



**Lake Village of Fairlane Apartments,
Dearborn, MI**

Section 223(f) Multifamily Insurance Program



Issue Date: September 30, 2014

Audit Report Number: 2014-CH-1012

TO: Barbara Chiapella, Director of Multifamily Housing Hub, 5FHLMA
Craig T. 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 Fairlane Apartments, Dearborn, MI

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG), final results of our review of Lake Village of Fairlane Apartments.

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

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

If you have any questions or comments about this report, please do not hesitate to call me at (312) 913-7832.



September 30, 2014

The Owner and Former Management Agents Lacked Adequate Controls Over the Operation of Lake Village of Fairlane Apartments, Dearborn, MI

Highlights

Audit Report 2014-CH-1012

What We Audited and Why

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

What We Recommend

We recommend that HUD require the owner to (1) support disbursements and that rental revenue was not lost or reimburse the project from nonproject funds, (2) reimburse the project for ineligible disbursements and lost rental revenue, (3) reimburse the project's underfunded security deposit account, and (4) implement adequate procedures and controls to address the findings cited in this audit report. We also recommend that HUD pursue double damages remedies, civil money penalties, and administrative sanctions against the responsible parties for their part in the violations of the regulatory agreement cited in the audit report.

What We Found

The owner and former management agents could not provide sufficient documentation to support that project funds were used for reasonable operating expenses or necessary repairs of the project. Further, (1) other project funds were not used for reasonable operating expenses or necessary repairs of the project, (2) the project's security deposit account balance did not equal or exceed the total obligations associated with the account, and (3) the project lost rental revenue by providing a household rent-free housing. As a result, HUD and the owner lacked assurance that nearly \$3 million in project funds was used for reasonable operating expenses or necessary repairs of the project and nearly \$19,000 in additional rental revenue was not lost. Further, nearly \$8,000 in project funds and more than \$10,000 in lost rental revenue were not available for reasonable operating expenses and necessary repairs of the project. In addition, nearly \$47,000 in security deposits was not available to (1) reimburse the owner for damages to project units, (2) pay the owner for unpaid rent, or (3) reimburse households.

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BACKGROUND AND OBJECTIVE

Lake Village of Fairlane Apartments is a 172-unit multifamily housing project in Dearborn, MI. In June 2009, the U.S. Department of Housing and Urban Development (HUD) insured the project's mortgage of more than \$11.4 million under section 223(f) of the National Housing Act and executed a regulatory agreement with the project's owner, Lake Village of Fairlane, LLC. Wynnestone Communities Corporation and Wingate Management Companies were the project's former management agents. Wynnestone, formerly Amurcon Corporation, was the project's identity-of-interest management agent from June 2009 through January 2013. The general partner of Lake Village of Fairlane, LLC, owned Wynnestone. Wingate was the project's management agent from February 2013 through March 2014. However, the general partner maintained control of the project's accounts. Staff from Silverman Development Company, LLC, an identity-of-interest company owned by the general partner and also previously known as Silverman Companies, processed the disbursements. The project's expenses were paid from the project's operating account and Wynnestone's corporate accounts.

As of August 2014, Freedomview Management Company, LLC, was the project's management agent. The project was in a non-surplus-cash position from January 2010 through December 2012. Further, as of August 1, 2014, the 2013 audited financial statements for the project had not been submitted. The project's records are located at 101 Southfield Road, Birmingham, MI.

Our objective was to determine whether the project's owner and former management agents operated the project in accordance with HUD's requirements and the regulatory agreement. Specifically, we wanted to determine whether (1) project funds were used only for reasonable operating expenses or necessary repairs of the project, (2) the project's security deposit account balance equaled or exceeded the total obligations associated with the account, and (3) the project lost rental revenue by providing a household rent-free housing.

RESULTS OF AUDIT

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

The owner and former management agents could not provide sufficient documentation to support that project funds were used for reasonable operating expenses or necessary repairs of the project. Further, (1) other project funds were not used for reasonable operating expenses or necessary repairs of the project, (2) the project's security deposit account balance did not equal or exceed the total obligations associated with the account, and (3) the project lost rental revenue by providing a household rent-free housing. These weaknesses occurred because the owner and former management agents lacked adequate procedures and controls for the operation of the project to ensure that project funds were used and security deposits were managed in accordance HUD's requirements and the regulatory agreement. As a result, HUD and the owner lacked assurance that nearly \$3 million in project funds was used for reasonable operating expenses or necessary repairs of the project and nearly \$19,000 in additional rental revenue was not lost. Further, nearly \$8,000 in project funds and more than \$10,000 in lost rental revenue were not available for reasonable operating expenses and necessary repairs of the project. In addition, nearly \$47,000 in security deposits was not available to (1) reimburse the owner for damages to project units, (2) pay the owner for unpaid rent, or (3) reimburse households.

The Project Lacked Sufficient Support for Nearly \$3 Million Disbursed From Its Operating Account

Contrary to paragraphs 6(b), 6(e), and 9(b) of the owner's regulatory agreement and paragraphs 2-6(A)(4) and 2-6(E) of HUD Handbook 4370.2 REV-1, CHG-1, the owner and former management agents were unable to provide sufficient documentation to support nearly \$3 million disbursed from the project's operating account. Further, nearly \$8,000 in operating funds was not used for reasonable operating expenses or necessary repairs of the project.

Disbursements to Wynnestone

We reviewed 152 disbursements from the project's operating account to Wynnestone totaling nearly \$2.1 million. Silverman Development Company, LLC's corporate controller stated that more than \$1 million in disbursements was loans from the project and nearly \$878,000 in disbursements was to pay for project expenses. The corporate controller did not comment on the remaining nearly \$176,000 in disbursements. However, the owner and former management agents could not provide sufficient documentation to support \$2,008,598 associated with 143 of the 152 disbursements. The corporate controller also

stated that Wynnestone reimbursed the project for more than \$930,000 of the more than \$1 million in loans. However, the documentation provided only showed that Wynnestone transferred nearly \$799,000 into the project's operating account. Deposits into and disbursements from Wynnestone's corporate account were not always clearly traceable to the project. In addition, the balance of the corporate account was less than \$15,000 as of December 31, 2013, and less than \$20 as of June 30, 2014.

Disbursements to Other Payees

We also reviewed 113 disbursements totaling nearly \$1.1 million from the project's operating account to payees other than Wynnestone.¹ The owner and former management agents were unable to provide sufficient documentation to support that \$953,500 associated with 107 disbursements was for reasonable operating expenses or necessary repairs of the project. Of the \$953,500, the project's owner and former management agents did not provide documentation to show that (1) \$541,440 in disbursements was supported with sufficient invoices and properly procured, (2) \$373,207 in disbursements was properly procured, (3) \$36,765 in purchasing service fees (markup) that identity-of-interest companies charged was reasonable,² and (4) \$2,088 in disbursements was supported with sufficient invoices.

In addition, \$7,521 from three disbursements was not for reasonable operating expenses or necessary repairs of the project. The disbursements included (1) a distribution to a limited partner, (2) duplicate costs (3) expenses for another apartment complex, and (4) late payment fees.

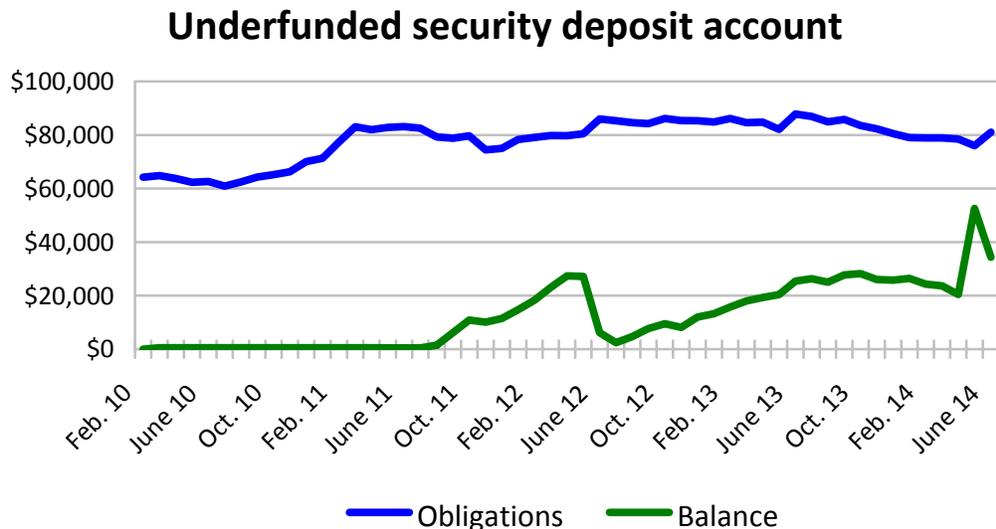
The Project's Security Deposit Account Was Underfunded by Nearly \$47,000

The project's security deposits were not appropriately managed as required by paragraph 6(g) of the owner's regulatory agreement and paragraph 2-9(A) of HUD Handbook 4370.2, REV-1, CHG-1. The security deposits were not placed into a separate trust account from June 2009 through January 2010. Further, from February 2010 through June 2014, the balance in the project's security deposit account did not equal or exceed the total outstanding obligations associated with the account. In addition, \$85,000 was transferred from the security deposit account into Wynnestone's corporate account and \$52,500 was transferred from the corporate account into the security deposit account from February through July 2012. Two transfers from the security deposit account to the corporate account totaling \$32,500 were not reimbursed. The security deposit account was underfunded by \$54,809 as of December 31, 2013, and \$46,731 as of June 30,

¹ The 113 disbursements included 61 disbursements totaling nearly \$680,000 to companies disclosed as having an identity-of-interest relationship with the project.

² The project used identity-of-interest companies as purchasing agents to acquire supplies, equipment, and services.

2014. The following graph shows the difference between the outstanding obligations and the balance of the account from February 2010 through June 2014.



The Project Lost Rental Revenue by Providing a Household Rent-Free Housing

One of the project’s units was used to provide a household rent-free housing from February 2011 through December 2013. The rents during this period totaled nearly \$36,000. The project’s site manager said that the tenant was a former maintenance employee of the project whose employment ended in February 2013. However, sufficient documentation was only provided to support that the tenant worked at the project 11 pay periods during 7 months from February 2011 through February 2013. Therefore, contrary to paragraph 6(h) of the owner’s regulatory agreement, the project lost \$10,250 in rental revenue by allowing the household to inappropriately live in a unit for 10 months (March through December 2013) and lacked sufficient documentation to support that \$18,700 in additional rental revenue was not lost.

The Owner and Former Management Agents Lacked Adequate Procedures and Controls

The weaknesses described above occurred because the project’s owner and former management agents lacked adequate procedures and controls for the operation of the project to ensure that operating funds were used and security deposits were managed in accordance with HUD’s requirements and the regulatory agreement.

The general partner of the project said that the former employees of Wynnestone were responsible for disbursing funds from the project's operating account to Wynnestone and the poor accounting and record keeping. He removed the responsible employees in 2012. However, Silverman Development Company, LLC's director of finance and assistant vice president said that the general partner approved all of the project's disbursements starting in August 2012. Further, Wingate allowed the general partner to maintain control of the project's accounts when it became the project's management agent in February 2013. Nearly \$1.2 million of the nearly \$2.1 million in unsupported project funds disbursed to Wynnestone and nearly \$146,000 of the \$953,500 in unsupported project funds disbursed to other payees were disbursed after August 2012. In addition, the general partner said that procurement was not required for professional service firms.

The general partner said that he was not aware that the project's security deposit account was underfunded until we informed him during our audit. However, the project's audited financial statements for 2010, 2011, and 2012 included a finding that the project's security deposit account was underfunded. The summary of auditee's comments on the findings and recommendations stated that management was aware that the project's security deposit account was underfunded and the account would be fully funded as soon as possible. Further, the general partner certified that he examined the annual audited financial statements and supplemental data and certified that the annual audited financial statements and supplemental data were complete and accurate.

The general partner also said that he was not aware that the household received rent-free housing until we informed him during our audit. However, Wingate notified the general partner of the situation in November 2013.

Conclusion

The project's owner and former management agents lacked adequate procedures and controls for the operation of the project to ensure that operating funds were used and security deposits were managed in accordance with HUD's requirements and the regulatory agreement. As a result, HUD and the owner lacked assurance that nearly \$3 million in project funds was used for reasonable operating expenses or necessary repairs of the project³ and nearly \$19,000 in additional rental revenue was not lost. Further, nearly \$8,000 in project funds and more than \$10,000 in lost rental revenue were not available for reasonable operating expenses and necessary repairs of the project. In addition, nearly \$47,000 in security deposits was not available to (1) reimburse the owner for damages to project units, (2) pay the owner for unpaid rent, or (3) reimburse households, as appropriate, when the households move out of the units.

³ The nearly \$3 million included (1) more than \$2 million in disbursements to Wynnestone and (2) \$953,500 in disbursements to other payees.

Recommendations

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

- 1A. Support or reimburse the project from nonproject funds \$2,008,598, as appropriate, for the project funds disbursed to Wynnestone without sufficient documentation to support that the project funds were used for reasonable operating expenses or necessary repairs of the project.
- 1B. Support or reimburse the project from nonproject funds \$541,440, as appropriate, for the project funds disbursed to payees other than Wynnestone without documentation showing that the disbursements were supported with sufficient invoices and properly procured.
- 1C. Support or reimburse the project from nonproject funds \$373,207, as appropriate, for the project funds disbursed to payees other than Wynnestone without documentation showing that the disbursements were properly procured.
- 1D. Support or reimburse the project from nonproject funds \$36,765, as appropriate, for the project funds disbursed for purchasing service fees charged by identity-of-interest companies.
- 1E. Support or reimburse the project from nonproject funds \$2,088, as appropriate, for the project funds disbursed to payees other than Wynnestone without documentation showing that the disbursements were supported with sufficient invoices.
- 1F. Reimburse the project from nonproject funds \$7,521 for the project funds that were not used for reasonable operating expenses or necessary repairs of the project.
- 1G. Reimburse the project's security deposit account from nonproject funds \$46,731 for the amount by which the security deposit account was underfunded.
- 1H. Reimburse the project from nonproject funds \$10,250 for the lost rental revenue.
- 1I. Support that additional rental revenue was not lost or reimburse the project from nonproject funds \$18,700 as appropriate.
- 1J. Implement adequate procedures and controls to ensure that (1) project funds are used for reasonable operating expenses or necessary repairs of the project when the project is in a non-surplus-cash position, (2) the project's security

deposit account equals or exceeds the total outstanding obligations associated with the account, and (3) rental revenue is not lost by providing a household rent-free housing.

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

- 1K. Pursue double damages remedies against the responsible parties for the ineligible use of the project's operating funds, the applicable portion of the unsupported disbursements, and the 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 their part in the violations of the regulatory agreement cited in the audit report.

SCOPE AND METHODOLOGY

We performed our onsite work from January through July 2014 at Wynnestone's office located at 101 Southfield Road, Birmingham, MI. The audit covered the period June 2009 through December 2013 and was expanded as determined necessary.

To accomplish our objectives, we reviewed

- Applicable laws; Title 12, United States Code, sections 1715z-4a and 1735f-15; Federal regulations at 2 CFR (Code of Federal Regulations) 180 and 2424; HUD's regulations at 24 CFR Parts 24, 200, and 207; HUD Handbooks 4350.1 REV-1, CHG 9; 4370.2 REV-1, CHG-1; and 4381.5 REV-2; and HUD's regulatory agreement with the project's owner.
- The project's audited financial statements for 2009 through 2012; accounting records; management agent agreements; and data in HUD's Integrated Real Estate Management System.
- Wynnestone's accounting records; data for the project in its Timberline and OneSite systems; policies and procedures; and organizational chart.
- Wingate's bank statements and organizational chart.
- HUD's files for the project.

In addition, we interviewed employees of Wingate and Silverman Development Company, LLC; the general partner of the project's owner; and HUD's staff.

Project funds were disbursed from the project's operating account to (1) Wynnestone, (2) companies other than Wynnestone that were disclosed to have an identity-of-interest relationship with the project, and (3) payees that were not disclosed as having an identity of interest relationship with the project. Through 1,099 disbursements, more than \$7.3 million was disbursed from the operating account from January 1, 2011, through December 31, 2013.⁴ We selected for review all 152 disbursements totaling nearly \$2.1 million to Wynnestone and all 61 disbursements totaling nearly \$680,000 to companies disclosed to have an identity of interest relationship with the project. We also initially selected for review a non-statistical sample of 15 disbursements totaling more than \$200,000 from 557 disbursements totaling nearly \$4.5 million to payees that were not disclosed as having an identity-of-interest relationship with the project. We selected one disbursement from each of the 10 payees that received the most disbursements

⁴ The disbursements included (1) 622 checks totaling more than \$5 million, (2) 148 wire transfers totaling more than \$2.2 million, and (3) 329 electronic withdrawals totaling nearly \$101,000. We did not include the electronic withdrawals in the three populations due to the average withdrawal being significantly less than the average disbursement made through checks and wire transfers.

in total dollars and five other disbursements that we determined to be of high risk. Based on our review of the 15 disbursements, we then selected for review a non-statistical sample of an additional 37 disbursements totaling more than \$219,000. We used non-statistical samples since 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 high risk and we were not projecting the results to the population that we did not review.

We reviewed the project's tenant security deposit bank statements for February 2010 through June 2014 and the project's monthly rent roll reports for February 2010 through June 2014.

We also reviewed the project's employee credit report to identify households receiving reduced-rent or rent-free housing.

We relied in part on data maintained in Wynnestone's systems. 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 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 finding and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our finding 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 objectives:

- 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 over the operation of the project to ensure that operating funds were used and security deposits were managed in accordance with the regulatory agreement and HUD's requirements.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/	Unsupported 2/
1A		\$2,008,598
1B		541,440
1C		373,207
1D		36,765
1E		2,088
1F	\$7,521	
1G	46,731	
1H	<u>10,250</u>	
1I		<u>18,700</u>
Totals	<u>\$64,502</u>	<u>\$2,980,798</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

From: Deborah Lock
Sent: Tuesday, September 16, 2014 3:38 PM
To: Buzz Silverman
Cc: Carla Caswell; Jason Pivoz (jp111@msscpa.com)
Subject: Draft of HUD Response LVF

LVF

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:

Comment 1

**Comments 1
and 2**

Comment 3

The \$1.6 million of disbursements which were deemed to have lacked sufficient documentation (pages 4 and 5) 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 \$1.6 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. An additional \$500,000 that were deemed unsupported were specifically for payroll 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.

PAYROLL DOCUMENTATION:

Comment 4

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. That information did include pay summaries, time cards

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Comment 4

have not been used since electronic strike payroll became state of the art through third party.

Comment 4

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 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.

Comment 1

Of the \$878,000 mentioned at the bottom of page 4 as disbursements for project expenses, \$500,000 is for payroll, \$50,000 was for health insurance, \$217,000 were for management fees, and the remaining \$92,000 were for miscellaneous expenses such as audit fees, website hosting, freight, and advertising. Certain expenses were disallowed without any follow up questions from the audit team. Items such as management fees, which are calculated as a percentage of sales are an example. Invoices for items such as health insurance were provided but were deemed to be insufficient to support the expenditure.

Comment 5

Comment 6

ADDITIONAL INFORMATION REGARDING TRANSFERS TO THE PROJECT:

Comment 1

In the previously provided intercompany payment application spreadsheet there are transfers to and from the project in a very short period of time that directly offset each other, however only the transfers out of the project accounts were addressed in the report.

DISBURSEMENTS TO OTHER PAYEES:

Comment 7

Comments 2 and 7

Additional documentation has been supplied by Wynestone "managing agent" management over the past several days and weeks regarding questions in this area. It is unclear as to whether the draft audit report was updated with that additional documentation (attached is support previously sent, but not reflected).

PROCUREMENT RECORDS:

Comment 8

It appears that three were large numbers of invoices that were deemed to be appropriate expenses traced to the project, however were disallowed because of a lack of procurement documentation. For example, Landmark and [REDACTED]

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Comment 9

Attorney at Law had approved invoices, they were longstanding relationships used previously with agreed upon unit pricing. Owner had no affiliation with either.

SECURITY DEPOSITS:

We are currently in the process of investigating how and why that occurred and are resolving it.

LOST REVENUE:

Comment 10

Payroll reports were provided with respect to each employee that received a rent free apartment. This was provided on a pay period by pay period basis, however was not accepted as appropriate supporting documentation. With respect to [REDACTED], the unrelated, third party management company fired, but never evicted him.

CONCLUSION:

Comment 1

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.



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OIG's Evaluation of Auditee Comments

Comment 1 Silverman Development Company, LLC's corporate controller stated that the \$1.6 million in disbursements from the project's operating account to Wynnestone questioned in the report reflects only the transfers out of the project's bank account and does not reflect transfers back into the project's bank account. These payments were reconciled and a summary of the use of the disbursements were reflected in the intercompany payment application spreadsheet. Of the \$878,000 mentioned in the report as disbursements to pay for project expenses, \$500,000 was for payroll, \$50,000 was for health insurance, \$217,000 was for management fees, and the remaining \$92,000 were for miscellaneous expenses. The corporate controller also stated that through the end of the audit period and as of September 16, 2014, Wynnestone had funded the project's operating losses, covered payroll, and paid bills for the project in excess of reimbursements to Wynnestone from the project.

However, the owner and former management agents could not provide sufficient documentation to support more than \$2.1 million in disbursements from the project's operating account to Wynnestone. According to the corporate controller, the amounts in the spreadsheet were reconciled to Wynnestone's general ledger but were not verified using source documentation. Further, sufficient documentation was not provided to support the amounts in the spreadsheet. The corporate controller previously stated that more than \$1 million in disbursements was loans from the project and Wynnestone reimbursed the project for more than \$930,000 of the loans. Loans from the project to Wynnestone would be a violation of the regulatory agreement. In addition, sufficient documentation was not provided to support that the nearly \$799,000 transferred from Wynnestone into the projects operating account were reimbursements for loans.

Comment 2 We did not include in appendix B the attachments that the corporate controller provided since the attachments were not necessary to understand the corporate controller's comments. We provided the Director of HUD's Detroit Office of Multifamily Housing Programs with a complete copy of the corporate controller's written comments plus the attachments.

Comment 3 The corporate controller stated that the largest use of funds disbursed from the project to Wynnestone was for \$500,000 in payroll. However, as stated in the report, according to the corporate controller, more than \$1 million in disbursements was loans from the project.

Comment 4 The corporate controller stated that payroll was processed electronically through third party vendors; HUD's Office of Inspector General (OIG) was provided nearly 100 percent of the information, including pay summaries, provided by the vendors; and payroll disbursements were appropriate. However, not all of the pay summaries identified the project where the employees worked. Further, the

owner and management agents did not provide sufficient documentation to support that employees were paid by Wynnestone.

Comment 5 The corporate controller stated that certain expenses, such as management fees, were disallowed without any follow up questions from HUD's OIG. We requested documentation to support the project's disbursements to Wynnestone and held update meetings throughout the audit. Further, we provided the general partner and employees of Silverman Development Corporation, LLC, schedules showing unsupported disbursements to Wynnestone during the audit.

Comment 6 The corporate controller stated that invoices for items such as health insurance were provided but were deemed insufficient to support the disbursements. Invoices could not always be traced to disbursements from the project's operating account to Wynnestone. Further, the owner and management agents did not provide sufficient documentation to support that Wynnestone disbursed funds for project expenses.

Comment 7 The corporate controller provided documentation, as attachments to the response to the report, for disbursements from the project's operating account to payees other than Wynnestone.

We revised the report to state the following:

- Of the \$953,500, the project's owner and former management agents did not provide documentation to show that (1) \$541,440 in disbursements was supported with sufficient invoices and properly procured, (2) \$373,207 in disbursements was properly procured, (3) \$36,765 in purchasing service fees (markup) that identity-of-interest companies charged was reasonable, and (4) \$2,088 in disbursements was supported with sufficient invoices.

We also amended recommendations 1B, 1C, 1D, and the schedule of questioned costs to reflect this revision.

Comment 8 The corporate controller stated that disbursements were questioned due to a lack of procurement documentation although the disbursements appeared to be supported by invoices. Some disbursements were based on long standing relationships and agreed upon unit pricing. Paragraph 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. Paragraphs 6.50(a) and (b) of HUD Handbook 4381.5 REV-2 require solicitation of estimates for any contract, ongoing supply, or service. Paragraph 6.50(c) states that documentation of all bids should be retained as part of the project's records for three years following the completion of the work.

Comment 9 The corporate controller stated that Silverman Development Company, LLC, was investigating how and why the project's security deposit account was underfunded. We commend Silverman Development Company, LLC, for investigating how and why the account was underfunded. The project owner's should work with HUD's Detroit Office of Multifamily Housing Programs to resolve recommendations 1G and 1J as applicable.

Comment 10 The corporate controller stated that payroll reports were provided for each employee that received a rent-free unit at the project.

We revised the report to state the following:

- One of the project's units was used to provide a household rent-free housing from February 2011 through December 2013. The rents during this period totaled nearly \$36,000. The project's site manager said that the tenant was a former maintenance employee of the project whose employment ended in February 2013. However, sufficient documentation was only provided to support that the tenant worked at the project 11 pay periods during 7 months from February 2011 through February 2013. Therefore, contrary to paragraph 6(h) of the owner's regulatory agreement, the project lost \$10,250 in rental revenue by allowing the household to inappropriately live in a unit for 10 months (March through December 2013) and lacked sufficient documentation to support that \$18,700 in additional rental revenue was not lost.

We also amended recommendation 1I to reflect this revision.

Appendix C

FEDERAL REQUIREMENTS AND STATE LAWS

Paragraph 6(b) of HUD's regulatory agreement with the project's owner states that without the prior written approval of HUD's Secretary, the owner must not convey, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs. Paragraph 6(e) states that without the prior written approval of the Secretary, the owner must not 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 must 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 will be made from borrowed funds prior to the completion of the project or when there is any default under the regulatory agreement or mortgage note; (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 and 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. Paragraph 6(g) states that any funds collected as security deposits must be kept in a separate trust account apart from all other funds of the project. The account balance must at all times equal or exceed the total outstanding obligations associated with the account. Paragraph 6(h) states that the owner must not without the prior written approval of the Secretary, permit the use of the dwelling accommodations of the project for any purpose except the use which was originally intended.

Paragraph 9(b) of the regulatory agreement states that payment for services, supplies, or materials shall 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. Paragraph 9(c) states that the mortgage property, equipment, buildings, plans, offices, apparatus, devices, books, contracts, records, documents, and other papers relating thereto must at all times be maintained in reasonable condition for proper audit and subject to examination and inspection at any reasonable time by the Secretary or his duly authorized agents. Owners shall keep copies of all written contracts or other instruments which affect the mortgaged property, all or any of which may be subject to inspection and examination by the Secretary or his duly authorized agents. Paragraph 9(g) states that all rents and receipts of the project must be withdrawn only in accordance with the provisions of the regulatory agreement for expenses of the project or distributions of surplus cash as permitted by paragraph 6(e) of the regulatory agreement. Any owner receiving funds of the project other than by such distribution of surplus cash must immediately deposit such funds in the project bank account and failing to do so in violation of the regulatory agreement, must hold such funds in trust.

Paragraph 13(f) of the regulatory agreement defines surplus cash as 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. Paragraph 13(g) defines a distribution as any withdrawal or taking of cash or any asset of the project, including the segregation of cash or assets for subsequent withdrawal within the limitations of paragraph 6(e) of the regulatory agreement, and excluding payment for reasonable expenses incident to the operation and maintenance of the project.

Paragraph 2-6(A) of HUD Handbook 4370.2 REV-1, CHG-1, authorized management agents to hold project funds in a centralized account. Paragraph 2-6(A)(4) states that deposits to and disbursements from the centralized account must clearly be traceable to each project. The actual cash position of each and every project in the centralized account must be easily identifiable at all times without exception. Paragraph 2-6(E) states that all disbursements must be supported by approved invoices/bills or other supporting documentation. Paragraph 2-9(A) states that individual states have specific regulations governing the handling of tenant security deposits that should be complied with. Paragraph 2-9 (B) states that all disbursements from the security deposit account must be supported by approved invoices/bills or other documentation. Disbursements must be only for refunds to tenants and for payment of appropriate expenses incurred by the tenant.

Paragraph 6.50(a) of HUD Handbook 4381.5 REV-2 states that when an owner/agent is contracting 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 which is expected to exceed \$10,000 per year. Paragraph 6.50(b) states that 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 in order to assure that the project is obtaining services, supplies, and purchases at the lowest possible cost. The agent should make a record of any verbal estimate obtained. Paragraph 6.50(c) states that documentation of all bids should be retained as a part of the project records for three years following the completion of the work.

HUD's regulations at 24 CFR 24.1 state that HUD is permitted to take administrative sanctions against employees or recipients under HUD assistance agreements that violate HUD's requirements. The sanctions include limited denial of participation, suspension, or debarment and are authorized by 2 CFR 2424.1110, 2 CFR 180.700, and 2 CFR 180.800, respectively. HUD may impose administrative sanctions based upon the following conditions:

- Failure to honor contractual obligations or to proceed in accordance with contract specifications or HUD regulations (limited denial of participation);
- Violation of any law, regulation, or procedure relating to the application for financial assistance, insurance, or guarantee, or to the performance of obligations incurred pursuant to a grant of financial assistance, or pursuant to a conditional or final commitment to insure or guarantee (limited denial of participation);
- Violation of the terms of a public agreement or transaction so serious as to affect the integrity of an agency program such as a history of failure to perform or unsatisfactory performance of one or more public agreements or transactions (debarment); or

- Any other cause so serious or compelling in nature that it affects the present responsibility of a person (debarment).

Title 12, United States Code, section 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, United States Code, section 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 mortgagor 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 mortgagor, 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 only be used 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.