



**Lake Village of Auburn Hills
Auburn Hills, MI**

Section 223(f) Multifamily Insurance Program



Issue Date: September 29, 2014

Audit Report Number: 2014-CH-1010

TO: Barbara Chiapella, Director of Multifamily Housing Hub, 5FHMLA
Craig Clemmensen, Director, Departmental Enforcement Center, CACB

//signed//

FROM: Kelly Anderson, Regional Inspector General for Audit, (Chicago Region) 5AGA

SUBJECT: The Owner and Former Management Agents Lacked Adequate Controls Over the Operation of Lake Village of Auburn Hills, Auburn Hills, MI

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our audit of the Lake Village of Auburn Hills multifamily 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 the 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 (312) 353-7832.



September 29, 2014

The Owner and Former Management Agents Lacked Adequate Controls Over the Operation of Lake Village of Auburn Hills, Auburn Hills, MI

Highlights

Audit Report 2014-CH-1010

What We Audited and Why

We audited the Lake Village of Auburn Hills multifamily project as part of the activities in our fiscal year 2014 annual audit plan. We selected the project based on a request from the U.S. Department of Housing and Urban Development's (HUD) Detroit Office of Multifamily Housing. Our objective was to determine whether the project's owner and former management agents operated the project in accordance with the regulatory agreement and HUD's requirements.

What We Recommend

We recommend that HUD require the owner to (1) support or reimburse the project for the unsupported disbursements and rental credits; (2) reimburse the project from nonproject funds for the non-revenue-generating housing units, ineligible expenditures, and the underfunded security deposit account; and (3) implement adequate procedures and controls to address the finding cited in this report. We also recommend that HUD pursue double damages, civil money penalties, and administrative sanctions, as appropriate, for the finding cited in this report.

What We Found

The project's owner and former management agents did not ensure that (1) adequate documentation was maintained to support disbursements or that funds were used for reasonable operating expenses or necessary repairs of the project, (2) the project's housing units were used for their intended purpose, and (3) tenants' security deposits were appropriately maintained. As a result, HUD lacked assurance that more than \$7.1 million was used for reasonable operating expenses or necessary repairs of the project and nearly \$116,000 in additional rental revenue was not lost. Further, more than \$8,400 in project funds and nearly \$134,000 in lost rental revenue was not available for reasonable operating expenses and necessary repairs of the project. In addition, nearly \$192,000 in tenant security deposits was not available to (1) pay for damages to the project's housing units, (2) apply toward tenants' unpaid rent, or (3) reimburse households.

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BACKGROUND AND OBJECTIVE

Lake Village of Auburn Hills is a 584-unit market-rate multifamily rental housing project located in Auburn Hills, MI. On June 12, 2008, the U.S. Department of Housing and Urban Development (HUD) insured the project's mortgage under section 223(f) of the National Housing Act and executed a regulatory agreement with the project's owner, Lake Village of Auburn Hills, LLC. Wynnestone Communities Corporation and Wingate Management Companies were the project's former management agents.¹ As of August 2014, Freedomview Management Company, LLC, was the project's management agent.

From June 2008 through December 2012, the project was in a non-surplus-cash position in excess of \$1 million. Further, in 2009 and 2011, HUD designated the project as a troubled status entity. As of July 28, 2014, the project's audited financial statement for its fiscal year 2013 had not been received by HUD. The project's records are located at 100 Lake Village Boulevard, Auburn Hills, MI.

We selected the project for review based on a request from HUD management. Our objective was to determine whether the project's owner and management agents operated the project in accordance with the regulatory agreement and HUD's requirements. Specifically, we wanted to determine whether (1) project funds were used for reasonable operating expenses or necessary repairs of the project, (2) the project's housing units were used for their intended purpose, and (3) tenants' security deposits were appropriately maintained.

¹ The general partner of the Lake Village of Auburn Hills, LLC, owned Wynnestone. Wynnestone, formerly Amurcon Corporation, was the identity-of-interest management agent from June 2008 through February 2013. Wingate Management Companies was the project's management agent from March 2013 through February 2014.

RESULTS OF AUDIT

Finding 1: The Project's Owner and Former Management Agents Did Not Always Operate the Project in Accordance With the Regulatory Agreement and HUD's Requirements

The project's owner and former management agents did not always ensure that (1) adequate documentation was maintained to support disbursements or that funds were used for reasonable operating expenses or necessary repairs of the project, (2) the project's housing units were used for their intended purpose, and (3) tenants' security deposits were appropriately maintained. The weaknesses occurred because the project's owner and former management agents lacked adequate procedures and controls to ensure that (1) disbursement and procurement documentation was properly maintained and (2) HUD approved the project's use of non-revenue-generating housing units and application of rental credits. In addition, the project owner disregarded its regulatory agreement and HUD's requirements regarding the maintenance of tenant security deposits. As a result, HUD lacked assurance that more than \$7.1 million was used for reasonable operating expenses or necessary repairs of the project and nearly \$116,000 in additional rental revenue was not lost. Further, more than \$8,400 in project funds and nearly \$134,000 in lost rental revenue was not available for reasonable operating expenses and necessary repairs of the project. In addition, nearly \$192,000 in tenant security deposits was not available to (1) pay for damages to the project's housing units, (2) apply toward tenants' unpaid rent, or (3) reimburse households.

The Project Lacked Sufficient Support for Disbursements From Its Operating Account

Contrary to paragraphs 6(b) and 9(b) of the project owner's regulatory agreement, the owner and former management agents were unable to provide sufficient support for more than \$7.1 million disbursed from the project's operating account. Further, more than \$8,400 in operating funds was not used for reasonable or necessary project-related expenses or repairs. The funds were disbursed from the project's operating account when the project was in a non-surplus-cash position.

Disbursements to Wynnestone

We reviewed 182 disbursements from the project's operating account totaling nearly \$6.6 million. Of the 182 disbursements, the project owner was unable to provide sufficient documentation to support 176 disbursements totaling nearly \$6.5 million. Further, more than \$6.4 million (99 percent) of the unsupported

disbursed funds represented transfers from the project's operating account into Wynnestone's corporate account.² Wynnestone provided an intercompany transfer schedule to support the more than \$6.4 million that was transferred to its corporate account. The schedule identified nearly \$1.9 million in payroll, insurance, management fees, taxes, and miscellaneous costs paid by Wynnestone on behalf of the project. It also showed that Wynnestone reimbursed the project nearly \$5.2 million. According to the corporate controller for the Silverman Development Company, LLC,³ the amounts reported in the schedule were reconciled to the corporate general ledger but were not verified to the source documents.

Using the project's bank statements, we identified 42 transfers from the corporation to the project's operating account between January 2011 and December 2013 totaling more than \$4.6 million. Nearly all of the reimbursements were posted to the project's general ledger as other loans and notes payable from surplus cash.⁴ According to the corporate controller, the account entitled other loans and notes payable from surplus cash was used to record only the transfers between the project and the corporate account. As of December 31, 2013, the other loans and notes payable from surplus cash account showed that the project transferred more than \$1.2 million to the corporation that was not reimbursed.

Disbursements to Other Payees

We reviewed 61 disbursements from the project's operating account totaling \$648,126. Of the \$648,126 in disbursements, the project's owner and former management agents did not provide sufficient documentation to support that (1) \$595,319 in disbursements was properly procured in accordance with HUD Handbook 4381.5, REV-5, (2) \$40,884 in disbursements was appropriately disbursed and procured, and (3) \$3,503 in purchasing service fees (markup) charged by its identity-of-interest entities was reasonable.⁵

The remaining \$8,420 in project funds was not disbursed for reasonable operating expenses or necessary repairs of the project. These disbursements included payments for (1) work completed at a different project, (2) yoga classes, and (3) a duplicate expense.

² According to the project's 2012 audited financial statements, the auditor issued a qualified opinion on the financial statements and supplemental data, in part because there were distributions of partnership assets not applied to specific invoices, resulting in potentially misstated accounts.

³ An identity-of-interest company owned by the project's general partner.

⁴ The 42 transfers totaled \$4,626,724 and the amount of reimbursements posted to the other loans and notes payable account totaled \$4,614,075.

⁵ The project used identity-of-interest entities as purchasing agents to acquire supplies, equipment, and services.

The Project Lost Rental Revenue

Contrary to paragraph 6(h) of the regulatory agreement, the project had three non-revenue-generating housing units. According to the project's application for mortgage insurance,⁶ all 584 units were intended to be revenue-generating units. However, one housing unit was used as a maintenance shop, and the other two units were models. Therefore, from June 2008 through December 2013, the project lost \$133,923⁷ in rental revenue by not leasing the three units.

Additionally, from July 2008 through December 2013, 20 individuals were provided monthly rental credits. According to the director of finance and assistant vice president for the Silverman Development Company, LLC, monthly rental credits were given to individuals who worked for the project. However, documentation, such as timesheets, pay stubs, or Internal Revenue Service Forms W-2, was not provided to show that the individuals worked for the project and that rental credits were part of their employment benefits. Documentation was also not provided to show that HUD approved the use of rental credits. The amount of lost rental revenue for the 20 individuals totaled \$115,877.

Tenants' Security Deposits Were Not Appropriately Maintained

Before June 2011, tenants' security deposits were not maintained in a separate account in accordance with section 6(g) of the project owner's regulatory agreement and paragraph 2-9(a) of HUD Handbook 4370.2, REV-1, CHG 1. Tenants' security deposits were inappropriately deposited into and disbursed from the project's operating account.

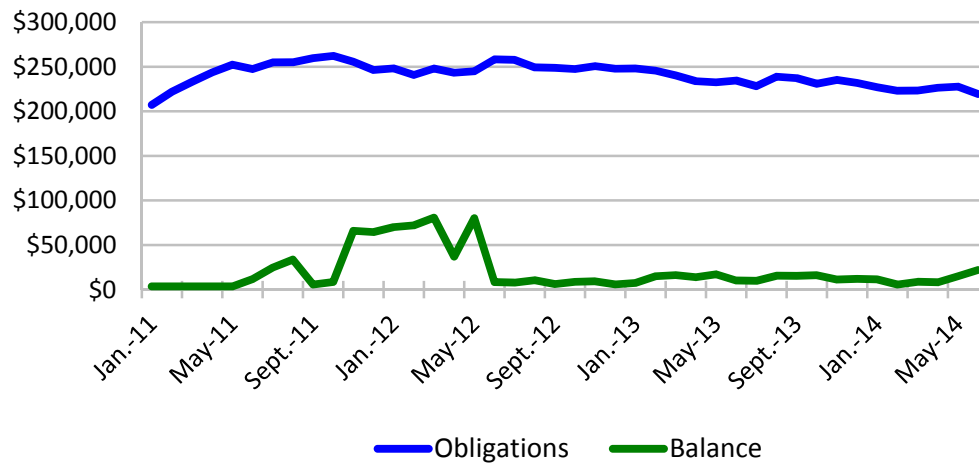
From January 2011 through July 2014, the balance of the project's security deposit account did not equal or exceed the total outstanding obligations associated with the account. As of July 31, 2014, the project's security deposit liability was \$217,885; however, its security deposit bank account balance was \$26,317.⁸ Therefore, as of July 31, 2014, the project's security deposit account was underfunded by \$191,568.

⁶ Section C, item number 7, of the project's application for multifamily housing project mortgage insurance under section 223(f) (form HUD-92013), dated January 29, 2008

⁷ Our methodology for this estimate is explained in the Scope and Methodology section of this audit report.

⁸ The \$26,317 includes the (1) \$4,464 balance in the security deposit account controlled by Wynnestone and (2) \$21,853 balance in the security deposit account controlled by Freedomview.

Underfunded security deposit account



The Project Violated the Regulatory Agreement and HUD’s Requirements

The weaknesses described above occurred because the project’s owner and former management agents lacked adequate procedures and controls to ensure that (1) disbursement and procurement documentation was properly maintained and (2) HUD approved the project’s use of non-revenue-generating housing units and the application of rental credits. In addition, the project owner disregarded its regulatory agreement and HUD’s requirements regarding the maintenance of tenant security deposits.

Wynnestone was owned by the project’s general partner and was the project’s identity-of-interest management agent from June 2008 through February 2013. According to the project’s general partner, the former employees of Wynnestone were responsible for disbursing funds from the project’s operating account to Wynnestone’s account and maintaining complete and accurate records of the accounting transactions. However, the general partner was responsible for the project, which included providing management and oversight of Wynnestone’s employees and ensuring that project funds were managed appropriately.

According to the director of finance and assistant vice president for the Silverman Development Company, LLC, while working in the accounting department starting in August of 2012, the general partner would approve disbursements for accounts payable and transfers to the corporate account. In February 2013, when the Wingate began managing the project, the general partner continued to maintain control of the project’s operating account.

Further, the general partner said that the loan underwriter did not include the three non-revenue-generating units in the loan origination documents. However, according to the project's application for mortgage insurance, which was signed by the general partner, all 584 units were intended to be revenue-generating units. The general partner also did not notify HUD that the project had non-revenue-generating units to obtain approval as required by the regulatory agreement.

The general partner also said that he was not aware that the project's security deposit account was underfunded until our audit. However, on September 23, 2011, the Director of Asset Management of HUD's Michigan State Office of Multifamily Housing Programs sent a letter to the project regarding its monthly accounting report review for July 2011. The letter stated that HUD had met with the project's management staff on January 20, 2011, to discuss the underfunded security deposit account. The letter also stated that proof that the account was fully funded was required within 30 days. Additional letters were sent in November and December 2011 and January through March 2012. Further, the project's audited financial statements for 2010 through 2012 included a finding that the project's security deposit account was underfunded. In addition, the summary of the auditee's comments on the findings and recommendations in the audited financial statements for 2010 and 2011 stated that management was aware that the project's security deposit account was underfunded. The project's audited financial statements for 2010 through 2012 included a certification from the general partner on the completeness and accuracy of the financial statements and supplemental data.

Conclusion

The project's owner and former management agents lacked adequate procedures and controls to ensure that (1) adequate disbursement and procurement documentation was maintained, (2) HUD approved the project's non-revenue-generating units and the use of rental housing credits, and (3) tenants' security deposits were maintained in accordance with the regulatory agreement and HUD's requirements.

As a result, HUD lacked assurance that more than \$7.1 million⁹ in project funds was used for reasonable operating expenses and necessary repairs of the project and \$115,877 in additional rental revenue was not lost. Further, \$8,420 in project

⁹ The \$7,131,496 included (1) \$6,491,790 in unsupported disbursements to Wynnestone, (2) \$595,319 in disbursements without procurement documentation, (3) \$40,884 in disbursements that were missing supporting eligibility and procurement documentation, and (4) \$3,503 in unsupported fees for purchasing services.

funds and \$133,923 in lost rental revenue was not available for reasonable operating expenses and necessary repairs of the project. In addition, \$191,568 in security deposits was not available to (1) pay for damages to the project's housing units, (2) apply toward tenants' unpaid rent, or (3) reimburse households.

Recommendations

We recommend that the Director of HUD's Detroit Office of Multifamily Housing Programs require the owner to

- 1A. Support or reimburse the project from non-project funds, as appropriate, for the \$6,491,790 in project funds disbursed without sufficient documentation to support that project funds were used for reasonable operating expenses or necessary repairs of the project.
- 1B. Support that the \$595,319 of project funds disbursed without appropriate procurement documentation was used to pay for costs that were reasonable, or reimburse the project from non-project funds for the amounts that were not reasonable.
- 1C. Support or reimburse the project from non-project funds, as appropriate, for the \$40,884 in project funds disbursed without sufficient documentation to support (1) that project funds were used for reasonable operating expenses or necessary repairs of the project and (2) the reasonableness of the procurement.
- 1D. Support or reimburse the project from non-project funds, as appropriate, for the \$3,503 in purchasing service fees (markup) charged by its identity-of-interest entities.
- 1E. Reimburse the project \$8,420 from non-project funds for the disbursements that were not used for reasonable operating expenses or necessary repairs of the project.
- 1F. Reimburse the project \$133,923 from non-project funds for the lost revenue associated with the three non-revenue-generating units.
- 1G. Support or reimburse the project \$115,877 from non-project funds, as appropriate, for the rental credits cited in this finding.
- 1H. Reimburse the project's security deposit account \$191,568 from non-project funds.

- 1I. Implement adequate procedures and controls to ensure that (1) project funds are used for reasonable operating expenses or necessary repairs of the project, (2) rental revenue is not lost, and (3) the project's security deposit account equals or exceeds the total outstanding obligations associated with the account.

We recommend that the Director of HUD's Detroit Office of Multifamily Housing Programs

- 1J. Review the project's non-revenue-generating units and application of rental credits to determine whether the non-revenue-generating units and credits are acceptable. If the units and credits are acceptable, HUD should provide approval to the project in writing.

We recommend that the Director of the Departmental Enforcement Center, in coordination with the Director of HUD's Michigan State Office of Multifamily Housing Programs,

- 1K. Pursue double damages remedies against the responsible parties for the unsupported and ineligible use of the project's operating funds and improper management of the project's security deposits cited in this audit report that violated the regulatory agreement.

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

- 1L. Pursue civil money penalties and administrative sanctions against the responsible parties for the violations of the regulatory agreement cited in this audit report.

SCOPE AND METHODOLOGY

We performed our onsite audit work between January 2013 and July 2014 at Wynnestone Communities Corporation's office located at 101 Southfield Road, Birmingham, MI. The audit covered the period June 12, 2008, through December 31, 2013, but was adjusted as determined necessary.

To accomplish our objectives, we reviewed

- Applicable laws; HUD's regulations at 24 CFR (Code of Federal Regulations) Parts 5, 200, and 207; HUD Handbooks 4350.1, 4370.1, 4370.2, and 4381.5, REV-2; HUD's 2009 and 2011 management reviews; HUD's Real Estate Assessment Center 2008, 2009, 2010, 2011, and 2012 financial statement reviews; HUD's monthly accounting report reviews; and the project owner's regulatory agreement with HUD.
- The project's accounting records and reports; disbursement records; contracts and agreements; entity filings; loan documents; operating and security deposit bank statements; general ledger; and annual audited financial statements for 2008, 2009, 2010, 2011, and 2012.
- Wynnestone's bank statements, general ledger, computerized databases, policies and procedures, and organizational charts.
- HUD's files for the project.

We also interviewed the project's employees and staff from Wynnestone and HUD.

Disbursements to Wynnestone

We reviewed the project's payment documentation for disbursements to Wynnestone. The project paid more than \$7 million from its operating account through 212 disbursements to the corporation between January 1, 2011, and December 31, 2013. We reviewed all 166 transfers from the project's operating account to Wynnestone's general bank account totaling nearly \$6.4 million and all 15 checks to Wynnestone totaling \$72,303. In addition, we selected one transfer from the project's operating account to Wynnestone's payroll account totaling \$130,000. We selected this one transfer because the amount was higher than the amounts for other monthly payroll expenses. The results of our review were limited to the sample items selected and could not be projected to the population.

Disbursements to Other Payees

We reviewed the project's payment documentation for disbursements to non-identity-of-interest parties. The project paid nearly \$2.7 million from its operating account between January 1, 2011, and December 31, 2013, using 1,226 checks issued to its non-identity-of-interest recipients.¹⁰ We selected a nonstatistical sample of 57 disbursements related to 834 transactions totaling more than \$578,000. We used a nonstatistical sample rather than using 100 percent selection or representative selection sampling methods because we knew enough about the population to identify a relatively small number of items of interest that were likely to be misstated or otherwise have a high risk. In our assessment of high risk, we considered the payees who received more than \$100,000, disbursements to payees that were not reported in the project's check register, duplicate payments or disbursements, among other things. The results of our review were limited to the sample items selected and could not be projected to the population.

We reviewed the project's payment documentation for disbursements to identity-of-interest entities. The project paid more than \$253,000 from its operating account between January 1, 2011, and December 31, 2013, through 33 disbursements to identity-of-interest entities other than Wynnestone. We selected a nonstatistical sample of 4 disbursements from the project's operating account related to 67 transactions totaling nearly \$70,000.¹¹ We used a nonstatistical sample rather than using 100 percent selection or representative selection sampling methods because we knew enough about the population to identify a relatively small number of items of interest that were likely to be misstated or otherwise have a high risk. In our assessment of high risk, we considered the payees who received the largest disbursements. The results of our review were limited to the sample items selected and could not be projected to the population.

Rental Revenue

We reviewed the project's housing unit history ledger and identified the lowest rental rate charged for housing units with floor plans similar to those of the maintenance shop and model units to establish a conservative amount of monthly rent revenue associated with the non-revenue-generating units. There are 2,029 days from June 12, 2008, through December 31, 2013. Therefore, approximately 67 months of income that was included in the loan application was not available to the project ($2,029 / 365 * 12 = 66.7$) as a result of the non-revenue-generating units. To be conservative, we used 66 months in our calculation. We multiplied the lowest rent for each non-revenue-generating unit by 66 months. We then multiplied the results by the 87.5 percent occupancy rate listed on project's application for mortgage insurance.¹² Further, we

¹⁰ The 1,226 checks totaling nearly \$2.7 million disbursed from the project's operating account exclude 227 checks totaling more than \$12.4 million for regular and recurring operating payments for mortgage, services, and utilities, such as electricity, gas, and waste management.

¹¹ The results of our evaluation of non-identity-of-interest and identity-of-interest disbursements were combined in finding 1 of the audit report. The combined sample included 61 disbursements (57 + 4), 901 transactions (834 + 67), and \$648,126 in project funds disbursed (\$578,156 + \$69,970).

¹² Section H, item number 2, of the project's application for multifamily housing project mortgage insurance under section 223(f) (form HUD-92013), dated January 29, 2008

added the totals for each unit to determine the total rental revenue not collected. See the table below.

Vacant unit use	Vacant unit floor plan code	Lowest rent rate for occupied units with similar floor plans	Total rent*	Lost rent**
Model	1X1 C3	\$699	\$46,134	\$40,367
Model	2X2 D1	730	48,180	42,158
Maintenance shop	2X2 D1 H	890	58,740	51,398
Totals		\$2,319	\$153,054	\$133,923

*Lowest rent rate x number of months

**Total rent x occupancy rate

We obtained and reviewed the project’s transaction detail report from its OneSite system for all rent credits from January 1, 2008, through December 31, 2013. We identified the number of tenants who received rent credits from July 1, 2008, through December 31, 2013.

We relied in part on data maintained by Wynnestone and the project. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequately reliable for our purposes. We provided our review results and supporting schedules to the Director of HUD’s Detroit Office of Multifamily Housing Programs and the project’s owner during the audit.

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 reporting – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

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 Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- The project's owner and former management agents lacked adequate procedures and controls to ensure that (1) adequate disbursement and procurement documentation was maintained, (2) HUD approved the project's non-revenue-generating units and the use of rental housing credits, and (3) tenants' security deposits were maintained in accordance with the regulatory agreement and HUD's requirements.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/	Unsupported 2/
1A		\$6,491,790
1B		595,319
1C		40,884
1D		3,503
1E	\$8,420	
1F	133,923	
1G		<u>115,877</u>
1H	<u>191,568</u>	
Total	<u>\$333,911</u>	<u>\$7,247,373</u>

- 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

From: Deborah Lock
Sent: Tuesday, September 16, 2014 2:56 PM
To: Buzz Silverman
Cc: Jason Pivoz; Carla Caswell
Subject: Draft Response Hud Audit

LVAH

In response to the draft audit report issued by the U.S. Department of Housing and Urban Development's Office of Inspector General, we have the following comments:

SUPPORT FOR DISBURSMENTS TO WYNNESTONE "MANAGING AGENT":

The \$6.6 million of disbursements which were deemed to have lacked sufficient documentation (page 4) were derived from the project bank statements. These payments were reconciled and a summary of the uses of the disbursements were reflected on the intercompany payment application spreadsheet previously provided to the audit team (attached). The \$6.6 million reflects only 'transfers out' of the bank account and does not reflect the 'transfers in' of cash as shown on the intercompany payment application spreadsheet or usage of funds to pay project operating expenses. The single largest usage of funds that were disbursed in this manner over the course of the multi-year audit period were for the payment of payroll for on site project personnel by using a third party electronic payroll vendor.

Comment 2

PAYROLL DOCUMENTATION:

Throughout the entirety of the audit period, the payroll processing was conducted by ADP, LLC or Paychex, Inc. when Wynnestone "managing agent" was the managing agent of the project or by another outside third party when third party management agent Wingate Companies was the managing agent of the project. Throughout this time period the payroll was processed electronically by third party vendors. The employees logged their hours electronically, and in many cases were paid electronically and provided electronic pay stubs. We provided to the audit team essentially 100% of the information that was given to us by the third party payroll services. Time cards have not been used since electronic strike payroll became state of the art through third party.

Comment 3

It is our understanding that the entirety of the payroll expense for this project has come into question and has been disallowed as part of the audit result. We feel that to be wholly unreasonable. It is only logical that you need employees to run the property. Typically for this size of property you would find a general manger, a manager, a leasing agent, office assistant and two or three maintenance people as an absolute minimum staffing level. The payroll disbursements are appropriate for payroll.

MANAGEMENT FEES:

Management fees are a monthly recurring charge, however only three month's worth of management fees were considered supported.

Ref to OIG Evaluation

Auditee Comments

Comment 4

ADDITIONAL INFORMATION REGARDING TRANSFERS TO THE PROJECT:

In our previously provided schedule of transfers to the project there was a summary of cash transfers that totaled \$5.2 million. The audit team reduced the value of those transfers to \$4.6 million based upon their inability to locate support for certain transfers. After reviewing their schedule, we have the following additional information that they had not previously included:

1. 5/13/2011 \$100,000 – this was originally entered into Timberline and nets against a transfer out for the same amount so it is not reflected when it was transferred into Onesite. GL trans #17772.
2. 5/24/2011 \$3,068.61 – this was originally entered into Timberline and nets against an accounts payable entry for same amount. It was not reflected when transferred into Onesite. AP trans 57562.
3. 3/22/2012 \$5180.53 and 4,400.00 – entered in Onesite JE#5321 3/22/12 for \$9580.53 offset account 2190.024
4. 11/15/12 \$74,648.17, \$25,000, and \$500.00 entered in Onesite JE# 8453 11/30/12 \$100,148.17 offset account 2190.024
5. 12/3 & 7/12 \$315,400.00 and \$102,450.00 entered in Onesite JE # 8474 12/31/12 \$417,850.00 offset account 2190.024
6. 5/8&10&17&20/12 \$18,000.00, \$20,000.00, \$77,062.00 and \$40,500 entered in Onesite JE# 11277 for \$155,562.00 5/31/12 offset account 2190.024
7. 6/21&25/12 \$39,500.00 & \$240,000.00 entered in Onesite JE #11291 for \$279,500 6/30/12 offset account 2190.024.

Comment 4

To reconcile to the previously mentioned \$5.2 million you would need to add the transfers to security deposit account:

1. 08/29/11 \$28,500 JE #2501
2. 10/17/11 \$40,000 JE #2720
3. 11/16/11 \$50,000 JE #3165
4. 02/28/12 \$70,500 JE #4944
5. 03/27/12 \$70,000 JE #5327
6. 5/21/12 \$77,500 JE #6029
7. 11/16/13 \$341,179.63 mortgage expense paid direct by Wynnestone “managing agent”

Comment 4

It is important to note that account 2190.024 - Other loans, notes payable, surplus cash was used as a catch all account to record all operating transfers and reimbursements between Wynnestone “managing agent” and the property. The funds going into this account were not considered to be “loans” to the property on the date of transfer, and should not be considered “loans” to the property as indicated in paragraph 2 on page 5.

Comment 5 and 6

UNSUPPORTED PROCUREMENT:

Please find again attached the procurement information. We were never notified that this was insufficient and considered unsupported.

Ref to OIG Evaluation

Auditee Comments

**Comment 5
Comment 6
Comments 5
and 7**

With respect to payments and procurement information regarding Landmark, files were provided to the audit team from Wynnestone "managing agents" attorneys discussing the difficulties in the relationship with Landmark. At no point after that were we notified that there were still unanswered questions regarding the supporting documentation provided. There were four missing checks that were found on top of the box and are now attached that would move toward addressing that issue. Landmark had approved invoices, they were longstanding relationships used previously with agreed upon unit pricing. Owner had no affiliation with either.

Comment 8

LOST REVENUE:

As stated in yesterday's meeting, it was concluded that it was an error in the mortgage agreement when written and that these units are necessary for a property of this size.

Comment 9

SECURITY DEPOSITS:

We are currently in the process of investigating how and why that occurred and will resolve.

Comment 10

CONCLUSION:

Through the end of the audit period, and to date, Wynnestone "managing agent" funded the operating losses, covered payroll, and paid bills for the property in excess of any reimbursements paid to it. The cure for the transfers mentioned in the draft audit report is to replace the funds, however that becomes moot, as it has already occurred.



Deborah Lock

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OIG's Evaluation of Auditee Comments

- Comment 1** The corporate controller for Silverman Development Company, LLC stated that the amounts questioned in our report represent transfers out of the project's bank account and does not reflect the transfers back into the project's bank account. As stated in the audit report, Wynnestone provided an intercompany transfer schedule; however, according to the corporate controller for the Silverman Development Company, LLC, the amounts reported in the schedule were reconciled to the corporate general ledger but were not verified to the source documents. Further, the project did not provide documentation to support the amounts reported in the schedule. Using the project's bank statements, we noted amounts transferred back to the project; however the payments were posted to the project's general ledger as other loans and notes payable from surplus cash.
- Comment 2** The corporate controller stated that payroll is processed electronically through a third party and that the payroll disbursements are appropriate. In conjunction with its response, payroll documentation for one pay period from its third-party payroll processor was provided. The payroll records showed that all employees paid during our audit period were employees of Wynnestone. However, documentation, such as timesheets, pay stubs, Internal Revenue Service Forms W-2, or other support documentation to show that the individuals worked for the project was still not provided.
- Comment 3** The corporate controller stated that management fees are a monthly recurring charge; however, we only considered 3 months of fees as supported. During the audit, the project's accounting records showed that the project made three transfers and three check disbursements that were clearly identifiable as payments for 6 months of management fees. Management fees should not be a flat recurring charge. According to chapter 3 of HUD Handbook 4381.5, REV-2, section 3.2(a), management fees should be calculated charges since there are five major types of fees that, when added together, make up the overall management fee for a project. The five types of fees are: (1) residential income fee; (2) commercial income fee; (3) miscellaneous income fee; (4) special fees; and (5) add-on fees. In addition, section 3.2(b) of the handbook, states that fees derived from project income (residential, commercial, and miscellaneous) must be quoted and calculated as a percentage of the amount of income collected by the agent. Therefore, multiplying the fee percentage by the income collected would provide the actual amount of fee to be paid to the agent.
- Comment 4** In its written response to the audit report, the corporate controller included additional information to add on to its schedule, which was provided during the audit, in regards to its transfers to the project. The listing of transfers also included transfers to and from the project's security deposit account. As stated in

this audit report, according to the corporate controller for the Silverman Development Company, LLC., the amounts reported in the schedule were reconciled to the corporate general ledger but were not verified using source documents. The documentation provided was not sufficient to determine that the payments were for reasonable and necessary operating expenses. We revised the report to include the corporate controller's statement that the account entitled "other loans and notes payable from surplus cash" from the project's ledger was used only to record the transfers between the project and the corporate account. According to the regulatory agreement, all rents and receipts of the project should be withdrawn in accordance to the provisions of this agreement. Any owner receiving funds of the project other than by such distribution of surplus cash must immediately deposit such funds into the project's bank account or hold such funds in trust.¹³ HUD's Handbook 4370.2 states that deposits to and disbursements from the centralized account must clearly be traceable to each project. The actual cash position of every project in the centralized account must be easily identifiable at all times without exception.¹⁴ Further the handbook states that all disbursements from the regular operating account (including checks, wire transfers, and computer-generated disbursements) must be supported by approved invoices, bills, or other supporting documentation.¹⁵

Section 6(g) of the regulatory agreement with HUD states that any funds collected as security deposits must be kept separate and apart from all other funds of the project in a trust account, the amount of which must at all times equal or exceed the aggregate of all outstanding obligations under that account. Therefore transfers to and from the corporate account for amounts that were to remain in the security deposit account were *not* allowed.

Comment 5 The corporate controller stated that the project is resubmitting its procurement documentation. HUD Handbook 4381.5, REV-2, chapter 6, section 4, paragraph 6.50(a),(b),and (c) lists the requirements for procurement documentation. The documentation that was provided during the audit and with the comments was not sufficient to determine that proper procurement procedures were followed.

Comment 6 The corporate controller stated that the project was not notified that the documentation it provided was insufficient. We disagree. We held audit update meetings and provided the results of our reviews throughout the audit. The results included the lack of supporting documentation for payments and transfers.

Comment 7 The corporate controller stated that four of the missing checks were provided with its comments to the draft audit report. The checks supported the expenditures;

¹³ Section 9(g) of the regulatory agreement with HUD

¹⁴ HUD Handbook 4370.2, chapter 2, paragraph 6(A)(4)

¹⁵ HUD Handbook 4370.2, chapter 2, paragraph 6(e)

however, they did not support the procurement of the incurred expenditures. We adjusted the audit report accordingly.

Comment 8 The corporate controller stated that there was an error in the mortgage agreement regarding the number of revenue generating units. As stated in the audit report, section 6(h) of the regulatory agreement states that owners must not, without the prior written approval of the HUD Secretary, permit the use of the dwelling accommodations of the project for any purpose except the use that was originally intended. According to the project's application for mortgage insurance, all 584 units were intended to be revenue-generating units. However, one housing unit was used as a maintenance shop, and the other two units were models. Documentation was not provided to support that the project received HUD's approval to maintain non-revenue generating units.

Comment 9 The corporate controller stated that the project owner was investigating how and why the security deposits were underfunded. We commend the project owner for investigating how the security deposits were underfunded. The project owner should work with HUD to resolve the issue.

Comment 10 The corporate controller stated that through the end of our audit period, Wynnestone was that managing agent and that it had funded the project's operating losses, payroll, and paid bills in excess of reimbursements to the corporation from the project. As stated in this audit report, Wynnestone ceased being the project's management agent as of February 2013, yet maintained control of the project's bank accounts. The documentation provided for the transfers between the project and the owner's corporate account was not sufficient to determine that the transfers were allowable in accordance with the regulatory agreement or repaid. The repayments were posted to the project's ledger as other loans and notes payable from surplus cash account. As of December 31, 2013, the other loans and notes payable from surplus cash account showed that the project transferred more than \$1.2 million to the corporation that was not reimbursed.

Appendix C

FEDERAL AND STATE REQUIREMENTS

Finding 1

Section 6(b) of the project's regulatory agreement with HUD, dated June 12, 2008, states that owners must not, without the prior written approval of the HUD Secretary, pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs.

Section 6(e) of the regulatory agreement states that owners must not, without the prior written approval of the HUD Secretary, "(e) make, or receive and retain, any distribution of assets or any income of any kind of the project except surplus cash and except on the following conditions: (1) All distributions should be made only as of and after the end of a semiannual or annual fiscal period, and only as permitted by the law of the applicable jurisdiction; (2) no distribution should be made from borrowed funds, prior to the completion of the project or where there is any default under this Agreement or under the note or mortgage; (3) any distribution of any funds of the project, which the party receiving such funds is not entitled to retain hereunder, must be held in trust separate and apart from any other funds; and (4) there must have been compliance with all outstanding notices of requirements for proper maintenance of the project."

Section 6(h) of the regulatory agreement states that owners must not, without the prior written approval of the HUD Secretary, permit the use of the dwelling accommodations of the project for any purpose except the use that was originally intended.

Section 9(b) of the regulatory agreement states that payment for services, supplies, or materials should not exceed the amount ordinarily paid for such services, supplies, or materials in the area where the services are rendered or the supplies or materials are furnished.

Section 9(c) of the regulatory agreement states that the mortgaged property, equipment, buildings, plans, offices, apparatus, devices, books, contracts, records, documents, and other papers relating to them must at all times be maintained in reasonable condition for proper audit and subject to examination and inspection at any reasonable time by the HUD Secretary or his duly authorized agents. Owners should keep copies of all written contracts or other instruments that affect the mortgaged property, all of which may be subject to inspection and examination by the HUD Secretary or his duly authorized agents.

HUD Handbook 4381.5, REV-2, chapter 6, section 4, paragraph 6.50, states that (a) when an owner or agent contracts for goods or services involving project income, an agent is expected to solicit written cost estimates from at least three contractors or suppliers for any contract, ongoing supply, or service that is expected to exceed \$10,000 per year or the threshold established by the HUD area office with jurisdiction over the project. (b) For any contract, ongoing supply, or

service estimated to cost less than \$5,000 per year, the agent should solicit verbal or written cost estimates to assure that the project obtains services, supplies, and purchases at the lowest possible cost. The agent should make a record of any verbal estimate obtained. (c) Documentation of all bids should be retained as a part of the project records for 3 years following the completion of the work.

Section 9(g) of the regulatory agreement states that all rents and other receipts of the project must be deposited in the name of the project with a financial institution in which deposits are insured by an agency of the Federal Government. Such funds should be withdrawn only according to the provisions of this agreement for expenses of the project or for distributions of surplus cash as permitted by paragraph 6(e). Any owner receiving funds of the project other than by such distribution of surplus cash must immediately deposit such funds into the project's bank account or hold such funds in trust.

Section 13(f) of the regulatory agreement states that "surplus cash" means any cash remaining after "(1) the payment of: (i) all sums due or currently required to be paid under the terms of any mortgage or note insured or held by the Secretary; (ii) all amounts required to be deposited in the reserve fund for replacements; (iii) all obligations of the project other than the insured mortgage unless funds for payments are set aside or deferment of payment has been approved by the Secretary; and (2) the segregation of: (i) an amount equal to the aggregate of all special funds required to be maintained by the project; and (ii) all tenant security deposits held."

Section 13(g) of the regulatory agreement states that "distribution" means any withdrawal or taking of cash or any asset of the project, including the segregation of cash or assets for later withdrawal within the limitations of paragraph 6(e) and excluding payment for reasonable expenses for the operation and maintenance of the project.

HUD Handbook 4370.2, chapter 2, paragraph 6(A)(4), states that deposits to and disbursements from the centralized account must clearly be traceable to each project. The actual cash position of every project in the centralized account must be easily identifiable at all times without exception.

HUD Handbook 4370.2, chapter 2, paragraph 6(e), states that all disbursements from the regular operating account (including checks, wire transfers, and computer-generated disbursements) must be supported by approved invoices, bills, or other supporting documentation. The request for project funds should be used only to make mortgage payments, make required deposits to the reserve for replacements, pay reasonable expenses necessary for the operation and maintenance of the project, pay distributions of surplus cash permitted, and repay owner advances authorized by HUD.

Section 6(g) of the regulatory agreement states that any funds collected as security deposits must be kept separate and apart from all other funds of the project in a trust account, the amount of which must at all times equal or exceed the aggregate of all outstanding obligations under that account.

HUD Handbook 4370.2, chapter 2, paragraph 9(a), states that in instances in which the regulatory agreement allows the receipt of security deposits from project tenants, a separate bank account should be established to maintain these funds. There should be one security deposit account per project. Funds in the single security deposit account must not be commingled with any other funds.

The Office of Management and Budget's (OMB) guidance at 2 CFR 180.25 states that each Federal agency implementing regulation (a) must establish policies and procedures for that agency's nonprocurement debarment and suspension programs and activities that are consistent with the guidance. When adopted by a Federal agency, the provisions of the guidance have regulatory effect for that agency's programs and activities.

OMB's guidance at 2 CFR 180.30 states that each Federal agency that participates in the governmentwide nonprocurement debarment and suspension system must issue a regulation implementing these guidelines.

Regulations at 2 CFR Part 2424 state that HUD adopts, as HUD policies, procedures, and requirements for nonprocurement debarment and suspension, the OMB guidance in subparts A through I of 2 CFR Part 180, as supplemented by this part. This adoption gives regulatory effect for HUD to the OMB guidance as supplemented by this part.

Title 12, U.S.C. (United States Code) 1715z-4a, Double Damages Remedy for Unauthorized Use of Multifamily Housing Project Assets and Income, allows the U.S. Attorney General to recover double the value of any project assets or income that was used in violation of a regulatory agreement or any applicable regulation, plus all cost relating to the action, including but not limited to reasonable attorney and auditing fees.

Title 12, U.S.C. 1735f-15, Civil Money Penalties Against Multifamily Mortgagors, allows HUD's Secretary to impose a civil money penalty of up to \$25,000 per violation against a borrower with five or more living units and a HUD-insured mortgage. A penalty may be imposed for any knowing and material violation of a regulatory agreement by the borrower, such as paying out any funds for expenses that were not reasonable and necessary project operating expenses or making distributions to owners while the project is in a non-surplus-cash position.

Section 554.607 of the Michigan Compiled Laws states that a security deposit may be used only to "(1) reimburse a landlord for actual damages to a rental unit or any ancillary facility that are the direct result of conduct not reasonably expected in the normal course of habitation of a dwelling, or (2) pay a landlord for all rent in arrearage under a rental agreement, rent due for premature termination of a rental agreement by a tenant, and utility bills not paid by a tenant."