



City of Chattanooga

INTERNAL AUDIT

City Hall

Chattanooga, Tennessee 37402

Stan Sewell
Director

Ron Littlefield
Mayor

January 25, 2007

Honorable Ron Littlefield
Mayor, City of Chattanooga
City Hall
Chattanooga, TN 37402

RE: Chattanooga Neighborhood Enterprise (CNE) Management and Development Agreement for Morrison Springs Apartments, Audit 06-06

Dear Mayor Littlefield:

Attached is the Internal Audit Division's report on the Chattanooga Neighborhood Enterprise (CNE) Management and Development Agreement for Morrison Springs Apartments.

We thank the staff of CNE for their cooperation and assistance during this audit.


Very truly yours,

Stanley L. Sewell, CPA, CGFM
Director of Internal Audit

cc: **Dan Johnson, Chief of Staff**
Daisy Madison, City Finance Officer
Paul Page, Director of General Services
John Foy, Chairman (CNE)
Rayburn Traugher, President (CNE)

**CNE MANAGEMENT AND DEVELOPMENT AGREEMENT FOR
MORRISON SPRINGS APARTMENTS
AUDIT 06-06
NOVEMBER 27, 2006**

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Auditor



Director

**CNE MANAGEMENT AND DEVELOPMENT AGREEMENT FOR
MORRISON SPRINGS APARTMENTS
AUDIT 06-06**

INTRODUCTION

Chattanooga Neighborhood Enterprise, Inc. (CNE) is a private, not-for-profit organization created in 1986 to develop, finance, renovate and manage affordable housing for Chattanooga and Hamilton County's low-to-moderate income citizens. CNE has four main product lines: home purchase, home improvement, housing development, and property management.

The City of Chattanooga entered into a Management and Development Agreement with CNE effective May 1, 1994. However, that contract was terminated and the City engaged in another Management and Development Agreement with CNE effective October 1, 1995. The agreement called for CNE to manage the Morrison Springs Apartments which are owned by the City. CNE is to handle all of the accounting and management duties related to the property and forward relevant bank statements, financial statements, management plans, etc. to the City on a regular basis. CNE also maintains a special bank account for management of Morrison Springs. CNE receives 9% of all rental income quarterly to manage the property. In addition, any cash flow remaining at the end of each year is to be disbursed equally between the City and CNE.

STATEMENT OF OBJECTIVES

1. Determine if contractor was in compliance with the guidelines specified in the Management and Development Agreement.
2. Determine whether financial data contained in the contractor's reports and statements were reasonable.
3. Determine if rental income was collected for all units and vacant units were actually vacant.
4. Determine if competitive bids and/or written approval were obtained for expenditures and if all proper channels/procedures were followed per the City's guidelines, when applicable.
5. Document purpose and terms of City receivables on CNE's books.
6. Determine if insurance proceeds were received from any disasters that may have occurred at the Morrison Springs property.

STATEMENT OF SCOPE

Based on the work performed during the preliminary survey and the assessment of risk, the audit period covered the operations related to the CNE Management Agreements with the City of Chattanooga during the time period of May 1, 1994 to June 30, 2006. We limited our testing of expenditures that required compliance with the City's procurement law and procedures to test compliance with competitive bidding requirements.

STATEMENT OF METHODOLOGY

Internal Audit (IA) staff reviewed the Management and Development agreements between the City and CNE, met with City and CNE officials to obtain an understanding of operations, reviewed CNE's accounting records and other supporting documentation that relate to the Morrison Springs property, and made on-site visits to the Morrison Springs property to better understand how the property is managed.

Computer processed data was not used to arrive at our conclusions. Therefore, we did not assess or attest to the reliability of this type of data. Since we did not intend to infer the sample results to an overall population, judgmental samples were used in some areas of our test work. This improved the overall efficiency of the data selection and analysis.

STATEMENT OF AUDITING STANDARDS

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to afford a reasonable basis for our judgments and conclusions regarding the organization, program, activity, or function under audit. An audit also includes assessments of applicable internal controls and compliance with requirements of laws and regulations when necessary to satisfy the audit objectives. We believe that our audit provides a reasonable basis for our conclusions. In addition we abide by the standards of professional practice established by the Institute of Internal Auditors.

AUDIT CONCLUSIONS

1. It appears that CNE was not in compliance with the guidelines specified in the Management and Development Agreement.
2. It appears financial data contained in the contractor's reports was not reasonable.

3. It appears rental income was collected for all units.
4. It appears that competitive bids were not obtained for all expenditures where required and all proper channels/procedures (including written approvals) were not followed per the agreement guidelines.
5. The purpose and terms of City receivables on CNE's books were documented. However, it appears City receivables on CNE's books are not reasonable.
6. It appears that insurance proceeds were received and properly accounted for.

BACKGROUND INFORMATION

The City and CNE entered into a Management Agreement for the management of Morrison Springs Apartments on May 1, 1994. This agreement specified the following: CNE was to prepare and submit a management plan to the City that included an operating budget and staffing and market analysis along with recommendations for approval by the City; CNE was to manage the property in full compliance with all requirements and restrictions imposed by Contract of Sale between the City and Department of Housing and Urban Development (HUD). Per the City's Contract of Sale with HUD, HUD had to approve all capital improvements for the renovation/rehabilitation of the Morrison Springs Apartments. Repairs or alterations involving an expenditure in excess of \$2,500 for any one item should be made only with the prior written approval of the City; any contract having a term longer than one (1) year or requiring an annual payment in excess of \$2,500 should be authorized in writing by the City; CNE was to prepare and render to the City monthly statements of operations; CNE was to keep the City informed of the financial status of the premises; and CNE was to generally do all things reasonably deemed necessary or desirable for the proper management of the premises.

On October 1, 1995 the original agreement dated May 1, 1994 was terminated and the City and CNE entered into another management agreement dated October 1, 1995 to manage the Morrison Springs Apartments. This agreement specified the following: CNE was to annually prepare and submit Development and Management Plans to the City, with recommendations for approval of the City; CNE was to provide the City with monthly copies of all bank statements and a quarterly statement of account which shows the status of any advances and any unrecouped deficiencies; CNE was to ensure compliance with all terms of the Contract of Sale between the City and U.S. Department of Housing and Urban Development (HUD). Per the City's Contract of Sale with HUD, HUD had to approve all capital improvements for the renovation/rehabilitation of the Morrison Springs Apartments; and CNE was to maintain orderly files containing all documents and papers pertaining to the premises.

The October 1, 1995 agreement provided for an initial renovation/capital improvements program that involved \$800,000.00 of expenditures. In regard to these initial capital improvements, CNE was to prepare or have prepared all procurement and construction documentation, to be approved by the City. Although the agreement exempts CNE from specific written approval requirements related to purchases/contracts in excess of \$10,000.00 for these initial capital improvements, it imposes more stringent requirements. CNE was to meet all requirements of the City's procurement laws (City Code) and procedures, as well as utilize procurement services and procedures of the City's Purchasing Department.

During the time of the initial capital improvements, some of the City's procurement law/procedures were: Any expenditure of \$4,000 or more mandated public advertising and competitive bidding, such purchases also required specific approval by the City Council (governing body) and, the City's procurement law required contracts to be executed in writing.

The October 1, 1995 agreement required that all expenditures, with the exception of the initial capital improvements, for repairs and alterations involving an expenditure in excess of \$10,000 for any one item shall be only with the prior written approval of the City; and any contract having a term longer than one year or requiring an annual payment in excess of \$10,000 must be authorized in writing by the City.

OPINION

We believe the findings discussed below, in the aggregate, significantly impair the operations of the Morrison Springs Apartments and they present risks that can be more effectively controlled. Due to poor management, the City should consider alternatives to CNE management of the Morrison Springs property, as well as any other properties. Further, the City should take steps to recover amounts expended by CNE in violation of the management agreement. Should the City pursue this course of action, additional documentation should be reviewed to determine amounts due as our audit only involved examination of a portion of the transactions executed by CNE for Morrison Springs.

FINANCIAL DATA

Per the management agreements, CNE was to provide the City with monthly copies of all bank statements and a quarterly statement of account which shows the status of any advances and any unrecouped deficiencies. However, it appears the City never received any financial data from CNE or booked any financial activity until 2002, although, there had been financial activity since 1994 (year of original contract). In addition, information received was limited.

Further, the City Code, Section 2-548(b) states, “the original of all contracts shall be delivered to and kept by the City Finance Office”. However, it appears the City’s Finance Officer did not have a copy of the agreements until 2002 and did not book any financial activity until then.

RECOMMENDATION 1

If CNE continues to manage the Morrison Springs property, they should follow all guidelines specified in the management agreement. The City should begin ensuring receipt of, reviewing, and maintaining all information received from CNE in regards to the Morrison Springs account. It appears the purpose of such reports was to alert the City to problems/deficiencies. We recommend the City investigate the possibility of recovering questionable expenditures as detailed in this report, as well as other amounts that may be deemed wasteful or unreasonable. The City Finance Officer should maintain original copies of all City contracts.

AUDITEE RESPONSE

Effective immediately CNE will follow all guidelines specified in the management agreement. CNE has a new management team and is implementing improvements to policies, processes and procedures. Improvements implemented or being implemented include an enhanced procurement policy, improved financial reporting, and a revised employee handbook. Additionally, CNE will review and strengthen controls regarding contract compliance and payment processing.

AUDITEE RESPONSE – FINANCE (CITY)

We concur. The referenced agreements were entered into during a prior administration. The Finance Office now has a copy of the agreements on file.

MANAGEMENT PLANS

Per the agreements, CNE was to submit annual Development and Management Plans which would provide projected revenues, operating expenses, debt service, other disbursements and retirement of receivables on the books to the City. However, it appears the City never received any management plans. Further, CNE could not provide the auditors with any such plans.

RECOMMENDATION 2

If CNE continues to manage the Morrison Springs property, they should follow all guidelines specified in the Management Agreements. The City should begin ensuring receipt of, reviewing, and maintaining all information received from CNE in regards to the Morrison Springs account. It appears the purpose of such plans was to alert the City to existing and expected problems/deficiencies. We recommend the City investigate the possibility of recovering questionable expenditures as detailed in this report, as well as other amounts that may be deemed wasteful or unreasonable.

AUDITEE RESPONSE

Effective immediately CNE will follow all guidelines specified in the management agreement. Additionally, CNE will review and strengthen controls regarding contract compliance.

EXPENDITURES NOT IN COMPLIANCE

Auditors tested one hundred sixty-nine (169) expenditure transactions representing \$1,069,293.59. The transaction dates ranged from May 1994 to June 2006. The expenditures included capital improvements, repairs and maintenance, utility bills, lawyer fees, management company (CNE) compensation, and other miscellaneous expenditures.

Of the tested transactions, CNE could not provide auditors with supporting documentation for the following thirteen (13) items totaling \$54,174.89:

<u>Description (Per CNE Listing)</u>	<u>Transaction Date</u>	<u>Amount</u>
donotuseSUPPLY-KNOXVILLE	05/10/02	\$687.00
A Cut Above	06/02/94	\$1,200.00
Home Depot	08/08/94	\$16,491.38
Caren Giles	01/13/95	\$6,710.00
American Electrical	06/09/95	\$2,357.00
donotuseSUPPLY-KNOXVILLE	02/01/02	\$269.00
donotuseSUPPLY-KNOXVILLE	03/29/02	\$289.52
donotuseSUPPLY-KNOXVILLE	07/12/02	\$328.97
donotuseSUPPLY-KNOXVILLE	03/15/02	\$269.00
Heritage	11/06/03	\$783.74
Heritage	12/23/0	\$675.00
CKS -No S In MS A/C (journal entry)	06/30/94	\$19,154.00
AmSouth Bank of TN	11/08/96	<u>\$4,960.28</u>
TOTAL		<u>\$54,174.89</u>

Of the tested transactions, sixteen (16) appeared to require written approval from the City per the May 1, 1994 agreement. The agreement was in effect from May 1, 1994 to October 1, 1995 and required written approval from the City for expenditures in excess of \$2,500.00 (see background section for detail of requirements). CNE could not provide documentation of City approval for any of the sixteen transactions which total \$104,451.83.

Of the tested transactions, eighty-five (85) appeared to require written approval from the City per the October 1, 1995 agreement. The agreement required written approval from the City for expenditures in excess of \$10,000.00 (see background section for detail of requirements). CNE could not provide documentation of City approval for any of the eighty-five transactions which total \$346,731.39.

Of the tested transactions, fourteen (14) were related to the initial capital improvements and appeared to require competitive bidding per the City Code (see background section for detail of requirements). CNE could not provide documentation to substantiate competitive bidding for four (4) of the transactions which total \$23,226.00. It further appears that CNE did not obtain City Council approval for any of the 14 tested transactions which total \$182,204.72.

In total, one hundred fifteen (115) of the tested transactions appeared to require either competitive bidding or a written approval from the City. Only ten (10) of those transactions appear to have met these requirements.

It appears CNE made no effort to obtain written approvals from the City as required by the contract. It further appears that CNE did not utilize the procurement services/procedures of the City's purchasing department for expenditures related to the initial capital improvements as required by the agreement. It also appears that CNE did not always adhere to the City's procurement law for the initial capital improvements as required by the agreement.

RECOMMENDATION 3

If CNE continues to manage the Morrison Springs property, they should obtain written approval from the City prior to making expenditures that exceed the \$10,000 limit. CNE should immediately credit their Morrison Springs (City) receivable account for the undocumented transactions amount of \$54,174.89, as well as any other expenditures posted to the Morrison Springs account that are not documented. Further, the City should consider taking action to recoup amounts paid by CNE in violation of the agreement. This would include a more extensive examination of all transactions (our audit involved only a portion) to determine the full extent of expenditures made in violation of the agreement.

In order to limit the risk of waste, abuse and fraud, the City should monitor the performance of its contractors. In particular, organizations that provide property management services.

AUDITEE RESPONSE

In the future, CNE will obtain written approval from the City prior to making expenditures that exceed the \$10,000 limit. Also, CNE is implementing an enhanced procurement policy. Expenditures charged to the Morrison Springs Apartments (City) were constructively received and benefited Morrison Springs, and therefore are the responsibility of Morrison Springs. Also, some of these expenditures date back twelve years, which exceeds the guidelines for retention time period for documentation outlined in "Records Management for Municipal Governments".

AUDITOR COMMENT

With respect to the items totaling \$54,174.89 detailed above, CNE could provide no documentation that the expenses were valid. The mere posting of an accounting entry to the Morrison Springs Apartments provides no indication that anything of value was constructively received or benefited Morrison Springs.

Guidelines specified in Records Management for Municipal Governments are irrelevant. Section 4.18 of the Management Agreement states "Contractor shall maintain orderly files containing rent records, insurance policies, leases and subleases, correspondence, receipted bills and vouchers and all other documents and papers pertaining to the Premises and the operation and maintenance thereof, the same to be and at all times to remain the property of the owner...."

Written approvals and procedures such as competitive bidding were required by the contract to ensure fair and competitive rates/prices were paid. CNE's failure to adhere to such requirements has resulted in expenditures in excess of the benefits received by Morrison Springs Apartments. We reaffirm our finding and recommendation.

AUDITEE RESPONSE – GENERAL SERVICES (CITY)

We concur. However, the Morrison Springs management contracts were entered into by a previous administration and operations continued under previous administrations. This administration has devoted substantial resources to monitoring activity and resolving the problems related to Morrison Springs. We would further note that the Morrison Springs management agreement with CNE requires multiple reports to be submitted to the City that could have alerted administration to problems. Such reports were not received by the City. While monitoring on the part of the City is needed for such contracts, we would

point out that the agreement placed no burden on the City to request the required reports from CNE or to monitor CNE's performance.

VENDORS WITHOUT CONTRACTS

Of the one hundred sixty-nine (169) transactions tested, one hundred thirty-six (136) appear to be for services where contracts would be expected as a matter of good business practice. CNE could not provide contracts related to fourteen of the tested transactions.

Section 4.05 of the October 1, 1995 agreement authorizes CNE to execute contracts to facilitate the repairs and operations of Morrison Springs Apartments. Section 4.18 requires CNE to maintain records and documents pertaining to the operation and maintenance of the apartments. Section 4.21 of the agreement states that CNE "shall do all things reasonably necessary or desirable for the proper management of the business." Similar provisions are in the May 1, 1994 agreement. Further, with regard to contracted services related to the initial capital improvements, the City Code requires contracts be executed (signed) in writing.

Written contracts with a detailed scope of services description and payment provisions, along with detailed invoices, are necessary to ensure amounts paid are for the appropriate level of services provided. In addition to the lack of written contracts stated above, auditors noted multiple invoices that didn't provide enough detail to determine the actual level of service or product received.

RECOMMENDATION 4

To facilitate proper management of the business, CNE should ensure written contracts are executed for services provided under the management agreement. CNE should institute control procedures that require invoices with documentation of deliverables be matched with associated contracts prior to payment.

Vague invoices, lack of documentation, violations of policies and procedures (i.e. requirements of the agreements) and failure to follow reasonable business practices are indicators of fraudulent activity. Therefore, we would recommend that CNE's Board of Directors consider further investigation. This recommendation is made taking into consideration other indicators of fraud noted elsewhere in this report.

The City should consider taking action to recoup amounts paid by CNE from the special account that lack the appropriate documentation to determine what, if any, service or product was received.

AUDITEE RESPONSE

CNE will review and strengthen its procedures and controls regarding written contracts and payment processing. Also, CNE is implementing an enhanced procurement policy. CNE's Board of Directors will consider further investigation.

HERITAGE RENOVATIONS

CNE paid \$319,331.39 from the City's special bank account for various services (\$28,372.56 in FY03, \$104,540.00 in FY04, \$154,114.48 in FY05, and \$32,304.35 in FY06) to Heritage Renovations Construction Company related to repairs and renovations of the Morrison Springs property. These payments were made from January 17, 2003 until October 14, 2005. It appears, none of the Heritage expenditures were approved by the City. Section 4.03 of the agreement requires CNE to obtain written approval from the City prior to making any single repair or alteration expenditure in excess of \$10,000. Further, section 4.05 requires CNE to obtain prior written approval from the City for any contracts in excess of one year or requiring an annual payment in excess of \$10,000.

At best, payments to Heritage Renovations appear to be wasteful, abusive, excessive, and in violation of the terms of the management and development agreement. Heritage installed vinyl siding on thirteen (13) of thirty-one (31) buildings including the pool house and office building at the Morrison Springs property for \$106,910.19. However, CNE could not produce a contract for the installation of the vinyl siding.

CNE produced several "Invitations to Bid" documents that were sent to various contractors. However, CNE only produced one bid proposal from one contractor. This particular contractor was willing to complete all buildings (31), including the pool house and office building for \$125,300.00. However, as stated above Heritage Renovations charged \$106,910.19 to complete only 13 buildings and the pool and office building. Auditors also noted that CNE could not produce a bid proposal from Heritage. Further, the maintenance technician employed by CNE for Morrison Springs indicated that the vinyl installation appeared to be sub par. Upon visual examination, the City's General Services Department confirmed the installation appeared to be substandard. It appears that the lowest or better bidder was not chosen in this situation.

RECOMMENDATION 5

If CNE continues to manage the Morrison Springs property, they should abide by the Management Agreement related to Morrison Springs purchases. The City should consider taking action to recoup amounts paid by CNE for expenditures made to Heritage. CNE made these expenditures without following the Management and Development Agreement. Because it appears that excessive payments were intentionally

made to Heritage by CNE, we recommend the City and CNE's Board of Directors consider further investigation. We would further recommend that CNE credit their Morrison Springs (City) receivable account for the total amounts paid to Heritage.

AUDITEE RESPONSE

Effective immediately CNE will follow all guidelines specified in the management agreement. Expenditures charged to the Morrison Springs Apartments (City) were constructively received and benefited Morrison Springs, and therefore are the responsibility of the Morrison Springs Apartments.

AUDITOR COMMENT

Written approvals were required by the contract to ensure fair and competitive rates/prices were paid. CNE's failure to adhere to such requirements has resulted in expenditures in excess of the benefits received by Morrison Springs Apartments. We reaffirm our finding and recommendation.

DOUBLE PAID INVOICES

Four of the Morrison Springs Heritage Renovations Construction Company invoices were paid twice by CNE out of the special bank account for Morrison Springs. The total amount that CNE paid in excess of what was owed relating to these four invoices was \$3,788.45.

RECOMMENDATION 6

CNE should credit their Morrison Springs (City) receivable account for the double paid invoices. CNE should implement control systems to ensure that invoices are not paid twice.

AUDITEE RESPONSE

CNE will credit the Morrison Springs (City) receivable account for the double paid invoices. CNE will review its control system and implement improvements to help prevent duplicate payments.

HUD APPROVAL FOR CAPITAL IMPROVEMENTS

Both agreements required CNE to ensure compliance with all terms of the Contract of Sale between the City and HUD. Per the Contract of Sale with the City of Chattanooga and HUD, all capital improvement expenditures for the rehab of the Morrison Springs Apartments needed to be approved by HUD. Per a "Consent and Waiver" dated August 3, 1996, HUD approved an \$800,000 loan to be used for capital improvements. This letter appears to approve detailed expenditures in the amount of \$800,000.00 to be made with the loan proceeds.

Auditors obtained a letter from HUD to the City (addressed to the City's Director of Office of Economic and Community Development) dated December 15, 1994, which indicated HUD did not approve capital improvements requested for approval on November 15, 1994 due to excessive costs. However, CNE had already made the expenditures. These expenditures totaled \$187,000.00. Although HUD disapproved these improvements and notified the City's Director of Office of Economic and Community Development of what appear to be wasteful and abusive expenditures, the City continued to allow CNE to make purchases without HUD approval and without following the purchasing/contracting guidelines of the management agreement.

Per the letter from HUD dated December 15, 1994, all copies of documents involving the procurement of goods and services for all capital improvements completed including an explanation of the procurement procedures, written specifications, product information for items purchased and receipts were to be sent to HUD. However, it does not appear that any of this information was ever received by or sent to HUD.

In addition, per an account listing from CNE, the last expenditure funded under the \$800,000 HUD approval was made on July 24, 1998. However, it appears there were capital improvements after this date that were not approved by HUD nor the City (i.e. vinyl siding totaling \$106,910.19 paid from 2003-2005).

The City is currently negotiating a sale of the Morrison Springs property. In relation to this sale, the City submitted (as prepared by CNE) to HUD on November 15, 2006 for approval, capital expenditures totaling \$1,297,081.34. This amount included the \$800,000 in renovations HUD approved on August 3, 1996. Under the terms of the contract of sale between HUD and the City, upon the sale of the property, the City will lose (to HUD) any amounts expended for capital improvements that were not approved by HUD.

It appears the Department of General Services (department in which the contracts originated) and more specifically the Office of Economic and Community Development (office under General Services that was directly corresponding with HUD and CNE regarding the capital/renovation expenditures) failed to properly monitor contract performance by CNE.

RECOMMENDATION 7

The City should ensure that they receive all proper documentation (and perform a diligent review) from any outside agency managing a property they own. More importantly, when made aware of potentially wasteful, abusive, or fraudulent activity, the City should take immediate and aggressive steps to investigate and correct. If CNE continues to manage the Morrison Springs property, they should follow all requirements specified in the Management and Development Agreement and Contract of Sale. Further, because CNE was responsible for obtaining HUD approvals, contingent on anticipated denials from HUD, CNE should credit their Morrison Springs (City) receivable account for the difference between improvement expenditures and the amount approved by HUD.

AUDITEE RESPONSE

Effective immediately CNE will follow all guidelines specified in the management agreement. We understand HUD has approved substantially all of the construction expenditures as submitted. Expenditures charged to the Morrison Springs Apartments (City) were constructively received and benefited Morrison Springs, and therefore are the responsibility of the Morrison Springs Apartments.

AUDITOR COMMENT

CNE's failure to adhere to all Management Agreement requirements has resulted in expenditures in excess of the benefits received by Morrison Springs Apartments. We reaffirm our finding and recommendation.

AUDITEE RESPONSE GENERAL SERVICES (CITY)

We concur. However, the Morrison Springs management contracts were entered into by a previous administration and operations continued under previous administrations. This administration has devoted substantial resources to monitoring activity and resolving the problems related to Morrison Springs. While monitoring on the part of the City is needed for such contracts, we would point out that the agreement placed no burden on the City to request the required reports from CNE or to monitor CNE's performance. Further, this administration has and will aggressively pursue indications of waste, abuse and fraud. The Director of Office of Economic and Community Development that received the referenced notification from HUD is no longer employed with the City of Chattanooga.

DEFERRED INTEREST EXPENSE

The Management Agreement dated October 1, 1995 anticipates CNE providing the City a ten year amortizing loan in the maximum amount of \$850,000 at 9% interest per annum to fund capital improvements. The loan was to be nonrecourse, secured by the Morrison Springs property only and the assignment of rents and leases for the loan term. CNE was to provide loan documents for approval and execution of the City. CNE did obtain a loan dated September 26, 1996 in the amount of \$800,000 from AmSouth bank at an interest rate of 7.75%, secured by the Morrison Springs property. However, this was in the form of a promissory note from CNE to AmSouth Bank amortized over 15 years.

It appears the City did approve CNE's use of the Morrison Springs Property for securing the note. It further appears that the proceeds of the debt were utilized to fund capital improvements at Morrison Springs Apartments (see other sections of this report related to the legitimacy of such expenditures). However, auditors could not locate and CNE could not provide any loan documents (promissory note, loan agreement, etc.) between the City and CNE.

CNE maintains accounting records and manages a special checking account for the City related to operations of Morrison Springs Apartments. CNE recorded the \$800,000.00 AmSouth Bank note as a Note Payable for Morrison Springs Apartments. Further, CNE has been making payments, from the special account, on the loan since its inception based on invoices received from AmSouth Bank with the resulting debits reducing the amount of debt and charging interest expense (in line with the amortization schedule associated with the AmSouth Bank note).

In March 2006, CNE booked interest expense of \$121,936.02 (and an associated deferred liability) to Morrison Springs Apartments. Upon inquiry by auditors, management indicated the additional interest is the difference in the interest rate per the Management Agreement (9%) and the amount AmSouth Bank charged (7.75%). Auditors noted that under the assumption that the City is liable for this difference in interest, the amount recorded appeared to be substantially overstated. CNE management indicated that an adjustment would be made to reduce the amount to \$73,418.39.

It is the opinion of the City Attorney that the City is not liable for any interest amounts beyond those paid based on the original note between CNE and AmSouth Bank. CNE was able to obtain a 7.75% loan from AmSouth and elected to do so rather than follow the provisions of the Management Agreement with the concurrence or acquiescence of the City. The circumstances surrounding the AmSouth loan evidences the intention of the parties to either construe the contract to permit this course of action or to informally modify the contract to approve this course of action.

RECOMMENDATION 8

CNE should remove any entries related to deferred interest from the books maintained for Morrison Springs Apartments. To ensure prompt attention by the City to claims made by CNE, in the future, CNE should make direct billings, invoices or assertions to the City for claims of liability. It is very likely that this issue would not have come to the attention of City Administration were it not for the audit being performed.

AUDITEE RESPONSE

The terms of the Management Agreement clearly indicated the intent of the City to pay CNE at the 9% interest rate.

AUDITOR COMMENT

The terms of the Management Agreement clearly state that CNE was to provide the City with loan documents for **approval** and **execution** by the City. Either (1) CNE did not provide such documents and therefore, the City did not have the opportunity to ensure provisions for prepayment without penalty, refinancing options, etc. were included or (2) it was the intent of the parties that the loan documents related to the note from CNE to AmSouth Bank (7.75%) and secured by the Morrison Springs property serve as the “loan documents.” Thus, the City never approved or executed a loan, as clearly required by the Management Agreement, or the City approved a 7.75% loan amortized over 15 years.

Further, the Management Agreement states that “The loan contemplated by this Agreement shall be subject to prior approval of HUD as required....” The loan approved by HUD was the 7.75% loan from AmSouth to CNE. We reaffirm our finding and recommendation.

RECOMMENDATION 9

The City should not fund projects with debt unless absolutely necessary. The City of Chattanooga has a longstanding history of maintaining an AA bond rating. When the City lacks the funds necessary for projects, debt can be obtained at much lower rates than those obtained from banks by private parties. In the future, the City should only incur long-term debt by bond issue.

City Administration should not subject the City to long-term liabilities without sufficient written documentation that has been reviewed by the City Attorney.

RESPONSE (CITY)

We concur. The referenced transaction occurred under a prior administration.

UNJUSTIFIABLE MILEAGE & SALARY EXPENSES

The normal duties of the Property Maintenance Technician employed at the Morrison Springs apartments are to perform general maintenance services at the Morrison Springs property. However, occasionally he performs duties and services at other complexes also managed by CNE, but not owed by the City. In addition, he is paid mileage when traveling to the various complexes to perform services. Although he may perform a service at a different complex other than Morrison Springs, he is still reimbursed for his mileage from the Morrison Springs account. In addition, he is paid his full time regular salary (from the Morrison Springs Account) when performing duties at other locations. When performing duties at other complexes managed by CNE, the Maintenance Technician should be paid from the account of the complex in which he performed the service, not from the Morrison Springs account.

RECOMMENDATION 10

CNE needs to discontinue allowing employees from Morrison Springs to perform duties at other locations unless they are being paid from the location account in which they have performed the duty. Further CNE should reimburse (credit the City/Morrison Springs receivable account) the City for amounts related to non-Morrison Springs services performed by Morrison Springs staff. CNE should implement accounting system procedures to ensure expenditures are recorded to the appropriate entity (cost center).

AUDITEE RESPONSE

Effective immediately all CNE employees will be paid by the property at which duties are performed. CNE will reimburse the City for any identified amounts due to Morrison Springs employees performing duties at other properties, and will charge the City for any identified amounts due to other employees performing duties at Morrison Springs. CNE will review and strengthen accounting system procedures to ensure expenditures are recorded to the appropriate entity.