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March 28, 1997
97-FW-211-1805

MEMORANDUM FOR: Elva Castillo
Director of Multifamily Housing, 6JHM

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

SUBJECT: LULAC East Park Place Apartments
San Antonio, Texas
Project No. 115-44012

At your request, we conducted a survey of LULAC East Park Place Apartments. LULAC East Park Place Apartments is a 172-unit property insured under Section 236 with all units assisted with Section 8 Loan Management Set-Aside. The Local Council of the League of United Latin American Citizens (LULAC) is the beneficiary of the trust that owns the property. The trust is governed by a Board of Trustees (Owner). Our primary survey objective was to determine if there were any indications of diversions of project funds or assets by the owner or agent. Our secondary objectives were to review the issues raised in your request to determine if they warranted an audit. The issues were whether: (1) the $909,910 Flexible Subsidy Loan was spent on rehabilitation and in accord with the HUD approved Management Improvement and Operating (MIO) Plan; (2) the reduction in the appraised value of the property for real estate tax purposes was the result of diversion of Flexible Subsidy Loan proceeds; (3) the Owner properly accounted for the receipt and disbursement of previously frozen operating bank account balances; and (4) whether a discrepancy between the ending 1993 and beginning 1994 cash balances shown in the independent audits represented improper diversion of funds.

We did not identify any indications of improper diversions of project funds or assets by the owner or agent other than: (1) the $24,000 in mortgagor entity legal fees previously identified by your staff and (2) a $563 purchase of supplies with project funds that were for another project owned by the agent. We also observed that the owner and management agent have sufficient documentation to show the expenditure of the Flexible Subsidy Loan was for rehabilitating the project and in accord with the HUD approved MIO Plan. Further, we noted: (1) the taxing districts reduction in the appraised value was based on value before the completion of the flexible subsidy funded rehabilitation work; (2) the owner has accounted for the 1993 receipt and disposition of funds from the frozen bank account; and (3) the independent auditor's 1994 report contains an explanation for the beginning cash balance.

However, we did observe that the owner and management agent had not properly disclosed identity-of-interest relationships with contractors and suppliers. HUD does not prohibit such related party transactions but does require disclosure and prohibits prices paid being more than that available from arms-length companies. The owner and management agent obtained bids and/or proposals from unrelated contractors to support that prices paid were reasonable.

Based on the survey, we do not believe a full audit is warranted. However, we are making some recommendations regarding the questioned cost and identity-of-interest disclosure issue. The results of our review and recommendations are attached. Within 60 days please give us, for each recommendation in this memorandum, a status report on: (1) the corrective action taken; (2) the proposed corrective action and 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 review.

If you or your staff have any questions, please contact Darrel M. Vaught, Assistant District Inspector General for Audit.

Attachment

SURVEY OF OPERATIONS
LULAC East Park Place Apartments
San Antonio, Texas
Project No. 115-44012

Scope of Review

Our review for any improper diversions covered the period from November 1992 to December 1996. To accomplish our objectives, we reviewed:

- San Antonio HUD Multifamily Asset Management Branch files to gather background and funding information;
- Relevant HUD regulations and contracts for the Flexible Subsidy Program and the Regulatory Agreement to determine HUD requirements;
- Relevant property, management agent files, and project audited financial statements for fiscal years 1991 through 1995 to identify any indicators of diversion of funds; and
- The owner and agent records for the Flexible Subsidy including advertising, bids, board minutes, contracts, invoices, canceled checks, bank statements, and accounting reports to determine if they supported completion of the work items in the MIO Plan and use of Subsidy funds.

We also scanned the general ledgers, canceled checks, invoices, bank statements, and accounting reports for the period. We interviewed HUD Asset Management, LULAC East Park Place Apartments, and management agent staff. When necessary, we also interviewed third parties for relevant information.

Results of Review

1. Flexible Subsidy Loan funded activity.

   HUD approved the Flexible Subsidy Loan in 1992 for $909,910. The Flexible Subsidy Loan was used for the rehabilitation of the apartment units. The term of the contract was for a 12-month period from November 1, 1992, through October 31, 1993. However, the owners and agents did not meet this initial schedule. The contract period and the MIO Plan went through various extensions and revisions before the completion of the work in December 1995. The following circumstances caused delays:

- During 1990, 1991, and 1993, the owners of LULAC East Park Place Apartments were parties in a lawsuit. Local and national LULAC organizations were fighting for control of the owner entity. The court ruled on the lawsuit in May 1993 which gave control to the Local Council of LULAC.

- Since 1990, there have been seven management agents at LULAC East Park Place Apartments. This was due to the turmoil in the owner entity and the lack of coordination and trust between the management agents and the owner.

- The original MIO Plan estimates were low and did not include cost for the asbestos abatement or mansard repair. During 1994, asbestos testing results were positive and all the units were affected. Also during 1995, they replaced all the mansards due to water leak damage. The mansard replacement was not on the original MIO Plan. The asbestos abatement cost \$166,000 and the mansards cost \$242,000 to repair. These action items alone cost \$408,000 or 45 percent of the Flexible Subsidy Loan.

2. <u>Flexible Subsidy Transactions and identity-of-interest relationships</u>.

The owner and agent had sufficient records to support the proper use of Flexible Subsidy funds. The work undertaken was in accord with the HUD approved MIO Plan. The owner and agent also used competitive means for procurement of goods and services. The owner and agent used some identity-of-interest firms to provide air conditioning units, services, hardware, and supplies for the rehabilitation work.

The Regulatory Agreement and the Flexible Subsidy Contract do not prohibit the use of identity-of-interest firms. However, the owners and agents are required by Paragraph 10(b) of the Regulatory Agreement to obtain all goods and services at amounts ordinarily paid for such services, supplies, or materials in the local area. The owner and agent did get written estimates from other non-identity-of-interest firms related to the purchase of materials and services. It appears the prices obtained from the identity-of-interest firms were reasonable and comparable to the other local non-identity-of-interest firms.

HUD Handbook 4370.2 REV-1, Chapter 3, Section 4G requires the owner and the management agent to disclose and list the identity-of-interest companies in the Annual Audited Financial Statements. However, the management agent and the owner did not disclose these identity-of-interest firms in the corresponding 1994 and 1995 Annual Audited Financial Statements. The four companies identified are:

- <u>Jireh Services and U.S. Trading</u> - Owned by a current Member of the Board of Trustees for LULAC East Park Place Apartments

- <u>Allied Electric and Air Conditioning Company</u> - Owned by a member of the Board of the Local Council of LULAC. The Local Council is the beneficiary of the Owner entity.

- Apartment Warehouse Supply - Owned by an employee of the management agent.[1]

The purchases from identity-of-interest firms were supported and appeared to be reasonably priced. However, in following up on identity-of-interest activity, we also scanned invoices for goods and services paid with operating funds up to December 1996. Although Apartment Warehouse Supply was no longer an identity-of-interest supplier in 1996, our follow-up noted one discrepancy. The agent, in July 1996, purchased $563.33 of materials from Apartment Warehouse Supply which were shipped to another apartment complex which is owned by the management agent. The management agent stated that this was a billing error and he will reimburse the project.

3. Activity involving frozen operating funds.

In 1991, as a result of the litigation surrounding the project owners and changes in management agents, a court froze bank accounts containing about $105,000 of project operating funds. After a final court ruling, the owner's attorney received these funds in 1993. The attorney provided the following accounting to the owner:

	Amount
Frozen Account Cash Balances	$ 105,861
Repay Operating Loan and Interest	(14,230)
Pay Legal Fees	(20,000)
Funds Transferred to Project Operating Account	$ 71,631

LULAC Scholarship Committee, Inc. provided the project an operating loan in 1990. The owner was to repay the loan with interest by July 1991. However, because of the litigation, the loan was not paid. The independent auditors report for 1993 notes the $14,230 represented the principal and interest due on the note.

Your office has questioned the Owner's use of $20,000 to pay legal fees of the mortgagor entity. Mortgagor entity expenses are not operating expenses and, therefore, represented a violation of Paragraph 7(h) of the Regulatory Agreement. Your office also identified another $4,000 paid from the project's operating account for legal services. The records indicate that the $4,000 also relates to the Owner's litigation. The former management agent, by letter, dated May 23, 1994, advised the Trust Chairman of the Board of Trustees that HUD would probably question the $24,000 as unapproved legal expenses.

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[1] This individual was directly involved in administering the Flexible Subsidy Loan funded activity. He left employment with the agent in 1995. During the period he was employed by the agent, the agent purchased supplies from his company.

Project records show the $71,631 was deposited into the project operating account on September 8, 1993. However, the owner's independent auditor for the 1993 financial statements apparently did not properly disclose the ending cash balance. The 1994 financial statements include an explanation that the former independent auditor incorrectly wrote off one of the frozen bank accounts.

4. Valuation for real estate tax purposes

In 1994 the management agent hired a local tax service to protest the increase in assessed value by the Bexar County Appraisal Authority. The agent won the appeal and the Appraisal Authority adjusted the assessed value from $2,626,000 to $988,000. The assessed value does not reflect the rehabilitation work done with the Flexible Subsidy Loan during 1994 through 1995.

Recommendations

We recommend the San Antonio Field Office require the owner and the management agent to:

1A. Disclose identity-of-interest firms on the management certifications and to their independent auditor at the start of independent financial audits and ensure the disclosure is included in the annual audited financial statements;

1B. Provide evidence that the management agent reimbursed the operating account $563.33; and

1C. Reimburse the project operating account $24,000 in mortgagor entity legal fees.