



Issue Date May 18, 2006

Audit Report Number 2006-LA-1011

TO: Janet L. Browder, Director, San Francisco Multifamily Housing Hub, 9AHMLA
Margarita Maisonet, Director, Departmental Enforcement Center, CV
R. Faye Austin, Regional Counsel, 9AC

Joan S. Hobbs

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

SUBJECT: Sundial Care Center, Modesto, California, Used \$659,746 in Project Funds for
Ineligible and Undocumented Costs and Was Unable to Account for Revenue
Totaling \$407,454

HIGHLIGHTS

What We Audited and Why

We reviewed the books and records of Sundial Care Center (project), a 68-bed assisted living facility. We initiated the audit in response to a request for audit from the San Francisco Multifamily Housing Hub of the U.S. Department of Housing and Urban Development (HUD) due to its concerns about the owner's use of project funds. Our objective was to determine whether the owner used project funds in compliance with the regulatory agreement and HUD's requirements.

What We Found

The owner, Sundial Care Center, Inc., used \$659,746 in project funds for nonproject (ineligible) purposes or lacked supporting documentation and could not account for \$407,454 in project revenue receipts, both of which occurred while the project had no surplus cash and/or was in default on its HUD-insured

mortgage. The ineligible uses included \$244,370 for payments on unauthorized loans, \$89,000 for an inappropriate lease, \$22,000 for nonproject legal fees, \$8,654 in excessive management fees, and \$1,771 for other miscellaneous nonproject expenses. The owner lacked documentation to support additional disbursements of \$293,951 for insurance expenses, consulting expenses, and other costs.

What We Recommend

We recommend that the director of HUD's San Francisco Multifamily Housing Hub ensure that the owner reimburses HUD's Federal Housing Administration insurance fund for the ineligible disbursements and provides documentation for the unsupported payments and revenue receipts or reimburses those amounts that cannot be adequately supported to HUD's Federal Housing Administration insurance fund. We also recommend that HUD's Regional Counsel, in conjunction with the director of HUD's San Francisco Multifamily Housing Hub and HUD's Office of Inspector General, pursue double damages remedies for the misuse of project funds and inappropriate collection of project revenue in violation of the regulatory agreement.

We recommend that the director of HUD's Departmental Enforcement Center take administrative actions against the owner and its principals/officer for their part in the regulatory violations. We also recommend that the director impose civil money penalties against the owner and its principals.

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 on April 13, 2006. We attempted to hold an exit conference on the scheduled date of April 21, 2006, but the auditee failed to attend. The owner provided written comments on April 28, 2006. The owner generally disagreed with our report findings.

The complete text of the auditee's written response, along with our evaluation of that response, can be found in appendix B of this report.

TABLE OF CONTENTS

Background and Objectives	4
Results of Audit	
Finding 1: The Project’s Owner Improperly Used or Lacked Supporting Documentation for the Use of \$659,746 in Project Funds	5
Finding 2: The Project’s Owner Could Not Account for \$407,454 in Project Revenue	10
Scope and Methodology	13
Internal Controls	14
Appendixes	
A. Schedule of Questioned Costs	15
B. Auditee Comments and OIG’s Evaluation	16
C. Federal Requirements	26

BACKGROUND AND OBJECTIVES

Sundial Care Center (project) is a 68-bed assisted living facility located in Modesto, California. The project was insured under section 232 of the National Housing Act, and its regulatory agreement was executed on March 1, 2000. The project's owner is Sundial Care Center, Inc. (owner). The president of the owner (president), who is also the majority shareholder, has control over all project operations.

The project was never in a surplus cash position. The owner defaulted on its U.S. Department of Housing and Urban Development (HUD)-insured mortgage on May 2, 2004. The owner's mortgage note was assigned to HUD on October 8, 2004. At the note sale on March 16, 2005, HUD suffered a \$3.6 million loss from the sale of the mortgage note. The final closing of the note sale occurred on March 31, 2005.

We initiated the review based on a request from HUD's San Francisco Multifamily Housing Hub due to its concerns about the owner's improper use of project funds.

Our objective was to determine whether the owner used project funds in compliance with the regulatory agreement and HUD's requirements.

RESULTS OF AUDIT

Finding 1: The Project's Owner Improperly Used or Lacked Supporting Documentation for the Use of \$659,746 in Project Funds

The project's owner violated the terms of the project's regulatory agreement by using \$659,746 in project funds for nonproject (ineligible) purposes during a period when the project did not have surplus cash available for distribution and/or was in default on its HUD-insured mortgage. The ineligible uses included \$244,370 for payments on unauthorized loans, \$89,000 for an inappropriate lease, \$22,000 for nonproject legal fees, \$8,654 in excessive management fees, and \$1,771 for other miscellaneous nonproject expenses. The owner also lacked documentation to support additional disbursements of \$293,951 for insurance expenses, consulting expenses, transfers, and other costs. The problems occurred because the owner failed to follow the project's accounting procedures and disregarded the project's regulatory agreement with HUD. As a result, the project's funds available for debt service were reduced, contributing to the default on its \$7.2 million HUD-insured mortgage and eventual \$3.6 million loss to HUD.

The Project Paid \$244,370 for Unauthorized Loans

Project funds totaling \$244,370 was used for ineligible loan repayments and interest payments as follows:

- From July 2003 to October 2004, operating funds totaling \$138,000 were disbursed to two identity-of-interest companies, San Francisco Care Center and Van Ness Care Center, to repay advances the owner's president obtained for the project's operations. Using her authority as managing general partner of the two identity-of-interest companies, the president had advanced \$867,200 to the project from these two identity-of-interest companies. The repayments occurred while there was no surplus cash available for distribution, and \$78,000 (57 percent) was disbursed while the project was in default of its mortgage. The return of these funds directly benefited the owner's affiliated companies to the project's detriment.
- In October 2002, project funds were used to make principal payments of \$100,025 on a loan derived from a Bank of America line of credit that belonged to the sister-in-law of the owner's president. The owner's president claimed the funds from this line of credit were advanced to the project for its operations in February 2001. However, there is no evidence that any of the funds loaned to

the project were deposited into the project's bank account. From October 2003 to February 2005, \$6,345 in project operating funds was used to pay the interest on another Bank of America line of credit that belonged to the brother of the owner's president. There is no evidence that the funds withdrawn from this credit line were used for project operations.

According to HUD Handbook 4370.2, REV-1, owner advances made for reasonable and necessary operating expenses may only be repaid from surplus cash or with HUD approval.

**The Project Inappropriately
Disbursed \$89,000 to the
Owner's President for a
Parking Lot Lease**

In March 2005, the project inappropriately paid a lump sum of \$89,000 to the owner's president, which the owner later identified as a parking lot lease payment. The owner purchased the parking lot in a separate transaction when it acquired the project with HUD insurance. HUD did not include the parking lot as part of the original mortgaged property because it was not necessary for the operation of the project. Since the residents of the assisted living facility don't drive, and the project provided their transportation, the 27 parking spaces available on the project premises were sufficient for visitors. Therefore, leasing of the parking lot would not be a necessary and reasonable project expense.

However, the owner's president claimed the project leased the parking lot from her from April 2000 to March 2004. The president signed the lease agreement as both the owner of the parking lot and as the project's agent. Although the lease terms required a monthly rent payment, the project did not make any monthly payments, and no such liability was accrued in the project's accounting records for four years. In addition, although HUD Handbook 4370.2, REV-1, requires identity-of-interest activity to be disclosed in the project's audited financial statements, neither the lease nor a liability was identified in the project's audited financial statements submitted to HUD.

A year after the lease term ended, on March 21, 2005, a lump-sum disbursement of \$89,000 was made to the owner's president. The project's general ledger and the bank's withdrawal memorandum used to withdraw the funds did not identify the purpose of this payment. These funds were moved from the project's bank accounts five days after the note sale, while the project remained in default. The terms of the regulatory agreement were still in effect until the note sale was final on March 31, 2005; the payment, therefore, represents an ineligible disbursement to the owner.

**Project Funds Totaling \$22,000
Were Used for Nonproject
Legal Fees**

Between August 2002 and January 2005, \$22,000 in project operating funds were used to pay nonproject legal fees. In July 2002, a former management agent filed a lawsuit against the owner, the owner's president, and an individual unrelated to the project. Although the project was not a named party in the lawsuit, the owner used project funds to pay legal expenses incurred in connection with the case. Legal services provided in the case were not for the operation of the project. It is unreasonable for the project to bear the cost of legal services provided to the owner, the owner's president, and an unrelated third party.

**The Project Paid \$8,654 in
Excessive Management Fees**

For the period between June 2001 and February 2002, the project paid \$8,654 in excessive management fees to Eskaton Properties, Inc. (Eskaton). The owner and Eskaton certified to HUD that the project would pay Eskaton a management fee that was 5 percent of the monthly operating revenue. However, the project paid Eskaton a minimum monthly management fee, which for seven months during Eskaton's tenure as the management agent, was more than the amount that was certified to HUD.

**Project Funds Were Used for
\$1,771 in Other Miscellaneous
Nonproject Expenses**

The project paid \$1,771 for other miscellaneous nonproject expenses. These ineligible expenses included a \$500 cash gift to a project employee, \$716 in travel reimbursements to an identity-of-interest company's employee, and a \$555 reimbursement to a project employee for a catered staff dinner. These expenses are not considered reasonable and necessary to the operation of the project; therefore, they are prohibited by the regulatory agreement.

**More Than \$293,951 in
Disbursements Were Not
Supported**

The project lacked documentation to support \$293,951 in disbursements. In accordance with paragraph 9(c) of the regulatory agreement, books and records

must be maintained at all times in reasonable condition for proper audit and be available for inspection by HUD. The unsupported expenses included \$163,357 in insurance expense, \$43,638 in consulting fees, and \$74,785 in other costs such as reimbursement charges to Eskaton, a refund to a nonresident, nonpayroll disbursements to employees, phone charges, supplies, etc. The project disbursed an additional \$12,171 in project funds to unknown entities. The owner could not explain who received the project funds and for what reasons.

Conclusion

The owner used \$659,746 in project funds to pay ineligible and unsupported expenses. Despite knowledge of HUD requirements and a December 2004 warning from HUD the owner's continued to use of funds in an unauthorized manner and misused project assets in violation of its regulatory agreement. The improper use of project funds significantly contributed to the owner's default on its \$7.2 million HUD-insured mortgage. Further, the improper use of project funds makes the owner subject to criminal and civil money penalties, including the equity skimming statutes set out in Title 12, *United States Code*, sections 1715z-19 and 1715z-4a.

Recommendations

We recommend that the director of HUD's San Francisco Multifamily Housing Hub require the owner to

- 1A. Reimburse HUD's Federal Housing Administration insurance fund \$365,795 for the ineligible disbursements cited in this report.
- 1B. Provide documentation to support the \$293,951 in undocumented disbursements cited in this report or reimburse the Federal Housing Administration insurance fund for the applicable portion.

We also recommend that HUD's Regional Counsel in conjunction with HUD's director of the San Francisco Multifamily Housing Hub and HUD's Office of Inspector General

- 1C. Pursue double damages remedies against the responsible parties for all violations of the project's regulatory agreement mentioned in this audit report.

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

- 1D. Pursue appropriate administrative sanctions and impose civil money penalties against the owner and/or its principals for their part in the regulatory violations cited in this audit report.

RESULTS OF AUDIT

Finding 2: The Project's Owner Could Not Account for \$407,454 in Project Revenue

The owner did not ensure the project collected and accounted for \$407,454 in rental revenue. This uncollected revenue included \$67,592 in unconfirmed revenue deposits, \$15,460 in outstanding accounts receivable that were at least a year old, and \$324,402 in outstanding accounts receivable that had accumulated for less than a year. These problems occurred because management failed to follow its own accounting procedures and ignored HUD rules and regulations, including its HUD regulatory agreement. As a result, less revenue was available for project operations and debt service, which contributed to the default on the \$7.2 million HUD-insured mortgage and the \$3.6 million loss to HUD.

The Owner Was Unable to Confirm \$67,592 in Revenue Deposits

Of the total revenue the owner claimed the project collected in 2002, rental receipts totaling \$67,592 were unconfirmed deposits. All rents and other project receipts must be deposited into the project's bank account as required by paragraph 9(g) of the regulatory agreement. However, the owner could not produce the supporting documentation necessary to confirm rental receipts recorded in the project's accounting records were deposited into the project's bank account. As a result, there is no evidence that \$67,592 in tenant rent payments were deposited into the project's bank account as required by the regulatory agreement.

The Project Left \$15,460 in Accounts Receivable Outstanding for More Than a Year

The project had \$15,460 in outstanding accounts receivable balances that were at least a year old. These accounts receivable had been left outstanding since 2002, 2003, and 2004. The project made no effort to collect these accounts when they came due, violating the project's accounts receivable policies for collecting delinquent accounts. As a

result, the outstanding balances could not be considered bad debt writeoffs. Further, the owner could not provide any reasonable explanation why these balances still existed and had not been sought for collection.

The Owner Failed to Document Whether the Project Collected \$324,402 in Revenue

The project's general ledger showed additional outstanding tenant accounts receivable of \$324,402 accruing between December 2004 and March 31, 2005. In the past, the owner ensured the accountant routinely reconciled the project's accounting records quarterly. However, beginning in December 2004, the owner did not give the accountant permission to update the general ledger, including recording rental receipts. As a result, many tenant invoices remained open and potentially uncollected through March 2005. Supporting documentation was not available to show these open invoices were paid and that funds were deposited into the project's bank account. In accordance with paragraph 2-3 of HUD Handbook 4370.2, REV-1, books and accounts must be complete, accurate, and kept current at all times; and postings to the general ledger must be made at least monthly. However, the project's accounting records for the first quarter of 2005 remained unreconciled as of December 2005. The owner failed to maintain the project's accounting records in an auditable condition to show whether the project collected and deposited \$324,402 in revenue.

Conclusion

The owner failed to maintain proper accounting records to ensure the project collected and deposited \$407,454 in rental revenue. Despite knowledge of HUD requirements, the owner continued to not update or reconcile the project's accounting records for a year in violation of its regulatory agreement with HUD. Therefore, it is uncertain whether the project received any of the revenue earned. The unconfirmed deposits and uncollected revenue have significantly contributed to the owner's default on its \$7.2 million HUD-insured mortgage and the \$3.6 million loss to HUD. Further, diversion of project revenue makes the owner subject to criminal and civil money penalties, including the equity skimming statutes set out in Title 12, *United States Code*, sections 1715z-19 and 1715z-4a.

Recommendations

We recommend that the director of HUD's San Francisco Multifamily Housing Hub require the owner to

- 2A. Provide documentation to support that the \$407,454 in uncollected revenue cited in this report was deposited into the project bank account before HUD's note sale or reimburse the Federal Housing Administration insurance fund for the applicable portion.

SCOPE AND METHODOLOGY

We performed the review at HUD's San Francisco regional office and the project site in Modesto, California, from September 2005 through March 2006. To accomplish our objective, we interviewed officials of the San Francisco HUD Multifamily Housing Hub; HUD Headquarters Asset Sales Office; Sundial Care Center, Inc., the project's owner and management; Mok, Shen & Company, the project's accountant; Eskaton Properties, Inc., a former management agent; and Paradigm Senior Living, a former management consultant.

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 articles of incorporation and bylaws;
- The owner's mortgage documents;
- The owner's board minutes;
- The owner's settlement agreement with a former management agent;
- The project's audited financial statements;
- The project's financial records such as bank statements, canceled checks, and general ledgers;
- The project's contract with a former management agent; and
- The former management agent's certification.

Our review generally covered the period from June 1, 2001, through March 31, 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 items are significant weaknesses:

- The project owner circumvented the project's procedures for procurements, disbursements, receipts and collections, and ignored controls that would reasonably ensure project funds were used in compliance with the regulatory agreement and HUD requirements (see finding 1 and 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/	Unsupported 2/
1A	\$365,795	
1B		\$293,951
2A		\$407,454

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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

SUNDIAL CARE CENTER, LP.
406 Arguello Blvd. San Francisco, CA 94118
Tel: (415) 923-7123 Fax (415) 923-7125

Via E-mail
Hardcopy in the mail

April 27, 2006

Office of Inspector General
Attn: Joan S. Hobbs, Regional Inspector General for Audit, Regional IX, 9DGA
U.S. Department of Housing and Urban Development
611 West Sixth Street, Suite 1160
Los Angeles, CA 90017

Re: Response to Sundial Care Center Audit Report Draft

Ms. Hobbs:

As requested, this letter is in response to your Audit Report Draft of Sundial Care Center.

1. Finding 1: The Project's Owners Improperly Used or Lacked Supporting Documentation for the Use of \$659,746 in Project Funds

- Claim: Payments to identity of interest companies in the amount of \$138,000.

Response:

The funding was made to identity of Interest Company due to error transfers and repayment of emergency loan. However, there were funding put back to Sundial afterward for operating expenses.

- Claim: Repayment to a relative in the amount of \$100,025.

Response:

We submit the loan agreement to the auditors in 10/10/2005 as requested and we informed her that the total amount was deposited at different times with different amount, we need more time to collect all the data and we will fax to her. However, the auditors kept substantial amount of the bank statements that we were unable to reconcile at the time.

Comment 1

Comment 2

- Claim: Ineligible interest payments in the amount of \$6,345.20

Response:

The line of credit was a short term interest bearing account for operating expenses. The funding was made in and out to reduce interest payment.

- Claim: The Project Inappropriately disbursed \$89,000 to the Owner's President for a Parking Lot Lease.

Comment 3

Response:

The Parking Lot space was needed to fulfill section 901 et seq. of the Uniform Fire Code. It specifies that access roads shall have an unobstructed width of not less than 20 feet for fire apparatus. Failure to comply with the lawful orders of the Fire Department would have left us open to criminal prosecution. The lease was obtained to meet these requirements.

Comment 4

In addition, in order to comply with two city codes, this area was needed to store the facility dumpsters. They had to be stored here to allow fire access and be a safe distance from the building. Again, we have to comply with the city government codes to stay open. The extra space also helped the overflow of parking requirements needed by guests, family, and employees as there is no street parking available.

Comment 5

Knowing the project did not have positive cash flow the owner of the parking lot (and the President of the project) was willing to defer the rent collection. The \$89,000 was made to pay the overdue rent.

- Claim: Project Funds Totaling \$22,000 Were Used for Non-project Legal Fees.

Comment 6

Response:

Brunn and Flynn were retained for all facility legal matters. We are not sure what lawsuit is you referring to that you claim was not related to the project and who is the individual unrelated to the project that you mention.

- Claim: The Project Paid \$8,654 in Excessive Management Fees

Comment 7

Response:

Eskaton is a HUD recognized management agency. That was an industry standard contract that allows for a minimum rate or 5% charged, whichever is higher. The minimum rate was charged over the 5% according to the terms of this contract at various points. This is common procedure in this industry and HUD did not have objection to the contract.

Comment 8

- Claim: Project Funds Were Used for \$1,771 in Other Miscellaneous Non-project Expenses.

Response:

\$1,055.69 was disbursed to employees for employee recognition and reimbursements. \$500 was awarded to an employee for outstanding service to the facility and residents. \$555.69 was reimbursement to the Administrator of the project for company Annual Christmas Dinner. We believe company Christmas parties are common practice and good for company morale. The remaining was reimbursement to a trainer for traveling expenses. All of this information was previously sent to the auditors.

- Claim: More Than \$293,951 in Disbursements Were Not Supported

Response:

The 163,357.10 were all insurance payments comprised of four amounts: All these expenses were eligible operating expenses and required by law and all the supporting information were sent to the auditors.

Comment 9

The \$65,850.86 was made to Andreini & Company for the facility's property and liability insurance. Insurance policies, invoices and front and back of the cancelled checks were submitted to the auditor.

Comment 10

The \$5,056.70 was made to Health Net is for the Employee's Health Insurance. Insurance policies, invoices and front and back of the cancelled checks were submitted to the auditor.

Comment 11

The \$78,185.91 was made to Imperial Premium Finance Inc. for property and liability insurance, the previous insurance company. Insurance policies, invoices and front and back of the cancelled checks were submitted to the auditor.

Comment 12

The \$14,263.63 was made to State Compensation Fund for Employee Workers Compensation. Insurance policies, invoices and front and back of the cancelled checks were submitted to the auditor.

- Claim: The \$43,638.41 was unsupported expenses for project related consulting fees:

Comment 13

Response:

The \$7,291.48 was made to [REDACTED] the Marketing and Sales Consultant. Contract, payment request and front and back of cancelled checks were submitted to the auditor.

Comment 14

The \$3,580.85 was made to [REDACTED] a Registered Nurse that worked at the facility. Contract and front and back of cancelled checks were submitted to the auditor.

Comment 15

The \$11,221 was made to [REDACTED] the Human Resource and Operations Specialist who was on probation period. Front and back of cancelled checks were submitted to the auditor.

Comment 16

The \$21,545.18 was made to portion of the Paradigm Senior Living for the company to provide an interim facility supervisor. Invoice and front and back cancelled check were submitted to the auditor.

Comment 17

The \$74,785.96 was made up of two separate amounts. The \$65,053.17 was made to Eskaton, a HUD recognized Management Agency, for expenses. As the approved management agency, they had authorization to sign their own checks for expenses. At the end of their contract they provided all records back to the facility. OIG auditor took all of these records from the premises to their offices. We were not given the opportunity to inspect the content of the records

Comment 18

The items that make up the \$9,731.79 were legitimate project expenses. Supporting information such as invoice, check request and front and back of cancelled checks were submitted to the auditor.

Claims: The owner could not explain who received the project funds and for what reasons in the amount of \$12,171.

Comment 19

Response:

Check #575 dated 1/10/2005 in the amount of \$896.61 and check #2016 dated 2/7/2005 in the amount of \$4,400.00 was submitted to the auditor in 12/09/2005.

Comment 20

Check #266 dated 11/18/2004 in the amount of \$829.89, check #2590 dated 10/14/2004 in the amount of \$1,160.00 and check #2621 dated 10/13/2004 in the amount of \$4,884.22 were in the request information list dated 12/08/05 sent to Paradigm Senior Living, a copy of the request was also submitted to the auditor on the same day. We do not the above record because Paradigm Senior Living sent our accounting records to HUD multi family instead to the owner. We suggest OIG request the same information from Paradigm Senior Living.

Names have been redacted for privacy

Finding 2: The Project's Owners Could Not Account for \$407,454 in Project Revenue

- Claims: The Owner was Unable to Confirm \$67,592 in Revenue Deposits

Response:

We recall we had submitted a total of 112 pages of double sided documents consisting copy of checks, daily receipt reports, deposit slips and bank receipts to your auditor who signed the receipt of the submittal dated 11/8/2005.

Comment 21

- Claim: The Project Left \$15,460 in Accounts Receivable Outstanding for More Than a Year.

Response:

I am not sure I understand this claim. We do not recognize this amount was ever asked by the auditors.

Comment 22

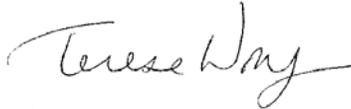
- Claim: The Owner Failed to Document Whether the Project Collected \$324,402 in Revenue

Response:

This was explained to OIG auditor in an email dated February 19th, 2006. This is a shortfall for QuickBooks program function that it doesn't register balance carry forward. The first invoice is for the basic rate, the second invoice is with the ancillary charge added on. The QuickBooks program does not register add-on or balance carry forward function. We are not sure why the auditor state that the owner did not give the accountant permission to update the general ledger, including recording rental receipts beginning in December 2004.

Comment 23

Yours sincerely,



Teresa Wong
President

OIG Evaluation of Auditee Comments

Comment 1 During the audit, the owner asserted that one of the disbursements to the identity-of-interest companies was made to correct a transfer error. She explained the project disbursed \$12,000 to an identity-of-interest company in October 2004 to correct a transfer error made in December 2003. However, this explanation is not reasonable given the long period of time, ten months, before the claimed reimbursement was made. The project accountant would have caught such a transfer error and notified the owner when she performed the project's bank reconciliations at the end of the quarter in which the original disbursement occurred. Further, the bank statement shows the accountant's handwritten note labeling the December 2003 transfer into the project account as a loan from the identity-of-interest company. There is no evidence to substantiate the owner's claim that the transfer in December 2003 was an error and the disbursement in October 2004 was a correction.

According to the regulatory agreement, owner advances may only be repaid from surplus cash or with HUD approval. Further, HUD Handbook 4370.2, REV-1, prohibits the repayment of owner advances when the project is in default.

Comment 2 The line of credit was not for the project. Instead, the line of credit was for the brother of the owner's president. There is no evidence that funds from this line of credit were used for the project's operating expenses.

Comment 3 California Fire Code, Part 3, Article 9, Section 902, Fire Department Access, specifies that fire apparatus access roads must have an unobstructed width of not less than 20 feet. However, the California Fire Code did not require the project to lease or purchase additional space to ensure the fire apparatus access road is free from obstruction.

Comment 4 The City of Modesto does not have specific requirements for dumpster placement as long as the dumpster does not block the street right-of-way, per Modesto Municipal Code, Title 5, chapter 5. Furthermore, the Modesto City Planning Division agreed that the project with the number of parking spaces available on its premises can be self-contained. The facility did not need the parking lot adjacent to the project to operate.

Comments 5 The leasing of the parking lot was an unnecessary and unreasonable expense. The owner's president should not have obligated the project for this expense. The owner could have used the \$89,000 to pay the mortgage, which was in default. Instead, the owner chose to pay the owner's president for an ineligible expense.

Comments 6 A schedule of ineligible and unsupported costs was previously provided to the owner to assist the owner in identifying the specific questionable payments found in the audit.

Comments 7 The Project Owner's/Management Agent Certification submitted to HUD states that Eskaton would receive a management fee equal to 5% of residential income collected. It further states that no special fee would be charged. The certification does not state that a minimum fee would be charged if the calculated management fee fell below a certain dollar amount.

Comments 8 While these expenses may be common practices for uninsured properties, the \$1,771 in expenses were not reasonable and necessary under the terms of the regulatory agreement

Comment 9 The owner stated that \$65,851 was paid to Andreini & Company for the project's property and liability insurance. However, the owner could not provide any insurance policy purchased from Andreini & Company for our review. While supporting documentation given to the auditors included invoices, copies of canceled checks, and a promise-to-pay letter, none of the information indicates the project purchased property and liability insurance from Andreini & Company. Instead, the promise-to-pay letter shows the owner's president agreed to repay Andreini & Company for funds advanced to pay workers compensation insurance. However, neither the owner nor Andreini & Company could provide the workers compensation insurance policy to support the \$65,851 in disbursements.

Comment 10 The invoice provided by the owner supported only a portion on the payment. The remainder of the disbursement included \$4,957 in manual adjustments and a \$100 overpayment that the owner could not explain.

Comment 11 Imperial Premium Finance, Inc. is not an insurance provider. It provides insurance premium financing. Contrary to her statement, the owner could not provide any insurance policies related to payments made to Imperial Premium Finance, Inc. The owner also could not provide invoices for 10 out of 19 payments. Of the invoices that were provided, none of them contained sufficient information to show what the project was being billed for.

Comment 12 The owner could not provide an insurance policy to support these disbursements. Instead, the owner provided a workers compensation insurance policy rate sheet that covered the period from July 27, 2004, to July 27, 2005, as proof of insurance coverage. While the rate sheet may be acceptable support for payments made during the covered period, it

cannot be used to support disbursements made in October 2002 and September 2003 totaling \$14,264.

Comment 13 Documentation provided to support three payments totaling \$7,291 consisted of only copies of the face of canceled checks. Canceled checks by themselves are insufficient information to document the eligibility of these disbursements.

Comment 14 The Nurse Consultant's contract specified that she would be compensated based on the number of hours worked. Since the number of hours the Nurse Consultant worked fluctuated from week to week, a timecard was used to track her work hours. A timecard was not available to support five out of seven payments made. No other evidence was available to show the \$3,581 paid to the Nurse Consultant was appropriate.

Comment 15 The project did not have a contract with this consultant. Accordingly, it could not be determined what type of work the consultant performed, the number of hours worked, and the rate charged. Canceled checks by themselves are insufficient information to prove the disbursements were appropriate project expenses.

Comment 16 The project did not have a contract with Paradigm Senior Living to provide any type of service. Further, the owner could not provide any supporting documentations relating to eight of the nine payments made to the company. A copy of the face of a canceled check and an invoice were provided for one payment. The invoice requested payment for an individual's time for five days and reimbursement for his travel and meal costs. Since there was no contract to establish a scope of work and compensation, it is unclear what services were provided, if any, and why travel and meal expenses were reimbursed.

Comment 17 In addition to its management fee, Eskaton charged the project for other items. Invoices provided by the owner lacked sufficient information to demonstrate these other charges, totaling \$65,053, were eligible project expenses. These other charges included postage, general stores, workers compensation for an Administrator, an Administrator's salary and FICA, and other unidentified expenses purportedly paid by Eskaton. None of these charges were supported by documentation evidencing that Eskaton incurred/paid for these expenses or that they were related to the project.

The owner gave the auditors permission to remove records from the project. Per the owner's instruction, project staff inspected and inventoried the documents before the auditors left the project premises. All documents were subsequently returned and signed for by the owner upon receipt.

Comment 18 Information provided by the owner for these expenses was insufficient. The \$9,732 consisted of 11 disbursements. Five of the disbursements were for vendor payments without supporting invoices and three were reimbursements to employees without supporting receipts. The owner could not offer a logical explanation supporting the eligibility of the other three payments. During the review, the owner claimed one of these three payments was a refund to the daughter of a resident who passed away.

However, the check request merely stated it was a second request and made no reference to a refund. Also, there was no evidence that either of the two names that appeared on the canceled check was affiliated with a resident of the project. As such, the owner's claim was unsupported. The owner claimed another payment was a stipend paid to an employee. However, the personnel file did not show the employee was entitled to a stipend. The only documentation provided to support this payment was a copy of the face of a canceled check. The third payment was made to another employee. The owner could not explain why the disbursement was made because supporting documentation, including the canceled check, could not be located.

Comment 19 Although these two checks and the related support were subpoenaed, they were not delivered to us as part of the owner's December 9, 2005, response to our subpoena. The owner could not provide any information to show the payments were for reasonable project operating expenses. Therefore, these disbursements remained unsupported.

Comment 20 While the owner did email Paradigm Senior Living to request information related to the three disbursements (which was not provided), it is the owner's responsibility to maintain the project's books and records in a reasonable condition for proper audit. The owner is responsible to maintain all documentation related to the project's operations and make it available for HUD's inspection.

Comment 21 We reviewed the documents submitted by the owner. However, the documents submitted to us did not include the information needed to confirm reported revenue received from tenants was deposited in the project's bank account. Although numerous requests were made to the owner asking for the missing information (e.g. copies of checks, daily receipt reports, deposit slips, and bank receipts), the owner could not provide any new information or documents confirming the deposit of such revenue in the project's bank account.

Comment 22 On December 14, 2005, we emailed the owner a list of all outstanding resident balances, including those that were more than a year old. In the email, we asked the owner to confirm whether any of the outstanding accounts receivables were collected. The owner did not respond. On

December 20, 2005, we met with her in person and again asked for information on the \$15,460 in accounts receivables that were reported as being uncollected for more than a year. The owner responded that she did not know why these account balances remained outstanding and why they were not collected.

Comment 23 The owner's February 19, 2006, email only explained an error for the month of December 2004, where the accounting system recorded two billings for every resident. The owner explained that the first set of billings recorded only the basic rate, while the second set billed each resident for the basic rate plus any additional ancillary charges. We accepted the owner's explanation for the double-billing error and took it into account in our reconciliations. The amount of the double-billing was removed from the initial outstanding receivables balance of \$427,051 to arrive at the final outstanding receivables balance of \$324,402 at the end of March 2005. The owner could not explain why the outstanding receivable balance of \$324,402 remained on the project's books or whether it was valid.

The owner hired an accounting firm to perform bank reconciliations and reconcile the project's accounting records. In the past, usually at the end of a quarter, the owner arranged for the accountant to carry out these accounting functions at the project's corporate office in San Francisco. However, the accountant did not have the owner's permission to perform any project work for 2005. Therefore, the project accounting records for 2005 were not reconciled or kept up-to-date. When asked why the project accounting records were not properly maintained for 2005, the owner held the accountant liable for not taking care of her bookkeeping responsibilities. However, as set out in the regulatory agreement, it is the owner's responsibility to make certain that the project's books and accounts are kept current and up-to-date.

Appendix C

FEDERAL REQUIREMENTS

Regulatory Agreement

Important provisions of Sundial Care Center, Inc.'s regulatory agreement include the following:

- Paragraph 6(b) mandates that the owner may not, without the prior written approval of the secretary of HUD, 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 6(e) prohibits the project owner from making or receiving and retaining any distribution of assets or any income of any kind of the project except surplus cash unless HUD has given prior written approval.
- Paragraph 6(f) forbids the owner from incurring any liability or obligation not in connection with the project without first obtaining written approval from HUD.
- Paragraph 9(b) states that payment for services, supplies, or materials shall not exceed the amount ordinarily paid for such services, supplies, or materials in the area where the services are rendered or the supplies or materials furnished.
- Paragraph 9(c) requires that 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. The owner shall keep copies of all written contracts or other instruments which affect the mortgage property. All or any of these documents and records may be subject to inspection and examination by the secretary of HUD or his duly authorized agents.
- Paragraph 9(d) requires the books and accounts of the operations of the mortgage property and of the project to be kept in accordance with the requirements of the secretary of HUD.
- Paragraph 9(f) requires that at the request of the secretary of HUD, his agents, employees, or attorneys, the owner shall furnish monthly occupancy reports and shall give specific answers to questions upon which information is desired from time to time relative to income, assets, liabilities, contracts, operation, and condition of the property and the status of the insured mortgage.

- Paragraph 9(g) stipulates that all rents and other receipts of the project shall be deposited in the name of the project in a bank and that such funds shall be withdrawn only in accordance with the provisions of the agreement for expenses of the project. Any owner receiving funds of the project shall immediately deposit such funds in the project's bank account and, failing to do so in violation of the agreement, shall hold such funds in trust. At such time as the owner shall have lost control and/or possession of the project, all funds held in trust shall be delivered to the lender to the extent that the mortgage indebtedness has not been satisfied.
- Paragraph 12 stipulates that upon default, the owner is not permitted to collect and retain any rents due or collected thereafter.
- Paragraph 17 stipulates that the project owner, Sundial Care Center, Inc., remains liable under the agreement "a) for funds or property of the project coming into their hands which, by the provisions hereof, they are not entitled to retain; and b) for their own acts and deeds or acts and deeds of others which they have authorized in violation of the provisions hereof."

Applicable Handbook Requirements

HUD Handbook 4350.1, REV-1, "Multifamily Asset Management and Project Servicing," paragraphs 8-11 and 8-12, authorize HUD to impose civil and criminal penalties to enforce program requirements.

HUD Handbook 4370.1, REV-2, "Reviewing Annual and Monthly Financial Reports," paragraph 1-3, states that a monetary penalty may be imposed for any violation of the regulatory agreement, including failure to maintain books and accounts of the project according to requirements prescribed by the secretary of HUD.

In the same handbook, paragraph 2-21, Compliance with HUD Requirements, states that owners' advances made for reasonable and necessary operating expenses may be paid from surplus cash at the end of the annual or semiannual period. Repayment is generally not considered an owner distribution. Repayment of owner advances when the project is in a non-surplus-cash position may subject the owner to criminal and civil money penalties.

In the same handbook, paragraph 2-22, Potential Diversions of Project Assets, stipulates that use of project assets (e.g., cash, security deposits, equipment, supplies, etc.) for other than necessary and reasonable operation of the project or for payment of authorized distributions to owners constitutes a violation of the regulatory agreement. Such diversions of project assets can cause defaults in mortgage payments and may also be violations of federal law.

HUD Handbook 4370.2, REV-1, “Financial Operations and Accounting Procedures for Insured Multifamily Projects,” paragraph 2-3, “Maintenance of Books and Accounts,” states that books and accounts must be complete and accurate. The books of original entry must be kept current at all times, and postings must be made at least monthly to ledger accounts. Standard journal entries may be established for recurring items and posted monthly.

In the same handbook, paragraph 2-6, Regular Operating Account, stipulates that project funds should only be used to make mortgage payments, make required deposits to the reserve for replacements account, pay reasonable expenses necessary for the operation and maintenance of the project, pay distributions of surplus cash permitted, and repay owner advances authorized by HUD.

In the same handbook, paragraph 2-11, Repayment of Owner Advances, states that advances made for reasonable and necessary operating expenses may be paid from surplus cash at the end of the annual or semiannual period. Such repayment is not considered an owner distribution. It is considered a repayment of advances. Repayment of owner advances when the project is in a non-surplus-cash position will subject the owner to criminal and civil monetary penalties.

In the same handbook, paragraph 3-4, Preparation of Financial Reports, requires business activities conducted with identity-of-interest entities to be disclosed in the audited financial statements if payments for services performed for the project totaled \$1,000 during the operating period.

In the same handbook, paragraph 4-4, Manual of Accounts, distinguishes mortgagor/corporate expenses from expenses necessary and reasonable for the operation of the project. The handbook states that owners may only charge these expenses against the project’s operations with the prior written approval of HUD.

Equity Skimming and Civil Remedies Statutes

Title 12, *United States Code*, section 1715z-4a, Double Damages Remedy for Unauthorized Use of Multifamily Project Assets and Income, allows the U.S. attorney general to recover double the value of any project assets or income that was used in violation of the regulatory agreement or any applicable regulation, plus all cost relating to the action, including but not limited to reasonable attorney and auditing fees.

Title 12, *United States Code*, section 1715z-19, Equity Skimming Penalty, authorizes a fine of not more than \$500,000 and/or imprisonment of not more than five years for any owner, agent, or manager who willfully uses or authorizes the use of any part of the rents, assets, proceeds, income, or other funds derived from the property for any purpose other than to meet reasonable and necessary expenses in a period during which the mortgage note is in default or the project is in a non-surplus-cash position as defined by the regulatory agreement.

Title 12, *United States Code*, section 1735f-15, Civil Money Penalties Against Multifamily Mortgagors, allows the secretary of HUD to impose a civil money penalty of up to \$25,000 per violation against a mortgagor of a property with five or more living units and a HUD-insured mortgage. A penalty may be imposed on that mortgagor, on a general partner of a partnership mortgagor, or on any officer or director of a corporate mortgagor for any knowing and material violation of the regulatory agreement, such as paying out any funds for expenses that were not reasonable and necessary project operating expenses, failing to maintain the books and accounts of the operations of project, failing to make promptly all payments due under the note when there is adequate project income available to make such payments, or making distributions to owners while the project is in a non-surplus-cash position.