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Audit Case Number	99-PH-212-1001

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

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

SUBJECT: Charlestowne at Cavalier Mutual Homes, Inc.
Multifamily Mortgagor Operations
Portsmouth, VA

We completed an audit of the operations of Charlestowne at Cavalier Mutual Homes, Inc. Our report contains three findings requiring follow-up action by your office.

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 completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

If you have any questions, please contact Jeffrey Green, Auditor, at (804) 278-4500, Extension 3201.

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Executive Summary

We performed an audit of the mortgagor operations of Charlestowne at Cavalier Mutual Homes, Inc. The objective of this audit was to determine whether the mortgagor and management agents operated the project according to the terms and conditions set forth in the Regulatory Agreement, and other applicable HUD directives.

We determined the mortgagor and management agents did not administer project operations in accordance with applicable regulations and requirements. Inadequate controls and mismanagement in project financial operations and program administration resulted in ineligible and unsupported costs of \$591,952 and \$177,583, respectively.

The Project Did Not Remit Excess Income Due HUD

The project has not remitted monthly excess income according to HUD requirements. Because the project Board disregarded HUD requirements, mortgage interest subsidies provided by HUD were not offset by excess income collections. Consequently, \$586,929 was improperly retained by the project.

The Project Was Not Managed According To HUD Guidelines

Contrary to HUD guidelines, the project Board and Management Agents have not provided adequate management oversight and direction to ensure efficient project operations. This lack of oversight caused the project to incur ineligible and unsupported costs, totaling \$5,023 and \$177,583, respectively. Additionally, the project does not have an adequate accounting system to record the day to day operations of the project. Because the Board was apparently unaware of and/or disregarded HUD requirements, daily transactions were improperly recorded and funds were expended unnecessarily and without proper documentation.

The Project Did Not Comply With HUD Guidelines For Tenant Certifications

Project staff and the management agent have not conducted tenant certifications according to HUD guidelines. The resident manager and management agent's lack of knowledge and disregard for HUD Guidelines may have resulted in income loss to the project and overpayment of Housing Assistance Payments by HUD.

We recommend the owner take appropriate action to reimburse the projects for ineligible costs, justify unsupported costs or repay those costs not supported, and implement specific controls and procedures to correct deficiencies involving project administration.

We discussed the results of our review during the audit, and met with the Board President after completion of audit field work on October 20, 1998, and at an exit conference on January 26, 1999, to brief her on draft findings. Additionally, we provided HUD program staff and the auditee with draft findings for comment. We have included the auditee's written response in its entirety (Appendix B) and where appropriate their comments are summarized in the report.

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Introduction

Charlestowne at Cavalier Mutual Homes, Inc., Sections I and II, are HUD-insured multifamily housing cooperatives consisting of 240 units located in Portsmouth, Virginia. The mortgages were initially endorsed for insurance under Section 236 of the National Housing Act on October 28, 1971 and January 6, 1976, respectively. The mortgagor executed a five-year Housing Assistance Payment (HAP) contract on May 2, 1995 with HUD for 40 units.

The mortgagor, Charlestowne at Cavalier Mutual Homes, Inc., is a Maryland corporation empowered to do business in Virginia. The mortgagor elects a Board of Directors who is responsible for the administration of the Corporation. The current President of the Board is Vanessa Mack.

Prior to May 1997, the projects were self managed. However, mismanagement of the project by the Board resulted in HUD requiring a management agent to be hired. Realty Management Associates, Inc. (RMA) managed the property from May 1997 through February 1998. Century Realty has managed the property from March 1998 to present.

Records were maintained at the project office, 1590 Darren Circle, Portsmouth, VA., and Century Realty, 3300 Western Branch Blvd., Chesapeake, VA.

Audit Objectives

The primary objective of the audit was to determine whether the owner operated the project in accordance with the Regulatory Agreement and applicable HUD directives. Specific objectives were to determine whether the owner and agent(s): (a) established adequate internal controls to safeguard project assets, and assure reliable accounting data and operating efficiencies; (b) properly administered the Section 8 Housing Assistance Payments Program; and (c) properly computed Excess Income according to HUD guidelines and remitted any owed excess income funds to HUD.

Audit Scope and Methodology

To achieve our objectives, we reviewed applicable HUD guidelines, management agent and project files as well as records maintained at HUD's Virginia State Office. We also interviewed pertinent HUD and project staff.

Our audit period generally covered project activities from January 1995 through July 1998. We performed our on-site review from July 1998 to October 1998. The audit period was expanded when appropriate.

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

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The Project Did Not Remit Excess Income Due HUD

The project Board has not remitted monthly excess income according to HUD requirements. Because the project Board disregarded HUD requirements, mortgage interest subsidies provided by HUD were not offset by excess income collections. Consequently, \$586,929 was improperly retained by the project.

Paragraph 4(i) of the Regulatory Agreement states , the owner is required to prepare a monthly report of excess income and remit the difference between the total carrying charge collections and the basic carrying charge per unit for all occupied units. HUD Notice H 98-10, dated 2/28/98 changed the basis for calculating excess income from total monthly rent collections to a per unit calculation. Additionally, HUD Notice H 98-10 provided for the project to retain excess income based on HUD's prior approval and only if all past due excess income is paid in full.

Monthly Excess Income Reports Were Not Submitted

As of September 1998, HUD's Departmental Accounts Receivable Tracking/Collection System indicated the project has not remitted \$125,910 of excess income. However HUD's accounts receivable system only reflects balances for excess income when the project submitted a report without remitting the funds. In addition to not remitting funds when excess income reports were submitted, 97 and 107 monthly excess income reports for Section I and Section II of the project, respectively, were also not submitted. We recalculated excess income due HUD and determined \$586,929 was not remitted between October 1990 and July 1998.

Excess Income Due HUD

<u>YEAR</u>	<u>AMOUNT</u>
OCT - DEC 1990	\$19,346
1991	\$75,068
1992	\$73,670
1993	\$76,376
1994	\$77,656
1995	\$70,981
1996	\$68,571
1997	\$77,695
JAN - JULY 1998	\$53,300
Amount Remitted March 1998 through July 1998	(\$5,734)
TOTAL	<u>\$586,929</u>

The Project has not remitted excess income reports and funds due HUD dating as far back as 1986. During this time period the project has had two independent management agents and were self managed. We believe the primary reason for the project’s failure to make excess income payments was the mismanagement of project operations by the Board. Ultimately, the project owners, or in this case the cooperative Board are responsible for providing the necessary oversight and direction to ensure accurate excess income reports are prepared and funds are remitted to HUD. The current management agent has submitted three excess income reports and made two payments. However, the amounts submitted to HUD were incorrect as the reports did not include Housing Assistance Payments and were not in accordance with the terms and conditions set forth in HUD Notice 98-10.

\$586,929 Excess Income
Was Not Remitted to HUD

Because the project Board has not adequately provided the necessary oversight and direction, \$586,929 of excess income has not been remitted to HUD. Additionally, as detailed in the remaining findings much of the extra money that should have been remitted to HUD was expended for questionable items.

Auditee Comments

The auditee stated excess income was not paid when they were self managed and professionally managed, and they were told by previous management agents they did not have to pay excess income. Further, the auditee stated that HUD management reviews only mentioned that excess income had not been paid. The auditee said it was her understanding that no one knew how much excess income was due, and that the current management agent was working out an agreement with HUD. Finally, the auditee proposed that they remit excess income payments due HUD from March 1998 forward, and HUD forgive the excess income quantified in the finding.

OIG Evaluation of Auditee Comments

We agree with the auditee that excess income has not been remitted for many years, when the project was self managed and professionally managed. However, the Regulatory Agreement clearly states excess income payments are required on a monthly basis and therefore, we do not agree that \$586,929 of excess income due HUD should be forgiven. It should be noted that our calculation of excess income due HUD only dates back to October 1990, and that excess income has not been remitted as far back as 1986. Accordingly, we believe the project should make payment arrangements to remit excess income payments on a monthly basis, subject to the HUD program staffs review and approval.

Recommendations

We recommend you require the project:

- 1A. Repay HUD \$586,929 representing excess income due HUD between October 1990 and July 1998.
- 1B. Prepare Excess Income Reports in accordance with HUD Notice 98-10 for all months since July 1998 and remit any excess income due.

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The Project Was Not Managed According To HUD Guidelines

Contrary to HUD guidelines, the project Board and Management Agents have not provided adequate management oversight and direction to ensure efficient project operations. This lack of oversight caused the project to incur ineligible and unsupported costs, totaling \$5,023 and \$177,583, respectively. Additionally, the project does not have an adequate accounting system to record the day to day operations of the project. Because the Board was apparently unaware of and/or disregarded HUD requirements, daily transactions were improperly recorded and funds were expended unnecessarily and without proper documentation.

Criteria

The Regulatory Agreement paragraph 6 states, no compensation or fee shall be paid by the owner except for necessary services and at such rate as is fair and reasonable in the locality for similar services, except with the prior approval of HUD.

The Management Certification in paragraphs 3a and 4a provides that the agent will (1) comply with the project's Regulatory Agreement, and (2) assure that all project expenses are reasonable in amount and necessary to the operations of the project.

Project funds were expended by the Board and management agents without regard to HUD requirements. As illustrated below ineligible and unsupported project expenditures included: management fees calculated on revenues that HUD guidelines prohibit from inclusion of management fee calculations; duplicate payments; payments for services without assurance they were procured at the lowest prices; and miscellaneous vendor payments without proper supporting documentation.

Ineligible/Unsupported Management Fees

A review of management fee calculations from May 1997 to March 1998 disclosed that the former management agent collected \$2,285 in fees on the following ineligible income:

- Excess Income;
- Supplementary Income; and
- Membership Fees

HUD Handbook 4381.5, REV-2, paragraph 3.3 states, when determining Residential Income, only cooperative carrying charges and Section 8 payments can be included. Contrary to this requirement, the agent included excess income, supplementary income and membership fees in their calculation of the management fees.

From March 1998 through July 1998, the current management agent collected partial fees totaling \$22,318. According to the agent, the management fee had to be taken in partial payments due to a lack of cash in the project's accounts. The agent, however, could not provide any documentation identifying the basis for calculating the management fee.

Duplicate Payments

A duplicate payment, totaling \$2,738, was made to a contractor for rehabilitating a unit. The Resident Manager had no explanation as to why two payments for repairing the same unit had been made.

The Management Certification in paragraphs 4c and d requires that the agent obtain contracts, materials, supplies, and services on terms most advantageous to the project. Paragraph 4e requires the agent to obtain the necessary verbal or written cost estimates and document the reasons for accepting other than the lowest bid.

Materials, Supplies and Service Expense

The Board and Management Agents did not document that the project had obtained the lowest price for the following services and materials obtained between October 1995 and September 1998:

Cleaning	\$ 14,590
Security	\$ 88,200
Grounds Cleaning	\$ 9,003
Unit Inspections/Part-time Office Assistant	\$ 5,046
Miscellaneous Repairs	<u>\$ 38,426</u>
Total	<u>\$155,265</u>

The Board and management agents obtained services from family members, tenants, and others without requiring contracts for these services. Additionally, invoices relating to much of the above services were not sufficient to document the project actually obtained the services. Project disbursements of \$88,200 was paid to a tenant for security

services. Daily security reports provided by the tenant did not evidence that he was actually providing project security services or detail if he was providing for additional security patrols as required by his agreement with the project. A rent free unit was also provided to the security agent until March 1997.

In another instance an independent contractor was paid for services that could have easily been performed by the project's maintenance staff. Specifically, the contractor received per diem amounts which were identified as either on-call services or emergency calls. The invoices provided by the contractor did not adequately document the services performed and appeared to be television repair service tickets.

The President of the Board stated that they had hired the various vendors because the project only had two maintenance men and they could not complete all the work that needed to be performed. However, the Board did not determine whether it would have been beneficial to hire additional staff or competitively procure the services. As a result, materials, supplies, and services were procured from vendors without documentation justifying the \$155,265 in costs were necessary to project operations.



Unsupported Vendor Payments

In addition to the ineligible and unsupported costs detailed above, we noted numerous other vendor payments that lacked sufficient documentation to determine what was purchased or the service provided.

HUD Handbook 4370.3, paragraph 2-8(C)(1) states that a request for a check must have supporting documentation (i.e., invoice itemizing amount requested with an authorized signature) in order for approval to be obtained to make the disbursement.

The President of the Board could not explain why there was no supporting documentation to support the payments made to the various vendors. In a written response she stated that she thought the prior management agent had requested all records from 1995 through May 1997, and that the agent probably had lost some records (Details covering the ineligible and unsupported costs were provided to the Board and current management agent).

HUD Handbook 4370.2 REV-1, Chapter 2 states that the project's accounting system should meet certain general objectives, which include: 1) Reporting on all financial transactions using HUD guidelines and Generally Accepted Accounting Principles (GAAP); 2) Provide timely, accurate and complete information for management decision making; 3) Safeguard project assets; 4) Maintain records in a form that will facilitate a speedy and effective audit; and 5) Bookkeeping should be complete and accurate, postings must be made at least monthly to the ledger accounts.

Paragraph 6B of the Management Certification states that: "The agent shall establish and maintain the project's accounts, books and records in accordance with HUD's Administrative requirements, GAAP, and in a condition that will facilitate an effective audit."

Inadequate Accounting System

Contrary to HUD guidelines, both the agent and the board did not maintain an adequate accounting system. In effect, the project staff and management agent maintained separate accounting systems with conflicting information.

We noted the following deficiencies in the financial records maintained by the project staff and the management agent:

Deficiencies Noted at the Project

The Assistant Resident Manager incorrectly posted late fees to current rents when delinquent tenants paid the prior month's rent. Therefore, project rent rolls were inaccurate. Additionally, project staff provided preferential treatment to several tenants by holding their rent checks past the due date without requiring late payments.

The Assistant Resident Manager did not post Housing Assistance Payments to month end reports which caused the excess income reports to be incorrect.

Deficiencies Noted at the Management Agent

The management agent's financial records were not maintained according to HUD requirements. Specifically, the management agent provided erroneous reports identifying \$173,000 in uncollected rent.

The management agent could not provide tenant listings that identified each individual tenants required rent payment and which units were occupied rent free by project staff.

The management agent could not produce general ledger financial statements at fiscal year end.

General Operating Reserve Not Funded

Paragraph 3 of the Regulatory Agreement states, the project is required to fund and maintain a general operating reserve equal to 25% of annual carrying charges.

Based on the Profit and Loss Statement for fiscal year ending September 30,1997, the required General Operating Reserve of \$212,055 was not funded.

* * * *

In summary, Because the Board was not aware of and/or disregarded HUD requirements there is no assurance that project funds were expended for reasonable and necessary expenses or properly recorded.

Auditee Comments

The auditee generally agreed that they need to improve staff training, improve their accounting system and fund the general operating reserve. Regarding the ineligible and unsupported costs the auditee could not explain why a duplicate payment was made, and has asked the management agent to address some of the unsupported management fees. Additionally, the auditee provided explanations as to why the questioned services were needed.

OIG Evaluation of Auditee Comments

We agree with the auditee's assessment that they need to improve staff training, improve their accounting system and fund the general operating reserve. Although, the auditee generally provided their explanations why certain services were needed they did not address why these services were not procured competitively. Additionally, the auditee did not

provide any additional documentation to support the ineligible and unsupported costs to include detailed security reports.

Recommendations

We recommend you require the project to:

- 2A. Reimburse the operating account \$5,023 improperly paid from operating funds for excessive management fees and the duplicate payment made to a vendor.
- 2B. Reimburse the operating account \$155,265 unless supporting documentation warranting a lesser amount is provided.
- 2C. Provide documentation identifying the basis for calculating \$22,318 management fees taken by the current agent.
- 2D. Set up one Accounting System in accordance with HUD Guidelines.
- 2E. Fund the General Operating Reserve as required by the Regulatory Agreement.
- 2F. Demonstrate the project staff and management agent have the ability to provide adequate management and comply with HUD guidelines.

The Project Did Not Comply With HUD Guidelines For Tenant Certifications

Project staff and the management agent have not conducted tenant certifications according to HUD guidelines. The resident manager and management agent's lack of knowledge and disregard for HUD Guidelines may have resulted in income loss to the project and overpayment of Housing Assistance Payments by HUD.

Background

Tenants receiving Section 8 Housing Assistance Payments or paying below market rent are required to certify their income on an annual basis. HUD prescribes specific guidelines for project staff to follow regarding the tenant certification process. Specifically, HUD Handbook 4350.3 CHG-27, Chapter 3, states that owners must verify all income, expenses, assets, household characteristics and circumstances that effect eligibility or tenant rent. The verification must come directly from the source, the third party.

Tenant File Review

Contrary to HUD guidelines third party verification was not obtained in 26 of 43 tenant files reviewed. Additionally, based on information provided by the Virginia Employment Commission, it appears that seven tenants may have under reported their income. We also noted numerous other deficiencies as illustrated below:

- 1) The Board President's income was certified for below market rent even though information contained in her file indicated her income was high enough to pay market rent.
- 2) Two tenants, both active duty military did not have their housing allowance included in their income as required. One of the tenants may have submitted a false verification of employment.
- 3) Project staff are certifying income for other staff and members of their families.

Our review disclosed that the project staff and management agent were not following many HUD Guidelines, including the need for third party verification, not using pay stubs as the only source in verifying income and including housing allowances in military income. The resident manager was the only person performing certifications that has received HUD training.

The resident manager claimed that the prior resident manager did not stress the need for third party verification and told her not to use housing allowances for determining military income. Additionally, the resident manager said that a representative from HUD reviewed the tenant files and said they were in compliance with HUD Guidelines.

* * * *

In summary, because tenant certifications were not completed according to HUD guidelines, there is no assurance tenant rent calculations are accurate. Consequently, tenants may not be paying the appropriate share of rent and HUD could be overpaying Section 8 Housing Assistance Payments.

Auditee Comments

The auditee generally agreed with the finding and recommendations.

Recommendations

We recommend you require the project:

- 3A. Recertify the two military tenants and the 26 tenants whose income was not verified by a third party and remit to HUD any excess income or ineligible Housing Assistance Payments.
- 3B. Implement controls to ensure that employees are trained and fully aware of HUD requirements regarding certifying tenant eligibility and calculating tenant rents.
- 3c. Have the management agent certify project staff and members of their family.

Management Controls

In planning and performing our audit, we obtained an understanding of the management controls that were relevant to our audit. Management is responsible for establishing effective management controls. Management controls, in a broad sense, include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Management Controls

We determined that the following management controls were relevant to our audit objectives:

- Management oversight to ensure that the Project is administered in accordance with HUD directives for Section 236 Properties
- Adequate accounting systems to properly record and safeguard the Project's assets

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

It is a significant weakness if management control does not give reasonable assurance that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and reliable data is obtained, maintained, and fairly disclosed in reports.

Significant Weaknesses

Based on our review, we believe management oversight to ensure that the Project is administered in accordance with HUD Guidelines, adequate accounting systems to properly record and safeguard the Project's assets are significant weaknesses.

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Follow Up On Prior Audits

This was the first audit of Charlestowne at Cavalier Mutual Homes, Inc., Operations.

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Schedule Of Questioned Costs

<u>Recommendation Number</u>	<u>Type of Questioned Costs</u>	
	<u>Ineligible 1/</u>	<u>Unsupported 2/</u>
1	\$586,929	
2	\$ 5,023	\$177,583
	<u>\$591,952</u>	<u>\$177,583</u>

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.

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Auditee Comments

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Distribution

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