



U.S. Department of Housing and Urban Development

District Office of the Inspector General  
Office of Audit  
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October 22, 1997

Audit Related Memorandum  
No. 98-AT-211-1801

MEMORANDUM FOR: Martha A. Littlefield, Director, Office of Housing,  
Jacksonville, Florida, 4HH

FROM: Nancy H. Cooper  
District Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: Multifamily Project Operations  
Bethel Community Heights Apartments  
FHA Case No. 067-35042  
St. Petersburg, Florida

In conjunction with Operation Safe Home and a recommendation from the Jacksonville Area Office (JAO), we conducted a limited review of Bethel Community Heights Apartments (BCH) project operations. The review was designed primarily to identify diversion of project funds or serious program abuse.

The project is an 84 unit multifamily complex located at 731 15th Street South, St. Petersburg, Florida. Bethel Community Heights, Inc. a State of Florida not-for-profit corporation, owns BCH. Searchwell Thorne & Associates is the management agent (MA) for the project. BCH's mortgage is insured by the Department of Housing and Urban Development (HUD) under Section 221 (d) (3) of the National Housing Act. The project receives Section 8 rental assistance for all units under the terms of an Annual Contributions Contract and was at 92 percent occupancy at the time of our review. BCH also received a flexible subsidy loan from HUD in 1992 for \$410,654. The flexible subsidy contract was amended in 1994 and increased to \$1,351,339 to correct the physical and financial deficiencies of the project.

We interviewed the project's owner, MA employees and HUD staff about the operations of the project. We also reviewed selected BCH's records and activities from September 1, 1994, through April 30, 1996. We performed our on-site review between May 1996 and September 1996. During the review, we identified deficiencies in the flexible subsidy program and routine project management that warrant your office's and the owner's attention.

## SUMMARY

The MA paid himself construction oversight fees of \$120,454 to which he was not entitled. Of the 120,454 paid, \$94,358 was paid from flexible subsidy program funds and \$26,096 from operations. The fees were not included in the Management Improvement and Operating (MIO) Plan. On two occasions, HUD specifically disapproved his request to pay the fees from operations.

We also identified aspects of routine project management that needed corrective actions. For example, the MA used project facilities and equipment to operate his business, which encompassed more than just BCH. This violated the Regulatory Agreement because he failed to obtain HUD's approval. We also noted that the MA overpaid himself \$3,462, used tenant security deposits to fund operating deficits, and obtained inadequate fidelity bond coverage. The owner needs to take action to prevent further violations of the Regulatory Agreement.

We inspected the exterior and two vacant units of the project in May 1996. Rehabilitation work, to date, appeared to have been completed in a workmanlike manner.

Details of our conclusions are contained in Attachment 1. We provided a copy of the report to the owner, the MA and JAO on April 11, 1997. We discussed our report with the owner and the MA during our review and at an August 20, 1997 exit conference. Both the owner and the MA provided written comments. The MA also provided exhibits. The comments and exhibits were considered in preparing this final report. Attachments 4 and 5 contain the comments.

Within 60 days please give us a status for each recommendation 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 review.

If you have any questions, please contact Sonya D. Lucas, Assistant District Inspector General for Audit, at (404) 331-3369.

### ATTACHMENTS:

- 1 - Findings and Recommendations
- 2 - Schedule of Ineligible Costs
- 3 - Schedule of Oversight Fees
- 4 - Owner's Comments to Draft Findings 1 and 2
- 5 - Management Agent's Comments to Draft Findings 1 and 2
- 6 - Distribution

**Finding 1: The Management Agent Collected Fees To Which He Was Not Entitled**

The MA paid himself construction oversight fees of \$120,454 to which he was not entitled. Of the 120,454 paid, \$94,358 was paid from flexible subsidy program funds and \$26,096 from operations. The fees were not included in the MIO Plan. On two occasions, HUD specifically disapproved his request to pay the fees from operations.

In April 1992, the owner entered into a Financial Assistance Contract with HUD to administer a flexible subsidy program. This program provided financial assistance to restore the project's physical and financial soundness at the lowest cost to the federal government. The owner agreed to complete the action items budgeted in the MIO Plan. The plan listed in detail the specific rehabilitation work to be done and the estimated cost.

According to HUD Handbook 4355.1, Flexible Subsidy, Section 6-4 b, oversight fees up to six percent of the MIO Plan hard costs may be allowed if work involves substantial rehabilitation and oversight by a general contractor, architect, or administrator.

The MIO Plan was prepared by the MA and did not include fees for construction oversight. No MIO Plan revisions were submitted or approved by HUD to include construction oversight fees. Twice, HUD disapproved payment of fees from operations. The agent requested approval in November 1994 and August 1995, and JAO disapproved both requests. JAO told us that their reason for denying the fee was that the service received was not acceptable and the request was after the fact. Records showed that between March 1994 and August 1995, the agent received 24 checks totaling \$120,454 (See Attachment 3), indicating the agent's disregard of HUD's denial.

**Auditee Comments**

We incorporated comments within the finding as appropriate. In addition, the MA stated that he believed the fees charged were reasonable, within the guidelines established by HUD, and approved by both the Board of Directors of Bethel Community Heights, Inc. and HUD.

**OIG Evaluation**

Use of operating funds was not intended or anticipated as a consequence of the flexible subsidy rehabilitation. The MIO plan budget did not provide for oversight fees and HUD denied payment of the fees from project operating income.

**Recommendation**

We recommend you instruct Bethel Community Heights, Inc. to:

- 1A. Reimburse the ineligible oversight fee paid to the MA totaling \$120,454.

## **Finding 2: Project Management Needed Corrective Actions**

The project management needed corrective actions. The MA used project facilities and equipment to operate his business, which encompassed more than just BCH. This violated the Regulatory Agreement because he failed to obtain HUD's approval. We also noted the MA overpaid himself \$3,462, used tenant security deposits, which are required to be held in trust, to fund operating deficits, and did not obtain adequate fidelity bond coverage. The owner needs to take action to prevent further violations of the Regulatory Agreement.

### **Management Agent Improperly Used Project Facilities To Operate His Company**

The MA used BCH offices to operate his management company. BCH was only one of the agent's clients. The project manager, employed by the MA, occupied one rental office and worked on-site full time. According to payroll distribution records, she spent only about 40 percent of her time on BCH activities. The remainder of her time was devoted to the management company's other business. The MA occupied another office in which he kept his company files, furniture, and equipment. His business card showed the project's telephone number as his company's number. The MA confirmed that he conducted his company's business from the project, but stated it was because the BCH Board requested him to maintain an on-site presence. The MA did not compensate the project for his use of facilities.

We confirmed that the Board had given its approval. HUD, however, had not. Sections 7(b) and (g) of the Regulatory Agreement provided that the owner shall not without the prior written approval of HUD pay out funds except for reasonable operating expenses or permit commercial use of the project greater than that originally approved by HUD. The MA's use of project resources constituted commercial use of the project. Without HUD's approval, it violated the agreement.

### **Management Agent Was Overpaid \$3,462**

The MA collected fees from operations to which he was not entitled. The MA billed the project \$2,646 for a general ledger review fee in an invoice he submitted on May 4, 1996. The project paid the bill. Handbook 4381.5 REV-2, Management Agent Handbook, allows certain management fees including residential income fee, commercial income fee, miscellaneous income fee, special fees, and add-on fees. All requests must be submitted to HUD for approval on Form HUD-9839. The fee was requested on the management certification dated March 1994, however HUD returned the certification unapproved. The agent could provide no documentation to justify the charge or subsequent approval from HUD. Thus, the fee was ineligible.

We also determined that the MA received his fee prior to collection of rents contrary to the Management Certification and to HUD's specific instructions. This practice resulted in overcharges to the project. By provision 1(a) of the certification, the owners agreed to pay a fee of 7.55 percent of residential income collected. HUD clarified this provision in a March 11, 1994 letter to the owners stating, "management fees are to be paid in arrears as the fee is based on actual collections for a prior given month (emphasis supplied)." The MA still did not comply. Instead, he continued to bill the project in advance of rent collections and calculated his fee assuming 100 percent occupancy and full collection. From September 1, 1995 through April 30, 1996, he had been overpaid \$816.



## **Tenant Security Deposits Were Used To Fund Operating Deficits**

Paragraph 7(f) of the Regulatory Agreement states that tenant security deposits must be maintained in a trust account separate from all project funds. The balance in the account must always equal or exceed the corresponding obligations. Handbook 4370.2 REV-1, paragraph 2-9A, prohibits commingling of security deposits with other funds.

On October 28, 1994, the MA transferred \$5,488 of tenant security deposits to the project's operating account. On the same day, he transferred operating funds to the payroll account to cover payroll costs. He returned the tenant security deposits to the trust account on December 29, 1994, 2 months later. The MA admitted the tenant security deposits were transferred into the operating account. He said it was needed to cover an operating deficit in order to prevent stoppage of work and slowing of rehabilitation.

The MA and owner need to be cautioned about the seriousness of this violation and their liability.

## **Fidelity Bond Coverage Was Not Adequate**

The project's fidelity bond coverage did not name the mortgagee and HUD as additional loss payees and the amount of coverage was less than required. Handbook 4381.5 REV-2, paragraph 2.14b and d., requires the MA to provide fidelity bond coverage that names the mortgagee and HUD as additional loss payees. The minimum insurance must be at least 2 months' gross potential income. The agent agreed to contact the insurance agent and increase the coverage, however he remained unconvinced that the mortgagee and HUD are required to be named.

## **Auditee Comments**

We incorporated comments within the finding as appropriate. The MA claimed the general ledger review fee of \$2,646 was a project related accounting expense since the property's books were maintained by a bookkeeping service. The MA stated that he computed the management fee in the same manner as the prior agent. He claimed he had not been overpaid.

## **OIG Evaluation**

Contrary to his response, our test showed his method of computing the monthly fee did, in fact, result in overpayment.

## **Recommendations**

We recommend you:

- 2A. Determine whether commercial use of the project is beneficial. If so, determine a reasonable commercial rent. If not, assess the MA for his use up until the time he vacates the property.

We also recommend you instruct Bethel Community Heights, Inc. to:

- 2B. Reimburse the project \$3,462 for ineligible fees. Verify that the MA fees were properly calculated from May 1996 to date.
- 2C. Pay approved management fees based on actual collections according to the terms of the Management Certification and HUD requirements.
- 2D. Maintain tenant security deposits as required.
- 2E. Ensure fidelity bond coverage is sufficient and includes the Mortgagee and HUD as loss payees.

## SCHEDULE OF INELIGIBLE COSTS

<u>Recommendation</u>	<u>Ineligible<sup>1</sup></u>
1A	120,454
2B	<u>3,462</u>
Total	<u>\$ 123,916</u>

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<sup>1</sup> Costs not allowable by law, contract, HUD or local agency policies or regulations.



## SCHEDULE OF OVERSIGHT FEES

<u>Date</u>	<u>Check No.</u>	<u>Flex-Sub Fee</u>	<u>Consulting</u>	<u>Work Out</u>
11/18/94	646		\$ 2,016	
11/18/94	660	\$ 12,129 <sup>1</sup>		
11/18/94	661	6,525 <sup>1</sup>		
12/09/94	678			\$ 5,000
12/06/94	692		6,000 <sup>1</sup>	
12/23/94	741		7,450 <sup>1</sup>	
12/22/94	744		6,550 <sup>1</sup>	
01/13/95	712			2,500
01/23/95	714			2,500
02/02/95	722			2,500
02/10/95	845	9,989 <sup>1</sup>		
03/04/95	762			2,500
03/10/95	775			1,000
03/10/95	879			2,500 <sup>1</sup>
03/22/95	912		8,521 <sup>1</sup>	
04/03/95	916			4,400 <sup>1</sup>
04/13/95	957			455 <sup>1</sup>
05/31/95	1041	9,797 <sup>1</sup>		
06/15/95	1051	5,650 <sup>1</sup>		
06/16/95	1064	6,500 <sup>1</sup>		
07/01/95	838			2,500
07/05/95	1108	3,500 <sup>1</sup>		
08/01/95	908	5,580		
08/01/95	1169	4,392 <sup>1</sup>		
Totals		<u>\$ 64,062</u>	<u>\$ 30,537</u>	<u>\$ 25,855</u>

<sup>1</sup> \$94,358 paid from Project Improvement Account

OWNER'S COMMENTS TO DRAFT FINDINGS 1 AND 2







MANAGEMENT AGENT'S COMMENTS TO DRAFT FINDINGS 1 AND 2

















































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The Honorable John Glenn, Ranking Member, Committee on Governmental Affairs,  
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