



Issue Date	October 7, 1996
Audit Case Number	97-DE-214-1001

TO: Ronald C. Bailey, Director, Office of Housing, 8AH

FROM: W. D. Anderson, District Inspector General for Audit, 8AGA

SUBJECT: Rawson Management Company
Multifamily Management Agent
Hooper, Utah

At the request of the HUD Rocky Mountain Office of Housing's Multifamily Management Operations Branch, we have audited Rawson Management Company's operations of its six HUD-insured projects. The audit was conducted as part of Operation Safe Home. The purpose of our review was to determine whether: (1) the agent was properly in compliance with the terms and conditions of the Regulatory Agreements and other applicable HUD directives; and (2) the agent's charges to the HUD-insured projects were reasonable and necessary project expenses.

We found that the agent was not complying with the terms and conditions of the Regulatory Agreements or HUD regulations and instructions relating to the operation of HUD-insured projects. The agent: (1) has charged the projects for ineligible salaries; (2) has improperly distributed project funds to the project owner; and (3) has not established adequate controls over project funds. In addition, the agent has not thoroughly investigated conversion to energy saving individual utility meters.

Within 60 days, please furnish this office, for each recommendation cited in the report, a status report on: (a) the corrective action taken; (b) the proposed corrective action and the date to be completed; or (c) why action is not considered necessary. Also please furnish us copies of any correspondence or directives issued because of the audit.

We appreciate the courtesies and assistance extended by the Office of Housing program staff during this audit. Should you have any questions, please contact Ernest Kite, Assistant District Inspector General for Audit, at (303)672-5452.

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Executive Summary

We have audited Rawson Management Company's operations of its six HUD-insured projects. The audit was conducted as part of Operation Safe Home. The purpose of our review was to determine whether: (1) the agent was properly in compliance with the terms and conditions of the Regulatory Agreements and other applicable HUD directives; and (2) the agent's charges to the HUD-insured projects were reasonable and necessary project expenses. Our Review covered the period from January 1, 1990 through December 31, 1994.

We found that the agent was not complying with the terms and conditions of the Regulatory Agreements or HUD regulations and instructions relating to the operation of HUD-insured projects. The agent: (1) has charged the projects for ineligible salaries totalling \$688,210; (2) has improperly distributed \$124,397 of project funds to the project owner; and (3) has not established adequate controls over project funds. In addition, the agent has not thoroughly investigated conversion to energy saving individual utility meters.

Salaries were ineligible

The projects have been charged and have paid \$688,210 in ineligible salaries from 1990 through 1994. This includes \$572,880 for excess payments to reimburse the agent for maintenance and repairs payroll, \$101,650 for payments to reimburse the agent for the cost of ineligible salaries for central office staff and \$13,680 for payments to reimburse the agent for on-site manager salaries that were never incurred. These improper payments happened because the agent has disregarded HUD requirements. As a result, the projects have been deprived of needed operating funds.

Distributions were improper

The management agent has improperly disbursed to the project owner withdrawals totaling \$124,397 from the Normandie Apartments operating accounts. The owner received the withdrawals without the required HUD approval and when the projects had no surplus cash. These withdrawals have occurred because the agent has disregarded HUD's requirements for owner distributions even after being notified by HUD that the disbursements were ineligible. As a result, the Department's security interest in these projects has been jeopardized.

Controls are not adequate

The agent has not established adequate controls over project funds. Enhanced internal controls and cash management improvements are needed to ensure that common expenses are fairly allocated among the HUD-insured projects, materials and supplies are provided to the projects at the most advantageous terms, security deposits are protected, fidelity bond coverage is adequate, and rent receipts are safeguarded. These control weaknesses have occurred primarily because the agent has decided not to comply with HUD requirements. These weaknesses have exposed the projects to inefficient use of their resources and may have exposed HUD to excessive rent subsidies.

Auditee Comments

The audit results were presented to the auditee in the form of a draft audit report and were discussed with him at an exit conference on June 7, 1996. The auditee provided us with several written responses dated May 20, 1996 through June 7, 1996.

The auditee generally disagreed with our audit findings. He claims that HUD either verbally approved the items we cite in this report or that HUD was aware of the items and did not instruct him to change his operations, thereby approving. He did not offer any documentation that would compel us to change our original conclusions.

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Introduction

Thompson Rawson Co. (a Utah Corporation), dba Rawson Management Company, and R. F. Rawson Company, is an identity-of-interest management agent located in Hooper, Utah. The President of Thompson Rawson Co. is Rodger F. Rawson. The agent manages Thompson Rawson Co.'s six HUD-insured apartment complexes, two Farmer's Home subsidized projects, miscellaneous other real estate holdings, its farm, and its related construction businesses.

According to Rawson Management Company's most recent management profile, the agent has managed HUD-subsidized properties since 1973 and manages a total of 324 subsidized units. The agent has managed all six HUD-insured projects since at least 1989. The latest audited financial statements for the six HUD-insured projects managed by Rawson Management Company show that Thompson Rawson Co. and/or Rodger Rawson are general partners in each project. The six projects managed by the agent are located in Utah and Idaho.

The mortgages on each of the six projects are insured and subsidized by HUD under the Section 236 program. In addition, each of the six projects receive Section 8 subsidy assistance under Housing Assistance Payment Contracts. The projects' rents are based on the projects' budget of revenues and expenses.

Specific project information is listed below:

Project Name	Location	Project Number	Year Insured	No. of Units	Rawson Ownership Percentage
LaDawn I	Roy, UT	105-44029	1973	32	50%
LaDawn II	Roy, UT	105-44034	1974	32	50%
Norman Manor	Burley, ID	124-44007	1972	48	100%
Normandie I	Ogden, UT	105-44002	1971	36	100%
Normandie II	Ogden, UT	105-44022	1973	16	100%
Osmond Heights	Ogden, UT	105-44035	1974	40	100%

The agent managed all six projects during the entire audit period, and received a percentage of project receipts as a management fee for managing the projects in compliance with HUD requirements.

The agent procured materials and services for the projects, and used its own employees and equipment to maintain the properties. The maintenance employees worked for the HUD projects,

and for the agent/owner's other properties, construction and farm activities. The agent billed the HUD-insured projects monthly for the maintenance and management services provided.

Project records are located at the Rawson Management office at 5175 West 4000 South, Hooper, Utah.

Audit Objectives

The purpose of our review was to determine whether: (1) the agent was properly in compliance with the terms and conditions of the Regulatory Agreements and other applicable HUD directives; and (2) the agent's charges to the HUD-insured projects were reasonable and necessary project expenses.

Audit Scope

To accomplish our objectives, we reviewed files and other information of the agent, the projects managed by the agent and HUD. We also interviewed the agent, his employees and employees of HUD. We analyzed accounting transactions and tested the accounting systems of the agent and of the projects he managed.

Audit Period

Our audit period generally covered activities from January 1, 1990 through December 31, 1994. We conducted the audit in accordance with government auditing standards.

The Management Agent has Charged the Projects for Ineligible Salaries

The projects have been charged and have paid \$688,210 in ineligible salaries from 1990 through 1994. This includes \$572,880 for excess payments to reimburse the agent for maintenance and repairs payroll, \$101,650 for payments to reimburse the agent for the cost of ineligible salaries for central office staff and \$13,680 for payments to reimburse the agent for on-site manager salaries that were never incurred. These improper payments happened because the agent disregarded HUD requirements. As a result, the projects have been deprived of needed operating funds.

HUD Requirements

HUD Handbook 4381.5, *Management Documents, Agents and Fees*, outlines the charges that may be paid out of the project accounts and those that must be absorbed by the management fee. This Handbook generally allows each project's accounts to be charged for the costs incurred for front-line management of the project.

Maintenance and Repairs Payroll

The projects were charged for maintenance and repairs salaries

Maintenance and repairs payroll expenses were charged to each of the projects by the management agent on a monthly basis. However, the agent could not demonstrate to us any factual basis for the amounts charged.

This expense item includes:

- Account #6510 - Janitorial and Cleaning Payroll Expense;
- Account #6540 - Repairs Payroll Expense;
- Account #6560 - Decorating Payroll/Contract Expense; and,
- Account #6535 - Grounds Payroll Expense.

Salary charges were based on estimates

All four expenses are billed by the management agent to each project similarly for each month. For 1990, the

projects were usually billed a flat dollar amount based on the annual budgeted amount. From 1991 through 1994, the agent estimated the amount of time that his maintenance staff spent on each activity during the month for each project. These estimated hours were billed to the projects at predetermined hourly rates.

The management agent told us that he based these rates on what local contractors charge for similar services. However, he did not have cost comparisons or written estimates from local contractors supporting the rates charged. Likewise, he had not based the rates on any other consistent and fair allocation of indirect costs.

He did tell us that his billing rates were marked-up about 100% from the actual wages paid. These mark-ups were intended to reimburse him for the actual base wages, direct overhead taxes, insurance and other overhead costs, (such as the use of his tools and equipment and transportation costs) as well as to allow for a reasonable profit. The agent said that he limits his annual charges for these expenses to the approved budget amount.

HUD allows only actual costs

HUD Handbook 4381.5, Section 2-15 allows for reasonable amounts incurred for front-line, day-to-day activities to be charged against the project accounts. If staff work is performed out of the agent's office for several projects, the agent must prorate the costs among the projects served in proportion to actual use. Also, the agent may not impose any surcharges or administrative fees on top of the actual costs.

Therefore, while the agent did incur costs while providing maintenance and repair services to the projects, he cannot arbitrarily charge the projects for those services. He must limit his charges to the actual costs he incurred.

The agent's records did not account for hourly billings

We attempted to identify the actual costs incurred by the agent in providing maintenance and repair services to the projects. There were several factors that made this task impossible:

- Most of the time, employees did not keep detailed timesheets showing hours worked by activity or by project.

- The amounts billed to the projects were based on estimates of hours spent by employees on various activities at each project.
- The agent did not reconcile the number of hours billed to all the projects with the actual number of hours worked for the month. The amount of hours charged by the agent appeared to be significantly more than would be supported by the agent's payroll.
- These expenses were for time spent by agent employees (manager or maintenance man) cleaning the common areas and performing janitorial services as well as time spent by the agent's maintenance crew performing repairs and decorating work at the projects. However, the on-site manager's salary is charged under management salaries (discussed later), and the maintenance employees work on HUD related and non-HUD related activities.
- The agent's computer system could not provide us with a consolidated general ledger printout for the entire year and other previous printouts for the period could not be located.

We computed the maximum actual cost

In order to obtain the most conservative disallowed cost possible, we determined actual, allowable maintenance and repairs salaries as follows:

- We computed the agent's actual amounts paid to his employees based on employer payroll records (any available W-2's, quarterly reports or year-end summaries).
- We computed a payroll overhead rate based on payroll overhead costs (taxes, workman's compensation insurance, unemployment insurance). The agent's other employee insurance costs were charged separately to the projects and were not included in this rate.
- Costs for employees who worked on more than one project were considered to be indirect and were prorated to each project based on that project's number of units as a percentage of all units managed by the agent (both

HUD insured and non-HUD insured). We did not deduct time spent by the indirect employees on the agent's farming or construction activities because we were unable to readily determine the percent of time devoted to such activities.

- For each project, we added the payroll costs of the direct employees and the prorated payroll costs of the indirect employees. We added to that total an amount for payroll overhead based on our computed payroll overhead amount. We believe this amount conservatively represents the total incurred by the agent for maintenance and repairs salaries.

Salary charges exceeded actual costs

Based on this amount, the agent has charged his HUD insured projects \$572,880 more than he has incurred for maintenance and repairs salaries. Each project was overcharged:

Normandie I	\$81,537
Normandie II	57,142
LaDawn I	80,448
LaDawn II	85,797
Norman Manor	168,438
Osmond Heights	<u>99,518</u>
Total	<u>\$572,880</u>

Office Salaries

The projects were charged for salaries of central office staff

According to the management agent, the Office Salaries expense was to reimburse the agent for the salaries of his central office staff. The central office staff included the management agent, the agent's bookkeeper and members of the agent's family who performed various functions.

The agent bills the projects for this expense monthly based on that month's share of the annual budgeted line item amount for each project. For most of the audit period from 1990 to 1993, the agent billed exactly \$10 per unit per month. For Normandie I and II, the agent received a rent increase and corresponding budget increase in 1993 and started charging \$13.89 per unit per month or \$500 per month for Normandie I and \$12.50 per unit per month or \$200 per month for Normandie II effective June 1993.

The amounts paid by each project from 1990 through 1993 are:

Normandie I	\$18,260
Normandie II	8,072
LaDawn I	15,383
LaDawn II	15,482
Norman Manor	23,905
Osmond Heights	<u>20,548</u>
Total	<u>\$101,650</u>

We reviewed expenses for test months

We reviewed these expenses for all of the HUD insured projects for December 1990, December 1991, December 1992, June and December 1993 and June and December 1994. We also reviewed these expenses for Normandie I and II for May, June, and July of 1994.

For each item we tested:

- the disbursement was to the management agent;
- the amount billed was based on a predetermined budget amount; and
- the amount billed was not supported by documentation of the agent's actual costs for eligible front-line services. The agent maintains payroll records for the central office staff. However, these records do not include documentation showing the types of activities performed or the amount of time spent on any individual project.

Payments are not eligible

Section 2-15 of HUD Handbook 4381.5 allows reasonable expenses incurred for front-line management activities to be charged to the projects' operating accounts. This section defines front-line activities as including:

- taking applications;
- screening, certifying and recertifying residents;
- maintaining the project; and,
- accounting for project income and expenses.

The Handbook does allow for prorating central office staff time for non-supervisory staff that work on front-line duties. However, all the HUD-insured projects had site managers and offices to handle the day-to-day project operations. They also all paid a contractor separately for bookkeeping and accounting services.

Therefore, lacking any evidence that non-supervisory central office staff worked on front-line duties, we conclude they did not, and these costs are not allowable.

The agent has stopped this practice

Correspondence with HUD in August 1994 indicated that the agent agreed that this was not a valid project expense. Although the agent continued to charge this expense, it was subsequently backed out from the projects' general ledgers and audited financial statements for 1994.

Management Salaries

The projects were charged for manager salaries

According to the management agent, the Management Salaries expense was to reimburse the agent for the salaries of the on-site managers. Each project made payments to the management agent for manager salaries during each year of our audit period.

Manager salaries can be charged to project accounts

HUD Handbook 4381.5 REV-1, *Management Documents, Agents and Fees*, issued June 1986, states that reasonable amounts incurred for front-line, day-to-day activities may be charged against the project operating accounts.

Manager salaries were not based on actual costs

However, the agent does not bill this expense item to each project based on the amount incurred. Rather, he bills the projects for this expense monthly based on the annual budgeted line item amount for each project.

We reviewed expenses for test months

We reviewed these expenses for all of the HUD insured projects for December 1990, December 1991, December 1992, June and December 1993 and June and December 1994. We also reviewed these expenses for Normandie I and II for May, June, and July of 1994.

For each item we tested:

- the disbursement was to the management agent;
- the amount billed was based on a predetermined budget amount; and
- the amount billed was not supported by documentation of the agent's actual costs for eligible front-line services.

Actual costs cannot be determined

During the audit we attempted to determine the actual amounts incurred for the manager's salary at each of the projects from 1991 through 1994. However, while the agent maintains payroll records for the on-site managers, in most cases these records do not include timesheets showing the types of activities performed or the amount of time spent on individual projects. Since in most cases the on-site manager also provided maintenance services for the project, the payroll records do not accurately show the actual salary cost incurred for project management.

Therefore, to obtain the most conservative ineligible expense possible, we classified all payments made to the managers as actual manager salary expense. We then computed a payroll overhead rate based on the management agent's payroll records and applied that rate to the salary expenses to obtain the total amount incurred by each project for on-site management.

The projects were overcharged

We found that, while some of the projects were overcharged and some undercharged, the HUD-insured projects managed by the agent were overcharged a cumulative \$13,680 for on-site manager salaries from 1990 through 1994:

Normandie I	\$12,053
Normandie II	8,088
LaDawn I	3,159
La Dawn II	3,417
Norman Manor	(12,842)
Osmond Heights	<u>(195)</u>
Total	<u>\$13,680</u>

The owner disregards HUD's requirements

We have observed many instances where the owner should have been aware of the requirements for operating HUD-insured projects, but chose to operate his HUD-insured projects differently. Other cases are detailed in the other findings. In this case, the HUD Handbook clearly states that the projects may pay for costs incurred to perform day-to-day functions. However, the owner has chosen to charge the projects for amounts that appear in the annual budgets.

Operating the projects in this manner results in more of the projects' assets being used to fund operations than normally anticipated by HUD. This results in fewer assets being available for debt service and capital expenditures than initially projected when HUD decided to insure the mortgage on the property.

HUD's interest in these properties is directly related to the physical condition of the properties as well as the punctual payment of the debt service. Therefore, HUD must take action to correct the way in which the owner charges the projects for office and management salaries.

Auditee Comments

The auditee provided us with several written responses dated May 20, 1996 through June 7, 1996. Those responses have been included in their entirety in Appendix A. The auditee also provided us with some supporting documentation which we have passed on to the appropriate HUD staff.

Maintenance and Repairs Payroll

The agent believes that he has charged the projects an amount for maintenance and repairs payroll which covered his cost of labor plus his cost of maintaining an extensive inventory of equipment, vehicles and tools. He feels that he should be able to charge for labor at rates that equal those charged by licensed tradesmen (electricians, plumbers, contractors, painters, etc.) in the area.

Also, he should be able to charge the projects for all of the costs incurred in maintaining the equipment, vehicles and tools. These costs include: fuel, repairs, maintenance, wear and tear.

In addition, he feels he should receive monies from the projects to reimburse him for his out-of-pocket cash he used for project expenses as well as for the thousands of hours he has spent personally working on maintenance, decoration, grounds and repair.

He feels we should reconsider the costs of outside contractors that were charged to the projects.

The agent stated that he no longer charges the projects for maintenance and repairs payroll based on estimated time. Each employee is now required to track his/her time each day. Charges are made to each project based on the actual time spent at that project each month.

Office Salaries

The agent has stopped charging the projects for office salaries. However, he asserts that his central office staff performs front-line duties at the projects. He feels it is necessary for his central office staff to perform these duties because they have fewer errors and problems than when the on-site managers perform these duties. He wants to track the time spent on front-line duties for the purpose of charging the projects for that time.

The agent would also like to charge the projects for bookkeeping expense since the contract bookkeeper hasn't provided any services since 1994.

Management Salaries

The agent indicated that he has started charging the projects for only the actual cost of the manager's salaries plus overhead.

OIG Evaluation of Auditee Comments

Maintenance and Repairs Payroll

We contend the projects have paid the agent \$572,876 for ineligible maintenance and repairs payroll. The agent's response did not provide any information that would dispute our contention.

The agent feels that he has charged the projects for the reimbursement of the cost of labor and equipment usage. However, his records provide no basis for charges of this type. As we explained in the finding, HUD rules do not allow for a surcharge on agent payroll costs for performance of front-line duties. Therefore, even though the agent holds tradesman licenses, he cannot charge higher than actual cost for the labor of his employees.

If the agent wishes to be reimbursed for the project related use of vehicles and equipment, he should document use by the projects and charge a reasonable rate for that use.

The purpose of this charge is not to reimburse the agent for his cost of the equipment, but to charge the projects' for use of the equipment. HUD does not require an extensive inventory of vehicles and equipment, nor does it prohibit one. Therefore, the maintenance of this inventory is entirely at the option of the agent. The agent should realize that it is not acceptable to have the projects pay an amount in excess of an appropriate, reasonable usage fee.

The agent may be allowed to be reimbursed from project accounts for his out-of-pocket cash he used for project expenses. However, he did not demonstrate to us when or how much out-of-pocket cash he has spent on project expenses. The agent should note that "owner advances" were only payable from surplus cash during most of the audit period.

HUD regulations do not allow an owner or agent to be reimbursed from project accounts for his/her labor. HUD Handbook 4370.2, Section 2-10 states that "The term distribution includes...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..." Distributions are only payable from surplus cash. In addition, HUD Handbook 4381.5 states that "Supervisory personnel are paid from the management fee, whether or not they perform supervisory or front-line tasks..."

We have not taken issue with any of the costs of outside contractors incurred by the projects. The fact that they are

not noted in this report indicates that they have not been disallowed.

The agent has started to charge the projects for maintenance and repairs payroll based on the actual time spent at each project by the maintenance staff. We recognize this as a positive reaction to our audit. However, this action does not address the ineligible costs identified during our audit.

Office Salaries

We contend that the projects have paid the agent \$101,650 for ineligible office salaries. The salaries are ineligible because the agent has no evidence that the payments were for non-supervisory central office staff performing front-line duties. The agent's response did not provide any information that would dispute our contention.

HUD has clearly defined which salaries can be paid by the projects and which salaries must be paid from the management fee. HUD Handbook 4381.5 states that the agent can charge the time of non-supervisory central office staff to the project accounts if that person's job description includes front-line duties and that person keeps track of the actual time spent performing front-line duties. However, the agent's central office staff did not have job descriptions that included front-line duties and non-supervisory duties, and the staff did not keep track of the time they spent performing front-line duties for the projects. Therefore, his charges to the projects for office salaries are not allowable.

If the agent wishes to develop job descriptions and charge the projects for the cost of office salaries, he must do so in accordance with HUD rules. However, we still do not feel it is reasonable to charge the cost of office salaries to a project that has an on-site manager. According to HUD Handbook 4381.5, the management fee is intended to pay for the cost of supervising and checking the performance of on-site staff.

If the agent wishes to be reimbursed by the projects for the cost of centralized accounting and bookkeeping, then he should follow the guidance in HUD Handbook 4381.5.

Management Salaries

No evaluation is necessary.

Recommendations

We recommend that HUD:

- 1A. Direct the management agent to reimburse each project for its share of the \$688,210 in ineligible costs paid.
- 1B. Direct the management agent to only charge the projects for the actual cost of maintenance and repairs payroll.
- 1C. Direct the management agent to acknowledge that payments for office salaries will not be made unless he develops a plan for charging these items and submits that plan for your approval.
- 1D. Direct the management agent to only charge the projects for the actual cost of management salaries incurred.
- 1E. Direct the management agent to provide evidence that these practices did not continue in 1995. If they have, require reimbursement for any ineligible amounts paid by the projects.
- 1F. Review the agent's operations after these recommendations have been implemented. Determine if the changes are adequate and in conformity with HUD regulations.
- 1G. Direct the owner to engage a new arms-length management agent if the current management agent is not responsive and effective in resolving this finding.

Project Funds Were Improperly Withdrawn

The management agent has improperly disbursed to the owner of the projects withdrawals totalling \$124,397 from the Normandie Apartments operating accounts. The owner received the withdrawals without the required HUD approval and when the projects had no surplus cash. These withdrawals have occurred because the agent has disregarded HUD's requirements for owner distributions even after being notified by HUD that the disbursements were ineligible. As a result, the Department's security interest in these projects has been jeopardized.

HUD Requirements

The use of project funds except for reasonable operating expenses and necessary repairs is a violation of Section 6(b) of the Regulatory Agreement. This section states that the owner shall not, without the prior written approval of the HUD Secretary, "*assign, transfer, dispose of, or encumber any personal property of the project, including rents or pay out any funds, other than from surplus cash, except for reasonable operating expenses and necessary repairs.*"

HUD Handbook 4370.2, *Financial Operations and Accounting Procedures for Insured Multifamily Projects* (effective January, 1991), provides other requirements that must be followed while operating HUD-insured housing.

Over \$120,000 improperly withdrawn and not repaid

According to the projects' audited financial statements, the owner received a total of \$124,397 from the Normandie I and II accounts from January 1, 1989 through December 31, 1994. These payments were made while neither Normandie project was in a surplus cash position.

The following is a summary of the \$124,397 in ineligible disbursements from the Normandie accounts during the audit period:

Finding 2

	Normandie I	Normandie II	Total
Payments to Ogden Door	\$58,979	\$33,794	\$92,773
Repayment of Owner Advances	\$24,952	\$2,672	\$27,624
Other Payments For\to Owner	\$3,200	\$800	\$4,000
Total	\$87,131	\$37,266	\$124,397

\$92,773 paid to former owner

Payments totalling \$92,773 have been made to the projects' prior owner, Ogden Door Company. As part of the purchase of this and several other projects in 1989, the current owner agreed to make these payments to Norman Thompson, dba Ogden Door Company as "funds become available from the project."

These amounts were accounted for on the projects' books as prior owner advances to the projects. However, all of the advances were made before the sale of the projects. Therefore, any amounts "owed" to the prior owner after the sale of the projects must be considered as part of the sale price of the projects.

Since these payments to the prior owner are actually payments on the purchase of the property, they are not "reasonable operating expenses and necessary repairs". As explained in Section 6(b) of the Regulatory Agreement, these payments can only be paid out of surplus cash.

The agent stated that the repayment of the advances from "available cash" was approved by HUD. However, correspondence in the HUD files shows no such authorization and instead shows that HUD has repeatedly requested that the owner repay the amounts to the projects because the payments were made when the project did not have surplus cash.

\$27,624 for repayment of owner advances

Payments totalling \$26,124 were paid to the owner during the years 1991 through 1994 for repayment of advances for 1990 operating expenses. An additional \$1,500 was paid to

the owner for interest on a loan he made to Normandie Apartments for installation of a new roof.

HUD Handbook 4370.2 requires that advances may be repaid only from surplus cash at the end of an annual or semi-annual period. In addition, prior HUD approval is needed if the owner wants to receive repayment before the end of the annual or semi-annual period. However, the Normandie projects were not in a surplus cash position during the years 1991 through 1994 and HUD did not give approval for any withdrawals.

\$4,000 paid for the benefit of the owner

The remaining \$4,000 payment was for an appraisal obtained by the owner for Title VI processing. This is an expense of the owner and not a reasonable operating expense of the project.

Project conditions could have been improved

Unauthorized withdrawals not only violate HUD regulations, they also weaken the financial condition of the projects and contribute to the lack of funds available to make needed repairs.

Inspections of Normandie Apartments during the audit period showed that the projects needed substantial repairs. A physical inspection by the HUD Asset Manager in September 1992 indicated the projects were in "below average" condition. In addition, an architectural inspection of the projects in December 1993 showed that the projects needed about \$84,000 in repairs.

Our inspection of the project in September 1994 indicated that most of the deficiencies on those prior inspection reports (e.g. retaining walls, sidewalks, soffits etc.) remained uncorrected. The money used for the unauthorized withdrawals could have been used to improve the physical condition of the projects.

Withdrawals must stop

The agent has repeatedly made these types of distributions even after HUD has notified him that they are improper. This makes it appear that the agent is intentionally disregarding HUD's requirements for owner withdrawals.

HUD needs to stop the agent from making these payments because it has an interest in ensuring that the projects are

financially and physically sound. Withdrawal of project funds at times other than authorized and when the projects have no surplus cash, is detrimental to the interest of the projects and HUD.

Auditee Comments

The auditee provided us with several written responses dated May 20, 1996 through June 7, 1996. Those responses have been included in their entirety in Appendix A. The auditee also provided us with some supporting documentation which we have passed on to the appropriate HUD staff.

The agent claims that at the time of the purchase of the property by the current owner, HUD agreed that the prior owner would be paid monies out of the projects' accounts. He further claims that agreement was an oral one and that HUD has since changed its opinion.

The agent would like to be reimbursed for payments he made several years ago for repairs at Normandie II and Osmond Heights.

He also claims that the appraisal fee originally paid by the project was repaid in 1995.

The agent took exception to our characterization of the physical condition of his projects and explained that he has repaired or corrected many physical deficiencies since buying the projects.

OIG Evaluation of Auditee Comments

We have found no indication that HUD has approved payment of project funds to the prior owner. In fact, HUD formally questioned payments made in 1989 (the year the current owner purchased the properties), 1990 and 1991. In response to these questions, the owner characterized the payments as reductions in "accounts payable".

However, any payments to the prior owner are clearly payments toward the purchase price of the projects. The sales agreement between the current and prior owners even states that these payments are payments on the sales price of the properties.

That same sales agreement states that the payments will "be paid to Sellers immediately upon funds becoming available from the projects". We believe this provision does not make a claim on project assets, but rather on partnership assets. Under the projects' regulatory agreements, the partnerships cannot receive project funds unless there is surplus cash.

Even if the sales agreement is interpreted to make a claim on the assets of the projects, we do not believe that the sales agreement can override the previously executed Regulatory Agreement which only allows payments for reasonable operating expenses and necessary repairs unless there is surplus cash.

The agent should consult with HUD regarding the repayment of advances he made to the projects in prior years. HUD has developed rules regarding repayment of advances.

During our exit conference, the agent provided us with a copy of the duplicate of a check dated 5/10/95 for \$3,200 to Normandie I for reimbursement of an appraisal fee. HUD should assure itself that this amount was deposited into the project accounts and that a corresponding deposit was made into the accounts of Normandie II.

We acknowledge that the agent has completed some physical repairs since the new owner purchased the project. We did not intend to imply that the physical condition of the projects has deteriorated. We do believe, however, that there were deficiencies that still needed to be corrected. The ineligible disbursements we noted in this finding could have been used to fund those corrections.

Recommendations

We recommend that HUD:

- 2A. Direct the agent to repay \$124,397 in unauthorized withdrawals to the Normandie projects' operating accounts. Determine if the project accounts reflect the repayment of the appraisal fees. If so, allow the agent credit for that amount.

- 2B. Identify any amounts improperly withdrawn after December 31, 1994. Require reimbursement to the projects' operating accounts.
- 2C. Advise the agent of the requirements that must be met before making future withdrawals of project funds.
- 2D. Direct the owner to engage a new arms-length management agent if the current management agent is not responsive and effective in resolving this finding.

Accounting and Management Controls Need to be Improved

The agent has not established adequate controls over project funds. Enhanced internal controls and cash management improvements are needed to ensure that common expenses are fairly allocated among the HUD-insured projects, that materials and supplies are provided to the projects at the most advantageous terms, that security deposits are protected, that fidelity bond coverage is adequate, and that rent receipts are safeguarded. These control weaknesses have occurred primarily because the agent has decided not to comply with some HUD requirements. These weaknesses have exposed the projects to inefficient use of their resources and may have exposed HUD to excessive rent subsidies.

HUD Requirements

HUD Handbook, 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*, Paragraph 2-12, provides guidelines for cash management controls over disbursements, security deposits, fidelity bonds, and cash receipts. These controls are necessary to ensure that project assets are adequately protected.

In addition, Paragraph 4-4 of the Handbook provides instructions relevant to the maintenance of project accounts including tenant and other accounts receivable. The projects' regulatory agreements and Paragraph 2-3 of the Handbook require the project books and records to be complete and accurate and kept in reasonable condition for proper audit at all times.

Control weaknesses exist in the agent's operations

We found significant control weaknesses in the following areas:

- Allocation of Indirect Costs
- Charges for Materials and Supplies
- Security Deposits
- Fidelity Bond Coverage
- Tenant Rent Receipts

The Agent does not have a fair and consistent method of allocating indirect costs to the projects.

HUD allows charges for overhead

HUD Handbook 4381.5 REV-2, *The Management Agent Handbook*, issued December 29, 1994, specifically states in Paragraph 6.38 that the agent may charge actual overhead expenses attributable to the performance of the front-line duties but may not impose surcharges or administrative fees in addition to actual costs. The agent may bill the project for staff performing front-line functions only if the following conditions are met:

- Salaries of the agent's supervisory personnel are not charged to the project.
- There is a job description for each position outlining the responsibilities of the position and that the position does not include supervisory functions.
- The agent develops a reasonable hourly billing rate not exceeding the amount that would have been paid to an on-site staff member with similar experience.
- Staff members document hours spent and duties performed for each project.

The agent does not fairly allocate overhead or expenses

The agent was not meeting these conditions at the time of our review. In fact, as explained more fully in Finding 1, the agent charged the projects for salary reimbursement based on cost estimates and arbitrary mark-ups.

In addition, the agent allocates some of his indirect expenses only to his eight federally insured projects (6 HUD and 2 Farmers Home Administration projects) instead of all projects and activities which may benefit from the expenses. Among the federally insured projects, some indirect expenses are allocated equally to the projects even though the projects may vary significantly in size.

Also, common expenses for Normandie I and II were allocated between the two projects based on an 80/20 ratio. However, the number of units in each project indicates that the allocation should be 69/31. These costs are not even allocated consistently from year to year. According to the

agent's accountant, these ratios change. In the past, they have also used 70/30 and 75/25 ratios.

The agent needs to establish an allocation system which fairly and equitably allocates all specifically identified common costs to each of the projects he manages. This system should be consistently applied each year.

The agent does not ensure that materials and supplies are provided to the projects at the most advantageous terms.

Amount allowed for identity-of-interest purchases is limited

Section 9(b) of the Regulatory Agreement limits allowable costs for goods and services provided under arms-length transactions. This paragraph states that *"payment for services, supplies, or materials shall not exceed the amount ordinarily paid for such services, supplies, or materials in the area where the services are rendered or the supplies or materials furnished."*

The projects must buy many things from identity-of-interest firms

The agent sells to the projects most of the materials and supplies they use. He purchases the items, stores them and distributes them when needed by the projects. He charges the projects for each item based on his original cost plus a percentage mark-up. The agent's usual markup on inventory items is 25% for items over \$50, 50% for items between \$10 and \$50, and 100% for items under \$10. The markups are intended to compensate the agent/owner for storage and handling costs.

Luxury Leasing, an Identity-of-Interest company, charges each project \$1 per-unit-per-month for newsletters and \$4.25 per-unit-per-month for computer rental and additional amounts for rental of furniture and equipment to the projects. Luxury Leasing also sells mini-blinds and drapes to the project at a 100% markup.

In addition, the agent paid the owner from the accounts of Normandie I and II for use of irrigation water stored on a strip of land that he owns and that is next to the project. The owner based his charges to the project on an arbitrary estimate of what he believed the project would have to pay if it used city water instead of irrigation water.

Prices paid may be more than market price

The agent was unable to demonstrate that the goods were provided to the projects at a price less than or equal to a price available on the open market. The agent feels the markups on goods provided by him are justified because the centralized purchasing of materials and supplies results in vendor discounts that reduced project operating costs. The agent also maintains that his contractor's and wholesaler's licenses allow him to purchase many items at wholesale.

While the agent did obtain discounts for quantity purchases, we noted that in practice, the markups were assessed even for items purchased individually or locally at full retail. We also believe that many of the discounts available to the agent would have also been available to the projects themselves.

Luxury Leasing claimed that the goods and services provided by them cost less than charged by local contractors. Some recent bids on mini-blinds had been obtained from several local vendors, but there was inadequate information in the agent's files to determine whether they were similar to the blinds sold to the projects.

The agent did not have any documentation to support the owner's estimates of the market value of the water provided to Normandie.

The agent cannot demonstrate reasonable prices

Regardless of the reasons the agent felt any of the mark-ups were justified, the fact remains that his system of controls provides no assurance that the price the projects pay for materials and supplies is the most reasonable available.

In fact, we found instances where the agent's charges exceeded comparable rates available in the local market. For example, we noted that the agent purchased cleaning supplies from Pace Warehouse and then sold those supplies to the projects at a 100% markup. The projects themselves should purchase the supplies from Pace and not incur the agent's markup.

The agent needs to implement a system that will demonstrate the reasonableness of prices paid by the projects. This system should include documentation of

reasonable market price as well as why the project would not be able to receive any discounts from the retail price.

Security deposits are not separately funded and accounted for.

HUD requires special treatment of security deposits

HUD Handbook, 4370.2 REV-1, Chapter 2, states that a separate bank account should be established to maintain security deposits from project tenants.

In addition, Paragraph 6(g) of the Regulatory Agreement, requires the owner to keep security deposits separate and apart from all other funds of the project in a trust account the amount of which shall at all times equal or exceed the aggregate of all outstanding obligations under said account.

The agent comingles security deposit funds

However, the agent has failed to place security deposits in separate accounts for Normandie I and II. The security deposit records are maintained manually and the amounts are not segregated for the individual projects until the end of the year financial statements and adjustments. The need to maintain separate accounts has been cited repeatedly in prior HUD reviews.

The agent expressed an unwillingness to comply with the requirements because he believed that separate accounts would create confusion and require additional forms, reports, statements and costs while reducing interest earnings. However, we believe separate accounts would provide more security over project assets.

Separate accounts would also allow use of the agent's monthly bank reconciliation program, check register and check printing programs which are used for other bank accounts. This would make the accounts easier to reconcile and would allow the use of the controls inherent in the agent's accounting system, thereby saving administrative time and reducing errors.

Fidelity Bond Coverage is inadequate.

The agent needs more coverage

HUD Handbook 4370.2 REV-1, Paragraph 2-12 states that fidelity bond coverage must be equal to at least two months potential rent collections. However, the agent had only

\$70,000 coverage for all of the properties he managed in 1994. This is less than the monthly rent potential for the HUD insured projects alone.

The agent's accountant felt that the amount of coverage was adequate because of the difficulty and expense involved in obtaining the present coverage. However, regardless of the cost or complications, the coverage prescribed in the Handbook is necessary to protect the interest of the owner and of HUD.

The agent is prorating the cost improperly

HUD Handbook 4381.5 REV-2, Paragraph 6.42 requires that the cost of fidelity bonds be prorated between the agent's supervisory staff and the on-site managers at each of the projects the agent manages. The cost allocated to each project should be based on the gross rent potential at each project.

However, the agent allocated the 1994 fidelity bond equally between his on-site managers for the federally insured projects. The agent did not make any deduction for any central office or supervisory staff which are also covered or for non HUD-insured properties which employ an on-site manager.

Controls over tenant rent receipts are not adequate.

Rent receipts are vulnerable

Additional controls over rent receipts are needed. We noted the following weaknesses in the agent's controls over cash receipts:

- Prenumbered rent receipts are not reconciled to actual collections and deposits.
- Tenant accounts receivable are not posted monthly to each project's general ledger.
- Accounts receivable for tenant damages are posted on a cash basis only.
- Bank reconciliations are prepared by the agent's accountant who also records cash and prepares checks.

These weaknesses need to be corrected to provide assurance that all of the funds received by the project remain available for use by the project.

The agent has caused these problems

In each of the control weaknesses, except for the weaknesses over rent receipts, the agent has made a decision to not comply with the related HUD requirements. While the agent may contend that the decisions were made to benefit the projects, we believe the results of those decisions have been to the benefit the agent. For example:

- The agent decided to charge the projects for front-line services by billing at arbitrary rates for estimated hours. The result was to reimburse the agent excessive amounts for front-line services.
- The agent decided not to segregate security deposit funds because he felt that it would be more difficult and reduce interest earnings.
- The agent did not obtain adequate fidelity bond coverage because it was a difficult process and would cost more.

These problems place the projects and HUD at risk

At a minimum, these control weaknesses have exposed the projects to a risk of misused or wasted resources. However, we believe that these weaknesses may have also exposed the Department to higher than necessary rent subsidies.

Each of the six projects receives Section 8 subsidy assistance under Housing Assistance Payment Contracts. The project rents are based on the projects' budget of revenues and expense. Each year, the budget is generally based on the actual recorded revenues and expenses in the past. These budgets are submitted to HUD to justify rent increases.

Under the rent subsidy program, a tenant's rent is based upon the amount of income they have. HUD subsidizes the remainder of the total rent. Therefore, if the total rent increases, HUD's rental subsidy increases.

If the budgets used to justify rent increases are based on expenses that are unreasonably high, then the total rent will

be unreasonably high, resulting in HUD's rental subsidy being unreasonably high.

Auditee Comments

The auditee provided us with several written responses dated May 20, 1996 through June 7, 1996. Those responses have been included in their entirety in Appendix A. The auditee also provided us with some supporting documentation which we have passed on to the appropriate HUD staff.

Supervisory Salaries

The agent states that he has stopped charging projects for salary reimbursement for these employees. He would like to start charging the projects for certain services that these employees perform.

Allocation of Overhead and Expenses

The agent states that he allocates expenses to the Normandie projects based on a 70/30 ratio. He is willing to change it to 69/31.

Materials and Supplies

The agent no longer maintains an inventory of supplies. He now charges the projects the actual cost of supplies. The identity of interest company is not currently supplying blinds or newsletters.

Security Deposits

The agent has separated the security deposits for Normandie I and II and has instituted procedures for automated accounting of the funds.

Fidelity Bonds

The agent is in the process of increasing the fidelity bond coverage and will allocate the cost of the bond based on the gross rent potential of each project.

Rent Receipts

The agent claims that the rent receipts have always been reconciled to actual collections and deposits. He also has a no cash policy which further safeguards receipts.

The agent will add the capability of recording tenant damages in accounts receivable as they occur.

The agent feels that he has good overall control over receipt of rents.

OIG Evaluation of Auditee Comments

Supervisory Salaries

We recognize that the agent has taken a positive step by stopping the charges for his central office staff. HUD should now work with the agent to structure all of his administrative fees in accordance with applicable rules.

Allocation of Overhead and Expenses

During the audit period, the agent did not have a consistent and logical method for allocating overhead and common expenses. HUD should determine if his current method of allocation is logical and fair and require that he apply any acceptable method consistently from year to year.

Materials and Supplies

We recognize that the agent has taken a positive step by stopping the markups on items supplied by him and the identity-of-interest company. The agent should now develop a plan for providing any goods and services to the projects. The plan should identify any markups that will occur and methods to ensure that prices will not exceed those obtainable by the projects. HUD should determine if that plan is acceptable.

Security Deposits

No evaluation necessary.

Fidelity Bonds

No evaluation necessary.

Rent Receipts

When we were conducting our audit, the agent's staff told us that receipts were not reconciled to actual collections by receipt number. If that procedure is now being performed, that is a positive step. Controls would also be improved by posting tenant damages to accounts receivable as they occur, not as they are collected.

Recommendations

We recommend that HUD:

- 3A. Direct the agent to develop a fair and consistent method of allocating administrative overhead and indirect costs to the projects. Require that the agent submit this allocation plan to you for review.
- 3B. Direct the agent to develop a method to document that any materials and supplies sold to the projects are at or below the price that could be obtained by the projects on the open market. This should include documentation of the reasons why the projects would not be able to obtain the same discounts the agent received.
- 3C. Determine if the agent's new procedures for handling tenant security deposits have been implemented properly and are functioning correctly.
- 3D. Direct the agent to increase fidelity bond coverage to comply with HUD requirements. The agent should also be required to develop a fair and equitable system for allocating the cost of the fidelity bond amongst his staff, HUD-insured project staff and non HUD-insured project staff.
- 3E. Direct the agent to design and implement procedures that ensure safeguarding of tenant rent receipts. The new procedures should be sent to HUD for review.
- 3F. Review the agent's operations after these recommendations have been implemented. Determine if the changes are adequate and in conformity with HUD regulations.

- 3G. Review the total operating costs of the projects after all of the recommendations in this report have been implemented. Determine if the current rent levels at the projects are justified and take any appropriate action to maintain the rents at appropriate levels.

- 3H. Direct the owner to engage a new arms-length management agent if the current management agent is not responsive and effective in resolving this finding.

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Issue Needing Further Study and Consideration

During our audit we noted another matter that warrants HUD's consideration and action. There is additional initiative required to convert the projects to tenant paid utilities.

Conversion to Individual Meters is Needed

HUD Handbook, 4350.1, *Insured Project Servicing Handbook*, encourages controlling utility costs by undertaking feasible, cost effective actions to increase energy efficiency. Chapter 12, Section 5, of the Handbook provides steps for obtaining tenant input and HUD approval for conversion from master meters to individual metered (tenant paid) utilities.

The agent has checked into converting to individual meters in the past but reportedly didn't have enough reserve funds to pay for the conversion. At the time of our review, there were adequate funds in some of the project's reserves to fund the conversion. Since HUD benefits directly from any savings in reduced subsidy to the project, it should assist the owner in pursuing the steps for converting to individual meters outlined in HUD Handbook 4350.1.

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Internal Controls

In planning and performing our audit, we considered internal controls of the projects' activities in order to determine our audit procedures and not to provide assurance on internal controls.

Internal controls consist of the plan of organization and methods and procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data is obtained, maintained, and fairly disclosed in reports.

Internal Controls Assessed

We determined the following controls were relevant to our audit objectives and each was assessed during our review:

- Controls to ensure adequate maintenance of the projects' grounds, buildings and improvements;
- Controls to ensure reliable financial management, including procedures for charging management agent cost to project accounts;
- Controls to ensure compliance with leasing and occupancy rules and regulations; and
- Controls to promote adherence to the agent's general management practices.

We assessed all the controls identified above by determining the risk exposure and assessing control design and implementation.

Assessment Procedures

The following audit procedures were used to evaluate internal controls:

- Interviews with the management agent/owner and his employees;
- Review of files maintained by the management agent/owner;
- Tests and evaluation of the management agent/owner's operating policies and procedures as they relate to the identified relevant controls; and

Assessment Results

- Review of the projects' accounting and administrative records maintained by the management agent/owner.

A significant weakness exists if internal controls do not give reasonable assurance that resources are used consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss and misuse; and that reliable data is obtained and maintained, and fairly disclosed in the financial statements and reports.

Based on our review, the following items which are discussed in the report, are significant weaknesses:

- The agent did not have adequate financial management controls to safeguard the assets of the project (discussed in Findings 1 and 3).
- The agent did not have adequate financial management controls to ensure that the projects' expenses were supported and were made at the most economical cost possible (discussed in Findings 2 and 3).

Compliance

We selected and tested transactions and records to determine whether the management agent/owner complied with laws and regulations governing the management and maintenance of multifamily insured and subsidized projects. For the items tested, we found noncompliance with these laws and regulations as described in the Executive Summary and Findings. The extent of noncompliance on transactions tested suggested that the agent also may not have fully complied on other transactions which we did not test.

Follow Up On Prior Audits

This is the Office of Inspector General's first audit of Rawson Management Company.

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