audit report
OFFICE OF INSPECTOR GENERAL

Issue Date June 4, 1997	
Audit Case Number 97-PH-212-1007	

TO: Charlie Famuliner, Director, Multifamily Division, Virginia State Office, 3FHM

FROM: Edward F. Momorella, District Inspector General for Audit, 3AGA

SUBJECT: Princeton Lakes Apartments
Multifamily Mortgagor Operations
Virginia Beach, Virginia

As you requested we have audited the operations of Princeton Lakes Apartments (project) to determine whether the owner operated the project according to the terms and conditions of the Regulatory Agreement and other HUD requirements.

The report identifies that the owner improperly disbursed project funds and failed to maintain proper control over project operations.

Within 60 days, please give us, for each recommendation made 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 considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

If you have any questions, please contact Irving I. Guss, Assistant District Inspector General for Audit, at (215) 656-3401.

Executive Summary

We audited Princeton Lakes Apartments to determine whether the owner operated the project according to the terms and conditions of the Regulatory Agreement and other applicable HUD requirements.

Owner improperly administered project funds

Project funds were used to pay owner debts in lieu of meeting the project's full debt service and repairing units that failed Housing Quality Standards. These Regulatory Agreement violations have placed the project owner in a default status, and $121,738 is currently due HUD.

Maintenance of accounting controls and security deposits deficient

The owner did not maintain proper control of project operations in violation of the Regulatory Agreement and HUD requirements. Specifically, the owner failed to: (1) maintain and control the project's accounting records and (2) fund the security deposit liability at all times. The owner's action represents mismanagement and disregard for effectively controlling the financial operations of the project.

We recommend the owner cure the default and pay HUD the mortgage debt, and maintain proper control of the projects' operations.

We discussed the original draft findings with the owner during the audit and at an exit conference held on March 13, 1997, subsequently, draft finding 1 was revised. The draft findings were provided to the owner and the responses received from the owner were considered in our report. Adjustments were made to costs questioned, and resolved issues were removed from the report.

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Abbreviations

CRMMF	Cash Resource Money Market Fund
FDIC	Federal Deposit Insurance Corporation
HQS	Housing Quality Standards
HUD	Department of Housing and Urban Development
IA	Independent Auditor
LIHPRHA	Low-Income Housing Preservation and Resident Homeownership Act
OIG	Office of Inspector General

Introduction

Princeton Lakes Apartments is a HUD-insured multifamily housing project in Virginia Beach, Virginia with 125 Section 8 units. The mortgage received final endorsement for insurance under Section 221(d)(3) of the National Housing Act on October 23, 1969.

The owner, Princeton Lakes Associates, a limited partnership, was organized on January 20, 1984. Mr. Herbert J. Zukerman is the managing general partner.

The owner and HUD are currently in litigation to establish conditions agreeable to both parties to settle the project's mortgage debt. No settlement has been reached as of the date of this report.

Since 1991 several agents have managed the project. The project is currently managed by Hercules Real Estate.

Primary tenant records are maintained at the projects' office in Virginia Beach, Virginia. Financial records are maintained by the current management agent, and the owner. The owner and agent offices are located at 168 Business Park Drive, Virginia Beach, Virginia.

Audit Objectives

The objectives of the audit were to determine whether the owner complied with the Regulatory Agreement and other applicable HUD requirements. Specific objectives were to determine whether the owner: (1) established adequate internal controls to safeguard project assets, and maintained reliable accounting data; (2) paid disbursements that were reasonable and necessary; and (3) administered the Section 8 Housing Assistance Payments Program properly.

Audit Scope

We examined the project's accounting records, located at agents and the owner's offices. We reviewed tenant records at the project. We reviewed financial statements and records located in HUD's Virginia State Office. We reviewed the project's Independent Auditor's work papers for Fiscal Year 1994. We interviewed the owner and staff members of the prior and current management agents and HUD staff. We inspected four vacant units and nine occupied units.

Audit Period

The Audit was started in March 1996 and was suspended because of the unavailability of the managing general partner.

Work was resumed in July 1996 and performed during various periods through May 1997 and covered activities between January 1995 through August 1996. The audit period was expanded when appropriate.

We conducted the audit in accordance with generally accepted government auditing standards.

Improper Disbursement Of Project Funds By The Owner

Project funds were used to pay owner debts in lieu of meeting the project's full debt service and repairing units that failed Housing Quality Standards (HQS). These Regulatory Agreement violations have placed the project owner in a default status, and $121,738 is currently due HUD.

Paragraph 6(e) of the Regulatory Agreement states the owner shall not without HUD's prior written approval: make any distribution except from surplus cash, limited in any one year to six percent on the initial equity investment; make no distribution when there is any default under the mortgage; comply with all notices for proper maintenance of the project and incur any liability other than for current operating expenses, exclusive of the mortgage debt.

From 1990 to August 1996, the owner made the following payments totaling $844,124 from an unsecured brokerage account with few exceptions:

- Payments of notes to the previous owner, owner's wife and other partners.
- Payments for refinancing note from previous owner.
- Payments to the managing general partner and a partner.
- Payments for costs associated with the Low-Income Housing Preservation and Resident Homeownership Act (LIHPRHA).
- Payments to legal firms for non-operating costs.

Our analysis of the payment transactions disclosed the following conditions:

- On September 25, 1987 an owner representative requested HUD permit the use of the project's Residual Receipts Account to pay down the principal portion of the Surplus Cash Note to the previous owner. On May 6, 1988 HUD approved the request. From income generated by the project, subject to the owner meeting project debt service and other obligations and taking eligible distributions, the remaining balance per HUD could be used to reduce the Surplus Cash Note.

- Contrary to the Regulatory Agreement the owner made improper payments in 1996 to the former owner and partners and charged the project for LIHPRHA and legal costs which were owner costs.

Review of annual financial statements through 1994 indicated that the project generated surplus cash. The project is limited to surplus cash distributions of $11,984 annually. For the period 1990 to 1996 distributions of $83,888 are allowable. During this period the ownership partners contributed $191,521 to the project. Considering both sources of funds owner equity totaled $275,409.

Owner not meeting debt service payments

Application of owner equity and HUD's approval to use residual receipts to pay the former owner's Surplus Cash Note offset the $844,124 disbursed from the brokerage account. However, the owner's application of project funds during 1996 had an impact on the financial and physical aspects of project operations. Effective with the April 1996 monthly payment through December 1996 the owner was making partial debt service payments to HUD. Since January 1997 to date the owner discontinued debt service payments. As of May 1997 a deficit of $121,738 exists and the mortgage is in default.

In October 1996 HUD abated Section 8 payments to the owner for 16 units because of uncorrected HQS violations. At the end of April 1997 four units still did not meet HQS.

In summary during 1996 funds from operations were available to pay debt service and correct HQS violations. Contrary to the Regulatory Agreement the owner choose to make note payments rather than meeting project obligations.

The owner has made a written offer to pay off the HUD mortgage. The offer has not been accepted and a counter offer by HUD has been made. The owner failed to respond and the offer has expired. HUD has placed the mortgage loan in foreclosure subject to full payment.

Auditee Comments

In response to the revised finding the owner stated:

"I received and reviewed the revised finding 1 and I am in basic agreement with the following comments and questions:

1. Please provide me with a breakdown of the $121,738 stated as due HUD so I can review the elements for accuracy (i.e. mortgage payment, replacement reserve, tax escrow, insurance escrow, etc.)

2. Please note that the partnership borrowed $600,000 in January 1997 and, after paying off all other notes, contributed $41,418.36 to the project for expenses.

3. The owner has responded to HUD's counter offer with a revised offer.

4. All units listed with HQS violations have been corrected and approved by HUD.

5. The HUD loan has not been placed in foreclosure (to the best of my knowledge) but the owner has been notified of default and given a time frame to cure the default."

OIG Evaluation of Auditee Comments

1. HUD has provided the owner a Statement Of Multifamily Mortgage Account dated April 18, 1997. The statement describes each account item that supports the delinquent total of $121,738.

2. HUD and our office is unaware of the funds borrowed by the partnership and contribution to the project.

3. We are unaware of any counter offer by the owner. HUD's offer has expired.

4. HUD has not advised our office that the four units with HQS violations have been corrected.

5. The loan is in foreclosure and has been accelerated per the April 18, 1997 statement.

Recommendations

We recommend the owner:

1A Cure the current default and pay the $121,738 due HUD. Make full future debt service payments on time.

1B Repair the four units that failed Section 8 Housing Quality Standards. Notify HUD when the repairs have been completed to have units inspected, and reinstated for housing assistance payments.

1C Meet applicable terms and conditions of the Regulatory Agreement before making any payments on notes due the former owner and current partners.

Owner Failed To Maintain Proper Control Over Project Operations

The owner did not maintain proper control of project operations in violation of the Regulatory Agreement and HUD requirements. Specifically, the owner failed to:

- Maintain and control project accounting records.

- Fund the security deposit liability at all times.

The owner's action represents mismanagement and disregard for effectively controlling the financial operations of the project.

A. Accounting records

The owner did not maintain and control accounting records properly by failing to: (1) maintain current project records; (2) submit an independent financial and compliance audit of the project for Fiscal Year 1995; (3) obtain project records from a prior management agent; (4) maintain project funds in F.D.I.C. insured accounts, and (5) support some project costs.

Paragraph 9(d) of the Regulatory Agreement requires that the owner maintain the project's books and accounts in accordance with HUD requirements.

1. Project records not current

HUD Handbook 4370.2 REV-1, Chapter 2, paragraph 2-3B. 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." Paragraph 2-13C. states that one of requirements of the management agreement is for the qualified agent to handle record keeping, collection of records and payment of bills.

Owner maintained separate cash account clouding accountability

Since March 1996, the owner signed all checks from the project operating account. The owner did not always inform the management agent about transferring operating funds to the brokerage account, nor about checks disbursed from the brokerage account. As a result, the agent did not post these disbursements to the general ledger, and report these disbursements on monthly accounting reports submitted to HUD. Review of the 1994 Independent Auditor's (IA) working papers disclosed that the IA recorded the 1994 activities in the brokerage account to the project records. Activity in the brokerage account for 1995 and 1996 was not recorded in the general ledger because audits have not been done.

The owner stated that he signs checks because HUD would not let him manage the project and he wanted to relieve the agent from any accountability in his actions with HUD.

By the owner, taking over the cash disbursement responsibilities from the agent, the project's books are incomplete and unreliable.

2. Independent audit not submitted

Paragraph 9e of the Regulatory Agreement states that an independent audit of the project's books and records must be furnished to HUD within 60 days following the end of the fiscal year.

HUD has not received a financial and compliance audit of the project for the Fiscal Year ended on December 31, 1995. The Fiscal Year 1996 audit was due HUD in March 1997, and is also overdue.

3. Books and records not obtained from prior agent

HUD Handbook 4370.2 REV-1, Chapters 2, paragraphs 2-3A. and 2-13B.4., requires the owner to maintain the projects' records in reasonable condition to permit a speedy and effective audit; and requires the management agent to turn over to the owner all the project's cash, trust accounts, investments, and records within thirty days after the agreement is terminated.

To perform this audit, we reviewed records at the prior management agent's office. The absence of all project records centrally located with the owner or current agent impeded the audit. The owner claimed the agent told him that the records were unavailable. However, the agent stated the records were their property and copies had been offered to the owner who refused to accept the copies. Both the agent and the owner violated HUD requirements.

4. Project funds not in F.D.I.C. insured accounts

The Regulatory Agreement paragraph 9(g) requires the owner to deposit project funds in accounts insured by the F.D.I.C.

The owner maintained a portion of operating funds and tenant security deposits in two brokerage accounts not insured by F.D.I.C. The owner used the brokerage accounts because the operating funds and security deposits in the bank accounts were not earning interest. The owner stated he obtained approval from HUD to use the brokerage accounts. The owner did not provide documents indicating HUD approval.

5. Unsupported costs

HUD Handbook 4370.2 REV-1, Chapter 2, paragraph 2.3A states: "... Owners shall keep copies of all written contracts or other instruments which affect the mortgaged property..."

From July 1990 through August 1996, the owner paid unsupported costs from the brokerage account totaling $4,796 as follows:

- Progressive Property Management - $3,296
- Brokerage and Wire Transfer Fees - $518
- Commerce Bank - $500
- Security Deposit Refund - $334
- Internal Revenue Service - $98
- Treasurer of Virginia - $50

The unsupported costs listed represent adjusted amounts based on the owner's responses prior and subsequent to the exit conference. The owner did not provide any documentation supporting these payments as project costs.

B. Security deposits

Paragraph 6(g) of the Regulatory Agreement provides that security funds shall at all times equal or exceed the aggregate of all outstanding obligations under that account.

Security deposit account underfunded

At August 31, 1996 the security deposits account was underfunded as follows:

Security deposit liability	$12,540
Security deposit account balance	$ 5,862
Underfunded balance	$ 6,678

During 1996, the security deposit account was underfunded in May, June and August because funds were transferred to the brokerage account.

The owner stated that he periodically takes loans from the account, but he fully funds the account at year end.

In summary the owner did not properly control project operations and comply with the financial management and accounting procedures for project operations required by HUD. As a result there is no assurance of financial integrity over project operations.

Auditee Comments

The owner stated:

In general this finding is an attempt to create an issue when none should exist. How can you conclude that we failed to maintain and control project accounting records yet be able to review these records and determine Finding 1.

If you are going to make an assertion challenging the records we have kept, please be specific or there is no ability for us to refute your assertion. Please see the detailed response as follows:

a) Accounting records

1. Absolutely inaccurate, as we have excellent current records

2. True, but please disclose that we engaged the auditor last March but he has not performed.

3. Please be specific; which records, which agent

4. The money market account only invests in US government instruments.

5. Your unsupported costs are covered by the enclosed documentation.

b) Security deposits

1. Your security deposit liability is incorrect

2. The security deposit account is fully funded, please disclose that fact.

c) Section 8 claims

Please disclose the fact that this has already been corrected and that it was an innocent one time mistake.

OIG Evaluation of Auditee Comments

a) Accounting records

1. We disagree with the owner's assertion on the condition of the records. During the audit, we visited three sites, two agents offices, and the owner's office, and subpoenaed bank records to perform the audit. We reviewed cancelled checks and bank and brokerage account statements because the owner did not maintain the disbursement journal and the general ledger showing the deposits and disbursements from the brokerage accounts. The preceding actions were necessary because all project records were not centrally located and incomplete.

2. The managing general partner of the ownership entity is a Certified Public Accountant. He has the

responsibility of engaging another firm to perform the audits in the absence of performance.

3. The agent referred to is not the current agent. The agent had the project general ledgers, bank statements, cancelled checks, paid invoices, etc. at their office.

4. The funds in the brokerage account are invested in a cash resource money market fund (CRMMF). The prospectus indicated that the CRMMF invests in various financial instruments including corporate obligations and commercial paper that can be issued by foreign issuers. The CRMMF fund is not FDIC insured.

5. We reviewed the documents the owner provided covering the unsupported costs. The net effect was to reduce unsupported costs to $4,796.

b) The owner did not provide documents showing the security deposit account was fully funded and matched the liability.

c) The Section 8 Special Claims billing was corrected and the issue was removed from the finding.

Recommendations

We recommend the owner:

2A. Centralize all financial records of the project in one location. Assure all financial transactions are recorded in the general ledger accounts and the general ledger cash account is reconciled to the bank statements on a monthly basis.

2B. Submit to HUD an independent financial and compliance audit of the project for Fiscal Years 1995 and 1996.

2C. Obtain project records from the prior management agent for calendar years 1994 through 1996.

2D. Deposit all operating funds and security deposits into F.D.I.C. insured accounts. Discontinue the brokerage accounts for project financial activities.

2E. Provide documentation supporting the propriety of costs totaling $4,796 or deposit any portion of the costs not supported to the project operating account.

2F. Fund the liability for security deposits and maintain the balance at the required level at all times.

Internal Controls

In planning and performing our audit, we considered the internal control systems of the management of Princeton Lakes Apartments in order to determine our auditing procedures and to provide assurance on internal controls. Internal control is the process by which an entity obtains reasonable assurance as to achievement of specified objectives. Internal control consists of interrelated components, including integrity, ethical values, competence, and the control environment which includes establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Internal controls assessed

We determined that the following internal control categories were relevant to our objectives:

- Cash receipts and disbursements
- Accounting records
- Tenants security deposits
- Section 8 Housing Assistance Payments

Significant weaknesses found

A significant weakness exists if internal control does not give reasonable assurance that the entity's goals and objectives are met; 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. Based on our review, we believe the following items are significant weaknesses:

- Cash disbursements
- Accounting records
- Tenants security deposits

These weaknesses are detailed in the findings in this report.

Follow Up On Prior Audits

This was the first OIG audit of Princeton Lakes Apartments.

Schedule Of Ineligible And Unsupported Costs

Finding Number	Ineligible 1/	Unsupported 2/
1	$121,738	
2		$4,796

1/ Ineligible amounts are clearly not allowed by law, contract, or HUD policies or regulations.

2/ Unsupported amounts were not clearly eligible or ineligible but warrant being contested for various reasons, such as the lack of satisfactory documentation to support eligibility.

Distribution

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