audit report
OFFICE OF INSPECTOR GENERAL

Issue Date
August 26, 1997
Audit Case Number
97-FW-211-1003

TO: E. Ross Burton
Director, Office of Housing, 6AH

FROM: D. Michael Beard
District Inspector General for Audit, 6AGA

SUBJECT: Medlock Southwest Management Corporation
Multifamily Management Agent
Lubbock, Texas

In response to a complaint, we performed an audit of Medlock Southwest Management Corporation. The purpose of the audit was to determine the validity and materiality of problems identified with payments for employee injury insurance premiums, management agent reimbursement for payrolls, payments to owners for administrative management fees, and charges to projects by identity-of-interest companies. This report contains findings in these areas. We have provided Medlock Southwest Management Corporation a copy of this report.

Within 30 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 taken 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 this audit.

Should you have any questions, please contact Jerry Thompson, Assistant District Inspector for Audit, or me at (817) 978-9309.

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Executive Summary

In response to a citizen's complaint, we audited Medlock Southwest Management Corporation. Our objectives were to determine the validity and materiality of problems reported with payments for employee injury insurance premiums, management agent reimbursement for payrolls, payments to owners for administrative management fees, charges to projects by identity-of-interest companies, and the reasons for any non-compliance with the Regulatory Agreements and/or HUD requirements. The findings in this report relate to each of the objectives.

Medlock inappropriately commingled funds from all projects and cannot support billings and expenditures approaching $1 million. Specifically: Medlock billed HUD projects $587,198 above actual insurance costs; $416,467 above actual payroll costs; and $195,765 for contractors who used project personnel who already worked at the projects. Medlock did not have internal accounting controls over its centralized payroll system, thus individual project costs and funds were not tracked and accounted for. The excess collections and lack of accounting systems violated both project Regulatory Agreements and HUD requirements.

Medlock paid general partners of four projects $24,000 in administrative management fees when the projects were not in surplus cash positions.

Medlock provided us written comments, contained in Appendix D, and we discussed the findings at an exit conference on July 15, 1997. Medlock agrees they overbilled projects for $362,886.02 in payroll but contends $53,581.21 charged for unsupported payroll should be allowable because they say the projects received the work. Medlock contended the projects realized substantial savings over Worker's Compensation as a result of the insurance program but has discontinued it to return to Worker's Compensation. Medlock did not agree it should repay the $587,197.75 collected in excess of the insurance costs. Medlock stated it has improved its controls. Medlock also provided invoices and copies of contractor payments that caused additional questions concerning related party transactions. Medlock disagreed that the administrative management fees should be repaid to the projects based on the partnership agreements. Medlock's comments did not change our position.

We are making recommendations to require Medlock to repay the projects all the questioned costs. Also, we are making recommendations for the management agent to implement internal accounting controls and accounting systems that satisfy HUD requirements.

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Introduction

Medlock Southwest Management Corporation (Medlock), headquartered in Lubbock, Texas, is a management agent for HUD insured, Farmer's Home, and conventional projects located throughout Texas. The president and owner of Medlock is Mr. W. E. Medlock, Jr. Our principal contact for the audit was Mr. Bobby Griffith, Medlock's vice president. During the period reviewed, Medlock has managed as many as 23 HUD insured multifamily projects and currently manages 12 projects. The Fort Worth HUD Office services 19 of the projects, the Dallas Office services 2, and the San Antonio Office services 2.

Medlock is an identity-of-interest management agent for 11 of the 12 HUD insured projects it currently manages. Medlock is the general partner of the partnership that owns Parkway Village. W. E. Medlock, Jr., owner of Medlock, is also general partner in each of the following projects.

Casa Orlando
Central Village
Northcrest Apartments
Winwood of Amarillo
Winwood of Lubbock
Winwood of Plainview

JDM Properties, Inc. is the general partner of partnerships owning four HUD insured properties managed by Medlock. The Medlock Family Trust owns 100 percent of the stock in JDM Properties, Inc. Projects involving JDM Properties, Inc., as the general partner and managed by Medlock are:

Kings Square doing business as (d/b/a) Holliday Creek Gardens
Park Village
Pine Haven
Sun Valley

The other HUD insured property currently managed by Medlock is Mount Franklin which is owned by the Mount Franklin Kiwanis Charitable Trust.

Medlock managed 11 other HUD insured properties during our review period. Medlock or the owners terminated Medlock management of properties at various times as follows:

Childress Manor	September 1993
Suncrest	October 1993
Villa Del Norte	October 1993
Amber Falls	March 1994
Lexington Square	June 1994
Morningview Oaks	June 1994
Country Park	August 1995
Highpoint I	August 1995
Highpoint II	August 1995
Amarillo Gardens	December 1995
Elm Ridge	December 1995

During our review period, Medlock and Southwest Personnel Corporation handled the payroll for the projects Medlock managed. Southwest Personnel is also owned by Mr. W. E. Medlock, Jr. Medlock officials told us Southwest Personnel "leased" employees to projects managed by Medlock. According to management officials, Mr. Medlock purchased Southwest Personnel in November 1994 and operated it until April 1995 when Medlock started using its own payroll account. Southwest Personnel Corporation's 1992, 1993, and 1994 federal tax returns show Mr. Medlock was President of Southwest Personnel Corporation at least as early as February 1994, when he signed the 1992 federal tax return. Medlock staff operated both corporations during our review period and both corporations billed the projects for payroll and insurance.

The owners of 1 of the 12 projects currently managed by Medlock, King's Square d/b/a Holliday Creek Gardens, was delinquent on payments to the reserve for replacement and late charges. These payments are delinquent by $121,035.05 as of May 20, 1997. Appendix C contains a schedule of the projects and their mortgage status, according to HUD records.

HUD sold the mortgage of 1 of the 11 projects formerly managed by Medlock, Amber Falls, in a non-performing note sale in October 1995. We did not identify an identity-of-interest between the owners and Medlock regarding this property. HUD released and terminated the Regulatory Agreement prospectively from the date of the sale. However, HUD did not release any breaches of the Regulatory Agreement that occurred before the sale. Consequently, HUD would be entitled to any recoveries of project income improperly used before the sale.

Audit Objectives

Our primary audit objectives were to determine the validity and materiality of problems identified with payments for employee injury insurance premiums, management agent reimbursement for payroll, payments to owners for administrative management fees, and charges to projects by identity-of-interest companies. We also wanted to know the reasons for any non-compliance with Regulatory Agreements and HUD requirements.

Scope and Methodology

We examined governing regulations, HUD handbooks, Regulatory Agreements, and management certifications. We interviewed HUD and Medlock officials and staff. We also interviewed various current project employees, where appropriate.

Based on initial survey results, we concentrated our audit efforts on selected areas. Our audit procedures included, but were not limited to, a review of the following:

- Medlock's Employee Accident Program that included funds from all 23 projects for June 1991 through December 1995;

- Medlock's collection of payroll that included funds from all 23 projects for January 1993 through May 1996;

- Cash disbursements from project funds for administrative management fees for 12 projects from January 1992 through November 1996; and

- Medlock's use of identity-of-interest companies at 12 projects in 1995.

For each of the areas, we reviewed the accounting records of the projects. We also reviewed insurance policies, insurance trust records, payroll records including invoices, time sheets, and canceled checks.

Medlock arranged the commingling of certain funds from all projects and could or would not provide us adequate records to support expenditures of these funds. Medlock used its own centralized payroll account and its affiliated "personnel" corporation, Southwest Personnel Corporation, to make payroll, health benefit, and other payments on behalf of the projects. Medlock reimbursed the accounts from project funds. Medlock told us ledgers and other records for the centralized accounts were not available. Consequently, the lack of reliable accounting records restricted our ability to identify all expenditures from project funds that went into centralized accounts.

We conducted the audit at Medlock's office and the Dallas and Fort Worth HUD Offices. Medlock's office is at 201 N. University, Lubbock, Texas. The audit was initially to cover the period January 1, 1995, through December 31, 1995; however, we extended the period in each of the areas covered as indicated above because of the problems noted. We performed field work at Medlock from March 1996 to March 1997 and conducted the audit in accordance with generally accepted government auditing standards.

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Abbreviations

HUD	U.S. Department of Housing and Urban Development
OIG	Office of Inspector General

Management Agent Overbills for Insurance Premiums and Payroll

Medlock, through Southwest Personnel Corporation or its payroll account, inappropriately commingled funds from all projects and cannot support billings and expenditures approaching $1 million.[1] Specifically: Medlock billed HUD projects $587,198 above actual insurance costs; $416,467 above actual payroll costs; and paid $195,765 to contractors who leased personnel from Southwest Personnel to work at the projects. Medlock used Southwest's bank account to make payments for payroll, employee insurance, and to collect reimbursements for all projects. Medlock did not have internal accounting controls over this process to ensure individual project funds were properly tracked and accounted for. Nor did Medlock have adequate controls to ensure projects were billed correctly. The excess collections and incorrect accounting violated project Regulatory Agreements and HUD requirements.

Criteria

The Regulatory Agreements governing the use of project funds address project expenses and maintenance of project assets. The agreements say owners shall not, without the prior written approval of the Commissioner: assign; transfer; dispose of; or encumber any personal property of the project, including rents; or pay out any funds, except for reasonable operating expenses and necessary repairs. Regarding the receipt of improper funds, the Agreement states that all rents and other receipts of the project shall be deposited in the name of the project in a bank, whose deposits are insured by the F.D.I.C. Such funds shall be withdrawn only in accordance with the provisions of this Agreement for expenses of the project. Any owner receiving property of the project in violation of this Agreement shall immediately deliver such property to the project and failing to do so shall hold such property in trust.

Paragraph 2-21.J. of HUD Handbook 4370.1 REV-2, Reviewing Annual and Monthly Financial Reports, provides that commingling of funds is permissible only with the advance approval of HUD and when the management agent's accounting system has the capacity to identify all receipts and

[1] Medlock had not collected $63,750 from Holliday Creek Gardens because it was in default and had cash flow difficulties. As of May 20, 1997, Holliday Creek was only delinquent on its payments to Reserve for Replacement by $121,035.

disbursements to a particular project at all times. The paragraph further states commingling of funds in an agent's transfer account is an acceptable practice if approved in advance by HUD and if the agent can identify the exact amount of funds belonging to a particular project at all times.

Regarding payroll and fringe benefit plans, HUD Handbook 4381.5 REV-2, The Management Agent Handbook, paragraph 6.37 c., states the following:

> "Rather than maintaining separate payroll and separate fringe benefits plans for each property, some agents consolidate payroll and fringe benefit plans in order to reduce costs for the properties. In such a system, all personnel for several properties are listed under a single Federal employer I.D. Number. The salary and fringe benefits costs are prorated to the various properties in the following ways.
>
> (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 administrative fees in addition to actual costs.
>
> (3) The properties served may make reimbursement payments to the consolidated employer upon issuance of payroll checks.
>
> (4) Discounts, rebates, dividends, commissions, or other recoveries of fringe benefits costs must be prorated among the properties served in proportion to actual use during the period to which the recovery applies."

HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects, requires the mortgagor to keep the records in an auditable condition. Section 2.3, Maintenance of books and accounts, paragraph A, states that the Regulatory Agreement contains provisions that the accounts of mortgaged property operations be kept in accordance with the requirements of the Secretary and in such form as to permit a speedy and effective audit.

Finally, form HUD 9839-B, Project Owner's & Management Agent's Certification for Multifamily Housing Projects for Identity-of-Interest or Independent Management Agents, was signed by the management agent and owners. The management agent agreed to comply with the project's Regulatory Agreement and HUD requirements. Also, item number 7.b. of the Certification states that the Agent agrees that:

> "HUD, the General Accounting Office (GAO), and those agencies' representatives may inspect: (1) any records which relate to the project's purchase of goods or services, (2) the records of the Owner and the Agent, and (3) the records of companies having an identity-of-interest with the owner and the agent."

Medlock commingles funds from all projects

Medlock, without approval from HUD, used its own centralized payroll account and a separate corporate entity (Southwest Personnel) that leased its employees to the projects. Southwest also leased personnel to contractors working at the projects. Allegedly, consolidating the personnel into Southwest Personnel was to reduce payroll costs for the properties. However, neither Medlock nor Southwest Personnel had an accounting system with the capacity to identify all receipts and disbursements to a particular project at all times.

Medlock creates program in lieu of Worker's Compensation and collects $587,198 of ineligible insurance costs from projects

From June 1991 to December 1995, Medlock billed 23 HUD projects $587,198 in excess of actual insurance costs for Workers' Compensation. In 1991, Medlock opted out of the Worker's Compensation Insurance program and initiated its own "Group Occupational Accident Plan" (Plan). Medlock met with several insurance companies to develop the specific aspects of the Plan including costs to the projects and planned reserves. The resulting Plan with an insurance company had a $10,000 deductible per occurrence, per employee. The insurance company billed a premium based on the total annual payroll for all employees controlled by Medlock. Medlock billed the projects between 10 and 15 percent of their labor costs for the Plan. Medlock deposited the funds into Southwest's account that included funds collected from conventional projects, Farmer's Home projects, management agent funds, and other unidentified companies. Southwest paid the insurance company. Medlock officials kept what was left after paying the insurance company and any claims that did not reach deductibles. They said the excess was a reserve fund to pay claims.

Medlock did not allocate to the individual projects the actual cost of the premiums, the actual claims under the deductible, or the reserve amount that should have remained in the account. Amounts the projects paid Medlock over the premium and claim costs lost their identity in Southwest's bank account.

Medlock uses an unfunded trust to keep control of funds

Medlock's insurance plan has a trust account. The insurance company's plan administrator notifies Medlock when it is necessary to deposit funds to pay claims from the zero-balance trust account. Medlock deposits funds from Southwest's account to the trust account. The administrator issues a check to the employee or medical center and provides Medlock a copy of the check and a voucher or invoice. Medlock set up the trust account as an unfunded trust. According to Medlock, the Employment Retirement Income Security Act of 1984 (ERISA) says an employer cannot withdraw deposits from a funded trust. Should an employer dissolve, trust funds become the property of the employees. In an unfunded trust, the employer deposits funds only when a claim needs to be paid. Medlock said they used the unfunded trust to keep control of the reserve funds. But, Medlock used the funds intended for the reserve for other unidentified purposes.

Reserve nonexistent

No reserve exists to pay deductibles or claims. Based on total annual premiums and total annual payrolls, we calculated the percentage of the premiums that Medlock should have charged each project. We multiplied that percentage by each project's annual payroll to find each project's share of the insurance premium. We then subtracted what should have been each project's actual premiums from the amount each project paid into the centralized payroll account. Using information from the Plan Administrator, we also subtracted any claims applicable to each project that Medlock paid under the deductible amount. The remaining amount is what should be in the reserve account for each project. The total of those amounts, $587,198, should be in the reserve account for 23 HUD projects (see Appendix B).

Medlock says it should keep the $587,198 as a reasonable and necessary expense

Medlock officials did not agree that they should repay the excess funds collected for the insurance deductible reserve. Medlock officials stated the projects could not afford to pay for Worker's Compensation. Medlock's Plan allowed the projects to have coverage without bankrupting the projects. Medlock also contends that it saved the projects' money by starting the Plan. Also, if the projects had paid the money to an insurance program, they would not be entitled to any refunds for excess payments. Finally, Medlock officials contend that HUD officials were aware of the Plan and knew that Medlock was not saving funds collected for the deductible reserve. Medlock officials stated they had thoroughly explained the Plan to HUD asset management officials at a management agent conference. Further, they also claimed to have explained the Plan to a HUD attorney in Fort Worth when Medlock had planned to use the Plan for a separate HUD contract to manage HUD owned properties.

Excess insurance costs are ineligible

Any amounts over actual cost and any reserve accumulated belongs to the projects. Medlock should have separately accounted for and tracked the excess as required by the Regulatory Agreements. Medlock is not an insurance company and is not authorized to make a profit on insurance plans. As stated above, HUD does not permit management agents to impose surcharges or administrative fees to actual costs of payroll or fringe benefit programs. Thus, the excess funds collected were not reasonable and necessary project expenses. Further, not only did Medlock profit when it spent the excess funds collected for a deductible reserve, it has exposed the projects to unnecessary risk of lawsuit from Medlock's employees.

We could not corroborate Medlock officials' statement that HUD officials knew that Medlock did not intend to create a deductible reserve. A HUD official told us an industry conference led by Medlock's vice president included a description of a program for self-insuring a worker's compensation program. Also, he said HUD's only comment regarding this program was that it had to comply with any state or federal laws for worker's compensation insurance and the cost to the projects should not exceed the reasonable cost of an independent insurance program. We reviewed the presentation materials used at the management agent conference. The materials indicated employers using such a program should collect and save funds to cover the high deductibles. The individual who presented the program to the conference stated that she recommends that companies accrue a reserve balance to pay for deductibles. Further, the presentation was not specifically a presentation of Medlock's Plan. Therefore, the attendance of the HUD officials at the conference would not have alerted the HUD officials that Medlock did not plan to create a deductible reserve. In fact, the presentation conveyed that employers using an employee accident program should accrue a deductible reserve. The HUD attorney also could not corroborate Medlock's contention that HUD knew it did not keep a reserve balance. The HUD attorney stated he and Medlock did not discuss substituting the Plan for Worker's Compensation for projects that Medlock managed. They only discussed whether Medlock could use the Plan on a different HUD contract to manage HUD owned properties. Because it did not meet the requirements of the contract, the HUD Office of Counsel could not allow the Plan to be used. Therefore, he did not review it.

Medlock overbills $416,467 for payroll

Medlock's Southwest Personnel Corporation overbilled the projects for employee wages. The Payroll Corporation billed the projects for payroll bi-weekly. The payroll invoice listed and billed each employee class (e.g., manager, maintenance, etc.) separately, yet did not include the names of specific employees of each class. Rather than have its own recordkeeping system, Southwest used project time sheets to support the amounts billed. Southwest required employees not assigned to a specific project to submit time sheets also. The amounts billed to the projects should have been a direct reimbursement of employee wages that it paid based on the projects' time sheets. However, the billed amount did not agree with the time sheets. Generally, Southwest billed the projects more than what the time sheets showed.

We determined the amount of employee payroll for regular hours (not overtime or other pay categories) that Medlock should have billed and compared this to the billings. We calculated the excessive payroll billed for regular hours during the period January 1993 through May 1996. Because our survey testing indicated that the overtime billed was generally correct, we calculated only what Medlock should have paid for regular hours based on the time sheets. We subtracted the amounts that Medlock should have billed for regular hours from the amounts billed for regular hours. The difference is $416,467.

Medlock agrees it should repay most of the overbilling

We provided Medlock with copies of our calculations to enable them to provide additional documentation or explain the difference. Medlock personnel provided names of employees and amounts of payroll totaling $57,465 they felt should be allowed to be charged to various projects. But they were unable to provide any additional documentation or time sheets to show why they felt the employees should be charged in this manner. Medlock officials said they lacked time sheets and other support for this amount; however, the projects received benefit from the work paid for. Medlock stated that one of its employees did not keep a time sheet. Medlock tracked his hours by having the employee orally report his hours to the Payroll Clerk or by having the Project Manager or Medlock's owner report the employee's hours to the Payroll Clerk. The auditor observed that the employee would spend at least 1 to 2 hours a day on janitorial work for Medlock's office and then proceed elsewhere. Medlock and the employee stated that he did janitorial work at the projects for the remainder of his day. Medlock stated that the Payroll Clerk knew where the employee had worked at the end of the pay period and billed the correct projects. According to Medlock, the Payroll Clerk can review an invoice and remember which employees worked on a project during a payroll period. Medlock believes the projects received benefit from both the janitorial employee and the employees whose time sheets they could not provide. Accordingly, Medlock believes it should not have to repay the $57,465. Medlock did agree they should repay the remaining overbillings.

We reviewed the additional information provided by Medlock in explanation of the $57,465. The Payroll Clerk had reviewed our calculations and informed us of which employees she had billed to the projects that we did not include in our calculations. We noted the Payroll Clerk often said the entire 80 hours of the janitor should be billed to HUD projects without allocating any of the 10 to 20 hours per pay period that he worked at Medlock's office. The Payroll Clerk also appears to have occasionally misbilled projects. When we reviewed the employees' time sheets, we would sometimes find that the employees had worked the full pay period elsewhere. Of the $57,465 for which Medlock personnel provided explanations, $53,581 might have resulted from employees working at various projects without time sheets or proper documentation for cost allocations. However, neither Medlock nor Southwest could provide documentation to support the charges.

Medlock/Southwest cannot support amounts paid to contractors

Medlock hired contractors to work at projects using employees the contractors "leased" from Southwest. Southwest billed the contractors for labor but did not have controls to ensure that its employees appropriately segregated time spent working for the projects from time spent working for the contractor. Consequently, Southwest cannot support the amount of time that the employees worked for the contractor. The audit noted two instances of double billing:

- Medlock and Southwest Personnel Corporation charged five projects for carpet installation by its identity-of-interest company, Texas Wholesale. Project employees installed the carpet. Texas Wholesale charged the projects $7,439 for labor. Medlock repaid this overcharge when we brought it to their attention.

- From 1993 through May 1996, Medlock paid a contractor $213,500 for construction on three projects (Central Village $11,212; Northcrest $121,968; and Holliday Creek $80,320). The contractor sometimes used Southwest employees to perform the work; they did not segregate the time spent working for the contractor from the time spent working for the projects. As a result, Medlock cannot substantiate the amount of time its employees worked for the contractor and cannot determine whether labor paid for by the contractor was not also included in our calculation of allowable payroll.

For each payment to the contractor, we asked that Medlock provide us with time sheets of Medlock employees used or a list of subcontractors or contractor employees used. In addition, the contractor provided us with invoices that it had paid to Southwest, plus the names of two subcontractors who had worked for it. We attempted to verify that the subcontractors had worked for the contractor. Only one of the subcontractors returned our calls, but stated it would not be able to remember working for the contractor until it talked to Medlock. The subcontractor has not called us since then.

The contractor did provide $17,735 in invoices from Southwest. The invoices included employee names. Using these invoices, we subtracted duplicate labor hours from our calculation of payroll supported by the time sheets. Thus after Medlock repays payroll overbilling, $17,735 of the $213,500 will be supported. The balance, $195,765, is not and is therefore questioned.

Medlock and Southwest lacked internal controls

Medlock did not have the internal controls to ensure that projects did not pay more than what they owed. Nor did it have the controls to assure that it properly tracked and accounted for project funds. Medlock stated that from the start of the employee accident program it never planned to track and account for project funds separately. Neither did it look at the reserve balance. Medlock agreed that its controls were inadequate to account for the funds properly in the reserve account. Medlock also agreed it should not have billed the projects more than what the time sheets supported. To ensure that it bills the projects more accurately, Medlock developed a new invoice for the Payroll Corporation during our audit. The invoice not only lists employee classes, it also lists employee names and amounts paid to each employee.

Medlock denied records to auditors

Although Medlock was responsible for accounting for project funds, it could not account for what happened to the project funds it collected over the costs of the insurance program and payrolls. Medlock stated that it has receivables for the used reserve funds. It provided a list of payroll account receivables from the HUD projects as of December 1996 totaling $83,325.[2] Medlock stated that the other funds were also tied up in receivables. When we asked for a list of other receivables. Medlock's lawyer advised us that we would need a subpoena to obtain such a list. Medlock's lawyer stated that Medlock had provided the necessary information to determine the questioned cost. The lawyer also stated that Medlock had just reasons for denying us those records including that the

[2] Medlock's payroll receivable from the projects at the end of 1996 was $83,325. However, this included some current payroll that was repaid in January. Of the $83,325, Medlock did not anticipate collecting $63,750 before the end of the audit. The $63,750 is the amount that Medlock did not collect from Holliday Creek Gardens in prior years. Medlock does not believe the project will be able to repay any of this amount before the audit ends.

Payroll Corporation contained the records of other entities not owned or related to Medlock's owner or Medlock in any way. Medlock's denial violates the management agent certification.

Auditee Comments

Medlock provided us written comments and we discussed the finding at an exit conference on July 15, 1997.

Medlock agrees they overbilled projects for $362,886.02 for payroll but contends the $53,581.21 charged for unsupported payroll should be allowable because they say the projects received the work. Medlock said the Texas Employment Commission issued them a directive that prohibits non-centralized payroll. Medlock stated internal controls have been implemented to ensure proper project accounting using a centralized payroll.

Regarding the employee insurance program, Medlock stated the projects realized substantial savings over Worker's Compensation as a result of the program and Medlock will provide figures to HUD for determining whether the $587,197.75 should be repaid. However, Worker's Compensation insurance has gone down recently and Medlock has now changed from the employee insurance program to Worker's Compensation. Medlock stated even though they do not believe they should have to refund this money, they have eliminated future questions regarding this program.

Medlock said the contractor involved in the unsupported contract payments has supporting documentation for the Northcrest contract. Medlock said this should reduce the questioned cost by $121,968. Medlock provided us copies of the available documentation at the exit conference. Medlock said the contractor has been unable to provide documentation for the other two properties in question.

Medlock's complete written response is contained in Appendix D.

OIG Evaluation of Auditee Comments

Medlock's comments did not change our position. Based on the Texas Employment Commission guidelines, management agents with multiple projects report employee salary figures under one employer identification number. This does not preclude the management agent from maintaining its payroll accounting system by project. As stated above, commingling of funds is permissible only when the accounting system is capable of identifying all receipts and disbursements by project at all times and with prior approval by HUD. Regarding the $53,581.21 in payroll charged without supporting time sheets, Medlock will need to repay this unless it can provide HUD adequate proof the projects actually did receive the work. This has not been done yet.

HUD requirements, the Regulatory Agreement, and the management certification are clear on the employee insurance issue. Any recoveries of costs must be returned to the projects. Also, project funds should not be taken from the project for insurance costs when they are not used for insurance costs.

In response to the questioned contractor costs, Medlock provided us with 69 invoices totaling $38,150.70 and 18 Rae's Contracting checks totaling $53,363.88. Sixty vendor invoices totaled $16,518.54. Nine invoices from Medlock's Southwest Personnel Management Corporation totaled $21,632.16 but the copy of the contractor's check supposedly issued as payment for the Southwest invoices was for $25,000. Medlock provided copies of seven Rae's Contracting check payments totaling $11,845.07 to two subcontractors without invoices. The vendors addressed their invoices to Medlock Southwest Management or to Northcrest Apartments in care of Medlock Southwest Management, but Rae's Contracting wrote checks to pay the vendors. The invoices from vendors were dated from November 23, 1993, to February 28, 1994. Seventeen payment checks were generally in sequential order; numbered 1002, dated January 10, 1994, to 1023, dated March 16, 1994. One check dated December 22, 1993, was a temporary check, indicating a new account. The sequence indicates Medlock was Rae's only or major customer.

The invoices from Medlock's Southwest Personnel Management Corporation were for pay periods from November 19, 1993, to April 8, 1994. Medlock provided us a copy of one check from Rae's for $25,000 dated August 4, 1994. Medlock, in a role as vendor to Rae's (supplying labor), was unable to explain why Rae's paid Medlock more than Medlock billed. Medlock officials stated they assumed the excess was for other jobs. The lack of billing records from

Medlock to Rae's is more than unusual. Medlock asked us to reduce the questioned cost of $195,765 by the amount of invoices and checks they provided plus a reasonable amount for Rae's profit. However, the documents Medlock provided raise further questions regarding related party transactions and we feel HUD should ask for a full accounting for the costs on these projects.

Recommendations

We recommend HUD require Medlock to:

1A. Reimburse the projects or HUD $587,198 in ineligible insurance costs[3] (see Appendix B);

1B. Reimburse the projects or HUD the $416,467 in ineligible payroll[3] (see Appendix B);

1C. Reimburse Central Village, Northcrest, and Holliday Creek the $195,765 for unsupported contractor charges or provide supporting documentation for materials and labor charges;

1D. Discontinue using Southwest Personnel Corporation and any other form of centralized payroll accounting until it can show HUD it has established and implemented accounting procedures for centralized payrolls and has sought and obtained HUD's approval to use one; and

1E. Should Medlock not repay the questioned costs, HUD should take appropriate administrative and civil actions.

[3] $63,750 is not a cash transaction since it was not collected from Holliday Creek Gardens, but Medlock needs to reverse the receivables it has booked. Medlock should repay the respective projects if mortgages are current. For Amber Falls, Medlock should repay HUD since HUD sold the mortgage in the non-performing note sale of October 1995. For Holliday Creek Gardens, where the payments to the reserve for replacement are delinquent, Medlock should remit any amount of repayment not needed for current necessary and reasonable operating expenses so that HUD can apply this to the delinquency.

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Medlock Makes $24,000 in Unauthorized Owner Distributions

From January 1992 through November 1996, Medlock disbursed administrative management fees of $24,000 to three general partners from four projects' operating accounts when the projects were not in surplus cash positions. Medlock officials said they believed these were reasonable project expenses based on provisions in the partnership agreements of the properties. These disbursements violated the Regulatory Agreements of these properties and HUD requirements. These funds should have been used to pay necessary project expenses.

Criteria

The Regulatory Agreements state the Owners shall not without the prior written approval of the Commissioner: assign; transfer; dispose of; or encumber any personal property of the project, including rents; or pay out any funds, except for reasonable operating expenses and necessary repairs. Also, Regulatory Agreements define a distribution as any withdrawal or taking of cash or any assets of projects other than for the payment of reasonable expenses necessary to the operation and maintenance of the project. Distributions are not allowed except from surplus cash.

HUD Handbook 4370.2 REV-1, Financial Operations and Accounting Procedures for Insured Multifamily Projects, states further that the term distribution includes for example, supervisory fees paid to the general partners and any salaries or other fees paid to the sponsor or mortgagor unless those salaries or fees have been approved by HUD as essential to the operation of a project (e.g., a management fee approved by HUD and paid on an owner managed project).

Additionally, paragraph 6.41 of HUD Handbook 4381.5, Management Agent's Handbook, states:

> "... a. Asset management functions are those activities associated with managing and protecting the assets of the ownership entity and overseeing the management agent's performance. Asset management activities include: (1) Disbursing surplus cash. (2) Periodic owner visits to the project to review the agent's

> performance... . b. Asset management costs must not be billed to a project's operating account. These costs may only be paid from funds available for distribution to owners in accordance with the terms of the Regulatory Agreement and HUD Handbook 4370.2."

The partnership agreements for Casa Orlando, Central Village, Northcrest, and Winwood of Plainview provide that the general partners shall receive a cumulative aggregate annual administrative management fee from the partnership for the partners' services in managing the partnership and the project. The agreements describe the fee as covering services including monitoring the project's operation, supervision of all matters related to rental procedures and policies, adherence to HUD regulations, preparation of required forms, periodic physical inspections of the project, assistance in preparation of applications for rent increases, review of project accounting systems, review of monthly operating statements and proposed annual budget, and other services related to partnership entity business (tax returns, legal matters, etc.).

Administrative management fees paid

Medlock paid $24,000 in annual administrative management fees to the general partners of Casa Orlando, Central Village, Northcrest, and Winwood Village of Plainview when the projects were not in surplus cash position. Specifically, Medlock paid unauthorized administrative management fees to the general partners of the projects in the amounts as shown below.

Casa Orlando	$3,000
Central Village	$2,000
Northcrest	$14,000
Winwood Village of Plainview	$5,000

Medlock accrued the fees for the four projects until 1992. Medlock then paid the total accrued amounts to the general partners for Casa Orlando, Central Village, and Winwood Village. Medlock then paid the administrative management fees for these properties annually. Medlock did not pay administrative management fees for Northcrest until March 1996 because the project mortgage payments had been delinquent and the project had cash flow problems. In March

1996, Medlock paid all accrued fees for Northcrest through 1995.

For each of the projects, we reviewed the surplus cash available for the preceding year to determine whether the distribution was proper. We added the amounts distributed when the project did not have enough surplus cash available to arrive at the unauthorized distribution amount of $24,000. Medlock made unauthorized distribution from Winwood Village of Plainview in 1992. However, the surplus cash available in 1993 from Winwood Village of Plainview was enough to allow Medlock to disburse both 1993 and prior years' fees. Although the early distribution technically violates HUD requirements, we did not include it because the funds would have been distributable as of the end of the 1993 fiscal year and would have no current effect.

Medlock believes these payments from project funds were allowable based on the definition of "Net Distributable Cash Flow" in the partnership agreements signed by the partners for the four projects. However, distributions from the projects to the partnerships are governed by the HUD Regulatory Agreements and requirements, as shown above. Surplus cash must be available for distributions to the partnership before any funds can come under the jurisdiction of the partnership agreement.

By either ignoring or not adhering to the Regulatory Agreements and applicable HUD requirements and paying the administrative management fees to the general partners when the projects were not in a surplus cash position, Medlock made $24,000 in unauthorized distributions to the partnerships. The payments resulted in the projects having less cash than needed to pay their current liabilities, or negative surplus cash positions, as of the end of the 1995 fiscal year. Medlock told us it would collect the unauthorized payments by making accounting entries to reduce the amounts of administrative management fees currently payable to the partners. However, if the projects are not currently in surplus cash positions, Medlock needs to repay the projects for the unauthorized distributions in cash to improve the negative surplus cash positions.

Auditee Comments

Medlock stated our finding is unacceptable because the partnership agreements provide that the administrative management fees were to be paid from the available cash flow of the property. Medlock further stated that the IG has not identified a regulation or law requiring payment to be made from "Surplus Cash." HUD servicers consistently approved these distributions. The audited financial statements, presumably reviewed by HUD, consistently and accurately reflected the distributions, without comment from HUD. The distributions were made in strict accordance with the HUD-approved partnership agreements. Medlock further stated the 1996 audits have incorporated the administrative management fees into the limited distribution and offsetting entries have been made as per extensive discussion with IG auditors. These are properly booked and accounted for and no repayment is necessary.

OIG Evaluation of Auditee Comments

We disagree with Medlock's comments. Any fees for managing the partnership agreed on between the partners must be paid from funds available to the partners under the Regulatory Agreements. Funds are not available to the partners except through distributions of surplus cash. Therefore, any cash used to pay administrative management fees that was not surplus cash needs to be returned to the projects to pay the projects' operating liabilities.

Recommendations

We recommend the HUD Field Office ensure that Medlock Southwest Management Corporation or the partners:

2A. Reimburses the properties in cash amounts of:

(a) $3,000 to Casa Orlando;

(b) $2,000 to Central Village;

(c) $14,000 to Northcrest; and

(d) $5,000 to Winwood of Plainview and

2B. Provide assurance that administrative management fees will only be paid from surplus cash in the future.

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Internal Controls

In planning and performing our audit, we considered the internal controls of Medlock Southwest Management Corporation's management agent operations, to determine our auditing procedures and not to provide assurance on such internal controls. Medlock has responsibility for establishing and maintaining a system of internal administrative controls. Internal control is the process by which an entity obtains reasonable assurance for the 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.

Significant Controls

We considered the following internal controls were relevant to our audit objectives:

Accounting records and reports
Cash disbursements

We assessed all of the relevant controls identified above.

Significant Weaknesses

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, we believe the following items are significant weaknesses:

> Medlock did not develop and implement adequate controls, accounting records and reports to ensure project funds are disbursed only for reasonable and necessary expenses, in compliance with laws, regulations and policies (Findings 1 and 2).

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Schedule of Ineligible and Unsupported Costs

Recommendation Number	Ineligible[1]	Unsupported[2]
1A	$ 587,198	
1B	416,467	
1C		$195,765
2A	24,000	
TOTALS	$1,027,665	$195,765

1 Costs clearly not allowed by law, contract, HUD, or local agency policies or regulations.

2 Costs not clearly eligible or ineligible but which warrant being contested (e.g., lack of satisifactory documentation to support the eligibility of the cost, etc.).

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Schedule of Amounts Questioned by Project

Project Name	Insurance Reserve	Overbilled Payroll	Unsupported Payroll	Less: Amount Not Collected	Total Questioned Amounts Paid
Amarillo Gardens	$ 20,275.65	$ 175.65	$ 0.00	$ 0.00	$ 20,451.30
Amber Falls	19,516.74	4,259.06	0.00	0.00	23,775.80[1]
Casa Orlando	43,020.64	58,384.97	22,792.00	0.00	124,197.61
Central Village	34,356.22	31,858.13	1,118.00	0.00	67,332.35
Childress Manor	5,721.38	3,300.00	0.00	0.00	9,021.38
Country Park	25,807.19	(34,185.97)	0.00	0.00	(8,378.78)
Elm Ridge	35,808.71	(11,673.21)	0.00	0.00	24,135.50
Highpoint I	7,764.83	4,430.50	192.00	0.00	12,387.33
Highpoint II	39,698.23	26,700.03	3,535.80	0.00	69,934.06
Holliday Creek	71,218.11	21,395.57	2,203.75	(63,750.00)	31,067.43[2]
Lexington Square	25,556.69	10,261.81	1,329.00	0.00	37,147.50
Morningview Oaks	8,159.65	(80.50)	0.00	0.00	8,079.15
Mount Franklin	38,128.79	19,823.10	0.00	0.00	57,951.89
Northcrest	22,924.10	7,439.69	1,199.51	0.00	31,563.30
Park Village	22,114.26	(2,018.38)	0.00	0.00	20,095.88
Parkway Village	34,044.01	37,668.64	5,470.68	0.00	77,183.33
Pine Haven	23,854.91	28,173.84	2,792.45	0.00	54,821.20
Sun Valley	32,007.77	25,469.75	443.83	0.00	57,921.35
Suncrest	8,036.99	11,394.09	0.00	0.00	19,431.08
Villa Del Norte	(3,773.45)	8,209.30	580.00	0.00	5,015.85
Winwood of Amarillo	27,534.52	42,788.75	694.74	0.00	71,018.01
Winwood of Lubbock	44,982.19	56,058.23	11,229.45	0.00	112,269.87
Winwood of Plainview	439.62	13,052.97	0.00	0.00	13,492.59
TOTALS	$**587,197.75**	$**362,886.02**	$**53,581.21**	($**63,750.00**)	$**939,914.98**

[1] Amber Falls was sold in the West of the Mississippi note sale in October 1995. Therefore, questioned costs should be repaid to HUD.

[2] Holliday Creek is delinquent on its mortgage payments (Reserve for Replacements). Therefore, repayment of questioned costs should be remitted to be applied to this delinquency, if not needed for current operating expenses.

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Schedule of Projects Managed by Medlock Southwest Management Corporation

Number		Project Name	FHA Number	Sec. of Act	No. of Units	HUD Held	Amount Delinquent
Currently	1	Casa Orlando	133-44029	236	70	no	Current
Managed	2	Central Village	133-44009	236	84	no	Current
	3	Holliday Creek	113-44006	207	184	yes	$121,035
	4	Mt. Franklin	133-44011	236	100	no	Current
	5	Northcrest	133-35002	221D3MR	68	yes	Current
	6	Park Village	133-44033	236	76	no	Current
	7	Parkway Village	133-44014	236	75	no	Current
	8	Pine Haven	059-44061	236	64	no	Current
	9	Sun Valley	113-44033	236	132	no	Current
	10	Winwood of Amarillo	133-44040	236	100	no	Current
	11	Winwood of Lubbock	133-35033	221D3MR	111	yes	Current
	12	Winwood of Plainview	133-35044	221d4	64	no	Current
Formerly	1	Amarillo Gardens	133-35021	221D3MR	100	no	Current
Managed	2	Amber Falls	113-53021	221d4	120	no	See Note[1]
	3	Childress Manor	133-44039	236	50	no	Current
	4	Country Park	112-35296	221d4	168	no	Current
	5	Elm Ridge	115-35037	221d3	130	no	Current
	6	Highpoint I	113-35072	221d4	50	no	Current
	7	Highpoint II	113-35073	221d4	144	no	Current
	8	Lexington Square	112-35028	221d3	100	no	Current
	9	Morningview Oaks	115-35008	221d3	52	no	Current
	10	Suncrest	133-44037	236	100	no	Current
	11	Villa Del Norte	133-55006	221d3BMR	60	yes	Current
		TOTALS			**2,202**		**$121,035**

[1] Amber Falls was sold in the West of the Mississippi note sale in October 1995. The Loan Sale Agreement stipulated that breaches of the Regulatory Agreement occurring before the sale are recoverable by HUD.

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Auditee Comments

3 pages

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Washington, DC 20548 **Attn: Judy England-Joseph**
Mr. Pete Sessions, Govt Reform & Oversight Comm., U.S. Congress,
House of Rep., Washington, D.C. 20515-4305
The Honorable Fred Thompson, Chairman, Comm. on Govt Affairs,
U.S. Senate, Washington, D.C. 20510-6250
The Honorable John Glenn, Ranking Member, Comm. on Govt Affairs,
U.S. Senate, Washington, D.C. 20510-6250
Cindy Sprunger, Subcomm. on Gen. Oversight & Invest., Room 212,
O'Neill House Ofc. Bldg., Washington, D.C. 20515
Inspector General
Auditee