audit report
OFFICE OF INSPECTOR GENERAL

Issue Date
November 25, 1997
Audit Case Number
98-PH-212-1002

TO: Charlie Famuliner, Director, Multifamily Division, Virginia State Office, 3FHM

FROM: Edward F. Momorella, District Inspector General for Audit, Mid-Atlantic, 3AGA

SUBJECT: Caru and Caru East Apartments
Multifamily Mortgagor Operations
Roanoke, Virginia

As you requested we audited the operations of Caru and Caru East Apartments (projects), to determine whether the owners and identity-of-interest management agent (agent) operated the projects according to the Regulatory Agreement and HUD requirements.

The report identifies that the owners and agent incurred ineligible and unsupported expenses. Additionally, the owners received improper cash distributions.

Within 60 days, please give us, for each recommendation made in the report, a status report on: (1) the corrective action taken; (2) the proposed corrective action 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.

A copy of the report has been provided to the owners.

If you have any questions, please contact Irving I. Guss, Assistant District Inspector General for Audit, at (215) 656-3401.

Executive Summary

We audited the operations of the projects to determine whether the owners operated the projects according to the Regulatory Agreement, and HUD requirements.

The owners financial management of the projects requires improvement to ensure operational effectiveness and proper physical maintenance of the properties.

Projects funds improperly expended

Ineligible and unsupported costs, totaling $455,880, were paid with project funds contrary to the Regulatory Agreement and HUD requirements. The owners/agent disregarded HUD requirements, thereby receiving the benefit of funds disbursed directly or through identity of interest companies. As a result, funds necessary to meet operating and maintenance costs of the projects were lost.

Improper distribution paid the owners

In 1994 & 1995, the owners made improper semi-annual cash distributions, totaling $85,824. These distributions were made despite physical inspections from 1993 to 1996 indicating serious maintenance problems at both projects. The owners actions represented a disregard for HUD requirements. As a result, funds needed to correct the maintenance problems were unavailable.

We recommend the owners reimburse the projects the ineligible $455,052, and document the eligibility of the unsupported $86,652 or reimburse the projects the costs not supported.

We discussed the draft findings with the owners during the audit and at an exit conference held on November 13, 1997. The draft findings were provided to the owners and the responses received were considered in our report. Adjustments were made to costs questioned, and resolved issues were removed from the report. The owners response is included as Appendix B.

The draft findings were provided to your office and a response was received. Draft finding 1 was provided to Headquarters, Director Office of Asset Management and Disposition, however no response was received.

Table of Contents

Abbreviations

CPA	Certified Public Accountant
HUD	Department of Housing and Urban Development
OIG	Office of Inspector General
VHDA	Virginia Housing Development Authority

Introduction

Caru and Caru East Apartments are HUD-insured multifamily projects consisting of 116 and 128 Section 8 units, respectively, located in Roanoke, Virginia. The mortgages were endorsed for insurance under Section 221(d)(3) of the National Housing Act in 1970 (Caru) and 1973 (Caru East).

Caru Realty Company, a general partnership, was organized on October 1, 1970 and Caru East Apartments, a limited partnership, was organized on October 30, 1973 to acquire, build and operate Caru and Caru East Apartments. The General Partners of Caru Realty Company and Caru East Apartments are James E. Carr and Thomas D. Rutherfoord. The projects are managed by Melrose Development, an identity-of-interest management agent.

Financial and tenant records are maintained at the projects office located at 3530 Dona Drive, N.W., Roanoke, Virginia.

Audit Objectives

The primary objective of the audit was to determine whether the owners managed the projects in accordance with HUD regulations and requirements. Specific objectives were to determine if the owners are: (1) safeguarding project assets, maintaining reliable accounting data and efficiencies in operations, and promoting adherence to management's policies primarily relating to receipts and expenditures, (2) administering the Section 8 Housing Assistance Payments Program properly, and (3) complying with the Regulatory Agreements.

Audit Scope

We reviewed HUD, agent and project files and interviewed pertinent HUD and project staff.

Audit Period

Our audit was performed between February 1997 and September 1997, and covered the activities from January 1995 through December 1996. The audit period was expanded when appropriate.

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

Ineligible And Unsupported Costs Paid With Project Funds

Ineligible and unsupported costs, totaling $455,880 were paid with project funds contrary to the Regulatory Agreement and HUD requirements. The owners/agent disregarded HUD requirements, thereby receiving the benefit of funds disbursed directly or through identity of interest companies. As a result, funds necessary to meet operating and maintenance costs of the projects were lost.

A. Ineligible Costs

The owners/agent used $369,228 of project funds to pay expenses unnecessary to project operations. They included: (1) Management fees to an identity-of-interest agent, (2) excessive lease payments to the owners for two trucks, (3) owner-related expenses, and (4) delivery services to the owners/agent.

1. Management Fees

The Management Agent's certification requires the agent to manage the projects by performing many services including the following:

- Select and admit tenants and perform subsidy contract administration.
- Obtain contracts, materials, supplies and services.
- Establish and maintain the projects' books and records.

No services performed by agent to justify fee

From 1994-1996 the identity-of-interest agent was paid $330,974 in management fees. However, contrary to the management certification, the agent did not perform any management oversight or services that justifies the fee. Instead, day-to-day management of the projects operations were handled by the on-site staff paid with project funds. The only duties performed by the owners/agent were signing checks and consulting with on-site staff. These duties are those associated with ownership. The owners stated that prior to 1975, they used a management company to manage the project. However, due to high crime and to protect the projects against negligence they decided to create an identity-of-interest agent and manage the projects themselves.

2. Leased Truck

Paragraph 9b of the Regulatory Agreement 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 the materials furnished.

HUD Handbook 4370.2 REV-1, Chapter 2, paragraph 2-6B states that all disbursements must be supported with approved invoices and other supporting documentation.

Contrary to the Regulatory Agreement, the owners, through an identity-of-interest company, Caru Realty, charged the projects excessive lease payments for two trucks, one leased in 1992 and the other in 1996. The excessive payments totaled $18,503.

Projects paid excessive truck lease costs

From 1992 to 1996, the owners leased a 1992 truck to the project for $600 per month. However, the retail installment sales contract between Caru Realty and the General Motor Assistance Corporation indicated that the total sale price when all the payments were made would be $11,843. From 1992 to 1996 the projects paid $25,263 in lease payments for the truck. The lease agreement benefitted Caru Realty at the expense of the projects. As the numbers show the purchase of the truck by the projects would have been significantly cheaper than leasing through Caru Realty. As a result, we classified the difference between actual lease payments paid to Caru Realty and the total sales price identified on the sales contract as an ineligible expense. Lease payments in excess of the actual sale price totaled $13,420.

In June 1996, the 1992 truck was disposed of and a new 1996 truck was purchased and leased to the project for $600 per month. However, according to the projects accountant, a new lease agreement does not exist. The retail installment sales contract between Caru Realty and the General Motors Assistance Corporation indicated that the monthly payments would be $209 for sixty months. We consider the $391 difference between the monthly payment identified on the sales contract and the lease payments paid to Caru Realty by the projects over a thirteen month period from July 1, 1996 to July 1, 1997 as an ineligible expense. Lease payments in excess of monthly payments identified on the sales contract totaled $5,083. No benefit accrues to the projects under this agreement other than to enrich Caru Realty.

A cost analysis to comply with the Regulatory Agreement justifying a lease payment in excess of the amount identified in the sales contract was unavailable. The owners stated the lease payments were justified because there were two projects and having one truck was less expensive. The analysis presented clearly shows the projects have and continue to pay inflated lease costs through Caru Realty.

3. Owner-Related Expenses

HUD Handbook 4370.2 REV-1 states that Corporate or Mortgagor Expenses recorded in the 7000 account series are distinguished from expenses necessary and reasonable to the operation of the project. Additionally, owners and agents may charge expenses included in the 7000 series against project operations with prior written approval from HUD. The owners/agent did not comply with the requirements as follows:

a. Virginia Commonwealth Low-Income Tax Credit Certification Program

Cost of tax credit improperly paid by the projects

From 1994-1996 the Virginia Housing Development Authority was paid $10,980 for the receipt of a Low-Income Tax Credit. According to the program requirements, the owner receives the low-income tax credit if he follows the requirements set forth in the owner's annual certification. The fee for the program is $15 per unit. The cost incurred for the low-income tax credit clearly benefitted the owners and not the project, and is ineligible.

b. Financial Services

Owners CPA costs improperly paid by the projects

In 1994 and 1995 the owners/agent paid a CPA firm, $3,570, for services described in the invoices as a review of annual Virginia Housing Development Authority project information reports for tax credit certification, telephone consultations, assisting the new bookkeeper with utility reimbursements, preparing payroll reconciliations, reconciling a cash discrepancy between the client's general ledger and the bank statements, postage, and meeting with the successor auditor. These services are not associated with either the financial statement audits or tax preparation and represent owner costs, therefore ineligible.

In October 1996 another CPA firm was paid $3,400 for owner related costs. These costs were originally classified as unsupported. However, based on the owners response they are ineligible.

4. Delivery Services

Owners/agent charged their delivery costs to the projects

HUD Handbook 4381.5 REV-2, Chapter 6 Paragraph 41 a & b states: "Asset Management functions are those activities associated with managing and protecting the assets of the ownership entity and overseeing the management agent's performance". Asset management costs cannot be billed to the project's operating account. In accordance with the requirements set forth in the Regulatory agreement and HUD Handbook 4370.2, REV-1, these costs can only be paid with funds available for distribution to the owners.

The owners/agent incorrectly charged the project $1,801 for delivery services provided by an overnight carrier. The recipient portion of the invoice identified charges for packages delivered from the project to the owners/agent and vice versa. These payments are owners/agent related expenses and ineligible.

B. Unsupported Costs

Project funds totaling $86,652 were used to pay expenses that were unsupported by the owners/agent. The unsupported costs listed below represent adjusted amounts based on the owners response.

Paragraph 6b of the Regulatory Agreement states the owner cannot assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds, other than those from surplus cash, except for reasonable operating expenses and necessary repairs.

HUD Handbook 4370.2 REV-1, Chapter 2, paragraph 2-6B states that all disbursements must be supported with approved invoices and other supporting documentation.

Absence of financial and accounting oversight over operations

The owners/agent's disregard for HUD policies covering proper financial and accounting operations resulted in the disbursement of projects funds for expenses without proper supporting documentation as follows:

- From 1994-1996, $84,894 was paid to a maintenance contractor. Invoices to support $75,617 could not be located in the files, $9,277 was resolved based on the owners response.

- In 1996 $9,800 was paid to a CPA firm. Invoices to support $6,400 of $9,800 could not be located in files. Based on the owners response the $3,400 was reclassified as ineligible.

- Disbursements totaling $6,533 to miscellaneous vendors were unsupported, because they either lacked an invoice or the invoice provided was not sufficient to support the expense. Based on the owners response $4,472 was resolved and $2,061 remains unsupported.

- In 1994, $2,368 was paid to an overnight carrier. Invoices provided by management showed only the amount due the overnight carrier and did not provide any details describing the charges.

- Payments made to the Assistant Resident Manager, totaling $206, for mileage to Greensboro, North

Carolina and Herndon, Virginia for seminars. Supporting documentation describing the seminars attended and its application to project operations was not provided.

The resident manager agreed to research the unsupported costs and provide documentation to support them. However, documentation for the items cited was not provided.

****

In summary the owners/agent improperly used project funds to benefit identity-of-interest firms to the detriment of the projects. This condition is illustrated by the long standing neglect of necessary maintenance and repairs for both projects. In Finding 2 we point out that physical inspections of the projects conducted by HUD and the mortgagees in four years (1993-1996) identified serious uncorrected maintenance problems. The unsupported costs depicts the absence of oversight of the projects financial operations by the identity-of-interest agent. This condition supports OIG's position that agent services were not performed.

Auditee Comments

A. <u>Ineligible Costs</u>

The owners non-concurred with the finding.

1. <u>Management Fees</u>

The owners stated that as principal officers of Melrose Development company (agent), the owners were directly responsible for supervision, oversight and policy making for the projects, including financial management and projecting repair maintenance costs. They provided a letter from the on-site manager identifying the agent (owners) as the responsible party for directing the operation of the projects. The owners pointed out that the fees were reasonable and reported to HUD each year. The owners commented that the OIG's finding is "punishing the agent for a job well done." They stated that the projects were successful and the agent has met HUD housing quality standards, providing safe and sanitary conditions for the tenants.

2. Leased Truck

   The owners stated, on September 1, 1997 they will purchase the truck in their name to eliminate any unnecessary cost.

3. Owner-Related Expenses

   a. Virginia Commonwealth Low-Income Tax Credit Certification Program

   b. Financial Services

A letter from the owners CPA firm was provided as a basis to justify the expenses, for the above items.

In their letter, the CPA's, stated that the tax credits were part of the partnership tax return, and should be allowable. Further, the funds paid to the VHDA for the tax credits are also allowable. The CPA firm cited payments received in October 1996 were for their review of the HUD management review and physical inspections of Caru and Caru East Apartments, and assistance in the preparation of the Management Improvement and Operating Plan. The CPA firm stated HUD requires the auditors to review the reports and see that the findings are resolved.

4. Delivery Services

   The owners state that the delivery costs were incurred with respect to their on-going day to day management of the projects financial operations. The day to day management of the projects consisted of the following: (1) reviewing project costs; (2) maintenance schedules; (3) approving and reviewing expenditures and executing the checks in satisfaction of these expenditures.

B. Unsupported Costs

   The owners provided copies of documents to justify the unsupported costs.

OIG Evaluation of Auditee Comments

A. Ineligible Costs

1. Management Fees

We agree the owners, are responsible for directing the operation of the projects. However, the management certification requires the agent to manage the project by performing many services, some of these services were mentioned in the finding as follows:

a. Select and admit tenants and perform subsidy contract administration.

b. Obtain contracts, materials, supplies and services.

c. Establish and maintain the projects' books and records.

All these services are performed by the employees of the project. Additionally, the agent must allocate management costs between the management fee and the operating account. There is no clear cut evidence of agent activities vis-a-vis ownership responsibility.

The owners state that they can use project employees to administer the day to day operations of the project using project funds and still collect a management fee through an identity interest agent. However, this is in non-compliance with the management certification. Contrary to the owners comments, inspections conducted by the mortgagee and HUD have rated the project "below satisfactory" on numerous occasions between 1993 and 1996.

2. Leased Truck

We acknowledge the owners concurrence with recommendation 1B, and documentation supporting the purchase will be required. However, the owners made no mention of the $18,503 in excessive payments, these funds must be repaid to the project.

3. Owner-Related Expenses

a. Tax Credits

The preparation of partnership tax returns are allowable expenses from operations but has nothing to do with using operating funds for tax credits. Tax credits are owner-related expenses, benefiting the owner not the project.

b. Financial Services

The CPA's letter did not address the finding issues. Our finding referred to payments totaling $3,570 made in 1994 and 1995 to another CPA firm. The auditee did not mention these payments.

The October 1996 payments, referred to in the CPA's letter, were classified by the OIG as unsupported, because the invoices did not adequately describe the exact nature of the services rendered. The CPA's letter and documents provided by the owners described the services performed as those associated with preparing the Management Improvement and Operating Plan. According to HUD Handbook 4370.2 REV-1, Chapter 3, paragraph 3-3D, the CPA and the mortgagor cannot have any other business relationship except for the performance of audit, systems work and tax preparation. The preparation of the Management Improvement and Operating Plan does not fall into any of the three categories noted above. As a result, the $3,400 paid to the CPA firm for these services, previously classified as unsupported, are ineligible.

4. Delivery Services

The owners justify using operating funds to pay for delivery costs., because the delivery costs were incurred for their on-going management of the projects financial operations. However, the day to day management of the projects financial operations is an activity associated with protecting the assets of the partnership. HUD Handbook 4381.5, REV-2 does not allow these costs to be billed to the operating account. As a result, the delivery costs incurred for the day to day management of the projects financial operations must be paid from the management fee or surplus cash not from operations.

B. Unsupported Costs

Documents provided by the owners supported $13,749. Costs of $3,400 paid to a CPA were classified as ineligible, see explanation under A3b above. As a result, $86,652 remains unsupported.

Recommendations

We recommend the owners/agent:

1A. Reimburse the projects the ineligible $369,228. The funds should be used to begin correcting the maintenance and repairs necessary for both projects.

1B. Terminate the arrangement covering excessive truck payments with Caru Realty. Either lease or purchase the truck in the project's name, to eliminate unnecessary surcharges by identity-of-interest firms.

1C. Provide documentation for the unsupported costs or reimburse the projects $86,652.

Improper Cash Distributions Paid To The Owners

In 1994 & 1995, the owners made improper semi-annual cash distributions, totaling $85,824. These distributions were made despite physical inspections from 1993 to 1996 indicating serious maintenance problems at both projects. The owners actions represented a disregard for HUD requirements. As a result, funds needed to correct the maintenance problems were unavailable.

Paragraph 13G of the Regulatory Agreement defines surplus cash as any cash remaining after the current mortgage payments are made; all required deposits are made to the reserve fund for replacements; and the payment of project expenses. Paragraph 6B(4) requires the owners to comply with all outstanding notices of requirements for proper maintenance of the project before making any surplus cash distributions.

Owners received distributions when projects required repairs

Contrary to the Regulatory Agreement, the owners made semi-annual cash distributions in 1994 & 1995, totaling $85,824, $25,148 from Caru and $60,676 from Caru East despite physical inspection reports prepared by HUD and the mortgagees, from 1993 to 1996, noting serious maintenance problems at both projects. Specifically, a 1993 physical inspection conducted by HUD, identified items requiring maintenance with an estimated cost of $579,340 for Caru and $717,840 at Caru East. Items requiring replacement, repairs or maintenance included:

Projects exterior: Wall and foundations, roofs, parking lots, paving, walks, steps, guardrails, doors, windows, screens, lawns and exterior painting.

Projects interior: Floors, carpets, cabinets, doors, closets, interior painting, curtains and shades, refrigerators and ranges, electrical fixtures, plumbing fixtures and systems, heating and air conditioning, hot water system, boiler room.

These same items were also noted on the mortgagees' inspection reports in 1994 and 1995. Further, a 1996 physical inspection, conducted by MTB Investments, for HUD, also reported the same items requiring corrective action. Documents stating that maintenance problems were corrected to HUD's satisfaction were unavailable. Accordingly, the $85,824 the owners took as distribution of surplus cash while the projects were in disrepair is ineligible.

Auditee Comments

No written response was provided by the owners. During the exit conference the owners expressed their nonconcurrence with the finding.

Recommendation

2A. We recommend the owners reimburse the projects $85,824 ($25,148, Caru and $60,676, Caru East).

Internal Controls

In planning and performing our audit, we considered the internal control systems of the management of Caru and Caru East Apartments in order to determine our auditing procedures and not to provide assurance on internal control. Internal control is the process by which an entity obtains reasonable assurance as to achievement of specified objectives. Internal control consists of interrelated components, including integrity, ethical values, competence, and the control environment which includes establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

Internal controls assessed

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

- Accounting records and reports
- Cash receipts and disbursements
- Section 8 Housing Assistance Payments
- Procurement

Significant weaknesses found

A significant weakness exists if internal control does not give reasonable assurance that the entity's goals and objectives are met; that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports. Based on our review, we believe the following items are significant weaknesses:

- Cash Disbursements

These weaknesses are detailed in the findings in this report.

Follow Up On Prior Audits

This is the first OIG audit of Caru and Caru East Apartments.

Schedule Of Ineligible And Unsupported Costs

Finding Number	Ineligible 1/	Unsupported 2/
1	$369,228	$86,652
2	85,824	
Total	$455,052	$86,652

1/ Ineligible amounts are clearly not allowed by law, contract, or HUD policies or regulations.

2/ Unsupported amounts are not clearly eligible or ineligible, but warrant being contested for various reasons, such as the lack of satisfactory documentation to support eligibility.

Auditee Comments

Distribution

Secretary's Representative, Mid-Atlantic, 3AS
Internal Control & Audit Resolution Staff, 3AFI
Director, Multifamily Division, Virginia State Office, 3FHM
Virginia State Coordinator
Assistant to the Deputy Secretary for Field Management, SDF (Room 7106)
Comptroller, Housing, HF (Room 5132)
Acquisitions Librarian, Library, AS (Room 8141)
Director, Participation and Compliance Division, HSLP (Room 9164)
Director, Housing Finance Analysis Division, REF (Room 8204)
Chief Financial Officer, F (Room 10164)
Deputy Chief Financial Officer for Finance, FF (Room 10164)
Deputy Secretary, SD (Room 10100)
Assistant Secretary for Housing, H (Room 9100)
Assistant Secretary for Congressional and Intergovernmental Relations, J (Room 10120)
Deputy Assistant Secretary for Public Affairs, W (Room 10220)
Chief of Staff, S (Room 10000)
Counselor to the Secretary, S (Room 10234)
Senior Advisor to the Secretary for Communications Policy, S (Room 10222)
Director, Housing and Community Development Issue Area, U.S. GAO, 441 G Street, NW, Room 2474, Washington, DC 20548
Ranking Member, Committee on Governmental Affairs, US Senate, Washington, DC 20515-4305
Chairman, Committee on Governmental Affairs, US Senate, Washington, DC 20515-4305
Government Reform and Oversight Committee, Congress of the US, House of Representatives, Washington, DC 20510-6250
General Partners, Caru & Caru East Apartments, 3530 Dona Drive, NW, Roanoke, VA 24017
Chairman, Committee on Government Reform & Oversight, House of Representatives, Washington, DC 20515-6143
Subcommittee on General Oversight & Investigations, Room 212, O'Neill House Office Building, Washington, DC 20515