Issue Date
March 18, 2009

Audit Report Number
2009-LA-1008

TO: Thomas W. Azumbrado, Director, San Francisco Multifamily Hub, 9AHMLAP

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Los Angeles, 9DGA

SUBJECT: Campaige Place at Jackson, Phoenix, Arizona, Did Not Use Its Project Funds in Compliance with HUD's Regulatory Agreement and Other Federal Requirements

HIGHLIGHTS

What We Audited and Why

We audited Campaige Place at Jackson (Campaige Place) to determine whether it used its project funds in compliance with the U.S. Department of Housing and Urban Development's (HUD) regulatory agreement and other federal requirements. We performed this audit because Campaige Place defaulted on its HUD-insured $10 million mortgage, and the project owed more than $500,000 in interest and back payments for principal.

What We Found

Campaige Place did not use its project funds in compliance with HUD's and other federal requirements. Specifically, we determined that

A. Owner advances of $73,750 were repaid when the project had no surplus cash,
B. Tenant security deposit accounts were underfunded by $57,608,
C. An unexplained payable of $26,328 was mistakenly recorded as a liability,
D. Support was incomplete or missing for operating expenses of at least $8,341, and
E. Management expenses of $20,714 were inappropriately charged to the project.

The expenditures we questioned partially contributed to Campaige Place's operating cash shortfalls. As a result of the project's operating cash shortfall, Campaige Place had fallen behind in its mortgage payments and, near the end of our audit, the mortgage was assigned to HUD.

What We Recommend

We recommend that the director of the San Francisco multifamily hub require the project's owner/agent to repay or support questioned costs of $160,413 less $81,284 already repaid or supported and to remove the unsupported payable of $26,328 from the project's accounts. We also recommend that the director require the project to establish controls to ensure compliance with HUD's regulatory agreement and other federal requirements.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided our discussion draft report to Campaige Place on February 11, 2009 and held an exit conference with the project's officials on February 18, 2009. The project provided comments on February 26, 2009. The project generally agreed with the substance of our 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. However, the attachments to the response will be made available upon request.

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BACKGROUND AND OBJECTIVE

Campaige Place at Jackson (Campaige Place) is a 302-unit multifamily project insured under Section 221(d)(4) of the National Housing Act, 12 U.S.C. (*United States Code*) 1715. U.S. Department of Housing and Urban Development (HUD) statutory and regulatory provisions authorized the Federal Housing Commissioner to regulate the borrower through a regulatory agreement.

Campaige Place Phoenix One, also known as Campaige Place at Jackson, was formed as a limited partnership under the laws of the State of Arizona on May 9, 2000, for the purpose of constructing and operating a low-income rental housing project for the downtown Phoenix, Arizona, workforce. The partnership was between NewHom Management, as a general partner, with .01 percent interest and John Hancock Corporate Tax Credit Fund, as the limited partner, with 99.99 percent interest. This owner-managed multifamily project was developed with a $10 million HUD-insured mortgage and $4.5 million in tax credit funds. The project consists of 100 percent affordable units and has always charged rents less than the tax credit limit.

During our audit, we noted that the downtown Phoenix economy remained difficult for affordable housing and that the market conditions contributed to the project's financial problems. Therefore, our audit focused on the extent to which the project's expenditures were allowable and reasonable. Specifically, our objective was to determine whether Campaige Place used its project funds in compliance with its regulatory agreement with HUD and other federal requirements.

RESULTS OF AUDIT

Finding 1: Owner's Advances Were Repaid While the Project Was in a Non-Surplus-Cash Position

Campaige Place repaid a total of $73,750 in owner's advances from 2005 through 2008 while in a non-surplus-cash position. This condition occurred because the owner/agent had insufficient knowledge of HUD's requirements regarding repayment of owner's advances. The project's repayment of the owner's advances from affiliates while in a non-surplus-cash position partially contributed to the project's operating cash shortfalls.

The Project Repaid $73,750 in Owner's Advances

Campaige Affordable Housing - Company B, an affiliate of the project, advanced a total of $461,000 to the project from January 2005 through November 2008. Financial records showed that the project repaid advances that totaled $73,750 during the audit period: three repayments in 2005 (in January, February, and April), one repayment in March 2007, and two in 2008 (in July and September). As of November 2008, the balance of the advances payable to the affiliate was $854,974 instead of $928,724 as it should have been.

Year	Payable to affiliate* ending balances	Repayment
2005	$ 523,974	$ 26,750
2006	558,974	0
2007	742,974	22,000
2008 (As of November)	854,974	25,000
Total		**$ 73,750**

*Campaige Affordable Housing - Company B

The Project Was in a Non-Surplus-Cash Position

Since its inception in 2003, Campaige Place had not been in a surplus-cash position. Review of the project's 2005, 2006, and 2007 financial statements showed net losses before depreciation. Operating expenses increased each year, while rental income fell short of projections. Additionally, the surplus (deficiency) cash amounts for 2005, 2006, and 2007 were $(368,555), $(266,719), and $(378,516), respectively.

Campaige Affordable Housing - Company B advanced funds to the project during deficit periods. HUD allows repayment of such owner's advances subject to its approval only when the project has surplus cash (see criteria in appendix C). According to the regulatory agreement, the project's surplus cash position should be computed at the end of the annual or semiannual periods. The project's repayment of owner's advances while in a non-surplus-cash position violated the regulatory agreement. Because Campaige Place repaid $73,750 in owner's advances while in a non-surplus-cash position, its financial situation became more difficult.

The owner/agent acknowledged insufficient understanding of HUD rules and regulations regarding repayment of owner's advances. After our audit work was completed, the owner/agent took corrective actions to resolve some of the discrepancies. Campaige Affordable Housing – Company B repaid $15,000 to the project on January 27, 2009.

Recommendations

We recommend that the director of the San Francisco multifamily hub require the owner of Campaige Place to

1A. Reimburse HUD's Federal Housing Administration insurance fund $73,750 less amounts repaid after the completion of the audit ($15,000) for the ineligible disbursements cited in this report.

1B. Ensure that controls are in place to determine the project's surplus-cash position in accordance with its regulatory agreement and only make distributions or repayment of owner's advances when authorized.

Finding 2: Tenant Security Deposits Were Underfunded

During our audit, project records showed a liability of $57,608 for tenant security deposits. However, the tenant security deposit bank account was underfunded because its balance ranged from $0 to $20,000. This condition occurred because project management disregarded financial statement audit findings and HUD rules and regulations regarding security deposits. As a result, the tenants' security deposits were not safeguarded and were at risk of being diverted by management for unauthorized uses.

The Security Deposit Account Had Been Underfunded for Years

Originally, the project had two separate bank accounts designated for tenant security deposits; however, it did not deposit the security deposit collections into these bank accounts dollar for dollar. The project commingled receipts for tenant security deposits with rent receipts and other revenue by keeping all of the funds in the project's operating bank account. Over time, the tenant security deposit accounts became underfunded; i.e., the balance of the tenant security accounts was less than the aggregate of all outstanding obligations. At the time of our audit, the project had no separate bank account designated for tenant security deposits, and the recorded liability was $57,608. In November 2008, the project opened a new security deposit account, and management transferred an initial amount of $20,000 into the account. After we completed our work, the owner/agent provided documentation to show that the tenant security deposit account had been fully funded as of December 31, 2008.

Tenant Security Deposits Were Not Safeguarded

The financial statement audit reports for years 2005 through 2007 disclosed the project's noncompliance under HUD regulations and the project's regulatory agreement regarding tenant security deposit requirements. According to HUD regulations, deposits paid by a tenant at the time a unit is rented (security deposits) should be placed into an account specifically for tenant deposits and held until the tenant vacates the unit (see criteria in appendix C). According to the owner, management did not heed the findings because local real estate practices did not require segregation of tenant deposits. As a result, the tenants' security deposits were not safeguarded and were at risk of being diverted by management for unauthorized uses.

Recommendations

We recommend that the director of the San Francisco multifamily hub require the management (owner/agent) of Campaige Place to

2A. Fully fund the security deposit account for the liability amount of $57,608 less amounts deposited during the audit.

2B. Establish controls to ensure that all tenant security deposits are safeguarded and maintained in the designated security depository bank accounts in compliance with the regulatory agreement.

Finding 3: An Unexplained Payable Was Mistakenly Recorded as a Liability

The project mistakenly recorded a professional service fee of $26,328 as an operating expense. Management initially stated that this was a development expense that had not yet been paid to the project's architect but did not provide documentation to support this assertion. Management had inadequate internal controls over classification and support of project operating expenses. As a result, liabilities were overstated.

Management Failed to Support a Questioned Cost

Campaige Place recorded a payable in 2004 for an architect fee of $26,328. HUD questioned this cost in July 2008 and determined that it was an unallowable development expense. During our review this amount was still recorded as past due in the aged accounts payable; however, the owner/agent could not provide an invoice or other documentation as support.

Management Had Inadequate Controls Over Project Expenses

Campaige Place was the owner/agent's first HUD-insured property and, therefore, management's experience with HUD rules was limited. HUD requires the owner/agent to maintain documentation for project expenses and to establish a financial accounting system that segregated operating funds from other project funds (see criteria in appendix C). In this instance, the project's failure to follow HUD requirements occurred because there were inadequate controls over the classification and support of project operating expenses. After our audit work was completed, the owner/agent stated that the former controller mistakenly entered the payable without supporting documentation. Management also confirmed that all of the architectural fees for the project had been paid in full. The owner/agent planned to remove this expense from the project's liabilities. By leaving this payable in its accounts, Campaige Place had overstated its liabilities.

Recommendation

We recommend that the director of the San Francisco multifamily hub require the management (owner/agent) of Campaige Place to

3A. Confirm that the $26,328 in unallowable expense has been removed from the project's books.

3B. Establish controls to ensure all recorded transactions are properly classified and adequately supported.

Finding 4: Documentation to Support Operating Expenses Was Not Complete

The project did not always provide detailed vendor invoices to support expense items paid with its corporate credit card. This condition occurred because management did not have adequate internal controls to ensure expenses were properly supported. Without the proper supporting documentation, auditors and other reviewers could not verify that expenses were eligible and recorded accurately. As a result, we questioned $8,341 in expenses based on the sampled transactions tested.

Credit Card Statements Were Paid with Incomplete or Missing Invoices

Campaige Place management (owner/agent) used an affiliate's American Express corporate credit card to pay for operating expenses for all six projects that it owned and managed. When the credit card statement was received, management allocated the charges to whichever project had incurred the expense. However, expense items were not always adequately supported by detailed vendor invoices. The following table shows details of the unsupported transactions pertaining to Campaige Place that were identified in a test sample.

Date	Item	Expense	Unsupported amount
Aug. 3, 2007	Allied Forces	$1,443.48	$1,443.48
Oct. 1, 2007	Uniforms	258.60	258.60
Oct. 1, 2007	Minimart supplies	450.23	136.59
Oct. 1, 2007	Advertising - Phoenix New Times	2,580.00	2,580.00
Oct. 1, 2007	M&R - materials	1,817.10	817.11
Oct. 1, 2007	Newspaper	500.00	500.00
Nov. 1, 2007	M&R - materials	447.92	447.92
Nov. 1, 2007	Tenant incentive	540.94	477.56
Nov. 27, 2007	Cox Communications	54.96	54.96
Dec. 31, 2007	Newspaper	1,625.00	1,625.00
	Total		**$8,341.22**

Controls over Documentation of Expenses Were Inadequate

Management did not have adequate internal controls to ensure expenses were properly supported. The above expenses were paid with inadequate supporting documentation, which was not in compliance with requirements outlined in the HUD handbook (see criteria in appendix C). As a result, the project's records could not provide assurance that the unsupported expenses were reasonable and properly allocated to Campaige Place. We questioned $8,341 in unsupported costs. After our audit work was completed, the auditee provided supporting documentation for $6,210 in questioned expenses and repaid a total of $2,131 for the unsupported amounts using nonfederal funds.

Recommendations

We recommend that the director of the San Francisco multifamily hub require the management (owner/agent) of Campaige Place to

4A. Provide documentation to show the unsupported costs of $8,341 were either repaid using nonfederal funds, or are now adequately supported.

4B. Establish controls to ensure expenses are properly supported.

Finding 5: Management Expenses Were Paid from Project Operating Funds

The project used its operating funds to pay for management (owner/agent) expenses to supervise project staff and oversee project operations. The owner/agent had an insufficient understanding of HUD rules and regulations regarding allowable management costs because Campaige Place was its first HUD-insured project. As a result, $20,714 in operating funds was not available for project expenses, including the mortgage payments.

Management Expenses Were Paid from Project Funds

Management charged unallowable expenses to the project for management agent staff travel and incentives. Our review of a limited number of transactions from the years 2005 through 2007 identified the following unallowable expenses:

Ineligible project expenses		
Date	**Description**	**Amount**
Apr. 29, 2005	Lease commission	$9,000.00
July 26, 2005	Lease commission	1,000.00
Feb. 10, 2006	Lease commission	3,210.00
Feb. 10, 2006	Lease commission	1,000.00
Apr. 30, 2007	Lunch	27.14
Apr. 30, 2007	Airfare	108.80
Apr. 30, 2007	Rental car	87.39
May 2, 2007	Per diem	118.00
June 1, 2007	Travel – auto	575.48
July 1, 2007	Travel	1,007.20
July 31, 2007	Per diem	590.00
Aug. 1, 2007	Travel	380.63
Aug. 7, 2007	Per diem	590.00
Nov. 1, 2007	Airfare	256.80
Nov. 1, 2007	Travel	952.64
Nov. 1, 2007	Employee incentive	206.01
Nov. 30, 2007	Airfare	247.30
Nov. 30, 2007	Travel	860.08
Nov. 30, 2007	Meals	99.03
Dec. 31, 2007	Ground transportation	362.04
Dec. 31, 2007	Lunch	35.92
	Total	**$20,714.46**

The management owner/agent's director of operations stated that management staff traveled to Campaige Place to hire employees, provide training, and perform inspections. However, these tasks were the responsibility of management and, therefore, the travel costs should have been paid by management from the fee it received. Campaige Place paid the owner/agent a fee of 3.6 percent of its residential, commercial, and miscellaneous income collected. This management fee should have been used to pay for services that were not front-line activities; for example, management staff travel, recruiting, hiring, training, monitoring, filling staff vacancies, and supervising project personnel (see criteria in appendix C). In addition, because the project collected a management fee on its commercial leases, management costs such as brokerage commissions should be paid from that fee.

Operating Expenses Were Overstated

As a result of charging management expenses to the project, operating expenses were overstated, and insufficient funds were available to pay front-line project expenses and other eligible costs, including mortgage payments. After our audit work was completed, the auditee repaid $335 of the total amount owed to the project.

Recommendations

We recommend that the director of the San Francisco multifamily hub require the management (owner/agent) of Campaige Place to

5A. Reimburse HUD's Federal Housing Administration insurance fund $20,714 less amounts already repaid ($335) for ineligible project expenses cited in this report.

5B. Establish controls to ensure that costs covered by management fees are not paid from operating funds.

SCOPE AND METHODOLOGY

The audit covered the use of project funds for the period January 1, 2005, through December 31, 2007. However, to quantify the results of two findings, we extended the scope to November 2008. Our audit was performed at Campaige Place located in Phoenix, Arizona, and at the management agent's office in San Diego, California. We performed our audit work from September 15 through November 30, 2008.

To perform our audit, we

- Reviewed applicable laws, regulations, and guidance issued by HUD (see criteria in appendix C);
- Reviewed pertinent financial records maintained by the project on site and at the corporate office of the owner/agent;
- Interviewed staff from the project and the owner/agent;
- Reviewed HUD files and interviewed HUD officials in the Phoenix Office of Multifamily Housing; and
- Physically inspected the property.

Specifically, our audit included the review of Campaige Place's financial records and the management agent's accounting system, policies, and procedures. We reviewed transactions from 2005 through 2007 and tested a non-statistical sample of receipts and disbursements for support, accuracy, and compliance with HUD rules and regulations. We did not project our results to the universe of transactions in our audit scope.

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 an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved:

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They 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 objectives:

- Administering the project's operations in compliance with applicable laws and regulations,
- Maintaining complete and accurate records, and
- Safeguarding the project's resources.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

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

The project did not have adequate controls in place to ensure that

- Project financial transactions complied with applicable laws and regulations (findings 1, 2, 3, 4, and 5).
- Tenant security deposits were adequately safeguarded (finding 2).
- Project financial records were complete and accurate (finding 4).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/	Unsupported 2/
1A	$73,750	
2A	$57,608	
3A		$26,328
4A		$8,341
5A	$20,714	
Totals	**$152,072**	**$34,669**

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 polices or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

THE TOM HOM GROUP

February 26, 2009

Joan S. Hobbs
Regional Inspector General for Audit
US Dept. of HUD - OIG
611 West Sixth Street, Suite 1160
Los Angeles, CA 90017

Re: Campaige Place at Jackson, Phoenix, AZ
Response to Office of Inspector General's Draft Audit Report

Dear Ms. Hobbs:

I am writing to provide formal written comments to the Office of Inspector General's (OIG) draft audit report regarding Campaige Place at Jackson, located in Phoenix, AZ, (the "Property"), which was issued February 11, 2009. We appreciate this opportunity to provide our comments and to point out some errors in the draft report.

While we recognize that it is the duty of the OIG to report all compliance issues identified during the audit, we expected the report to include a comprehensive discussion of the seriously distressed Phoenix rental market underlying the financial conditions at the Property. We also expected the audit to fully acknowledge all of the corrective actions implemented by the Owner. As currently written, the draft report includes inconsistencies and misrepresents amounts due to the Property, as well as the recommended actions still remaining. As a result, the corrective actions requested are overstated by approximately $100,000. Therefore, we request your consideration of and action on the following.

I. <u>General Observations</u>

Before we address each of the findings, we provide a general overview of our efforts to manage the Property. As noted in the OIG report, this is our first and only HUD project. Naturally, we did not intend to disregard the HUD rules. Any non-compliance was a mere oversight resulting from our efforts to comply with the HUD obligations while also dealing with many other significant stressors.

We regret that our inexperience with HUD requirements and the many financial, management and local market challenges facing the Property resulted in some instances of non-compliance; however we have diligently strived to learn and comply with HUD

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Comment 1

requirements and manage the Property as successfully as possible. Accordingly, we respectfully request that the following information be reflected in the "Highlights" and "Background and Objective" sections of the OIG's report.

A. Phoenix Rental Market and Operating Cash

In addition to the challenges we faced as a new HUD participant, we struggled with an extremely volatile Phoenix, Arizona rental market, where growth slowed dramatically in recent years and rents declined in 2008 while operating costs rose. As a result of soaring foreclosure rates and rising unemployment, there is an oversupply of rental housing in Phoenix that has compromised demand and driven down rental prices. As a result, vacancy rates increased sharply, rising more than 200 basis points since third quarter 2007, and are more than 50% higher than the national average.

Struggling with the flooded Phoenix rental market, the owner and management agent have had difficultly maintaining occupancy, particularly at the rents needed to support the financing that was underwritten during the housing boom, when demand and rents were much higher. In order to meet the operating cash short falls created by rising vacancies and other market challenges, the owner and its affiliates have advanced more than $958,000 to the Property since final closing of the HUD-insured loan.

B. HUD Guidance

While we continuously worked to meet our obligations under the HUD documents and handbooks, compliance presented particular challenges given the volume of information, internal inconsistencies within the materials and numerous provisions that are open to interpretation. We note that the primary HUD guidance in this area, the Management Agent Handbook, Housing Handbook 4381.5 REV-2 (the "Handbook'), has not been comprehensively reviewed or revised in over fourteen (14) years. In many cases the guidance in the Handbook is outdated or internally inconsistent. We understand that HUD has recognized the problems posed by this situation and is currently reviewing the Handbook and considering a number of policy revisions.

We have adopted reasonable interpretations of the applicable HUD guidance where necessary. In certain cases, the management agent may have assumed that HUD requirements and standards were consistent with the local real estate practices applied at other properties. To address the unique challenges of interpreting and complying with HUD requirements and local practices, we have sought and hired more experienced personnel to assist with the management and operation of the Property.

C. Staff and Auditor Turnover

In an effort to increase depth of knowledge of HUD requirements, the management agent underwent significant staff turnover in the past two years. Through attrition and, in one case, termination, the management agent has replaced many long-term senior staff members with more seasoned professionals knowledgeable of HUD requirements. While these transitions presented an immediate management challenge for the Property, the addition of competent professionals who are better suited than their predecessors to handle the complexities of a HUD project and the local market challenges will benefit the Property in the long run.

We also changed auditors to ensure better compliance with HUD requirements. After experiencing significant problems with the prior auditors, at the end of 2006 we terminated their services and hired Novogradac & Co. We believe that Novogradac & Co. will provide the Property with better service and guidance on HUD program requirements in the future.

II. Highlights

Comment 2

The preliminary section of the draft audit report gives the impression that the questioned expenditures caused the mortgage default and fails to recognize the significant corrective actions taken by the owner. While we acknowledge that some deviations from HUD guidance occurred, these limited violations were not the primary cause of the financial default on the HUD insured mortgage.

A. "What We Found"

We recognize that the OIG must report the results of its findings as of the date of the audit; however we continue to believe the audit should reflect a more accurate description of the underlying conditions that lead to the owner's need to make such sizeable advances. Accordingly, the statement at the top of page two should be revised as follows:

> *Some of the expenditures we questioned may have contributed to Campaige Place's operating cash shortfalls, however these expenditures were offset by owner/affiliate advances to the property and were not the proximate cause of the mortgage default.*

Comment 3

The draft as currently written overemphasizes the deductions from the Property's cash flow by approximately $100,000. A total of $69,464, and not $178,400 as the OIG asserts, represents the total outstanding questioned expenses.[1]

Of the amounts stated in the draft audit, $57,608 relates to security deposits that do not impact operating cash flow, $26,328 relates to an item that was mistakenly characterized as an unpaid expense and $25,000 is for mistaken repayments of owner advances that

[1] We believe that we have supported or repaid all questioned expenses. The OIG has acknowledged our repayments and accepted most of the support submitted and we understand that only the following expenses remain in question (1) $48,750 of the total questioned repayments of owner advances ($73,750); and (2) $20,714 of alleged management expenses.

3

have already been returned to the Property. The remaining questioned expenses ($69,464) have been overwhelmingly offset by the owner/affiliate's substantial contributions to the Property during this period by a ratio of nearly seven to one. Thus, the questioned expenses did not significantly impact operating cash shortfalls or cause the eventual mortgage default. As discussed above, operating cash shortfalls primarily resulted from the high vacancy rates and other challenges relating to the decimated Phoenix rental market.

B. General Recommendations

As you are aware, we have already provided support for most of the questioned expenditures and we have repaid the balance of those deemed to be unsupported or questioned ($27,465.98) to the Property.[2] Our calculations suggest that the maximum potential repayment amount after the completed corrective actions are taken into account is $69,129.[3]

Comment 4

We recognize that the OIG must report the total of its original questioned costs, but we note that this amount already appears in Appendix A to the report. As written, the general recommendation suggests that the Hub Director must demand repayment or support of more than is owed, which is inconsistent with the recommended findings and the corrective actions already undertaken. To avoid providing inconsistent or unclear guidance to the report's recipients, we request the first paragraph under Recommendations be revised as follows:

> *We recommend that the Director of the San Francisco Multifamily Hub require the project to repay the $69,129, the outstanding balance of the total questioned expenditures reported herein ($178,400).*

III. <u>Finding 1: Repayment of Owner Advances</u>

Comment 5

The owner and its affiliates have advanced over $958,000 to the Property since final endorsement of the mortgage loan. We regret that on occasion inadvertent repayments of these advances occurred when the Property was in a non-surplus cash position, however the repayments totaled only 7.5% of the total amount advanced and were more than offset by the substantial advances. But for these significant advances, the Property would have been more severely impacted by fluctuations in the market and would likely have

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[2] Repayments totaling $27,465.98 include the return of mistakenly repaid owner advances ($25,000.00), unsupported operating expenses ($687.71), misallocated operating expenses ($1,443.48) and two repayments for management expenses classified as operating expenses ($259.25 and $75.64).

[3] Of the alleged management expenses classified as operating expenses ($20,714), $334.89 has already been repaid. Accordingly, outstanding questioned expenses total $69,129 ($48,750 mistaken repayment of advances and $20,379 alleged management fees).

Comment 5

defaulted on the mortgage much sooner. As noted above, the operating cash shortfall and eventual default resulted primarily from the distressed Phoenix rental market and not from a limited number of accounting errors. In order to avoid an overstatement of the impact of the mistaken repayments, we respectfully request that the last sentence of the introductory paragraph be revised as follows:

> *The project's repayment of advances from affiliates while in a non-surplus cash position may have contributed, in part, to the project's operating cash shortfalls.*

A. The Project Repaid $73,750 in Owner Advances

In order to accurately reflect the advances made to the Property and the corresponding repayments to the owner's affiliate, Campaige Affordable Housing – Company B, we request that the table of payables be revised accordingly. As indicated in the revision below, every mistaken repayment was more than offset by subsequent advances, the July 14, 2008 mistaken repayment ($10,000) was swiftly identified and repaid to the Property within two days, and the September 9, 2008 mistaken repayment has been repaid to the Property (**Tab A**).

> *Campaige Affordable Housing – Company B, an affiliate of the project, advanced a total of $476,000 to the project from January 2005 through January 2009. Financial records showed that the project repaid advances that totaled $73,750 during the audit period: three repayments in 2005 (January, February, and April), one repayment in March 2007, and two in 2008 (July and September). The owner identified the repayment made in July 2008 and returned it to the project two days later. As of February 2009, the balance of the advances payable to affiliates was $958,224 instead of $1,006,974, as it should have been.*

Advances from Campaige Affordable Housing Company B			
DATE	**REPAID**	**ADVANCE**	
Beginning Balance Due all Affiliates			**(535,973.60)**
01/14/2005	22,500.00		
02/11/2005	1,000.00		
04/07/2005	3,250.00		
06/07/2005		21,000.00	
07/26/2005		62,000.00	
12/01/2006		35,000.00	
01/19/2007		10,000.00	
02/14/2007		20,000.00	
03/07/2007	22,000.00		

03/29/2007		20,000.00*	
05/21/2007		15,000.00	
05/25/2007		15,000.00	
05/30/2007		15,000.00	
07/17/2007		5,000.00	
07/31/2007		43,000.00	
09/05/2007		40,000.00	
10/11/2007		15,000.00	
11/07/2007		3,000.00	
11/16/2007		15,000.00	
11/21/2007		10,000.00	
01/04/2008		15,000.00	
01/10/2008		7,000.00	
02/07/2008		30,000.00	
03/05/2008		25,000.00	
03/21/2008		10,000.00	
05/05/2008		20,000.00	
05/27/2008		20,000.00	
07/14/2008	10,000.00		
07/16/2008		10,000.00	
09/09/2008	15,000.00		
01/27/2009		15,000.00	
	73,750.00	**496,000.00**	
Ending Balance Due all Affiliates			**(958,223.60)**

** This advance was made by owner affiliate William Newbern*

B. The Project Was in a Non-Surplus-Cash Position

Given that the twenty-five sizeable affiliate advances overwhelmingly mitigated the impact of the six mistakenly repaid advances, we request that the last sentence of the second paragraph be revised as follows.

Comment 5

> *Were it not for the substantial owner advances, the mistaken repayment of $73,750 to the owner while the project was in a non-surplus-cash position would have contributed to the project's already stressed financial situation.*

We also request that the last paragraph of this section be revised to fully acknowledge the corrective actions undertaken.

Comment 6

> *After our audit work was completed, the owner/agent took corrective actions to resolve all of the discrepancies. Campaige Affordable Housing Company B (1) repaid $15,000 to the Project on January 27, 2009; (2) demonstrated that the $10,000 mistaken repayment made on July 14, 2008 was repaid to the Project on*

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Comment 6

Comment 7

Comment 8

> *July 16, 2008; (3) demonstrated that all other mistaken repayments had been offset by subsequent advances; and (4) implemented new procedures to prevent repayment of advances when the project is in a non-surplus cash position, which includes identifying and reversing repayments if they occur.*

C. Recommendations

The OIG recommendation understates the amounts already repaid. We respectfully suggest that the recommendation be revised to acknowledge the full amount already repaid ($25,000) and permit the owner to net the outstanding potential repayments ($48,750) against the advances payable to affiliates, which would reduce the payable to $909,474.

> *1A. Reduce the current amount payable to affiliates ($958,224) by the amount of ineligible disbursements cited in this report and not already repaid ($48,750).*

IV. <u>Finding 2: Tenant Security Deposits Were Underfunded</u>

We acknowledge and regret that the tenant security deposit fund was underfunded, however as noted in the draft audit report, this account was fully funded as of December 31, 2008. We have also provided training and implemented safeguards to ensure that the security deposit funds remain segregated. We respectfully request that Recommendation 2A be removed because the tenant security deposit account has already been fully funded and this issue has been resolved.

V. <u>Finding 3: Architect's Fee</u>

We respectfully request that the caption of this finding be rephrased as ***"A Perceived Development Cost was Mistakenly Recorded as an Operating Expense"*** to more accurately reflect the treatment of this expense.

As the OIG and we have determined, the questioned cost was not a development cost, but was mistakenly recorded as project payable. As indicated by the attached email **<u>(Tab B)</u>** from Leslie Nordman at Rob Wellington Quigley, FAIA (the "Architect"), the Owner has paid all architect fees and owes nothing to the Architect. As we have discussed, we and the Property's current auditors have been unable to locate any support for this expense and we believe that it was mistakenly recorded as an operating expense by the former controller. Accordingly, the introductory paragraph should be revised as follows.

> *The project recorded a professional service fee of $26,328 as an operating expense. Management initially stated that this was a development cost that had not yet been paid to the architect, but after further investigation management presented evidence that all of the architect's expenses have been paid and concluded that this*

was not an expense of the property. Management did not timely support this expense in order to determine its correct classification, which lead to an overstatement of operating expenses.

A. Management Failed to Support Questioned Cost

Comment 9

As noted above, the former controller erroneously recorded this expense, so when initially questioned, we assumed that fees paid to the architect were a development expense. However, after researching this we ultimately determined that this was not a development expense. Accordingly, we suggest that the title of this paragraph be relabeled "***Management Failed to Support Questioned Cost,***" in order to accurately characterize the cost. We also request the following revision to the last sentence of the paragraph.

Comment 10

When questioned about the expense during our audit the owner/agent could not provide an invoice or other documentation as support; however the Owner later confirmed that all architect's fees were paid at final closing and that the questioned expense was mistakenly recorded against the project operating account.

B. Recommendations

"3A. Remove the $26,328 in unallowable expense from the project's books"

We have instructed the auditor to remove this expense from the project's books. Accordingly, we request that Recommendation 3A be revised to reflect this action, as follows.

Comment 11

3A. Confirm that the $26,328 in unallowable expense has been removed from the project's books.

"3B. Establish controls to ensure that project operating expenses are fully supported and maintained separately from development funds."

Comment 12

As noted above, the questioned expense was not a development expense and thus the owner did not violate the requirement that operating and development funds be maintained separately. We have made changes in our accounting staff and switched auditors, and we have implemented internal controls to ensure proper classification and support of operating expenses. Accordingly, we request that Recommendation 3B be removed because there was no departure from HUD requirements that such expenses be segregated, but rather an inadvertent classification error occurred.

VI. <u>Finding 4: Operating Expenses</u>

Comment 13

A. "Credit Card Statements Were Paid With Incomplete or Missing Invoices"

The owner has submitted supporting invoices for most of the questioned expenses listed in the table in this section and has repaid the balance of the expenses. We request that the following sentence be added to the end of the paragraph.

> *The Owner has provided support for most questioned transactions and repaid all remaining unsupported or misallocated expenses.*

Supporting invoices for the following questioned expenses have been submitted to and accepted by the OIG.

Advertising (Phoenix New Times)	$2,580.00
M&R Materials (Home Depot)	$817.11
Newspaper (Phoenix New Times)	$500.00
M&R Materials (Home Depot)	$447.92
Newspaper (Phoenix New Times)	$1,625.00
	$5,969.31

The only arguably open outstanding expense is the $258.60 expense incurred for uniforms on October 1, 2007. We have submitted an invoice for $250.00 to the OIG and repaid $18.60 for tax charges that were misallocated to the Property. As indicated by the annotation on the attached invoice (**Tab C**), the submission supports the questioned expense. We understand that it is the vendor's policy to charge the affiliate's American Express credit card when services are provided and later create an invoice that reflects the date the invoice was created, not the date service was rendered. We cannot control the timing of the vendor's invoice preparation practices.

Regrettably, certain questioned expenses were misallocated to the Property and supporting documentation could not be obtained for others. We are disappointed that these accounting errors occurred. We have repaid all misallocated and unsupported amounts (**Tab D**), listed below, and have increased training and oversight of the management agent's accounting staff to ensure such errors do not reoccur.

Allied Forces	$1,443.48
Minimart supplies	$136.59
Tenant Incentive	$477.56
Cox Communication	$54.96
Uniforms (Taxes)	$18.60
	$2,131.19

B. Controls over Documentation of Expenses Were Inadequate

As noted above, we provided supporting documentation or repaid all questioned expenses. To more accurately reflect the information provided and the owner's

Comment 13

Comment 14

Comment 15

Comment 14

Comment 16

corrective actions, we suggest that the last sentence of this paragraph be revised as follows.

> *After our audit work was completed, the auditee provided supporting documentation for most of the expenses we questioned and repaid the balance of the questioned costs, $2,131.90, using non-federal funds.*

We also request that the following sentence be added to acknowledge the additional corrective actions we have taken.

> *Additionally, the auditee has implemented training and oversight procedures to ensure proper allocation of expenses and retention of supporting documentation in the future.*

C. Recommendations

"4A. Provide the documentation for the unsupported costs of $8,341 less amounts already repaid/supported or reimburse the project for the remaining portion using nonfederal funds."

All questioned expenses have been supported or repaid. Accordingly, Recommendation 4A has already been accomplished and should be removed.

"4B. Establish controls to ensure expenses are properly supported."

We respectfully request that Recommendation 4B be removed, as adequate controls have already been established and documented.

VII. <u>Finding 5: Management Expenses Were Paid from Project Operating Funds</u>

As you know, HUD Headquarters is presently evaluating a number of policies in the Management Agent Handbook, as many policies are outdated and the Handbook is either silent or internally inconsistent on a number of matters. It has been more than fourteen (14) years since the last comprehensive review or update of this pivotal guidance document. We understand that the ambiguities and internal inconsistencies discussed below are among those topics under review and reconsideration.

While we respect that the OIG is required to report its findings and make recommendations to HUD based on issues that existed at the time of the audit, we believe that citing violations and recommending corrective actions when policy reviews and clarifications are pending amounts to policy making by the OIG and runs the risk that inconsistent policies and treatment of owners' actions may result. In light of the pending policy revisions and the fact that our practices were either consistent with or reasonable interpretations of existing Handbook guidance, we believe the following revisions are appropriate.

Ms. Hobbs
Campaige Place Phoenix
February 26, 2009

A. Management Expenses Were Paid from Project Funds

The table in this section should be revised as follows.

Ineligible project expenses		
Date	**Description**	**Amount**
April 30, 2007	Lunch	27.14
April 30 ,2007	Airfare	108.80
April 30, 2007	Car rental	87.39
November 1, 2007	Employee incentive	75.64[4]
December 31, 2007	Lunch	35.92
TOTAL		334.89

Comment 17

As discussed below, most of the questioned expenses were expenses incurred in connection with the front-line operation of the Property which are payable from the Property account pursuant to the Handbook.

While we regret that the small number of management fee items listed above were paid from Property funds, we note that these were isolated occurrences. Furthermore, we have repaid these expenses to the project's operating account (**Tab E**). We note that we initially believed that the full amount of the November 1, 2007 "Employee Incentive" expense related to recruiting a new Community Manager, but upon further investigation we have determined that this $75.64 expense relates to current employee incentives and was mistakenly paid from Property funds. We have repaid this amount to the Property (**Tab F**).

1. Legitimate Project-Related Expenses

Commercial Lease Commissions

Comment 18

Apr. 29, 2005 Lease Commission $9,000.00
Feb. 10, 2006 Lease Commission $3,210.00

These amounts were paid to a commercial real estate professional in connection with marketing and leasing the commercial space at the Property. Payment of lease commissions is a standard industry expense. While the management agent is responsible for renting the residential units, leasing commercial space requires special skills that are ordinarily contracted for. We searched for guidance on commercial leasing procedures and expenses generally and found that the Handbook was silent on the issue. Because all revenue from the commercial leases goes to support project operations, we feel the reasonable lease commissions paid to attract and establish appropriate commercial tenants are legitimate project expenses.

[4] The total questioned "Employee Incentive" expense, $206.01, includes $130.37 of expenses related to filling the community director vacancy. These expenses are discussed below.

Comment 19

Comment 20

Ms. Hobbs
Campaige Place Phoenix
February 26, 2009

Review of Commercial Leases

July 26, 2005	Lease Commission	$1,000.00
February 10, 2006	Lease Commission	$1,000.00

These amounts were paid to an affiliate of the management agent for drafting and legal review of the leases, which is akin to legal review of project-specific activities. Payments to the affiliate for these services were based on the guidance in Figure 6-2 of the Handbook, which provides that legal fees are payable from Property funds. We further note that the management agent used the services of an affiliate rather than an outside attorney to reduce the cost of these services.

Expenses Related to Filling Staff Vacancies at the Property

May 2, 2007	Per diem	$118.00	Maintenance vacancy
Jun. 1, 2007	Travel-auto	$575.48	Maintenance vacancy
Jul. 1, 2007	Travel	$742.40[5]	Community Mgr. vacancy
Jul. 31, 2007	Per diem	$590.00	Maintenance vacancy
Aug. 1, 2007	Travel	$380.63	Community Mgr vacancy
Aug. 7, 2007	Per diem	$590.00	Community Mgr vacancy
Nov. 1, 2007	Airfare	$256.80	Community Mgr vacancy
Nov. 1, 2007	Travel	$952.64	Community Mgr vacancy
Nov. 1, 2007	Meals	$130.37[6]	Community Mgr vacancy
Nov. 30, 2007	Airfare	$247.30	Community Mgr vacancy
Nov. 30, 2007	Travel	$860.08	Community Mgr vacancy
Nov. 30, 2007	Meals	$44.89[7]	Community Mgr vacancy
Dec. 31, 2007	Transport	$362.04	Community Mgr vacancy

The questioned travel expenses listed above were incurred in connection with filling front-line vacancies at the Property during 2007. The owner/management agent chose to temporarily fill the vacancies with experienced employees from other properties managed by the management agent. In an effort to save expenses for the financially troubled Property, the management agent charged only the travel expenses of the temporary replacement employees to the Property operating account, rather than the full salary. Paragraph 6-39 of the Handbook provides that supervisory staff filling front line vacancies at the Project may be paid from project funds after the first 40 hours, but there is no guidance about temporarily assigning employees from other projects and there is no discussion of how to allocate travel costs of these employees.

[5] The total questioned cost in the draft report of $1,007.20 includes $264.50 of recruiting costs discussed below.
[6] The total questioned expense of $206.01 includes $75.64 of employee incentive costs, discussed above.
[7] The total questioned expense of $99.03 includes $54.14 of recruiting costs, discussed below.

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Comment 21

Comment 22

Ms. Hobbs
Campaige Place Phoenix
February 26, 2009

Our actions were consistent with the HUD guidance and actually saved the Property money, as hasty hiring would have been more costly, and they enabled the immediate placement of proven and experienced employees. It is worth noting that the management agent did not indiscriminately charge all expenses relating to the temporary replacements to the Property, and instead appropriately differentiated between those borne by the management agent and those charged to the Property.

Recruiting Expenses

Jul. 1, 2007	Travel	$264.50	Recruiting Maint. Staff
Nov. 30, 2007	Meals	$54.14[8]	Recruiting Community Mgr.

The questioned expenses above were incurred by the Human Resources Director in connection with recruiting replacement maintenance personnel and a Community Manager for the Property. We note that Paragraph 6-39(b)(3) of the Handbook provides that recruiting costs must be paid out of management fee funds, however this contradicts Figure 6-2 of the Handbook which clearly provides that recruiting costs for on-site staff are payable from Property funds. Based on our reasonable interpretation of Figure 6-2, we paid these expenses from Property funds as permitted.

In light of these facts, we request that the final paragraph of this section be revised to read as follows.

> *The management agent/owner's director of operations initially stated that most of the questioned expenses were incurred in connection with trips that were made to carry out supervisory management agent functions. The owner later clarified that most of the questioned expenses related to filling front-line vacancies at the project and to recruiting front-line property personnel and were allocated to the Property as front-line expenses based on a reasonable interpretation of HUD Handbook guidance. A small number of expenses for regular management oversight and employee incentive costs were inadvertently paid from project funds. Campaige Place paid the owner/agent a fee of 3.6 percent of its residential, commercial and miscellaneous income collected. This management fee should have been used for services that were not front-line services or otherwise payable from project finds.*

B. Operating Expenses Were Overstated

As discussed above, the misallocated expenses total only $334.89. Accordingly we suggest that the second and third sentences of this section should be revised to acknowledge the minimal impact of these minor oversights.

[8] See footnote 5.

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Comment 23

Ms. Hobbs
Campaige Place Phoenix
February 26, 2009

> *As a result of charging management expenses to the project, operating expenses were nominally overstated at a time when insufficient funds were available to pay front-line project expenses and other eligible costs, including mortgage payments. While the owner has demonstrated that most of the questioned expenses were project operating expenses or were for services procured in a manner intended to save project funds, unallowable payments for management costs totaling $334.89 contributed, in small part, to Campaige Place's difficult financial position. After our audit work was completed, the auditee repaid all unallowable management expenses to the project.*

C. Recommendations

"5A. Reimburse HUD's Federal Housing Administration insurance fund $20,714 less amounts already repaid ($335) for ineligible project expenses cited in this report."

As discussed above, we have repaid all ineligible project expenses ($335). The balance of the questioned expenses are either eligible project expenses based on the provisions of the Handbook or a reasonable interpretation thereof. We respectfully request that Recommendation 5A be removed.

VIII. <u>Conclusion</u>

We appreciate your careful consideration of our comments and the proper attribution of all of the corrective actions already undertaken. We believe the information above addresses each of the OIG's findings and that the suggested changes to the draft audit report accurately and consistently reflect the owner's significant commitment to the Property, the substantial corrective actions taken, and the deleterious impact of the downturn in the Phoenix rental market on the Property's operating cash flow.

If you have any questions or require additional information, please contact me at 619-283-5515 extension 510.

Sincerely,

William W. Newbern
Authorized Agent
for Campaige Place Phoenix

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cc: Patricia Dahlgren, HUD OIG
Thomas Azumbrado, HUD SF MF Hub
Sally Thomas, HUD Phoenix MF Program Center
Marilyn Yazzi, HUD Phoenix Program Center
Lavonna Llewellyn, HUD Phoenix Program Center
Lisa A. Tunick, Esq.

OIG Evaluation of Auditee Comments

Ref to OIG Evaluation **Auditee Comments**

Comment 1 We acknowledge the auditee's comments regarding the difficult rental housing market in downtown Phoenix. The report did not address this issue in detail because it was beyond the scope of our audit objective. Specifically, our objective was to determine whether Campaige Place used its project funds in compliance with its regulatory agreement with HUD and other federal requirements. To meet this objective our audit focused on the extent to which the project's expenditures were allowable and reasonable. Out report did note the difficult downtown-Phoenix rental market—the Background and Objective section stated: During our audit, we noted that the downtown Phoenix economy remained difficult for affordable housing and that the market conditions contributed to the project's financial problems.

The report noted, on page 5, that owners/affiliates of Campaige Place had advanced more than $900,000 to the project. Such advances were in accordance with the Partnership agreement between the general partner (NewHom Management) and the limited partner (John Hancock). The agreement contained an operating deficit guarantee which required NewHom to advance funds to the project during the initial operating period if it incurred operating deficits

Comment 2 We recognize that the total amount of costs we questioned was significantly less than the amount past-due on the HUD-insured mortgage. However, the unallowed uses of operating funds did contribute to the project's inability to meet its obligations. We changed the report language to state that the expenditures we questioned partially contributed to the project's operating cash shortfalls.

Comment 3 We changed the language in the Highlights section to acknowledge up front that the auditee has already repaid, or provided additional supporting documentation for, some of the costs questioned in the report. However, the report correctly stated that costs totaling $160,413 plus an unsupported payable of $26,328 were questioned as a result of our audit. Each finding contained information regarding specific amounts either repaid or supported after our audit work was completed. See comments below for our evaluation of the auditee's position on specific items.

Comment 4 We added language in the general recommendation section to acknowledge the amount which the auditee either repaid or supported with additional documentation after the audit was completed.

Comment 5 We modified the report to state that the repayments of owner advances from affiliates while in a non-surplus-cash position partially contributed to the project's operating cash shortfalls. We recognize that the total amount advanced by affiliates greatly exceeded the amount that was improperly repaid. However, this was not the basis of the finding. The funds advanced to the project and the repayments to the project were two separate transactions and did not offset each other. HUD Handbook 4370.2, REV-1 states clearly that repayment of owner advances when a project is in a non-surplus-cash position is a violation of HUD regulations (tantamount to diversion of funds) which can subject the owner to criminal and civil monetary penalties. Therefore, we did not recognize mistaken repayments as being offset by subsequent advances.

Comment 6 We acknowledged the $15,000 repayment made on January, 27, 2009 as a result of the audit. As stated in our response in Comment 5, we cannot offset the other repayments by subsequent advances that were made. Thus, $58,750 was still outstanding for this finding. Regarding the auditee's implementation of new control procedures over repayments of advances, after the report is issued HUD officials will verify that any corrective actions are responsive to the final recommendations.

Comment 7 The report acknowledged that the tenant security deposit account was fully funded after our field work was completed. However, the underfunded account remains a report finding and a questioned cost. We modified recommendation 2A to require full funding of the tenant security deposit account less amounts already deposited.

Comment 8 We agree that the caption for finding 3 inaccurately characterized the questioned cost. We modified the caption to state: An Unexplained Payable Was Mistakenly Recorded as a Liability.

Comment 9 We modified the title to state: Management Failed to Support a Questioned Cost

Comment 10 The auditee's comments understated the significance of the unsupported liability. Management had been submitting monthly accounting reports to HUD (with an attached schedule of aged open invoices) that showed this payable as overdue. Our report noted that HUD questioned the cost as early as July 2008, yet the undocumented payable remained on the project's operating accounts at the time of our review. By failing to determine the nature of this liability and investigate why it had not been paid for four years, management did not practice due diligence over expenses allocated to the project. After our audit work was completed, the auditee obtained confirmation that the architect (to whom the expense was originally attributed) had been paid in full. Therefore, we modified the finding text to more accurately portray the questioned amount as an error.

Comment 11 Recommendation 3A was modified to require confirmation that the $26,328 in unallowable expense has been removed from the project's books.

Comment 12 We agreed that recommendation 3B was not necessary because the project will not incur any more development costs. We removed this recommendation and recommendation 3C is now shown in the report as 3B.

Comment 13 The report acknowledged that, after audit work was completed, the auditee provided supporting documentation for $6,210 in questioned expenses and repaid $2,131 to the project. OIG verified the supporting documentation provided by the auditee.

Comment 14 Recommendation 4B required the project to establish controls to ensure expenses are properly supported. After the report is issued, HUD officials will verify that corrective actions, including the training and oversight procedures referred to in the auditee's comment, were adequately implemented.

Comment 15 Recommendation 4A properly addressed an issue that was identified as a result of the audit. After our report is issued, HUD officials will verify that corrective actions were taken.

Comment 16 HUD's Office of Multifamily Housing regularly issues notices and other guidance to clarify and update its comprehensive handbooks. Like the auditee, OIG relied on HUD's published guidance to arrive at its conclusions. HUD officials will evaluate OIG's conclusions and recommendations during the formal audit resolution process. Accordingly, any policy changes would be made by HUD program offices, and not OIG.

Comment 17 We modified the report to acknowledge the additional repayment of $75.64 deposited on February 26, 2009 for a total repayment of $334.89 for the questioned management expenses paid from project funds.

Comment 18 We questioned the eligibility of the brokerage commissions paid to lease the project's commercial spaces primarily because the project collected a management fee percentage on its commercial rents as it did on the housing units. The management fees were designed to cover management services not performed by front-line staff, such as supervising and overseeing project operations. According to HUD Handbook 4381.5, paragraph 3-6, the owner can propose a special management fee to accomplish a specific task such as "obtaining or renewing a lease for commercial space at the project." However, HUD officials noted that no special fees were requested in this instance, and concurred with our conclusion.

Comment 19 We determined that commissions paid to an affiliate of the management agent were management expenses. HUD officials concurred that the task of reviewing the commercial leases was a management responsibility. Although the auditee stated that the review expense was incurred in lieu of legal fees, we note that the affiliate was not a lawyer, and therefore the expense cannot qualify as a legal expense.

Comment 20 We determined that travel expenses for management agent staff to temporarily fill in vacant front-line positions on site were management expenses. HUD Handbook 4381.5 REV-2, paragraph 6-38, Figure 6-2 clearly states that travel expenses for the agent's supervisory staff are costs to be paid from the management fee. We note that figure 6-2 also shows that the salary for a supervisory (management) employee designated to replace a project employee for hours worked at the project above and beyond the first 40 consecutive hours may be charged to the project. In addition, HUD Handbook 4381.5 REV-2, paragraph 6-38(b)(3) specifies that a reasonable hourly rate can be used to bill the project for time spent by agent staff performing front-line functions. HUD officials concurred with our conclusion.

Comment 21 We acknowledge that the HUD Handbook is ambiguous regarding the allowability of recruiting expenses. Although the handbook can be interpreted to state that recruiting costs for front-line staff are chargeable to the project, the auditee did not provide documentation of the recruiting activity. Instead the cost was for travel expenses, and the handbook clearly states that travel expenses for the agent's supervisory staff should be paid from the management fee (see comment 20). HUD officials concurred with our conclusion.

Comment 22 As reported under finding 5, the total amount of unallowed management expenses we identified during our audit was $20,714.

Comment 23 The report acknowledged repayment of $335 for the questioned ineligible expenses that should have been paid from the management fee received. We considered the auditee's response regarding the remainder of the ineligible expense items, and our conclusions are presented under comments 17 through 21.

Appendix C

CRITERIA

Finding 1

1. HUD Handbook 4370.2, REV-1, paragraph 2-11, states that advances made for reasonable and necessary operating expenses may be paid from surplus cash at the end of the annual or semiannual period. Such repayment is not considered an owner distribution. It is considered a repayment of advances. Repayment of owner advances when the project is in a non-surplus-cash position will subject the owner to criminal and civil monetary penalties.

Finding 2

2. HUD Handbook 4370.1, REV-2, paragraph 2-21, states that deposits are paid by a tenant at the time a unit is rented. The deposit is placed into an account specifically for tenant deposits and held until the tenant vacates the unit. A security deposit may be applied to pay for any damages caused by the tenant.

3. HUD Handbook 4370.1, REV-2, paragraph 3-9, states that under the regulatory agreement, tenant security deposits must be fully funded. A security deposit deficiency will often indicate a diversion of funds. The diversion could be for payment of project operating costs or for the personal use of the owner or management agent.

4. HUD Handbook 4370.2, REV-1, paragraph 2-12, states that any funds collected as security deposits must be kept separate and apart from all other project funds in an account maintained in the name of the project. The balance of the account must not at any time be less than the aggregate of all outstanding obligations under the account for security.

Finding 3

5. HUD Handbook 4370.2, REV-1, paragraph 2-3, states that in establishing a financial accounting system, auditing problems can be avoided by keeping operating funds separate from other project funds. Particularly when occupancy occurs before final closing, care must be taken to segregate construction and operating funds. Accounting of any construction expenses shall be in accordance with HUD Handbook 4470.1, Mortgage Credit Analysis for Project Mortgage Insurance, section 207.

Finding 4

6. HUD Handbook 4370.2, REV-1, paragraph 2-1, states that the financial operations and accounting requirements of a HUD-insured multifamily project must include maintenance of books and accounts; completeness and accuracy of books and accounts; auditable paper trail, invoices, etc.; treatment of specific transactions such as surplus cash and residual receipts;

distribution to owners; cash controls; and use of management agreements.

7. HUD Handbook 4370.2, REV-1, paragraph 2-12, states that a request for a check must have supporting documentation (i.e., invoice itemizing amount requested with an authorized signature) in order for approval to be obtained to make the disbursement.

8. HUD Handbook 4981.5 REV-2, paragraph 3-6, states:

a.Use of Special Fees. In addition to the percentage-based fees described above, owners may agree to pay special management fees if a project has special needs or problems. Proposing special fees (rather than adjusting the fee percentage) is an appropriate and cost effective way to address specific project conditions that should be temporary in nature.

b.Circumstances When Special Fees Are Allowed. Agents may earn special management fees only if all six conditions listed below are met.
(1)The agent did not cause the problem the fee is designed to address.
(2)The fee is tied to the correction of specific problems or the accomplishment of specific tasks. Examples of such tasks include:
(a)Renting-up the project (unless compensation for this is provided from a supplemental management fund);
(b)Obtaining or renewing a lease for commercial space at the project;
(c)Completing significant rehabilitation work or utility conversion;
(d)Reducing vacancies or improving rent collections;
(e)Reducing a specific excessive expense (e.g., utility costs or property taxes); and
(f)Processing membership transfers at cooperatives.

Finding 5

9. HUD Handbook 4381.5, REV-2, paragraph 6-38, states:

a. Front-line Costs and Day-to-Day Activities

(1) Reasonable expenses incurred for front-line management activities may be charged to the project operating account. HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects, provides a complete listing of allowable expenses. Front-line activities include:
- o taking applications;
- o screening, certifying, and recertifying residents;
- o maintaining the project; and
- o accounting for project income and expenses.

Figure 6-2 provides examples of front-line management costs.

(2) If front-line management functions for several properties are performed by staff of the agent operating out of a single office, the following conditions apply.

(a) The agent must prorate the total associated costs among the projects served in proportion to the actual use of services. Allowable total associated costs include:

(i)Salaries and fringe benefits of personnel performing front-line duties; and
(ii) Actual office expenses, fees, and contract costs directly attributable to the performance of front-line duties.

(b) The agent may not impose surcharges or administrative fees in addition to actual costs.

(c) The cost of performing front-line management functions off-site may not exceed the total cost of performing these functions at the property.

(3) The salaries of the agent's supervisory personnel may not be charged to project accounts, with the exception of supervisory staff providing oversight for centralized accounting and computer services for the project.

10. HUD Handbook 4381.5, REV-2, paragraph 6-39, states:

a. Expenses for services that are not front-line activities must be paid out of management fee funds, except for centralized accounting and computer services.
b. Salaries, fringe benefits, office expenses, fees, and contract costs for the following activities must be paid out of management fee funds. These costs include
    (1) Designing procedures/systems to keep the project running smoothly and in conformity with HUD requirements.
    (2) Preparing budgets required by the owner or HUD, exclusive of rent increase requests and MIO [management improvement and operating] Plans.
    (3) Recruiting, hiring, and supervising project personnel.
    (4) Training for project personnel that exceeds the line item budget for training expenses.
    (5) Monitoring project operations by visiting the project or analyzing project performance reports.
    (6) Analyzing and solving project problems.
    (7) Keeping the owner abreast of project operations.
    (8) Overseeing investment of project funds.
    (9) Ensuring that project positions are covered during vacations, sickness, and vacancies.