

November 21, 1995

AUDIT RELATED MEMORANDUM
96-SF-212-1802

MEMO FOR: William F. Bolton, Director, Multifamily Division, Sacramento, CA.

FROM: Mark J. Pierce, Senior Auditor

SUBJECT: Sharps and Flats Apartments
Multifamily Mortgagor Operations
Davis, California

We completed a survey of Sharps and Flats Apartments to identify instances of assets used in violation of the regulatory agreement governing project operations. Our initial work identified risk in the areas of (1) development costs, (2) owner advances, (3) litigation, and (4) tenant security deposits account. Subsequent work, however, identified no material violations of the regulatory agreements or found that HUD asset management had approved the owner's actions. Therefore, we concluded that a detailed audit was not necessary. We noted several matters, however, that warranted monitoring by HUD.

BACKGROUND

Sharps and Flats (FHA project 136-35681) is a multifamily housing development located in Davis, California. The mortgage loan is insured by HUD under Section 221(d)(4) of the National Housing Act. Final endorsement for insurance occurred in 1993. The project is owned by Waggener Ranch Limited Partnership, whose general partner is Edward MacDonald. Jon Berkley Management, also located in Davis, manages the project. Project operations are governed by a regulatory agreement with HUD in consideration of the mortgage insurance.

The project has severe cash flow problems because projected gross income has not been realized. Mortgage payments and property taxes were almost 80 percent of the total revenues in 1994, leaving insufficient funds for other operating expenses. The mortgage payments are current because: the owner advanced funds to the project; tenant security funds and reserve for replacement funds were used to make mortgage payments; and the management agent reduced its fee to two percent. The project is now fully occupied and rents are planned to be raised. Thus, the financial condition may improve.

PURPOSE AND METHODOLOGY OF SURVEY

We began this review to determine if project assets were used in violation of the regulatory agreement governing project operations. To accomplish this objective, we:

- ö interviewed HUD staff, the owner, management agent staff, and the public accountant who performed the audit of the project's 1994 financial statements.

- ö reviewed HUD's asset management and development files, project records maintained by the management agent, public accountant's workpapers, and litigation records provided by the owner; and

- ö gained an understanding of the internal control structure. We did not conduct tests to determine control effectiveness because this was not necessary for the limited objective of this review.

The review covered activities from August 1, 1993 to July 31, 1995. We did the field work in August 1995 and conducted the review in accordance with generally accepted government auditing standards.

SURVEY RESULTS

Our initial work identified risk of possible asset misuse in the areas of (1) development costs, (2) owner advances, (3) litigation, and (4) tenant security deposits account. Subsequent work, however, identified no material violations of the regulatory agreements or found that HUD asset management had approved the owner's actions.

Development Costs. The 1993 statement of cash flows shows a \$219,000 payment of a note payable, \$119,405 repayment of advances from affiliates, and \$384,275 payment of construction costs payable. Based on our review of project records, we concluded that nearly all of these payments were proper. We did note that some development costs were paid from the operating account for interest payments and service fees associated with lines of credit used during construction; but the amount totaled less than \$6,500 during the time when the owner was advancing monies to the project.

Owner Advances. Since April 1993 the owner has advanced \$474,000 to meet the operational needs of the project. The owner has received partial repayments of about \$80,000 on these advances. The repayments generally occurred during the same or subsequent month an advance was made. The owner also occupies an apartment at the project rent-free with the amount

of the recorded advances being further reduced for the value of the rent. While such repayments are violations of the regulatory agreement, the owner has shown a commitment to keeping the mortgage current. We cautioned the owner and management agent that repayments of advances are to be approved by HUD.

Litigation. In 1994 an action was brought by the general contractor, Brown Construction, against Waggener Ranch limited partnership and its general partner, Edward MacDonald. The action seeks to recover the sums of two promissory notes in the amounts \$130,000 and \$200,000. The owner subsequently filed a cross-complaint. According to the owner, he executed the promissory notes in September 1992 when it appeared that there would be a substantial construction cost savings. The notes were to be paid when the general contractor completed another owner-related development called Greek Court.

The \$200,000 note represents cost savings to be passed on to the general contractor. The owner stated that the cost savings never materialized, and the general contractor is trying to enforce the notes although the Greek Court development has not begun.

The \$130,000 note represents a "good faith deposit" made to the mortgagee by the general contractor. The general partner told us that it was his intention to repay the deposit from additional funds requested in the owner's application to HUD under a statutory waiver. The waiver was denied. The general contractor agreed to include the deposit in his limited partnership interest. The general partner explained that the general contractor's agreement with him provided that the general contractor would receive an ownership interest in the project in lieu of a builders profit. Thus, the general contractor is a limited partner.

The \$130,000 note represents part of the general contractor's equity investment in the project. If the owner returns any of the general contractor's investment, funds must not come from project resources, except from available surplus cash. Likewise, litigation expenses are partnership expenses. Nevertheless, we found no evidence that significant project funds had been used to pay for litigation expenses or to refund the contractor's investment.

Tenant Security Deposits Account. The management agent transferred funds from the tenant security deposits account to the operating account to help meet expenses. Only \$1,200 remained in the account in mid-December 1993. Then, on December 28, 1993 the general partner advanced \$50,000 to the account. The security account was later reduced to \$1,023 by May 1994, and refunded by another \$50,000 in July. Starting in October, the

management agent began transferring funds from the security account at the end of the month and returning it several weeks later. The security account was only used once in 1995, and it appears that the practice has stopped. HUD verbally approved the use of the tenant security funds to meet the projects's operating needs. (HUD also approved the use of \$40,000 in reserve for replacement funds to be applied toward the August 1994 mortgage payment.) As of July 21, 1995, the tenant security account held \$49,280 compared to a liability of \$74,301.

CONCLUSION

We concluded that further audit work was not warranted at this time; however, the HUD asset management branch should closely monitor this project, particularly for the litigation, security deposit, and owner advance matters. We are not controlling any audit recommendations as a result of this review.