

Issue Date

August 8, 1996

Audit Case Number

96-SF-113-0002

TO: Keith Axtell, Director of Housing, 9AH

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

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

We have audited the financial statements of the Acorn II project, a HUD-owned multifamily project located in Oakland, California. The financial statements cover the period of December 31, 1991 through September 30, 1995.

The audit did not disclose any issue requiring HUD action.

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

(This page is blank intentionally.)

Executive Summary

We have audited the financial statements of the Acorn II project for the period December 31, 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. Also, as discussed in Note 8, HUD officials in the California State Office are intending to demolish the project. Thus, there is substantial doubt the project will continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Financial statements and accompanying notes

The financial statements include the following:

- **Balance Sheet.** As of September 30, 1995, total assets were \$2,137,865 and total liabilities were \$52,222. The project equity was \$2,085,643.
- **Income Statement.** During the period December 31, 1991 through September 30, 1995, project revenues were \$723,408 and expenses were \$9,929,270, resulting in a loss of \$9,205,862.
- **Statement of Cumulative Results of Operations.** The cumulative results of operations had a negative balance of \$9,205,862 at September 30, 1995.
- **Statement of Cash Flows.** The FHA insurance fund provided \$11,291,505 to subsidize project operations from December 31, 1991 to September 30, 1995.

Internal Control and
Compliance with Laws
and Regulations

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

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.

Comments from the HUD
Office of Housing

The California State Office of Housing in San Francisco concurred with our audit results.

Table of Contents

Management Memorandum	i
Executive Summary	iii
Report of Office of Inspector General	1
Financial Statements and Accompanying Notes	3
Report of Office of Inspector General on Internal Control and Compliance with Laws and Regulations	11
Appendix	
Distribution	15

Abbreviations

FHA	Federal Housing Administration
HUD	Department of Housing and Urban Development

(This page is blank intentionally.)

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 II project, as of September 30, 1995, and the related statements of income, cumulative results of operations, and cash flows for the period from December 31, 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 II project as of September 30, 1995, and the results of its operations and its cash flows for the period from December 31, 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. As discussed in Note 8, HUD officials are intending to demolish the project. Thus, there is substantial doubt that the project will continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

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

(This page is blank intentionally.)

Financial Statements And Accompanying Notes

ACORN II BALANCE SHEET SEPTEMBER 30, 1995

ASSETS

CURRENT ASSETS:

Tenant Accounts Receivable	\$141
Payment Due from Republic	<u>31,211</u>
Total Current Assets	31,352

NON-CURRENT ASSETS:

Land	385,612
Building	2,256,617
Less: Accumulated Depreciation - Building	<u>(535,716)</u>
Total Non-current Assets	2,106,513

TOTAL ASSETS

\$2,137,865

LIABILITIES AND PROJECT EQUITY

CURRENT LIABILITIES:

Vendor Accounts Payable	\$ 13,215
Accrued Management Fees	1,158
Accrued Property Taxes	8,268
Payment Due to Former Tenants	<u>29,581</u>

TOTAL LIABILITIES

\$52,222

PROJECT EQUITY:

Payments From FHA Insurance Fund	11,291,505
Cumulative Results of Operations	<u>(9,205,862)</u>

TOTAL PROJECT EQUITY

\$2,085,643

TOTAL LIABILITIES AND PROJECT EQUITY

\$2,137,865

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

**ACORN II
INCOME STATEMENT
FOR PERIOD DECEMBER 31, 1991 TO SEPTEMBER 30, 1995**

REVENUE

Tenant Rent Payments	\$559,480	
Miscellaneous Income	<u>163,928</u>	
TOTAL REVENUE		\$ 723,408

EXPENSES

Administrative	\$1,000,214	
Utilities	256,794	
Operating and Maintenance	6,166,973	
Depreciation - Building	535,716	
Taxes	854,416	
Rehabilitation	1,109,281	
Other	<u>5,876</u>	
TOTAL EXPENSES		<u>9,929,270</u>

NET INCOME (LOSS) **\$(9,205,862)**

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

ACORN II
STATEMENT OF CUMULATIVE RESULTS OF OPERATIONS
FOR PERIOD DECEMBER 31, 1991 TO SEPTEMBER 30, 1995

Cumulative Results of Operations at December 31, 1991	\$0
Less: Loss for the Period Ended September 30, 1995	<u>(9,205,862)</u>
Cumulative Results of Operations at September 30, 1995	<u>\$(9,205,862)</u>

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

ACORN II
STATEMENT OF CASH FLOWS
FOR PERIOD DECEMBER 31, 1991 TO SEPTEMBER 30, 1995

Cash Flows From Operating Activities:			
Net Loss			\$(9,205,862)
Adjustments to Reconcile Net Income to			
Net Cash Provided by Operating Activities:			
Add:			
Increase in Accounts Payable	\$13,215		
Increase in Accrued Management Fees	1,158		
Increase in Accrued Property Taxes	8,268		
Increase in Payments Due to Former Tenants	29,581		
Increase in Depreciation Expense - Building	535,716		
Less:			
Increase in Tenant Accounts Receivable	(141)		
Increase in Payment Due from Republic	<u>(31,211)</u>		<u>556,586</u>
Net Cash Provided by Operating Activities			(8,649,276)
Cash Flows From Investing Activities:			
Purchase of Land and Building			(2,642,229)
Cash Flows From Financing Activities:			
Payments From FHA Insurance Fund			<u>11,291,505</u>
Net Increase In Cash			0
Cash at December 31, 1991			0
Cash at September 30, 1995			<u>\$0</u>

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

NOTES TO THE FINANCIAL STATEMENTS

Note 1. Description of Entity

Background

Acorn II is a 198-unit low-income project located in Oakland, California. Built in 1970, 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 December 31, 1991, HUD took over the management of Acorn II 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 II 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 II

As of September 30, 1995, Acorn II was completely vacant and not operational. In early 1994, HUD decided to start rehabilitating the project and began transferring residents of the project to another HUD-owned project, Acorn I. After the complete transfer of residents to Acorn I, the project closed and the premises were fenced off in late 1994.

The start of rehabilitation work, however, has been postponed because HUD is intending to demolish Acorn II. (See Note 8)

Project Manager

HUD contracted with Republic Management Services, Inc. (Republic) to manage Acorn II on December 31, 1991. Republic, founded in 1978, is a national management company headquartered in Houston, Texas. Republic manages Acorn II at its local office located on an adjacent HUD-owned project's 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 II, 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.
- There is no provision for income taxes because the federal government is exempt from any income taxes.
- The building is being depreciated on a straight-line method over 20 years which HUD estimates as the useful life.

Note 3. Cash

Acorn II did not have a petty cash fund or any other cash account.

Note 4. Receivables from Tenants

The \$141 was due from a tenant who moved to Acorn I. Republic expects the tenant will pay this amount.

Note 5. Payment Due From Republic

In a July 14, 1995, HUD instructed Republic to reimburse \$41,830 to Acorn II and Acorn I, for tenant rent payments that a former project administrator stole from the projects during 1994. Of that total, \$31,211 applied to Acorn II. 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 \$31,211 to the project.

The tenant payments totaling \$31,211 relating to Acorn II were separated as follows:

- \$1,630 was credited to bad debt expense to reverse previously written off tenant accounts.
- \$29,581 will be reimbursed to former tenants when Republic pays the amount due to HUD. (See Note 6)

Note 6. Current Liabilities

Accrued management fees of \$1,158 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 \$8,268 were due to local government for the months of July through September that were not paid by HUD as of September 30, 1995.

Payments due to former tenants of \$29,581 was the portion of the total amount stolen by a former project administrator in Note 5 that should be reimbursed to the former tenants when Republic pays the amount due to HUD.

Note 7. Contingent Liability

A March 5, 1996 letter, from HUD Assistant General Counsel discussing a litigation case, involving HUD and former tenants of the project is pending. The litigation involves 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 eighty-nine claims (at \$35,000 per claim) from Acorn II and Acorn I were filed. HUD Legal Counsel projected favorable outcome for HUD, but it is mindful of the potential loss and is consequently exploring the possibilities of extremely modest settlements.

Note 8. Subsequent Event - Intention to Demolish the Project

HUD is intending to demolish the project and sell the land. In a March 18, 1996 letter to potential buyers, HUD stated that it was intending to demolish Acorn II and sell the site to the City of Oakland or a non-profit organization for a possible development of senior housing. Demolition is proposed because the cost of rehabilitating the units would exceed the cost of new construction.

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 II project for the period December 31, 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 December 31, 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.

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

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 December 31, 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

(This page is blank intentionally.)

Distribution

Secretary Representative, 9AS
Comptroller, 9A
Director, Housing Division, 9DH
Director, Accounting Division, 9AF
Assistant to the Secretary for Field Management, SC
Marta Angueira, Audit Liaison Officer, HF
Acquisitions Librarian, Library, AS
Director, Participation & Compliance Division, HSLP
Director, Division of Housing Finance Analysis, TEF
Chief Financial Officer, F
Deputy Chief Financial Officer for Operations, FO
Associate Director, US GAO, 820 1st St. NE Union Plaza, Bldg. 2, Suite 150, Washington,
DC 20002, Attn: Jim Wells
Jan Kennedy, Area Supervisor, Republic Management Services, Inc. 805 Filbert Street,
Oakland, CA 94607-31093