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Audit Case Number	97-NY-212-1001

TO: Rosalinda Lamberty, Director, Multifamily Housing Division
Buffalo Area Office

FROM: A. Paul Kane, District of Inspector General for Audit
New York/New Jersey

SUBJECT: Pilgrim Village Associates
Multifamily Project Operations
Buffalo, New York

We completed a review of the books and records of Pilgrim Village Apartments, Project Number 014-35034 (herein called the project), located in Buffalo, New York. The project is owned by Pilgrim Village Associates (herein called the Mortgagor), a limited partnership, and managed by Trammell Associates (herein called the Management Agent), an identity of interest management agent. The objectives of the audit were to determine whether the Mortgagor complied with its Regulatory Agreement with the U.S. Department of Housing and Urban Development (HUD) concerning the computation and distribution of surplus cash, and the use of project funds to only pay for reasonable operating expenses and necessary repairs.

Our review disclosed that the Mortgagor/Management Agent did not comply with provisions of the Regulatory Agreement pertaining to making distributions with only surplus cash and using project funds to pay only reasonable operating expenses. Specifically, the audit disclosed that: (1) distributions of \$41,900 were computed and made to the General Partner for periods when the project was not in a surplus cash position; (2) unauthorized withdrawals of \$14,100 have not been repaid to the project; (3) a \$12,250 loan from the Reserve for Replacement Account was not used properly nor repaid; (4) loan origination fees of \$7,276 were charged to project costs even though the loan was not obtained; (5) Bond Debt Service Reserve funds were used improperly to write-off loans and advances; (6) questionable administrative fees, totaling \$34,578.72 were charged to the project; and (8) payroll costs of \$308,320 are considered unsupported because the Management Agent's payroll allocation method is unsupported. In conclusion, the audit identified \$124,018.84 of ineligible distributions and unauthorized withdrawals of project funds, \$56,276 of ineligible costs, and \$342,898.72 of unsupported costs (See Appendix A).

Within 60 days, please furnish this Office, for each recommendation cited in the report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is not considered necessary. Also, please furnish copies of any correspondence or directives issued related to the audit.

If you have any questions, please contact Alexander C. Malloy, Assistant District Inspector General for Audit at (212) 264-8000, extension 3976.

Executive Summary

We audited the books and records of Pilgrim Village Apartments, which is owned by Pilgrim Village Associates. The objectives of the audit were to determine whether the Mortgagor complied with provisions of its Regulatory Agreement with HUD concerning the computation and distribution of surplus cash, and the use of project funds to only pay for reasonable operating expenses and necessary repairs.

Our review disclosed that the Mortgagor/Management Agent did not comply with provisions of the Regulatory Agreement pertaining to making distributions with only surplus cash and using project funds to pay only reasonable operating expenses. Specific instances of noncompliance are discussed below:

Ineligible distributions and unauthorized withdrawals

The review disclosed that during 1991, 1992 and 1993 the project's computations of surplus cash were incorrect, which resulted in the General Partner receiving distributions totaling \$41,900 for periods when the project was not in a surplus cash position. The review also disclosed that during 1994 and 1995 the General Partner constantly withdrew and repaid funds to the project. Specifically, we found that between March 11, 1994, and October 11, 1995, the General Partner withdrew \$31,400, but only repaid \$17,300, leaving an outstanding balance of \$14,100, which has been written off the project's books. In our opinion, such activity shows that the General Partner failed to comply with the provision of the Mortgagor's Regulatory Agreement with HUD that prohibits funds from being taken from the project except for surplus cash. As a result, funds that should have been available to pay operating and improvement costs were taken improperly by the General Partner.

Funds loaned, advanced and used in connection with attempting to obtain a loan should be repaid

The review disclosed that the General Partner took \$12,250 from the project in the form of a loan and \$36,934 in advances to pay commitment fees in connection with applying for a Section 241 loan that was not obtained. Also, in connection with attempting to obtain that loan, the General Partner used project funds of \$7,276 to pay loan origination cost. We consider this cost to be unnecessary and ineligible since the Mortgagor voluntarily aborted the loan process to obtain a loan from another lending institution. We also believe that since the loan was not obtained, the General Partner should have returned the funds loaned and advanced so that they

Bond Reserve Fund used to repay unauthorized loans and project funds used for ineligible legal fees

would have been available to pay necessary and reasonable operating costs.

The Mortgagor used the project's Bond Debt Service Reserve funds of \$55,768.84 at December 1992 to reimburse the project for unauthorized loans and advances made to the General Partner and Management Agent prior to December 1992. Because the Bond Fund Agreement provides that any funds remaining in the Bond Debt Service Account should be forwarded to HUD, the Mortgagor's use of the funds was improper. Additionally, we found that in January 1993, the Mortgagor transferred \$49,000 of project funds to the Management Agent's account to pay the legal costs associated with refinancing the project's 11-B bonds. Inasmuch as such legal costs are not project operating expenses, they cannot be paid with operating funds of the project; therefore, the transfer of the \$49,000 was improper.

Questionable administrative fee charged to the project

The Management Agent is charging the project a questionable administrative fee. Specifically, the Management Agent charged the project a fee of 15 percent of the gross payroll. According to a staff member of the Management Agent the fee is for payroll processing, fidelity bond coverage, and disability insurance. However, requirements contained in the Management Agent Handbook, provide that the agent may not charge an administrative fee for payroll processing. Therefore, we considered the fees charged, which totaled \$34,578.72, unsupported costs pending an eligibility determination by HUD's Buffalo Area Office (BAO).

Payroll allocation method does not comply with HUD requirements

The Management Agent's payroll allocation method does not comply with applicable requirements provided in HUD Handbook 7381.5 REV-2, The Management Agent Handbook. As a result, adequate assurances that salary and fringe benefits costs are allocated properly among the projects managed by the Management Agent do not exist. Therefore, payroll costs, which totaled \$308,320, charged during our audit period are considered unsupported pending an eligibility determination by HUD's BAO.

We recommend that you require the Mortgagor to reimburse the project from non-project/Federal funds, the amount of the ineligible distributions and unauthorized withdrawals of \$124,018.84, as well as ineligible costs of \$56,276. Also, we

recommend that your office determine the eligibility of the unsupported costs of \$342,898.72 and provide the Mortgagor with your determination.

Additionally, the Mortgagor should be instructed to comply with all applicable regulations and HUD requirements in determining and distributing surplus cash and in paying for reasonable operating costs with project funds.

Exit conference

The results of our review were discussed with officials of the Mortgagor during the audit and at an exit conference held on December 5, 1996, attended by:

Pilgrim Village Associates (Mortgagor)

Wilbur P. Trammell, General Partner
Joseph M. Klimek, Certified Public Accountant, Lumsdent
McCormick, LLP

Buffalo Area Office - Housing Division

David G. Roaldi, Acting Chief, Multifamily Branch
Gail A. Scharmach, Asset Manager

Office of Inspector General

Garry D. Clugston, Senior Auditor
Theresa S. Tetlow, Auditor
Thomas J. Egloff, Auditor

A written response to the draft findings was submitted by the General Partner on December 11, 1996. A summary of the auditee's comments is included in each finding while an entire copy of the auditee's response is included as Appendix B to this report.

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Table of Contents

Management Memorandum	i
Executive Summary	iii
Introduction	1
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Findings	
1 Ineligible Distributions and Unauthorized Withdrawals of Project Funds	3
2 Funds Loaned, Advanced, and Used in Connection With Attempting to Obtain a Loan Need to be Repaid	7
3 Bond Reserve Funds Used to Repay Unauthorized Loans and Advances, and Operating Funds Used to Pay Ineligible Legal Costs	11
4 Questionable Administrative Fee Charged by the Management Agent	15
5 Payroll Allocation Method Does Not Comply With HUD Requirements	17
<hr/>	
Internal Controls	19
<hr/>	
Follow Up On Prior Audits	21

Appendices

A	Schedule of Ineligible Distributions, Unauthorized Withdrawals and Ineligible and Unsupported Costs	23
B	Auditee Comments	25
C	Distribution	29

Abbreviations

BAO B u f f a l o A r e a O f f i c e

HUD U.S. Department of Housing and Urban Development

IPA Independent Public Accountant

OIG Office of Inspector General

Introduction

In 1980 the Federal Housing Administration (FHA) insured a \$3,135,000 mortgage of Pilgrim Village Associates under Section 221(d)(4) of the National Housing Act. The project was financed with Multifamily Mortgage Revenue Bonds with the Bond Issuer being the Pilgrim Village Housing Development Corporation, a non-profit corporation constituting an instrumentality of the Buffalo Municipal Housing Authority. The General Partner of Pilgrim Village Associates is Wilbur P. Trammell.

The project is a 90 unit family complex consisting of 2 and 3 bedroom apartments, and is located at 37 Holloway Boulevard, Buffalo, New York. Project operations are primarily governed by a Regulatory Agreement with HUD, which was entered into on July 3, 1980. The Regulatory Agreement limits distributions with project funds to surplus cash, as permitted by the laws of the jurisdiction. Also, the project receives Section 8 subsidies from HUD which reduces the amount of the monthly rent paid by participating tenants.

Objectives and Methodology of the audit

The objectives of the audit were to determine whether the Mortgagor and/or Management Agent complied with provisions of the Mortgagor's Regulatory Agreement with HUD concerning the computation and distribution of surplus cash, and the use of project funds to only pay for reasonable operating expenses and necessary repairs.

To accomplish the audit objectives, we:

- Reviewed the financial statements and audit reports for Fiscal Years 1994 and 1995. This review was extended back to Fiscal Year 1990 because of surplus cash distribution concerns.
- Interviewed members of HUD's BAO, the managing general partner, and the Management Agent staffs. Also, we interviewed the project's accountant, and its Independent Public Accountant (IPA).
- Reviewed HUD's files (Asset Management), the project's and the Management Agent's files, and the IPA's working papers.

Our site work was conducted between the period May 1996 and December 1996. The review generally covered the period July 1, 1994 to December 1995, but was extended to other periods when appropriate.

The audit was conducted in accordance with generally accepted government auditing standards.

A copy of this report has been provided to the Mortgagor.

Ineligible Distributions and Unauthorized Withdrawals of Project Funds

Our review disclosed that from 1991 to 1993 the project's computations of surplus cash were incorrect, which resulted in the General Partner receiving distributions totaling \$41,900 for periods when the project was not in a surplus cash position. The review also disclosed that during 1994 and 1995 the General Partner constantly withdrew and repaid funds to the project. In this regard, we found that between March 11, 1994 and October 11, 1995, the General Partner withdrew \$31,400, but only repaid \$17,300, leaving an outstanding balance of \$14,100, which has been written off the project's books. In our opinion, such activity shows that the General Partner failed to comply with the provision of the Mortgagor's Regulatory Agreement with HUD that prohibits funds from being taken from the project except for surplus cash. As a result, funds that should have been available to pay operating and improvement costs were taken improperly by the General Partner.

Criteria

Paragraph 8 of the Regulatory Agreement provides that Owners shall not without the prior written approval of the secretary:...(e) make, or receive and retain, any distribution of assets or any income of any kind of the project except surplus cash and distributions made only as of and after the end of a semiannual or annual fiscal period.

Surplus cash amounts were computed incorrectly

Our review disclosed that distributions were made to the General Partner of Pilgrim Village in 1991, 1992, and 1993 from amounts determined to be surplus cash. However, we found that the surplus cash amounts were computed incorrectly because a loan receivable due from the General Partner was included in the computations as cash. Our computation of surplus cash revealed that the project was in a non-surplus cash position in 1990 and 1991 and only had surplus cash of \$12,100 in 1992. In each of the three years, a distribution of \$18,000, for a total of \$54,000 was made by an offset to accounts receivable due from the General Partner. In fact, as indicated in the table on page 4 only \$12,100 of the distributions were eligible. Consequently, the General Partner received ineligible distributions of \$41,900, which should be returned to the project's operating account.

Finding 1

YEAR	ACTUAL SUR-PLUS CASH	DISTRIBUTION MADE	DISTRIBUTION ALLOWED	INELIGIBLE DISTRIBUTION
1990	(\$41,517)	\$18,000	\$ 0	\$18,000
1991	(\$22,670)	18,000	0	18,000
1992	\$12,100	18,000	12,100	5,900
TOTAL		\$54,000	\$12,100	\$41,900

Regarding unauthorized withdrawals, we noted that on seven occasions during the period reviewed, unauthorized withdrawals, totaling \$31,400, from project funds were made by the General Partner and the Project Manager. An unauthorized withdrawal is a cash withdrawal from the project's account that was neither approved by HUD nor used to pay eligible project expenses. Details on the unauthorized withdrawals are as follows:

Schedule of Unauthorized Withdrawals

Date	Payee	Amount
03/11/94	W. P. Trammell	\$ 4,000
04/20/94	Wilbur P. Trammell	3,000
07/22/94	Wilbur P. Trammell	4,000
08/19/94	Trammell Tower Associates Endorsed Mark Trammell	1,400
11/16/94	Wilbur P. Trammell	5,000
07/25/95	Wilbur P. Trammell	10,500
10/11/95	Kimberly Park Associates Endorsed Mark Trammell	3,500
	TOTAL	\$31,400
	Total amount returned per deposit slips	\$17,300
	Outstanding balance (Written off)	\$14,100

As shown above, \$17,300 of the withdrawals was returned to the project while the balance of \$14,100 was written off the project's books. Specifically, \$9,400 was written off in 1994 and \$4,700 in 1995. Since the outstanding balance was a part of the unauthorized withdrawals, it should have

been returned to the project. Furthermore, although 1996 was not part of our audit period, we found indications that additional funds are currently being withdrawn from the project's account.

In our opinion, the ineligible distributions and unauthorized withdrawals of the project's cash, when the project was not in a surplus cash position had an adverse affect on the project's financial position. As a result, the project's financial ability to make necessary repairs and improvements was jeopardized.

Auditee Comments

Distributions

This distribution was made erroneously in 1990 because of confusion arising from a question of being or not being a limited distribution entity . Any determination of surplus was made by our accountant. Since the error was discovered repayment was made from surplus, with the exceptions noted in your report.

Withdrawals

Unauthorized payments were expended as set forth in schedule "A" attached hereto (see page 27). The \$14,100.00 will be applied to the reduction of the second Mortgage.

There were no unauthorized withdrawals in 1996.

Recommendations

We recommend that you:

- 1A. Instruct the General Partner to reimburse the project from non-project/Federal funds for the \$41,900 of ineligible distributions, and the \$14,100 in unauthorized withdrawals.
- 1B. Determine if there were any additional unauthorized withdrawals after our audit period and instruct the Mortgagor to reimburse the project from non-project/Federal Funds.

- 1C. Provide assurances that future surplus cash computations will be accurate and that the practice of withdrawing/returning project funds for unspecified purposes will cease.

Funds Advanced and Used in Connection With Attempting to Obtain a Loan Need to be Repaid

Our review disclosed that the General Partner took \$36,934 in advances to pay commitment fees in connection with applying for a Section 241 loan that was not obtained. Part of the \$36,934 was a loan received from the project's Reserve for Replacement Account in the amount of \$12,250. Also, in connection with attempting to obtain that loan, we found that funds of \$7,276 were used to pay loan origination cost. The balance of \$17,400 is included in the unauthorized withdrawals discussed in Finding 1. We believe that the incurrence of such cost was unnecessary and that the cost is ineligible since the Mortgagor voluntarily aborted the loan process to obtain a loan from another lending institution. Furthermore, we believe that since the loan was not obtained, the General Partner should have returned the loaned and advanced funds so that they would have been available to pay necessary and reasonable operating costs.

Criteria

Since eligible project costs were not incurred with funds obtained and/or used in connection with applying for a Section 241 loan, we believe that the Mortgagor violated Paragraph 6(b) of the Regulatory Agreement, which stipulates that the mortgagor cannot without HUD approval pay out funds except for reasonable project operating expenses.

Details pertaining to the loan of \$12,250, the advances totaling \$36,934, and the loan origination cost of \$7,276 are discussed below:

A \$12,250 loan from the Reserve for Replacement Account was not repaid

We found that on October 12, 1994, HUD's BAO authorized the General Partner to borrow funds from the Reserve for Replacement Account to pay commitment fees associated with obtaining a Section 241 Loan from Manufacture and Traders Trust Bank (M&T Bank). We noted that when HUD approved the withdrawal, HUD explicitly stated that "this fee is to pay the commitment fee for the 241 loan and that this fee will be reimbursed to the reserve for replacement account after the loan proceeds are received by the property owners." Although the General Partner aborted obtaining the loan from the M&T Bank, the \$12,250 was not returned to the Reserve

for Replacement Account nor reflected as a note receivable on the project's financial statements.

Furthermore, we found that the General Partner's request for project funds to pay loan origination fees stated that "time is of the essence as we must have a bank commitment prior to November 9th". Our analysis revealed that only \$2,500 was paid to the bank and that \$9,750 was paid to the General Partner as a development fee. Although the loan was not obtained, we believe that the General Partner was still obligated to reimburse the Reserve for Replacement Account from non-project/Federal funds.

Advances totaling \$36,934 were reclassified as a deferred charge

In addition to the above, we noted that the project's 1994 audit report reflects advances of \$36,934 to a related party to obtain a new loan. The report also revealed that the advances were subsequently reclassified as costs in the 1995 financial statements based on proposed closing costs of a Section 241 loan obtained from Continental Securities in September 1995.

Since the Continental Securities loan did not close until 1995, it is questionable whether the \$36,934 recorded as advances in the 1994 audit report was connected with that loan. Furthermore, we found that all the closing costs related to the Continental Securities loan were paid with funds from the proceeds of the loan. We further found that in 1995, the \$36,934 was reclassified on the project's books as a deferred charge to be amortized, which was reported as such in the project's 1995 financial statement.

We believe that the Mortgagor's decision to reclassify the \$36,934 to a deferred charge was inappropriate and violates Generally Accepted Accounting Principles (GAAP). GAAP requires that a future economic benefit be realized for the deferral of the costs of assets. Since charges associated with an unobtained loan will not result in a future asset, the charges should not be deferred and amortized. Therefore, we believe that the deferred charges should be removed from the project's books.

Loan origination cost of \$7,276 are ineligible

Additionally, a review of the project's financial records disclosed that \$7,276 of project's funds were used to pay loan

origination cost associated with applying for a Section 241 loan that was not obtained. Since no benefit was derived from the cost, we considered it to be unnecessary and ineligible for inclusion in project costs.

Auditee Comments

The Mortgagor indicated that they believed that the amount was expended properly in obtaining a Conventional Mortgage Commitment. After trying to refinance it was determined that a Section 241 loan should be pursued in order to insure the \$150,000 annual HUD savings when converted to gas.

The Mortgagor has indicated that the questionable deferred charges of \$36,934 was an error made in judgement because of a change in audit personnel in the year ended December 31, 1994. This entry will be reversed and reflected as a loan receivable from the General Partner in the 1996 financial statement.

In addition to the \$12,400 from Finding 1, the \$12,250 and the \$7,276 from this finding are included in the \$36,934 to set up as a loan receivable. Repayment of these loans will satisfy these findings and clear them when the General Partner makes the payment.

OIG Evaluation of Auditee Comments

The \$12,250 that the General Partner took from the project's cash account as a loan was misused by making a \$9,750 payment to the General Partner and by paying \$2,500 in commitment fees on a Section 241 loan that was not obtained. Nonetheless, the funds were provided in the form of a loan from the Reserve for Replacement Account, which should be returned from non-project/Federal funds.

Establishing a loan receivable from the General Partner to the project for \$36,934 will recognize that unauthorized withdrawals were made and ineligible costs were incurred, but all amounts indicated in our recommendations should be deposited in the project operating account and/or Reserve for Replacement Account, as appropriate, from non-project/Federal funds.

Recommendations

We recommend that you:

- 2A Require the General Partner to deposit into the project's Reserve for Replacement Account the amount of \$12,250, from non-project/Federal funds to replace the amount taken out in form of a loan.

- 2B Instruct the Mortgagor to reverse the entry that reclassified advances of \$36,934 to deferred charges on the project's books, and to properly reflect future transactions pertaining to loan acquisition costs in accordance with GAAP.

- 2C Require the Mortgagor to deposit \$7,276 in the project's operating account from non-project/Federal funds to reimburse the project for ineligible closing cost associated with a loan that was not obtained.

Bond Reserve Funds Used to Repay Unauthorized Loans and Advances, and Operating Funds Used to Pay Ineligible Legal Costs

The Mortgagor used the project's Bond Debt Service Reserve funds of \$55,768.84 to reimburse the project for unauthorized loans and advances made to the General Partner and Management Agent prior to December 1992. Because the Bond Fund Agreement provides that any funds remaining in the Bond Debt Service Account should be forwarded to HUD, the Mortgagor's use of the funds was improper. Additionally, we found that in January 1993, the Mortgagor transferred \$49,000 of project funds to the Management Agent's account to pay legal costs associated with refinancing the project's 11-B bonds. Inasmuch as such legal costs are not project operating expenses, they cannot be paid with operating funds of the project; therefore, the transfer of the \$49,000 was improper.

The Mortgagor
disregarded regulations

In our opinion, the actions of the Mortgagor as discussed above show a disregard of:

- The provisions in the Regulatory Agreement that prohibit the mortgagor from (a) receiving any funds of the project except for surplus cash, and (b) paying out funds except for reasonable operating expenses and necessary repairs.
- The section of the Bond Fund Agreement that provides that any funds remaining in the bond account are to be forwarded to HUD.

Reserve Funds used to
repay loans and advances

Contrary to the above, the funds that remained in the Bond Debt Service Reserve Account were deposited into the project's operating account and used to reimburse the project for funds taken out by the General Partner and the Management Agent as loans and advances. In addition to not having those funds available, the project was also denied the use of \$49,000, which was transferred to the Management Agent's account to pay refinancing legal fees. Since such fees would not be eligible for inclusion in the project's operating costs, the

Mortgagor's decision to transfer funds to pay for them was improper.

Criteria

Paragraph 8 of the Regulatory Agreement provides that Owners shall not without the prior written approval of the secretary....(e) make, or receive and retain, any distribution of assets or any income of any kind of the project except surplus cash and distributions made only as of and after the end of a semiannual or annual fiscal period. Regarding the bond proceeds, Section 4.13(b) of the Bond Fund Agreement provides that upon redemption of the Bonds any monies remaining in the fund shall be paid by the Trustee to HUD.

Project funds of \$55,768.84 were loaned and/or advanced to the General Partner and Management Agent

Our review disclosed that prior to December 1992, project funds totaling \$55,768.84 were used to provide loans to the Management Agent and General Partner. The last loan was made on December 22, 1992, to the General Partner for \$8,268.84 which brought the total amount of outstanding loans to \$55,768.84, which was the exact amount in the Bond Debt Service Reserve Account. This account was established at the beginning of the project (1981) with \$33,400. It accrued interest to the extent that when the original Bonds were redeemed in 1992, the balance in the Bond Debt Service Reserve Account was \$55,768.84. The bank account was in the name of Pilgrim Village Housing Development Corporation Mortgage Revenue Bonds, Bond Debt Reserve and was held in trust by Bank One Ohio Trust Company, NA.

Bond Reserve of \$55,768.84 used to repay loan and advances

The financial records of the project disclosed that on December 21, 1992, the project received a Fedwire deposit for the \$55,768.84 that was in the Bond Debt Service Reserve Account. These funds were recorded on the project's books by writing off \$55,768.84 in outstanding loans and advances due from the Management Agent and General Partner. The accounting input sheet shows the \$55,768.84 as repayment of loans from W.P.T (Wilbur P. Trammell). In accordance with an applicable provision of the Bond Fund Agreement, the \$55,768.84 that remained in the Bond Debt Service Reserve Account should have been remitted to HUD.

\$49,000 was transferred to Management Agent account

Additionally, on January 4, 1993, \$49,000 was transferred from the project operating fund to the bank account of Trammell Associates, the Management Agent. An invoice

from Wilbur P. Trammell, shows the \$49,000 as part of the disbursements rendered in connection with refinancing of 11-B Bonds. The Management Agent's books reflect the \$49,000 as a Notes Payable (Short Term). It is our position that the transfer of the \$49,000 in project funds was improper since bond refinancing legal costs are not eligible operating expenses of the project. Thus, the Mortgagor should be required to reimburse the project's operating account the amount \$49,000 from non-project/Federal funds.

Auditee Comments

The Mortgagor indicated that this finding erroneously concluded that the initial \$33,400 was proceeds from the 1981 Bond Proceeds. This was a required and separate payment from the developer, and according to the Bond Indenture was returnable to the owner/developer. Therefore, it should be allowed as a proper disposition. Any erroneous loan write off was corrected to reflect the proper indebtedness in the 1994 audited financial report. Also, the Mortgagor indicated that it is very likely that the \$49,000 was repaid during the year ended December 31, 1993.

OIG Evaluation of Auditee Comments

The Bond Debt Service Reserve Account was not in the developers or the General Partner's name. It was in the name of the Pilgrim Village Housing Development Corporation. Further, the Bond Fund Agreement provides that upon redemption of the Bonds any monies in the Fund shall be paid by the Trustee to HUD. Therefore, using the funds to write-off outstanding loans due from the General Partner was in violation of the Bond Fund Agreement. Regarding the \$49,000 that was transferred to pay ineligible legal expenses, we were not provided with any documentation showing that the funds were repaid to the project in 1993.

Recommendations

We recommend that you:

- 3A. Instruct the Mortgagor to restore to the project's books the amount of \$55,768.84, which represents unauthorized loans due from the General Partner and Management Agent. The General Partner and Management Agent should be instructed to reimburse

the project the \$55,768.84 from non-project/Federal funds.

- 3B. Determine whether the \$55,768.84 from the Bond Debt Service Reserve Account should be paid to HUD, the Bond Issuer or the project, and insure that the proper entity receives the funds.
- 3C. Instruct the Management Agent to reimburse the project the amount of \$49,000, which represent the amount transferred to the Management Agent's account to pay legal costs associated with refinancing the project's 11-B bonds.

Questionable Administrative Fee Charged by the Management Agent

Our review disclosed that the Management Agent is charging the project a questionable administrative fee. Specifically, we found that the Management Agent charged the project a fee of 15 percent of the gross payroll. According to a staff member of the Management Agent, the fee was for payroll processing, fidelity bond coverage, and disability insurance. However, requirements contained in the Management Agent Handbook, provide that the agent may not charge an administrative fee for payroll processing. Therefore, we considered the amount charged, which totaled \$34,578.72, unsupported costs pending an eligibility determination by the HUD's BAO.

Criteria

Paragraph 6.37(c) of the Management Agent Handbook HUD 4381.5 Rev 2 states that "rather than maintaining separate payroll and separate fringe benefits plans for each property, some agents consolidate payroll and fringe benefits plans in order to reduce costs for the properties." The paragraph further provides that:

- (1) Salaries and fringe benefits of personnel performing front-line duties are prorated among the properties served in proportion to actual use.
- (2) The agent may not impose surcharges or an administrative fee in addition to actual costs.

Administrative fee used to offset payroll and insurance costs

Based on conversations with the Management Agent's General Manager, the administrative fee is used to offset the payroll and insurance costs incurred by the Management Agent. In this regard, we noted that the Management Agent has contracted with a computerized payroll service to process its weekly payroll. Also, the Management Agent pays premiums for fidelity bond coverage and disability insurance. In lieu of being charged an allocated amount, the project is charged approximately \$285.00 a week as an administrative fee. However, the Management Agent could not provide adequate documentation supporting the reasonableness of the fee.

For 1994 and 1995 the project paid \$17,650.17 and \$16,928.65, respectively for payroll processing

Furthermore, our analysis revealed that Pilgrim Village's portion of the payroll service and premiums for fidelity bond coverage and disability insurance would only be a total of \$22.86 per week or appropriately \$1,188.72 a year. However, we found that for operating years of 1994 and 1995, the project paid \$17,650.07 and \$16,928.65 respectively, to the Management Agent for payroll processing and insurance coverage.

Based on the results of our analysis, we believe that the administrative fee being charged is unreasonable and unsupported; therefore, we considered costs of \$34,578.72 to be unsupported pending a eligibility determination by the HUD's BAO.

Auditee Comments

The Mortgagor's response indicates that although they feel justified in their payroll and fee charges, they have discontinued the administrative fee and allocated the proper payroll tax of 23 percent.

OIG Evaluation of Auditee Comments

We believe that the administrative fee being charged is unreasonable and unsupported; therefore, HUD's BAO should determine the amount of administrative costs that should be charged to the project for payroll processing, fidelity bond coverage, and disability insurance.

Recommendations

We recommend that you:

- 4A. Determine the amount of the unsupported administrative fees charged of \$34,578.72 that should be considered eligible, and require the Mortgagor to reimburse the project the balance from non-project/Federal funds
- 4B. Require the Mortgagor to provide written assurances that any administrative fee charged to the project after our audit period is determined in accordance with HUD requirements.

Payroll Allocation Method Does Not Comply With HUD Requirements

Our review disclosed that the Management Agent's payroll allocation method does not comply with applicable requirements provided in HUD Handbook 7381.5 REV-2, The Management Agent Handbook. The Management Agent currently allocates its payroll and fringe benefits costs based upon the number of employees assigned to a particular project, a percentage method. The rationale for the allocation method was neither documented nor sufficiently explained. Furthermore, our review revealed that several employees' salaries and fringe benefits were charged exclusively to the project, when in fact, the employees also perform non-project activities. As a result, adequate assurances that salary and fringe benefits costs are allocated properly among the projects managed by the Management Agent do not exist.

Criteria

The Regulatory Agreement provides that the owners shall not pay out any funds except for reasonable operating expenses and necessary repairs. Paragraph 6.37(c) of the Management Agent Handbook provides that salaries and fringe benefits of personnel performing front-line duties are prorated among the properties served in proportion to actual use.

Management Agent staff could not explain rationale behind allocation method

Payroll and fringe benefits costs are currently allocated to the project by a method developed by the Management Agent's accountant. Neither members of the project's staff nor the Management Agent's staff could explain the rationale behind the allocation method. Furthermore, the Management Agent did not maintain any documentation to support the allocation percentages. Our review of the Management Agent's allocation method disclosed it does not accurately reflect employees' actual work schedules. For example, the Occupancy Specialist/Assistant Manager is charged 100 percent to the project but maintains the financial records and collects the rents for another project. The maintenance supervisor oversees and performs maintenance operations at Pilgrim Village and another project, but his salary and fringe benefits are charged 100 percent to the Pilgrim Village project.

Payroll costs of \$308,320 considered unsupported

During our audit period, payroll costs of \$308,320 were charged to the project's operating account. Because the Management Agent did not use a supported payroll allocation method, we could not determine the reasonableness of the project's salary and fringe benefit costs. Therefore, those costs, totaling \$308,320, are considered unsupported pending an eligibility determination by HUD's BAO.

Auditee Comments

The Mortgagor indicated that although they feel justified in their salary and benefits charges, they have reallocated a portion of the administrative assistant to another property and will abide by any further directions from HUD.

OIG Evaluation of Auditee Comments

The problem noted in the finding is that the Management Agent's payroll allocation method does not comply with HUD requirements and was not adequately supported. As a result, the reasonableness of the payroll costs could not be determined.

Recommendations

We recommend that you:

- 5A. Determine whether the unsupported payroll costs totaling \$308,320 are allowable and advise the Mortgagor of your determination.
- 5B. Require the Mortgagor/Management Agent to implement an allocation method that meets HUD requirements and is adequately supported.

Internal Controls

In planning and performing our audit, we considered internal controls of the Mortgagor to determine auditing procedures and not provide assurance on internal controls.

Internal controls consist of a plan of organization and methods and procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss and misuse; and that reliable data is obtained, maintained, and fairly disclosed in reports.

Internal controls assessed

We determined that the following internal controls categories were relevant to our audit objectives.

- Controls over supporting documentation for costs
- Controls over cash receipts and disbursements
- Controls over maintenance of books and records

We evaluated all of the control categories identified above by determining the risk exposure and assessing control design and implementation.

It is a significant weakness if internal controls do not give reasonable assurance that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports.

Weaknesses in internal controls

Based on our review, there are weaknesses in the internal control areas cited in the Findings.

- Controls over supporting documentation for costs (Finding 2 through 5)
- Controls over cash receipts and disbursements (Finding 1 through 5)
- Controls over maintenance of books and records (Finding 1 and 2)

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Follow Up On Prior Audits

Our audit was the initial OIG audit of the Mortgagor.

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Schedule of Ineligible Distributions, Unauthorized Withdrawals and Ineligible and Unsupported Costs

Finding Number	Item	Ineligible Distributions/ Unauthorized Withdrawals (1)	Ineligible Costs (2)	Unsupported Costs (3)
1	(a) Unauthorized Withdrawals	\$ 14,100.00		
	(b) Non-Surplus Cash	\$ 41,900.00		
2	Loan from Reserve for Replacement Account	\$ 12,250.00		
	Ineligible Closing Costs		\$7,276.00	
3	(a) Unauthorized use of Bond funds	\$ 55,768.84		
	(b) Ineligible legal costs		\$49,000.00	
4	Unsupported Administrative Cost			\$ 34,578.72
5	Unsupported Allocated Costs			\$308,320.00
	TOTAL	\$124,018.84	\$56,276.00	\$342,898.72

- (1) Ineligible Distributions/
Unauthorized Withdrawals - Funds taken out of the project without HUD's approval and were not available surplus cash.
- (2) Ineligible Costs - Costs clearly not allowed by law, contract, HUD, or local agency policies and regulations.

- (3) Unsupported Costs - Costs not clearly eligible or ineligible but warrant being contested (e.g., lack of satisfactory documentation to support eligibility of the costs, etc.).

Auditee Comments

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Distribution

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Director, Multifamily Housing Division, 2CHM, Buffalo Area Office (2)
Field Comptroller, Midwest Field Office, 5AF
Buffalo Area Coordinator, 2CS (2)
Assistant to the Deputy Secretary for Field Management, SDF (Room 7106)
Office of the Housing-FHA Comptroller, HF (Attention: Comptroller,
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(Room 10166) (2)
Associate General Counsel, Office of Assisted Housing and
Community Development, GC (Room 8162)
Director, Housing and Community Development Issue Area, U.S.
GAO, 441 G Street, NW, Room 274, Washington, DC 20548 (2)
General Partner, Pilgrim Village Associates, Buffalo, New York