Issue Date

August 8, 1996

Audit Case Number

96-SF-113-0001

TO: Keith Axtell, Director of Housing, 9AH

FROM: Gary E. Albright, District Inspector General for Audit, 9AGA

SUBJECT: Acorn I Project
HUD-Owned Multifamily Project
Oakland, California

We have audited the financial statements of the Acorn I project, a HUD-owned multifamily project located in Oakland, California. The financial statements cover the period of August 25, 1991 through September 30, 1995.

The audit disclosed one issue requiring HUD action.

Within 60 days please furnish us, for the one recommendation in the report, a status on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued related to the audit.

If you have any questions, please call Richard Bahr, Assistant District Inspector General for Audit, or Melissa Wong, Supervising Auditor, at (415) 436-8101.

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Executive Summary

We have audited the financial statements of the Acorn I project for the period August 25, 1991 through September 30, 1995. We considered the project's internal control structure to determine our audit procedures for the purpose of expressing our opinion on the financial statements. Also, as part of obtaining reasonable assurance as to whether the financial statements are free of material misstatement, we made tests to determine management's compliance with certain provisions of laws and regulations which, if not complied with, could have a material effect on the project's financial statements.

Opinion on financial statements

In our opinion, the financial statements are presented fairly and in conformity with generally accepted accounting principles. The project is not an independent economic entity but is part of the Federal Housing Administration's inventory of foreclosed properties held for sale, and the project depends on funding from FHA to meet operating expenses.

Financial statements and accompanying notes

The financial statements include the following:

- Balance Sheet. As of September 30, 1995, total assets were $6,717,153 and total liabilities were $181,820. The project equity was $6,535,333.
- Income Statement. During the period August 25, 1991 through September 30, 1995, project revenues were $2,767,893 and expenses were $34,300,743, resulting in a loss of $31,532,850.
- Statement of Cumulative Results of Operations. The cumulative results of operations had a negative balance of $31,532,850 at September 30, 1995.
- Statement of Cash Flows. The FHA insurance fund provided $38,068,183 to subsidize project operations from August 25, 1991 to September 30, 1995.

The accompanying notes are an integral part of these financial statements.

Internal Control and Compliance with Laws and Regulations

We did not identify any matters involving the internal control structure and its operation that we consider to be material weaknesses.

For items tested, project management complied in all material respects with applicable laws and regulations. For items not tested, nothing came to our attention that caused us to believe the project's management had not complied with those provisions in all material respects.

Finding

HUD paid $7,472 of project expenses which were incurred before HUD took possession of the project on August 25, 1991. Under the August 12, 1991 mortgagee-in-possession agreement, HUD assumes none of the liabilities, costs or expenses incurred by the mortgagor prior to taking possession of the project. This occurred because the owner did not take full responsibility to pay project expenses as required and HUD did not pursue reimbursement from the prior owner. As a result, HUD unnecessarily spent more than it should to operate the project.

Comments from the HUD Office of Housing and OIG Evaluation

The California State Office of Housing in San Francisco concurred with our audit results and the facts of the finding. It, however, requested that we delete the finding and recommendation because the previous ownership entity has since been dissolved and the collectible amount is low for the Department of Justice's involvement.

The Office of Housing did not attempt to secure reimbursement from the prior owner after the payment was made. Further, request for reimbursement from the owner does not necessarily have to be referred to the Department of Justice. Under the August 12, 1991 mortgage-in-possession agreement between the prior owner and HUD, HUD assumed none of the prior owner's expenses.

Even if the ownership entity was dissolved, HUD should attempt to secure reimbursement from its general partners who would be personally liable to HUD.

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Abbreviations

FHA	Federal Housing Administration
HUD	Department of Housing and Urban Development

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Report of Office of Inspector General

To the Director of Housing, California State Office
Department of Housing and Urban Development

We have audited the accompanying balance sheet of the Acorn I project, as of September 30, 1995, and the related statements of income, cumulative results of operations, and cash flows for the period from August 25, 1991 through September 30, 1995. These financial statements are the responsibility of the project's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Acorn I project as of September 30, 1995, and the results of its operations and its cash flows for the period from August 25, 1991 through September 30, 1995 in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that the project will continue as a going concern. As described in Note 1, the project is not an independent economic entity but is part of the Federal Housing Administration's inventory of foreclosed properties held for sale. The project is administered by the Department of Housing and Urban Development and it depends on funding from the FHA to meet operating expenses.

This report is intended solely for the information and use of the Department of Housing and Urban Development and should not be used for any other purpose.

Office of Inspector General

March 18, 1996

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Financial Statements and Accompanying Notes

ACORN I
BALANCE SHEET
SEPTEMBER 30, 1995

CURRENT ASSETS:			
Petty Cash		$1,482	
Tenant Accounts Receivable	11,246		
Less: Allowance for Doubtful Accounts	(8,524)	2,722	
Payment Due from Republic		10,881	
Supplies Inventory		11,199	
Fire Damage Payment Due from a Tenant (current portion)		600	
Total Current Assets		26,884	
RESTRICTED DEPOSITS:			
Tenant Security Deposits		52,514	
NON-CURRENT ASSETS:			
Fire Damage Payment Due from a Tenant (non-current portion)		33,335	
Land		1,044,895	
Building		6,993,716	
Less: Accumulated Depreciation - Building		(1,434,191)	
Total Non-current Assets		6,637,755	
TOTAL ASSETS			**$6,717,153**
CURRENT LIABILITIES:			
Vendor Accounts Payable		$18,799	
Accrued Wages and Payroll Taxes		70,834	
Accrued Management Fees		11,616	
Accrued Property Taxes		18,583	
Prepaid Tenant Rents		9,178	
Payments Due To Former Tenants		533	
Total Current Liabilities		129,543	
DEPOSIT LIABILITY:			
Tenant Security Deposit Obligation		52,277	
TOTAL LIABILITIES			**$181,820**
PROJECT EQUITY:			
Payments From FHA Insurance Fund		38,068,183	
Cumulative Results of Operations		(31,532,850)	
TOTAL PROJECT EQUITY			**$6,535,333**
TOTAL LIABILITIES AND PROJECT EQUITY			**$6,717,153**

The accompanying notes are an integral part of these financial statements.

ACORN I
INCOME STATEMENT
FOR PERIOD AUGUST 25, 1991 TO SEPTEMBER 30, 1995

REVENUE		
Tenant Rent Payments	$2,559,643	
Laundry and Vending	2,073	
Miscellaneous Income	206,177	
TOTAL REVENUE		**$2,767,893**
EXPENSES		
Administrative	$ 2,927,146	
Utilities	978,359	
Operating and Maintenance	18,339,065	
Depreciation - Building	1,434,191	
Taxes	2,093,170	
Rehabilitation	8,506,950	
Other	21,862	
TOTAL EXPENSES		**$34,300,743**
NET INCOME (LOSS)		**$(31,532,850)**

The accompanying notes are an integral part of these financial statements.

ACORN I
STATEMENT OF CUMULATIVE RESULTS OF OPERATIONS
FOR PERIOD AUGUST 25, 1991 TO SEPTEMBER 30, 1995

Cumulative Results of Operations at August 25, 1991		$0
Less: Loss for the Period Ended September 30, 1995	(31,532,850)	
Cumulative Results of Operations at September 30, 1995	**$(31,532,850)**	

The accompanying notes are an integral part of these financial statements.

ACORN I
STATEMENT OF CASH FLOWS
FOR PERIOD AUGUST 25, 1991 TO SEPTEMBER 30, 1995

Cash Flows From Operating Activities:			
Net Loss			**$(31,532,850)**
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Add:	Increase in Accounts Payable	$18,799	
	Increase in Accrued Payroll and Taxes	70,834	
	Increase in Accrued Management Fees	11,616	
	Increase in Property Taxes	18,583	
	Increase in Prepaid Tenant Rent	9,178	
	Increase in Tenant Security Deposit Obligation	52,277	
	Increase in Payments Due to Former Tenants	533	
	Increase in Depreciation Expense - Building	1,434,191	
Less:	Increase in Net Tenant Accounts Receivables	(2,722)	
	Increase in Payments Due from Republic	(10,881)	
	Increase in Inventory	(11,199)	
	Increase in Tenant Security Deposit	(52,514)	
	Increase in Fire Damage Payment Due from a Tenant (current portion)	(600)	1,538,095
Net Cash Provided by Operating Activities			
(29,994,755)			
Cash Flows From Investing Activities:			
Increase in Purchase of Land		(1,044,895)	
Increase in Purchase of Building		(6,993,716)	
Increase in Fire Damage Payment Due from a Tenant (non-current portion)		(33,335)	
Net Cash Provided by Investing Activities			**(8,071,946)**
Cash Flows From Financing Activities:			
Payments From FHA Insurance Fund			
		38,068,183	
Net Increase In Cash			**1,482**
Cash at August 25, 1991			**0**
Cash at September 30, 1995			**$1,482**

The accompanying notes are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

Note 1. Description of Entity

Background

Acorn I is a 485-unit low-income project located in Oakland, California. Built in 1967, the project was insured under Section 221(d)(3) of the National Housing Act. In 1976, the project obtained Section 8 subsidy assistance and became housing for low income residents. HUD withdrew Section 8 subsidy assistance from the project on April 1, 1991 because the owner did not properly maintain the project.

On August 25, 1991, HUD took over the management of Acorn I as mortgagee-in-possession. This occurred when HUD initiated foreclosure action to protect the health and safety of the residents and to preserve the project's assets. Under mortgagee-in-possession, the owner retained legal title of the project, but HUD acted as a fiduciary on behalf of the owner.

Since HUD became the mortgagee-in-possession, Acorn I has been monitored by the Multifamily Property Disposition Branch in San Francisco. The project is funded through insurance by the Federal Housing Administration (FHA). HUD completed the foreclosure process on April 29, 1993 and obtained title to the project. The project is not an independent economic entity but is part of the FHA's inventory of foreclosed properties held for sale.

Current Status of Acorn I

As of September 30, 1995, Acorn I was fully operational and had about 80-percent unit occupancy. However, the project depends on funds from the FHA, and without those funds it will not be able to continue its operations.

Project Manager

HUD contracted with Republic Management Services, Inc. (Republic) to manage Acorn I on August 25, 1991. Republic, founded in 1978, is a national management company headquartered in Houston, Texas. Republic manages Acorn I at its local office located in the project premises and is responsible for the day-to-day management of the project.

Note 2. Summary of Accounting System, Basis and Policies

Accounting System

Financial management of all HUD-owned projects, including Acorn I, is accomplished through the Property Management System. It is a computer-based information and accounting system developed and managed under contract by Data Prompt, Inc. of Silver Spring, Maryland. The system was designed to accomplish the following objectives:

- Establish and maintain an automated, centralized data base for HUD-owned properties;

- Record project collections, accept and report project budgets, pay project invoices, maintain and report project disbursements and procurement activities, and provide reports on all tenant activities; and

- Maintain a system which allows HUD to monitor all project activity on a local and national level.

Project accounting information is contained in the system's data base. The system also produces accounting ledgers and reports. Input into the system is done at the project site, the property manager's office, the local HUD Multifamily Property Disposition Branch, and HUD Headquarters.

Project revenues and expenses, including payments for goods and services that are normally regarded as capital improvements, are recorded in the Property Management System when received or paid. Tenant collections (exclusive of security deposits) and other project receipts are sent to a lockbox via certified mail to a bank controlled by Data Prompt. Project payments (exclusive of security deposits and petty cash disbursements) are made by checks issued by Data Prompt through the system. Project receipts and payments by Data Prompt are made to and from the FHA insurance fund.

Basis of Accounting

The Balance Sheet, Income Statement, Statement of Cumulative Results of Operations, and Statement of Cash Flows were prepared on the accrual basis of accounting in accordance with generally accepted accounting principles.

Significant Accounting Policies

- The accompanying financial statements present only the operations of the project and do not include transactions of HUD and FHA not directly related to the operations of the project.

- Security deposit payments by tenants are shown as an asset and the obligation to refund the tenant security deposits is shown as a liability in the balance sheet.

- There is no provision for income taxes because the federal government is exempt from any income taxes.

- There is a provision for uncollectible tenant accounts receivable. The receivables are generally written off 60 days subsequent to tenant eviction and after the account is referred to a collection agency.

- The building is being depreciated on a straight-line method over 20 years which HUD estimates as the useful life.

Note 3. Petty Cash

The petty cash account is one of two project-related bank accounts maintained locally by the project manager and is used for postage and small miscellaneous employee reimbursements such as mileage and parking fees. Petty cash disbursements are made by either its petty cash fund or by check from the account.

Note 4. Receivables from Tenants

a. Tenant Accounts Receivable

As of September 30, 1995, the amounts due from project tenants were as follows:

	Amounts
Current (30 days or fewer)	$ 1,753
Delinquent (31-60 days)	3,459
Delinquent (61-90 days)	1,333
Delinquent (over 90 days)	4,701
Total	$11,246

b. Fire Damage Payment from Tenant

On July 26, 1993, a unit was damaged by a fire caused by a tenant. The tenant agreed to pay the fire damage by making monthly payments of $50 over 58 years. The payments began in December 1993. As of September 30, 1995, the current portion due from the tenant is $600 and the remaining $33,335 is the non-current portion.

Note 5. Payment Due From Republic

In a July 14, 1995 letter, HUD instructed Republic to reimburse a total of $41,830 to Acorn I and another HUD-owned project, Acorn II, for tenant rent payments that a former project administrator stole from the projects during 1994. Of that total, $10,619 applied to Acorn I. Republic identified an additional $262 in missing rent payments. Republic did not file charges against the former employee and accepted the responsibility of repaying the project through its insurance carrier. Thus, as of September 30, 1995, Republic owed $10,881 to the project.

The tenant payments totaling $10,881 relating to Acorn I were separated as follows:

- $6,471 has been credited to the applicable tenant accounts previously shown as delinquent.

- $1,326 has been credited to bad debt expense to reverse previously written off tenant accounts.

- $2,551 was credited to the proper current tenants who paid the excess amount after their initial payments were stolen. (See Note 8)

- $533 will be reimbursed to former tenants when Republic pays the amount due to HUD. (See Note 8)

Note 6. Supplies Inventory

Acorn I maintains an inventory which includes a small number of high-dollar items such as stoves and refrigerators. The amount reported represents the acquisition cost of these items.

Note 7. Tenant Security Deposits

A tenant security deposit account is the second project-related bank account maintained by the property manager. The account is restricted to refunding the security deposits to vacating tenants in good standing, covering the costs of damages caused by vacating tenants, and being applied to tenant receivables from evicted or vacating tenants. Payments by the tenants and subsequent reimbursements to the tenants are made locally.

Note 8. Current Liabilities

Accrued wages and payroll taxes consisted of the following:

- $67,112 in unpaid wages earned by the project's employees as of the financial statement date.

- $3,722 provision for employer taxes on the above.

Accrued management fees of $11,616 were earned by the property manager for the month of September that were not paid by HUD as of September 30, 1995.

Accrued property taxes of $18,583 were due to the local government for the months of July through September that were not paid by HUD as of September 30, 1995.

Prepaid tenant rents of $9,178 were advances made by tenants. Of that amount, $2,551 represented the portion of the total amount stolen by a former project administrator in Note 5 that has been credited as prepaid.

Payments due to former tenants of $533 was the portion of the stolen amount that should be reimbursed to the former tenants when Republic pays the amount due to HUD.

Note 9. Contingent Liabilities

Acorn I has a cable system contract that contained provisions in the event the contract is terminated by HUD. In addition, a March 5, 1996 letter from HUD Assistant General Counsel discussed that a litigation case involving HUD and former tenants of the project is pending.

A provision in the 10-year cable system contract that HUD entered on August 13, 1993 requires HUD to be responsible for monthly charges of $7,775 to the cable company. The contract, however, is fully transferrable to a new owner of the project without penalty to HUD.

The pending litigation involves some former tenants of the project who have filed claims against HUD for damages they allegedly suffered as a result of housing conditions which existed at the project during their tenancy. One hundred and eighty-nine claims (at $35,000 per claim) from Acorn I and Acorn II were filed. HUD Legal Counsel projected a favorable outcome for HUD, but it is mindful of the potential loss and is consequently exploring the possibilities of extremely modest settlements.

Note 10. Subsequent Event - Intention To Sell The Project

In a March 18, 1996 letter to potential buyers, HUD stated that it was intending to sell the project and is in the process of searching for a qualified non-profit organization to own and operate the project.

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Report of Office of Inspector General on Internal Control and Compliance with Laws and Regulations

To the Director of Housing, California State Office
Department of Housing and Urban Development

We have audited the financial statements of the Acorn I project for the period August 25, 1991 to September 30, 1995 and have issued an opinion thereon. This report pertains only to our consideration of the internal control structure and our review of compliance with laws and regulations for the period August 25, 1991 to September 30, 1995.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit, we considered the project's internal control structure to determine our audit procedures for the purpose of expressing our opinion on the project's basic financial statements and not to provide assurance on the internal control structure. Thus, we do not express an opinion on the control structure.

The project's management is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgements by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles and applicable laws and regulations.

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also projection of any evaluation of the structure to future periods is subject to risk that procedures may become inadequate because of changes in conditions or that the effectiveness of design and operations of policies and procedures may deteriorate.

For the purpose of this report, we have classified the project's significant internal control structure policies and procedures, including those relevant to compliance with laws and regulations, into the following categories:

- Tenant Collections
- Tenant Recertification
- Expenditures
- Payroll
- Project Maintenance
- Inventory

For all of the internal control structure categories listed above, we obtained an understanding of the control structure, assessed control design, and assessed control risk. Except for controls over payroll, we did not test the implementation of policies and procedures for the other control categories since it was more efficient to rely solely on substantive tests.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. During our tests, we did not identify any matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

The management of the project was also responsible for compliance with applicable laws and regulations. As part of obtaining reasonable assurance as to whether the financial statements are free of material misstatement, we selected and tested transactions and records to determine management's compliance with certain provisions of the following laws and regulations which, if not complied with, could have a material effect on the project's financial statements.

- The Project Management Contracts

- HUD Property Management System Procedure Manual

- HUD Handbook 4350.3, Occupancy Requirements of Subsidized Multifamily Housing Programs

- Title 24, Code of Federal Regulations, Part 290, Management and Disposition of HUD-owned Multifamily Housing Projects.

Our objective was not to provide an opinion on the overall compliance with such provisions. Accordingly, we express no such opinion. Because of the limited purposes for which our tests of compliance were made, the laws and regulations tested did not cover all legal requirements with which project management has to comply.

The results of our tests for the period August 25, 1991 to September 30, 1995 indicate that, with respect to items tested, project management complied in all material respects with those provisions of laws and regulations referred to above. With respect to transactions not tested, nothing came to our attention that caused us to believe that the project's management had not complied with those provisions in all material respects.

Office of Inspector General

March 18, 1996

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HUD Should Seek Reimbursement for Prior Owner's Expenses

HUD paid $7,472 of project expenses which were incurred before HUD took possession of the project on August 25, 1991. Under the August 12, 1991 mortgagee-in-possession agreement, HUD assumes none of the liabilities, costs or expenses incurred by the mortgagor prior to taking possession of the project. This occurred because the owner did not take full responsibility to pay project expenses as required and HUD did not pursue reimbursement from the prior owner. As a result, HUD unnecessarily spent more than it should to operate the project.

HUD paid prior owner's expenses

Under the August 12, 1991 mortgagee-in-possession agreement between the owner of Acorn I and HUD, the owner was required to give to HUD all project funds. HUD will use these funds to pay necessary expenses and will assume none of the liabilities, costs or expenses incurred by the project prior to August 25, 1991.

HUD paid $22,226 of utilities and telephone expenses that were incurred prior to August 25, 1991. HUD gave approval for Republic to make the payments to avoid possible liens and penalties on the project. A HUD official said that it was economically advantageous for HUD to pay the expenses.

The owner subsequently deposited $14,754 of project funds to the project account on April 29, 1992. According to the HUD Multifamily Property Disposition staff in San Francisco, the owner deposited no other funds to offset the remaining expenses. As a result, HUD unnecessarily spent $7,472 ($22,226 - $14,754) more than it should to operate the project.

This occurred because the owner did not take full responsibility to pay project expenses incurred prior to HUD's possession in August 25, 1991 and HUD did not pursue reimbursement from the prior owner.

OFFICE OF HOUSING COMMENTS AND OIG EVALUATION

The California State Office of Housing in San Francisco concurred with our audit results and the facts of the finding. It, however, requested that we delete the finding and recommendation because the previous ownership entity has since been dissolved and the collectible amount is low for the Department of Justice's involvement.

The Office of Housing did not attempt to secure reimbursement from the prior owner after the payment was made. Further, request for reimbursement from the owner does not necessarily have to be referred to the Department of Justice. Under the August 12, 1991 mortgage-in-possession agreement between the prior owner and HUD, HUD assumed none of the prior owner's expenses.

Even if the ownership entity was dissolved, HUD should attempt to secure reimbursement from its general partners who would be personally liable to HUD.

Recommendation

1A. We recommend you provide documentation to show that the ownership entity was dissolved and attempt to secure reimbursement of the $7,472 from the general partners. If the ownership entity is not dissolved, secure reimbursement from the prior owner.

Distribution

Secretary Representative, 9AS
Comptroller, 9A
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