audit report

OFFICE OF INSPECTOR GENERAL

Issue Date January 21, 1997	
Audit Case Number 97-CH-214-1004	

TO: Patricia A. Knight, Director, Multifamily Division, Cincinnati Area Office

FROM: Dale L. Chouteau, District Inspector General for Audit, Midwest

SUBJECT: Jena Apartments
Multifamily Mortgagor Operations
Cincinnati, Ohio

We completed an audit of the operations of Jena Apartments. We performed the audit at the request of the Cincinnati Area Office. Our objectives were to evaluate whether the owner/management agent complied with requirements of the Regulatory Agreement, HUD regulations, and other HUD requirements relating to the project's payroll.

From January 1, 1994 through December 31, 1995, Jena Apartments paid $24,265 for ineligible salaries. According to the Regulatory Agreement and other HUD requirements, the salaries should have been paid from the management agent's fee. Because of these ineligible payments, less money was available for maintaining the project and correcting its physical deficiencies.

Within 60 days, please provide us, for each recommendation, 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 me at (312) 353-7832.

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Executive Summary

We completed an audit of the operations of Jena Apartments. We performed the audit at the request of the Cincinnati Area Office. Our objectives were to evaluate whether the owner/management agent complied with requirements of the Regulatory Agreement, HUD regulations, and other HUD requirements relating to the project's payroll.

During our audit, the Cincinnati Area Office and Jena Apartments' owner reached an agreement. The agreement resolved issues regarding project management, physical condition, audited financial statements, and disbursements raised by the Cincinnati Area Office. Consequently, we did not review these areas. We limited our review to payroll, another issue raised by the Cincinnati Area Office, but not resolved.

Jena paid for ineligible salaries

Jena Apartments paid $24,265 over two years for ineligible employees' salaries which the management agent should have paid. The employees worked in the agent's law office. Their duties included both management agent and front-line project activities. The management agent, however, could not charge the project for the cost of the employees' front-line activities because the agent did not comply with HUD requirements. Specifically, the employees' job descriptions and the agent's records did not distinguish between front-line and non-front-line duties. Because of these ineligible salary payments, less money was available for maintaining the project and correcting its physical deficiencies.

Recommendation

We recommend that the Cincinnati Office's Director of the Multifamily Division requires the owner of Jena Apartments to reimburse the project's operating account that portion of the $24,265 for payroll costs paid by the project between January 1, 1994 and December 31, 1995 for which no supporting documentation is provided. The money should be deposited into an escrow account to be used to repair the project.

We provided our draft finding to Jena Apartments' owner during the audit. We held an exit conference on December 2, 1996. The owner provided written comments to the draft finding and recommendation. We considered the response in preparing our final report. We included the complete text of the response in Appendix B.

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Introduction

Jena Apartments is a 32-unit scattered-site project near downtown Cincinnati, Ohio. Jena Apartments is owned by Lance Cox, Managing General Partner, and Ray Nein, General Partner. Jena Apartments entered into a Regulatory Agreement with HUD and signed the mortgage note on December 30, 1974. The mortgage is a 40-year loan in the amount of $715,800. In addition, Jena Apartments entered into a housing assistance payments contract with HUD on April 11, 1984 with a maximum annual contract commitment of $204,648.

Jena Apartments defaulted on its mortgage loan during 1979 and on October 30, 1980, the mortgagee assigned the mortgage to HUD. As of July 1, 1996, the amount of the mortgage delinquency was $124,862.

The Cincinnati Area Office had concerns regarding the operations of Jena Apartments. These concerns were that the owners: 1) paid excessive payroll costs; 2) obligated the project to interest-bearing notes payable while in default and without HUD approval; 3) paid excessive maintenance costs; 4) received unsatisfactory ratings on the management review and physical inspection report; 5) received a rent increase totaling $19,190 which was not used for security as outlined on the budget request; and 6) did not submit the 1995 audit report. In October 1996, Jena Apartments and the Cincinnati Area Office signed an agreement settling the concerns raised by the HUD Office, except for ineligible payroll payments. The agreement provided that:

- The owners repay $5,887 to the project account for interest accrued on a notes payable.
- The owners contribute $17,025 towards the amount owed to the General Contractor;
- The owners contribute $40,000 in a separate escrow account to deal with the physical condition of the project;
- The owners will strive to correct the security items identified in the most recent HUD physical inspection;
- The project will pay the independent public accountant the amount owed him. The independent public accountant has completed the 1995 audit, but the Cincinnati Office will not accept the report because the accountant was not licensed at the time he did the audit.

Although the $19,100 rent increase was not used for security, we did not find any instances where project funds were used for ineligible purposes, except for the issue of payroll (see the Finding). Because of the agreement between the Cincinnati Office and the project owners, we limited our review to the payroll issue, and we terminated our audit work for the other issues.

Through January 31, 1996, the Creekwood Group, Inc., an identity-of-interest firm, managed Jena Apartments. Since February 1, 1996, Rivers Investments, based in Detroit, Michigan, has been the management agent. The books and records were at the Creekwood Group, Inc., 480 Ohio Pike, Cincinnati, Ohio.

Audit objectives

Because of the agreement between HUD and Jena Apartments, we focused our audit on the review of payroll. The objectives of our audit were to evaluate whether the owner/management agent's complied with requirements of the Regulatory Agreement, HUD regulations and other HUD requirements relating to the project's payroll.

Audit scope and methodology

We performed our on-site work between August 1996 and October 1996 at the Cincinnati Area Office and at Jena Apartments. To accomplish our objectives we tested compliance with the Regulatory Agreement and HUD requirements, interviewed former management agent officials, current management agent officials, and HUD staff.

At the Cincinnati Area Office, we reviewed the 1993 and 1994 financial reports, physical inspection reports, monitoring reports and correspondence. From Jena Apartments' records, we reviewed a sample of disbursements between January 1, 1994 and January 31, 1996. We reviewed the cancelled checks, bank statements, monthly accounting reports, and invoices. We also reviewed independent audit reports and the mortgage note. We inspected the interior of all 30 occupied units at Jena Apartments.

The audit generally covered the period January 1, 1994 through January 31, 1996. However, we expanded the coverage as necessary.

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

We held an exit conference with Jena Apartments' owner on December 2, 1996 and provided a copy of the report to him.

Jena Apartments Paid for Ineligible Salaries

Jena Apartments paid $24,265 over two years for ineligible employees' salaries which the management agent, Creekwood Group, Inc., should have paid. The employees worked in Creekwood's central office, which was also the owner's law office. Their duties included both management agent and front-line project activities. The management agent, however, could not charge the project for the cost of the employees' front-line activities because the agent did not comply with HUD requirements. Specifically, the employees' job descriptions and the agent's records did not distinguish between front-line and non-front-line duties. Because of these ineligible salary payments, less money was available for maintaining the project and correcting its physical deficiencies.

HUD requirements

The Regulatory Agreement and HUD Handbook 4381.5 REV-2, The Management Agent's Handbook, prohibit charging the project for management agent expenses. The Regulatory Agreement requires the owner to use project funds only to pay reasonable expenses necessary for the operation and maintenance of the project (paragraph 6(b)).

The Management Agent's Handbook describes the costs that may be properly charged to project operating accounts and those that must be paid from the management fees. HUD permits only front-line, day-to-day activities to be charged to the project accounts. These costs include taking applications; screening, certifying, and recertifying residents; maintaining the project; and accounting for project income and expenses (paragraph 6.38).

The Handbook also states that the management agent must pay the cost of office salaries and expenses from management fees. It must also pay for supervising project personnel, on-site monitoring, dealing with project problems, reviewing tenant certifications and supervising project books (paragraph 6.39b).

The project may be charged for the time a staff generalist spends on front-line duties. A generalist is a central office staff member who assumes front-line duties as needed. To charge the project, however, the agent must develop a job description outlining the generalist's front-line and non-front-line responsibilities. The non-front-line responsibilities may not include supervisory functions. The generalist must also document hours spent and duties performed on front-line and central office activities.

The project paid the salaries of two agent employees

Between January 1, 1994 and December 31, 1995, Jena Apartments paid $24,265 in salaries to two employees who worked in the management agent's office. One of the employees held the title of Co-Manager and the other was a clerk. Although they conducted management agent duties, the Creekwood Group did not absorb any part of their salaries. The following shows the amount each employee earned in 1994 and 1995:

Year	Co-Manager	Clerk	Totals
1994	$10,450	$1,932	$12,382
1995	9,880	2,003	11,883
Totals	$20,330	$3,935	$24,265

The Co-Manager's statements and her job description indicated that her duties included management agent duties and project-related duties. The management agent duties included supervising the office clerical staff, acting as a liaison between the project and HUD, obtaining bids for insurance, inspecting units, and dealing with problems with utility companies.

The clerical activities were not exclusively project activities. For example, typing the Co-Manager's payroll reports and tax forms were management agent expenses since the Co-Manager performed management agent activities. Photocopying and general filing were either management or project activities. Therefore, to designate whether the function was an agent or project activity, the employee would have had to document the purpose of the activity.

About the only front-line activities the office employees performed were paying bills, bookkeeping, and scheduling maintenance. The cost of these activities could not be charged to the project, however, because the employees' job descriptions and the agent's records did not comply with HUD requirements. The job descriptions did not identify each duty as front-line or non-front-line. Furthermore, the agent did not keep records documenting the duties the employees actually performed and the associated time spent on them.

Money for maintenance and repairs was reduced

On April 12, 1995 and July 12, 1996, the Cincinnati Area Office's contractor inspected and gave the project unsatisfactory ratings. The inspections showed the project needed about $74,300 and $77,000 in repairs, respectively. Because project money was used to pay for ineligible management agent costs, Jena Apartments had less money available for maintaining the project and correcting its physical deficiencies.

A consultant replied to our draft findings on behalf of the Creekwood Group.

Auditee Comments

We acknowledge that the job descriptions as presently constituted did not clearly delineate the portions that should be charged to the project as a pass-through expense, and what should be paid for management fees. However, if one understands the programs, one could determine what was a project expense and what was a management expense. I have taken the liberty to mark up the job description identifying those items based on my program experience that are project pass-back expenses and those that clearly must be paid for out of the management fee.

OIG Evaluation of Auditee Comments

The consultant agreed that the job descriptions did not identify management agent and project activities. Of the 13 activities listed on the Co-Manager's job description, the consultant identified seven as management agent activities, five as project activities, and one as divided between agent and project activities.

We disagree with three of the consultant's five classifications of project activities. One, emergency contacts for tenant problems, is not chargeable to the project. The project can only be charged for this type activity if the generalist replaces a project employee beyond 40 consecutive hours (see Management Agent Handbook, paragraph 6.38, Figure 6-2). Therefore, occasional emergency contacts for tenant problems is an agent activity.

The descriptions for general typing and for preparation of payroll reports [Internal Revenue Service and miscellaneous tax forms] are not specific and clear enough to be exclusively project activities; especially since the Co-Manager's activities admittedly included management activities.

Auditee Comments

One of the items in your report that we take issue with is your assertion on page 2 which states:

"Specifically, the clerk performed the following management agent duties: typing payroll reports and Internal Revenue Service Forms W-2 and 1099, photocopying, and general filing".

The time spent by the person in question who performs these duties for project employees is clearly a project pass-back expense covered under Handbook 4381.5 figure 602 on page 6-30 under costs paid from project account third box. The general language associated with cost, covers the payroll costs for project employees. This function clearly isn't a supervisor type function.

OIG Evaluation of Auditee Comments

We have revised the statement to emphasize that the clerical activities were not exclusively project activities.

Auditee Comments

We acknowledge that Creekwood Management failed to satisfactory document and support the cost passed back. However, the fact remains that some portion of the costs are allowable, in that the bills were paid by the employees in question as were other allowable functions performed. Your finding disallows 100 percent of the cost charged back to the project while some portion yet to be determined and documented should be approved as being allowable. There are various methods that can be used by my client to develop the supporting documentation. I assure you that I will be working with my client to provide a submission that will satisfy the intent of paragraph 6.38 b. (4) of HUD Handbook 4381.5. However, in my opinion your report would be accurate, if your finding stated that some portion, yet to be determined, was improperly passed back to the project rather than being paid for out of the Management Fee. I assure you, however, that I will work closely with my client to provide the necessary information and documentation to the Cincinnati HUD Asset Management staff in order to gain their approval to close the Audit findings once the final Audit has been issued.

OIG Evaluation of Auditee Comments

The consultant agreed that the agent failed to document and support the cost charged to the project. We have stated, in our finding, the essence of the auditee's position: some of the costs charged for central office employees were for project activities. However, the finding disallowed 100 percent of the salaries because the agent failed to document the time spent on project activities, as required. The documentation that supports the cost charged to the project should show the hours spent and the duties performed on front-line activities and those spent on central office functions.

Auditee Comments

In closing, I would like to point out that Creekwood Management deferred taking $21,332.33 in Management Fees over the period in question which is presently being carried on the projects books as a deferred liability. Would it not be in every ones interest that your recommendation include a comment that whatever amount is finally determined to be owed that the amount be applied against the deferred Management Fee, thus reducing the amount shown on the project's books and records as being a deferred liability? You may be assured that we will be working closely with our client and the Cincinnati HUD Asset Management staff to close the issues that remain outstanding in your final audit report.

OIG Evaluation of Auditee Comments

The draft financial statements for fiscal year ended December 31, 1995 show that the project paid Creekwood the full management fees owed; and no fees were owed at year end.

Recommendation

We recommend that the Cincinnati Office's Director of the Multifamily Division requires the owner of Jena Apartments to:

A. Reimburse the project's operating account that portion of the $24,265 for the payroll costs paid by the project from January 1, 1994 and December 31, 1995 for the Co-Manager and clerk for which no supporting documentation is provided. The documentation that supports the cost charged to the project should show the hours spent and the duties performed on front-line activities and those spent on central office functions. The money paid back should be deposited in an escrow account to be used to repair the project.

Internal Controls

In planning and performing our audit, we considered the internal control systems of Jena Apartments. Internal control is the process by which an entity obtains reasonable assurance as to achievement of specified objectives, such as to ensure that its goals and objectives are met; resource use is consistent with laws, regulations, policies; resources are safeguarded against waste, loss, and misuse; and reliable data are obtained, maintained, and fairly disclosed in reports. 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.

Relevant internal controls

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

- Accounting system and controls;

Our assessment of internal control was limited to the payroll expenses the agent charged to the project. The settlement agreement between HUD and Jena Apartments resolved the other issues within the scope of our audit.

Significant weakness

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.

Based on our review, the following item is a significant weakness:

- Accounting system and controls.

  The lack of effective controls in Jena Apartments' accounting system resulted in the payment of $24,265 over two years for ineligible employees' salaries that the management agent should have paid. No recommendations were made since the Creekwood Group no longer manages Jena Apartments (see Finding).

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Follow Up On Prior Audits

This was the Office of Inspector General's only audit of Jena Apartments. The latest independent public accountant audit report was for fiscal year ended December 31, 1994. The findings in this report related to the system of internal controls while the Creekwood Group managed Jena Apartments. The Creekwood Group no longer manages Jena Apartments. In addition, the settlement agreement between HUD and Jena Apartments resolved HUD's concerns regarding the operations of Jena Apartments. Therefore, we did not follow up.

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Schedule of Questioned Costs

Recommendation No.	Ineligible Costs
1A	$24,265

Ineligible costs are amounts that are questioned because of an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds.

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Auditee Comments

CREATIVE SOLUTIONS

P.O. Box 1503
White Plains, MD 20695
(301) 870-1537
Fax (301) 870-5865

December 5, 1996

Mr. James J. Sobota
Senior Auditor
U.S. Department of Housing and
Urban Development
Office of Inspector General for Audit
Midwest
200 North High Street, Room 334
Columbus, Ohio 43215-2499

Subject: Response to your letter of November 19, 1996 to the owners of Jena Apartments Cinn. Ohio, transmitting a copy of the draft audit and proposed findings requesting their response within 10 days from the date of the letter.

Dear Mr. Sobota,

The owners of Jena Apartments have contracted with Creative Management Solutions to work with HUD Cinn. with the purpose in mind of reaching an agreement to restore the financial and physical condition of the property to a satisfactory condition. As you are aware, we have executed a letter agreement with HUD, which accomplishes the task assigned to me. However, we realize that the audit findings must be dealt with quickly so that the resolution isn't jeopardized. The owners of Jena Apartments have authorized Creative Management Solutions to respond to the draft findings.

Immediately upon receipt of your letter, I sent a written request for an extension of time. As per your telephone call to me on 11/27 the request was denied. Also, at the close out meeting held December 2, 1996 with the owners, you indicated that a response must be received no later than Friday December 6, 1996, if it was going to be included in your Final Audit Report. While some of the findings are not at issue, there are portions that we believe you should reconsider, based on the facts in the case. Therefore, in the time allotted, I can only provide you with a very general overview in this interim response.

General Interim Response:

First issue: **Job Description failed to clearly delineate what duties where project expense and what duties were charged to the Management Fee.**

We acknowledge that the job description as presently constituted, did not clearly delineate the portions that should be charged to the project as a pass through expense and what should be paid for from Management Fees. However, if one understands the programs, one could determine what was a project expense and what was a Management expense. I have taken the liberty to mark up the job description identifying those items based on my program experience that are project pass back expenses and those that clearly must be paid for out of the Management Fee. (attachment 1) One of the items in your report that we take issue with is your assertion on page 2 which states;

> "Specifically, the clerk performed the following management agent duties: typing payroll reports and Internal Revenue Service Forms W-2 and 1099, photocopying, and general filing".

The time spent by the person in question who performs these duties for project employees is clearly a project pass back expense covered under Handbook 4381.5 figure 6-2 on page 6-30 under costs paid from project account third box. The general language associated with cost, covers the payroll costs for project employees. This function clearly isn't a supervisor type function. Your report compares the cost experienced under Creekwood Management with the costs being experienced by Rivers Investment, the successor manager to support your finding. However, the difference in operating costs between the two firms is not relevant to the issue. The cost experience by Creekwood Management for allowable project pass back costs need only be reasonable and comparable to what the cost would be if the project employed a person to perform the duties at the project site.

The number of employees and what duties each performed were negotiated between HUD and Rivers Investment, and were approved temporarily for calendar year 1996 only. The purpose of this arrangement was to provide a greater degree of expertise in dealing with the project problems in 1996. For calendar year 1997, HUD and the owners have agreed that they will require that Rivers Management return to the normal staffing. To assure that the project is maintained in satisfactory condition we have agreed to require Rivers Management to develop a shared employee agreement with the other projects they manage in the area. Based on this I believe that the comparison should be dropped, as it isn't necessary to support your findings. As stated, it provides the reader with a picture that isn't supportive of the facts as temporarily approved by HUD.

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Director, Housing and Community Development Issue Area, U.S. GAO, 441 G Street, NW, Room 2474, Washington, DC 20548 Attn: Judy England-Joseph