Issue Date March 29, 1996	
Audit Case Number 96-SF-212-1004	

TO: William F. Bolton, Director, Multifamily Division, Sacramento Area Office, 9GHM

FROM: Mark Pierce, Senior Auditor, 9AGA

SUBJECT: Harvest Oaks and Auburn Palms
Multifamily Mortgagor Operations
Lincoln and Auburn, California

We reviewed selected activities of multifamily projects Harvest Oaks and Auburn Palms located in Lincoln and Auburn, California. Both projects had the same general partner and were managed by an identity-of-interest company. The audit found that the general partner:

- made, or caused to be made, misrepresentations to the Department by inflating project income and tenant occupancy for Harvest Oaks in an apparent attempt to convince HUD to approve a second similar project. (Harvest Oak's insured mortgage loan subsequently went into fiscal default.)

- received distributions of at least $187,270 of Auburn Palms assets and income greater than the maximum permitted by the regulatory agreement.

- violated other requirements of the regulatory agreements governing project operations such as not maintaining adequate accounting records and not submitting financial data to HUD.

BACKGROUND

Harvest Oaks

HUD's Federal Housing Administration (FHA) insured the mortgage loan of Harvest Oaks (project 136-43052) under Section 232 of the *National Housing Act*. Lincoln Retirement Community, a California Limited Partnership, owns the project. The general partners are Frank and Beverly Aiello, and the limited partners are Daniel, David, Allison, and Lee Anne Aiello. R.S. Management Company, an identity-of-interest firm, managed the project.

The project is a 50-room, 100-bed board and care facility for the elderly located in Lincoln, California. The residents are provided meals, activities, 24-hour staff support, and other services. R.S. Management leases office space in the building. The owners defaulted on the Harvest Oaks mortgage loan on March 1, 1994, and on April 29, 1994 the lender assigned the mortgage to HUD. HUD put its foreclosure proceedings on hold when the owners filed for bankruptcy protection under Chapter 11.

Auburn Palms

FHA insured the mortgage loan of Auburn Palms (project 136-44249), located in Auburn, California, under Section 236 of the *National Housing Act*. Section 236 is an interest-reduction program by which the interest rate paid by the owner is reduced with the Department paying the difference. Frank and Beverly Aiello own the fifty-unit apartment complex for the elderly, and manage it through R.S. Management. The terms and conditions of the regulatory agreement limit the owners to annual distributions of six percent on the initial equity investment. The development also receives Section 8 subsidies from HUD, reducing the amount of rents paid by eligible tenants.

OBJECTIVES AND METHODOLOGY OF THIS AUDIT

The initial purpose of an audit of HUD-insured projects Harvest Oaks and Auburn Palms was to determine whether the owners made improper distributions of project assets and income. As the audit progressed, certain issues arose that caused us to modify the audit objectives. The revised audit objectives were to determine whether:

- reliable rental receipt totals and occupancy levels of Harvest Oaks were reported to the Department in 1991 and 1992, and

- improper distributions of Auburn Palms assets and income were made to the owners.

The memorandum-in-hand also reports on other instances of noncompliance with the terms and conditions of the regulatory agreements that came to our attention.

The audit generally covered the period from January 1991 to December 1994.

To accomplish the audit objectives, we:

✓ considered the organization's internal control systems to determine auditing procedures and not to provide assurance on internal control. We determined that the following internal control systems were relevant to the audit objectives.

  - accounting records and reports

  - cash receipts and revenues

  - cash disbursements and expenses

  We assessed these systems by obtaining an understanding of the control structure and determining the risk exposure. We did not assess control effectiveness due to the lack of an adequate accounting system and a weak control environment.

- ✓ analyzed and verified selected information contained in financial statements and monthly reports.
- ✓ interviewed staff of R.S. Management, Auburn Palms, Harvest Oaks, HUD Sacramento office, and public accountants who performed audits of the two projects.
- ✓ tested available accounting records of R.S. Management, Auburn Palms, and Harvest Oaks.
- ✓ compiled tenant rental income and occupancy levels from available records maintained by Harvest Oaks and R.S. Management.
- ✓ verified a sample of tenant occupancy data by contacting prior tenants or their responsible parties.
- ✓ examined project bank records obtained under OIG administrative subpoenas.

We conducted the audit in accordance with generally accepted government auditing standards except we did not obtain formal comments of the Aiellos concerning the audit results and conclusions. Thus, the audit does not consider the owners' position on the audit conclusions. We did hold informal discussions with Frank Aiello on issues discussed here.

RESULTS OF AUDIT

We concluded that the general partner: (1) made, or caused to be made, misrepresentations to the Department by inflating project income and occupancy levels at Harvest Oaks, (2) received distributions of at least $187,270 of Auburn Palms assets and income greater than the maximum permitted by the regulatory agreement, and (3) violated other requirements of the regulatory agreements governing project operations.

OCCUPANCY LEVELS AND PROJECT INCOME WERE INFLATED

Harvest Oaks revenues and occupancy were, as reported to HUD, significantly overstated. Reported rents from residents and project occupancy levels for 1991 and 1992 were up to twice the actual amounts. The financial viability of the project was also embellished by including in the financial statements related-party transactions at values significantly higher than market. The misrepresentations made to HUD by the owners appear to violate Section 1001 of Title 18 of the United States Code, which makes it a criminal offense to make a willfully false statement to any department or agency of the United States as to any matter within its jurisdiction. HUD had told the owners that it would endorse a sister project the owners planned to build in Grass Valley if Harvest Oaks was financially viable. The owners apparently falsified the actual conditions of Harvest Oaks to influence HUD to conclude that the project was financially viable, when in fact it was not.

Statements Made by Owner and Staff Caused Us to Question Reliability of Information

We began the audit of Harvest Oaks in September 1994 principally to determine whether the owner made improper distributions of project assets and income. The owners defaulted on the Harvest Oaks mortgage payments in March 1994. Financial reports submitted to HUD showed that the project was generating sufficient cash to satisfy the mortgage payments. However, based on comments made by the owner and the staff, we modified the audit objective to determine whether the total rental receipts and occupancy levels previously reported to the Department were reliable.

The owner indicated to us that the information previously reported to HUD was inaccurate. Frank Aiello told us that he was supporting the project with his funds. A December 27, 1994 letter to HUD from Aiello's legal counsel asserted that Mr. Aiello personally subsidized the project at $30,000 a month since its opening. Also, on January 4, 1995 Frank Aiello told us that Harvest Oaks' tenant rental income averaged about $38,000 to $40,000 per month, which is only enough to cover payroll and accounts payable. The owners had previously reported to HUD that monthly tenant rental receipts were over $70,000.

In addition, Harvest Oaks staff told us that information previously reported to HUD was inaccurate. The manager of Harvest Oaks stated that the previous manager had asked her to come in during the evening to help make vacant rooms appear to be occupied. The project administrator stated that HUD was told the occupancy was about 85 percent. (HUD records show that on January 19, 1993 it was told by management that the project was 83 percent occupied.) He also said that 1994 occupancy levels of slightly over 50 percent were the highest to date.

OIG Compiled Data Due to Poor Condition of Records

The project lacked an accounting system that readily permitted the tracking of the collection and use of project receipts. To evaluate rental income amounts and occupancy levels, it was necessary for us to compile data from tenant occupancy records maintained by both Harvest Oaks and R.S. Management personnel. We used three sources of information from the project and management agent: (1) tenant ledger cards and tenant files maintained by Harvest Oaks, (2) R.S. Management tenant ledger cards, and (3) infrequent monthly cash receipt journals prepared by R.S. Management. Based on information compiled from these sources, we estimated the annual tenant rental receipts and occupancy levels for the years 1991 to 1994. To test the reliability of our estimates, we contacted a random sample of tenants or their responsible parties to verify tenancy periods. Also, we subpoenaed bank records, including deposited items, to verify tenant rental receipts and tenancy periods. Based on these tests, we concluded that the tenant rental receipts and occupancy levels compiled from tenant occupancy records are generally consistent and reliable.

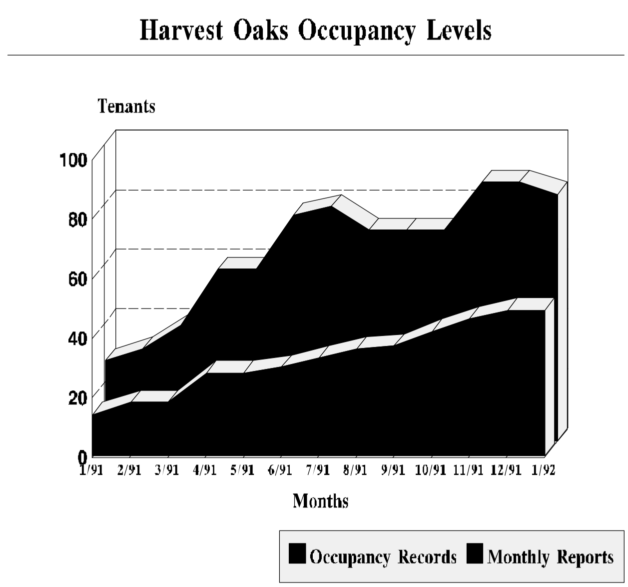
Data obtained from available 1991 and 1992 bank records did not differ materially from information compiled from tenant occupancy records. R.S. Management deposited tenant rental receipts into Harvest Oaks' operating account at Bank of America until August 1991, after which a new operating account was opened at U.S. Bank. We received incomplete 1991 data from the banks due to the age of the requested records. (We identified $93,599 [30 percent] of total 1991 tenant receipts of $315,318.) Most of the 1992 records were received. On a per-tenant-basis, the tenant receipts shown in the bank records, when provided, generally agreed with rental receipts identified from tenant occupancy records. Also, the bank records did not disclose any tenants not previously identified in the tenant occupancy records.

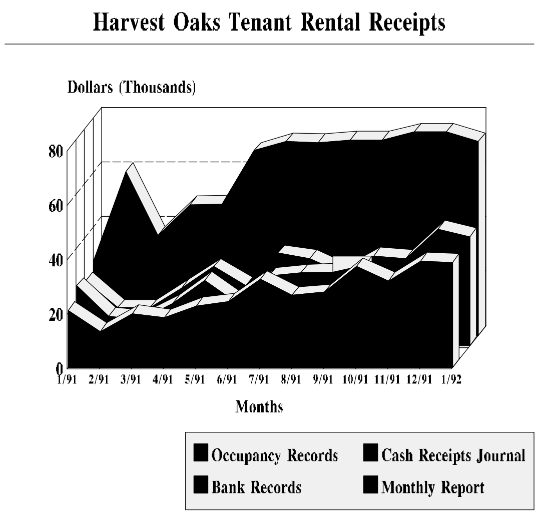
Tenant rental income reported in the 1991 and 1992 audited financial statements were apparently based on amounts deposited into the project's operating account. It appears that deposits of $230,361 in 1991 were actually owner advances. During eight months of the year, large payments were deposited into the project's operating accounts, most from wire transfers. The lump-sum advances ceased in 1992; however, in August 1992 a $67,197 check related to another Aiello project was deposited into the Harvest Oaks account and counted as project revenue.

The public accountant firm Marcia L. Fritz, CPA (conducted 1993 audit) concurred with our conclusions concerning the 1992 rental receipts and made the appropriate prior period adjustments to the financial statements. The adjustments eliminated a $195,236 asset amount (due from related party) and significantly reduced partner's equity. The 1993 audited financial statements show that the tenant rental income totalled $445,628, which is consistent with our estimate of 1992 tenant receipts of $474,054.

Inaccurate Information Submitted to HUD on Monthly Accounting Reports

Monthly accounting reports submitted to HUD inflated tenant rental income and occupancy levels. The owners submitted monthly reports (form HUD-93479) for the period January 1991 through January 1992. We compared the data shown on the monthly reports with tenant occupancy records and concluded that rental incomes and occupancy levels reported to HUD by management were about twice the amounts supported by management's records. Consequently, misrepresentations appear to have been made to the Department.





HUD records showed that it was withholding endorsement of Mr. Aiello's proposed board-and-care center in Grass Valley until satisfied that Harvest Oaks was financially viable. A November 18, 1991 internal HUD memorandum concluded, based on monthly accounting reports from January 1991 to May 1991, that the project's financial position was not stable enough to approve another project. Subsequent monthly reports showed higher and more stable occupancy levels and rental receipts. The June 1991 monthly report showed a $19,547 increase in rental income and an 18-tenant increase in occupancy. Following monthly reports showed that rental receipts remained at a stable level, despite fluctuations of the occupancy levels. (Reported occupancy decreased by 8 tenants in August 1991, and increased by 16 tenants in November 1991.)

Inaccurate Information Reported on Annual Financial Reports

The 1991 and 1992 audited financial statements included material misrepresentations of rental income by management. The 1991 audited financial statements for Harvest Oaks showed tenant rental income of $726,666. The 1992 financial statements showed rental income of $632,553. Project records supported 1991 tenant rental income of only $315,318, which is $411,348 less than the $726,666 shown in the 1991 financial statements. Likewise, the 1992 project records only supported tenant rental income of $474,054, or $158,499 less than the $632,553 shown in the audited financial statements.

We attempted to review the public accountants' workpapers supporting the 1991 audit; however the accountant, Steve Grimm, told us that a flood destroyed his workpapers. We did review workpapers supporting the 1992 audit of the project by Tate, Propp, Beggs, and Sugimoto, CPAs and Consultants. Their workpapers showed that tenant rental income was based on deposits made to the project's operating account. As mentioned earlier, the bank records showed significant deposits made from wire transfers and other non-tenant sources.

The overstatement of tenant rental income by management caused the 1991 and 1992 financial reports to be misleading. Net income was overstated by $569,847 ($411,348 in 1991 and $158,499 in 1992); owners equity was overstated by $569,847; liabilities (amounts due to related party) were understated by $411,348 in 1991; assets (amounts due from related party) were overstated by $158,499 in 1992; and the statement of cash flow showed $569,847 coming from tenants rather than owner advances. The owners certified that the financial statements are true, accurate and a complete presentation of the financial facts; however, in our opinion the owners knew that the financial statements contained material errors because they supported the project with funds from other sources.

Inaccurate Information Provided to HUD On-Site Inspector

Management reported an inflated number of occupied units to a HUD inspector on a site visit. On January 19, 1993 a HUD loan specialist made an on-site review of Harvest Oaks. The specialist interviewed Beverly Aiello and the project manager and was told that the development was 83 percent occupied. Also, on September 13, 1993 J P Mortgage Company (mortgagee) made a physical inspection of Harvest Oaks. The inspector reported that out of 100 units, 14 were vacant (86 percent occupancy), but the source of this information is not indicated. The mortgagee forwarded the physical inspection report to HUD on December 21, 1993.

Related Party Transactions Valued Above Market Rates

The financial viability of the project was also enhanced by related party transactions valued by management at rates above market. The 1991 through 1993 financial statements reflected substantial earnings from related party transactions for laundry services and office lease. Harvest Oaks earned laundry services from Lincoln Care Center, a nursing home owned by the Aiellos. During the three year period the project received a total of $794,796 for cleaning the nursing home's laundry ($261,324 in 1991, $269,952 in 1992, and $263,520 in 1993). Harvest Oaks ended the laundry services when a commercial linen firm took over in December 1994. The branch manager of the firm estimated it will cost an average of $3,000 to $4,000 per month to do Lincoln Care Center's laundry, which amounts to $36,000 to $48,000 per year. The independent contractor's cost for providing laundry services is significantly lower (at least $213,000 per year) than laundry services income reported in the financial statements.

Likewise, management valued office-lease income above market rates. In the same period, the project received lease income of $111,600 for providing office space to the owner-related management agent, R.S. Management ($33,600 in 1991, $43,800 in 1992, and $34,200 in 1993). Based on the square footage of office space used by R.S. Management, we estimated that the project received a monthly average lease income of $2.26 per square foot. A local realtor told us that the market value for office space in Lincoln is $1.19 per square foot. The cost R.S. Management would have paid if it had leased the office space elsewhere in Lincoln is significantly lower (almost 50 percent) than office lease income reported in the financial statements. Paying higher than market rates for laundry services and office lease enabled the owners to advance the project funds without the appearance of doing so. Thus, the project appeared to be more financially viable than it really was.

IMPROPER DISTRIBUTIONS OF AUBURN PALMS ASSETS AND INCOME

In our opinion, the owners received unauthorized distributions of Auburn Palms assets and income. The regulatory agreement limits distributions to annual payments of six percent on the initial equity investment if surplus cash is available. The owners violated the regulatory agreement by taking distributions of $187,270 in excess of the allowable annual disbursement. As of fiscal year ended December 31, 1993, the owners owed the project $164,129, representing the balance of project cash transferred to a commingled account. In addition, the owners received undisclosed distributions of $30,679 during 1992 using inflated payroll expenses. Thus, these distributions totaling $194,808 exceeded the amount allowed of $7,538 by $187,270. Also, questionable payroll expenses of $120,597 may have been used to disguise distributions received in prior years. As a result, the funds were not put under HUD's control as required.

Distribution Requirements

Paragraph 6(e)(1) of the regulatory agreement shows that *"All distributions shall be made only as of a semiannual or annual fiscal period . . . [and] all such distributions in any one fiscal year shall be limited to six per centum on the initial equity investment, as determined by the Commissioner . . ."* If surplus cash exceeds the maximum distribution amount, paragraph 2(c) requires that the excess be deposited in a separate account which shall be under the control of the Commissioner to be available for future legitimate project needs.

Paragraph 9(g) of the regulatory agreement shows that *"All rents and other receipts of the project shall be deposited in the name of the project in a bank . . . Such funds shall be withdrawn only in accordance with the provisions of this Agreement for expenses of the project . . . or for distributions of surplus cash as limited by Paragraph 6(e)."*

The owners' equity investment equalled $62,823. Therefore the owners were entitled to annual distributions of $3,769 (6 percent of $62,823) from available surplus cash.

Excessive Distributions Identified in Audited Financial Statements

The most recent audited financial statements showed that the owners received unauthorized distributions. The Auburn Palms balance sheet for the year ended December 31, 1993 included a current asset, due from related party, of $164,129. The due-from-related-party balance accumulated during 1992 and 1993. The amount represented project funds transferred to a commingled account in excess of claimed project-related uses. As discussed in the next several paragraphs, the commingled account was used for receipts from HUD-insured projects as well as businesses owned by Frank and Beverly Aiello. Since the project funds were not maintained in a separate account and were not supported by eligible project expenses, the balance represented an unauthorized use of project assets and income.

Handling and Use of Project Income

The project's operating account was set up to funnel project receipts to a non-project account. Tenant, cable, and laundry income collected by the on-site manager was deposited into a bank account in the name of the project. The operating account was not a normal account, rather it was a "zero-balance account," or "sweep account" where funds were transferred immediately to another account. Project funds flowed into the R.S. Management account, which was commingled with funds of other businesses owned by the Aiellos. In addition to business expenses, the commingled account was also used to pay personal expenses of the owners. The sweep account circumvented HUD's requirement that all project funds be maintained in a separate account in the name of the project. Monies allocable to the various owner-related projects and businesses were not readily determinable due to the commingling of funds and the absence of an adequate accounting system.

The owners had tenant rental subsidies payments wired directly into their personal account. In July 1994, the owners submitted a direct deposit form to HUD's accounting division directing the Department to wire funds into a bank account named Frank and Beverly Aiello dba Fallowfield. Fallowfield is the name of the owners' ranch. Subsidy payments began flowing to the

Fallowfield account in August 1994. Prior to August, the Department wired Section 8 subsidies to the R.S. Management commingled account as the owners requested.

The regulatory agreement stipulates that project funds must be maintained in a separate account, which means project funds must not be commingled with other funds. All disbursements from the regular operating account including checks, wire transfers, and computer generated disbursements must be supported by invoices, bills, or other documentation. Project funds should only be used to: make mortgage payments, pay reasonable expenses necessary for the operation and maintenance of the project, pay distributions of surplus cash as permitted, and repay owner advances as authorized by the Department. The owners violated paragraph 6(b) of the regulatory agreement by transferring funds from the project operating account without support from invoices, bills, or other documentation.

Additional Distributions Were Due to Inflated Expenses

The Auburn Palms 1992 financial statements included unsupported payroll costs of $30,679. It appears that the owners inflated payroll expenses in order to receive excess distributions without HUD's knowledge. The owners were able to inflate payroll costs by manipulating information reported in the financial statements, which was accomplished by the lack of an adequate accounting system and the owner's ability to mislead the public accountants. As a result of the misrepresentations, undisclosed distributions of $30,679 were received by the owners during 1992. Mr. Aiello was apparently aware that these expenses were inflated because he had no proper basis for asserting to the public accountants that they had omitted payroll expenses of $30,679 for 1992. Mr. Aiello gave the public accountants figures shown in the 1991 financial statements.

Only the payroll costs of on-site managers were readily determinable. It was necessary to interview project employees to determine who else worked at the project and to estimate how much time workers spent at the project. To estimate the actual Auburn Palms payroll, we examined the IRS W-2 employee earnings forms issued at the end of the year for employees determined to have worked at the project, considering the approximate portion allocable to the project as described below.

The employees informed us that there was usually an on-site couple managing the project and an assistant manager. The project administrator claimed that a maintenance worker was on-site 2 to 3 days per week. A maintenance worker also told us the same thing. R.S. Management generally had three maintenance workers that rotated among projects. Because of inadequate time cards, there was little documentation to support the maintenance payroll allocable to Auburn Palms. The maintenance workers did not keep track of their time. However, R.S. Management sometimes used time cards to keep track of the maintenance workers. Also, a project manager sometimes maintained a log that described on-site work done by the manager, assistant manager, and the maintenance workers. The time cards and the log showed that primarily two maintenance workers usually worked at the project, one for approximately 30 percent of the time and the other 20 percent. We allocated a conservative 50 percent share of the two maintenance workers salaries to the project. Based on this information, we estimate that the annual gross payroll of Auburn Palms equalled $20,530 in 1992. Our payroll estimate is comparable with the $20,214 shown in the 1992 financial statements under the managers and repairs payroll expenses.

The 1992 audited financial statements showed total payroll expense of $50,893, which was 60 percent more than the payrol costs we identified. The difference primarily can be related to an unsupported adjustment made by the public accountant of $30,679. The adjustment consisted of payroll expenses as folows: Janitor - $4,007, Grounds - $17,689, and Decorating - $8,983. These additional salaries were identical with payroll expenses shown for the same positions in the 1991 financial statements, but it would be unlikely that workers paid hourly would be paid the same in successive years. The public accountant told us that, after owner Frank Aiello reviewed the draft financial statements, he informed them of the additional payroll expenses. The public accountant accepted the expenses as reasonable after they performed an analytical procedure where the payroll expenses were compared with prior year totals. The test showed that the additional wages did not materially differ from wages reported in the prior year. There was no material difference since the 1991 and 1992 amounts were identical. Such a test is faulty if previous years' expenses are also overstated.

The recently audited 1993 financial statements show payroll expenses comparable to our estimates. A different accounting firm audited these financial statements. The year's payroll expenses for the project totaled $17,422, which is consistent with our estimate of 1992 payroll expenses of $20,530. There was no evidence to suggest that the development operated any differently in previous years.

Payroll Costs from Prior Years are Questionable

Similarly, previous years' payroll expenses were not supported, and they also appeared to be inflated. The 1989 to 1991 audited financial statements showed that, like 1992, payroll expenses were reported in addition to managers and repairs salaries. During the three-year period, reported expenses totalled $194,273 (averaged $64,750 per year). This includes expenses of $120,597 shown under job classifications that were overstated in 1992. The expenses were allocated as follows: Janitor - $27,759; Grounds -$40,994; Decorating - $32,510; and Pest Control - $19,334. Reducing the total payroll expenses by the questionable expenses equals $73,676, which averages $24,500 per year. The reduced amounts are more consistent with our estimate of 1992 payroll expenses.

OTHER REGULATORY AGREEMENT VIOLATIONS

We identified other violations of the regulatory agreements during the audit:

- inadequate accounting records
- improper encumbrances
- default of insured mortgage loan
- overdue financial statements
- monthly accounting reports not submitted
- tenant security deposit funds not accounted for

We consider these violations to be very serious. In our opinion, they are largely the result of the owners' disregard of HUD requirements. One effect of these conditions is to conceal or delay disclosure of project operations to regulatory agencies such as HUD and to raise the extent and likelihood of mortgage loan default. Discussions of regulatory agreement violations not already discussed are as follows:

Inadequate Accounting Records

The regulatory agreements state that:

> *". . . The mortgaged property, equipment, building, plans, offices, apparatus, devices, books, contracts, records, documents, and other papers relating thereto shall at all times be maintained in reasonable condition for proper audit and shall be subject to examination and inspection at any reasonable time by the Commissioner or his duly authorized agents . . ."*
>
> *". . . The books and accounts of the operations of the mortgaged property . . . shall be kept in accordance with the requirements of the Commissioner. . ."*

Due to the condition of the records and documents of the entity, a speedy and effective audit of the organization was not feasible. The management agent lacked an accounting system. There was no general ledger, subsidiary ledgers, journals, or bank reconciliations. R.S. Management was unable to or unwilling to provide us with requested bank documents. It was necessary for us to issue administrative subpoenas to gather necessary information from banks. Also, the general condition of the records was chaotic. For example, invoices and bills were not maintained in a central location. It was necessary for us to look in several different rooms to find project records, and when records were found they were frequently unorganized.

Improper Encumbrances

The regulatory agreements state *". . . Owners shall not without the prior written approval of the Secretary convey, transfer, or encumber any of the mortgaged property, or permit the conveyance, transfer, or encumbrance of such property. . ."*

The owners failure to meet their obligations resulted in the encumbrance of properties owned by the Aiellos by federal and state agencies. On April 25, 1994 the Internal Revenue Service (IRS) filed a tax lien for $156,380 against Frank and Beverly Aiello, dba R.S. Management. Also, the IRS filed a lien for $224,746 on August 8, 1994. The lien amounts covered all properties owned by the Aielos, including Harvest Oaks and Auburn Palms. The liens were filed because the owners have unpaid payroll taxes going back to 1992. On December 5, 1994 the IRS levied the owners accounts as follows: various accounts at Plumas Bank, the R.S. Management account at Sumitomo Bank, and the Fallowfield (Aiello's ranch) account at U.S. Bank.

The state also placed a lien on the owners' estate. On June 20, 1994 the state employment development department filed a tax lien for $42,663 against Frank and Beverly Aiello, dba R.S. Management and D A D Maintenance. The lien amount covers all properties owned by the Aiellos, including Harvest Oaks and Auburn Palms. The lien was filed because the owners had not made 1994 first quarter unemployment payments. The owner Frank Aiello told us that the liability to the state and $200,000 of the liability to IRS had been satisfied, but, he did not provide us with any evidence to support his claim.

Throughout 1994 the management had difficulty meeting debts as they became due and payable. During several occasions there were insufficient funds in the bank to cover payroll checks. There were boxes of unpaid invoices and bills. Some vendors have sought collection agencies or initiated court proceedings to recover past due amounts.

Default of Mortgage Loan

The regulatory agreements state that *". . . Owners . . . shall promptly make all payments due under the note and mortgage . . ."*

The owners did not always make prompt payments due under the notes. The Harvest Oaks' note went into default on March 1, 1994. On April 29, 1994 the lender assigned the mortgage to HUD. The May 20, 1995 statement of multifamily mortgage account showed a monthly payment of $40,794, a delinquent amount of $330,266, for a total past due amount of $371,060 due May 1, 1995. The statement also showed that the unpaid principal balance equalled $2,276,000. HUD had started foreclosure proceedings; however, they were suspended when the owners filed for bankruptcy protection under Chapter 11. The owners also defaulted on the Auburn Palms note in July and August of 1994. The mortgage was brought current in August after HUD threatened to withhold Section 8 subsidy payments.

Overdue Financial Statements

The regulatory agreements state:

> *". . . Within sixty days following the end of each fiscal year the Commissioner shall be furnished with a complete annual financial report based upon an examination of the books and records of the mortgagor prepared in accordance with the requirements of the Commissioner, prepared and certified to by an officer or responsible Owner and, when required by the Commissioner, certified by a Certified Public Accountant, or other person acceptable to the Commissioner. . ."*

The audited 1993 financial statements for Harvest Oaks and Auburn Palms were submitted to HUD a year late. The 1993 financial statements for Auburn Palms were due to HUD by January 1, 1994, and the 1993 statements for Harvest Oaks were due by March 1, 1994. The firm Marcia L. Fritz, Certified Public Accountant, issued the audited financial statements of Harvest Oaks and Auburn Palms in March 1995.

Prior financial statements were also late. HUD received the 1992 audited financial statements for Harvest Oaks and Auburn Palms on January 26, 1994, eleven months past the due date. HUD received the 1991 statements for Harvest Oaks (first year of operations) over two months late, and the statements for Auburn Palms five months late. The 1990 financial statements for Auburn Palms were sent to HUD eleven months late. The 1989 financial statements for Auburn Palms were nine months late.

Monthly Accounting Reports Not Submitted

The regulatory agreements state:

> *". . . At request of the Commissioner, his agents, employees, or attorneys, the Owners shall furnish monthly occupancy reports and shall give specific answers to questions upon which information is desired from time to time relative to income, assets, liabilities, contracts, operation, and condition of the property and the status of the insured mortgage. . ."*

In recent years, the owners have failed to provide HUD with monthly accounting reports. HUD mailed a letter to the owners on March 29, 1994 notifying them to submit to it monthly accounting reports for Harvest Oaks and Auburn Palms by May 10, 1994. To date the owners have not submitted any monthly accounting reports as required by the Department's request.

Earlier attempts include a December 17, 1991 letter stating that it was the fourth written notice requesting monthly accounting reports. (The May 1991 report was the last one received.) The letter threatened a limited denial of participation against the owners unless they submitted the past due reports. HUD subsequently received the requested reports on December 26, 1991.

Tenant Security Deposit Funds Not Accounted For

The regulatory agreement states that *". . . Any funds collected as security deposits shall be kept separate and apart from all other funds of the project in a trust account, the amount of which shall at all times equal or exceed the aggregate of all outstanding obligations under said account. . ."*

The funds in the tenant security account were missing for four months. A tenant security deposit account for Auburn Palms was closed in June 1994 with the withdrawal of the $8,418 balance. The tenant security deposit account was not reestablished until November 7, 1994 (one month after the start of the audit). The IRS placed a levy on the account on December 5, 1994.

CORRECTIVE ACTION BEING TAKEN

HUD has taken the following action to address the matters raised in this memorandum:

- ✓ An auditor from the Office of Inspector General provided a sworn statement on the noted regulatory agreement violations to the U.S. Attorney to help support the federal government's position that control of project operations should be taken from the owners. In January 1995, project operations were taken over by a court-appointed trustee.

- ✓ The Office of Inspector General pursued with the U.S. Attorney the possibility of criminal and civil legal action against the owners. The U.S. Attorney did not believe such action is warranted because (1) a criminal conviction would not materially add to Mr. Aiello's recent sentence of 135 months of imprisonment and $3.5 million in restitution and fine for Medicare fraud and (2) the owners are not expected to have significant assets to compensate HUD for a civil suit after paying the restitution and fine.

- ✓ The Office of Inspector General filed a complaint with the California state board of accountancy and has recommended that HUD bar the public accountant responsible for performing substandard audits of the projects. The state board is currently conducting its independent investigation to determine whether disciplinary action should be taken against the accountant. The debarment recommendation is under HUD legal review.

- ✓ Your office recommended to Headquarters that Frank Aiello be barred from future participation in HUD programs. We understand that this recommendation is also under review.

Both of our offices continue to work with the U.S. Attorney's office in order to protect HUD's interests. Thus, we are controlling no recommendations on the issues raised here.

Footnote(1)

The owners allegedly inflated payroll costs at another project, Portola Senior Apartment, which was insured by the Farmers Home Administration (FmHA). Karyl Kent alleged in her deposition (*qui tam* suit Karyl Kent vs. Frank Aiello) that she mailed to California State FmHA a letter showing discrepancies between payroll expenses reported in the 1989 audited financial statements and actual payroll expenses. According to the court records, the financial reports showed that $16,632 were expended for caretaker, general maintenance and repairs, and grounds maintenance compared with approximately $11,507 that was actually paid.

If you have any questions, please contact senior auditor Mark Pierce at 415-436-8101.