



U.S. Department of Housing and Urban Development

Pacific/Hawaii

Office of Inspector General for Audit
450 Golden Gate Avenue, P.O. Box 36003
San Francisco, California 94102-3448

April 14, 1997

MEMORANDUM FOR: SEE DISTRIBUTION BELOW

FROM: Glenn S. Warner, District Inspector General for Audit, 9AGA

SUBJECT: Granada Gardens
Use of HUD's Earthquake Loan Program (HELP) Funds
Granada Hills, California
Report No. 97-SF-219-1002

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()	Morris Grissom at OIGPOST2 (CCMAIL only)	
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OUTSIDE HUD

()	Alfred E. Mann, General Partner, Granada Gardens Ltd. 12744 San Fernando Road, Sylmar, CA 91342-9219	1
()	Southwest Development Co., Management Agent 260 Maple Court Suite 205, Ventura, CA 93003	1
()	Director, Housing and Community Development Issue Area, US GAO, 441 G Street, NW, Room 2174, Washington, DC 20548, Attn: Judy England-Joseph	<u>1</u>
	Subtotal	3

OIG-PACIFIC/HAWAII

()	Warner, McCargar, Bahr, Lovell, Velasco, Mangassarian (2)	7
()	DIGA Files (4), LA Files, Phoenix Files	<u>6</u>
	Subtotal	14
()	Total	<u>43</u>



Issue Date	April 14, 1997
Audit Case Number	97-SF-219-1002

TO: Michael Kulick, Director, Housing Division, 9DH

FROM: Glenn S. Warner, District Inspector General for Audit, 9AGA

SUBJECT: Granada Gardens
Use of HUD's Earthquake Loan Program (HELP) Funds
Granada Hills, California

We completed an audit of Granada Gardens' use of HUD's Earthquake Loan Program (HELP) funds. The audit report contains two findings.

We have provided a copy of this report to the project's General Partner and the Management Agent.

Within 60 days please furnish us, for each recommendation in the report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should your staff have any questions, please have them contact Ruben Velasco, Senior Auditor at (213) 894-8016.

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Executive Summary

We completed an audit of Granada Gardens' (project) use of HUD's Earthquake Loan Program (HELP) funds. The objective of our audit was to determine whether the project used the funds in compliance with the HELP contract and applicable HUD requirements, regulations, and instructions. We performed the audit field work at the management agent's office. We reviewed project files, interviewed HUD's Los Angeles Field Office and the management agent's officials and staff to determine the project owner's compliance with the terms of the HELP contract. We also visited and talked to various contractors involved in repairing the project. Our audit generally covered all activities relating to the receipt and use of HELP and other earthquake related funds.

The majority of HELP funds were used in accordance with the HELP contract

Although the project generally used HELP funds in accordance with the HELP contract and applicable HUD requirements, regulations, and instructions, the owner did not return or prepay the HELP loan from unused HELP funds or property tax refunds that the project received.

The project's owner misused \$322,432 of HELP funds

Contrary to HUD requirements and the Financial Assistance Contract, the project's owner (owner) improperly used \$322,432 in leftover HELP funds that were earmarked for the project's earthquake related financial deficit arising from vacancy losses. The owner used this amount rather than returning it to HUD to prepay part of the HELP loan. Those funds would not have been necessary had the owner returned the tenants to their units when they became available for re-occupancy. The owner purposely delayed the return of the tenants to their units even though the repairs had been completed. This action resulted in lost rental revenue to the project. This occurred because of the owner's disregard for HUD regulations, contract, and requirements, prompted by a dispute between the owner and HUD. As a result, HUD provided more HELP funds than necessary.

Property tax refund of \$11,037 should have been used to reduce HELP loan

Contrary to HUD requirements, the project's owner did not prepay a portion of the HELP loan with the \$11,037 received as a property tax refund. This occurred because the project's owner was unaware of HELP loan requirements. As a result, HUD unnecessarily provided more in HELP funds than the program had intended.

Auditee Comments

We discussed the findings with management agent officials during the audit and with the owner at the January 7, 1997

exit conference. We provided the owner with the draft findings on November 21, 1996 and we received his written response on January 22, 1997. The owner's response and our evaluation thereof are discussed in the findings as appropriate. The complete written response is included as Appendix A. At the exit conference and in the written response, the owner disagreed with draft Finding 1 concerning the date that the project was ready for re-occupancy. The owner also stated that OIG's computation of lost rental revenue assumed a 100 percent rent-up which was unrealistic.

At the exit conference, the owner agreed with Finding 2.

OIG Evaluation of Auditee Comments

We revised draft Finding 1 to give consideration to the owner's comments that the work was not completed in a condition permitting safe occupancy until July 1996. Thus, we have only questioned the actual financial deficit of \$36,221 for the disputed period (March 31 through July 31, 1996). However, we have disallowed \$286,211 in remaining HELP funds for the period beyond July 31, 1996. We agreed with the owner that assuming 100 percent rent-up was unrealistic. However, the project would have generated enough income to cover its actual deficits assuming 80 percent rent-up which we obtained using actual occupancy and the project's waiting list.

Recommendation

We are recommending that the owner be required to prepay \$297,248 of the HELP loan consisting of \$286,211 in leftover HELP funds and the \$11,037 refund from property taxes. In addition, we are recommending that HUD determine the allowability of \$36,221 in costs that are questioned because of the disagreement with the owner as to when the units were ready for occupancy. Any of the \$36,221 that is determined to be unallowable should also be used to prepay the HELP loan.

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Abbreviations

HELP	HUD Earthquake Loan Program
HUD	U. S. Department of Housing and Urban Development
IA	Independent Auditor
LAAO	Los Angeles Area Office
MIO	Management Improvement Operation
OIG	Office of Inspector General

Introduction

BACKGROUND

Emergency Appropriations Act of 1994 provided \$100 million to repair earthquake damaged projects

On February 10, 1994, President Clinton signed into law the Emergency Supplemental Appropriations Act of 1994 to provide relief to the victims of the January 1994 Northridge earthquake. Chapter 7 of this Act provided \$100 million in Flexible Subsidy Loans specifically to help HUD-assisted multifamily projects to recover from the earthquake.

Although the funding was made available under the Flexible Subsidy Program, the HUD Earthquake Loan Program (HELP) was intended specifically to encourage owners whose buildings were damaged in the Northridge earthquake to make use of these funds to correct earthquake related physical and financial problems.

To qualify, the owner was required to submit a Management Improvement Operations (MIO) Plan to HUD which identified the extent of the earthquake related damages and the estimated cost of repairing them, and all expenses incurred for which reimbursement was being sought. HUD requires strict compliance with the terms and conditions applicable to the program upon which the MIO Plan was funded.

HELP allowed the project to initially absorb the emergency repair costs until HELP funds were released. Upon receipt of the funds, the Project owner can be reimbursed for all emergency repair costs already incurred. HELP required project owners and management agents to practice formal procurement procedures for handling major earthquake repairs.

HUD makes direct transfer of HELP funds to a separate bank account established for each of the projects that received HELP funds to pay general contractors, mortgagees, and project reimbursements.

Granada Gardens received \$6,220,013 in HELP loan

On May 20, 1994, HUD approved a \$5,942,587 HELP loan to Granada Gardens, a 169 unit project located in Granada Hills, California. Due to changes in the scope of repair work to be done, HUD increased the loan amount to

\$6,220,013 in August 1995. The project was originally insured under Section 236 of the National Housing Act, and owned by Granada Gardens, a California limited partnership, and managed by Southwest Development Company (management agent), an identity-of-interest management agent located in Ventura, California. At the time of our audit, the management agent was managing two other HUD-insured projects in Orange County, California.

On February 12, 1997, Alfred E. Mann, Owner, sold Granada Gardens to Granada Gardens RHF Housing, Inc., a private non-profit organization. Following the sale the owner received \$6.9 million in sales proceeds. The purchaser assumed a combined \$8.7 million in loans. Of the \$6.9 million sales proceeds, HUD placed \$333,469 in escrow pending the resolution of the audit findings in this report.

**AUDIT OBJECTIVES,
SCOPE AND
METHODOLOGY**

The purpose of our audit was to determine whether the project used the HELP funds in compliance with the HELP contract and applicable HUD requirements, regulations, and instructions.

We conducted the audit field work at the management agent's office and generally covered the period January 17, 1994 through September 30, 1996. We reviewed project files, interviewed HUD's Los Angeles Area Office and management agent's officials and staff to determine owner's compliance with the terms of the HELP contract. We also visited and talked to various contractors involved in repairing the project. Our audit generally covered all activities relating to the receipt and disbursements of HELP and other earthquake related funds. We discussed the results of our audit with a management agent official during the audit and the owner at a January 7, 1997 exit conference. We started our on-site work on April 1, 1996 and completed it on September 30, 1996.

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

The Project's Owner Improperly Used \$322,432 Of HELP Funds

Contrary to HUD requirements and the Financial Assistance Contract, the project's owner (owner) improperly used \$322,432 in leftover HELP funds that were earmarked for the earthquake related financial deficit arising from vacancy losses. The owner used this amount rather than returning it to HUD to prepay part of the HELP loan. Those funds would not have been necessary had the owner returned the tenants to their units when they became available for re-occupancy. The owner purposely delayed the return of the tenants to their units even though the repairs had been completed. This action resulted in lost rental revenue to the project. This occurred because of the owner's disregard for HUD regulations, contract, and requirements, prompted by a dispute between the owner and HUD. As a result, HUD provided more HELP funds than necessary.

Funding can be provided to cover deficits due to loss of rents as a direct result of the earthquake

HUD Notice H 94-15, Implementation of the Special Allocation for Flexible Subsidy - HUD Earthquake Loan Program (HELP), dated March 17, 1994, Eligible Items for Funding, states that funding could be provided to cover deficits due to move outs or loss of rents as a direct result of the earthquake until such units are restored to full occupancy.

The Notice also states that prior to the receipt of HELP funds, the owner must certify to HUD that the repair plan for earthquake related damage, as developed, would restore the property to economic viability. Owners must also certify that they will comply with the terms and conditions applicable to the program for which the final MIO plan, as developed, was funded.

The Financial Assistance Contract also provides that if the estimated amounts for improvements or operating deficits exceed the actual costs for those items, the owner agrees that the Commissioner may reduce the maximum amount of the Flexible Subsidy assistance and/or Financial Relief by an amount equal to the difference between the estimated and actual costs.

\$322,432 budgeted for vacancy losses should be returned to HUD

The owner improperly used \$322,432 of HELP funds that were earmarked for the earthquake related financial deficit in lieu of rental income that the project would have received had the units been occupied. Sufficient rental income was not available because the owner purposely delayed the return of tenants to the project even though units that had been repaired were ready for re-occupancy.

The project's owner received \$924,938 (\$892,920 in HELP funds and \$32,018¹ in insurance reimbursement) to cure the project's earthquake related financial deficit. The actual deficit as of March 31, 1996, however, amounted to only \$602,506, which was \$322,432 less than the total \$924,938 that the owner received. The project's deficit was determined based on the audited financial statement that the project's Independent Auditor (IA) calculated and provided to us (Appendix B). The IA's calculation was made in accordance with HUD Handbook 4355.1 REV-1, Flexible Subsidy Handbook, which states that the financial deficit represents the difference between expenses that are necessary to operate a project efficiently and revenues that it generates. Also, the deficit that is funded should only include expenses that are routinely paid from project income and exclude expenses for major one-time physical or financial improvements.

The owner disputed date units were ready for occupancy

In our draft finding we reported that the project became ready for re-occupancy on March 31, 1996; therefore, we calculated the project's deficit through that date. Our conclusion was based on statements by the general contractor and documents that he provided. However, the owner disagreed and stated that the project became ready for re-occupancy on July 31, 1996. Since the owner and the general contractor did not agree on the date of completion, we are separating the deficit (\$36,221) for the period March 31, 1996 through July 31 of 1996 from the total \$322,432 that we originally disallowed. As a result, we are disallowing \$286,211 and questioning \$36,221.

¹ The Project received a total of \$614,859 in fire insurance reimbursement. Of this amount, \$32,018 was for rental losses and \$582,841 was for construction costs. The Project's owner was required to use the \$32,018 insurance reimbursement first before using any of the HELP money.

The owner planned to ignore the provisions of the Use Agreement

As early as June 1995, the owner threatened to change the project's low income characteristic and convert the project's current rents into market rates. The owner expressed his intention not to return the tenants to the project despite the fact that he had already signed the HELP funds Use Agreement, agreeing to continue the low income characteristic of the project for 15 additional years.

The Use Agreement was HUD's assurance that the low income characteristic of HUD-assisted projects would be continued. Hence, HUD required each HELP loan recipient to sign a Use Agreement and, in exchange, agreed to provide financial assistance to their projects for the repair of damages or the recovery of losses directly related to the earthquake. With the Use Agreement in effect, the owner would have no basis to refuse the return of the tenants to their units or to change the project's low income characteristic, regardless of any dispute with HUD.

The owner's decision to keep the repaired units vacant and continue to incur rental losses was due to his dispute with HUD Los Angeles Area Office (LAAO) officials over the loss of Section 8 rental subsidy benefits available under Section 241, Title II Preservation and Prepayment Program. The owner contended that without the Section 8 benefits attached to Section 241 Program, the preservation loan was no longer lucrative.

In an August 23, 1995 meeting with HUD's LAAO Director of Housing, the owner informed HUD that he would not agree to bring the tenants back without the Section 8 benefit attached to the Section 241 Program funding arrangement. The owner also stated that without the Section 8 funding, he would not maintain the project as subsidized affordable housing.

On August 29, 1996, HUD sent several letters declaring that, among others, the owner was in serious violation of the Regulatory Agreement, the HELP contract, MIO Plan, and HUD Notice H 94-15, for intentionally not renting available units to earthquake displaced and eligible prospective tenants. In those letters, HUD instructed the owner to immediately correct the violations, otherwise

HUD would take necessary legal action to protect the interests of the Department, tenants, and community.

In a September 20, 1996 letter, the owner informed HUD that he was returning the tenants to their units.

Auditee Comments

The owner disagreed with our determination that the project was ready for re-occupancy in April 1996. He said that the work was not completed in a condition that would permit safe occupancy until after July 1996. He added that in fact the general contractor, who is always motivated to file his certificate of completion at the earliest possible date, did not sign the Notice until July 26, 1996 and it was recorded on July 31, 1996.

The owner stated that our computation of potential rental income assumed an immediate 100 percent rent-up, which was unrealistic. He added, that after 2-1/2 years of alternative housing many of the tenants had made other arrangements, either permanently or at least until their current lease would expire. At the time when he directed that rent-up be aggressively pursued 76 units had already been occupied. Four months after rent-up began, only 100 (59%) units of the 169 units were occupied.

The owner asserted that OIG inaccurately stated that the owner ignored the provisions of the Use Agreement. The only new restriction imposed by the Use Agreement was the additional fifteen (15) year restriction, and even that restriction may have been of doubtful validity because the owner never received any benefits under the Preservation Act. If the owner violated any agreement, which he did not concede, it was not the Use Agreement.

The owner contended that OIG inaccurately stated that in June 1995 the owner threatened to change the project's low income character and convert the project's current rents into market rents. The owner further said that the project was not completed until the end of July, and even if those alleged statements were made, the project was not available for occupancy in June 1995.

**OIG Evaluation of
Auditee Comments**

We revised the draft finding to reflect the owner's comments that the work was not completed in a condition permitting safe occupancy until after July 1996. Since the owner and the general contractor did not agree on the date of completion, a disputed period arose which covered March 31 through July 31, 1996. We decided to isolate the portion of the deficit that related to that four month period for HUD's evaluation. Since the actual financial deficit for those four months amounted to \$36,221, we are questioning that amount instead of disallowing it.

The general contractor had told us that his work was substantially completed by March of 1996, and showed us his letter to the project's management dated March 8, 1996, which stated that "All work, per contract & change orders, has been completed at the Granada Gardens project and all subcontractors have been paid for their work in connection with this project (except retentions due Randall Plumbing and Coyle Electrical). I therefore request that a Notice of Completion be filed with the proper authorities within five (5) working days from receipt of this letter and that final payment be remitted, per contract, to my company. If no Notice of Completion is filed by the Owner within that time period my company will then proceed upon filing the Notice."

The general contractor said that it was the owner's responsibility to file the Notice of Completion but the owner did not, so he finally filed it on the owner's behalf. He also said that the owner's management would not accept that the job was done, delayed the process, and did not pay him his retention.

We agree that assuming an immediate 100 percent rent-up may not be realistic; therefore, we have made a revised estimate of potential rental income using the actual occupancy on July 31, 1996 and adding those actually on the waiting list at that date. This showed 137 (80%) of the 169 units were either occupied or had prospective tenants waiting for them. By applying this 80% factor to the potential monthly rent of \$81,500 we estimate that the project could have received at least \$62,200 in monthly rental income after July 31, 1996. That was the date that even the owner admitted the project was ready for

occupancy. The \$62,200 would have provided \$32,850 more than the \$32,350 in rental income that had actually been received for the month of August 1996. That extra \$32,850 would have been more than enough to cover the deficit of \$19,871 for that month.

We are not stating that the owner actually violated the Use Agreement. The owner, however, had threatened to change the project's low income characteristic and convert the project's current rents into market rates. That change would have violated the Use Agreement had it been carried out.

In June and August 1995, the owner had clearly expressed to HUD his intention to change the project's low income character and convert the project's current rents into market rents without the Preservation funding arrangement. In June 1995 the owner, in a meeting with HUD, had stated that he could see no reason to reoccupy damaged units until HUD could assure him it would keep its commitment to provide agreed incentives in exchange for keeping Granada Gardens as affordable housing.

Recommendations

We recommend that you:

- 1A. Require the project's owner to prepay \$286,211 of the HELP loan; and
- 1B. Determine if the deficit of \$36,221 for the period March 31 through July 31, 1996 is allowable. If you find this amount is not allowable, you should require the owner to prepay an additional \$36,221 of the HELP loan.

Property Tax Refund Of \$11,037 Should Be Used To Prepay A Portion Of HELP Loan

The project's owner did not prepay a portion of the HELP loan with the \$11,037 received as a property tax refund. This occurred because the project's owner was unaware of HELP loan requirements. As a result, HUD unnecessarily provided the owner with \$11,037 more in HELP funds than the program had intended.

Tax refunds should be used to prepay HELP loan

HUD Notice H 94-15, Implementation of the Special Allocation for Flexible Subsidy - HUD Earthquake Loan Program (HELP), dated March 17, 1994, states that all funds received from insurance carriers, tax refunds related to earthquake damage, or funds received from other agencies for earthquake related damage, must be placed into the project account and used for approved costs/repairs or to prepay the HELP Loan.

The project realized \$11,037 as a tax refund

To reduce the project's property tax liability, the owner initially applied for a reassessment of the project's property value. In the application, the owner cited \$5 million in earthquake related damages to the project. The County of Los Angeles, however, did not respond to the owner's initial request. As a result, the owner obtained the services of an attorney who reapplied on his behalf. For fiscal years 1993 and 1994, the attorney supported a total decline of over \$1.7 million in the project's value. Accordingly, the County of Los Angeles returned a tax refund of \$13,235 for those two fiscal years. The project's management agent used \$2,198 of the \$13,235 refund to pay for the legal services in connection with obtaining the refund; therefore, the net refund amounted to \$11,037.

Since the remaining HELP account balance sufficiently covers the project's total remaining and approved costs, the owner should use the \$11,037 tax refund to prepay the HELP loan, as required by HUD Notice H 94-15.

The owner did not prepay the HELP loan with the tax refund because he was unaware of HUD's requirements. At the exit conference he agreed with this finding.

Recommendation

We recommend that you require the project's owner to prepay \$11,037 of the HELP loan because of the tax refund.

Internal Control

In planning and performing our audit, we considered the Management Agent's internal control systems in order to determine our auditing procedures and not to provide assurance on internal control. Internal control is the process effected by an entity's board of directors, management, and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

In each of these three categories of objectives, organizations will establish their own specific control objectives and control procedures aimed at achieving these broad objectives. If organizations are to meet these control objectives, five components of internal control - control environment, risk assessment, control activities, information and communication, and monitoring - must be present. That is, the control objectives in each category are inextricably linked with the five supporting components.

We evaluated pertinent internal control systems

We determined the following internal control categories were relevant to our audit objectives:

- Receipt and disbursements of HELP and other earthquake related funds.

We evaluated all of the relevant control categories identified above by determining the risk exposure and assessing control design and implementation.

Significant control weaknesses were noted

A significant weakness exists if internal control does not give reasonable assurance that control objectives are met. Based on our review, we believe the following were significant weaknesses:

- The owner disregarded HELP loan requirements (Finding 1).
- The owner was unaware of HELP loan requirements pertaining to the use of tax refunds (Finding 2).

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Auditee Comments

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Calculation of Project Related Financial Deficit For The Period January 17, 1994 Through March 31, 1996

Description	Month Ending February 1994	Month Ending March 1994	Year Ending March 31, 1995	Year Ending March 31, 1996	Total
Net Loss	(\$38,115)	(\$30,264)	(\$471,475)	(\$257,816)	(\$797,670)
Adjustments:					
Depreciation Expense	0	0	94,742	123,508	218,250
Acc. Int. on Flex Note	0	0	24,334	53,988	78,322
Earthquake Repairs	0	0	100,328	0	100,328
Mtg. Prin. Payments	(5,090)	(5,090)	(71,768)	(72,356)	(154,304)
Sponsor's Dividend	(1,824)	(1,824)	(21,892)	(21,892)	(47,432)
Total Adjustments	(6,914)	(6,914)	125,744	83,248	195,164
Operating Cash Deficit	(\$45,029)	(\$37,178)	(\$345,731)	(\$174,568)	(\$602,506)

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Schedule of Ineligible and Unsupported Costs

	<u>Ineligible Amount (1)</u>	<u>Unsupported Amount (2)</u>
<u>Finding No. 1</u>		
Misuse of HELP Funds	\$286,211	\$36,221
<u>Finding No. 2</u>		
Property Tax Refund	<u>11,037</u>	_____
Totals	<u>\$297,248</u>	<u>\$36,221</u>

- (1) Ineligible amounts obviously violate law, contract, HUD or local agency policies or regulations.
- (2) Unsupported amounts do not obviously violate law, contract, policy or regulation but warrant being contested for various reasons such as the lack of satisfactory documentation to support eligibility and HUD approval.

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Distribution

Secretary's Representative, Pacific Hawaii, 9S
Area Coordinator, Los Angeles Office, 9DS (2)
Director, Housing Division, 9DH
Director, Administrative Service Center #3
Office of Comptroller, Texas State Office, 6AF, Attn: K.J. Brockington
Director, Accounting Division, 9AFF
Assistant to the Deputy Secretary for Field Management, SC (Room 7106)
Director, Participation and Compliance Division, HSLP (room 9164)
Director, Housing Finance Analysis Division, REF (Room 8204)
Chief Financial Officer, F (Room 10164) (2)
Acquisitions Librarian, Library, AS (Room 8141)
Deputy Chief Financial Officer for Finance, FF (Room 10164) (2)
Audit Liaison Officer, Kathryn Rock, HFC (Room 5132) (3)
Alfred E. Mann, General Partner, Granada Gardens Ltd. 12744 San Fernando Road, Sylmar,
CA 91342-9219
Southwest Development Co., Management Agent 260 Maple Court Suite 205,
Ventura, CA 93003
Director, Housing and Community Development Issue Area, US GAO, 441 G Street, NW,
Room 2174, Washington DC Attn: Judy England-Joseph

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