U.S. Department of Housing and Urban Development
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District Inspector General for Audit

May 28, 1997

Audit Related Memorandum
No. 97-PH-212-1808

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

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

SUBJECT: Lafayette Villa Nursing Home
Mortgagor Operations
Norfolk, Virginia

Pursuant to your request, we have completed a review of operations for Lafayette Villa Nursing Home (LV). Your request identified questionable disbursements of LV funds.

The purpose of our review was to determine if LV was operated in accordance with the terms and conditions set forth in the Regulatory Agreement and applicable HUD directives.

We reviewed LV records and reports and analyzed cash disbursements. We interviewed Asset Management Branch staff in the Virginia State Office and LV personnel. The audit period covered activities from January 1 to December 31, 1996 and was extended when necessary.

Results of Review

Our review disclosed the following:

I. LV contrary to requirements did not maintain proper books and accounts for the mortgaged portion of the nursing home. Since 1987, only the addition to the nursing home's original building was mortgaged and insured by HUD. This portion of the property represented about fifty percent of the nursing home's total square footage. The Regulatory Agreement requires that separate books and accounts be maintained for the mortgaged property. Books and accounts unique to the addition were not maintained. Instead, LV used one accounting system to record transactions from both portions of the property and used one general operating account to deposit and expense funds. In order to adequately monitor financial operations and to ensure HUD's interests are protected, LV needs to establish an accounting system to capture and report the financial status of operations that relate to the mortgaged property.

II. The owner used LV funds to pay expenses unnecessary to LV operations contrary to HUD requirements. LV funds improperly used totaled $832,562. The Regulatory Agreement states that the owners shall pay out funds only for reasonable operating expenses and necessary repairs. The owner disregarded HUD requirements and made improper cash disbursements that generally benefitted the owners and family members and included:

A. Owner compensation

A review of payroll files and disbursement records showed during the period January 1995 through February 1997 LV paid $526,806 in owner compensation to include salaries, deferred compensation, bonuses, consulting fees, and related payroll costs (FICA, medicare, and unemployment taxes). These salary related costs are questionable since the owners were also officers of the corporation. HUD handbook 4370.2 Rev-1 dated May 1992 states that officer salaries cannot be charged to project operations unless approved by HUD. In addition, during the period of review, calculations made by an independent auditor showed no surplus cash was available for distribution. The Regulatory Agreement states that owners cannot receive any income of any kind except available surplus cash.

B. Insurance premiums

An analyses of payroll records and bank statements revealed that LV made questionable payments for life, disability, and health insurance premiums on owner policies totaling $195,206 during the period January 1995 through December 1996. We were told that the policies were necessary to ensure continuity of operations in the event of the death of one of the owners. In our opinion, these costs do not represent costs necessary for LV operations and should be paid by the owner.

C. Costs related to additional properties

During 1996, LV incurred questionable expenses related to properties acquired by LV and included mortgage payments, maintenance and repairs, and property taxes totaling $36,619. As of December 31, 1996, LV records showed that three adjacent properties and one nearby property were owned by LV and acquired without HUD approval. The expenses associated with these properties were superfluous to LV operations.

Additionally, incurring obligations not connected with the property is prohibited by the Regulatory Agreement unless HUD approval is obtained.

D. Accounting services

LV paid $28,875 for accounting services that were not related to the property or unsupported as a property expense during 1996. Unrelated expenses amounting to $2,864 included payments made for services provided to the owner for personal accounting services and those related to other business ventures. Additional payments totaling $26,011 were unsupported as necessary and related to LV operations.

E. College Expenses

From December 1995 through February 1996, LV paid college tuition and expenses amounting to $18,315 for one of the owners son. LV staff told us that these costs were payable under the terms established in a retirement agreement between one of the owners, who also was LV's former administrator, and LV. However, these costs do not represent necessary expenditures; accordingly, LV funds should not have been used to pay these costs. The retirement agreement is treated as a separate issue and is further discussed in paragraph V.

F. Vehicle related expenses

LV paid $16,866 during 1996 for costs related to personal vehicles used by the owners. Costs included AAA memberships, fees for county tags, lease payments, and repairs and maintenance. In our opinion, these expenditures were beneficial to the owners and were not necessary to LV operations.

G. Credit card purchases

During 1996, LV paid $4,006 for credit card purchases made by one of the owners. The items purchased were used by the owner and not related to LV operations.

H. Phone and pager charges

LV paid $3,292 for cellular phone service, calling card phone charges, and pager service during 1996. The cellular and pager service was personally used by two of the owners. The calling card was used by an owner's son in college.

I. Legal fees

Questionable legal fees totaling $2,577 were paid by LV during 1996. These costs related to services provided to draw up a retirement agreement for one of the owners who retired as the nursing home's administrator in June 1996.

The owner needs to immediately terminate the practice of using LV funds to pay expenses not related to nursing home operations and implement cash disbursement procedures consistent with HUD criteria. Also, the owner should analyze the source and use of funds during 1996 (and extended periods where identified) and determine to what extent the $832,562 in questionable disbursements identified during the audit can be applied to operations associated with the non-mortgaged portion of the property.

III. As a result of the improper cash disbursements, LV did not have sufficient cash to pay operational expenses and incurred $96,154 in additional late fees and finance charges during 1996. Additional costs included:

- $39,376 in interest paid to commercial lenders for loans used to manage cash flow problems.

- $32,836 in interest charges for unpaid vendor debts that were converted to notes payable.

- $23,942 in late fees and finance charges assessed by vendors for untimely payment of operational expenses.

Mismanagement of LV cash disbursements has placed the property in financial distress. The short term financial problem will be further compounded in light of a $66,736 balloon payment due on one of the vendor notes in November 1997. Unless corrective action is promptly taken, this situation will likely get worse, seriously jeopardizing HUD's interests.

IV. LV made improper loans to owners contrary to requirements. As of December 31, 1996, LV records showed that notes receivable balances resulting from loans made by LV to 4 of the 6 owners totaled $246,035. These loans represent an unauthorized distribution of LV funds. The Regulatory Agreement states that the owners may not make or receive any distribution of project assets or income of any kind except for surplus cash. The practice of loaning LV funds to owners should be terminated and existing loans should be promptly repaid.

V. In March 1992, an executive retirement agreement was established between the owner and the nursing home's administrator. At the time, he was also part owner of the corporation, as he is currently. This agreement established a retirement benefits package to be provided to the administrator that included property, forgiveness of $149,939 in debt, and deferred compensation totaling $309,000 to be incrementally paid out beginning June 1996 through September 1999. Costs associated with this agreement have been paid with LV funds. HUD was not aware of the agreement as the owner never sought or obtained HUD approval. In our opinion, these costs are not reasonable operating costs of LV and should instead be paid by the owner with available surplus cash distributions.

Recommendations

We recommend the owner:

1A. Establish a separate accounting system that will record and report the 1997 financial status of operations as it relates to the mortgaged property. Ensure this system includes a separate general operating account and records only those revenues and expenses unique to the operations of the mortgaged property. For those costs that are not unique and shared by the entire operation, ensure that a reasonable and logical methodology is used to prorate shared costs as accurately as possible.

1B. Terminate the practice of using LV funds to pay expenses not related to LV operations. Establish and implement cash disbursement procedures consistent with HUD directives.

1C. Analyze the sources and uses of funds relevant to LV, and justify to what extent the $832,562 in questionable disbursements made in 1996 (and relevant extended periods) can be applied to the non-mortgaged and HUD insured mortgage portion of LV's operations. Submit this justification to HUD for review, and the amount to be repaid to LV.

1D. Minimize late fees and finance charges paid to vendors by paying invoices in a timely manner.

1E. Stop making loans to shareholders. Establish a formal plan to dissolve current loan balances and submit the plan to HUD for approval.

1F. Do not use LV funds to pay for provisions contained in the Executive Retirement Agreement between Lafayette Villa, Inc. and the former administrator.

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The owner declined an exit conference; however, the results of our review were discussed with responsible LV personnel. We also discussed the results of our review with state Medicaid officials and your staff.

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

Attachment - Distribution

CC: OSWALD
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Correspondence Code	3AGA			
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Attachment

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