

AUDIT RELATED MEMORANDUM
96-CH-212-1807

March 29, 1996

MEMORANDUM FOR: Robert J. Turner, Director, Office of Housing, Michigan State Office

FROM: Dale L. Chouteau, District Inspector General for Audit, Midwest

SUBJECT: McKinley Associates
Multifamily Equity Skimming
Ann Arbor, Michigan

We completed an audit of the books and records of five HUD-insured and HUD-held projects owned by McKinley Associates. The five projects were insured under Section 223 (f) of the National Housing Act. McKinley Associates managed the properties through its identity-of-interest management agent, McKinley Properties, Inc. The projects were in the Ann Arbor, Michigan area. The following table shows the project names and the number of units.

Project	Units
Scenic Lake	477
Pinewood Village	252
Schooner Cove II	228
Park Place	312
Glencoe Hills	583

The audit objectives were to determine whether the use of project operating funds was reasonable and complied with the Regulatory Agreement and applicable HUD requirements. Our specific objectives were to determine whether the owners: made distributions only from available project surplus cash; assured that all project expenses were reasonable in amount and necessary to the operations of each project; and made all needed repairs to the buildings.

The owners of McKinley Associates were Ronald Weiser, William C. Tyler, and D. Keith Hayward. During the audit, Mr. Hayward was the official representative. The books and records for the projects were at McKinley Properties. The Company's main office was at 320 N. Main Street, Ann Arbor, Michigan.

Our audit covered the period January 1, 1991 to June 30, 1994. We extended the coverage as necessary. We conducted the audit at McKinley Properties, Inc. between July and October 1994.

We concluded that McKinley Associates did not fully comply with the Regulatory Agreement and other HUD requirements. Contrary to the Regulatory Agreement, the owners withdrew \$411,662 of project funds in excess of surplus cash from Glencoe Hills in 1994. During the audit, the owners reimbursed the project account for these withdrawals. Therefore, no further follow-up is needed regarding this issue.

Between 1991 and 1994, the owners also made other ineligible disbursements totaling \$175,217 from the projects. Four projects were in default at the time the ineligible payments were made, and HUD's most recent inspection of one project, Scenic Lake, found the project's physical condition to be below average with required repairs totaling \$133,350. HUD rated the other three projects, Pinewood, Schooner Cover, and Park Place, satisfactory on their most recent inspections. The remaining project, Glencoe Hills, was current on its mortgage, but had deferred maintenance repairs totaling \$156,870. Attachment 1 describes in more detail our finding regarding the \$175,217.

We provided our draft findings to Mr. Hayward and the Michigan State Office during the audit. We held an exit conference on December 5, 1994. The auditee provided us written comments to our draft finding and recommendations, which are summarized in the attached finding. A copy of the complete comments is included in Attachment 2. The auditee did not agree with our finding.

Please furnish us copies of correspondence or directives issued because of the audit. If you have question, please contact me or my assistant, Kathleen Creighton, at (312) 353-7832.

McKinley Associates Made Ineligible Disbursements

Between 1991 and 1994, McKinley Associates made ineligible disbursements totaling \$175,217 from five HUD-insured projects. The disbursements were made to the identity-of-interest Management Agent. The payments were for: legal costs; collection costs; project telephone charges; general administration costs; travel and meal costs; and delivery expenses and photocopy costs. The Agent's Treasurer told us he was unaware that certain management agent costs could not be charged to the projects. Because of the ineligible disbursements, the projects had fewer funds available for normal operations. Four of the projects were in default at the time the ineligible payments were made. The remaining project had deferred maintenance totaling \$156,870.

HUD Requirements

The Regulatory Agreement addresses the requirements for payments of management fees and management costs. Paragraph 7(a) requires the owners to assure that all project expenses are reasonable in amount and necessary to the operation of the project. Paragraph B7(b) requires the owners to comply with the Secretary's administrative requirements regarding the payment and reasonableness of management fees and allocation of management costs between the management fee and the project account. Paragraph 7(d) allows the owners to purchase goods and services from identity-of-interest individuals. However, the charges leveled by those individuals may not be more than the costs that would be incurred in making arms-length purchases on the open market.

The projects' Management Certifications say that the Agent agrees to comply with Lender and HUD requirements regarding payment and reasonableness of management fees and allocation of management costs. Paragraph 4(a) states that the Agent agrees to assure that all project expenses are reasonable and necessary to the operation of the project.

HUD Handbook 4381.5 Rev-1, Management Documents, Agents and Fees, paragraph 2-14(B) requires that the Agent's overhead and office costs of front-line personnel

who do not work at the project site be covered by its management fee. Paragraph 2-15(H) states that Agents may not impose surcharges or administrative fees on top of the actual costs. Figure 2-4 of the Handbook shows the types of overhead expenses. They include: supplies and equipment; transportation and phone calls to projects; and office space. Paragraph 2-14(A) states that the management fee must pay for salaries, fringe benefits, office expenses, fees and contract costs incurred in recruiting, hiring, and supervising project personnel, monitoring project operations, analyzing and solving project problems, and overseeing investments.

Ineligible payments totaling \$175,217 were made to the identity-of-interest Management Agent

Between January 1, 1991 and June 30, 1994, five HUD-insured projects made ineligible payments totaling \$175,217 to the identity-of-interest Management Agent. The payments were for: legal costs; collection costs; project telephone charges; general administration costs; travel and meal costs; and delivery expenses and photocopy costs. A table showing the payments by project and description of the payments follow.

Account Title	SCENIC LAKE	PINEWOOD TWNHSES	SCHOONER COVE II	PARK PLACE	GLENCOE HILLS	Total
Legal Costs	\$51,112	\$2,691	\$16,236	\$14,931	\$17,415	\$102,385
Collections	\$11,484	\$6,567	\$2,924	\$2,931	\$9,221	\$33,127
Telephone	107	1,360	393	516	938	3,314
General Admin	141	104	486	516	1,981	3,228
Travel/Meal	616	538	384	516	768	2,822
Delivery/ Print	123	5,710	5,303	6,695	12,510	30,341
TOTAL	\$63,583	\$16,970	\$25,726	\$26,105	\$42,833	\$175,217

Legal Cost. The Management Agent charged the projects excessive legal fees. The Agent's legal staff prepared and filed tenant eviction notices, attended court hearings, and held telephone conferences. Between 1991 and 1993, the Agent charged the projects \$35 per case and between \$40 and \$110 per hour for staff time. HUD regulations permit the owners to purchase services from identity-of-interest individuals. However, the charges may be no greater than

they would be on the open market. If the Agent had used outside attorneys, the projects' costs for processing evictions would have been substantially less. Beginning in 1993, the Agent used outside attorneys to process eviction cases. We reviewed the invoices submitted by the outside attorneys. The average charge per case was \$37. If the Agent had used outside attorneys all along, the projects would have paid \$102,385 less in legal costs for tenant evictions.

Collection Fees. The Agent improperly charged the projects \$33,127 for ineligible collection fees. The Agent charged the projects for rents and rental assistance payments collected for tenants still occupying their units, or within the first month a tenant vacated the unit. Such costs are included in the management fee.

Telephone Costs. The Management Agent charged the projects \$3,314 for telephone calls. These calls were made from the Agent's office or mobile telephone to the project sites. The Agent billed the projects on a pro-rated basis or for actual costs. According to HUD regulations, telephone calls to project sites were part of the Agent's overhead costs and should have been paid from the management fee. Therefore, such expenditures were not eligible project costs.

General Administrative Expenses. The projects improperly paid \$3,228 to the Management Agent for administrative costs. The payments included the costs of a newsletter and petty cash expenses such as, office supplies, food, and dry cleaning. These administrative costs were part of the Agent's overhead and therefore, ineligible project expenses.

Travel and Meal Costs. The Management Agent charged the projects \$2,822 for employee travel to the projects and for meals. The Agent divided the costs among the projects based on the number of units in each project. The costs of travel to the projects and meals were part of the Agent's overhead, and the Agent should have paid for them from the management fee.

Delivery and Photocopy Expenses. The projects paid the Management Agent \$30,341 for postage and copying costs. The Agent charged the projects for postage and copying

costs based on \$.60 per unit per month. The copying costs were for photocopies of the projects' bills at the Agent's office. Such expenditures were not eligible project costs.

The Treasurer for the projects' general partnership said he was not aware that the Agent could not charge certain management agent costs to the projects. The Treasurer also said the Agent undercharged the projects for allowable costs such as payroll taxes and workers compensation. We believe that undercharging the projects for allowable project expenses was not justification for charging the projects for ineligible costs.

The project's owners could have used the ineligible disbursements to pay normal project expenses. Four of the HUD projects - Scenic Lake, Pinewood, Schooner Cove, and Park Place - defaulted on their mortgages. The mortgage for Glencoe Hills was current. HUD's most recent physical inspections showed the condition of Scenic Lake and Glencoe Hills to be below average. Needed repairs totaled \$133,350 and \$156,870, respectively. The physical conditions of Pinewood, Schooner Cove, and Park Place were satisfactory.

Auditee Comments

The auditee did not agree with the finding. The projects' Chief Financial Officer provided the comments. Excerpts from his comments on our draft finding follow. The complete text is on Attachment 2.

The Agent provided the auditors with a summary of the annual direct costs of the legal department. The hourly direct cost of the department based upon annual salaries of the staff plus taxes and fringe benefits was \$50.45 per hour. The auditors incorrectly calculated the hourly direct cost (of staff time) by computing an average of the salary amounts instead of combining them. The correct total hourly cost of the department is the cost of the attorney and the support staff divided by the total billable hours of the attorney which is 52 weeks less 4 weeks for vacation and sick time, or 1,920 hours.

The \$35 flat rate charge per case is a standard practice used by most attorneys doing tenant eviction cases. This cost

covers (i) the time the staff spends on preparing the paperwork for filing the case, (ii) time of the attorney reviewing the filings, (iii) making the copies required; and (iv) physically filing the case with the court.

OIG Evaluation of
Auditee Comments

After the auditee's submission of his comments we re-evaluated our method for determining the allowable legal expenditures. In reviewing the auditee's records we determined that the auditee's outside attorneys charged an average of \$37 per case. In no instance, did the outside attorneys charge a flat \$35 charge on top of the hourly rate. HUD regulations allow the owners to obtain legal services from identity-of-interest individuals, but the charges may not be more than the cost incurred for such services in the open market. In this case, that was \$37 per case.

Auditee Comments

The auditors fail to mention that the outside attorneys also charge an hourly rate of \$50 per hour by the first attorney and \$75 for the first two hours and \$75 per hour for additional hours by the second attorney that is the same or greater than the rates charged by Agent's legal department.

The amount of the alleged excessive charges relating to Glencoe Hills would increase the surplus cash calculation at December 31, 1993, allowing a greater distribution, and would not impact the property's cash position.

OIG Evaluation of
Auditee Comments

We reviewed the invoices submitted by the outside attorneys for processing evictions. We found that the outside attorneys charged an average of \$37 per case. In determining the average charge per case, we included all outside attorneys' charges including any hourly billings.

Though Glencoe Hills may have surplus cash, the HUD inspection done during our audit showed the project had deferred maintenance totaling \$156,870. So, the owners should use the surplus cash to fix up the project.

Auditee Comments

Telephone. The items pointed out by the auditors are primarily for specifically identified long distance charges originating from the Corporate Office for properties and cellular phone charges that were allocated on a prorata basis. Marketing staff who made the cellular phone charges for all five properties worked at all properties and made phone calls on their cellular phones for the properties. The telephone charges are not ineligible property costs because they directly benefitted the properties, not the Management Agent.

The phone calls in question were made from the Agent's office or cellular phone to the projects.

OIG Evaluation of
Auditee Comments

According to HUD regulations, telephone calls to the projects' sites were part of the Agent's overhead costs, and the Agent should have paid for them from the management fee. Therefore, the phone calls were ineligible project expenditures.

Auditee Comments

General Administration. The auditors disqualified reimbursements for the cost of producing a company newspaper that was distributed to each of the property's employees. The newsletter benefits the property employees directly and the properties indirectly and not the Agent by building team spirit and morale.

Petty cash reimbursements were for office supplies used at the properties, food for employee and resident functions and other property related goods and services. These are reasonable property-related costs and are not part of the Agent's overhead.

OIG Evaluation of
Auditee Comments

The costs of producing the Agent's newspaper was part of the Agent's overhead costs and therefore, the Agent should have paid them from the management fee.

Our finding questioned those petty cash reimbursements that came from the Agent's petty cash and were charged to the projects. During the audit we repeatedly requested that the auditee produce evidence that the Agent made petty

cash payments for the benefit of the projects. The auditee produced no such evidence. In January 1995, after receiving the auditee's comments, we again requested the auditee provide support. The Agent's Treasurer told us he decided not to look for the support because it was not cost beneficial to spend the time. He considered the amounts as minor. Therefore, we believe the Agent should pay back the projects.

Auditee Comments

Travel and Meal Costs. Reimbursement to property employees for meals and mileage while conducting business for the properties is a reasonable property expense. The amount of \$2,822 for 3½ years for five properties does not seem unreasonable. The auditors disqualified \$653 of reimbursements included in this amount for a company-wide drawing for a one-week vacation for two people that was performance based and open to employees of all properties. Employees were eligible for the drawing only if they achieved certain occupancy and delinquency collection goals. This is a reasonable property expense that directly benefitted the properties. The expense was charged to all McKinley residential units on a prorata basis according to the number of units at each property.

OIG Evaluation of Auditee Comments

We did not question the reimbursement for meals and mileage to the projects' employees. We only questioned reimbursement to the Agent's employees that the Agent paid from project funds. In January 1995, after receiving the auditee comments, we again asked the auditee to provide proof to support their assertion that the costs for meals and travel were incurred for project employees rather than Agent employees. The Agent's Treasurer told us it was not cost beneficial for him to pursue the issue beyond giving us a verbal explanation. Therefore, the Agent should reimburse the project the amount of \$2,822.

In January 1995 the Agent's Treasurer provided us a memorandum explaining the marketing program that was open to all Agent employees. The winner received a boat cruise. The projects' Management Certification states that the Agent agrees to assure that all project expenses are reasonable and necessary to the operation of the project.

Therefore, we disallowed the \$653 charged to the projects for the boat cruise drawing.

Auditee Comments

Delivery and Photocopy Expenses. The Agent charged \$.60 per apartment unit per month to reimburse the Agent for the cost of postage for mailings for the property and to reimburse for the cost of making copies for the property's benefit. The postage was for mailing the payments of bills, security deposit returns, delinquency demands and traces, reports to HUD, auditor verification requests, federal, state, and local tax returns and other required governmental reports, with other property related correspondence. The photocopy costs were for copies of the above items that were necessary to keep for the properties and for various report and management forms that were used by the properties and maintained on site. The properties would have incurred these costs directly if these items had been posted from the properties and all copying and forms reproduction had been completed at the sites. The cost of overnight mail was charged to the properties when it was necessary to send documents to a third party or to the property overnight. Overnight mail costs were paid to non-identity-of-interest third party vendors. The delivery and printing expenses noted by the auditors are reasonable property expenses.

OIG Evaluation of
Auditee Comments

HUD Handbook 4381.5, Management documents, Agents, and Fees, Revision 1 requires that office and overhead expenses of front-line personnel who do not work at the project site to be paid from the management fee. Therefore, the postage charges and photocopying from the Agent's office are part of the Agent's overhead cost. During our subsequent review of documentation provided by the auditee, we reduced ineligible costs to allow for overnight delivery charges.

Recommendations

We recommend that the Michigan State Office's Director of Housing requires the projects owners to:

- A. Reimburse Glencoe Hills Apartments for ineligible and unsupported expenses totaling \$42,833 paid to the Agent.

- B. Repay HUD ineligible expenses totaling \$132,384 paid to the Agent from the projects that were in default - Scenic Lake, Pinewood, Schooner Cove II, and Park Place.
- C. Implement procedures and controls to ensure that all disbursements of projects funds are eligible and supported.

We also recommend that the Michigan State Office's Director of Housing:

- D. Consider imposing administrative sanctions against the owners to the full extent of the law.