employees of the project provided equal time to each project." This is representative of our concerns. When the owner does not properly allocate employee time between projects, HUD has no assurance that any of the projects' expenses are reasonable and necessary or accurate. The owner has a contractual obligation under the regulatory agreement to only incur reasonable and necessary expenses. Expenses which benefit another project are not reasonable or necessary to Wellston Townhouses. The owner has previously indicated to OIG that they:

- Do not keep timesheets or record the amount of time spent on each project,
- Employ three maintenance men and each project pays the salary of one maintenance man who works on all projects,
- Have a work order system, but it does not track which man performed the work, time spent, supplies used or the project charged, and
- Allocate employee time based on what the project can afford rather than how much time or supplies it requires.

The owner should be required to properly allocate employee time to the project receiving the benefit. If the owner had properly allocated these expenses the owner would have met its contractual obligation to only incur reasonable and necessary project expenses and avoided violating the regulatory agreement.

Comment 3

The owner's statement that "no funds of the development were used for any purpose other than the maintenance of the project" lacks validity. The payment of \$5,453 in excess management fees paid in 2003, \$2,642 paid to the City of St. Louis for water at another project, and \$770 paid to the management agent for a board of directors' meeting are all expenses that are not reasonable or necessary project expenses. The \$22,589 reimbursed to related entities for prior advances and deposit errors and the \$8,817 in rents diverted by the owner all benefited other projects and the owner and these assets were distributed without prior HUD approval. The owner should be required to obtain prior HUD approval before project assets are distributed to either the owner or to related entities. If the owner had

requested HUD approval prior to making disbursements for the owner's or related entity's benefit the owner would have met its contractual obligation and avoided violating the regulatory agreement. Requesting HUD's approval and not getting it would have kept project funds for the project's use and benefit.

Comment 4

HUD's instructions were clearly stated in the September 12, 2003, letter. HUD told the owner not to pay itself management fees after November 1, 2003. When the owner chose to ignore HUD's instructions and pay itself management fees, these fees became unreasonable and unnecessary project expenses. The owner should have complied with HUD's instructions. Since this was not the case, the owner did not meet its contractual obligation under the regulatory agreement to only incur reasonable and necessary project expenses.

Comment 5

The owner should have kept security deposit funds separate and apart from all other funds of the project in a trust account. The amount in this account should have always been equal to or more than the aggregate of all outstanding obligations under said account. Tenant security deposits should not, for any reason, be used for demands of the project. If the owner had maintained the tenant security deposit in the proper manner, the owner would have met its contractual obligation and avoided violating the regulatory agreement.

Comment 6

The owner's comments are not responsive to the issue at hand. Tenants are owed refunds of rent they had over paid. The regulatory agreement requires that only the proper amount of rent be collected. If the owner collects excess rent, the owner must notify the tenant and refund the rent. Maintaining rent credits for use at move out to cover damages violates the regulatory agreement.

Comment 7

HUD was very clear in its instructions to the owner. The owner did not comply with repeated requests for monthly accounting reports and did not provide audited financial statements for 2004 as required by the regulatory agreement. The owner did submit both an action plan and current operating budget, but HUD rejected them. The owner did not resubmit these items. Forwarding the financial reports to the mortgage holder and the Board of Directors, Mr. Brown's health and HUD's release of funds have no bearing on these issues. The owner's actions have violated the regulatory agreement.

Appendix C

SCHEDULE OF REGULATORY AGREEMENT VIOLATIONS

Regulatory agreement violations	Applicable sections
Allowing liens	8 (a)
Improperly allocating shared payroll expenses	12 (c) 12 (d)
Making unauthorized asset distributions	8 (b) 8 (e)
Paying unallowable management fees	12(a)
Underfunding tenant security deposits	8 (g)
Retaining tenant rent credits	5 (b)
Withholding financial reports and plans	12 (e) 12 (f)

Appendix D

REGULATORY AGREEMENT PROVISIONS

Paragraph 5 –

- (b) The maximum rent for each Section 8 unit is stated in the Housing Assistance Payments Contract and adjustments in such rents shall be made in accordance with the terms of the Housing Assistance Payments Contract.

Paragraph 8 –

Owners shall not without the prior written approval of the Secretary:

- (a) Convey, transfer, or encumber any of the mortgaged property, or permit the conveyance, transfer, or encumbrance of such property.
- (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.
- (c) Make, or receive and retain any distribution of assets or any income of any kind of the project except surplus cash and except on the following conditions:
 - (1) All distributions shall be made only as of and after the end of a semiannual or annual fiscal period, and only as permitted by the law of the applicable jurisdiction, and, in the case of a limited distribution mortgagor, all distributions in any one fiscal year shall be limited to six per centum on the initial equity investment, as determined by the Secretary which shall be cumulative;
 - (2) No distribution shall be made from borrowed funds, prior to the completion of the project or when there is any default under this Agreement or under the note or mortgage;
 - (3) Any distribution or any funds of the project, which the party receiving such funds is not entitled hereunder, shall be held in trust separate and apart from any other funds; and
 - (4) There shall have been compliance with all outstanding notices of requirements for proper maintenance of the project.
- (g) Require, as a condition of the occupancy or leasing of any unit in the project any consideration or deposit other than the prepayment of the first month's rent, plus a security deposit in an amount not in excess of one month's rent (the gross family contribution in Section 8 units) to guarantee the performance of the covenants of the lease. Any funds collected as security deposits shall be kept separate and apart from all other funds of the project in a trust account the amount of which shall at all times equal or exceed the aggregate of all outstanding obligations under said account.

Paragraph 12 -

- (a) Any management contract entered into by Owners or any of them involving the project shall contain a provision that, in the event of default hereunder, it shall be subject to termination without penalty upon written request by the Secretary. Upon such request, Owners shall immediately arrange to terminate the contract within a period of not more than thirty (30) days and shall make arrangements satisfactory to the Secretary for continuing proper management of the project.

- (c) The mortgaged property, equipment, buildings, plans, offices, apparatus, devices, books, contracts, records, documents, and other papers relating thereto shall at all times be maintained in reasonable condition for proper audit and subject to examination and inspection at any reasonable time by the Secretary or duly authorized agents of the Secretary. Owners shall keep copies of all written contracts or other instruments which affect the mortgaged property, all or any of which may be subject to inspection and examination by the Secretary or duly authorized agents of the Secretary.
- (d) The books and accounts of the operations of the mortgaged property and of the project shall be kept in accordance with the requirements of the Secretary.
- (e) Within sixty (60) days following the end of each fiscal year, the Secretary shall be furnished with a complete annual financial report based upon an examination of the books and records of mortgagor prepared in accordance with the requirements of the Secretary, certified to by an officer or responsible Owner and, when required by the Secretary, prepared and certified by a Certified Public Accountant, or other person acceptable to the Secretary.
- (f) At request of the Secretary, or duly authorized agents of the Secretary, the Owners shall furnish monthly occupancy reports and shall give specific answers to questions upon which information is desired from time to time relative to the income, assets, liabilities, contract, operation, and condition of the property and the status of the insured mortgage.