



U.S. Department of Housing and Urban Development
Office of Inspector General
Pacific/Hawaii District
450 Golden Gate Avenue, Box 36003
San Francisco, California 94102-3448

Audit Memorandum
99-SF-213-1802

January 8, 1999

MEMORANDUM FOR: Michael Kulick, Director, Multifamily Hub, 9DH

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

SUBJECT: Limited Review of Mortgagor Operations
Astoria Gardens Tenant Association (AGTA)
Sylmar, California

INTRODUCTION

As requested by the Los Angeles Area Office (LAAO) Director, Multifamily Housing Division, we performed a limited review of Astoria Gardens Tenants Association's (Mortgagor) operations. The purpose of our review was to determine whether concerns brought to HUD LAAO's attention pertaining to alleged misconduct by AGTA's board members and improper expenditure of grant funds could be substantiated.

SUMMARY

We determined that allegations of misconduct by AGTA board members were unsubstantiated; however, allegations concerning improper expenditure and imprudent use of grant funds were valid. We found that AGTA improperly retained bank refunds of \$64,062 relating to a good faith deposit and related fees that AGTA never actually paid. We also found that AGTA spent funds for ineligible lobbying activities and used \$55,342 for expenses that may not have been reasonable and necessary.

We discussed the results of our review with AGTA officials during the audit and at an August 31, 1998 exit conference. On July 17, 1998 we provided AGTA with a copy of the draft findings for their comment. We received their response on August 12, 1998 and included their comments in the findings. They generally disagreed with the findings and the full text of their response is included as Appendix A. On September 15, 1998, AGTA provided additional written comments to further support their concerns. Based on those comments, we made revisions to the findings. We have also included those written comments in this report (Appendix B).

BACKGROUND

Astoria Gardens Apartments (Project) was purchased from Astoria Gardens Apartments, Ltd., a California Limited Partnership, by AGTA, a California nonprofit corporation. The residents of Astoria Gardens formed this nonprofit corporation in early 1994 for the purpose of acquiring, rehabilitating, and owning the Project. AGTA proposed to own and operate the Project as a nonprofit organization on behalf of the Project's residents. All residents at Astoria Gardens were eligible for membership in AGTA, and each member was entitled to participate in the affairs of the corporation and to vote for the Board of Directors of the corporation. The rights and obligations of the members were set forth in the bylaws.

On October 27, 1994, HUD approved a Preservation Technical Assistance Grant (PTAG) of \$103,500, which was designed to assist AGTA in establishing and organizing a resident council or community-based nonprofit organization, and to provide training to the residents and board members.

On September 13, 1996, HUD approved an FHA-insured 241(f) loan in the amount of \$6,284,000 to be amortized at 8.75% over a period of 40 years. The total loan amount included \$4,488,800 for the acquisition of the property, \$1,158,650 for rehabilitation costs, \$308,250 for deposit into the reserve for replacement account, and \$328,300 for transaction costs. From the buyer's overage, HUD paid the project the sum of \$103,000 for financial/development consultant fees of \$38,000, sponsors administration/organizational fees of \$45,000, and legal fees of \$20,000.

The Housing Department of the City of Los Angeles, (LAHD) also provided a \$20,000 technical assistance grant to assist AGTA in purchasing the Project.

OBJECTIVE, SCOPE AND METHODOLOGY

The overall objective of our review was to evaluate whether the concerns raised in the May 30, 1997 referral from LAAO, Multifamily Housing Division, could be substantiated. To accomplish this objective we interviewed AGTA's board members, consultant, legal counsel, and the Project's management agent. We also reviewed HUD and AGTA records.

The review generally covered the period from January 1, 1995 to September 30, 1997. We conducted the audit in accordance with generally accepted government auditing standards.

REVIEW RESULTS

AGTA did not properly account for loan proceeds, or use grant funds in accordance with applicable HUD requirements. Specifically, AGTA inappropriately retained loan proceeds of \$64,062 relating to a refund of a good faith deposit and related fees that AGTA never actually paid; spent grant funds for ineligible lobbying activities and incurred \$55,342 for expenses that may have been unnecessary. As a result, HUD insured a higher loan amount than was necessary and AGTA incurred questionable expenditures. The deficiency concerning the improper retention of loan proceeds occurred because AGTA relied on the mortgagee's judgment that the loan was properly closed; therefore, it assumed that it was entitled to the refund. AGTA, however,

disregarded HUD’s program requirements with respect to the ineligible and unnecessary use of grant funds.

a. AGTA Inappropriately Retained Refunds of \$64,062

AGTA inappropriately retained loan proceeds of \$64,062 relating to a refund of a good faith deposit and related fees that AGTA never actually paid. AGTA’s consultant explained that AGTA officials stated that they did not know whether the Project was entitled to a refund or not; therefore, they kept the money assuming that the refund transaction was theirs. A mortgagee official said that it was their general practice to make such refunds, regardless of whether initial deposits were actually made.

AGTA and Mortgagee Certified Inaccurate Information to HUD

The certifications made by the mortgagor and mortgagee, however, stated that the mortgagee actually collected \$64,062 in connection with the financing of the loan. HUD, therefore, made its decision to insure this loan based on those certifications. The Mortgagee’s Certificate included a statement describing this sum as the deposit that was refundable, if AGTA could deliver the loan on time. Similarly, the Mortgagor’s Certificate stated that the fees and expenses itemized in the Mortgagee’s Certificate had been fully paid. These certifications were submitted to HUD as the basis for endorsing the loan.

The mortgagee informed AGTA in an October 29, 1996 letter that it was sending AGTA the following refunds as discussed at loan closing:

• Good Faith Deposit	\$31,420
• Extension Fee	31,420
• Warehouse Interest Balance	<u>1,222</u>
Total	<u>\$64,062</u>

Upon receiving the refund, AGTA deposited the money in a separate checking account called an Organizational Account. AGTA did not inform HUD of the existence of this account until it was disclosed during our audit, about one year after AGTA received the refund.

Refunds Should Be Applied Toward the Loan

HUD LAAO officials said that generally in the course of business, any refunds generated at a closing of a HUD-insured loan should be applied towards the principal balance of the loan to reduce the amount. HUD LAAO officials believed that mortgagees were aware of this policy and that a non-profit organization, such as AGTA, should not be entitled to receive such refunds. A mortgagee official said that it waived the initial deposit requirement because of AGTA’s non-profit designation. The official further explained that the refund was made because it was their normal practice to reimburse mortgagors for the amount it classified as a deposit, regardless of whether any actual deposit had been made. In cases where the initial deposit was not made, refunds are being paid out of loan proceeds.

According to its bylaws, AGTA was formed for charitable purposes, and had to engage in activities or exercise powers that would be in furtherance of these purposes. One of the specific purposes was to improve the quality of life of the residents of Astoria Gardens Apartments and the surrounding community. Therefore, the properties and assets of this Corporation are dedicated to charitable purposes, and no part of these assets of the Corporation should inure to the benefit of the Corporation.

Since AGTA did not apply the refund towards the principal balance of the loan, HUD not only insured a higher loan amount than necessary, but also caused the Project to pay a higher monthly mortgage payment than would have been required.

AUDITEE COMMENTS AND OIG EVALUATION

AGTA disagreed that it relied on the mortgagee's expertise. AGTA said that it relied on its own consultants because the mortgagee had never closed a loan on a resident controlled purchase. AGTA further contended that had it not been for their consultants, the good faith deposits would have been forfeited. Regarding the use of the funds, AGTA stated that on past occasions HUD allowed AGTA to use any surpluses generated at loan closings for purposes other than towards reducing the principal balance of the loan.

The draft finding did not imply that the closing of the loan was facilitated by the mortgagee's expertise. Rather, we were merely pointing out that the reason that AGTA kept the refund was because it relied on the mortgagee's expertise and judgement that the refund was proper. Mortgagee officials informed us that it is their normal practice to reimburse mortgagors for the amount classified as a deposit, regardless of whether any actual deposit had been made, and regardless of the type of loan. We disagree that AGTA would have forfeited the good faith deposits because no initial deposit was ever made. Further, regarding the use of the funds, HUD had not approved the funds for any purpose because AGTA did not inform HUD about the existence of these funds until they were disclosed during our audit, about one year after AGTA had received the refunds.

b. AGTA Spent Grant Funds For Ineligible Lobbying Activities

AGTA spent a portion of \$13,724 (PTAG - \$7,374 and loan proceeds - \$6,350) in grant funds for ineligible expenses related to lobbying activities that occurred during trips taken to attend conferences. As a result, a portion of the funds were not spent for eligible expenses designed specifically to assist AGTA in the Project's transition to tenant-based homeownership. The improper expenditures occurred because AGTA disregarded Federal rules and regulations prohibiting the use of federal funds for lobbying activities.

**Lobbying
Activities Should
Not Be Funded**

In April of 1984, OMB Circular A-122, *Cost Principles for Nonprofit Organizations*, was amended to explicitly state that "costs associated with most kinds of lobbying and political activities" are unallowable. Item 21.a.(3) states that notwithstanding other provisions of this Circular, costs

associated with the following activities are unallowable. In relevant part, OMB Circular A-122 states:

“...Any attempt to influence: (i) The introduction of Federal or State legislation; or (ii) the enactment or modification of any pending Federal or state legislation through communication with any member of Congress or state legislature (including efforts to influence State or local officials to engage in similar lobbying activity), or with any government official or employee in connection with a decision to sign or veto enrolled legislation....”

**AGTA Improperly
Used Funds for
Lobbying Activities**

Contrary to Federal requirements, AGTA spent a portion of the \$13,724 in grant funds for ineligible expenses relating to lobbying activities. AGTA used funds to pay for members of its board of directors to attend the National Low Income Housing Coalition (NLIHC) annual conferences in 1995, 1996, and 1997, held in Washington, DC; however, not all of the board members activities were directly related to the conferences.

Our review of the conference brochures disclosed that a major focus of the conferences was for lobbying activities. For example, information relating to the 1996 NLIHC conference states that lobby day is a major focus of the conference, including a rally in support of equitable national housing policies, and a reception on Capitol Hill with members of Congress. The 1997 NLIHC’s annual conference described the last day of their conference (the “Lobby Day”) as two components: “Rally At the U.S. Capitol” and “Reception on Capitol Hill with Members of Congress and their staff. The brochure described the day as an opportunity to meet with members of Congress and other national leaders to discuss the challenge of affordable housing and adequate infrastructure for low income neighborhoods everywhere. The brochure even provided “important lobbying tips” such as to contact local members of congress in advance to schedule an appointment.

Our discussions with AGTA board members confirmed their participation in the lobbying activities. For example, one AGTA board member told us that during one of those conferences she spoke in front of a crowd at a rally at the U.S. Capitol. Another AGTA board member told us that she participated in two of those conferences during which AGTA board members met with the aide to the Congressman from the Sylmar District, and aides to two Senators from California.

Item 21.b.(1) of Circular A-122 includes an exception that allows lobbying in response to a Congressional information or document request, but pursuant to this exception, costs for travel, lodging or meals are unallowable unless incurred to offer testimony at a regularly scheduled Congressional hearing pursuant to a written request for such presentation made by the Chairman or Ranking Minority Member of the Committee or Subcommittee conducting such hearing. Based on our review, the lobbying activities in question were not scheduled Congressional hearings for the purpose of obtaining testimony from AGTA board members.

In our opinion, AGTA disregarded Federal requirements when it certified in the Grant Agreement for Preservation Technical Assistance Planning Grant that it had not, and would not, use any federal funds for expenses related to lobbying activities.

As a result of the improper expenditures, AGTA deprived itself of limited resources given by HUD for training purposes, designed to help AGTA with its transition to tenant-based home ownership.

AUDITEE COMMENTS AND OIG EVALUATION

AGTA disagreed that it spent \$13,724 in grant funds for ineligible lobbying activities because HUD approved the expenditure of funds for conferences and related travel. At the exit conference, AGTA explained that the main purpose for attending the conference was for training, which occurred on the first three days of the conference, and that the lobbying activities were only held on the last day of the conference. AGTA further commented that while AGTA board members participated in lobbying activities, OIG incorrectly disallowed the entire expense, rather than only the portion associated with the lobbying activities. AGTA commented that HUD had also approved other tenant associations and non-profit owners to attend this annual conference. AGTA also claimed that the statutory authority cited by which OIG determined the ineligible lobbying activities was not applicable.

HUD officials disagreed that they had approved AGTA's planned expenditures for the lobbying activities. For one of the trips, the approving HUD official said he was not aware that the conference included lobbying activities when he approved the drawdowns. For another trip, the approving official said AGTA had not obtained HUD's approval in advance, thus, she felt compelled to approve the drawdown because the expenses had already been incurred. At the exit conference, OIG agreed to consider revising the finding to disallow that portion of the expenses associated with the lobbying activities if AGTA could provide an adequate breakdown between lobbying and training expenses. However, as of the issuance of this report, AGTA had not provided OIG with an adequate breakdown. AGTA also did not provide a list of other entities that received HUD approval to attend the same conference. Based on our research, we agree with AGTA that the statutory authority that we previously used to determine cost eligibility was not applicable. However, our research also discovered that OMB Circular A-122 was the correct statutory authority that was applicable to this case; therefore, our determination remains unchanged.

c. AGTA May Not Have Used Grant Funds Prudently

AGTA may not have used grant funds prudently. Specifically, we found that AGTA spent \$55,342 for expenses that did not appear to be reasonable and necessary. As a result, AGTA may have deprived itself of limited resources earmarked for training and administration purposes.

**Funds Should Be Used
Only For Reasonable
Expenses**

OMB Circular A-122, *Cost Principles for Nonprofit Organizations*, Sections A.2.a., A.3.a., and A.3.c. state that to be allowable under an award, costs must be reasonable for the performance of the award

and be allocable thereto under these principles. Further, a cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with organizations or separate divisions thereof which receive the preponderance of their support from awards made by Federal agencies. In determining the reasonableness of a given cost, consideration shall be given to:

- Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the organization or the performance of the award.
- Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees, clients, the public at large, and the Government.

AGTA May Not Have Used Funds Prudently

We found that AGTA may have imprudently spent \$55,342 when it paid a consultant \$84,342, against two contracts even though the two contracts for services amounted to only \$29,000, thereby, exceeding the contract amounts by \$55,342. AGTA did not make any revisions to increase the agreed contract amounts or provide any reason or justifications to incur the additional costs.

AUDITEE COMMENTS AND OIG EVALUATION

AGTA disagreed with our conclusion that it did not always use its grant funds prudently, and stated that it actually obtained three consultant contracts, not two, for services rendered prior to the purchase of the project totaling \$54,000, within the HUD approved maximum budget of \$75,000 for preservation-related activities through the completion of the purchase, exclusive of legal fees.

AGTA did not explain the reason for exceeding the contract amounts by \$30,342, including the third contract. AGTA also did not inform us about the existence of a third contract during the audit fieldwork. At the exit conference, OIG requested minutes of the board meeting supporting AGTA's approval of this third contract; however, AGTA did not provide such documentation. We also noted that HUD's approval of a \$75,000 budget for fees associated with the preservation activities included other professional services, including architectural, engineering, and financial, not just those of the consultant.

RECOMMENDATIONS

We are recommending you:

- 1A. Require AGTA to apply the \$64,062 refund towards reduction of the loan principal balance.
- 1B. Evaluate the \$13,724 spent for conference travel and require AGTA to repay HUD, from non Federal funds, for the costs associated with the ineligible lobbying activities.
- 1C. Evaluate the circumstances associated with the \$55,342 increase in expenditures for the consultant contracts and determine if they are allowable. Any expenses that you determine not allowable should be repaid to HUD with non Federal funds.

INTERNAL CONTROLS

In planning and performing our audit, we considered internal controls used by AGTA 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 commissioners, 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 communications, and monitoring - must be present. That is, the control objectives in each category are inextricably linked with the five supporting components.

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

- Receipt of funds
- Expenditures of grant funds

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

A significant weakness exists if internal controls do not give reasonable assurance that control objectives are met. Based on our review, we believe that the auditee's unfamiliarity and disregard of pertinent laws and regulations were significant weaknesses.

* * * * *

Within 60 days, please furnish us a status report on the recommendations stating (1) the corrective action taken, (2) the proposed corrective action and the date to be completed, or (3) why action is not needed. Also, please furnish us copies of any correspondence or directives related to this review.

If you have any questions concerning this report, please call Ruben Velasco, Assistant District Inspector General for Audit, at (213) 894-8016.

APPENDICES

- A Original Auditee Comments
- B Additional Auditee Comments
- C Distribution

APPENDIX A

Original Auditee Comments

APPENDIX B

Additional Auditee Comments

APPENDIX C

Distribution

Director, Multifamily Hub, 9DH
Secretary's Representative, California State Office, 9AS
Office of the Comptroller, Texas State Office, 6AF (Attn: Bettye Adams)
Director, Administrative Service Center #3, 8AA
Director, Field Accounting Division, 9AFF
Director, ASC Contracting Division, 8AAC
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Deputy Assistant to the Secretary for Field Management, SDF (Room 7106)
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Mr. Pete Sessions, Government Reform and Oversight Committee, Congress of
the United States, House of Representatives, Washington, DC 20510-6250
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