



Sutton Irvine Residence, Inc., Irvine, CA

Section 202 Program

**Office of Audit, Region 9
Los Angeles, CA**

**Audit Report Number: 2015-LA-1003
April 24, 2015**



To: Thomas Azumbrado, Acting Director, Los Angeles Office of Multifamily Housing, 9AHMLAP

//SIGNED//

From: Tanya E. Schulze, Regional Inspector General for Audit, 9DGA

Subject: Sutton Irvine Residence, Inc., Irvine, CA, Did Not Operate Its Section 202-Funded Project in Accordance With HUD Rules and Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of Sutton Irvine Residence, Inc.'s Section 202-funded project.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at <http://www.hudoig.gov>.

If you have any questions or comments about this report, please do not hesitate to call me at 213-534-2471.



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Sutton Irvine Residence, Inc., Irvine, CA, Did Not Operate Its Section 202-Funded Project in Accordance With HUD Rules and Requirements

Highlights

What We Audited and Why

We audited Sutton Irvine Residence, Inc.'s Section 202-funded project based on concerns expressed by the U.S. Department of Housing and Urban Development's (HUD) Office of General Counsel, Departmental Enforcement Center, regarding the management of the project. The concern was that Sutton Irvine had defaulted on its mortgage payments to HUD and may have diverted project funds for nonproject expenses. Our audit objective was to determine whether Sutton Irvine operated its project in accordance with HUD rules and requirements.

What We Found

Sutton Irvine did not operate its project in accordance with HUD rules and requirements. It failed to maintain an adequate financial management system and disbursed project funds for ineligible loans and unsupported expenses. In addition, it failed to manage its tenant rents and security deposits, submit required financial reports to HUD, and maintain the required number of board members. As a result, it used \$26,189 in project funds for ineligible expenses and did not ensure that at least \$159,843 in unsupported expenses was used for eligible program activities, including mortgage payments.

What We Recommend

We recommend that the Acting Director of the Los Angeles Office of Multifamily Housing require Sutton Irvine to (1) hire a HUD-approved management agent and develop and implement written policies and procedures to strengthen its controls to ensure compliance with HUD rules and requirements, (2) repay ineligible costs charged to the project, and (3) provide documentation for unsupported income and costs. If Sutton Irvine cannot provide support, HUD should require it to repay the unsupported amount from nonproject funds and correct the appropriate general ledger accounts.

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Background and Objective

The U.S. Department of Housing and Urban Development's (HUD) Section 202 program is often referred to as the Supportive Housing for the Elderly program. However, before a legislative change in 1990, Section 202 program funding was available to developers for housing elderly or disabled low-income households. HUD intended for the Section 202 program to help expand the supply of affordable housing with supportive services. This program provides very low-income residents with options that allow them to live independently but in an environment that provides support activities, such as cleaning, cooking, transportation, etc. HUD provides loans to finance the construction, rehabilitation, or acquisition of such projects as well as rent subsidies to help make the projects affordable.

Sutton Irvine Residence, Inc., owns a housing project funded under HUD's Section 202 Direct Loan for Housing for the Elderly or Handicapped Persons and a Section 8 housing assistance payments contract. The Sutton Foundation, Inc., is the project's sponsor. The sponsor obtained a Section 202 capital advance reservation and transferred it to Sutton Irvine, a nonprofit public benefit corporation and owner of the project. A project administrator oversees the daily operations of the project. A management company was hired to oversee the tenant aspects of the project. The project consists of three three-bedroom single-family homes. These three HUD-subsidized single-family homes are on separate parcels of land located in Irvine, CA.

In April 1983, Sutton Irvine executed a regulatory agreement with HUD for a mortgage that was made under Section 202 of the Housing Act of 1959 in the amount of \$555,600. In December 1985, HUD and Sutton Irvine modified the regulatory agreement to reflect a reduction of principal at final loan closing by HUD, resulting in the \$546,300 loan. The regulatory agreement establishes the rules, regulations, and restrictions regarding the use and operation of the project, such as what expenses may be paid with project funds.

In addition, Sutton Irvine executed a Section 8 housing assistance payments contract with HUD that became effective in August 1983. Effective May 2010, the contract was renewed and provided project rental housing assistance funds for the project's nine bedroom units. HUD provided the project rental housing assistance funds to cover the difference between the HUD-approved operating project costs and the tenants' rent contributions.

Our audit objective was to determine whether Sutton Irvine operated its project in accordance with HUD rules and requirements.

Results of Audit

Finding: Sutton Irvine Did Not Operate Its Project in Accordance With HUD Rules and Requirements

Sutton Irvine did not operate its project in accordance with HUD rules and requirements. Specifically it (1) failed to maintain an adequate financial management system, (2) disbursed project funds for ineligible loans and unsupported expenses, (3) failed to manage its tenant rents and security deposits, (4) failed to submit required financial reports to HUD, and (5) failed to maintain the required number of members on its board of directors. These conditions occurred because Sutton Irvine failed to follow HUD rules and requirements due to a lack of written policies and procedures and its unfamiliarity with the HUD program. As a result, it deprived the project of \$26,189 and did not ensure that at least \$159,843 spent for unsupported expenses was available for eligible Section 202 program activities, which included mortgage payments. Further, Sutton Irvine's actions did not ensure continued supportive and affordable housing for very low-income persons with disabilities.

Inadequate Financial Management System

Sutton Irvine's regulatory agreement, section 11(e), requires it to keep its project's books and accounts of its operations in accordance with HUD requirements. Further, HUD regulations at 24 CFR (Code of Federal Regulation) 84.21(b)(3) require that Sutton Irvine's financial management system provide effective control over and accountability for all funds, property, and other assets to ensure that they are used solely for authorized purposes (see appendix C).

Sutton Irvine did not have a financial management system that complied with Federal regulations and its regulatory agreement. Specifically,

- It did not maintain a complete and accurate general ledger of its transactions. During our review of the general ledger, there were instances of duplicate payee names, and at least 25 percent of the general ledger records did not have names or numbers to identify project transactions. The administrator attributed the duplicate and incomplete records to a lack of proper training in performing such duties as recording transactions in Sutton Irvine's financial management system.
- It lacked the procedures to manage the project. For example, it did not have written policies and procedures or contracts that defined administrative roles, qualifications, or duties. In addition, it did not have written accounting policies and procedures to ensure compliance with HUD record-keeping rules and requirements.
- Its record-keeping system, which included project files, was disorganized and unmanaged. For example, Sutton Irvine's administrator was unable to locate documents requested and support expenses discussed in this report.

Project Funds Disbursed for Unsupported Expenses

Sutton Irvine violated HUD regulations and its regulatory agreement as it could not support \$77,200 in administrative and management expenses, \$31,637 in income deposits, and \$13,418 in general expenses.

Sutton Irvine Lacked Contracts for Its Administrator and Management Agent Expenses

Sutton Irvine violated its regulatory agreement, section 11(b) and HUD Handbook 4381.5, REV-2, section 2-6, as it did not have the required proposal, management certification forms, and contracts. These documents define the administrative roles, qualifications, or duties of its current and previous administrator. Since late 2010, Sutton Irvine's current administrator had handled the day-to-day activities of the project without the required HUD documents. The administrator explained that she was unaware of HUD requirements that Sutton Irvine execute a management certification form and an agreement that defined her administrative role, qualifications, and duties. The administrator was not able to provide similar documentation related to the previous administrator. As a result, both the current and previous administrators incurred \$64,000 (\$58,000 and \$6,000, respectively) in unsupported administrator costs, which Sutton Irvine paid at a monthly rate of \$1,200.

In addition, Sutton Irvine violated its regulatory agreement, section 11(b), as it did not have the required contract, defining the role, qualifications, or duties of a management company it used to manage the tenant aspects of the project. According to the administrator, she was unsure of the role of the hired management company that was in place when she became Sutton Irvine's project administrator. However, she did know that the management company provided Sutton Irvine administrative services related to the Section 8 program, which included the execution of rental agreements, income verifications, and annual recertifications of the residing project-based tenants. Sutton Irvine's last contract with the management company expired in March 2005; however, services continued, and Sutton Irvine incurred costs of at least \$13,200, or a flat monthly fee of \$400, during the audit period. The administrator explained that she was unaware that a contract and amendments were required to continue management of the tenant aspect of the project. She also did not know that the contract had expired.

Overall, the administrative roles, qualifications, and duties of the administrator and management company were not official, defined, or supported by a valid contract. As a result, Sutton Irvine incurred costs of \$77,200 for unsupported administrative ($\$58,000 + \$6,000 = \$64,000$) and management (\$13,200) expenses.

Sutton Irvine Lacked Records To Support Accounting Journal Entries

HUD regulations at 24 CFR 84.21(b)(7) require that Sutton Irvine's financial management system have accounting records, including cost accounting records, that are supported by source documentation (see appendix C). Sutton Irvine did not have records to support the amounts of two account balance adjustment journal entries totaling \$31,637 in unknown deposits. The administrator explained that Sutton Irvine's accounting software had generated the entries and amounts recorded in the general ledger and she did not know the basis for the amounts or their relation to any transactions. She recalled that the accounting software had prompted her to accept the entries and amounts when she reconciled the bank statements.

Sutton Irvine Lacked Records To Support General Expenses

Sutton Irvine violated HUD regulations at 24 CFR 84.21(b)(7) when it disbursed a total of \$13,418 for unsupported expenses (see appendix C). Of this amount, it

- Reimbursed its sponsor for \$7,597 in unsupported expenses related to office supplies, postage, alarm installation, office space rent, gardening, and utilities;
- Disbursed \$2,856 for unsupported utility service expenses;
- Reimbursed its administrator for \$1,633 in unsupported expenses related to flowers and dirt, a transfer fee for bricks and sod, a telephone bill, and other unknown items;
- Reimbursed two individuals not employed by it for \$702 (\$665 + \$37) related to unknown items; and
- Disbursed \$630 for unsupported gardening services.

The administrator was not able to support the questioned expenses with receipts. Additionally, the administrator could not show that the questioned expenses supported with receipts were project-related. For instance, the administrator provided receipts for office supplies, but was not able to show that the expenses incurred for the supplies were project-related.

Project Funds Disbursed for Ineligible Expenses

Sutton Irvine's regulatory agreement, section 11(a), states that the owners will spend income and other project funds only for project-related purposes (see appendix C). Sutton Irvine made ineligible loans to its sponsor totaling \$118,300. As of October 31, 2014, the sponsor had repaid \$93,000 of the loaned funds. Therefore, we considered the remaining \$25,300 to be ineligible loans. The administrator explained that she was unaware that loans from the project were ineligible costs. She explained that the sponsor's board of directors was working toward repaying the outstanding loans.

Additionally, Sutton Irvine disbursed a total of \$889 for ineligible expenses. Of this amount, it

- Reimbursed its administrator \$316 for organizational costs, tax forms, food, home repair items, and utility expenses for a non-HUD-funded property;

- Disbursed \$453 for utility services provided to its non-HUD-funded property and late fees; and
- Reimbursed a nonemployee \$120 for unknown items and repairs performed at a non-HUD-funded property.

The administrator admitted that she was not aware of HUD programs and did not know what types of expenses were ineligible. Much of her knowledge in managing the project came from “trial and error type of learning.”

Mismanaged Tenant Rents and Security Deposits

Sutton Irvine’s regulatory agreement, section 11(h), requires that it deposit all receipts of the project in the name of the project. Further, any person receiving funds of the project must immediately deposit such funds into the project bank account. In addition, the regulatory agreement, section 7(f), requires the collection of security deposits from tenants as a condition of occupancy at the project. Further, the owners are required to keep funds collected as security deposits separate from all other funds of the project in a trust account. The amount of the account must at all times equal or exceed the sum of all outstanding obligations under the account (see appendix C).

Sutton Irvine’s sponsor collected the tenants’ portions of the contract rents for deposit into an improper nonproject bank account. The sponsor then remitted these funds to Sutton Irvine, which deposited the collected rents into the project’s bank account. This improper practice resulted in it not collecting at least \$37,138 in contract rents from its sponsor. Specifically, it did not collect a total of eight months of the tenants’ portions of the contract rents during the period of July 1, 2010, to October 31, 2014. Sutton Irvine did not have documentation to show that it had collected or deposited the tenants’ portions of the contract rents into the project’s bank account. Sutton Irvine’s administrator did not know that the sponsor’s practice of depositing the collected rents in a non-project bank account was inappropriate. The administrator explained that the collection and deposit of rents were performed in this manner because this was the method used by the previous administrators.

Sutton Irvine also did not require security deposits because the tenants were unable to pay the security deposits. However, Sutton Irvine’s general ledger showed a rental deposit account with a balance of \$450. The administrator could not verify if such a bank account for security deposits exist and whether the amount in question was for security deposits. As a result, it cannot be determined whether Sutton Irvine properly billed, collected, and deposited all security deposits to meet HUD’s requirements.

Operating Budget and Financial Statements Not Filed

Sutton Irvine’s regulatory agreement, section 3, requires that on or before the first day of each fiscal year during which the loan is outstanding, Sutton Irvine submit an operating budget to HUD for that fiscal year. Further, section 2(a) states that expenses must be made only in accordance with the operating budget submitted to and approved by HUD (see appendix C).

Sutton Irvine’s administrator was unable to provide us a copy of the last operating budget, as she did not know whether that document existed. The administrator explained that she was unaware

of HUD's requirement for the yearly submission of an operating budget and had not prepared or submitted the required operating budget to HUD.

Sutton Irvine's regulatory agreement, section 11(f), requires that it submit financial statements to HUD 60 days after the project's fiscal yearend (see appendix C). Sutton Irvine had not submitted its financial statements to HUD since its fiscal year ending June 30, 2012. On April 25, 2013, its independent certified public accountant withdrew from auditing its fiscal year ending June 30, 2012, financial statements due to concerns that the audit would result in an unfavorable report opinion. Sutton Irvine's president and administrator explained that its financial statements remained unaudited. Both were unsure whether another certified public accountant could perform the required audits.

Not Enough Members on Sutton Irvine's Board of Directors

Sutton Irvine's regulatory agreement, section 7(h), states that it may not amend its articles of incorporation or by-laws other than as permitted under the terms of the articles of incorporation approved by HUD. Further, article 5, section 1, of Sutton Irvine's by-laws states that a seven-member board of directors must govern its affairs (see appendix C).

Sutton Irvine's audited financial statements for its fiscal year ending June 30, 2011, listed six board members, including the administrator, who served as secretary-treasurer. However, at the time of the audit, the board consisted of only three members, four fewer than required. Sutton Irvine's administrator stated that she was unaware of the board's membership requirements and would discuss the required increase in membership with the board's president.

Administrator Lacked an Understanding of Rules and Requirements

The administrator was not aware that Sutton Irvine violated HUD rules and requirements. As noted in this report, the administrator admitted she was not aware of HUD programs. The administrator's lack of understanding the program was evident in the areas mentioned in this report. In addition, she attributed issues with the Sutton Irvine's accounting records to a lack of training in how to use the accounting program. The project administrator must understand her administrative role and duties, as well as of HUD rules and requirements. With training and technical assistance, the project administrator will ensure that project complies with HUD rules and requirements.

Conclusion

Sutton Irvine did not operate its project in accordance with HUD rules and requirements. This condition occurred because it failed to follow HUD rules and requirements in operating its Section 202-funded project due to a lack of written policies and procedures its unfamiliarity with the HUD program. As a result, it used \$26,189 in project funds for ineligible expenses and did not ensure that at least \$159,843 spent for unsupported expenses was available for eligible program activities, including mortgage payments. In addition, it did not ensure continued supportive and affordable housing for very low-income persons with disabilities.

Recommendations

We recommend that the Acting Director of HUD's Los Angeles Office of Multifamily Housing require Sutton Irvine to

- 1A. Execute contracts with the current administrator and management company that define the roles and responsibilities of each party as required by HUD rules and requirements.
- 1B. Develop and implement written policies and procedures covering its entire financial operations, including procedures to ensure that costs are reviewed, documented, and supported in accordance with HUD rules and requirements.
- 1C. Provide supporting documentation for the \$77,200 in unsupported administrative and management costs or repay its project from non-project funds for any costs that remain unsupported.
- 1D. Provide supporting documentation for the \$31,637 in unsupported income deposit entries and correct any inaccurate information related to the income deposits in its general ledger.
- 1E. Provide supporting documentation for the \$13,418 in unsupported general costs or repay its project from nonproject funds for any costs that remain unsupported.
- 1F. Require its sponsor to immediately repay the ineligible loans totaling \$25,300 from nonproject funds.
- 1G. Repay to its project \$889 from nonproject funds for incurred ineligible expenses.
- 1H. Provide supporting documentation showing the payment of the unremitted rents from its sponsor for deposit into the project's bank account totaling \$37,138 or repay its project from nonproject funds.
- 1I. Provide supporting documentation for the \$450 balance in its general ledger account related to security deposits, ensure that the required security deposit bank account is established and funded to the required amount in accordance with HUD rules and requirements, and correct any inaccurate information related to security deposits in its general ledger.
- 1J. Develop and implement written policies and procedures to ensure that required operating budgets and financial statements are submitted to HUD within the required period to minimize future penalties.
- 1K. Submit to HUD all outstanding operating budgets and financial statements.
- 1L. Ensure that the membership of its board of directors complies with its by-laws by consisting of seven members.
- 1M. Obtain HUD training and technical assistance for its project administrator, management company, and board of directors to ensure compliance with HUD rules and requirements that pertain to the management and operation of its project.

Scope and Methodology

We performed our audit work at Sutton Irvine's office in Anaheim, CA, and our office in Los Angeles, CA, from October 20, 2014, to January 22, 2015. Our review generally covered the period July 1, 2010, to October 31, 2014, and was expanded as necessary.

To accomplish our objective, we performed the following:

- Obtained relevant background information;
- Reviewed the regulatory agreement and applicable HUD rules, regulations, and guidance;
- Reviewed Sutton Irvine's articles of incorporation and by-laws;
- Reviewed Sutton Irvine's fiscal year 2011 audited financial statements;
- Reviewed the project's general ledger and check register;
- Reviewed bank statements related to income deposits and expenditures; and
- Interviewed Sutton Irvine's administrator that managed the project and HUD Los Angeles Office of Multifamily Housing staff.

The audit universe consisted of deposits and expenses totaling \$357,603 and \$350,630, respectively, during the period July 1, 2010, through October 31, 2014. For our review, we nonstatistically sampled 29 deposits totaling \$88,090 that represented 20 percent of the total deposits and 4 payees with expenses totaling \$228,515, which represented 65 percent of the total incurred expenses. In addition, we nonstatistically selected and reviewed the \$14,998 in documentation for expenses paid to Sutton Irvine's previous administrator and three nonemployees.

We relied in part on Sutton Irvine's general ledger as a basis for defining the audit universe and selecting a sample for testing. Using the data analysis application ACL Analytics, we analyzed Sutton Irvine's general ledger and determined that it was sufficiently reliable to meet the audit objective and for the intended use of the data.

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(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Internal Controls

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

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

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Reliability of financial information – Policies and procedures that management has implemented to reasonably ensure that it obtains relevant and reliable information to adequately support program expenditures and discloses that information in the required reports.
- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that program expenses are supported and comply with program funding guidelines and restrictions.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

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

- The project did not have adequate controls over the efficiency and effectiveness of program operations when it did not establish administrative controls to ensure the proper project management by a HUD-approved management agent (see finding).
- The project did not have an adequate financial management system to ensure that its books and records were maintained in accordance with HUD requirements, disbursed project funds were eligible and supported, and required financial reports were submitted to HUD (see finding).
- The project did not have adequate controls when it did not comply with HUD rules and requirements by charging ineligible and unsupported expenses, and mismanaging tenants' rents and security deposits (see finding).

Appendices

Appendix A

Schedule of Questioned Costs

Recommendation number	Ineligible 1/	Unsupported 2/
1C		\$77,200
1D		\$31,637
1E		\$13,418
1F	\$25,300	
1G	\$889	
1H		\$37,138
1I		\$450
Totals	\$26,189	\$159,843

- 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 policies 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

Comment 1

Sutton Irvine Residences

April 8, 2015

To whom it may concern,

In reply to the HUD Audit performed from October 20, 2014 to January 22, 2015, we would like to note that there have been flaws in our operations and acknowledge that going forward Sutton Irvine will make the necessary corrections to move forward with our operations.

Regarding the Loans made to Sutton Foundation:

- Loan on 06/01/2011 for \$3,000.00
- Loan on 06/14/2011 for \$4,200.00
- Loan on 08/12/2013 for \$15,010.00
- Loan on 10/15/2013 for \$3,010.00
- And all additional bank fees incurred on previous loans totaling an additional \$80.00

We are in agreement that these are outstanding loans and should be repaid by Sutton. During our plan of correction we will work with Sutton to have these items repaid in a timely manner.

Comment 2

The additional unsupported administrative fees totaling \$64,000.00 and management expenses of \$13,200.00 we are requesting to be re-evaluated for the following reasons:

- Although Administrative roles and qualifications were not to standard for HUD management of SIR properties, services were provided to Sutton Irvine by administrator.
- Physical appearances were provided to manage physical properties, as well as billing management by current and previous administrator.
- The lack of a valid contract does not disregard the actual work done for Sutton Irvine. Services were provided for the period audited
- The management by RPK was held by a professional and accredited management company, which provided services to Sutton Irvine.

Comment 3

The remainder of the \$82,643.00 in question for unsupported expenses we request to have outlined in greater detail so that we may look into our records and perhaps substantiate some of the questioned expenses. As a clerical company we do consider some office expenses such as rent, or postage to be valid expenses. Along with the consideration that since the company does not have a debit card, some expenses made by administrator that were refunded after emergency expensed occurred in the properties. Some which included the sod, and gardening mandated by association in which these properties are located.

Comment 4

Please note that we have continued operations with Sutton Irvine under difficult circumstances, and will look for the required training in HUD to gain the knowledge needed to correct our mistakes and prevent them from reoccurring.

Sincerely,



Ralph A. Flores
President
Sutton Irvine Residences

OIG Evaluation of Auditee Comments

- Comment 1: We appreciate Sutton Irvine's acknowledgement of the issues identified in the report. We commend the owners for taking the necessary actions to address the outstanding loans and ensure that the Sutton Foundation repay Sutton Irvine.
- Comment 2: Based on our discussion during the exit conference, Sutton Irvine must ensure that agreements are executed with the project administrator and management company. As mentioned in the report and exit conference, the execution of these agreements will ensure compliance with HUD rules and requirements. Sutton Irvine should work with the Los Angeles HUD Office of Multifamily to address the \$77,200 in questioned costs.
- Comment 3: HUD rules and requirements (see Appendix C) provide owners guidance to ensure that incurred expenses are supported and eligible. As stated in the report and during the exit conference, we could not verify that the \$82,643 in unsupported expenses was incurred by the owners for property-related expenses. Sutton Irvine can work with the Los Angeles HUD Office of Multifamily to resolve it.
- Comment 4: We acknowledge the difficult circumstances that the owners experience in operating the properties. We commend the owners for acknowledging these issues and taking the necessary corrective actions to ensure compliance with HUD rules and regulations.

Appendix C

Criteria

The following sections of the regulatory agreement, 24 CFR Part 84, 2 CFR Part 230, Handbook 4381.5, REV-2, and by-laws were relevant to our audit of Sutton Irvine's operation of the Section 202-funded project.

Regulatory Agreement, Section 2

- (a) Mortgagor will establish and maintain a special fund to be known as the revenue fund account in a bank which is a member of the Federal Deposit Insurance Corporation into which will be deposited (i) the minimum capital investment required pursuant to the Regulations and (ii) rentals, charges, income and revenue arising from the operation or ownership of the project. Expenditures shall be made only in accordance with the operating budget submitted to and approved by HUD.

Regulatory Agreement, Section 3

On or before the first day of each fiscal year during which the loan is outstanding Mortgagor will submit an operating budget for that fiscal year to HUD. The budget shall include all necessary operating expenses, current maintenance charges, expenses of reasonable upkeep and repairs, taxes and special assessment levies, prorated amounts required for insurance and all other expenses incident to the operation of the project; and shall show the expected revenues to pay such expenses, including annual debt service requirements and reserve fund deposits. The expenses incurred and disbursements shall not exceed the reasonable and necessary amount thereof, and the Mortgagor will not expend any amounts or incur any obligations in excess of the amounts approved in the annual operating budget except upon written certification by the Mortgagor to HUD that such expenses were unanticipated and are necessary and provided further, that nothing in this section shall limit the amount which the Mortgagor may expend from funds obtained from some other source than project revenues or other funds required of the Mortgagor pursuant to this Agreement or the Building Loan Agreement.

Regulatory Agreement, Section 7

Mortgagor shall not without the written approval of the Secretary:

- (f) Require, as a condition of occupancy or leasing of any unit in the project, any consideration or deposit other than the prepayment of the first month's rent (the gross family contribution in Section 8 units) plus a security deposit in an amount not in excess of one month's rent to guarantee the performance of the covenants of the lease. Any fund collected as security deposits shall be kept separate and apart from all other funds of the project in a trust account the amount of which shall at all times equal or exceed the aggregate of all outstanding obligations under said account;
- (h) Amend its articles of incorporation or by-laws other than as permitted under the terms of the articles of incorporation approved by HUD.

Regulatory Agreement, Section 11

- (a) If the Mortgagor has any business or activity other than the project and operation of the mortgaged property, it shall maintain all income and other funds of the project segregated from any other funds of the mortgagor and segregated from any funds of any other corporation or person. Income and other funds of the project shall be expended only for the purposes of the project.
- (b) Mortgagor shall contract for independent professional management of the project in a manner satisfactory to HUD. Any management contract entered into by the mortgagor involving the project shall contain a provision that it shall be subject to termination, without penalty and with or without cause, upon written request by HUD addressed to the Mortgagor and the management agent. Upon receipt of such request, the Mortgagor shall immediately move to terminate the contract within a period of not more than 60 days and shall make arrangements satisfactory to HUD for continuing proper management of the project.
- (e) The books and accounts of the operations of the mortgaged property and of the project shall be kept in accordance with the requirements of HUD.
- (f) Within 60 days following the end of each fiscal year HUD shall be furnished with a complete annual financial report based upon an examination of the books and records of the mortgagor prepared in accordance with the requirements of HUD certified to by an officer of the Mortgagor, and when required by HUD, prepared and certified by a Certified Public Accountant, or other person acceptable to HUD.
- (h) All receipts of the project shall be deposited in the name of the project in a bank, whose deposits are insured by the F.D.I.C. [Federal Deposit Insurance Corporation]. Such funds shall be withdrawn only in accordance with the provisions of this agreement for expenses of the project. Any person receiving funds of the project shall immediately deposit such funds in the project bank account and failing so to do in violation of this Agreement shall hold such funds in trust. Any person receiving property of the project in violation of this Agreement shall immediately deliver such property to the project and failing so to do shall hold such property in trust.

24 CFR Part 84, Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations, section 84.21, Standards for financial management systems

- (b) Recipients' financial management systems shall provide for the following:
 - (3) Effective control over and accountability for all funds, property and other assets. Recipients shall adequately safeguard all such assets and assure they are used solely for authorized purposes.
 - (7) Accounting records including cost accounting records that are supported by source documentation.

Handbook 4381.5, REV-2, Chapter 2: Approval of Management Agents, Section 2.6:
Management Agent Assumption of Responsibility

Generally, the management agent may assume management responsibility only after:

- (a) The HUD Loan/Asset Management staff has issued a letter approving the agent proposed by the owner; and
- (b) The owner and agent have executed and submitted the appropriate Management Certification form (Form HUD-9839a, b, or c); and
- (c) The owner and agent have executed a Management Agreement, as necessary.

By-Laws of Sutton Irvine Residence, Inc., Article 5, Section 1. Number and Qualifications

The affairs of the Corporation shall be governed by a Board of Directors composed of seven (7) persons except as otherwise required by law, the directors must be elected from among the membership of the corporation and need not to be residents of the State of California. The directors shall be broadly representative of community interest and professional experience.