Issue Date
January 26, 2012
Audit Report Number
2012-PH-1005

TO: Melanie N. Marston, Director, Office of Multifamily Housing, Washington, DC, Field Office, 3GHMLAU

//signed//

FROM: John P. Buck, Regional Inspector General for Audit, Philadelphia Region, 3AGA

SUBJECT: Second Northwest Cooperative Homes Association, Washington, DC, Did Not Identify and Remit Excess Income to HUD

HIGHLIGHTS

What We Audited and Why

We audited the Second Northwest Cooperative Homes Association's administration of the U.S. Department of Housing and Urban Development's (HUD) Section 236 program based on a hotline complaint. Our audit objective was to determine whether the Association properly identified and remitted excess income[1] to HUD according to its regulatory agreement and whether it hired staff according to applicable HUD regulations.

[1] HUD regulations at 24 CFR (Code of Federal Regulations) 236.60(a) define excess income as cash collected as rent from the residents by the borrower on a unit-by-unit basis that is in excess of the HUD-approved unassisted basic rent. The regulation further requires that excess income be returned to HUD monthly. Accordingly, Section 4 of the Association's regulatory agreement with HUD required its members to pay the greater of either the basic rent or market rent with specific adjustments based on each member's income. The regulatory agreement further stipulated that excess income must be remitted to HUD monthly.

What We Found

The Association did not establish market rents for any of the program units as required and charged all of the members occupying program units basic rents. Thus, the Association did not properly identify excess income as required by its regulatory agreement and failed to remit at least $172,977 in excess income to HUD for its program units. It also did not always hire staff according to its own bylaws.

What We Recommend

We recommend that the Director of HUD's Washington, DC, Office of Multifamily Housing direct the Association to (1) immediately establish market rents and obtain HUD's approval of the rents; (2) immediately recalculate rents for all members based on the most recent annual recertification performed; (3) remit to HUD $172,977 in excess income identified; and (4) identify and remit excess income for members occupying program units that were not reviewed during the audit. We also recommend that the Association establish and implement written policies and procedures to ensure that future tenant rents and excess income are properly calculated and excess income is remitted to HUD as required. Lastly, we recommend that the Association comply with its approved bylaws or obtain HUD's written approval of its amended bylaws.

For each recommendation in the body of the report without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-4. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided a draft report to the Association on December 19, 2011. We discussed the report with the Association during the audit and at an exit conference on December 22, 2011. The Association provided written comments to our draft audit report on January 10, 2012. It disagreed with the findings in the report. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVE

The Second Northwest Cooperative Homes Association is a nonprofit entity organized in 1977. Its mission is to provide housing in a manner that supports Section 236, Title II, of the National Housing Act. The affairs of the Association are governed by a board of directors, which consists of six members. The Association's president is Annie L. Hill and its management agent is Jeffery Charles and Associates. The Association is located at 1321 5th Street Northwest, Washington, DC.

The U.S. Department of Housing and Urban Development (HUD) entered into a regulatory agreement with the Association in 1977 for its Section 236-insured multifamily program. The program, established by the Housing and Urban Development Act of 1968, combined Federal mortgage insurance with interest reduction payments to the lender for the production of low-cost rental housing. Under this program, HUD provided interest subsidies to lower a project's mortgage interest rate to as low as 1 percent. This program no longer provides insurance or subsidies for new mortgage loans, but existing Section 236 properties continue to operate under the program. The interest reduction payment results in lower operating costs and, thus, a reduced rent structure.

The program's basic rent is the rent that the owner must collect to cover the property's operating costs given the mortgage interest reduction payments made to the property. The program market rent represents the rents needed to cover operating costs if the mortgage interest were not subsidized. Members occupying program units are required to pay rents based on annual income. At a minimum, members must pay at least basic rent for the program units but cannot pay rent that exceeds the established market rents. Members paying less than the Section 236 market rent are considered assisted members. If members pay rents that are above the basic rent amount, HUD defines the additional rent as excess income. Program participants are required to resubmit the excess income to HUD monthly.

There are currently 142 units located at the property. Of the 142 units, 99 are assisted with program funds, and the remaining 43 are assisted with Section 8 project-based vouchers. The Association received $1.2 million in interest reduction payments for years 2006 through 2010. For 2011, the Association received $231,707 in interest reduction payments.

Our audit objective was to determine whether the Association properly identified and remitted excess income to HUD according to its regulatory agreement and whether it hired staff according to applicable HUD regulations.

RESULTS OF AUDIT

Finding 1: The Association Did Not Identify and Remit Excess Income to HUD as Required

The Association failed to accurately calculate rents and failed to remit excess income to HUD for all 25 members reviewed. This condition occurred because the Association's management agent incorrectly believed that the Association was not required to establish market rents and obtain HUD's approval of the market rents. As a result, the Association members reviewed paid rents well below the market rent regardless of their income, and the Association failed to remit at least $172,977[2] in excess income to HUD as required. Of this amount, three members of the Association's board of directors and its site manager paid at least $24,972 less in rent than HUD required based on their income.

The Association Did Not Comply With Its Regulatory Agreement

Section 4(a) of the Association's regulatory agreement required that it establish basic rents and market rents for each of its program units. Basic rent is the rent that the owner must collect to cover the property's operating costs given the mortgage interest reduction payments made to the property, and it is the minimum rent that members can pay. Market rent is the rent members would pay if their mortgages were not subsidized. Section 4(b)(1) of the Association's regulatory agreement with HUD required its members to pay the greater of either the basic rent or market rent with specific adjustments based on each member's income. The 25 members audited reported annual income as required; however, since the Association did not believe it had to establish market rents, it collected only basic rent amounts from its members regardless of their income. Because of the reduced rent the higher income-earning members were asked to pay, HUD did not receive any of the excess income it was due for the members. We, therefore, recalculated the rents based on reported income for the 25 members and estimated the rents that should have been charged from 2006 through 2010. Based on our estimation, the Association needs to pay HUD at least $172,977 in excess income that it failed to collect from 25 high-income-earning members for the 5 years reviewed.

[2] See appendix C.

The Association Misinterpreted HUD's Requirements

The Association's management agent incorrectly believed that the Association was not required to establish market rents or ensure that members paid rents based on their reported income. The management agent told us that since HUD did not determine the market rents for the Association, he believed he could charge all members the basic rent. The 25 Association members reviewed paid rents well below the market rent regardless of their income, and the Association failed to remit to HUD at least $172,977 in excess income. Of this amount, three members of the Association's board of directors and its property manager received an estimated $24,972 in reduced rent.

Conclusion

The Association needs to establish and implement written policies and procedures to ensure that rents and excess income are properly calculated in accordance with its regulatory agreement and applicable HUD regulations. For the 25 members whose annual income we reviewed, the Association did not collect and remit to HUD at least $172,977 in excess income for calendar years 2006 through 2010. We divided $172,977 by the 5 years and estimate that at least $34,595 will be put to better use over the next year by implementing the recommendations in this report.

Recommendations

We recommend that the Director of HUD's Washington, DC, Office of Multifamily Housing require the Association to

1A. Immediately establish market rents and obtain HUD's approval of the established market rents as required by its regulatory agreement and applicable HUD regulations.

1B. Immediately recalculate rents for all members based on the most recent annual recertification performed.

1C. Remit to HUD from non-Federal funds, $172,977 in excess income identified.

1D. Identify and remit excess income for the remaining units that were not reviewed during the audit.

1E. Establish and implement written policies and procedures to ensure that rents and excess income are properly calculated in accordance with its regulatory agreement and applicable HUD regulations, thereby ensuring that an estimated $34,595 will be put to better use.

Finding 2: The Association Did Not Always Use Proper Hiring Practices

The Association hired an office manager who was closely related to the treasurer of its board of directors, which was prohibited by its HUD-approved bylaws. This condition occurred because the Association did not adhere to its own bylaws. Furthermore, the Association could not provide documentation supporting that it amended its bylaws and that HUD approved its amended bylaws. The Association's failure to use the hiring protocol documented in its HUD-approved bylaws resulted in an apparent conflict of interest and could potentially have increased the risk to HUD funds.

The Association Allowed an Apparent Conflict of Interest To Exist

The Association's HUD-approved bylaws at article 5, section 6, stated that a relative of its board of directors could not be an employee of the Association. However, the Association disregarded its own bylaws and hired an employee who was closely related to the treasurer of its board of directors. Specifically, the office manager was the daughter of the treasurer of the Association's board of directors.

At the time that the office manager was hired, the mother of the officer manager had been appointed as treasurer of the Association's board of directors. The office manager is responsible for collecting member rents, preparing check requests, and overseeing the daily business operations of the Association. The treasurer of the board of directors is responsible for reviewing rent collections, approving check requests, and overseeing the financial operations of the entity. The Association's hiring of a close relative of the treasurer of its board of directors created an apparent conflict of interest and violated the Association's own HUD-approved bylaws.

The Association Incorrectly Asserted That Its Hiring Practices Were Proper

The Association's management agent told us that hiring the office manager who was closely related to the treasurer of its board of directors was in accordance with its bylaws and HUD requirements. He explained that one of the Association's goals was to employ members of the Association so that income could be earned. He claimed that the Association amended its bylaws and removed the paragraph relating to the hiring of relatives. However, he could not provide documentation to support the amended bylaws and did not receive HUD's approval of amended bylaws as required.

Recommendations

We recommend that the Director of HUD's Washington, DC, Office of Multifamily Housing require the Association to

2A. Comply with the approved bylaws or obtain written approval from HUD to proceed with the amended version.

SCOPE AND METHODOLOGY

We conducted the audit from May to October 2011 at the Association located at 1321 5th Street Northwest, Washington, DC. The audit covered the period January 2006 to December 2010 but was expanded when necessary to include other periods.

To accomplish our audit objective, we reviewed

- Regulations at 24 CFR Part 236, applicable HUD guidance, and other directives that govern the program.
- The Association's regulatory agreement, audited financial statements, bylaws, and other program records.
- The Association's employee listing and personnel hiring practices.
- A nonstatistical sample of 25 members that earned high income in 2011. The reviews included analyzing the members' annual recertifications to determine whether rents and excess income were properly calculated.

We conducted interviews with responsible employees of the Association, its management agent, and responsible HUD staff. We reviewed the reported income all of the members occupying program units. Based on the members' most recent reported income, we selected and reviewed the 25 members who reported the highest income. The reported income ranged from $39,290 to $127,161. We recalculated the rents based on income. For the 25 members whose annual income we reviewed, the Association did not collect and remit to HUD at least $172,977 in excess income for calendar years 2006 through 2010. We divided $172,977 by the 5 years and calculated that HUD will put at least $34,595 to better use over the next year by implementing the recommendations in this report.

To achieve our audit objective, we relied in part on computer-processed data. The data included the Association's expenditures, rent payments, and other computer-generated data. Although we did not perform a detailed assessment of the reliability of the data, we did perform a minimal level of testing and found the data to be adequate for our purposes.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal control was relevant to our audit objective:

- Program operations - Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

We assessed the relevant control identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- The Association failed to accurately calculate rents and failed to remit excess income to HUD (Finding 1).

- The Association did not hire staff in accordance with its bylaws (Finding 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1C	$172,977	
1E		$34,595

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	**Auditee Comments**

SECOND NORTHWEST COOPERATIVE HOMES ASSOCIATION
1321 5TH STREET, N.W. • ROOM 103
WASHINGTON, DC 20001
(202) 265-3080

January 10, 2012

Mr. John P. Buck
Regional Inspector General for Audit
Philadelphia Region, 3AGA

Re: Second Northwest Cooperative
Homes Association
Washington, DC

Dear Sir:

This letter is written in response to the draft Audit Report submitted to the Cooperative for discussion and comment. In conducting your further review and revision, we request that you consider the additional information and corrections submitted below.

Excess Income

The draft Report makes a finding that the Association "did not properly identify excess income as required by the regulatory agreement" It further calculates that at least $172,977 in excess income is due to HUD for the period 2006-2010. These conclusions are erroneous for a number of reasons:

Comment 1

Comment 2

1. Paragraph 4(a) of the Regulatory Agreement states that "a fair market charge" is to be determined "with the prior approval of the Secretary" for each dwelling unit. In fact, the maximum allowable market rent calculations pursuant to Chapter 7, Section 6, paragraph 7-32 of the HUD handbook requires a calculation based on a Rent Compilation Worksheet using monthly HUD subsidy information which is maintained by HUD and not available to the Cooperative. According to paragraph 7-38, HUD is to prepare the rents by bedroom type in the case of Section 236 projects.

Comment 1

HUD has not, despite request, provided the information necessary to make the calculations, nor calculated the maximum allowable rents, nor questioned the Excess Income reports timely submitted to HUD, over the past three years.

Comment 3

2. Indeed, the issue of Excess Income was settled in June 2009 when the Cooperative entered into a re-payment plan with HUD on "the current amount of excess income owed to HUD." (See repayment agreement of June 26, 2009)

Comment 4

Therefore, the Report's conclusion that Excess Income is due from 2006 is erroneous.

Comment 5

3. Beginning in 2001, the Managing Agent informed HUD that due to budget increases, the basic rents in some cases were exceeding the market rents, but that HUD had not provided any new market rents. The approval was only for Basic and no new market rates had been provided. Therefore, the Cooperative would use the basic rents as the maximum rents unless advised by HUD that the market rents changed. (See letter from Jeffrey Charles and Associates, Inc. to Leland Jefferson at HUD dated August 13, 2001)

Comment 6

In conformity with this correspondence, the Cooperative has been submitting its monthly Excess Income forms reporting that no excess income is due. HUD has taken no exception to these reports, despite its responsibilities under Chapter 7 of the Handbook. To the contrary, according to the last Management Review on March 17, 2009, the Cooperative's management received a rating of "Satisfactory." More to the point, the review "did not reveal any procedural non-compliance" and notes that the Excess Income Reports have been "consistently submitted on a timely basis."

Comment 7

4. As reported to HUD, and according to HUD approved procedures, the Cooperative has not collected Excess Income payments. Pursuant to paragraph 7-28 of the HUD Handbook, the Cooperative is responsible to submit to HUD an amount by which total rentals *collected* exceeds the approved basic rentals. (***emphasis added)*** Given the above circumstances, the Cooperative is not in violation of the Regulatory Agreement, nor HUD requirements as to Excess Income.

Comment 7

Thus, the draft Report's finding that the Cooperative did not properly identify income or failed to make any required payment is not justified. The Cooperative is certainly willing to work with HUD in establishing and implementing procedures for the future as the draft Report also recommends; however, any finding of impropriety on the part of the Cooperative is misplaced, as is the recommendation that the Cooperative "remit to HUD from non-Federal funds" nearly $173,000. The Findings and Recommendations of the Report should be revised accordingly.

Proper Hiring Procedure

The draft Report states that the Cooperative failed to follow hiring protocol in hiring its office manager. "This condition occurred because the Association did not adhere to its own bylaws."

Comment 8

1. In drawing this conclusion, the draft Report does not cite what by-laws it is depending on as the "HUD-approved bylaws."

Comment 8

By letter of March 22, 1994, and March 28, 1994, Diana L. Brown, Chief, Loan Management Branch of HUD complained, *inter alia*, that the by-laws being used by the Cooperative "are not authenticated," and "cannot be relied upon as true and accurate copies of the current governing documents." Ms. Brown complained that "There was no evidence of adoption of the original By-Laws," and that the "Amended By-Laws of the second Northwest Cooperative Homes Association" were unsigned and lacked evidence of HUD approval.

Comment 8

A review of files was then conducted at the Cooperative and at HUD under the auspices of Mr. Henry Czauski, then general counsel at the HUD field office. At a meeting held on April 21, 1994 including Mr. Czauski, Hugh Allen (HUD), Jeffrey Turner (Cooperative's managing agent) and Carol Blumenthal (Cooperative's attorney), it was agreed that HUD would provide a copy of the HUD approved by-laws (since HUD is required to maintain a copy), or if there was none, a copy of model by-laws acceptable for Section 236 cooperatives. This agreement was memorialized by letter of April 21, 1994.

As of May 3, 1994, no approved by-laws had been located and direction was asked of HUD attorney as to how HUD wished the Cooperative to proceed. HUD then provided to the Cooperative a copy of the Model Form of By-Laws, and pursuant to instructions from HUD, the Cooperative undertook to create by-laws in conformity with the Model.

According to the Model by-laws Article V, Section 6, a director may not be an employee of the Corporation. There is no prohibition against hiring a "relative" of a director.

Based on the Model By-Laws HUD provided, Second Northwest Cooperative Homes prepared official By-Laws that were approved by the Board of Directors. Those by-laws were submitted to HUD on September 26, 1994.

It was understood and agreed with HUD counsel that the Cooperative "will be following the procedures set out in the enclosed-By-Laws (adopted and approved by the Board of Directors), unless you note any objections to us." (See transmittal letter of September 26, 1994)

The By-Laws adopted by the Cooperative, consistent with the Model By-Laws prohibited employment of a director, but did not prohibit hiring of a "relative."

Those By-Laws have been in place and operative for 15 years.

Comment 9

2. Given that HUD's own Model By-Laws do not prohibit the employment of a relative of a Director, it is clear that no policy concerns are implicated. The draft Report does not suggest that there has been any compromise of the management standards, nor any actual risk to HUD funds. Moreover, the Cooperative office manager has provided many years of faithful and diligent service

To the extent that HUD has not provided "written approval" of the By-Laws, the Report should recommend that HUD approve them forthwith and retroactively.

Based on the above, we ask that the final Audit Report modify its Findings and Recommendations to take into account the reality that the Cooperative's ability to fulfill its responsibilities is dependant upon HUD's honoring it duties to the Cooperative. Second Northwest Cooperative has operated consistently in conformity with the Regulatory Agreement and the By-laws as it understood them and as directed and approved by HUD. Second Northwest Cooperative has filed all reports, budgets and annual audits with HUD which has approved them for each annual budget cycle and during the management review process. These findings should be reflected in the final Audit Report along with recommendations as to cooperation in creation of written policies.

Sincerely,

Annie L. Hill

Annie L. Hill, President
Second Northwest Cooperative Homes Association

OIG Evaluation of Auditee Comments

Comment 1 Paragraph 4(a) of the regulatory agreement did in fact require the Association to obtain the prior approval of HUD before it established the basic and market rents for each of its program units. However, HUD's role is to review and approve the rents submitted by the Association. HUD's role is not to acquire all of the needed information for all of the units and ascertain the basic and market rents for the Association.

Comment 2 Chapter 7, Section 6, paragraph 7-32 of HUD Handbook 4350.1, REV-1, does require a calculation based on a Rent Compilation Worksheet using the monthly HUD subsidy. Contrary to the Association's assertion however, this information is readily available.

Comment 3 The Association states that the issue of excess income was settled in June 2009 when it entered into a repayment plan with HUD. The Association entered into the repayment plan with HUD to pay back delinquent excess income which was accumulated prior to 2001 when there was a fully completed rent schedule. Our review focused on the time period of January 2006 to December 2010. During this time we found that rents were not determined in accordance with the regulatory agreement which resulted in tenants underpaying in rent by at least $172,977.

Comment 4 The Association states that the report's conclusion of excess income being due from 2006 is erroneous. However, the audit evidence showed that the Association operated without established market rents for any of its program units and has allowed high-income earning tenants to only pay basic rents. Since the high earning tenants were only required to pay basic rents, the Association did not identify the amounts of excess income that was due HUD.

Comment 5 The Association stated that beginning in 2001, the management agent informed HUD that basic rents exceeded the market rents in some cases and that HUD had not provided any new market rents. However, HUD officials told us they have not received correspondence from the management agent regarding market rents and that the letter was not on file.

Comment 6 The purpose of our audit was to conduct an external audit of Second Northwest Cooperative Homes Association and its administration of its Section 236 property. Our audit did not focus on the internal operations of HUD or its management review process.

Comment 7 The Association claims that since it did not collect excess income, it is not in violation of the regulatory agreement. On the contrary, during our review we found that the Association did not charge rents based on a percentage of the members' incomes, which is in violation of the regulatory agreement signed with

HUD. Only basic rents were collected from all of the members, regardless of income, which resulted in the underpayment of $172,977 in rent between the years 2006 to 2010. When members of the Section 236 units underpay in rent, the loss is incurred in excess income (funds which are to be returned to HUD).

Comment 8 The Association stated that the report does not cite what bylaws that it is depending on as the "HUD approved by-laws." The Association provided the OIG with only one version of HUD approved bylaws and this is what we are referring to.

Comment 9 The HUD approved bylaws, at Article 5, Section 6, state that a resident director or family member or relative of a resident director may not be an employee of the corporation. Moreover, the Association's hiring of a close relative of the treasurer of its board of directors created an apparent conflict of interest and violated the Association's own HUD-approved bylaws.

Appendix C

SUMMARY OF UNCOLLECTED EXCESS INCOME

Member	Annual income for unit (most recent)	Rent paid for unit	Amount member should have paid in rent	Excess income due HUD (2006-2010)
1	$129,905	$542	$691	$7,152
2	129,287	542	691	8,940
3	121,987	592	759	10,020
4	110,078	495	631	6,528
5	107,917	542	691	3,636
6*	98,813	592	759	8,016
7*	86,951	542	691	8,940
8	82,658	495	631	8,160
9	82,466	542	691	8,940
10	78,768	542	691	8,940
11	73,214	495	631	5,352
12	68,568	495	631	6,684
13	67,843	542	691	5,364
14	63,499	495	631	1,224
15	56,630	542	691	5,364
16	55,676	495	631	6,528
17	55,073	495	631	6,108
18	53,574	495	631	6,528
19*	53,048	592	759	8,016
20	49,453	542	691	8,940
21	48,243	542	691	6,657
22	47,885	592	759	8,304
23	44,114	595	759	8,880
24	39,185	592	759	9,348
25	37,350	495	631	408
Total				**$172,977**

*Represents members who are also members of the Association's board of directors