



Issue Date	August 2, 2010
Audit Report Number	2010-LA-1014

TO: Tom Azumbrado, Director, San Francisco Multifamily Housing Hub, 9AHMLA

Tanya E. Schulze

FROM: Tanya E. Schulze, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: The Retreat at Santa Rita Springs, Green Valley, AZ, Did Not Comply With HUD Rules and Regulations and Other Federal Requirements

HIGHLIGHTS

What We Audited and Why

We completed a review of the Retreat at Santa Rita Springs (community), a Federal Housing Administration (FHA)-insured multifamily project under Section 231 of the National Housing Act. Our audit was in response to a request for audit from Representative Gabrielle Giffords of the 8th District of Arizona. The owner defaulted on the \$29.9 million U.S. Department of Housing and Urban Development (HUD)-insured mortgage in November 2009, the month after final endorsement.

Our objective was to determine whether the operations of the community complied with applicable HUD rules and regulations and other Federal requirements. We plan to review the mortgage loan underwriting and approval as a separate assignment.

What We Found

The community did not comply with applicable Federal rules and regulations and its regulatory agreement with HUD in the operation of the project. The audit found that

- Resident security deposits were converted to community fees and/or commingled with operating funds and not returned and

- Prohibited management costs and erroneous and duplicative billings were charged to the project.

Although funds were owed to the residents and the community, these violations were not material enough to be the primary cause of the project's mortgage default.

What We Recommend

We recommend that the Director of HUD's San Francisco Office of Multifamily Housing require the owner to refund \$11,000 in security deposits collected from former residents and prospective residents, and require the owner to reimburse the project \$19,216 for ineligible and unsupported expenses.

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 our discussion draft audit report to the owner on June 11, 2010, and held an exit conference on June 16, 2010. The owner provided written comments on July 27, 2010. The owner generally agreed with our report findings.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVE

The Retreat at Santa Rita Springs (community) is a 196-unit independent living facility located in Green Valley, AZ. The community's \$29.9 million mortgage was insured under Section 231 of the National Housing Act (project number 123 38033). The project was owned by the Retreat IL, LLLP, an Arizona limited liability limited partnership, a general partner of which, Retreat Fast, Inc., executed the regulatory agreement with the U.S. Department of Housing and Urban Development (HUD) on October 30, 2007.



The community started operations in January 2009, HUD approved the final endorsement of the Federal Housing Administration (FHA) mortgage loan in October 2009, and the community ceased operations in November 2009. When the community opened for occupancy in February 2009, the economy and housing market were on a downturn trend. Lease-up for the community remained at 6 percent from its inception, which led to the project's operating shortfalls. The owner's unwillingness to contribute additional funds to the project after final endorsement then led to its default. After the community defaulted on its mortgage payment in November, Red Mortgage assigned the mortgage to HUD on December 28, 2009.

The property was managed by Watermark Retirement Communities (WRC) beginning in October 2008. WRC also managed 10 other non-HUD and HUD properties in addition to the community. The owner owed WRC for back management fees from May 2009 until the contract termination on November 4, 2009. WRC has been pursuing legal action against the community's owner.

HUD's Lender Qualification and Monitoring Division has been performing a quality assurance project default review of the community to evaluate the project's underwriting. The results will be issued to the lender for comment before actions are taken on any potential findings.

Our objective was to determine whether the operations of the community complied with applicable HUD rules and regulations and other Federal requirements.

RESULTS OF AUDIT

Finding 1: Security Deposits Were Converted to Revenue and Comingled With Operating Funds

Security deposits were collected from prospective residents to guarantee a place in the community. The owner and management agent deemed the security deposits as nonrefundable and converted them to ineligible community fees upon residents' move-in. The security deposits were also commingled with the project's other cash in the operating bank account. In addition, we identified a \$1,000 tenant deposit in November 2009, the source of which could not be confirmed. These issues occurred because the owner and management agent had insufficient knowledge of HUD requirements for the Section 231 program and disregarded the owner's regulatory agreement with HUD. As a result, residents who moved into the community were charged ineligible fees, and prospective residents were not refunded their security deposits.

Security Deposits Were Converted to Revenue

The owner and management agent deemed the security deposits as nonrefundable, and they were converted to community fees upon residents' move-in. This practice violated the HUD-approved regulatory agreement, which states that the owners shall not require, as a condition of the occupancy or leasing of any unit, any consideration or deposit other than the prepayment of the first month's rent plus a security deposit in an amount not in excess of 1 month's rent, and any funds collected must be kept in a separate trust account (see appendix C). The security deposits inappropriately credited toward community fees totaled \$6,500 for the 13 residents who moved into the community.

Security Deposits Were Commingled With Project Funds

The owner and management agent commingled the security deposit cash in the community's operating bank account with the project's other funds. Security deposits were posted under the priority reservation general ledger account. Other miscellaneous collections were also posted in this account, including pet and bank fees. In April 2009, another general ledger account, called resident security deposits, was created with an initial amount of \$500; however, no cash collection supported this entry. The account balance was then reclassified to the priority reservation and nonrefundable fees accounts in July 2009.

In November 2009, an additional \$1,000 was posted under the priority reservation account for a prospective resident; however, the source of the funds could not be confirmed due to inadequate records, and the balance of the priority reservation account may have been overstated. According to the community's former executive director, this transaction could have been a rental payment from another resident, so the funds may be owed to a former resident.

The security deposit is a liability account that should be safeguarded for the protection of residents of the community. The project's regulatory agreement, therefore, requires funds collected as security deposits to be kept separate from other funds in a trust account. When the security deposits were not deposited into a separate bank account, the owner and management agent put the security deposits at risk of being used for other, unintended purposes. When operations ceased in November 2009, the operating bank account was depleted and closed. At that time, the project owed security deposits of \$4,500 to former prospective residents, who had not been refunded.

Conclusion

The owner and agent's practice of commingling resident security deposits and converting them to revenue violated HUD requirements. This violation occurred because the owner and management agent had insufficient knowledge of the Section 231 program and HUD regulations. As a result, resident funds were used for other, inappropriate purposes, and former residents and prospective residents were not refunded their security deposits.

Recommendations

We recommend that the Director of the San Francisco Office of Multifamily Housing

- 1A. Require the owner to reimburse the residents for ineligible community fees totaling \$6,500.
- 1B. Require the owner to refund security deposits collected from prospective residents totaling \$4,500.
- 1C. Require the owner and/or management agent to provide documentation that the \$1,000 is not a security deposit or repay that individual.

Finding 2: Management Charged Ineligible and Unsupported Project Expenses

The management agent charged the project for travel of non-front-line staff and markups on marketing and advertising vendor invoices. Additionally, the agent charged erroneous, duplicative, and unsupported expenses to the project. These violations occurred because the owner and management agent lacked knowledge of the HUD requirements for the Section 231 program and the management agent did not properly account for project disbursements. As a result, operating expenses were overstated, thus fewer funds were available to pay for eligible project expenses.

Costs Already Covered by the Management Fee Were Charged to the Project

HUD regulations require that expenses for services that are not front-line activities be paid from management fee funds (see appendix C). The project was charged for ineligible travel expenses of non-front-line management staff amounting to \$1,126 that were already covered under the management fees. In addition, the agent added markups on advertising invoices totaling \$6,281 although surcharges over actual costs are specifically disallowed under HUD Handbook 4381.5 (see appendix C).

Poor Accounting Resulted in Ineligible and Unsupported Expenses

The management agent administers retirement facilities other than the community. Non-front-line functions such as accounting and marketing for several properties are performed by management agent staff operating out of a single office. Due to an accounting error, the agent charged an erroneous advertising expense of \$7,267 to the community that was attributable to one of its other projects. The agent also charged the project for an erroneous duplicative posting of \$1,725, and unsupported expenses totaling \$1,817 that were not supported by valid vendor receipts.

The Owner and Agent Lacked Knowledge of HUD Regulations

The owner and management agent of the community were charged with protecting the financial viability of the HUD-insured multifamily project and were required to comply with HUD regulations, requirements, and guidelines. Financial compliance requires adequate internal controls and procedures for reporting and accounting to prevent misappropriation of project funds and claims and losses against the FHA insurance fund. The owner and agent's lack of knowledge of HUD regulations and poor accountability for project funds resulted in questionable costs being charged to the project.

Conclusion

The owner and agent's charging of ineligible management cost and erroneous/unsupported expenses to the project resulted in fewer funds being available to pay for eligible project expenses. Although this violation contributed to the operating shortfalls experienced by the community, these questioned costs were not significant enough to cause the project's default. The community's inability to lease up (see the Background and Objective section) was the primary cause of the continued operating shortfalls that led to the project's default.

Recommendations

We recommend that the Director of the San Francisco Office of Multifamily Housing

- 2A. Require the owner to reimburse the project \$16,399 for ineligible expenses.
- 2B. Require the owner to provide documentation to support \$1,817 for undocumented disbursements cited in this report or reimburse the project.

SCOPE AND METHODOLOGY

The audit covered the use of project funds for the period December 1, 2008, through November 30, 2009. Our audit was performed at the owner's business office located in Tucson, AZ. We performed our audit work from January 19 through April 2, 2010.

To accomplish our objective, we

- Reviewed applicable laws, regulations, and guidance issued by HUD (see criteria in appendix C);
- Reviewed pertinent financial records maintained by the project at the owner's business office;
- Interviewed staff from the project, the owner, and the management agent;
- Reviewed HUD files and interviewed HUD officials in the Phoenix Office of Multifamily Housing; and
- Performed site visits to the property

Specifically, our audit included the review of the community's financial records and the management agent's accounting system, policies, and procedures. We reviewed transactions from the start of the project's operations in January 2009 until it ceased operations in November 2009 and tested a nonstatistical sample of receipts and disbursements for support, accuracy, and compliance with HUD rules and regulations. We did not project our results to the universe of transactions in our audit scope.

In addition, we reviewed the HUD Lender Qualification and Monitoring Division's draft report on its quality assurance project default review results. We plan to review the mortgage loan underwriting and approval as a separate assignment.

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

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

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

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

Relevant Internal Controls

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

- Administering the project's operations in compliance with applicable laws and regulations,
- Maintaining complete and accurate records, and
- Safeguarding the project's resources.

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 Weaknesses

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

The project did not have adequate controls in place to ensure that

- Tenant security deposits were adequately safeguarded (finding 1).
- Project financial transactions were eligible and supported (finding 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible <u>1/</u>	Unsupported <u>2/</u>
1A	\$6,500	
1B	\$4,500	
1C		\$1,000
2A	\$16,399	
2B		\$1,817
Total	\$27,399	\$2,817

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

*RETREAT IL, LLLP,
an Arizona limited liability limited partnership
6061 E. Grant Rd., Suite #12, Tucson, Arizona 85712
Phone: (520) 321-0000*

June 25, 2010

Ms. Tanya E. Schulze
Acting Regional Inspector General for Audit
U.S. Department of Housing & Urban Development
Office of Inspector General, Region IX
611 West Sixth Street, Suite 1160
Los Angeles, California 90017-3101

RE: Retreat at Santa Rita Springs
Project No. 123-38033

Dear Ms. Schulze:

In response to your June 11, 2010 letter wherein you provided us with a copy of the draft audit report in connection with the Retreat at Santa Rita Springs Section 231 multifamily project, we offer the following formal comments for consideration/inclusion in the report:

Page 4, Background and Objective:

Note please, the Management contract was terminated by the Management Agent, Watermark Retirement Communities, Inc. on November 4, 2009;

Comment 1

Page 5, Results of Audit:

Finding 1: Security Deposits were Converted to Revenue and Comingled with Operating Funds:

"Security Deposits were collected from prospective residents to guarantee a place in the community. The owner and management agent deemed the security deposits as nonrefundable and converted them to ineligible community fees upon residents' move-in."

Comment 2

Upon review of the resident files, Owner acknowledges this statement is correct. The Owner has identified five (5) deposits of \$500 each from tenants that moved into the facility whose security deposits were converted to community fees. Those tenants include: [REDACTED]
[REDACTED] The Owner is working to locate those 5 tenants and will refund those security deposits as quickly as possible.

Comment 2

We are currently working to identify other deposits that may have been converted to community fees. It appears as if one tenant's deposit (██████████) was credited to the first month's rent; another tenant's deposit (██████████) was credited to the November 2009 rent; and, two tenants (██████████) were listed as having made \$1,500 deposits each when only \$500 checks were deposited. We are working with our auditor to resolve this issue and will refund any deposits due.

Owner and Owner's auditor have identified four prospective tenants that made security deposits that were not refunded. They include: ██████████ and ██████████. ██████████ made Security deposits of \$500 each while ██████████ made security deposits of \$1,000 each. We are attempting to locate these prospective tenants to refund their deposits.

We have been unable to identify any other prospective tenant that may have paid a security deposit. We ask that if the Inspector General's files have any other information that may assist us in identifying persons who are owed refunds, please provide us with that information.

"The Security deposits were also commingled with the project's other cash in the operating bank account."

The Owner acknowledges that security deposits were commingled with the operating funds. Please consider however, that the owner did not commingle the Security Deposits. When the Owner turned over project funds to the professional property manager, Watermark Retirement Communities, Inc., in October of 2008, the funds were turned over in two separate checks: Cashier's Check No. 107794 in the amount of \$4,486.34 representing the Security Deposits and Owner's Check No 1199 in the amount of \$5,000 which was marked "Open Operating Account". The funds were commingled when Watermark opened the Operating Account at Wells Fargo - Checking Account #1303106452. The owner did not have access to the Wells Fargo Operating Account. Copies of Cashier's Check No. 107794, Owner's Check No. 1199, and Wells Fargo Bank Statement, Account #1303106452 reflecting Watermark's November 8, 2008 comingled deposit totaling \$9,486.34, are attached for your review. Also note, Watermark completely depleted the Operating Account upon terminating their Management Agreement removing all funds, including the security deposits.

Comment 3

"In addition, we identified a \$1,000 tenant deposit in November 2009, the source of which could not be confirmed."

Watermark provided a response to our inquiry regarding this deposit by indicating they would be happy to help us make this determination but need access to the project files. We have provided copies of the tenant files to Watermark, and await their review/determination.

Page 6, Recommendations:

- 1A. Require the Owner to reimburse the residents for ineligible community fees totaling \$6,500;
- 1B. Require the owner to refund security deposits collected from prospective residents totaling \$4,500;
- 1C. Require the owner and/or management agent to provide documentation that the \$1,000 is not a security deposit or repay that individual;

Comment 4

Owner Agrees with recommendations and will make refund of any security deposits and provide HUD-OIG with evidence of refunds, when complete.

Page 7, Management Charged Ineligible and Unsupported Project Expenses:

“Costs already Covered by the Management Fee were Charged to the Project.”

Watermark has provided an itemized response to these charges (copy enclosed). They have acknowledged many of HUD-OIG’s findings as accurate but have disputed several.

For instance, Watermark acknowledges that the travel expenses of non-front-line management staff amounting to \$1,126 are ineligible though they indicate they were charging those expenses based on their signed management agreement. Though they provided you with excerpts from the management agreement, they failed to provide you with a copy of Article XII HUD Provisions, Section 12.1(d) of the management agreement, (copy enclosed), that clearly states: “in the event of any conflict by and between the terms and conditions of this Agreement, and the terms and conditions of any HUD requirements governing the HUD-Insured Loan, including these HUD-Insured Loan Provisions, the terms and conditions of the HUD requirements and the HUD-Insured Loan Provisions shall be deemed to prevail and govern.”

Additionally, Watermark has acknowledged that \$7,267.22 was erroneously charged to the project for advertising costs. They indicate that “upon direction from HUD-OIG, the financial records can be updated and Watermark defers to HUD-OIG about reimbursement.....”

Page 8, Recommendations:

- 2A. Require the owner to reimburse the project \$17,859 for ineligible expenses;*
- 2B. Require the owner to provide documentation to support \$2,357 for undocumented disbursements cited in this report or reimburse the project.*

We respectfully request that HUD-OAG direct Watermark to correct the financial records and refund any ineligible costs that were charged against the project. We acknowledge the Owner is ultimately responsible for Management Agent’s misdeeds and stand ready to repay the project the amount finally determined by HUD-OAG as ineligible, less the amount determined to be returned by the management agent.

Comment 4

Should you have any questions or need further information or documentation, please don’t hesitate to call.

Sincerely,



Michael J. Naifeh, President
Retreat Fast, Inc.
General Partner

Cc: Vincent Mussetter, Assistant Regional Inspector General for Audit, w/enc.

[REDACTED]

From: [REDACTED]
Sent: Thursday, June 17, 2010 2:02 PM
To: [REDACTED]
Cc: [REDACTED]
Subject: Document Related to Today's Fax
Attachments: HUD OID Draft Audit Findings Response2.xlsx

[REDACTED]

Attached please find our response to the draft audit report. It details our stand on the items in the report and is what we covered with the auditors in our conversation with them yesterday.


As you will see in our response (first item), we do not currently have access to the records to be able to provide the information you are requesting in regard to security deposits. If a time can be arranged to go to the site and retrieve this information, we will be happy to schedule it. Since the deposits were made to and contracts of residents were with Retreat II, LLLP, we did not take or keep information requested once we terminated the management agreement.

Our additional responses are detailed on the attached as well. During our conversation with the auditors, we were told that HUD would ultimately direct us what action to take regarding changing operating statements. Once we get that direction we will make any changes needed.

Please let either [REDACTED] or me know there are any other questions.

[REDACTED]
Managing Director
Watermark Retirement Communities
[REDACTED]



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Watermark Retirement Communities
Response to HUD-OIG Draft Audit Report
The Retreat at Santa Rita Springs Section 231 Multifamily Project

Item/Date	Ineligible or Unsupported Amount	Watermark's Response
Resident Security Deposits/Throughout. Agree.	By Resident	After further investigation and review of HUD's Management Agent Handbook, these deposits should not have been converted to community fees. Since termination of the management agreement, Watermark has not had access to the records needed to determine the origination nor needed disposition of the \$1,000 November deposit for an unnamed security deposit. Given access to those records, we would be happy to help make that determination.
Travel/Throughout. Agree.	\$1,125.98	After further investigation and review of HUD's Management Agent Handbook, these expenses are not project expenses. Watermark was operating under the terms of its signed Management Agreement which it thought had been approved by HUD. Upon direction by HUD-OIG, financial records can be updated and Watermark defers to HUD-OIG about reimbursement given the large outstanding balance owed agent by project for community purchases and management fees.
Agency Fees/Throughout. Disagree.	\$6,280.57	We respectfully disagree with your interpretation of this \$6,280.57 as ineligible charges. As an advertising agency, Watermark Marketing Group (WVG) receives a 15% agency fee from the media outlet where advertisements are placed. This is not a "mark-up" but instead an agency fee that the community is not eligible to receive as they are not a qualified agency. This fee compensates WVG for buying the space and coordinating the placement of the ad. In other words, if The Retreat purchased advertisement directly from the media outlet, they would pay exactly (or more) for the advertisement that was charged to them by WVG. We chose to bill the project this way because, as you know, we were racking up large expenses on behalf of The Retreat and not getting reimbursed. When Watermark terminated the management agreement, it was owed over \$100,000 in property expenses paid by Watermark and not reimbursed. Consequently, we tried to stop the bleeding by having the property pay for its advertisement directly and we simply billed them for the 15% agency fee. Our other choice was to stop all advertising which didn't seem like a responsible approach as lease-up was our number one priority.

Comment 4

Comment 5

Watermark Retirement Communities
Response to HUD-OIG Draft Audit Report
The Retreat at Santa Rita Springs Section 231 Multifamily Project

Comment 6

Item/Date	Ineligible or Unsupported Amount	Watermark's Response
SM209RSR. December 2008. Disagree.	\$184.73	From reviewing our records, the \$184.73 can only be located on a March invoice #TR309RSR which does not reference gift cards, please provide the receipt the charge is being matched to along with verification of the expense hitting December 2008 financials.
Thunderbird Invoice being charged to project. December 2008. Agree.	\$7,267.22	This invoice was erroneously charged to the project. Upon direction by HUD-OIG, financial records can be updated and Watermark defers to HUD-OIG about reimbursement given the large outstanding balance owed agent by project for community purchases and management fees.
Media Production. January 2009. Agree as to January's accrual.	\$1,725.00	The \$1725 was accrued for unbilled media production charges in December 2008 and again in January 2009 in anticipation of the same expense to be incurred, no invoice had been entered for the charges at the time of the entries. When the invoice for February 2009 was entered it only contained one charge for media production in the amount of \$1725 for the month of December 2008 and no expense for January. The original entry for the January anticipated expense was not backed out. Upon direction by HUD-OIG, financial records can be updated and Watermark defers to HUD-OIG about reimbursement given the large outstanding balance owed agent by project for community purchases and management fees.
KGVY 0910204. February 2009. Disagree.	\$800.00	KGVY invoice for \$800 was accrued for January as the invoice was not received until March; \$800 was additionally accrued for February in anticipation of the same expense. The expense for January offset the accrual and February's expense was never received. The additional expense for the February 2009 entry was reversed on JE#26 in April 2009. Accruals automatically reverse in the following month so generally need to be reaccrued unless the invoice for the expense has been received and processed.
KGVY 0910203. February 2009. Disagree.	\$330.00	KGVY invoice for \$330 was accrued for January and February 2009, the invoice for January 2009 posted to the expense account in March 2009 and the accrual was not reversed until JE#26 in April 2009.
KGVY 0910203. March 2009. Disagree.	\$330.00	February 2009 KGVY accrual for \$330 was offset when the invoice posted in March 2009.

Comment 4**Comment 4****Comment 7****Comment 8**

Watermark Retirement Communities
Response to HUD-OIG Draft Audit Report
The Retreat at Santa Rita Springs Section 231 Multifamily Project

Comment 9

Item/Date	Ineligible or Unsupported Amount	Watermark's Response
Recruiting and Hiring. May 2009. Disagree.	\$1,120.00	We respectfully disagree that this is an ineligible cost. These were recruiting expenses for staff who worked on location at The Retreat at Santa Rita Springs and had no duties outside of the project. As such, these costs should be considered project expenses as confirmed by HUD's Management Agent Handbook figure 6-2. These expenses were billed to the project by the management agent because we have a national contract with Career Builder and place employment ads for the community through this service. Having a national contract afforded the project a cost savings over an individual contract. Our internal invoice for these advertisements is attached.
Yellow Book. September 2009. Agree.	\$37.13	We are unable to document this additional expense amount charged versus current charges. Upon direction by HUD-OIG, financial records can be updated and Watermark defers to HUD-OIG about reimbursement given the large outstanding balance owed agent by project for community purchases and management fees.
Green Valley Reaccrued. November 2009. Disagree.	\$277.50	September 2009 invoice still not received as of date operating statements were completed. Original posting reversed, so needed to be reaccrued.
Green Valley Accrued. November 2009. Disagree.	\$277.50	Amount accrued in effort to have November operating statements be as complete as possible given limited information. Watermark terminated its operating agreement with The Retreat on 11/4/2009, so did not have full information to be able to complete statements. Upon request, any needed corrections can be made.
Dex Accrual. November 2009. Disagree.	\$113.34	Amount accrued in effort to have November operating statements be as complete as possible given limited information. Watermark terminated its operating agreement with The Retreat on 11/4/2009, so did not have full information to be able to complete statements. Upon request, any needed corrections can be made.
ATT Accrual. November 2009. Disagree.	\$305.00	Amount accrued in effort to have November operating statements be as complete as possible given limited information. Watermark terminated its operating agreement with The Retreat on 11/4/2009, so did not have full information to be able to complete statements. Upon request, any needed corrections can be made.

Comment 4**Comment 10****Comment 11**

preliminary/draft

Watermark Retirement Communities
Response to HUD-OIG Draft Audit Report
The Retreat at Santa Rita Springs Section 231 Multifamily Project

preliminary/draft

Comment 11

Item/Date	Ineligible or Unsupported Amount	Watermark's Response
Yellow Book Accrual. November 2009. Disagree.	\$42.00	Amount accrued in effort to have November operating statements be as complete as possible given limited information. Watermark terminated its operating agreement with The Retreat on 11/4/2009, so did not have full information to be able to complete statements. Upon request, any needed corrections can be made.
Amount Agree	\$10,155,333	
Amount Disagree	\$10,060,644	

- 5.10 Compliance with Government Rules and Regulations. Operator shall conduct the business of the Property in compliance with all applicable laws and regulations and ensure that no activity or condition occurs on or about the Property in violation of any such laws or regulations. In the event that Operator shall have reason to believe that any laws or regulations may be violated on or about the Property, the Operator shall promptly so notify Owner. Operator shall use reasonable efforts to comply with environmental laws, shall not negligently permit the discharge of hazardous or toxic substance and shall report any problem to Owner immediately. Upon notice and written approval of Owner, Operator will retain the appropriate consultants to determine and make recommendations to remedy the situation.
- 5.11 Credit and Pricing Policies; Billing and Collection Practices.
- a) Pricing Policies. Operator will propose in connection with the Operating Plan the rate and price schedules for all rooms, products and services provided at the Property.
 - b) Credit Policies. Operator shall establish and implement policies and procedures for verifying, accepting, limiting and rejecting the credit of residents and patrons of the Property.
 - c) Billing and Collection Practices. Operator shall establish and administer systems for the timely issuance of bills, including claims for reimbursement from governmental and other third-party payors as applicable, for all rooms, products and services provided at the Property and for which Owner is entitled to be paid. Operator shall employ its best efforts to collect any and all rents, charges, reimbursement and accounts receivable owed to Owner with respect to the Property. Subject to the provisions of Section 5.12, Operator may employ, as an Authorized Expenditure, collection agencies and legal counsel, where appropriate to pursue such claims on behalf of Owner.
- 5.12 Litigation. Operator, as an Authorized Expenditure, shall institute any necessary or desirable legal actions or proceedings to collect charges or other income of the Property or to evict or dispossess non paying or legally undesirable persons in possession, or exercise right to cancel or terminate or sue for damages under any agreement relating to the operation of the Property, other than this Agreement. No such action or proceeding shall be instituted without Owner's prior approval, and Operator shall only use counsel approved by Owner and shall direct counsel to supply Owner with a copy of all pleadings relating to such litigation. With respect to all actions brought by Operator concerning the Property, Operator shall be permitted to charge all necessary and appropriate filing and legal fees and expenses as an Authorized Expenditure.
- * 5.13 Home Office Activities. Operator shall reasonably employ the resources of its home office and personnel to supervise and assist the operation of the Property. Operator shall cause appropriate officers and employees of Operator or an affiliate of Operator to visit and inspect the Property and the operation thereof with reasonable frequency but no less frequently than once approximately every thirty (30) days. Neither the Property nor the Owner shall be obligated to reimburse Operator for the expenses or overhead associated with Operator's home office or home office personnel assisting at the Property, the costs for which are included in the fees paid hereunder, except that Owner agrees to pay or reimburse Operator for the following costs and expenses: (1) Operator's reasonable travel costs and related expenses as required and outlined in the approved Operating Plan, provided that such travel expenses shall not exceed Six Thousand Dollars (\$6,000) in the aggregate per annum without Owner's prior written approval, and such additional

reasonable travel and related expenses, if any, as may be approved in advance by Owner in connection with the Operating Plan; (ii) costs incurred with respect to Operator's home office employees, affiliates or contractors who assume on an interim basis Key Operating Personnel duties for a period of ten (10) days or more in any given month, where costs will be reimbursed at the budgeted expense of the appropriate Key Operating Personnel position plus benefits; (iii) graphic design services as outlined in Section 5.5; (iv) auditing services as outlined in Section 8.4; (v) recruiting services as outlined in Section 5.13; and (vi) technology services as outlined in the Operating Plan. Costs of the services in Section 5.13(iii), (iv), (v) and (vi) will be charges at Operator's then-current fee structure as outlined in Schedule B.

- 5.14 **Limitation Upon Obligations.** In the event that performance of any of Operator's obligations requiring expenditure of Owner's funds or Owner's assistance or cooperation hereunder shall be impeded by reason of unavailability of such funds or lack of Owner's assistance or cooperation, then Operator's performance of such obligations shall be excused to the extent so impeded and until such funds become available or until Owner's assistance or cooperation is obtained. Operator's obligations also shall be excused to the extent performance would be contrary to instructions of Owner. In addition, in the event Operator should be prevented from performing any of its obligations hereunder by operation of force majeure, any federal or state law or any order, rule or regulation of governmental authority, or other cause beyond Operator's control then while so prevented, Operator's obligation to comply with such obligations shall be suspended. The term force majeure shall include, but not be limited to, acts of God, strikes, lockouts, and accidents to building or machinery, explosions or other causes not within the control of Operator or Owner.
- 5.15 **Taxes and Assessments.** Operator shall obtain bills for real estate and personal property taxes, improvement assessments and other like charges that are, or may become liens against the Property and recommend to Owner payment thereof or appeal therefrom. Operator shall review and submit all real estate and personal property taxes and all assessments affecting the Property to Owner and shall file all personal property tax returns with respect to the Property.
- 5.16 **Inventories and Supplies.** Operator shall purchase such Consumable Supplies and other expendable items as are necessary to operate the Property and shall pay for such supplies out of the Operating Account. When taking bids or issuing purchase orders, Operator shall be under a duty to use its reasonable best efforts to secure for and credit to Owner any discounts, commissions or rebates obtainable as a result of such purchase.
- 5.17 **Liens.** Operator and Owner shall use their best efforts to prevent any liens from being filed against the Property which arise from any maintenance, changes, repairs, alterations, improvements, renewals or replacements in or to the Property.
- 5.18 **Related-Party Transactions.** In order to properly perform the services required by this Agreement, Operator is authorized to engage any entity that is an affiliate of Operator, provided that the compensation paid for the services shall be competitive with the compensation paid to nonaffiliated entities furnishing the same or similar services.
- 5.19 **Office and Facilities.** Owner shall make available reasonably suitable office space and other facilities on the Property for the use of Operator and affiliates of Operator in providing services at the Property, including but not limited to, services pursuant to this Agreement.

Comment 9

<u>The Retreat</u>	<u>Position</u>	<u>Date</u>	<u>Costs</u>
	ED	Sep-08	\$ 140.00
	Sales Dir	Sep-08	\$ 140.00
	ED	Nov-08	\$ 140.00
	HR	Dec-08	\$ 140.00
	Plant Operations	Dec-08	\$ 140.00
	Receptionist	Feb-09	\$ 140.00
	Security Guard	Mar-09	\$ 140.00
	Dining Room Srv	Mar-09	\$ 140.00
			\$ 1,120.00

Management Contract

ARTICLE XII HUD PROVISIONS

- 12.1 Applicability of HUD-Insured Loan Provisions. Notwithstanding any term of condition of this Agreement to the contrary, the Owner and the Operator hereby acknowledge and agree that the following HUD-Insured Loan Provisions shall be deemed to prevail and govern with respect to the respective rights, liabilities, and obligations of the parties hereunder or otherwise with respect to the enforcement or interpretation of this Agreement:
- a) Any Management fees to be paid hereunder shall, in any event, be computed and paid only in accordance with HUD requirements.
 - b) Upon the occurrence of any of the following events, HUD may require the Owner to terminate this Agreement:
 - i) Immediately, in the event of any default attributable to the Operator under the HUD-Insured Deed of Trust, Note, Regulatory Agreement, or Subsidy Contract;
 - ii) Upon thirty (30) days written notice to the Owner and the Operator, in the event of any failure by the parties to comply with the provisions of the Management Certification, or for other good cause as determined by HUD; or
 - iii) Immediately, and in the event that HUD takes over the Property as Mortgagee in Possession.
 - c) In the event of any termination of this Agreement by HUD, the Owner agrees to promptly make arrangements for the provision of management of the Property upon such terms and conditions as are deemed satisfactory to HUD.
 - d) In the event of any conflict by and between the terms and conditions of this Agreement, and the terms and conditions of any HUD requirements governing the HUD-Insured Loan, including these HUD-Insured Loan Provisions, the terms and conditions of the HUD requirements and HUD-Insured Loan Provisions shall be deemed to prevail and govern.
 - e) In the event that this Agreement may be terminated for any reason, the Operator hereby agrees to immediately (and in no event later than thirty (30) days after the Agreement termination date), turn over to the Owner, and to HUD, as appropriate, all of the Property's cash trust accounts, investments, and records.
 - f) In the event HUD has approved the Manager on a conditional basis, the term of this Agreement may be subject to such maximum term as is imposed by HUD. If the term of this Agreement is changed or otherwise extended, the Owner and the Operator hereby agree to submit a new Management Certification to HUD.
 - g) Notwithstanding any term or condition of this Agreement to the contrary including, without limitation, the applicable provisions contained in Article II, 2.2 hereof, the Operator shall not be deemed exempt from any and all liability for any damages or injuries which occur or are sustained by any person or entity during, or arising out of, the operation of the Property by the Operator.

The names were redacted for privacy reasons.

OIG Evaluation of Auditee Comments

Comment 1 The statement “The owners owed WRC for back management fees from May 2009 until it terminated its contract in November 2, 2009” was changed to “The owners owed WRC for back management fees from May 2009 until the contract termination in November 4, 2009.”

Comment 2 Based on our review of the books of account, there were 13 residents/families (some have their spouses as secondary occupants) that moved in the community. The security deposits of \$500 were converted into ineligible community fees. The auditee submitted no documentation to show that the security deposits were credited towards rent for the referenced tenants. Below is a list of residents that moved in the community and should be refunded their security deposits less fees for damages (if any) upon move out.

Resident No.	Apt/Bed	Admit Date	Amount
1	108202	January 31, 2009	\$500
2	108205	February 2, 2009	\$500
3	101102	March 31, 2009	\$500
4	108207	March 31, 2009	\$500
5	101201	April 11, /2009	\$500
6	108203	April 17, /2009	\$500
7	108209	April 30, 2009	\$500
8	108210	April 15, 2009	\$500
9	112102	April 22, 2009	\$500
10	106210	May 26, 2009	\$500
11	108201	May 28, 2009	\$500
12	106208	August 3, 2009	\$500
13	106110	August 9, 2009	\$500
Total			\$6,500

Note: Residents’ names were not disclosed to protect their privacy.

The community had been collecting security deposits of \$500 since it started operation. However, starting October 2009, the security deposit was increased to \$1,000. Below is a table listing the prospective residents who paid security deposit but did not move in the community and therefore should be refunded their security deposits. Note that prospective resident No. 6 paid \$1,000 in two installments of \$500 each dated October 27, 2009 and October 30, 2009 respectively.

Potential Resident No.	Date Security Deposit Received	Amount
1	December 1, 2008	\$500
2	March 11, 2009	\$500
3	September 8, 2009	\$500
4	September 14, 2009	\$500
5	October 21, 2009	\$500
6	October 27, 2009	\$500
	October 30, 2009	\$500
7	November 2, 2009	\$1,000
Total		\$4,500

Note: Potential residents' names were not disclosed to protect their privacy.

Comment 3 The owners are responsible for the management agent's actions. As stated in finding one of the report, the project's regulatory agreement required security deposit funds to be kept separate from other funds at all times.

Comment 4 The resolution to the recommendation will be between HUD and the auditee.

Comment 5 WRC managing director stated that it was WRC's procedure to add 15 percent mark-up to advertising invoice cost as a charge for managing the activity. As a qualified agency to the various advertising companies, WRC claimed to get a discount whenever it did business with these companies. However, no documentation was provided to support any discount was received and the claimed savings did not benefit the project because of the additional 15 percent surcharge.

Comment 6 We reviewed the additional information submitted by WRC and removed the questioned cost from the report.

Comment 7 In the February 2009 Media Placement general ledger account postings, the accrual for KGVY expense was posted three times under JE 1-00, JE10-00, and JE14-00, each amounting to \$800. The two duplicates (JE 1-00 and JE 14-00) were reversed in April 2009. However, in March 2009, the same amount was posted under JE 6-00, not reversed, and no invoice was provided to support the entry. Although we continue to question the item, we have re-categorized the questioned cost to unsupported.

Comment 8 The KGVY expense for \$330 was posted three times under JE 1-00, JE10-00, and JE14-00 in February 2009. We agree two of the postings were for two KGVY invoices of the same amount (09010203 and 09010214). However, the KGVY invoice 09010203 was also included as part of WRC invoice # SM209RSR under JE 10-00, resulting in a duplicate expense that was never reversed. In March

2009, the same amount was posted under JE 8-00 but no KGVY invoice was provided to support the entry, and it was not reversed. Therefore, we continue to question the costs; however, we have re-categorized them as unsupported expenses.

Comment 9 Although WRC's response indicates we categorized this expense as "ineligible" it was actually listed in our report as unsupported due to the lack of documentation provided. The document provided in the auditee's response, listing the expenses, appears to be an internally generated WRC document and not original vendor documentation. The agent subsequently provided additional documentation from the vendor to support \$800 of the Career Builder expense for the recruiting of 8 onsite staff at \$100 each. However, insufficient documentation was submitted for the remaining \$40 charged per employee, so the remaining \$320 remains unsupported.

Comment 10 Green Valley expense was first accrued in September 2009. Since the invoice had not been received, the entry was reversed and reaccrued in October 2009. In November 2009, the invoice still was not received, the October entry was reversed and reaccrued. There were two debit entries in November for the same amount, the reaccrual for the September expense and a new accrual for November expense. If the invoices for September and November were received, the accruals should be reversed and the correct expense amounts entered. However, since the amounts were merely accruals and not paid from project funds, we have removed the amounts from our questioned costs.

Comment 11 If the invoices for November 2009 were received, the accruals should be reversed and the correct expense amounts entered. However, since the amounts were merely accruals and not paid from project funds, we have removed the amounts from our questioned costs.

Appendix C

CRITERIA

HUD Handbook 4370.1, REV-2, paragraph 2-21, states that deposits are paid by a tenant at the time a unit is rented. The deposit is placed into an account specifically for tenant deposits and held until the tenant vacates the unit. A security deposit may be applied to pay for any damages caused by the tenant.

HUD Handbook 4370.2, REV-1, paragraph 2-12, states that any funds collected as security deposits must be kept separate and apart from all other project funds in an account maintained in the name of the project. The balance of the account must not at any time be less than the aggregate of all outstanding obligations under the account for security.

Regulatory agreement, paragraph 6g, states that owners shall not, without the prior written approval of the HUD Secretary, require, as a condition of the occupancy or leasing of any unit in the project, any consideration or deposit other than the prepayment of the first month's rent plus a security deposit in an amount not in excess of 1 month's rent to guarantee the performance of the covenants of the lease. 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.

HUD Handbook 4381.5, REV-2, paragraph 6-34(a), Financial Compliance.

Management agents are charged with protecting the financial viability of HUD-insured multifamily projects. The purpose of financial reviews is to verify that owners and management agents are in compliance with HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects, and related HUD requirements and guidelines.

HUD Handbook 4381.5, REV-2, paragraph 6-38, states:

a. Front-line Costs and Day-to-Day Activities

- (1) Reasonable expenses incurred for front-line management activities may be charged to the project operating account. HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects, provides a complete listing of allowable expenses. Front-line activities include:
 - o taking applications;
 - o screening, certifying, and recertifying residents;
 - o maintaining the project; and
 - o accounting for project income and expenses.

Figure 6-2 provides examples of front-line management costs.

Figure 6-2: Examples of Costs Paid from Management Fee and Project Account

Costs Paid from Fee	Costs Paid from Project Account
Agent's travel expenses to visit project and meet with owners. Training and travel expenses for Agent's supervisory staff.	Travel expenses incurred by front-line staff's responsibilities (e.g., making bank deposits, meeting with contractors, attending training, etc.).

- (2) If front-line management functions for several properties are performed by staff of the agent operating out of a single office, the following conditions apply.
 - (a) The agent must prorate the total associated costs among the projects served in proportion to the actual use of services. Allowable total associated costs include:
 - (i) Salaries and fringe benefits of personnel performing front-line duties; and
 - (ii) Actual office expenses, fees, and contract costs directly attributable to the performance of front-line duties.
 - (b) The agent may not impose surcharges or administrative fees in addition to actual costs.
 - (c) The cost of performing front-line management functions off-site may not exceed the total cost of performing these functions at the property.
- (3) The salaries of the agent's supervisory personnel may not be charged to project accounts, with the exception of supervisory staff providing oversight for centralized accounting and computer services for the project.

HUD Handbook 4381.5, REV-2, paragraph 6-39, states:

- a. Expenses for services that are not front-line activities must be paid out of management fee funds, except for centralized accounting and computer services.
- b. Salaries, fringe benefits, office expenses, fees, and contract costs for the following activities must be paid out of management fee funds. These costs include
 - (1) Designing procedures/systems to keep the project running smoothly and in conformity with HUD requirements.
 - (2) Preparing budgets required by the owner or HUD, exclusive of rent increase requests and MIO [management improvement and operating] Plans.
 - (3) Recruiting, hiring, and supervising project personnel.
 - (4) Training for project personnel that exceeds the line item budget for training expenses.
 - (5) Monitoring project operations by visiting the project or analyzing project performance reports.
 - (6) Analyzing and solving project problems.

- (7) Keeping the owner abreast of project operations.
- (8) Overseeing investment of project funds.
- (9) Ensuring that project positions are covered during vacations, sickness, and vacancies.