



Issue Date	March 25, 2009
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Audit Report Number	2009-FW-1007
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TO: Raynold Richardson  
Director, Multifamily Program Center, 6EHM

Henry S. Czauski, Acting Director, Departmental Enforcement Center, CV

*Gerald R. Kirkland*

FROM: Gerald R. Kirkland  
Regional Inspector General for Audit, Fort Worth Region, 6AGA

SUBJECT: The Owners of Stonebrook Apartments Phase I and Phase II, Baytown, Texas,  
Violated Their Regulatory Agreements with HUD

## **HIGHLIGHTS**

### **What We Audited and Why**

We audited Stonebrook Apartments Phase I and Phase II (projects) to determine whether the projects' owners complied with the regulatory agreements and U. S. Department of Housing and Urban Development (HUD) regulations. Specifically, we wanted to determine whether the owners (1) made unauthorized distributions of project funds when the projects were in a non-surplus-cash position, (2) fully funded the tenant security deposit accounts, and (3) supported disbursements with invoices or other supporting documentation. We selected the projects for review in accordance with our strategic plan and regional goals. In addition, the audited financial statements of the projects indicated potential unauthorized distributions and transfers.

### **What We Found**

The owners and/or their management agents did not comply with the regulatory agreements and HUD regulations. Specifically, the owners and/or their

management agents paid more than \$187,500 in questioned costs. The questioned costs included unauthorized distributions (\$81,035) from the projects' operating and tenant security deposit accounts when the projects were in a non-surplus-cash position, underfunded tenant security deposit accounts (\$27,514), ineligible (\$20,644) and unsupported (\$16,945) disbursements, duplicate payments (\$7,235), excessive management fees (\$26,134), and unreasonable and unnecessary bonuses (\$8,000). Further, audit testing disclosed that they did not maintain accurate financial information, did not submit annual audited financial statements in a timely manner, and transferred the management of the projects without HUD's approval.

## What We Recommend

We recommend that the Director, Houston Multifamily Program Center, require the owners to (1) repay the projects \$81,035 for unauthorized distributions, (2) fully fund the tenant security deposit accounts, (3) repay the projects \$62,013<sup>1</sup> for ineligible or unnecessary disbursements and either furnish supporting documentation or repay the projects \$16,945 for unsupported expenses, and (4) correct and maintain the projects' accounting records in compliance with the regulatory agreements. We also recommend that HUD's Acting Director of the Departmental Enforcement Center seek civil money penalties and administrative sanctions, as appropriate, against the owners for violating the projects' regulatory agreements.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

## Auditee's Response

We provided a draft report to the owners on February 27, 2009, held an exit conference on March 12, 2009, and requested a written response by March 13, 2009. At the auditee's request, we extended the response date to March 17, 2009. The owners provided written comments on March 17, 2009, and both agreed and disagreed with the findings and recommendations. HUD's Office of Multifamily Housing agreed with our position and indicated that it will take corrective actions. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report. The auditee also provided documents as attachments to the response that are not included in appendix B but are available upon request.

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<sup>1</sup> Ineligible and unnecessary disbursements of \$20,644 + 7,235 + 26,134 + 8,000 = \$62,013.

# TABLE OF CONTENTS

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Background and Objective	4
Results of Audit	
Finding 1: The Owners and/or Their Management Agents Paid More Than \$187,500 in Questioned Costs	5
Finding 2: The Owners and/or Their Management Agents Did Not Maintain or Submit Accurate Financial Information	10
Scope and Methodology	14
Internal Controls	15
Appendixes	
A. Schedule of Questioned Costs	16
B. Auditee Comments and OIG's Evaluation	17

## BACKGROUND AND OBJECTIVE

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Stonebrook Apartments Phase I, a 184-unit apartment complex, and Stonebrook Apartments Phase II, a 192-unit apartment complex, are both located at 619 Rollingbrook Street, Baytown, Texas. In May 2000, Baytown Stonebrook Apartments, Ltd. (owner), a Texas partnership, developed Stonebrook Apartments Phase I. In August 2002, Stonebrook at Goose Creek, Ltd. (owner), a Texas partnership, developed Stonebrook Apartments Phase II. Financing for both projects, more than \$10 million for Phase I and more than \$9.8 million for Phase II, was provided by Davis-Penn Mortgage Company and insured by the Federal Housing Administration (FHA) under section 221(d)(4) of the National Housing Act.

The owners for both projects remained the same throughout the audit period, but the individual partners of the partnerships changed. The two previous general partners for both projects were GT, L.C., owned by Mr. Gerald A. Teel, and TTDT, L.L.C., owned by Mr. Howard T. Tellepsen, Jr. The previous general partners requested the U. S. Department of Housing and Urban Development's (HUD) approval to sell their partnership interests to the new partners in August 2005. The new partners for both projects included Management Solutions, Inc., a general partner,<sup>2</sup> and seven limited partners. The new partners assumed control in August 2005, but the change in ownership was not recorded until November 2006. HUD did not approve the sale until April 24, 2007. The partners' attorneys explained to HUD that the transfer did not cause dissolution of the partnership under the applicable Texas law.

From May 2002 through our review period, three management agents managed the projects. Until July 2005, the management agent for both projects was Greystone Asset Management, L.P., which maintained its office and records at 3120 Southwest Freeway, Suite 410, Houston, Texas. Management Solutions, Inc., a related management agent, located at 400 North State Street, Fountain Green, Utah, managed both projects from August 2005 to July 2007. In July 2007, Management Solutions, Inc., transferred the management of the projects to another related entity, Starwood Management Company, Inc. Starwood Management Company, Inc., is located at 8299 Small Block Road, North Lake, Texas.

Our objective was to determine whether the projects' owners complied with the regulatory agreement and HUD regulations. Specifically, we wanted to determine whether the owners (1) made unauthorized distributions of project funds when the projects were in a non-surplus-cash position, (2) fully funded the tenant security deposit accounts, and (3) supported disbursements with invoices or other supporting documentation.

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<sup>2</sup> Management Solutions, Inc., was also the management agent of both projects. Mr. Wendell A. Jacobson is the president of the general partner and also the president of the management agent.

## RESULTS OF AUDIT

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### Finding 1: The Owners and/or Their Management Agents Paid More Than \$187,500 in Questioned Costs

The owners and/or their management agents violated the projects' regulatory agreements and paid \$187,507 in questioned costs. The questioned costs included unauthorized distributions, underfunded tenant security deposit accounts, ineligible and unsupported disbursements, duplicate payments, excessive management fees, and unreasonable and unnecessary bonuses. These improper payments occurred because the owners and/or their management agents disregarded the projects' regulatory agreements and/or they were not familiar with HUD's requirements and regulations, and did not have effective controls. Their actions unnecessarily depleted the projects' operating resources and increased the risk of default on the projects' FHA-insured loans.

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#### **The Owners Made Unauthorized Distributions**

In violation of the regulatory agreements,<sup>3</sup> the previous owners of the partnerships made unauthorized distributions totaling \$119,073 from the projects when the projects did not have surplus cash. The previous owners made the unauthorized distributions when they transferred the management of the projects and their ownership interests in the partnerships in 2005. They distributed all of the funds in the projects' bank and tenant security deposit accounts to themselves. A portion of the tenant security deposit funds was returned to the new partners and, ultimately, to the projects which reduced the total amount of the unauthorized distributions to \$81,035, as shown in the table on the next page.

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<sup>3</sup> Section 6(e) of the regulatory agreement states that without prior HUD approval, the owner shall 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 certain other conditions. Section 13(g) of the regulatory agreement states that "distribution" means any withdrawal or taking of cash or other assets of the project other than for mortgage payments or reasonable expenses.

### Unauthorized Distributions

	Phase I	Phase II	Totals
Project funds distributed	\$35,851	\$24,605	\$60,456
Plus tenant security deposit funds distributed	<u>26,515</u>	<u>32,102</u>	<u>58,617</u>
Total funds distributed	\$62,366	\$56,707	\$119,073
Less tenant security deposit funds transferred to new partners	(17,935)	(20,103)	(38,038)
Plus tenant security deposit funds not transferred to new partners	<u>8,580</u>	<u>11,999</u>	<u>20,579</u>
Outstanding unauthorized distributions	\$44,431	\$36,604	\$81,035

The previous owners knew that they could not make distributions if the projects did not have surplus cash; however, they disregarded this regulatory agreement requirement.

### The Current Owners Underfunded the Tenant Security Deposit Accounts

The current owners had not fully funded the projects' tenant security deposit accounts since they acquired their ownership interests in the projects.<sup>4</sup> The table below shows the amounts by which the projects' accounts were underfunded as of June 30, 2008.

### Underfunded Tenant Security Deposits

	Phase I	Phase II	Totals
Amount of deposits required	\$43,053	\$43,814	\$86,867
Less actual bank account balance	(18,282)	(20,492)	(38,774)
Amount underfunded	\$24,771	\$23,322	\$48,093
Less amount of unauthorized distributions in previous section	(8,580)	(11,999)	(20,579)
Remaining underfunded amount	\$16,191	\$11,323	\$27,514

The owners did not fully fund the accounts because they either ignored the regulatory agreements or did not understand them. Consequently, funds might not have been available to refund the tenants when needed.

<sup>4</sup> Section 6(g) of the regulatory agreement states that any funds collected as security deposits shall be kept separate and apart from all other funds of the project in a trust account, the amount of which shall at all times equal or exceed the aggregate of all outstanding obligations under said account.

### **The Owners and/or Management Agents Made Ineligible and Unsupported Disbursements**

The owners and/or management agents used project funds for \$20,644 in ineligible disbursements, \$16,945 in unsupported disbursements, and a \$7,235 duplicate payment.<sup>5</sup> Ineligible expenses included payments for personal expenses such as fees to an aquarium in Kemah, Texas; gasoline purchased in Lake Charles, Louisiana; food purchased in Las Vegas, Nevada; and other such purchases for an individual related to the owners and for legal fees to transfer the ownership interests of the projects. The unsupported disbursements included office expenses when the new partners acquired the projects and expenses which lacked support to show that they were for the projects. The duplicate payment occurred when the management agent paid one contractor twice for the same invoice. The above condition occurred because the owners and/or management agents did not have effective controls.

### **The Management Agents Paid Excessive Management Fees**

The management agents paid themselves at least \$26,134 in duplicate and incorrectly calculated management fees during the audit period. The management fees paid exceeded the 6 percent allowable management fees contained in the management agent certification. The management agents paid excessive management fees because they were not familiar with HUD's requirements and regulations regarding the management fees.

On two occasions, in August 2005 and July 2007, both the prior and current management agents paid themselves \$22,131 in management fees for operating the projects. Only one payment should have been made to either the incoming or outgoing management agent.

Both the prior and current management agents improperly calculated the management fees by including tenant security deposits as revenue when making the calculation. Tenant security deposits are not project revenue; therefore, management fees derived from tenant security deposits are not allowable.<sup>6</sup> Testing for eight months showed that Management Solution, Inc., and Starwood Management

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<sup>5</sup> Section 6(b) of the regulatory agreement states that without prior HUD approval, the owner shall not assign, transfer, dispose of, or encumber any personal property of the project, including rents, and shall not pay out any funds except for reasonable operating expenses and necessary repairs. HUD Handbook 4370.2, REV-1, paragraph 2-6E, requires that all disbursements from the regulatory operating account be supported by approved invoices/bills or other supporting documentation.

<sup>6</sup> HUD Handbook 4381.5, REV-2, section 3.2(b), relating to allowable management fees from project funds, states that fees should be derived from project income (residential, commercial, and miscellaneous).



Company were overpaid \$4,003. Since the excess charges occurred in all months tested, we concluded that they occurred throughout the period during which Management Solutions, Inc., and Starwood Management Company managed the projects. As a result, the owners will need to determine the total amount of the overpayments and ensure that those funds are returned to the projects.

### **The Owners Paid Unreasonable and Unnecessary Bonuses**

The owners and/or management agents did not overcharge the projects for normal payroll expenses. However, they paid unreasonable and unnecessary bonuses of \$8,000 to the employees for meeting the projects' "income goal". The bonuses should be disallowed<sup>7</sup> because the employees misreported income by recording deposits as having been received in future months once the project reached its goal for the current month (see discussion in detail in finding 2).

### **Conclusion**

The owners and/or their management agents violated the regulatory agreements and incurred \$187,507 in questioned costs when they made unauthorized distributions, underfunded the tenant security deposit accounts, used the projects' funds for ineligible and unsupported expenses, made a duplicate payment, overcharged for management fees, and paid unreasonable and unnecessary bonuses. The questioned costs reduced the availability of cash needed to fund the projects' operations.

### **Recommendations**

We recommend that the Director, Houston Multifamily Program Center,

- 1A. Require the owners to repay \$81,035 to the projects, \$60,456 to the projects' operating accounts and \$20,579 to the tenant security deposits accounts, for unauthorized distributions.
- 1B. Require the owners to deposit an additional \$27,514 into the projects' tenant security deposit accounts to fully fund them.
- 1C. Require the owners to repay \$27,879 for ineligible disbursements and a duplicate payment (\$20,644 + \$7,235).

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<sup>7</sup> Section 9(b) of the regulatory agreement states that payments 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 furnished.



- 1D. Require the owners to either furnish supporting documentation or repay the projects \$16,945 for unsupported expenses.
- 1E. Require the owners to repay \$26,134 for excessive management fees.
- 1F. Require the owners to have the management agent recalculate the management fees for the months not tested to determine the amount of overcharges and repay any overpayment of management fees to the projects.
- 1G. Require the owners to repay the projects \$8,000 for unreasonable and unnecessary bonuses.
- 1H. Require the owners to implement effective controls over the project disbursements to ensure that future distributions and expenditures comply with the regulatory agreement.

## Finding 2: The Owners and/or Their Management Agents Did Not Maintain or Submit Accurate Financial Information

The owners and/or their management agents did not maintain accurate financial information as HUD required<sup>8</sup> because they instructed their staff to record current deposits for future months, once the project reached its goal for the current month, and classify routine maintenance and repairs as capital improvements. In addition, the owners and management agents did not ensure that staff adequately allocated income and expenses between the two projects, deposited rental receipts in a timely manner, and properly accounted for tenant security deposits when the partnerships were sold. Further, the owners did not submit annual audited financial statements in a timely manner as required and transferred the management of the projects without HUD's approval. These conditions occurred because the owners and/or the management agents ignored HUD's requirements and regulations or did not understand them, or did not have effective controls. Consequently, HUD and other stakeholders could not reasonably assess the financial condition of the projects.

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### **The Owners Did Not Accurately Report Rental Receipts or Deposit Them in a Timely Manner**

The owners and/or their management agents did not accurately report the rental receipts for the months in which they were received and deposited. For example, the July and August 2007 rental receipts were received and deposited in the projects' bank accounts in July and August 2007; however, because the projects had reached the "income goal" set for those months, the staff changed the computerized general ledgers to record the deposits as having been made in September 2007. The reported revenue indicated that the owners and/or management agents did so to show the projects had a steady income stream or a steady increase in income each month. Also, the owners and/or management agents did not always deposit rental receipts daily as required by their operations manual. For instance, rental receipts totaling \$196,010, received between November 9, 2007, and December 26, 2007, were deposited in January 2008. The conditions occurred because, according to the current management agent's staff, the owners instructed them to record the current deposits received as if they had been received in future months once the project reached its goal for the current month. The projects' profit and loss statements, therefore, reflected only what was posted in the general ledgers and not what the projects actually collected from August 2005 to June 2008. Consequently, the projects' income was underreported.

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<sup>8</sup> Sections 9(c) and (d) of the regulatory agreement require the owner to keep the books and accounts of project operations in condition for a proper audit and in accordance with HUD requirements. HUD Handbook 4370.2, REV-1, paragraph 2-3B, requires that financial records be complete, accurate, and updated on a monthly basis.

### **The Owners Misclassified Maintenance and Repairs**

The owners and/or their management agents also instructed staff to classify routine maintenance and repairs, such as carpet replacements and flooring or roofing repairs, as capital improvements. The misclassification of maintenance and repairs as capital improvements incorrectly increased the projects' assets and decreased the amount reported as expenses.

### **The Owners Did Not Adequately Allocate Income and Expenses**

The owners and/or their management agents did not adequately allocate income and expenses between the two projects. For example, the current partners charged \$462,159 in payroll expenses to Phase I, but charged \$354,845 to Phase II for the period July 2005 to June 2008, although the employees worked for both projects and Phase I has 184 units while Phase II has 192 units. According to the management agent's staff, expenses other than payroll were allocated equally to the projects; however, the table below shows that the management agent's staff did not evenly split expenses based on the amounts reported in the projects' 2006 audited financial statements.

**Expense allocations**

<b>Financial Statement Categories</b>	<b>Phase I</b>	<b>Phase II</b>
Tenant charges	\$119,028	\$0
Advertising and marketing	54,947	12,305
Property & liability insurance	106,319	58,250
Mortgage insurance premium	0	78,116

The inadequate allocation of the projects' income and expenses overstated or understated the project income for each project and did not clearly disclose the transfer of funds between the projects in the financial records.

### **The Owners Did Not Properly Maintain or Account for Tenant Security Deposits**

The current owners did not properly establish or maintain the projects' tenant security deposit accounts. Although the current owners assumed ownership of the projects in August 2005, they did not establish the tenant security accounts until February 2007. Further, after establishing the accounts, the owners and/or their management agents did not use the accounts properly. Specifically, they did not

maintain the tenant security deposit funds separately, as required, and did not treat them as a liability of the projects. Instead, they deposited and refunded the tenant security deposit funds out of the projects' operating bank accounts.

The owners and/or their management agents also inaccurately reported tenant security deposits transferred by the previous partners as owners' contributions. The general ledgers and bank statements indicated that the previous partners transferred \$17,935 in tenant security deposit funds from Stonebrook Phase I and \$20,103 from Stonebrook Phase II to the new partners in August 2005 when they transferred the management and ownership to the new partners. The current partners deposited the tenant security deposits into new accounts and reported the amounts as owners' contributions, which incorrectly increased the partners' equity in the financial reports.

### **Audited Financial Statements Were Not Submitted in a Timely Manner**

The owners failed to submit the audited financial statements in a timely manner as required.<sup>9</sup> The annual audited financial reports for the fiscal years ending December 31, 2005; December 31, 2006; and December 31, 2007, were due to HUD on the 90<sup>th</sup> day following the end of each fiscal year. The owners, however, submitted the 2005, 2006, and 2007 reports on September 6, 2006; May 29, 2007; and July 31, 2008, respectively.

### **The Owners Transferred Management Agents without HUD's Approval**

Management agents are subject to HUD approval, and management fees may be paid only to the person or entity approved by HUD to manage the project.<sup>10</sup> In violation of this requirement, the current partners transferred the management of the projects from Management Solutions, Inc., to its related entity, Starwood Management Company, Inc., in July 2007 without informing HUD and/or obtaining HUD's approval.

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<sup>9</sup> Section 9(e) of the regulatory agreement requires the owner to submit audited annual financial statements within 60 days following the end of each fiscal year. HUD extended the period to 90 days in 24 CFR (*Code of Federal Regulations*) 5.801(c)(2).

<sup>10</sup> HUD Handbook 4381.5, REV-2, paragraphs 2-2 and 3-1.

## Conclusion

The owners' failure to maintain accurate financial records prevented HUD and other stakeholders from properly assessing the projects' true financial condition. The owners also violated the regulatory agreement when they did not submit the annual audited financial reports in a timely manner as required and transferred the management of the projects without reporting to HUD or obtaining HUD approval. The owners were responsible for implementing the required financial and accounting controls, obtaining HUD approval of the new management agent, and submitting the audited financial reports in a timely manner to ensure compliance with the regulatory agreement and HUD requirements.

## Recommendations

We recommend that the Director, Houston Multifamily Program Center, require the owners to

- 2A. Correct and maintain the projects' accounting records in accordance with HUD requirements.
- 2B. Submit annual audited financial statements in a timely manner.
- 2C. Obtain the services of a HUD approved management agent for both projects.
- 2D. Submit the monthly accounting reports for both projects to HUD.

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

- 2E. Seek civil money penalties and administrative sanctions, as appropriate, against the owners for the regulatory agreement violations disclosed in this report.

## SCOPE AND METHODOLOGY

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Our objective was to determine whether the projects' owners complied with the regulatory agreement and HUD regulations. To accomplish our objective, we

- Reviewed background information and the criteria that control the insured multifamily housing projects.
- Reviewed various reports, databases, and documents to determine existing conditions at Stonebrook Apartments. The data included available independent public accountant reports for fiscal years 2005, 2006, and 2007; information contained in HUD's Real Estate Management System; and documents maintained by the multifamily project manager assigned to monitor the project.
- Inspected the projects' common areas to determine overall physical condition.
- Reviewed disbursements and deposits in the accounting records and supporting documentation to determine whether they appeared appropriate. We reviewed and tested a nonstatistical sample of 60 disbursements. The selected sample included various vendors, accounts, and transactions that were, based on our professional judgment, likely to have a high risk of error. We expanded the sample and selected six more disbursements that equaled \$500 or greater for the vendors or contractors for which disbursements were ineligible or unsupported. The conclusions reached in this report relate only to the sample items tested and have not been projected to the universe of approximately 4,400 disbursements.
- Reviewed tenant security deposit accounts.
- Reviewed fund transfers into and out of the projects' bank accounts and contacted the independent public accountant to obtain the working papers which supported his or her findings.
- Conducted interviews with the previous partner, staff of the current management agent, the project manager, and HUD officials.

The current management agent's staff provided computerized general ledgers and check registers for the period August 2005 to June 2008 in excel files. We assessed the computerized data and found that the disbursements contained in the projects' general ledgers and check registers were sufficiently reliable as the disbursements were recorded in the check registers and the check register entries were located in the general ledgers. The allocation of expenses, however, was inadequate and the maintenance and repair expenses were misclassified (see finding 2). The results of our disbursement tests, therefore, are based on our review of source documentation, check vouchers, invoices, and bank records.

We performed the audit between August 2008 and January 2009 at the projects' office, the current management agent's office, and HUD's Houston field office. Our review period was January 1, 2005, to June 30, 2008. 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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

# INTERNAL CONTROLS

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Internal control is an integral component of an organization's management that provides reasonable assurance that the following controls are achieved:

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They 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.

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## Relevant Internal Controls

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

- Controls over compliance with laws and regulations and
- Controls over disbursements.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

## Significant Weakness

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

- Controls over compliance with laws and regulations were ineffective or nonexistent.
- Controls over disbursements did not ensure that the property funds were expended for only reasonable and necessary expenses.



## APPENDIXES

### Appendix A

#### SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible <u>1/</u>	Unsupported <u>2/</u>	Unreasonable or unnecessary <u>3/</u>
1A	\$81,035		
1B	27,514		
1C	27,879		
1D		\$16,945	
1E	26,134		
1G			\$8,000
<b>Totals</b>	<b><u>\$162,562</u></b>	<b><u>\$16,945</u></b>	<b><u>\$8,000</u></b>

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.

3/ Unreasonable/unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, and/or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.

## Appendix B

# AUDITEE COMMENTS AND OIG'S EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments

#### ***MANAGEMENT SOLUTIONS, INC.***

*400 n. State Street, Fountain Green, Utah 84632*

March 17, 2009

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Re: Response to HUD's Letter dated February 27, 2009 with respect to  
Draft Audit Report Number: 2009-FW-100X regarding:

Stonebrook Apartments, Phase I – 184 Units (FHA 221(d)(4) Insured), and  
Stonebrook Apartments, Phase II – 192 Units (FHA 221 (d)(4) Insured), both located at  
619 Rollingbrook Street, Baytown, Texas.

Dear Mr. Kirkland:

We acknowledge the receipt of your letter dated February 27, 2009, regarding the above referenced Audit Report for the above referenced properties. We understand that the audit findings are just draft findings which may be revised. Upon reviewing the draft report, we would respectfully dispute some of the issues and findings therein. We believe that with the written comments of this Response Letter, together with the attached or forthcoming supporting documentation showing those issues and draft findings to be resolved, you will revise the Audit Report accordingly. With respect to unresolved issues, we will seek agreement with you for corrective actions.

Please be advised that these properties remained in title under the same entities, however, effective August 2005, the previous partners (the "Previous Owners") sold their interests to the new partners composed of Management Solutions, Inc., whose principal is Wendell Jacobson, and its other partners (the "New Partners" or "New Owners"). At no time did, or has Management Solutions, Inc., as the respective Owners' Entities' General Partner and as the respective Owners' Property Manager, and/or its principal, ever assume the obligations of non-compliance which the previous partners had incurred regarding the respective regulatory agreements or HUD regulations prior to and existing as of August 2005. It has been the intentions of the New Partners to comply to the best of their abilities with the respective regulatory agreements and HUD regulations, in spite of the fact of the Previous Owners' non-compliance. Much has been done to correct and resolve these issues, however, the New Owners disclaim any personal responsibility for the actions of the Previous Owners. The New Owners have never intentionally or willfully disregarded the regulatory agreement or HUD regulations, and any sanctions and penalties which HUD may desire to impose should be directed against the Previous Owners and not the New Owners.

**RESPONSES TO THE RESULTS OF AUDIT REPORT - STONEBROOK I & II**

**FINDING 1: THE OWNERS AND/OR THEIR MANAGEMENT AGENTS PAID MORE THAN \$187,500 IN QUESTIONED COSTS.**

**Finding 1-a: The (Previous) Owners Made Unauthorized Distributions.**

The finding that Previous Owners' made unauthorized distributions of \$119,073, less funds thereafter returned to New Owners of \$38,038, reducing the total unauthorized distributions by Previous Owners to \$81,035, in violation of regulatory agreements. Of the \$81,035, the sum of \$20,579 represented Project's Tenant Security Deposit funds, and \$60,456 represented Project's Operating funds.

**Response to Finding 1-a:**

New Owners agree with the Auditor's conclusion that all of the \$81,035 retained and/or withdrawn by the Previous Owners constitutes "Unauthorized Distribution". The New Owners acknowledge receiving the \$38,038 of the Project's Tenant Security Deposits (short of the amount of \$20,579 of Tenant Security Deposits still held by Previous Owners).

**Comment 1**

(1) Since \$20,579 represented Project's Tenant Security Deposit funds withdrawn by Previous Owners, New Owners agree that Previous Owners may have made "Unauthorized Distribution" of the \$20,579 of the Project's Tenant Security Deposit funds. New Owners have assumed and replaced all Project Tenant Security Deposit funds (including the \$20,579 retained by Previous Owners) in segregated bank accounts. See explanation below.

**Comment 2**

(2) Since \$60,456 represented Project Operating funds withdrawn by Previous Owners, and according to the 2005 AFS there was no "Surplus Cash" available to make such distributions, such distribution was "Unauthorized Distribution" of Project Funds by the Previous Owners. The New Owners did not assume Previous Owners' liability for such withdrawal, and New Owners will attempt to retrieve the unauthorized withdrawn funds from Previous Owners.

**Comment 1**

**Proposed Resolution to Finding 1-a:**

(1) The amount required to be refunded of the Project's Tenant Security Deposit funds previously withdrawn of \$20,579 has been subsequently made and refunded by the New Owners, and therefore this Issue of the \$20,579 of the Project's Tenant Security Deposits should be deemed "RESOLVED" with no further action required.

**Comment 2**

(2) With respect to the \$60,456 amount of the Project's Operating funds previously withdrawn by Previous Owners:

- (i) New Owners will seek to get such amount refunded by Previous Owners within a reasonable time, and upon such refund, this issue would be deemed "RESOLVED" with no further action required; or
- (ii) In the event Previous Owners fail or refuse to refund the previous "Unauthorized Distribution" of Project Funds, New Owners agree, within a reasonable and agreed time, to make such refund, and upon such refund, this issue would be deemed "RESOLVED" with no further action required.

**Comment 1**

**Finding 1-b: The Current Owners Under-funded the Tenant Security Deposit Accounts.**

The finding that the current owners had not fully funded the Project's Tenant Security Deposit accounts having an under-funded amount of \$27,514.

**Response to Finding 1-b:**

We respectfully dispute your Finding 1-b. There has previously been a shortage in the funding of the Project's Tenant Security Deposits, due to the Previous Owners "Unauthorized Distribution" of some \$20,579 of the Project's Tenant Security Deposits. In addition, as of June 30, 2008, the Project's Tenant Security Deposit accounts may not have been fully segregated into the segregated security deposit accounts, funds were always on hand, and just had not been timely transferred. However, as of the end of the calendar year and by December 31, 2008, the actual respective bank account balances for the Project's Tenant Security Deposits match or exceed the amount required to be funded for the Project's Tenant Security Deposits for each and both properties.

<u>As of December 31, 2008</u>			
<u>Description</u>	<u>PHASE I</u>	<u>PHASE II</u>	<u>TOTALS</u>
Actual Bank Balances.....	\$ 54,464.63	\$ 55,358.49	\$ 109,823.12
Amt. of Tenant Deposits Required.....	\$ 54,310.00	\$ 55,199.50	\$ 109,509.50
Over-funded (Under-funded).....	<u>\$ 154.63</u>	<u>\$ 158.99</u>	<u>\$ 313.62</u>

AS you can see, as of December 31, 2008, the Project's Tenant Security Deposit accounts have been segregated and are currently over-funded. Currently, the Project's Property Manager monitors each month what the amount of tenant security deposits are required, and account balances are being maintained by Property Manager to equal or exceed the aggregate of all outstanding obligations under said Project's Tenant Security Deposit accounts.

**Comment 3**

Further, New Owners dispute the suggestion or conclusion that New Owners "either ignored the regulatory agreements or did not understand them". The Property Manager simply failed or overlooked in making the appropriate transfers of funds in a timely manner, and this suggestions or conclusion should be deleted.

Further, New Owners dispute the suggestion or conclusion that "consequently, funds might not have been available to refund tenants when needed". The Property Manager and New Owners always did have sufficient funds available on hand to refund tenants when needed and this suggestions or conclusion should be deleted.

**Proposed Resolution to Finding 1-b:** All amounts required to be funded into the respective segregated Project's Tenant Security Deposit Accounts has been made and have been fully funded as of the end of December 2008 (See copies of rent roll & security deposit report and Bank statement account balances), and therefore this issue should be deemed "RESOLVED" with no further action required.

## Comment 4

### **Finding 1-c: The Owners and/or Management Agents Made Ineligible and Unsupported Disbursements.**

The finding that the owners and/or management agents used Project funds of \$20,644 for ineligible disbursements, used \$16,945 for unsupported disbursements, and made a \$7,235 duplicate payment.

### **Response to Finding 1-c:**

We respectfully dispute your Finding 1-c regarding the stated \$20,644 of “ineligible disbursements”, the \$16,945 of unsupported payments, and \$7,235 in duplicate payments. We are still reviewing the information you previously sent as well as our own records and we will report specific explanation of these items to resolve these issues.

(1) New Owners dispute the “Ineligible Expenses” of \$20,644 mentioned by the report as personal expenses. There has been a contractor which, as part of our back-up information, may have submitted for our information a personal credit card statement which included his business expenses personally incurred for the Project. At no time, would personal expenses have been paid with the Project’s Operating funds. Contractor traveled from Utah to the job site in Baytown, Texas, and purchased gas in Las Vegas and along the way, as well as a seafood restaurant called Kemah-Aquarium SFD (Seafood). We believe these charges were the Contractor’s expenses and submitted as back-up to his invoice, which expenses are treated as reimbursable expenses/invoice for job cost.

(2) New Owners dispute the “Unsupported Expenses” of \$16,945 mentioned by the report as unsupported, and believe all of it to have been expenses of the Project.

(3) New Owners agree that a partial duplicate payment was made regarding the \$7,235. This was a payment made to Glenn’s Contracting for work and services performed to the Project. Any overpayments have been refunded.

### **Proposed Resolution to Finding 1-c:**

(1) For the \$20,644 of “Ineligible Expenses”, the New Owners will review the detail of the amounts where Project Operating funds were actually disbursed for the said “Ineligible Expenses”. New Owners will promptly, say within 30 days, research, verify and provide detailed explanation for such expenditures. (a) In the event it is found that such expenditures were proper and eligible this issue would be deemed “RESOLVED” and no further action would be required, or (b) In the event it is found that such expenditures were in fact “Ineligible Expenses”, the New Owners would then agree to assume such obligation and refund the \$20,644, or such ineligible portion if less, to the Project’s Operating account within a reasonable time, not to exceed 30 days, and therefore this Issue of the \$20,644 of “Ineligible Expenses” would be deemed “RESOLVED” with no further action required.

(2) For the \$16,945 of “Unsupported Expenses”, the New Owners will review the detail of the amounts where Project Operating funds were actually disbursed for the said “Unsupported Expenses”. New Owners will promptly, say within 30 days, research, verify and provide detailed explanation for such expenditures. (a) In the event it is found that such expenditures were proper and supportable this issue would be deemed “RESOLVED” and no further action would be required, or (b) In the event the it is found that such expenditures were in fact “Unsupported Expenses”, the New Owners would then agree to assume such obligation and refund the \$16,945, or such unsupported portion if less, to the Project’s Operating account within a reasonable time, not

to exceed 30 days, and therefore this Issue of the \$16,945 of "Unsupportable Expenses" would be deemed "RESOLVED" with no further action required.

(3) For the \$7,235 Duplicate Payment, the New Owners will research and review the detail of the amounts where Project Operating funds were actually disbursed, and provide within a reasonable time, say not to exceed 30 days, that such duplicate payment has been refunded and deposited into the Project's Operating account. (a) In the event it is found that the \$7,235 duplicate payment has been refunded and deposited into the Project's Operating account, this issue would be deemed "RESOLVED" and no further action would be required, or (b) In the event the it is found that duplicate payment has not been refunded, then the New Owners would then agree to assume such obligation and refund the \$7,235 to the Project's Operating account within a reasonable time, not to exceed 30 days, and therefore this Issue of the \$7,235 "Duplicate Payment" would be deemed "RESOLVED" with no further action required.

Further, New Owners dispute the suggestion or conclusion that New Owners or Property Management Agent "did not have effective controls". The Property Manager's employees, out of literally thousands of invoices and payments having to be made during the course of a year, simply failed and missed to catch and correct the missing documentation, which in terms of the thousands of transactions being handled is miniscule, and given changes in personnel, are totally within acceptable probabilities. Given the large scope of transactions and changes in employees, several missed documentation of transactions does not constitute "lack of effective controls" and is totally within normal and acceptable accounting controls.

## Comment 5

### **Finding 1-d: The Management Agents Paid Excessive Management Fees.**

The Management Agents paid themselves at least \$26,134 in duplicate and incorrectly calculated management fees during the audit period. On two occasions, August 2005 and July 2007 management fees of \$22,131 was paid in duplicate, where only one payment should have been made. Also, improper calculations were made which included \$4,003 in management fees derived from the security deposits collected.

### **Response to Finding 1-d:**

(1) New Owners agree that management fees may have been miscalculated or over-funded. Regarding your Finding 1-d regarding the stated \$22,131 of duplicate management payments. New Owners have been in contact with Mr. Paul Adams from the local HUD office regarding these over payments. As to the July 2007 management fee paid in duplicate, discussions with Paul Adams identified amounts which should have been refunded, and as of the date hereof, the sum of \$7,084.02 has been refunded to Phase I, and the sum of \$6,600.20 has been refunded to Phase II. Therefore, there is the sum of \$8,446.78 which is attributable to the August 2005 management fee which had been paid out in duplicate, one payment to the Previous Owners and one to the New Owners.

(2) New Owners acknowledge that a mistake has been made in the calculations of the Management Fees in that the Management Agents had inadvertently computed the management fees which may have included tenant security deposits in Project revenue.

## Comment 6

### **Proposed Resolution to Finding 1-d:**

(1) For the \$22,131 of duplicate management fees paid in August 2005 and July 2007, (a) the New Owners have already refunded and deposited the agreed amounts totaling \$13,684.22 for the overpayment of management fees in July 2007, therefore this Issue of the \$13,684.22 of July 2007 overpayment of management fees should be deemed “RESOLVED” with no further action required, and (b) the remaining amount of \$8,446.78 due for the overpayment of management fees in August 2005 had been paid to the Previous Owners. The New Owners will (i) first seek a refund of the \$8,446.78 from Previous Owners; or if Previous Owners are not able to or refuse to refund said sums in a reasonable time, say within 30 days, then (ii) the New Owners agree to assume such obligation and refund the \$8,446.78 to the Project’s Operating account within a reasonable time, not to exceed 30 days, and therefore this Issue of the \$8,446.78 overpayment of August 2005 management fees should be deemed “RESOLVED” with no further action required.

(2) For the incorrect calculations of management fees, New Owners and Management Agents accept the recommendation that the New Owners and Management Agents will go back and recompute management fees to determine and verify the correct amounts that should have been paid. In the event it is found that there has been an overpayment of management fees, New Owners agree, within a reasonable time to refund all such overpayment into the Project’s Operating account, and this issue would be deemed “RESOLVED” and no further action would be required.

### **Finding 1-e: The Owners Paid Unreasonable & Unnecessary Bonuses.**

The New Owners and Management Agents dispute that \$8,000 of bonuses paid were unreasonable and unnecessary and disallowed by Section 9(b) of the Regulatory Agreement.

### **Response to Finding 1-e:**

New Owners respectfully dispute your Finding 1-e regarding the stated \$8,000 of unreasonable or unnecessary bonuses. However, due to the “Goal Oriented” management plan at the time, we agree that there may have been some confusion on the amount and how bonuses were to be paid. Our bonus policy at the time had been to pay bonuses only for new leases or lease renewals. Any bonuses not paid accordingly will be refunded. Please provide us specific bonus expenditures so that we can research, verify and provide you with explanations. Bonuses are earned and shared by the Project’s staff. They are calculated only on executed new leases and on renewals of leases, and then are only paid 30 days after move-ins and renewals. That is an arrangement made with the Project’s staff as an agreement and as part of incentive compensation. No bonuses were paid to Management Agents, only to on-site staff personnel. No bonuses were ever paid for any misreported income. New Owners do not believe that such bonus payments were excessive, and they are, in the opinion of New Owners and Management Agents necessary to maintain employee morale and maintain the Project’s revenue, which is ultimately to the benefit of the Lender & HUD.

### **Proposed Resolution to Finding 1-e:**

New Owners request a detailed listing of which specific bonus amounts are suggested as being excessive and actually disbursed. New Owners will promptly, say within 30 days, research, verify and provide detailed explanation for such bonuses. (a) In the event it is found that such bonuses were reasonable and necessary paid on new leases or lease renewals, this issue would be deemed “RESOLVED” and no further action would be required, or (b) In the event it is found that such bonuses were in fact unreasonable and unnecessary and not for new leases or lease renewals, the New Owners would refund the \$8,000, or such ineligible portion if less, to the Project’s Operating



account within a reasonable time, not to exceed 30 days, and therefore this Issue of the \$8,000 of Bonuses would be deemed “RESOLVED” with no further action required.

**Response To Conclusions To Finding 1:**

New Owners dispute the conclusions described for Finding 1. Owners and Management Agents agree that there were questioned costs totaling \$187,507, but the questioned costs have been explained above and all have been or will be able to be Resolved as per the above Proposed Resolutions. The New Owners dispute the conclusion that the “questioned costs reduces the availability of cash needed to fund the project’s operations” as being incorrect. At no time have the Projects operations suffered and New Owners have always been ready to provide and have such cash available to the Projects as the Projects may require to meet its obligations.

**Response To Recommendations To Finding 1:**

New Owners oppose the recommendations made and request that the recommendations be modified and amended as follows:

- 1A. Require New Owners to seek \$60,456 from Previous Owners, and if Previous Owners fail or refuse, then Now Owners will need to obtain a refund to the Project all of the unauthorized distributions, from either Previous Owners or New Owners. OMIT the recommendation relating to the \$20,579 of Project’s Tenant Security Deposits as such amount has already been restored and the Issue has been Resolved.
- 1B. OMIT this recommendation relating to the \$27,514 of Project’s Tenant Security Deposits as such amount has already been restored and the Issue has been Resolved.
- 1C. Require New Owners to review the items identified by HUD comprising the \$20,644 to determine if they are “Ineligible Expenses”, and in the event some or all are ineligible, to obtain a refund to the Project for such Ineligible Expenses. Require New Owners to review the items identified by HUD comprising the \$7,235 duplicate payment to determine if they are “Duplicate”, and in the event some or all are duplicate, to obtain a refund to the Project for such duplicate expenses.
- 1D. Require New Owners to review the items identified by HUD comprising the \$16,945 to determine if they are “Unsupportable Expenses”, and in the event some or all are unsupportable, to obtain a refund to the Project for such Unsupportable Expenses.
- 1E. Require New Owners to obtain a refund to the Project of the August 2005 excessive management fees of \$8,446.78 from either Previous Owners or New Owners.
- 1F. OMIT this recommendation.
- 1G. Require New Owners to maintain effective controls over project disbursements.

**Comment 7**

**FINDING 2: THE OWNERS AND/OR THEIR MANAGEMENT AGENTS DID NOT MAINTAIN OR SUBMIT ACCURATE FINANCIAL INFORMATION.**

**Finding 2-a: The Owners Did Not Accurately Report Rental Receipts or Deposit Them in a Timely Manner.**

The Owners and Management Agents did not accurately report the rental receipts for the months in which they were received and not deposited in a timely manner.

**Response to Finding 2-a:**

New Owners respectfully dispute your Finding 2-a. The Owners and Management Agents have previously had a "Goal Oriented" management plan providing for goal oriented incentives and maximizing the Project's performance, but which may have had unintended effects. However, all funds received by the Project were and have always deposited into the Project's accounts, without any shortages. New Owners have made sure that all Project funds remain with and into Project accounts and only disbursed for allowed and authorized disbursements.

Beginning in 2009, New Owners and Management Agents have revised their management plan, and have discontinued and no longer have the previous "Goal Oriented" management plan to alleviate and correct any unintended accounting effects. Instead, emphasis will be placed on an aggressive marketing plan and providing superior customer service. Consequently, there will no longer be any financial reporting based on any "Goal Oriented" plan. New Owners dispute that such "Goal Oriented" management plan was detrimental to the operational and financial performance of the Project. The Project has always been able to meet all of its obligations, including payment of operating expenses and its FHA guaranteed mortgage without default. Further, the Project's financial information is being audited independently, and New Owners believe such audit will reflect that the Projects, as a whole, will have "Surplus Cash".

**Proposed Resolution to Finding 2-a:**

New Owners and Management Agents have discontinued and no longer incorporate the previous "Goal Oriented" management plan, in order to eliminate any unintended accounting effects. New Owners have instructed Management Agents to make sure that all deposits are to made in a timely manner. Further, Management Agents will be providing monthly reports on HUD's Monthly Report Form for each Project, Phase I and Phase II. New Owners' and Management Agents' actions of discontinuing the "Goal Oriented" plan and making sure all deposits are made in a timely manner will ensure that Issue has been taken care and should be deemed "RESOLVED". No further action is required by New Owners. New Owners are willing to submit to further audits in the future if desired by HUD.

**Comment 8**

**Finding 2-b: The Owners Misclassified Maintenance & Repairs.**

The Owners and Management Agents misclassified carpet replacements and flooring incorrectly as capital improvements, rather than as expenses.

**Response to Finding 2-b:**

New Owners respectfully dispute and object to Finding 2-a. The New Owners and Management Agents have been advised and instructed by its tax and financial accounting consultants that the IRS Code provides that if and because the improvements expended for flooring and carpet replacement had useful lives greater than 1 year (flooring and carpet replacement generally 3 years), such

**Comment 9**

amounts should be capitalized. These same expenditures were capitalized in the 2007 AFS for both Projects. Phase I had \$35,156, and Phase II had \$22,538, in such capital expenditures as approved by its independent Auditors, Gilbert & Stewart, CPA, PC.

**Proposed Resolution to Finding 2-b:**

It was not erroneous to capitalize the flooring and carpet replacement costs as these are normal capitalized costs, and there was no misclassification, therefore, this issue should be deemed “RESOLVED” and no further action is required.

**Finding 2-c: The Owners Did Not Adequately Allocate Income & Expenses in 2006.**

The Owners and Management Agents did not adequately allocate income and expenses between the two Projects, Phase I and Phase II in 2006.

**Response to Finding 2-c:**

New Owners respectfully dispute your Finding 2-c. Any inadequate allocations would have been made by the Project’s Auditors by adjusting entries.

**Proposed Resolution to Finding 2-c:**

New Owners and Management Agents propose to review their books and records for 2006, and review the AFS 2006 prepared by its Auditors, and in the event adjusting and reported entries have inadequately allocated income and expenses, such adjustments will be made accordingly by the Project’s independent Auditors in the upcoming 2008 AFS, and this issue should be deemed “RESOLVED” and no further action would be required other than the appropriate adjusting entries in the 2008 AFS.

New Owners specifically dispute the allegation or conclusion that the misallocation “appeared to be a way for the owners to transfer funds between the projects without clearly disclosing the transfers in the financial records”. There has never been any intention to “transfer funds ... without clearly disclosing the transfers on the financial records”. As a matter of fact there exists a Note Receivable to Phase II payable by Phase I, which clearly shows that funds are properly accounted for as needed, between Phase I and Phase II.

**Comment 10**

**Finding 2-d: The Owners Did Not Properly Maintain or Account for Tenant Security Deposits.**

The New Owners did not properly establish and maintain Tenant Security Deposits and previous transfers of Tenant Security Deposits were incorrectly reported.

**Response to Finding 2-d:**

New Owners respectfully dispute your Finding 2-a. The New Owners and Management Agents have established separate Project Tenant Security Deposit accounts for both Phase I and Phase II, though inadvertently misclassified some of the security deposits into Project’s operating accounts. New Owners are not sure whether the Projects’ Tenant Security Deposits obtained from the Previous Owners became misclassified as capital contributions.

## Comment 11

### **Proposed Resolution to Finding 2-d:**

New Owners and Management Agents have verified and all Tenant Security Deposits are being deposited in segregated Project Tenant Security Deposit accounts and posted separately from Project's rental revenue, therefore this issue should be deemed "RESOLVED" and no further action is required. New Owners will research and verify the postings to capital contributions, and in the event such amounts have been incorrectly posted, will direct its independent Auditors to make the appropriate adjusting entries to correct the erroneous entries in the up-coming 2008 AFS and this issue should be deemed "RESOLVED" and no further action is required.

### **Finding 2-e: The Audited Financial Statements were not Submitted in a Timely Manner.**

The Owners and Management Agents did not submit the Projects' Audited Financial Statements in a timely manner.

### **Response to Finding 2-e:**

Though the Audited Financial Statements are due 90 days following the end of the fiscal year, New Owners and Managements Agents have no control over its independent Auditors and the timeliness of their preparation of the reports. The Owners and Management Agents dispute they have any fault, as it was an unrelated third party responsible for the timeliness of the completion of the report which New Owners and Management Agents had no control. New Owners and Management Agents co-operated with the Auditors and provided information on a timely basis to the best of their ability.

### **Proposed Resolution to Finding 2-e:**

New Owners and Management Agents will try to assist Auditors in every way possible to expedite the completion of the Auditors' Reports in an effort to have them completed and submitted in a timely manner. In the event the current Independent Auditors are unable to complete and submit the reports in a timely manner, New Owners and Management Agents will select another Auditor to prepare the Reports in a timely manner and this issue will be deemed "RESOLVED" and no further action is required.

## Comment 12

### **Finding 2-f: The Owners Transferred Management Agents without HUD's Approval.**

The Owners allowed Starwood Management Company, Inc., a related entity, to manage the Projects for Management Solutions, Inc., not intending to violate the Regulatory Agreement or HUD regulations.

### **Response to Finding 2-f:**

New Owners respectfully dispute your Finding 2-e. The Management Agent of record is still Management Solutions, Inc., and no transfer was intended without HUD approval. Starwood Management Company and Management Solutions, Inc. are related entities with the same related principals, and HUD mistakenly assumed New Owners had transferred Management, when in fact, Starwood acted as a subcontractor for Management Solutions, Inc.

### **Proposed Resolution to Finding 2-f:**

New Owners agree to either (a) discontinue having Starwood manage the Projects and officially revert the management and all records back to Management Solutions, Inc., or (b) provide to HUD a subcontract agreement whereby certain functions are being performed by Starwood for MSI, or (c)

immediately, within 30 days, begin to submit Form 2530 to formally transfer property management to Starwood Management Company, and with such action to be taken, this issue will be deemed “RESOLVED” with no further action required. Management Solutions, Inc. the current approved management company y agrees to discuss further this issue with HUD seeking any other or alternate resolutions.

**Response To Conclusions To Finding 2:**

New Owners dispute the conclusions described for Finding 1. Owners and Management Agents agree that there may have been some lapses in certain recording of financial information, or not made in a timely manner. Further, there may have been incorrect adjusting entries previously made and failure to seek approval for transfer of management., however none of these actions or omissions have been made purposefully or intentional to hurt or damage the Project’s financial performance. All such questioned issues have been explained above and all have been or will be able to be Resolved as per the above Proposed Resolutions. At no time have the Project operations suffered and New Owners have always been ready to provide and have such cash available to the Projects as the Projects may require to meet their obligations.

**Response To Recommendations To Finding 2:**

New Owners oppose to the recommendations made and request that the recommendations be modified and amended as follows:

- 2A. Remain as Stated.
- 2B. Remain as Stated.
- 2C. OMIT, or provide that Management Solutions, Inc. remain as the Projects’ property management company, and if New Owners desire Starwood Management Company, for Starwood to submit Form 2530 and request approval for transfer of management.
- 2D. Remain as Stated.
- 2E. OMIT.

The New Owners and Management Agents, without admitting any intentional or tortuous conduct or liability with respect to its ownership and management of the Projects, as each Project is performing well and has never been in default of the payment of its operating expenses or the payment of its mortgage indebtedness, would be willing to offer to incur civil penalties of some agreed amount with respect to the issues noted.

**Additional Responses to Scope & Methodology.**

New Owners and Management Agents respectfully dispute the conclusions reached as being reasonable from the evidence obtained. The New Owners and Management Agents have provided its responses which will refute most, if not all, of the conclusions. Furthermore, the New Owners and Management Agents have provided “proposed Resolutions” to each and every item and finding made. For each such item and finding, New Owners and Management Agents have offered

recommendations and proposed actions, including taking the necessary corrective actions, with the intended purpose of resolving all of the issues in the report.

We request that you review this, our Response to the proposed Draft Audit Report No. 2009-FW-100X, and that you consider revising the proposed Draft into a Second Draft, incorporating our responses to exclude those items which have been resolved, and to include our proposed resolution and conclusions. We would like to then review such a Second Draft and make final comments before you finalize the Audit Report.

**Additional Responses to Internal Controls.**

New Owners and Management Agents respectfully dispute the conclusions of "Significant Weaknesses". New Owners and Management Agents recognize that there were previous mistakes, certain omission, clerical errors, and lack of timeliness of certain issues, but given the number of transactions to be accounted for, are all well within acceptable margin of error. Never has the Project suffered any detrimental effects, nor has there ever been misapplication and shortage of Project funds, or failure to pay operating expenses, or failure to pay or default on Project mortgage payments. Admittedly, controls could always be better, and New Owners and Management Agents pledge and agree to being more vigilant in applying controls over all Project funds.

If you should have any further questions or need further information, please contact us at the above address. We appreciate your co-operation in this matter as we look to resolve all of the issues for these Projects.

Sincerely,  
Management Solutions, Inc.

By:   
J.M. Szabuniewicz, Authorized Representative

## OIG Evaluation of Auditee Comments

- Comment 1 According to the response, the owners fully funded the tenant security deposit accounts as of December 31, 2008, which is after we conducted the audit of the projects. We acknowledge and appreciate the owners' efforts to correct the finding. HUD will need to verify that the accounts are fully funded before the recommendation will be closed.
- Comment 2 The owners agreed with the unauthorized distributions but did not assume the previous partners' liability and would attempt to retrieve the unauthorized withdrawn funds from previous partners. However, the owners agree to repay the unauthorized distributions whether they recover from the previous owners or not. We considered the owners' alternative recommendation but did not change our recommendation.
- Comment 3 The new owners disputed that they either ignored the regulatory agreements or did not understand them and claimed that the property manager simply failed or overlooked in making the appropriate transfers of funds in a timely manner. The regulatory agreements required the funds to be maintained separately and fully funded and the amounts must at all times equal or exceed the obligations. The accounts had been underfunded for an extended period which does not support the owner's claim. We did not revise our conclusion.
- Comment 4 The owners disagreed that they made ineligible and unsupported disbursements, and they had refunded the duplicate payment. The owners; however, did not provide any document to support their claim. We; therefore, did not change the finding and recommendations.
- The owners claimed that the transactions we determined to be unsupported were few compared to the numerous transactions they were processing; therefore, did not support our conclusion that they did not have effective controls. We believe that the existence of such errors and our ability to find them without reviewing all transactions demonstrates their lack of effective controls.
- Comment 5 The owners agreed that they paid excessive management fees, and they contacted the Departmental Enforcement Center and repaid \$13,864 of duplicate management fees. They were also in the process of recovering the overpaid management fees from the previous owners. Further, the owners agreed to recalculate the management fees for the months not tested to determine and repay the amount of overcharges. We compliment and appreciate their prompt action to correct this issue.
- Comment 6 The owners disagreed that the bonuses were unreasonable and unnecessary and stated that they only paid leasing bonuses. The owners and/or management agents paid both leasing bonuses and bonuses for meeting "income goal" which was misstated. We did not question leasing bonuses.



- Comment 7 The owners stated that they have discontinued the “goal oriented” management plan, agreed to deposit the rental receipts in a timely manner, and agreed to provide monthly accounting reports to HUD but disagreed that the “goal oriented” plan was detrimental to the operational and financial performance of the projects. We recognize the owner’s efforts to correct the deficiencies.
- Comment 8 The owners maintained that it was not erroneous to classify routine maintenance and repairs as capital improvements under the IRS code. According to the IRS Publication 535, Business Expenses, usually the investment in the business asset that adds value to it, lengthens the time to use it, or adapts it to a different use would be a capital improvement. The routine maintenance and repairs; therefore, usually should not be capital improvements.
- Comment 9 The owners agreed to review their books and records for 2006 and make the adjustment entries if needed. The owners did not address other inadequate expenses such as payroll which still incurred as of June 30, 2008, our ending audit period. We revised a statement regarding the disclosure of the transfers in the financial records.
- Comment 10 The owners claimed that some of the tenant security deposits were inadvertently misclassified into projects’ operating accounts, and they were not sure whether they had misclassified tenant security deposits from the previous owners. We disagree with the claim that the owners inadvertently misclassified some of the tenant security deposits into the projects’ operating accounts because the tenant security deposit bank statements as of December 31, 2008, that the owners provided as attachments showed that they deposited and refunded the tenant security deposit funds out of the projects’ operating bank accounts. Further, the 2007 audited financial statements clearly disclosed that the owners classified tenant security deposits obtained from the previous partners as owners’ contributions.
- Comment 11 The owners claimed that they are not responsible for late submission of the annual audited financial statements because they had no control over their independent auditors. The owners’ regulatory agreements with HUD and HUD regulations specified that it was the owners’ responsibility to submit the annual audited financial statements within 90 days following the end of each fiscal year.
- Comment 12 The owners claimed that they did not transfer the management agent but subcontracted the management of the projects to their related entity. The owners did not inform and obtain HUD’s approval to transfer or subcontract the management of the projects.