



Issue Date December 7, 2005

Audit Report Number 2006-LA-1003

TO: Janet L. Browder, Director, San Francisco Multifamily HUB, 9AHMLA

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: Owners of The Avenue, San Francisco, California, Misused More Than \$32,000
in Project Funds

HIGHLIGHTS

What We Audited and Why

We audited The Avenue (project), a Section 232 assisted living facility. We initiated the audit in response to a request for audit from the Department of Housing and Urban Development's (HUD) San Francisco Office of Multifamily Housing. Our objectives were to assess HUD's concerns and determine whether project funds were administered in compliance with the regulatory agreement and HUD requirements.

What We Found

San Francisco Care Center, L.P. (owner) improperly used \$32,851 in project funds from February through July 2005. The questionable disbursements included \$31,051 in excessive payments to Legacy Management Systems for a food service contract and \$1,800 to Eagle Wong for ineligible Feng Shui consulting services. The inappropriate disbursements reduced the funds available for necessary expenses and, therefore, increased the risk of mortgage default. They occurred because the owner/management ignored HUD requirements and failed to ensure adequate controls over procurement and disbursements were in place.

What We Recommend

We recommend that the director of HUD's San Francisco Multifamily HUB require The Avenue's owner/management to implement contracting and disbursement procedures in accordance with HUD requirements. We also recommend that HUD require the owner, San Francisco Care Center, L.P., to repay The Avenue from nonproject funds \$31,051 for the excessive contract payments for the food service contract and \$1,800 for the ineligible Feng Shui consulting expense.

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

We provided our discussion draft audit report to the owner's general partner on October 21, 2005, and held an exit conference on October 28, 2005. The owner's general partner provided written comments on November 7, 2005. The owner generally disagreed with our report findings.

The owner also submitted revised purchasing and disbursement procedures with the response. We reviewed the revised procedures and determined they meet HUD requirements.

The complete text of the auditee'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

The Avenue is a 145-bed assisted living facility constructed in 2004. The project is owned by San Francisco Care Center, L.P., the general partner of which is Van Ness Care Center, Inc. Two of San Francisco Care Center's limited partners are also owners and agents of the general partner and, together, control the ownership entity and the project's operations. In June 2002, the owner obtained a \$23,108,000 HUD-insured mortgage loan from Pacific Commonwealth Mortgage Company for the construction of the project. In June 2005, the owner submitted to HUD the project's cost certification, prepared by a certified public accounting firm, which included construction and operating costs through December 31, 2004.

In the request for audit, dated April 29, 2005, HUD expressed concerns over the owner's misuse of project funds. Therefore, our objectives were to determine whether concerns raised by HUD have merit and to assess whether project funds were administered in compliance with the regulatory agreement and HUD requirements.

In May 2005, the owner hired a third party management agent as required by HUD. During our review, the owner's managing general partner (management) continued to make all decisions for the project's daily operations.

Although The Avenue began operations in November 2004, it has been unable to generate sufficient cash flow to cover its mortgage payment and operating expenses. As of September 30, 2005, the most recent five mortgage payments were paid using the project's operating deficit escrow. The remaining balance of the operating deficit escrow can support three mortgage payments. However, the project's property taxes and insurance, due in November 2005, will exhaust the operating deficit escrow unless the owner pays these expenses with additional contributions. Further, it appears the owner must contribute additional funds to keep the mortgage current for subsequent months because the project cannot afford the mortgage at its current occupancy level.

RESULTS OF AUDIT

Finding 1: The Avenue Overpaid \$31,051 for a Food Service Contract

The Avenue overpaid \$31,051 to Legacy Management Systems (Legacy) for a food service contract for the period of December 2004 through June 2005. Excessive payments were made because management did not consider obtaining project services at a reasonable cost a priority and disregarded HUD's procurement requirements. While management did eventually remedy the situation by obtaining a lower-priced contract, the excessive costs left less funding available for debt service and increased the risk of mortgage default.

The Avenue Entered into an Unreasonable Food Service Contract

The Avenue paid Legacy \$135,844 for food services provided between December 16, 2004, and June 30, 2005. The owner/management admitted to contracting with Legacy on November 15, 2004, without soliciting quotes from other potential contractors to ensure the contract price was reasonable. The owner disregarded HUD Handbook 4381.5, REV-2, section 6.50, which requires the owner to solicit written cost estimates from at least three contractors for any contract expected to exceed \$10,000 per year. Instead, the owner relied on the recommendation of its former management consulting firm, Paradigm Senior Living.

Furthermore, the owner stated she knew the contract price was unreasonable as early as December 2004 but chose not to take any action to remedy the situation for seven months. The Avenue's regulatory agreement dictates that payments for services must not exceed the amount ordinarily paid in the area where the services are rendered. It was unreasonable for the owner to enter into this contract and then allow the contract to continue, knowing it was excessive, without taking immediate steps to remedy the situation.

Finally, in July 2005, the owner/management renegotiated with Legacy for a lower price contract and was granted a \$30,000 credit on the unpaid balance. In the new contract, Legacy agreed to charge 48 percent less for the fixed portion of the semimonthly charge based on serving 20 residents (\$8,061 versus \$15,469) and 54 percent less for each additional resident day (\$5.60 versus \$12.10). The original contract was unreasonable because the minimum semimonthly charge for serving up

to seven residents was \$9,904 and it also allowed extra payments for additional residents served, while the new contract amount charged less (\$8,061) yet allowed services for as many as 20 residents.

After applying the \$30,000 credit, The Avenue paid \$135,844 to Legacy for the fixed and variable portion of the contract for food services provided between December 16, 2004, and June 30, 2005 under the initial contract terms. However, the project would have only been obligated to pay \$104,793 over the same six-and-a-half-month period (\$8,061 semimonthly charge for up to 20 residents for six and a half months) under the new contract terms even without the benefit of graduated payments based on lower occupancy. The difference of \$31,051 represents an overpayment of project funds for services, which could have been avoided if the owner had followed proper procurement procedures from the outset.

These actions show the owner did not place a proper priority on ensuring project services were obtained at a reasonable cost. The excessive payments were made because the project did not have any procurement policies and procedures when it entered into the initial contract. The excessive cost of the contract reduced funds available for project operations and debt service, therefore, increasing the risk of mortgage default.

Along with its written comments to our draft report, the owner submitted revised purchasing procedures to include procurement procedures. We reviewed these procedures and determined they meet HUD procurement requirements.

Recommendations

We recommend that the director of HUD's San Francisco Multifamily HUB require

- 1A. The owner/management to implement the written procurement policies and procedures submitted with the comments in accordance with HUD requirements.
- 1B. The owner to repay The Avenue \$31,051 from nonproject funds for the excessive contract payments for the food service contract.

RESULTS OF AUDIT

Finding 2: The Avenue Paid \$1,800 for Ineligible Project Expense

The Avenue improperly used \$1,800 for Feng Shui consulting services not necessary for the project's operations. We attribute this inappropriate disbursement to the owner's/management's disregard for HUD requirements and inadequate controls to ensure only necessary and reasonable project expenses with proper support were paid. The project, consequently, had less funding available for its operations.

The Avenue Paid \$1,800 for Feng Shui Consulting Services

The Avenue paid \$1,800 to Eagle Wong for Feng Shui consulting services on March 17, 2005. The owner/management hired the Feng Shui consultant based on a personal belief that Feng Shui could help create a harmonious atmosphere and better living environment for the staff and residents. The owner/management attempted to justify the Feng Shui consulting services for the project with a design award the project received from a magazine. However, the owner/management could not provide anything to show that the Feng Shui consulting services expense was necessary and reasonable for the operations of a senior assisted living facility, as required by HUD Handbook 4370.2, REV-1, chapter 2-6, paragraph E. The owner/management also could not produce a supporting invoice for the disbursement, as required by the handbook. The ineligible expense was paid due to the lack of effective procedures and controls over project disbursements. As a result, the project had less funding available to pay for its reasonable and necessary expenses.

Along with its written comments the owner subsequently revised the purchasing procedures to ensure only authorized project expenses with proper supporting documentation are paid. We determined the revised procedures meet HUD requirements.

Recommendations

We recommend that the director of HUD's San Francisco Multifamily HUB require

2A. The owner/management to implement the revised written disbursement policies and procedures to ensure the project only pays for necessary and reasonable project expenses with proper supporting documents.

2B. The owner repay The Avenue \$1,800 from nonproject funds for the ineligible Feng Shui consulting expense.

SCOPE AND METHODOLOGY

We performed the review at HUD's San Francisco regional office and the project site from June through September 2005. To accomplish our objectives, we interviewed officials of the San Francisco HUD Multifamily HUB; San Francisco Care Center, L.P., the project's owner and management; Mok, Shen & Company, an identity-of-interest firm that provides bookkeeping services to the project; Paradigm Senior Living, a former management consultant; Michel Augsburger & Cluney Stagg, the project's HUD-approved management agent; Pacific Commonwealth Mortgage Company, the lender; and Legacy Management Systems.

To determine whether the owner/management used project funds in compliance with the regulatory agreement and HUD requirements, we reviewed

- The project's regulatory agreement,
- HUD handbook requirements,
- HUD files and correspondence related to the project,
- HUD's Real Estate Management System information related to the project,
- The owner's partnership agreement,
- The owner's mortgage documents with Pacific Commonwealth Mortgage Company,
- The owner's financial records such as bank statements, canceled checks, and general ledgers,
- The project's cost certification,
- The project's financial records such as bank statements, canceled checks, and general ledgers,
- The project's contract with the management agent, and
- The management agent's certification.

Our review generally covered the period from January 1, 2003, through June 30, 2005. This period was adjusted as necessary. We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

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

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 control was relevant to our audit objectives:

- Policies and procedures that management has in place to reasonably ensure the HUD-insured assisted living project was administered in accordance with the regulatory agreement and HUD requirements.

We assessed the relevant control 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 Avenue lacked effective procurement and disbursement procedures and controls to reasonably ensure project funds were used in compliance with the regulatory agreement and HUD requirements (see findings 1 and 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/
1B	\$31,051
2B	\$1,800

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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Comment 1

Comment 2
Comment 3

Comment 4

Comment 5

THE AVENUE
1035 Van Ness Avenue San Francisco, CA 94109
Tel: (415) 776-1800 Fax (415) 776-6800

November 3, 2005

Office of Inspector General
Attn: Joan S. Hobbs, Regional Inspector General for Audit, Regional IX, 9DGA
611 West Sixth Street, Suite 1160
Los Angeles, Ca 90017-3101

Re: Response to San Francisco Care Center Audit Report

Ms. Hobbs:

This letter is written to respond statements made in the draft of the findings of your OIG audit.

1. Finding 1

A. Develop and Implement Written Procurement Policies and Procedures
The Procurement policies and procedures that are in compliance of HUD requirements are attached.

B. Repay The Avenue \$119,234
Regarding the calculation of overpayment, the auditors have taken incorrect assumptions in their calculations. In July 2005 the Owner renegotiated with Legacy for a contract that provided for a lower price and gave the project back a \$30,000 credit. The credit was given for services that were not used based on an expected occupancy of 40 residents. The lower price was a result of adjusting the contract to the actual residency and reducing the services that Legacy had provided. The original contract with Legacy included janitorial, housekeeping and servers for the dining room. Now we do our own janitorial work, housekeeping and hire extra staff to help out the waiting services. The credit covered the services that were not used and the difference in contract price now shows up on The Avenue's payroll expenses in the additional personnel that were hired. The auditors' calculations do not take into account of these services changes.

The Owner believes it is necessary to contract with Legacy as it was cost effective to hire an outside contractor to startup food service operations. This would allow available resources to focus on the more important tasks of sales and marketing. Although the contract seemed front loaded, the Owner believes it was reasonable had the facility reached 40 residents as projected. Unfortunately, a combination of unforeseen obstacles prohibited the occupancy growth from reaching its expected censens.

The Owner did not ignore HUD requirement as the Project hired Paradigm Senior Living, a firm that specialized in HUD projects, to do startup operations related consultation. As represented, they are knowledgeable of HUD Handbook and we

Comment 6
Comment 7

Comment 8

Comment 9

believe they did follow HUD's procurement requirements. There is no evidence to prove otherwise.


Finding 2

- C. Written Procurement Policies and Procedures – Policies and procedures that are in compliance of HUD requirements are attached.
- D. Repay The Avenue \$1,800 - The services paid to Eagle Wong Feng Shui service were necessary and reasonable and the invoice is attached. This expense was in the budget of marketing expenses necessary to appeal to the San Francisco demographic and is common practice. The costs were reasonable. Rates for this kind of service usually range from \$5,000 to \$ 15,000 for commercial business.. The Owner disagrees with the auditors' opinions that this was personal belief. Other companies that have used the same type of service include: Borders Bookstore, Citibank, Coca Cola, Hyatt Hotels, Lucent Technologies, MGM Grand Hotel and Resorts, Mercedes Benz, Merrill Lynch, Motorola, Trump Towers, Universal Studios and Virgin Atlantic Airlines.
- E. Support or Repay \$1,750 – The Owners have complied with every documentation request by the auditors. The similar requests of this same vendor of different invoices have been submitted and signed by the receiving auditor. There is no record this particular amount was ever requested by the auditing party. The supporting invoice is now being attached and this letter serves as record of the Owner's compliance with the request.

The auditors' language stating "management did not consider obtaining project services at a reasonable cost a priority and disregarded HUD's procurement requirements" and "The inappropriate disbursements reduced the funds available for necessary expenses and, therefore, increased the risk of mortgage default." are biased and there is no place for this unfounded opinion in this report. The strong and intentionally damaging language such as "ignore", "disregard" "did not consider " and "chose to ignore" used in this report is truly offensive. This language infers that the Owners made intentional decisions to not follow guidelines. There is absolutely no basis to support these accusations. In contrary, the Owner's actions and efforts to maintain the project in good standing and comply with every HUD request shows just the opposite of such derogatory remarks.

Furthermore, the audits' emphasis of their concern of the Project's mortgage, property taxes and insurance payments and "must contribute additional funds to keep the mortgage current" contained in the "Background and Objectives" section deviates the original objective of assessing whether the Project's funding was misused. This Project has suffered enough from all kinds of obstacles and negative images imposed by different parties for various unknown motives that any additional and unnecessary comments will just cause more damages. We request that the report should use more neutral and impartial language and remove unnecessary comments and opinions.

Sincerely


Teresa Wong, General Partner

OIG Evaluation of Auditee Comments

- Comment 1** The owner subsequently revised The Avenue’s purchasing procedures to include procurement policies that meet HUD requirements. Our recommendation in the audit report has been revised accordingly.
- Comment 2** Since the owner could not provide the invoices to support the payments, we obtained the invoices for the payments in question from Legacy. After further review, we determined the amount paid for the food service contract was actually \$135,844 and the excessive amount was \$31,051. The audit report and recommendation have been revised accordingly.
- Comment 3** We recognized The Avenue received a \$30,000 credit from Legacy. The credit has already been accounted for in determining the ineligible amount. However, the credit was not given for services not used due to a difference between expected and actual occupancy. Legacy always billed The Avenue based on actual occupancy. In our interview with Legacy’s President, he told us Legacy was forced to give The Avenue a \$30,000 credit to avoid contract termination and to collect half of their unpaid balance totaling more than \$60,000.
- Comment 4** The original contract and the new contract require essentially the same level of service from Legacy. Under both the old and new contract terms, Legacy would not provide any services unrelated to preparing and serving meals once occupancy reached 20 residents. According to Legacy’s President, when the old contract was in effect, residents’ rooms were cleaned once a week by the dishwashers. The cleaning service was an immaterial part of the overall food service contract. As a result, the renegotiated semi-monthly rate of \$8,061 was sufficient for the contractor to provide food services for up to 20 residents, and is therefore applicable to the period in question. This rate would have been available to the project from the onset if the owner had followed competitive bidding requirements.
- Comment 5** The owner is required to follow HUD requirements whether or not the owner chooses to hire a consultant. The owner was unable to show they complied with HUD’s procurement requirements. They could not show us evidence that they obtained price quotes from a minimum of three contractors.
- Comment 6** The owner subsequently revised The Avenue’s purchasing procedure to ensure only authorized project expenses with proper supporting documentation are paid. Our recommendation in the audit report has been revised accordingly.
- Comment 7** The owner submitted a receipt for payment, not an invoice. The receipt is evidence that the Feng Shui consultant received payment from The Avenue.

Comment 8 Feng Shui consulting is not a necessary and reasonable expense for the operation of a HUD-insured assisted living facility.

Comment 9 The owner submitted additional invoices on November 8, 2005 supporting payment for computer services received from Sirius Analytical Sciences. The original finding on this issue and related recommendation have been removed from the audit report.