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| Issue Date March 14, 2012 |
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| Audit Report Number 2012-PH-1007 |
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TO: Encarnacion Loukatos, Director, Philadelphia Multifamily Hub, 3AHMLA

//signed//

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

SUBJECT: Four Freedoms House of Philadelphia, Inc., Philadelphia, PA, Generally
Managed Its Section 202 Housing Project in Accordance With Applicable
Requirements

HIGHLIGHTS

What We Audited and Why

We audited Four Freedoms House of Philadelphia, Inc.'s management of its Section 202 housing project. We selected Four Freedoms for an audit because we received a complaint alleging that it mismanaged its Section 202 housing project. Our objective was to determine whether Four Freedoms managed its Section 202 housing project according to the requirements of its regulatory agreement and applicable U.S. Department of Housing and Urban Development (HUD) requirements. We focused the audit on reviewing recent monitoring of the project; Four Freedoms' maintenance of the property, management of security deposits, use of emergency capital repair program grant and operating funds, management and use of replacement reserve funds; and whether its board of directors consisted of the number of members required by its regulatory agreement.

What We Found

Four Freedoms generally managed its housing project according to its regulatory agreement and HUD requirements and the allegations of mismanagement in the complaint generally had no merit. However, it did not properly deposit and insure all of its replacement reserve account funds, and its board of directors was comprised of fewer than the number of members required by the regulatory agreement.

What We Recommend

We recommend that HUD require Four Freedoms to (1) transfer replacement reserve account funds to other banks to ensure that the funds are deposited into interest-bearing accounts and fully insured at all times in accordance with HUD requirements and (2) increase the membership of its board of directors to comply with its regulatory agreement.

For each recommendation in 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 discussion draft audit report to Four Freedoms on February 15, 2012, and discussed it with Four Freedoms at an exit conference on February 21, 2012. Four Freedoms provided written comments to the draft report on February 22, 2012. It agreed with the conclusions and recommendations in the report. The complete text of the auditee's response can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVE

Four Freedoms House of Philadelphia, Inc., is a 282-unit housing project funded under the U.S. Department of Housing and Urban Development's (HUD) Section 202 direct loan program and a Section 8 housing assistance payments agreement with HUD. The owner of the project is Four Freedoms House of Philadelphia, Inc., a private nonprofit corporation. The president of Four Freedoms is Ben J. Man. The management agent of the project is Prudent Property Managers, Inc. The project is located at 6101 Morris Street, Philadelphia, PA.

Four Freedoms received a loan from the Housing and Home Finance Agency¹ in March 1965, which provided it with \$3.2 million to finance the construction of the project pursuant to Section 202 of the Housing Act of 1959. The construction of the project was completed in May 1967. Four Freedoms entered into a regulatory agreement with HUD in September 1965. The regulatory agreement establishes the rules, regulations, and restrictions on the use and operation of the project, such as eligible project occupancy, basic management powers, and payment for services. HUD provides project rental housing assistance funds to cover the difference between the HUD-approved operating cost for the project and the tenants' contribution toward rent. HUD provides project rental housing assistance for 220 of the housing project's 282 units.

The Pennsylvania Housing Finance Agency administers HUD's project-based Section 8 rental assistance program in Pennsylvania. Pennsylvania Multifamily Asset Managers (PMAM) is a private-sector partner of the Pennsylvania Housing Finance Agency commonly known as a performance-based contract administrator. PMAM is responsible for the implementation of all asset management core tasks under HUD's performance-based contract administrator annual contributions contract with the Pennsylvania Housing Finance Agency. The asset management core tasks include performing annual management and occupancy reviews of housing projects and assisting project owners and management in renewing Section 8 housing assistance payments contracts.

We received a complaint alleging that Four Freedoms mismanaged its housing project. Based on the complaint, we initiated the audit and focused our work on reviewing recent monitoring of the project; Four Freedoms' maintenance of the property, management of security deposits, use of emergency capital repair program grant and operating funds, management and use of replacement reserve funds; and whether its board of directors consisted of the number of members required by its regulatory agreement.

Our objective was to determine whether Four Freedoms managed its Section 202 housing project in accordance with its regulatory agreement and applicable HUD requirements.

¹ It was superseded by HUD by the Housing and Urban Development Act of 1965.

RESULTS OF AUDIT

Finding: Four Freedoms Generally Managed Its Housing Project in Accordance With Applicable Requirements

Four Freedoms generally managed its Section 202 housing project according to its regulatory agreement and HUD requirements and the allegations of mismanagement in the complaint generally had no merit. However, Four Freedoms did not properly deposit and insure all of its replacement reserve account funds, and its board of directors was comprised of fewer than the number of members required by the regulatory agreement. These conditions occurred because Four Freedoms did not fully understand HUD replacement reserve account requirements and it believed that its board of directors needed only to comply with the membership requirements in its bylaws. As a result, \$175,456 in replacement reserve account funds was not deposited into interest-bearing accounts as required, and \$501,696 was at risk of being lost if the bank failed. Also, the board of directors did not have the level of independence and broad representation of public interest groups that were required by the regulatory agreement.

Four Freedoms' Operations Had Been Closely Monitored

HUD's Philadelphia Office of Multifamily Housing conducted a comprehensive onsite management and operations review of Four Freedoms' operations in June 2010. The scope of the review consisted of reviewing the housing project's general appearance, maintenance and operating procedures, tenant services, and general management practices. The review resulted in a rating of below average. The rating was attributed to ineffective or missing maintenance and operational policies and procedures. HUD identified 26 issues, mostly related to the project's general appearance, requiring corrective action by Four Freedoms. Four Freedoms responded to all of the issues, and HUD closed six of them before our audit began. It last responded to the 20 open issues in July 2011. The resolution of the remaining issues is ongoing. Some of the corrective actions HUD required Four Freedoms to perform included painting apartment units and installing new refrigerators, ranges, and carpet. We verified that Four Freedoms was painting apartment units and installing new refrigerators, ranges, and carpet.

PMAM,² the performance-based contract administrator, conducted a limited management and occupancy review of the housing project in March 2011. The purpose of the review was to ensure that the quality of management and tenant services complied with HUD requirements. The review resulted in an above average rating, as it related to compliance with the project's housing assistance payments contract. The above average rating meant that management had

² PMAM is the asset management subcontractor for the Pennsylvania Housing Finance Agency.

established policies and procedures which were successful in carrying out the housing program objectives. PMAM determined that Four Freedoms followed these procedures with very few exceptions. PMAM identified eight issues mostly related to minor errors found in the tenant files requiring corrective action by Four Freedoms. Four Freedoms responded to all of the issues, and PMAM closed out the issues in June 2011.

Four Freedoms Had Developed Adequate Bed Bug Prevention Procedures and Followed Them

Four Freedoms had developed an adequate plan to prevent and eliminate bed bug infestation that generally complied with HUD Notice Housing 2011-20. It developed the plan in June 2011 in response to HUD's management and operations review. The plan included procedures for informing residents and maintenance staff of bed bug prevention, treating bed bug infestation identified by tenants, and providing protective tools such as bed bug post monitors and plastic encasements for mattresses and box springs to help prevent recurrences. The plan also included procedures for inspecting all apartment units within 5 days of the date a new tenant occupied a unit, inspecting all vacant units, and inspecting all units monthly.

Four Freedoms followed its procedures. It had inspection checklists and inspection reports demonstrating that its contract exterminator inspected the apartment units on 3 floors of the 12-floor building rotationally every week, units receiving new tenants were inspected for bed bugs within 5 days of the date the new tenant occupied the unit, and vacant units were inspected for bed bugs monthly. We accompanied the contract exterminator on two unit inspections and verified that the inspections were thorough.

Four Freedoms Complied With Security Deposit Requirements

Four Freedoms complied with HUD security deposit requirements. Regulations at 24 CFR (Code of Federal Regulations) 891.435 required Four Freedoms to collect security deposits equal to 1 month's tenant payment, place security deposits into a segregated interest-bearing account, and refund security deposits to tenants who provided a 30-day written notice. Four Freedoms maintained documentation, such as bank statements, original lease agreements, and 30-day written notices from tenants, to demonstrate that it complied with these requirements.

**Four Freedoms Used
Emergency Capital Repair
Program Grant Funds for Their
Intended Purpose**

Four Freedoms received a \$500,000 emergency capital repair program grant in October 2006. According to the Federal Register,³ the purpose of the grant was to provide one-time assistance for emergency capital repair needs related to items that presented an immediate threat to the tenants' health, safety, and quality of life. The grant funds were to be used to repair or replace systems, which included existing major building and structural components that were in critical condition. HUD approved Four Freedoms to expend the grant funds to make elevator repairs and upgrade its standpipe and fire system. Based on its grant application, it was clear that Four Freedoms planned to repair the elevator with the grant funds, including the replacement of many elevator components, which was consistent with the purpose of the grant. Four Freedoms used \$271,298 for the elevator repair and completed it in December 2007 and used \$228,702 for the standpipe and fire system upgrade and completed it in June 2009. We verified that the elevator was operating properly and that the standpipe had been installed.

**Four Freedoms Expended
Operating Funds as Required**

Four Freedoms expended operating funds as required by its regulatory agreement. The regulatory agreement required Four Freedoms to only pay for services, supplies, or materials rendered to the housing project. We reviewed 10 expenditures of operating funds valued at \$261,342 and determined that Four Freedoms maintained documentation submitted by contractors, such as contractor invoices, to support its expenditures. The documentation adequately supported that the payments were for services, supplies, and materials rendered to the housing project.

**Four Freedoms Established,
Maintained, and Expended Its
Replacement Reserve as
Required**

Four Freedoms established and maintained a replacement reserve account as required. Regulations at 24 CFR 891.405 required Four Freedoms to establish and maintain a replacement reserve account to aid in funding extraordinary maintenance and capital repair and replacement work items. The regulations also required Four Freedoms to make monthly deposits to the replacement reserve

³ Federal Register Volume 71, Number 98, dated May 22, 2006

account in an amount determined by HUD⁴ and build up and maintain the reserve at a level determined by HUD.⁵ Four Freedoms maintained documentation, such as bank statements, to support that it had established a replacement reserve, made the required monthly deposits, and maintained the reserve above the level determined by HUD. The documentation adequately supported Four Freedoms' efforts.

Four Freedoms expended reserve account funds as required. Regulations at 24 CFR 891.405 required Four Freedoms to draw down funds from its replacement reserve only with HUD approval. Four Freedoms maintained documentation such as HUD-approved funds authorization forms to demonstrate its compliance with this requirement. HUD Handbook 4350.1 required Four Freedoms to receive at least three bids when making withdrawals from the replacement reserve account and explain its selection of a higher bidder if the lowest bidder was not selected. We reviewed the procurement documentation supporting \$129,000 withdrawn for the installation of new sliding glass doors and found that Four Freedoms obtained three bids and selected the lowest bidder to do the work.

Four Freedoms Did Not Ensure That Replacement Reserve Funds Were Insured and Earning Interest as Required

Four Freedoms did not deposit replacement reserve account funds as required. Regulations at 24 CFR 891.405 required Four Freedoms to deposit its replacement reserve funds into an interest-bearing account, the balances of which were fully insured at all times. As of September 2011, Four Freedoms had replacement reserve funds totaling \$898,791 in three accounts with the same bank. Details regarding the accounts and balances are shown in the following table.

| Account description | Interest bearing? | Insured? | September 2011 balance |
|----------------------------|--------------------------|-----------------|-------------------------------|
| Repurchase agreement | Yes | No | \$501,696 |
| Commercial money market | Yes | Yes | 221,639 |
| Commercial checking | No | Yes | 175,456 |
| Total | | | \$898,791 |

⁴ HUD required monthly deposits to the replacement reserve totaling \$20,980, \$21,777, and \$22,190 for years 2009, 2010, and 2011, respectively.

⁵ According to HUD Handbook 4350.1, HUD required a minimum of \$1,000 per unit to be maintained in Four Freedoms' replacement reserve.

Because the checking account was a non-interest-bearing account, replacement reserve funds totaling \$175,456 did not earn interest as required. Four Freedoms was unaware that this account did not comply with requirements.

Four Freedoms also failed to insure all of its replacement reserve funds as required. In January 2001, it invested replacement reserve funds in a repurchase agreement. The repurchase agreement was a purchase of securities from the bank's portfolio under an agreement with the bank to repurchase the securities for a price that included interest at a mutually agreed-upon future date. Four Freedoms entered into this agreement because it believed that the repurchase agreement would generate more interest than other investment vehicles and that it was insured. However, the funds covered under this arrangement were not deposits and, therefore, were not insured by the Federal Deposit Insurance Corporation (FDIC). As a result, replacement reserve funds totaling \$501,696 were at risk of being lost if the bank failed.

The funds deposited in the checking account were insured by FDIC based on the Dodd-Frank Wall Street Reform and Consumer Protection Act.⁶ This temporary unlimited coverage is in addition to and separate from the coverage of at least \$250,000 available to depositors under FDIC's general deposit insurance rules. The temporary coverage expires on December 31, 2012. Although all of the funds in the checking and money market accounts were FDIC-insured as of September 2011, after December 31, 2012, the funds in both accounts would be subject to FDIC general deposit insurance of \$250,000 per depositor per insured bank.

To comply with requirements, Four Freedoms needs to deposit and insure its replacement reserve funds as required. In doing so, it will ensure that its replacement reserve account funds are deposited into interest-bearing accounts and fully insured at all times. During the audit, Four Freedoms indicated that it would transfer replacement reserve account funds to other banks to ensure that the funds were deposited into interest-bearing accounts and fully insured at all times.

Four Freedoms' Board of Directors Did Not Consist of the Number of Members Required by Its Regulatory Agreement

Four Freedoms' regulatory agreement required it to have basic management powers vested in a board of directors with no fewer than seven members that was fully independent and broadly representative of public interest groups. However, during the audit, the board consisted of only five members, two fewer than

⁶ Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act states that all funds in a non-interest-bearing transaction account are insured in full by FDIC from December 31, 2010, through December 31, 2012.

required by the regulatory agreement. Four Freedoms believed that its board of directors needed only to comply with the membership requirements in its bylaws.⁷ As a result, the board of directors did not have the level of independence and broad representation of public interest groups that were required by the regulatory agreement. To comply with requirements, Four Freedoms needs to increase the membership of its board. During the audit, Four Freedoms indicated that it would increase the membership of its board.

Conclusion

Four Freedoms generally managed its Section 202 housing project according to its regulatory agreement and applicable HUD requirements. The conditions identified by the audit occurred because Four Freedoms did not fully understand HUD replacement reserve account requirements and it believed that its board of directors needed only to comply with the membership requirements in its bylaws. As a result, \$175,456 in replacement reserve account funds was not deposited into interest-bearing accounts as required, and \$501,696 in replacement reserve account funds was at risk of being lost if the bank failed. Also, the board of directors did not have the level of independence and broad representation of public interest groups that were required by the regulatory agreement. To resolve these issues, Four Freedoms needs to transfer replacement reserve account funds to other banks to ensure that the funds are deposited into interest-bearing accounts and fully insured at all times in accordance with HUD requirements and increase the membership of its board of directors to comply with its regulatory agreement. Four Freedoms indicated that it would transfer replacement reserve account funds to ensure that the funds were deposited into interest-bearing accounts and fully insured at all times and increase the membership of its board.

Recommendations

We recommend that the Director of HUD's Philadelphia Office of Multifamily Housing require Four Freedoms to

- 1A. Transfer replacement reserve account funds to other banks to ensure that the funds are deposited into interest-bearing accounts and fully insured at all times in accordance with HUD requirements.
- 1B. Increase the membership of its board of directors to comply with its regulatory agreement.

⁷ Four Freedoms' bylaws required the board to consist of no fewer than 3 members and no more than 25 members.

SCOPE AND METHODOLOGY

We conducted the audit from October through December 2011 at Four Freedoms' office located at 6101 Morris Street, Philadelphia, PA, and at our office located in Philadelphia, PA. The audit covered the period October 2005 through August 2011 but was expanded when necessary to include other periods. We relied in part on computer-processed data in Four Freedoms' computer system. We used a computer-generated listing of all expenditures for the period September 2009 through August 2011 to review expenditures to determine whether operating funds were expended as required. 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.

To achieve our audit objective, we

- Obtained relevant background information.
- Reviewed the regulatory agreement and applicable HUD rules, regulations, and guidance.
- Reviewed minutes from the annual meetings of Four Freedoms' board of directors held on November 9, 2009, November 15, 2010, and April 11, 2011.
- Reviewed Four Freedoms' fiscal year 2009 and 2010 audited financial statements.
- Reviewed reports from HUD's management and operations review, dated July 28, 2010; PMAM's management and occupancy review, dated April 7, 2010, and April 28, 2011; and Four Freedoms' responses.
- Reviewed all 14 fund authorization forms (form HUD-9250) related to the withdrawal of \$405,754 in replacement reserve funds during the period September 2009 through September 2011. We reviewed the procurement documentation supporting \$129,000 withdrawn for the installation of new sliding glass doors because it represented the largest amount of funds paid to a single entity during the period.
- Reviewed bank statements related to security deposits and replacement reserve funds for the period September 2009 through September 2011.
- Reviewed Four Freedoms' July 2006 emergency capital repair program grant application, September 2006 emergency capital repair program grant agreement, and payment documentation.
- Reviewed 20 weekly inspection reports and 13 inspection checklists for units that new tenants occupied for the period July through October 2011. We also reviewed bed bug inspection checklists for all 15 vacant units as of October 2011.

- Reviewed Four Freedoms’ policies and procedures related to bed bug prevention and security deposits.
- Interviewed relevant Four Freedoms and Prudent Property Managers, Inc., staff and officials from HUD’s Philadelphia Office of Multifamily Housing.
- Reviewed a nonstatistical sample of 7 tenant files from the universe of 74 tenants who moved out of the project during the period September 2009 to October 2011 to determine whether Four Freedoms collected the correct security deposit amounts from its tenants and that it refunded the correct security deposit amounts to them.
- Selected a sample of 10 expenditures of operating funds valued at \$261,342 from a list of 1,254 expenditures totaling \$3.7 million during the period September 2009 through August 2011. We selected eight expenditures because they represented the largest expenditures, excluding expenditures for all routine monthly expenses such as utilities and mortgage payments. We selected two expenditures because they represented the latest payments Four Freedoms made to the maintenance contractor to which it made the largest total expenditures during the period. The 10 payments we reviewed were supported by 11 invoices and other supporting documentation.
- Accompanied a contract exterminator during bed bug inspections in two units and verified that the inspections were thorough.
- Physically verified that Four Freedoms painted five apartment units and installed new refrigerators, ranges, and carpet in compliance with the Philadelphia Office of Multifamily Housing’s comprehensive onsite management and operations review.
- Physically verified that Four Freedoms used its 2006 emergency capital repair program grant to repair the elevator and install a standpipe.

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. 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 controls were relevant to our audit objective:

- Policies and procedures that Four Freedoms implemented to ensure that activities met established program objectives and requirements.
- Policies and procedures that Four Freedoms implemented to ensure that resource use was consistent with applicable laws and regulations.

We assessed the relevant controls 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.

We evaluated internal controls related to the audit objective in accordance with generally accepted government auditing standards. Our evaluation of internal controls was not designed to provide assurance regarding the effectiveness of the internal control structure as a whole. Accordingly, we do not express an opinion on the effectiveness of Four Freedoms' internal control.

APPENDIX

Appendix A

AUDITEE COMMENTS

Prudent Property Managers, Inc.

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February 22, 2012

John P. Buck Regional Inspector General for Audit
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Office of Inspector General
Philadelphia Regional Office
Wanamaker Building
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Philadelphia, PA 19107-3380

**SUBJECT: FOUR FREEDOMS HOUSE OF PHILADELPHIA, INC.
DRAFT OF HUD AUDIT OF FOUR FREEDOMS HOUSE OF PHILADELPHIA**

Dear Mr. Buck:

Thank you for allowing us the opportunity to respond to the Discussion Draft Audit received via electronic mail on February 15, 2012 (the "Audit Report") prepared by the Office of Inspector General (hereinafter OIG) of the Department of Housing and Urban Development (hereinafter HUD) with respect to the OIG audit to determine whether Four Freedoms House of Philadelphia (hereinafter FFHP) managed its Section 202 Housing Project in Accordance with the requirements of the regulatory agreement and applicable HUD requirements.

FFHP has reviewed the audit findings and the recommendations and agrees with the findings and recommendations contained in the report. FFHP has pro-actively made and followed the two (2) recommendations as set forth in the audit report.

FFHP is pleased that the audit report reaffirms that FFHP manages its Section 202 Housing project in accordance with the requirements of the regulatory agreement and applicable HUD requirements, and that the allegations of mismanagement had no merit.

FFHP would like to thank the OIG for their thoroughness in performing this audit. We would also like to acknowledge and compliment the professionalism of the OIG staff. We appreciate the OIG and HUD'S oversight to ensure that FFHP operates in accordance with the regulatory agreement and applicable HUD rules and regulations.

Very truly yours,



Mark H. Hildebrandt
President and Chief Executive Officer
As Managing Agent for
Four Freedoms House of Philadelphia

MHH: cf