Issue Date April 10, 2007	
Audit Report Number 2007-DE-1005	

TO: Marcia D. LaPorte, Director, Denver Multifamily Hub, 8AHML

//signed//
FROM: Ronald J. Hosking, Regional Inspector General for Audit, 8AGA

SUBJECT: Rocky Mountain Mutual Housing Association, Denver, Colorado, Paid Ineligible Owner Expenses

HIGHLIGHTS

What We Audited and Why

We audited the Rocky Mountain Mutual Housing Association (Association), a nonprofit that develops and manages U.S. Department of Housing and Urban Development (HUD)-subsidized multifamily properties. We decided to perform an audit of the Association based on an anonymous tip. We wanted to determine whether the nonprofit inappropriately paid owner expenses.

What We Found

The Association did not always follow HUD disbursement requirements when paying owner-related expenses. The nonprofit was unfamiliar with HUD requirements relating to owner expenses and believed that the expenses were eligible. These violations could deprive the properties of almost $28,000 needed to pay reasonable operating expenses and for necessary repairs.

What We Recommend

We recommend that HUD ensure that the Association repays almost $28,000 to the properties. We also recommend that the director of HUD's Departmental Enforcement Center consider imposing civil money penalties against the Association for the payment of ineligible expenses that violated the regulatory agreements.

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

The Association generally agreed with the finding. However, they disagreed with the assertion that the payment of owner expenses did not allow the properties to pay reasonable operating expenses and necessary repairs. The Association also disagreed with the second recommendation and believed it was unwarranted. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

Rocky Mountain Mutual Housing Association (Association) was created in 1992 as a nonprofit to renovate or construct, own, and manage affordable housing. During the review period, the Association managed more than 1,000 units at six U.S. Department of Housing and Urban Development (HUD)-subsidized properties. It had an ownership interest in five of the properties. The Association has experienced financial difficulties in the last few years, primarily because of overleveraging and a declining rental market in the areas in which its housing is located. During this period, the Association's properties were not generating enough revenue to offset expenses and provide surpluses. The Association deferred its management fees and loaned operating cash to the properties. Since the Association had to borrow funds to maintain the properties, its going concern became in question. To remain viable, the Association began working to consolidate its operations. It raised cash by selling one property and is trying to sell a second. It is also in the process of negotiating a partial claim from HUD on another property.

Of the four properties in which the Association still had an ownership interest, two were in excellent physical condition and two were in good condition. As of August 31, 2006, these four properties owed the Association more than $661,000, and the Association had written off receivables of more than $591,000 from two of the properties.

We wanted to determine whether the Association inappropriately paid owner expenses.

RESULTS OF AUDIT

Finding: The Association Paid Ineligible Owner Expenses

The Association used operating funds to pay ineligible owner expenses in fiscal year 2005. It was not fully familiar with HUD requirements relating to owner expenses and believed that the expenses were eligible. Using funds to pay owner expenses when the multifamily property is operating at a deficit could deprive the development of cash needed to pay reasonable operating expenses and for necessary repairs.

Ineligible Owner Expenses

The Association used operating funds to pay almost $28,000 in ineligible owner expenses in fiscal year 2005. Three HUD-subsidized developments paid the owner expenses. The regulatory agreements for these developments limit payments to reasonable operating expenses and necessary repairs. HUD considers the payment of owner expenses to be owner distributions and only allows the payment of owner expenses with surplus cash. The three multifamily properties did not generate surplus cash during the review period.

The owner expenses paid by the developments included audit fees to prepare partnership tax returns, legal fees to research bond financing issues and a property sale, and directors' and officers' insurance. HUD only allows payment of directors' and officers' insurance from operating funds if the development is a nonprofit. The Association charged the insurance to all of the developments in which it had an ownership interest. However, two of them were profit motivated. HUD may authorize the insurance payments by a for-profit entity. However, in this case, the Association did not have prior written approval from HUD. The table on the next page identifies the properties that paid owner expenses.

Properties	Partnership tax returns	Legal fees - bonds	Legal fees - sale	Directors' & officers' insurance	Totals
Garden Court	-	3,574	10,000	3,545	17,119
Meeker Commons[1]	6,978	-	-	350[2]	7,328
Willow Grove	3,489	-	-	-	3,489
Totals	10,467	3,574	10,000	3,895	27,936

HUD Rules Not Understood

The Association was not fully familiar with HUD requirements relating to owner expenses and believed that the expenses were eligible. It should have determined whether all paid expenses benefited the operations of the property or the ownership entity. Once the Association determines that an expense benefits the ownership entity, it needs to ensure that it only pays that amount out of surplus cash. The Association was not aware that it had violated the regulatory agreements. After we informed the Association of the ineligible expenses, it repaid all of the expenses to the properties.

Funds Not Available for Operations

Using funds to pay owner expenses when the multifamily property is operating at a deficit could deprive the development of cash needed to pay reasonable operating expenses and for necessary repairs. The Association agreed to treat owner expenses properly in the future and work with HUD to resolve the finding.

Recommendations

We recommend that the director of the Denver Multifamily Hub

1A. Ensure that the Association repaid the $27,936 to the properties.

We also recommend that the director of HUD's Departmental Enforcement Center consider

1B. Imposing civil money penalties against the Association for the payment of ineligible expenses that violated the regulatory agreements.

[1] Meeker Commons defaulted on its mortgage in January 2006.
[2] The management agent billed Meeker Commons more than $1,200 for directors' and officers' insurance. However, it only received $350 of the outstanding balance.

SCOPE AND METHODOLOGY

Our review covered the period from September 30, 2004, through October 1, 2006.

To accomplish our objectives, we reviewed the pertinent records of the HUD-subsidized developments. We tested the cash controls for project funds, reliability of information in the projects books and records, and appropriateness of disbursements and the cost allocation methods. We selected a sample of invoices to review. Our sample targeted high-risk and material expenditures and was selected from fiscal year 2005 disbursements totaling $6.8 million from six HUD-subsidized multifamily developments. The Association had an ownership interest in five of the properties. We reviewed the supporting documentation of expenditures totaling $4.4 million. We selected expenditures from the largest vendors of each development. For certain expenses, such as professional fees, we reviewed all of the transactions. We also interviewed officials and staff of both HUD and the nonprofit.

We did not rely on computerized data but instead traced all data to source documents.

We performed our fieldwork from November 6 to December 19, 2006. The Association is located at 225 East 16th Avenue, Denver, Colorado.

We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal controls were relevant to our audit objectives:

- Policies, procedures, and practices that management has implemented to ensure proper allocation of expenses and salaries to the properties.

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

We did not identify any significant weaknesses.

APPENDIXES

Appendix A

SCHEDULE OF INELIGIBLE COSTS

Recommendation number	Ineligible 1/
1A	$27,936

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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

Rocky Mountain Mutual Housing Association, Inc.

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April 2, 2007

Mr. Ronald J. Hosking
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General
Region VIII Office of Audit
UMB Plaza – 24th Floor
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Denver, CO 80202-4801

Dear Mr. Hosking:

We have reviewed your letter of March 23, 2007 and the attached draft audit report. We also had an exit conference with Fred Smith and Mike Chacon of the Denver OIG staff and Linda Cluck of the Denver HUD regional office. This letter serves as Rocky Mountain Mutual Housing Association, Inc.'s (RMMHA) response to the draft audit report addressed to Marcie D. LaPorte.

The "Highlights" section of the report indicates a technical finding that approximately $28,000 of owner expenses was inappropriately paid from operating revenues at three different properties. We do not dispute this finding and it has already been corrected. Upon being advised of this finding, RMMHA refunded the entire amounts to the respective properties and provided evidence of these refunds to Mr. Chacon. We have also implemented procedures to prevent this from happening again.

Comment 1

The report also points out that the payment of owner's expenses from operating funds might have not allowed the properties "to pay reasonable operating expenses and necessary repairs." At no time were these properties deprived of reasonable operating funds and all necessary repairs were performed on the property in a timely manner. This is evidenced by the following recent REAC inspection scores at each of the properties: Meeker Commons (98.5 in 2006), Willow Grove (79 in 2006), and Garden Court (95 in 2004). It should also be noted that during the period covered by

Ref to OIG Evaluation **Auditee Comments**

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this audit, RMMHA advanced approximately $432,000 to cover operating expenses and necessary repairs at these properties.

Comment 2

The report recommends the consideration of penalties. We believe this is unwarranted for the following reasons:

- This violation was inadvertent and the result of a lack of sufficient understanding of the HUD regulations. RMMHA took immediate corrective action when advised of these mistakes. Procedures are in now place so that this does not happen again. Documentation of RMMHA's repayment has been provided to HUD.
- At no time did either our properties or residents suffer because of these mistakes. All necessary repairs were made on a timely basis, and the residents enjoyed a safe, secure, quality living experience.
- No one profited from these errors and financial penalties would only serve to take away from our mission of providing affordable housing.

We value our relationship with HUD, as we endeavor to provide safe, secure, affordable housing in our region. We trust that we have responded appropriately and adequately to the findings in this report. Please advise, should you have any further questions or comments.

Very truly yours,

Douglas B. Smith
Chief Executive Officer

DBS:cg

cc: Marcie LaPorte
Mike Chacon
Fred Smith
Linda Cluck

OIG Evaluation of Auditee Comments

Comment 1

We changed the wording in the Highlights and Finding sections to show that the payments "could" deprive the projects of funds necessary to pay reasonable operating expenses and necessary repairs. While the Association may be able to offset the immediate effects of these types of payments by not taking its earned fees, or by writing off receivables, its ability to do so in the future is not guaranteed. Depending on the future condition of the properties and the Association, these types of payments could have an adverse effect on the properties. The examples cited by the RMMHA Association in its response were already disclosed in the background section of the report.

Comment 2

We left the recommendation unchanged because we believe it is appropriate in this situation for HUD to evaluate the circumstances of the ineligible payments and assess appropriate penalties.