audit report
OFFICE OF INSPECTOR GENERAL

Issue Date June 27, 1996	
Audit Case Number 96-PH-212-1017	

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

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

SUBJECT: Dorchester Square Apartments
Multifamily Mortgagor Operations
Franklin, Virginia

As you requested we have audited the operations of Dorchester Square Apartments (project) to determine whether the Owner operated the project according to the terms and conditions of the Regulatory Agreement and HUD requirements.

The report identifies that improper cash distributions were paid to the Owner. Additionally, the identity-of-interest Agent and the Owner incurred ineligible and unsupported expenses, did not properly verify income of tenants reporting little or no income on recertification and failed to maintain the financial records of the project as required.

Within 60 days, please give us, for each recommendation in this 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.

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

Executive Summary

We audited Dorchester Square Apartments to determine whether the Owner operated the project according to the terms and conditions of the Regulatory Agreement and HUD requirements. Issues identified in the report indicate that the Owner/Agent's oversight of financial and certain program areas requires improvement. From a monetary standpoint these conditions resulted in ineligible and unsupported costs of $113,463 and $104,604 respectively.

Improper distributions paid Owner

The Owner was paid $16,856 in excess cash distributions and did not deposit an additional $17,076 in the residual receipts fund as required. Based on surplus cash computations for the period 1989 through 1995, there was not a cash surplus to support the excess distributions. The Owner's actions represent a disregard for HUD requirements and mismanagement of project funds.

Agent received and paid improper project expenses

The Agent increased management fees and paid their employee from project funds contrary to HUD requirements. The improper payments totaled $79,531. The Agent's actions were to their benefit and detrimental to project operations. As a result the project has lost needed revenue.

Unsupported project costs and questionable accounting transactions

Review of the projects' books and accounts identified numerous instances of non-compliance. The Owner/Agent: 1) Disbursed $96,108 from the operating account without proper supporting documentation. When documentation was available it did not fully identify the items purchased or the services performed. 2) Used an accounting system that produced unreliable information. These actions by the Owner/Agent demonstrate a disregard for HUD requirements, and have resulted in questionable financial operation of the project.

Management has failed to adequately justify tenants non-income status

Our review disclosed that five project tenants are reporting no income on recertification, and other tenants are reporting income as low as $100 per month. In all cases the files did not contain documentation that indicated all efforts were exhausted by management to verify possible income as required. As a result the potential exists that HUD has overpaid Housing Assistance Payments (HAP) for these tenants.

We recommend the Owner/Agent: (1) repay ineligible costs to the project; (2) justify the eligibility of unsupported costs; and (3) implement accounting and income verification requirements.

We discussed the finding issues with the Owner/Agent and staff during the audit and their comments are summarized in the findings. The draft findings were provided the Owner and responses received were considered in our report. The Owner's written response, exclusive of exhibits, is included as Appendix B. Copies of exhibits supporting the questioned costs in the findings were provided to the Owner and your staff.

An exit conference was held with the Owner on June 17, 1996.

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Abbreviations

HAP Housing Assistance Payments
HUD Department of Housing and Urban Development
OIG Office of Inspector General

Introduction

Dorchester Square Apartments is a HUD-insured multifamily housing project in Franklin, Virginia with 125 Section 8 units. The mortgage was initially endorsed for insurance under Section 221(d)(3) of the National Housing Act on December 27, 1972.

The Owner, Dorchester Associates, a limited partnership, was organized on December 1, 1972. On January 1, 1983, the current ownership was organized as a Virginia Limited Partnership. The principals of the partnership are Rocco Lassiter, David Levine and Gale Levine. The project is operated under the Section 8 Rental Supplement Program of the National Housing Act. David Levine and Gale Levine have managed the project since 1983 through an identity-of-interest management agent, Sun Realty Co (Agent). Sun Realty Co. offices are located in Virginia Beach, Virginia.

Primary tenant records are maintained at the project's office in Franklin, Virginia. Financial records are kept at Hodges Manor Apartments in Portsmouth, Virginia, another HUD-insured project managed by the Agent.

During the audit your office engaged a contractor to physically inspect the project. The contractor reported many physical conditions of the project were unsatisfactory together with the project's maintenance policies and practices. Ninety-nine percent of the units inspected by the contractor failed housing quality standards. We inspected ten units which failed housing quality standards, confirming the contractor's work. The physical condition of the project is not being reported since your office is handling the problem with the Owner.

Audit Objectives

The objectives of the audit were to determine whether the Owner complied with the Regulatory Agreement and HUD requirements. Specific objectives were to determine whether the project's system of internal control was adequate and disbursements were reasonable and necessary.

Audit Scope

We examined Dorchester Square's accounting and financial records, and reports located in the HUD Virginia State Office. We reviewed the project's independent public accountant's work papers for Fiscal Year 1993 and 1994. We interviewed project, Agent, and HUD staff members. We inspected two vacant and eight occupied units.

Audit Period

Audit work was performed between October 1995 and June 1996 and covered activities between January 1993 through December 1995. The audit period was expanded when appropriate.

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

Improper Cash Distributions Paid The Owner

The Owner was paid $16,856 in excess cash distributions and did not deposit an additional $17,076 in the residual receipts fund as required. Based on surplus cash computations for the period 1989 through 1995, there was not a cash surplus to support the excess distributions. The Owner's actions represent a disregard for HUD requirements and mismanagement of project funds.

Paragraph 9G of the Regulatory Agreement provides that surplus cash is any cash remaining after the current mortgage payment is made; all required deposits are made to the reserve fund for replacements; and the payment of project expenses.

The project is also required to make deposits in a residual receipts fund. The Regulatory Agreement limits distributions to six percent annually on the Owners initial equity investment amounting to $20,034. Any additional cash surplus must be deposited into the residual receipts fund. However, the Owners can take more surplus cash than they earned during the year if they had distributions accrued and unpaid in prior years.

Owner took excess distributions

The Owner contrary to the Regulatory Agreement took excess distributions without an available cash surplus and did not make the required deposit to the residual receipts fund. The Owner claims cash surpluses were available to support the distributions. Further, the Owner stated that $18,000 in surplus cash is available every year. However, our computations of surplus cash from 1989 to 1995 disclosed the Owner did not deposit $17,076 in the residual receipts fund as required, and made excess distributions totaling $16,856.

The Owner's lack of knowledge of HUD requirements has contributed to the mismanagement of project finances.

Auditee Comments

The Owner disputes the finding that they made excess distributions of surplus cash and failed to deposit funds in residual receipts as required. The basis for the dispute is the OIG Auditor failed to use the proper HUD forms to compute surplus cash and their accountant did. The accountant states that in 1994 and 1995 excess distributions of $14,000 and $14,700 respectively were repaid.

OIG Evaluation of Auditee Comments

Calculations of surplus cash were made in accordance with HUD Handbook 4370.2. The information compiled in the schedule provided to the Owner came directly from HUD Form 93486 (Computation of Surplus Cash, Distributions and Residual Receipts) and the project's accounting records.

Regarding the $28,700 reported as repaid to the project by the Owner documentation was not provided to support repayment.

Recommendations

We recommend the Owner:

1A. Provide documentation to support repayment of $28,700 to the project in 1994 and 1995. Documentation shall include bank deposits, bank statements, wire transfers, canceled checks and accounting analysis of the net amounts claimed. In the absence of documentation reducing excess distributions reimburse the project $16,856 for excess cash distributions and deposit $17,076 in the residual receipts fund as required.

1B. Implement accounting controls that conform to HUD requirements regarding the distribution of surplus cash.

Project Paid Ineligible Agent Costs

The Agent increased management fees and paid their employee from project funds contrary to HUD requirements. The improper payments totaled $79,531. The Agent's actions were to their benefit and detrimental to project operations. As a result the project has lost needed revenue.

A. Excess management fees taken by the Agent

The Agent increased its management fee without HUD's approval and took excess management fees totaling $35,968.

The Management Agreement signed by the Agent, Owner and HUD on January 1, 1983, stated that each monthly fee will be equal to six percent of gross collections during the preceding month. Further, the percentage fee may be increased by 1/4 of one percent on the anniversary date of the agreement, if HUD approves the Owner's written request.

HUD Handbook 4381.5 REV-2, Chapter 3, Section 3.10, states to request a change in the management fee percentage, the Owner and Agent are required to submit a new management certification with the revised management fee. Further, Section 3.11B states that rent increases do not trigger management fee reviews.

Agent improperly increased management fee

The Agent contrary to HUD requirements increased the percentage for the management fee without HUD's written approval. Additionally, the Owner never sought to obtain a new management agreement with HUD when it expired in 1985. The Owner claims that HUD approved the increased percentage for the management fee when it approved the rent increase in 1990.

In a memo dated October 31, 1995, HUD's Virginia State Office directed the Agent to reduce the fee to the amount agreed upon in the Management Agreement signed in 1983.

However, the Agent has not complied and continues to collect excess management fees.

B. <u>Ineligible payments made to an employee of the Agent</u>

The Agent paid an employee $28,563 classified as bookkeeping fees from January 1, 1993 to December 31, 1995. However, the bookkeeper for Hodges Manor Apartments, is the bookkeeper of Dorchester Square Apartments.

Project improperly paid Agent costs

The Agent also paid the same employee $15,000 which was classified as partners' distributions. The employee is not listed as a general or limited partner of the partnership entity therefore not entitled to distributions from surplus cash. The owner claims that HUD approved the payments to the employee when they approved the rent increase in 1990.

According to HUD Handbook 4381.5 REV-2, salaries of the Agent's personnel are paid from the management fee. Further, as stated above, rent increases do not trigger management fee reviews. As a result, the $15,000 and $28,563 are Agent costs not project costs and ineligible.

Auditee Comments

The Owner/Agent disputes that the Management Agreement has expired. A memo to HUD in 1985, Virginia contract law and the management review report that stated the contract was indefinite are cited as supporting their position.

The Owner/Agent contends that a HUD Asset Manager authorized the management fee increases prior to the issuance of the 1994 HUD Handbook 4381.5 REV-2.

The Owner/Agent states that the employee was paid additional fees for bookkeeping services performed beyond her normal duties. They also claim that the $15,000 was a bonus permitted by HUD Handbook 4381.5 REV-2 under extraordinary circumstances. Additionally, the bonus was disclosed to HUD in 1990, and not questioned.

OIG Evaluation of Auditee Comments

The Management Agreement between the Owner/Agent and HUD clearly states that the percentage fee may be increased by 1/4 of one percent on the anniversary date of the agreement, if HUD approves the Owner's written request. No documentation was provided that HUD approved such a request or the 1985 memorandum allegedly sent to HUD. The Management Review Report representation of indefinite by the reviewer indicates the management term was not definite and unclear. In our opinion the indefinite citation was made because the agreement had expired.

HUD Handbook 4381.5 and all subsequent revisions state to request a change in the management fee percentage, both the Owner and the Agent are required to submit a new management certification with the revised management fee. Further, there is no documentation that a HUD Asset Manager authorized any increase in the management fee.

Bookkeeping fees are allowable expense from operations. However, the employee in question does not perform any bookkeeping duties as stated in the finding.

HUD Handbook 4381.5 all revisions do not permit bonuses to the Agent's employees to be paid from the operating account. Salaries of agent's employees are paid from the management fee. HUD Handbook 4381.5 REV-2 will only allow the cost of supervisory personnel providing oversight of computer and accounting services to be paid from the operating account. However, they must be prorated and approved by HUD.

Recommendations

We recommend the Agent:

2A. Repay the project $79,531 for ineligible management fees and improper payments made to the employee. Repay the project additional fees taken from January 1, 1996 to date, and discontinue the improper practices.

2B. Submit to HUD for approval a new management certification and proposal for the management fee.

The Projects' Records Are Improperly Maintained

Review of the projects' books and accounts disclosed numerous instances of non-compliance. The Owner/Agent: 1) Disbursed $96,108 from the operating account without proper supporting documentation. When documentation was available it did not fully identify the items purchased or the services performed. 2) Used an accounting system that produced unreliable information. These actions by the Owner/Agent demonstrate a disregard for HUD requirements, and have resulted in questionable financial operation of the project.

A. Unsupported costs

The Regulatory Agreement, paragraph 9d, states that the books and accounts of the property must be maintained in accordance with the requirements of the Commissioner.

HUD Handbook 4370.2 REV-1, Chapter 2, paragraph 2B, states that the books and accounts must be complete and accurate. Further, paragraph 2-6B states that all disbursements must be supported by approved invoices and other supporting documentation.

Documentation not provided to support costs

During our review, we presented the Owner/Agent a list of questionable disbursements. We were told documentation would be provided to support the questioned disbursements. The documentation provided by the Owner/Agent supported some of the disbursements questioned. The following list represents the remaining $96,108 in questionable and unsupported disbursements.

A contractor was paid $58,942 from January 1, 1993 to December 31, 1995 for work identified as contract maintenance. The invoices provided by the contractor consist of envelopes filled with invoices from local hardware stores and convenience stores. Handwritten on the envelopes are the words wages and gas followed by dollar amounts. No contract was provided identifying the cost of labor or any other services requiring reimbursement.

A contractor was paid $6,800 for work identified as siding; however, no invoice was provided that identifies the cost of the labor or the materials used.

Two contractors were paid $9,220 for labor and materials; however, no invoices were provided to support the cost of the labor and materials.

The Agent paid a hardware store $12,784 and an office supplies store $1,906; however, in both instances the invoices provided only identified the amount owed on account. Supporting invoices identifying the items purchased on account was not provided.

Miscellaneous disbursements totalling $6,456 either did not have invoices available or if an invoice was available it lacked adequate detail to support the disbursement as a project expense.

The Owner/Agent was provided a detailed schedule of the above costs to assist them in gathering documentation to support the costs. To date we have not received any additional documentation, and the costs remain questioned.

B. <u>Accounting system deficiencies</u>

HUD Handbook 4370.2 REV-1, Chapter 2 states that the projects' accounting system should meet certain general objectives, two of which are, provide timely, accurate and complete information for management decision making; and safeguard the projects' assets. Contrary to HUD requirements the Owner/Agent accounting system does not meet these objectives. Examples of system deficiencies identified during our review follow:

- Amounts posted to tenants accounts receivable were based on the rent roll and did not agree with the tenant ledgers. Beginning in July 1995, the project used the tenant ledgers to calculate tenants' accounts receivable. However, our testing of July tenants' accounts receivable disclosed that those figures were incorrect.

- A bad debt account did not appear on any of the trial balances we reviewed, through December 1995. In the Fiscal Year 1994 Financial Statements, $8,496 was reported as bad debts. We requested postings to the account, but none were provided, and the write off is questioned.

- Postings made to the Housing Assistance Payment account were higher than those posted to the bank statements and the cash account for the two months we reviewed.

- The Owner/Agent allowed contractors, performing work at the project, to purchase materials at a local hardware store and charge the purchases to the project's account. The contractor simply signs the invoice. As stated in Part A, the Agent pays the hardware store from invoices that only identify the amount owed on account. Supporting invoices identifying the items purchased on account were not provided.

- Owner/Agent maintains two bank accounts for the project. Copies of cancelled checks show that the management fee and the bookkeeping fee were disbursed from both accounts. Maintaining two operating accounts confuses rather than simplifies accountability of financial operations.

- An Agent employee claims that bids are solicited when selecting contractors to perform work at the project. However, a review of the project's files did not disclose any bids or a bid selection process.

The Owner/Agent did not seem aware that there were any problems with their accounting system. However, other employees were aware of the problems but were concerned with job security and believed the best policy was to follow the Owner/Agent's direction.

Auditee Comments

Owner/Agent claim they are unable to provide supporting documentation to support the questioned costs, because the OIG Auditor, removed records from the files. Further, the findings did not identify the questionable costs and disbursements by contract and amount.

Owner/Agent does not believe items identified are really deficiencies that need to be corrected, and requested a more detailed explanation before they will make the corrections.

OIG Evaluation of Auditee Comments

No records were removed from the project or Owner/Agent's office by the auditor.

The disbursements in question were specifically identified in December to the Owner/Agent. The items identified in the report were those items that were not supported by documentation provided.

The HUD Handbook citation clearly identifies the basic requirements that the project's accounting system shall meet and the Owner is required to maintain. The accounting deficiencies cited identifies that the project's system does not meet HUD requirements.

Recommendations

We recommend the Owner/Agent:

3A. Provide supporting documentation for the disbursements questioned or reimburse the operating account for $96,108.

3B. Install an accounting system that will provide timely and accurate information to conform with HUD requirements. Establish an Internal Control System that adequately safeguards the project's assets. Use only one bank account to disburse funds for project operations. Provide documentation to support the $8,496 reported as a bad debt in Fiscal Year 1994.

Questionable Tenant Income Verification By Management

Our review disclosed that five project tenants are reporting no income on recertification. We also reviewed the files of tenants reporting income as low a $100 per month. In all cases the files did not contain documentation that indicated all efforts were exhausted by management to verify possible income as required. As a result the potential exists that HUD has overpaid HAP for these tenants.

HUD Handbook 4350.3 CHG-27, Chapter 3, Paragraph 3-30, requires Owners of Section 8 projects to verify all sources of income, expenses, assets, household characteristics and circumstances that effect tenant eligibility or rent.

Tenant income verification not effective

During November 1995, we identified nine tenants not reporting any income on recertification. In April 1996, we found only five tenants not reporting income on recertification, four from the list in November and one new tenant. In both November and April, contrary to HUD requirements, management did not perform an extensive search to verify all sources of income. Additionally, an inspection of the units occupied by the aforementioned tenants in April 1996 disclosed three telephones in one apartment, new furniture, stereo equipment and televisions. To afford such amenities some source of income exists. Further, the question arises how do these tenants subsist?

Reports received from the Virginia Employment Commission indicated that four of the tenants not reporting income in 1995 and 1996 are also not reporting income earned by the their adult children or unemployment benefits.

The resident manager claims that the Virginia Employment Commission will not allow access to certain information that might disclose unreported income. Further, she stated that HUD does not have any specific guidelines describing the necessary steps to take when a tenant reports no income. We point out that a thorough interview with the tenant, asking simple common sense questions might disclose unreported income. There was no evidence that such an approach was taken by management.

Auditee Comments

Owner/Agent nonconcurs that management did not adequately verify tenant income, and claims the following to support their contention: 1) Resident Manager verifies with social services to determine eligibility of benefits; 2) former HUD employee stated that there were no definitive guidelines to determine lack of income; and 3) tenants who lose their jobs provide verification of job loss and termination of unemployment benefits. Various documents were provided as support for income verification. Further, recommendation 4A has been accomplished, and need definition for extensive search, under recommendation 4B.

OIG Evaluation of Auditee Comments

The finding identifies nine tenants not reporting income on recertification in November 1995 and five tenants in April 1996. The documentation provided with the response is on three tenants, two who were reporting income on recertification in April 1996. Our assessment of the documentation provided disclosed the Owner/Agent did not verify that the tenant:

- received food stamps or other government assistance;
- was no longer employed;
- was receiving unemployment benefits; and
- identified the source of income to support amenities in all units cited. Response referred to only one unit.

The documents provided are not sufficient income verification. Recommendation 4A still requires implementation.

During the closing conference explanation was provided covering the type of questions that can be posed to a tenant during the certification interview. As stated in the finding asking common sense questions might disclose unreported income. This approach together with the guidelines provided in HUD Handbook 4350.3 CHG-27 provides the basis for adequately verifying tenant income.

Recommendations

We recommend the Owner/Agent:

4A. Recertify all tenants reporting no income and income of $100 or less. For tenants with validated income restructure the HAP payments. Establish a workout agreement with the tenants to recapture the subsidy overpayments due HUD. If there is a hardship for such a plan consult with HUD for appropriate action to be taken.

4B. Implement HUD requirements to ensure tenant interviews are conducted and verification procedures followed to identify all sources of income.

Internal Controls

In planning and performing our audit, we considered the internal control systems of the management of Dorchester Square Apartments in order to determine our auditing procedures and not to provide assurance on internal controls.

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 audit objectives:

- Accounting records and reports
- Cash receipts and disbursements
- Occupancy requirements

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:

- Accounting records and reports
- Cash receipts and disbursements
- Occupancy requirements

These weaknesses are detailed in the findings in this report.

Follow Up On Prior Audits

This was the first OIG audit of Dorchester Square Apartments.

Schedule of Ineligible and Unsupported Costs

Finding Number	Ineligible 1/	Unsupported 2/
1	$ 33,932	
2	79,531	
3		$104,604
	$113,463	$104,604

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

2/ Unsupported costs were not clearly eligible or ineligible but warrant being contested because of the lack of documentation supporting such costs.

Auditee Comments

Distribution

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