audit report

Issue Date December 22, 2009	
Audit Report Number 2010-NY 1006	

TO: Teresa Bainton, Director, Office of Multifamily Housing, New York, 2AHMLAP

FROM: Edgar Moore
Edgar Moore, Regional Inspector General for Audit, New York/New Jersey Region, 2AGA

SUBJECT: SFDS Development Corporation, New York, New York, Had Weaknesses in Its Financial, Procurement and Administrative Controls

HIGHLIGHTS

What We Audited and Why

We audited the SFDS Development Corporation (agent), management agent for three U.S. Department of Housing and Urban Development (HUD) subsidized Section 202 elderly housing direct loan properties, in response to a complaint to the Office of Inspector General (OIG) Hotline that alleged misappropriation of HUD funds by the agent. The objective of our review was to assess the merits of the complaint. It was expanded to assess the agent's compliance with HUD financial, procurement, and administrative regulations applicable to the Section 202 elderly housing program.

What We Found

The complaint had some merit, because as documented on page 5 of the report, some ineligible salary costs were erroneously allocated to the projects. In addition, weaknesses in the agent's financial, procurement, and administrative controls caused noncompliance with HUD regulations pertaining to the agent's management of the Section 202 properties. Specifically, the agent charged ineligible and unsupported expenses to the projects, failed to make required deposits to, or seek HUD approval for withdrawals from the replacement for reserve account, did not always conduct unit inspections or procure services in a prudent manner, and failed to file financial statements in a timely manner. As a result, the projects were deprived of $177,406, and HUD lacked assurance that $498,643 was disbursed for eligible expenses, units were properly maintained, and services were obtained at the most economical price. In addition, HUD was not made aware of the financial condition of the projects in a timely manner.

What We Recommend

We recommend that the Director of the New York Office of Multifamily Housing instruct the owner/agent to repay ineligible costs charged to the projects, provide documentation for unsupported costs, and if support cannot be provided, repay the amount with nonfederal funds, and strengthen controls over financial, procurement, and administrative functions.

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 discussed the results of our review during the audit and at an exit conference held on November 30, 2009. We provided a copy of the draft report to agent officials and requested their written comments by December 8, 2009, which we received on that date. Agent officials generally agreed with our findings and have taken, or plan to take, actions that are responsive to the report's recommendations. 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 SFDS Development Corporation (agent) is the management agent for three projects that received U.S. Department of Housing and Urban Development (HUD) Section 202 elderly housing direct loans, as well as for seven other non-HUD-subsidized properties. The three HUD Section 202-subsidized projects, located in New York, New York, are Casita Park, a 94-unit project; Mt. Pleasant, a 63-unit project; and Lucille Clark, a 61-unit project. The three projects are considered owner managed, and the agent is governed by a 12-member board of directors.

The Section 202 program is intended to help expand the supply of affordable housing with supportive services for the elderly. It provides very low-income elderly residents with options that allow them to live independently, but in an environment that provides support activities, such as cleaning, cooking, transportation, etc. HUD provides loans to finance the construction, rehabilitation, or acquisition of such projects, as well as rent subsidies to help make the projects affordable. HUD provided interest-free loans of $10.1 million, $6.2 million, and $6.7 million to Casita Park, Mt. Pleasant, and Lucille Clark, respectively, which do not have to be repaid as long as the projects remain affordable for low-income elderly tenants for 40 years. The three projects received cumulative rental assistance subsidy payments of $823,971 in fiscal year 2008.

The projects experienced cash flow difficulties and the agent had applied to HUD for a rent increase at each of the projects. However, the requests were denied because the applications were not filed on time and the projects had not filed required financial statements on time. On September 30, 2008, the agent contracted with a consultant, approved by HUD, to provide financial and advisory services. These services included paying bills, collecting rents, and maintaining an accounting system in accordance with generally accepted accounting principles. The agent pays for these services from the management agent fees it earns. It retains responsibility for unit inspections and maintenance.

A complaint to the OIG Hotline alleged that the agent misappropriated HUD funds by allocating excessive salary expense to the three HUD properties. Our initial review of the complaint concluded that the agent did erroneously misallocate salaries of some of the employee noted in the complaint to the HUD properties (see report page 5).

The objective of our review was to assess the merits of the complaint received by the Office of Inspector General (OIG) Hotline alleging that the agent misappropriated HUD funds. After an initial determination that the complaint had some merit, we expanded our review to assess the agent's compliance with HUD financial, procurement, and administrative regulations applicable to the management of Section 202 elderly housing projects.

RESULTS OF AUDIT

Finding: The Agent Had Weaknesses in Its Financial, Procurement, and Administrative Controls

Weaknesses in the agent's financial, procurement, and administrative controls caused noncompliance with HUD regulations pertaining to administration of the three Section 202 properties. Specifically, the agent (1) charged ineligible expenses to the projects, (2) lacked adequate documentation to support costs, (3) incorrectly calculated and overcharged management fees at one project, (4) failed to make required deposits to, or seek HUD approval for withdrawals from the replacement for reserve accounts, (5) did not conduct required annual inspections at one project, (6) did not always procure services in a prudent manner, and (7) failed to submit financial statements in a timely manner. As a result, the projects were deprived of $177,406, which could have been used for necessary expenses, and HUD lacked assurance that $498,643 was disbursed for eligible expenses, units were properly maintained, and procurement actions were executed in the most prudent manner. In addition, HUD was not made aware of the financial condition of the projects in a timely manner.

Projects Charged Ineligible Expenses

The agent charged the projects ineligible expenses of $146,867 related to the allocation of employee salaries and the cost of a consultant. Section 11(c) of the regulatory agreement[1] provides that payments should be made for services rendered that are reasonably necessary for the operation of the project. However, salary costs of $136,867 were improperly allocated to the three projects during the projects' fiscal years 2006 through 2008. Specifically, excessive salary expense of $136,867 was charged to the projects because the total salary of personnel who worked at non-HUD projects was charged to the HUD-subsidized projects. This occurred because the agent lacked a system to properly allocate salary costs among the projects it managed.

In addition, during our audit, the agent reallocated salary costs based upon an informal review, conducted by the consultant with whom it had recently contracted, of time spent by employees at each of its projects. However, this reallocation was based upon informal discussion with the employees involved and not documented by formal activity reports. If salary costs are not properly allocated among projects, HUD lacks assurance that the allocated expense is reasonable and necessary.

[1] The regulatory agreement specifies the responsibilities of the project owner in consideration for the Section 202 loan made by HUD.

Furthermore, the agent charged two of the three HUD-subsidized projects $10,000 for expenses of a consultant. HUD Handbook 4381.5, REV-2, provides that expenses for services that are not front-line[2] activities should be paid from the management fee. These types of expenses that should be paid from the management fee include designing procedures to keep the project running smoothly and in conformity with HUD regulations, preparing budgets required by the owner or HUD, and analyzing and solving project problems. The consultant was contracted to identify opportunities for greater efficiencies at the 10 properties managed by the agent, a service that would not appropriately be considered a front-line activity, but rather be paid from the management fee. Further, the agent lacked a rationale for the allocation of the expense to the two HUD-subsidized properties. The agent improperly charged this expense to Lucille Clark and Casita Park projects because it believed that the expense was eligible as a front-line expense and it lacked a proper method to allocate the costs. The agent said that it would adjust the projects' records to reduce the amount due it by these charges.

Costs Not Adequately Supported

The agent lacked adequate documentation to support $498,643 charged to the three projects during the projects' fiscal years 2006 through 2008. The expenses include disbursements for insurance, supplies, telephone, taxes, accounting, auditing, workmen's compensation, health, and other benefits. Section 11 (c) of the regulatory agreement provides that payments for services, supplies, or materials be reasonably necessary for operation of a project, and section d provides that books, contracts, records, documents, and all other related papers be maintained in reasonable condition for proper audit and be subject to examination and inspection by HUD and its duly authorized agents. The costs were not adequately supported because the agent did not maintain documentation to substantiate the costs paid. The agent said that its former accountant/bookkeeper, with whom it has a legal dispute (see page 10), is withholding financial records, including the documentation that should support these expenditures. Consequently, HUD lacked assurance that $498,643 in project funds was used in accordance with HUD rules and regulations.

The independent public accountant reports issued for the projects' fiscal year 2007 reported internal control deficiencies relating to invoices not being approved in accordance with agent procedures. Our review of disbursements for the audit period disclosed that this condition continued and that the agent lacked adequate controls over the approval of expenses. However, based upon the recommendations of the HUD-approved consultant contracted in September 2008 to provide financial and advisory services, the agent established procedures to

[2] Front-line activities include taking applications, screening and certifying residents, maintaining the projects, and accounting for project income and expenses

strengthen controls to ensure that all disbursements were adequately reviewed and documented before payment[3]. In addition, the agent has hired a chief financial officer to manage the day-to-day financial operations.

Management Fee Incorrectly Calculated

The agent incorrectly calculated management fees for the three HUD-subsidized projects. Specifically, it charged Mt. Pleasant project excess management fees of $30,539 and undercharged $17,636 for Lucille Clark and Casita Park projects. HUD Handbook 4381.5, REV 2, section 3.2(b), provides that the management fee should be calculated as a percentage of the amount of rental income collected, and attachment 1 of the project owner's/management agent's certifications[4] quoted a management fee as a percentage of the rent collected for each of the projects. This methodology is intended to provide the agent an incentive to maximize rent collections and automatically increase the fee yield as rents increase. However, rather than applying a percentage to the rents collected, the agent calculated the monthly fee by multiplying the number of units in the projects by a fixed dollar amount. Specifically, the agent used $51 in one year and $59 in two other years for Mt. Pleasant, and used $44 each year for the other two projects. This occurred because the agent was unaware of the proper methodology for calculating the fee.

Replacement for Reserve Not Administered Properly

The agent did not ensure that monthly deposits were made to the projects' reserve for replacement accounts as required and inadvertently made withdrawals from these accounts without HUD approval. Section 5(a) of the regulatory agreement requires that a reserve for replacement account be established, into which monthly deposits would be made as specified, and that withdrawals be made only after written consent from HUD. The reserve for replacement account is intended to ensure the availability of cash for replacement of capital items, such as heating/air conditioning, plumbing, and roofing. The agent made the required monthly deposits for fiscal year 2006 (December 2005 through November 2006) for the Mt. Pleasant project; however, it did not make deposits for fiscal year 2007 and 2008. Further, deposits were not made in any of the three fiscal years for the

[3] We did not review or test financial activity incurred since the agent instituted revised procedures; however, we discussed the matter with the agent and reviewed these procedures, which if implemented, should provide adequate controls.

[4] The project owner's/management agent's certification specifies the responsibilities to HUD of the project owner and management agent.

other two projects. As shown in the table below, the projects' reserve for replacement account was underfunded by $375,775.

Project	Required monthly deposit	Period not paid	Number of months	Deficient deposits 2006-2008
Casita Park	$6,900 $3,405	Oct. 2005-June 2007 July 2007-Sept. 2008	21 15	$144,900 51,075
Lucille C. Clark	$4,498 $1,998	Oct. 2005-Aug. 2007 Sept. 2007-Sept. 2008	23 13	$103,454 25,974
Mt. Pleasant	$2,190	Dec. 2006-Nov. 2008	24	$50,372[5]
Total				$375,775

Required monthly deposits for Casita Park and Lucille Clark were higher for the period October 2005 through August 2007 so that loans of $80,426 and $30,000, respectively, to pay real estate taxes from the replacement for reserve account would be repaid by the end of the projects' fiscal year 2007. However, the loan amounts had not been repaid.

This occurred because the projects experienced cash flow problems, did not have the funds with which to make deposits, and did not request a waiver from HUD to suspend the payments. The fiscal year 2007 independent public accountant's report noted that the required deposits were not made and recommended that the agent request HUD approval to suspend the monthly deposit requirement. While the agent responded to the report on February 4, 2009 that it would petition HUD, it did not do so until October 6, 2009 after our inquiry.[6]

In addition, the agent made three withdrawals totaling $2,750 from the reserve for replacement accounts of Lucille Clark and Mt Pleasant projects. Agent officials stated that the withdrawals were erroneously made and should have been disbursed from the projects' operating account.

[5] Mt. Pleasant funded its reserve account by an additional $2,188 in fiscal year 2006, therefore the amount of deficient deposits shown is $2,188 less.

[6] HUD has not responded to the request.

Annual Unit Inspections Not Conducted as Required

Regulations at 24 CFR (*Code of Federal Regulations*) Subpart G Section 5.705 require annual unit inspections of HUD-subsidized housing. However, unit inspections were not completed for the 94 units at Casita Park in 2008. This condition occurred because the property manager for Casita Park was transferred to another location in June 2008 and provisions were not made for unit inspections. As a result, HUD lacked assurance that the units complied with HUD unit maintenance standards. However, unit inspections for all units were conducted the following year.

Procurements Not Always Made in a Prudent Manner

The agent did not prepare cost estimates, solicit bids, or execute a contract with two bookkeepers who provided services to the three HUD-subsidized properties during the audit period at a cost of $18,850 and $43,505 in years 2006 and 2007, respectively. In addition, the agent did not solicit cost estimates for legal services obtained at a cost of $7,626 in 2006 and $8,627 in 2007.

HUD Handbook 4381.5, REV-2, section 6.50(a), provides that when an owner/agent is contracting for goods or services, an agent is expected to solicit written cost estimates from at least three contractors or suppliers for any contract, ongoing supply, or service which is expected to exceed $10,000 per year; (b) obtain verbal or written cost estimates for any contract, ongoing supply, or service estimated to cost less than $5,000 per year; and (c) maintain documentation of all bids as part of project records for three years after completion of the contract. Section 4 of the management certification provides that the necessary verbal or written cost estimates will be obtained and the reasons for accepting other than the lowest bid will be documented.

The agent failed to procure services in a prudent manner because it lacked controls to ensure compliance with HUD regulations and its own policies concerning procurements. As a result, HUD could not be assured that the auditee obtained the most economical and reasonable price available when procuring services.

Financial Statements Not Filed in a Timely Manner

Section 11(f) of the regulatory agreement requires that financial statements be submitted to HUD 60 days after the projects’ fiscal year end. However, the agent did not submit financial statements to HUD in a timely manner during the audit period. Specifically, it submitted financial statements between 8 and 14 months late for fiscal years 2006 and 2007, and those due for fiscal year 2008 for Casita Park and Lucille Clark projects had not been submitted and were 10 months late. This condition occurred because the agent's books and records were not adequately maintained. As a result HUD was not made aware of the financial condition of the projects in a timely manner.

Section 7a of the management certification specifies that all records related to the operation of the project, regardless of where they are housed, are considered the property of the project. However, much of the projects' fiscal years 2006 through 2008 financial records were kept by the projects' former accountant/bookkeeper, who refused to release the documents to the agent due to a dispute over payment of the bookkeeper's fees. After we initiated our audit, the agent instituted legal action to regain control of these records; however, the issue has not yet been resolved.

In May 2009, HUD imposed a $6,500 civil monetary penalty against the owner of Mt. Pleasant for noncompliance with financial statement filing requirements for fiscal years ending 2007 and 2008. HUD reached a settlement agreement on June 19, 2009, which required Mt. Pleasant's owner to pay the penalty and submit the financial statements within 120 days from the date of agreement. On June 19, 2009, Mt. Pleasant's owner paid the penalty and submitted the 2007 financial statements to HUD. The 2008 financial statements for Mt. Pleasant were subsequently submitted on October 14, 2009.

Conclusion

Weaknesses in the agent's financial, procurement, and administrative controls caused noncompliance with HUD regulations pertaining to the Section 202 elderly housing projects. As a result, the projects were deprived of funds that could have been used for necessary expenses, and HUD lacked assurance that funds were disbursed for eligible costs and that procurement actions were the most efficient. In addition, HUD was not made aware of the financial condition of the projects in a timely manner. While the agent had taken actions to address these weaknesses, additional action to reimburse the projects and strengthen financial, procurement, and administrative controls to provide greater assurance of compliance with applicable regulations is warranted.

Recommendations

We recommend that the Director of HUD's New York City Office of Multifamily Housing instruct the property owner /agent to

1A. Repay the projects from nonfederal funds the $146,867 disbursed from the projects' funds for employee services not received and the ineligible consultant costs.

1B. Develop and implement a cost allocation plan for the allocation of costs to the projects in accordance with HUD regulations.

1C. Strengthen controls over disbursements to ensure that all costs charged to the projects are eligible in accordance with HUD regulations and the agent's own policies.

1D. Provide documentation to justify $498,643 in unsupported costs charged to the HUD-subsidized projects. If documentation provided does not support the costs, this amount should be repaid to the projects from nonfederal funds.

1 E. Strengthen controls over disbursements to ensure that documentation and approvals exist before payments are made and that project funds are used in accordance with HUD rules and regulations.

1F. Repay from nonfederal funds the $30,539 in excess management fees charged a project and request HUD review and approval to charge the $17,636 in management fees earned, but not collected from the other two projects.

1G. Implement procedures to ensure that the management fee is properly calculated in accordance with HUD regulations.

1H. Repay the $2,750 incorrectly withdrawn from the reserve for replacement accounts from the projects operating account.

1I. Establish procedures to ensure that the loan repayments and required monthly deposits are made to the projects' reserve for replacement accounts or seek approval from HUD to suspend such deposits when sufficient cash is not available.

1J. Strengthen controls to ensure that all project units are inspected on an annual basis.

1K. Strengthen procurement procedures to achieve compliance with HUD requirements to provide assurance that services are procured in the most economical and prudent manner.

IL. Establish procedures to ensure that contracts identify that project records are the property of the owner and appropriate action is taken to enforce contract requirements.

IM. Implement procedures to ensure that financial statements are submitted to HUD in a timely manner to avoid the imposition of future penalties and ensure that HUD is aware of the projects’ financial condition in a timely manner.

SCOPE AND METHODOLOGY

Our audit generally covered the period October 1, 2005, through November 30, 2008,[7] and was expanded when necessary. We conducted our fieldwork between March and October 2009 at the offices of the management agent located at 1261 Fifth Avenue, New York, New York.

To accomplish our objective, we

- Reviewed federal law, multifamily housing regulations, and the applicable regulatory agreements and project owner's/management agent's certifications to determine applicable HUD requirements governing the operations of the Casita Park, Lucille Clark, and Mt. Pleasant projects.

- Reviewed the HUD project management files and discussed the projects with staff at the HUD field office to identify any concerns about the projects.

- Obtained an understanding of the management agent's structure and reviewed the organizational chart and duties of staff related to the projects reviewed.

- Reviewed the available audited financial statements to identify any management and internal control weaknesses and reportable conditions identified before our audit work.

- Documented and evaluated financial and operational controls identified through an internal control questionnaire and interviews with agent officials.

- Interviewed the former accountant/bookkeeper and consultant, complainant, and an agent board member to discuss complaint issues and records access.

- Reviewed accounting records to evaluate whether the agent had a formal and reasonable system for allocating salaries and other costs among its projects.

- Reviewed and tested project accounting records to determine the extent to which the agent complied with HUD record requirements, charged projects for costs that were reasonable and necessary, and maintained adequate support for disbursements.

- Reviewed procurement procedures and services procured to determine whether proper procurement procedures were followed.

- Reviewed and tested procedures for determining tenant rental subsidy and compliance with unit maintenance standards. We selected three units nonstatistically from each

[7]The period was October 1, 2005, through September 30, 2008, for two projects and December 1, 2005, through November 30, 2008, for the third project.

of two projects to assess tenant eligibility and rental subsidy calculation and found no problems; consequently, we did not expand our sample.

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 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.

Relevant Internal Controls

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

- Program operations - Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Validity and reliability of data - Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

- Compliance with laws and regulations - Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

- Safeguarding of resources - Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

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 Weaknesses

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

- The agent did not have adequate financial, procurement, and administrative controls over its program operations and compliance with laws and regulations when it did not establish adequate controls to ensure that costs charged to the projects were for eligible and supported project expenditures (see finding).

- The agent did not establish operational procedures for ensuring that disbursements from the reserve for replacement account were made in compliance with HUD regulations, contracts were adequately procured, and books and records were maintained in accordance with HUD requirements (see finding).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A	$146,867		
1D		$498,643	
1F	$30,539		$17,636
1H			$2,750
Total	$177,406	$498,643	$20,386

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/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this instance, if the auditee implements our recommendation, funds that were improperly withdrawn from the replacement for reserve account will be available for use when needed and projects will have paid the appropriate management fee.

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AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

SFDS Development Corp.

DBA, **LOTT COMMUNITY DEVELOPMENT CORPORATION**

1261 Fifth Avenue New York, NY 10029

Telephone: 212-534-6464 Fax: 212-534-1184

December 8, 2009

Mr. Edgar Moore
Regional Inspector General for Audit
New York/New Jersey
U.S. Department of Housing and Urban Development
Office of Inspector General
26 Federal Plaza, Room 3420
New York, NY 10278 - 0068

Dear Mr. Moore,

Please find attached written comments to be included in the final report of the audit conducted regarding the three HUD Section 202 properties managed by SFDS Development Corp.

We want to recognize John Harrison, Assistant Regional Inspector and his staff: Josephine A. Menzies-Cameron and Rasove Ramirez for the professional manner in which they conducted the audit.

Respectfully Submitted,

Carmen Villegas / HM
Carmen Villegas
Chairperson

Dan Forkell
Chief Financial Officer

James F. Janeski
President/CEO

East Harlem House - El Barrio Houses - Milagrosa Houses - SFDS/Mt. Carmel Houses - St. Cecilia Houses - San Juan Houses
San Francisco Houses - Mt. Pleasant Apartments - Lucille C. Clark Apartments - Casita Apartments - Lott Residence - All Saints Housing

Operated by SFDS Development Corporation a 501C3 Tax Exempt Corporation

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

SFDS Development Corp's Response HUD OIG Report

December 8, 2009

Background

This is being provided on behalf of SFDS Development Corp. in response to the HUD OIG Report presented to SFDS. By way of background, even before HUD commenced their audit, SFDS was actively conducting an internal investigation into certain allegations made by a former part time temporary employee relating to the use of HUD funds in the operation of SFDS (see chronology below).

Comment 1

By way of background, SFDS's former outside accountant/bookkeeper was responsible for the total financial operation of SFDS, including the three relevant HUD buildings. These responsibilities included invoicing, collections, financial reporting, vendor payment, etc.

During 2007, the Chief Executive Officer (CEO), the finance committee of the Board of Directors and the Board itself recognized that there were deficiencies with the organization's financial management and more specifically, with the quality and completeness of the services being provided by the former outside accountant/bookkeeper. In December 2007, the finance committee of the Board instructed the CEO to seek a replacement for SFDS's former outside accountant. In February 2008, a contract with entered into with an executive search firm to hire a Chief Financial Officer (CFO). Furthermore, in April 2008, SFDS hired a financial management consultant to analyze its operations. In May 2008, the consultant recommended that SFDS hire [redacted] to provide financial management services and discussion with [redacted] began.

On June 30, 2008 the CEO of SFDS and the former outside accountant met with officials from the New York City program office of HUD. At that meeting, HUD was complimentary about the management of the buildings and noted from their onsite review the satisfaction of the tenants. However, HUD was clear that it was dissatisfied with the current financial management and consistent with the recommendation made to SFDS by its consultant a month earlier, SFDS was instructed to secure professional financial management for the HUD funded buildings within SFDS's portfolio. To that end, HUD recommended that SFDS interview at least three separate management firms. The former outside accountant was present for the meeting at HUD and recognized that his position was going to be replaced forthwith.

After vetting three management firms, ultimately, SFDS contracted [redacted], one of the firms from HUD's approved list, with HUD's approval, to provide bookkeeping and accounting services. Further, in connection with the hiring of [redacted] HUD advised SFDS that it could continue to self-manage. [redacted] replaced the former accountant bookkeeper for two of the three HUD buildings on October 1, 2008, the first day of their respective fiscal years. [redacted] began providing services to the third HUD building on December 1, 2008 – the first day of its

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Ref to OIG Evaluation	Auditee Comments

fiscal year. Also, the new Chief Financial Officer was hired in October 2008 and actually began on December 1, 2008.

Prior to [redacted] commencing the provision of services, the former outside accountant/bookkeeper was solely responsible for maintaining all financial books and records for the SFDS properties, including the three HUD buildings. Inasmuch as the former outside accountant/bookkeeper was on actual notice of the changeover on each of October 1, 2008 and December 1, 2008, there was ample time for him to assemble and turnover all of SFDS's financial records that he maintained at his office. Moreover, the former outside accountant/bookkeeper was fully compensated for his services through the dates that [redacted] took over.

Comment 1

Notwithstanding the foregoing, at the time that the former outside accountant's services were formally terminated, the Board attempted amicably negotiate the return of files and records, however, despite (repeated) demands, the former outside accountant failed or otherwise refused to turn over substantially all of SFDS's financial records. As a result of his failure/refusal to turnover SFDS's records, in February 2008, SFDS had no alternative but to commence litigation seeking to secure its own records. At this time, nearly a year later, the parties are in the process of working toward a court stipulated settlement that is expected to, among other things; result in the return of SFDS's records to SFDS.

Comment 2

On October 15, 2008, cognizant that her functions were being assumed by [redacted], the former part time temporary employee referred to above as the complainant, resigned her position and transmitted a letter to the Board wherein she made a variety of allegations, including the misappropriation of funds.

Upon receipt of the former employee's letter, a special committee was created by the Board of Directors to investigate the allegations made by the former employee, which allegations appear to mirror the allegation made to the HUD OIG hotline.

In connection with that internal investigation, outside counsel was retained to assist the special committee. That committee, along with counsel, conducted an extensive investigation including conducting interviews with the former employee, current and former employees of SFDS, including those alleged by the former employee to have engaged in misconduct, as well as outside consultants engaged by SFDS, including SFDS's former outside accountant/bookkeeper. It is important to note that the former employee (and complainant), prior to becoming a direct employee of SFDS, was employed by its former outside accountant/bookkeeper.

The special committee and counsel reviewed all documents that were available including all documents provided to it by the former employee and its former outside accountant/bookkeeper. After conducting what it believed to have been an exhaustive investigation, the special committee determined there was no misappropriation nor malfeasance, but that new procedures needed to be implemented to ensure that the organization's financial management was better administrated.

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AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	Auditee Comments

Understandably, SFDS and its Board were and are quite concerned about the allegations that were made by the former employee and were and are deeply troubled by the fact that for some period the financial management of SFDS was not at a level that SFDS believes was satisfactory. To strengthen its financial management capability, SFDS hired [redacted] in late 2008 to serve as its CFO. [redacted] is a CPA, seasoned finance executive, and has had extensive experience working with HUD from 1979 - 1993 when he served in a similar role with [redacted] and its related companies [redacted] and [redacted] which developed and managed approximately 3,000 units of Section 8 Housing in New York City. Since joining SFDS, [redacted] has worked diligently, both internally and with [redacted], to develop and implement internal controls, correct past oversights and generally bring the properties into compliance with HUD rules and regulations.

Comment 3

With the engagement of [redacted] as well as addition of a new Chief Financial Officer, SFDS and its Board are confident that the problems of the past are being addressed and that the financial management of the SFDS properties is at a level that should provide comfort to HUD that its financial, reporting, procurement and administrative controls issues of the past will not be repeated.

The following is intended to address each of the points made in the HUD OIG report:

1. **Project Charged Ineligible Expense: $136,867**
   a. **Payroll costs of $136,867 were improperly allocated to the three projects during the projects' fiscal years 2006-2008.**
   Agent acted in good faith in properly trying to allocate above costs. When the 2008 misallocation was brought to the Agent's attention, during the course of the OIG audit, Agent made journal entries to the 2008 general ledgers to properly reflect the true costs to the projects. Agent further intends to properly reclassify prior years, misallocations to insure proper accounting treatment.

Comment 4

   b. **Agent charged two of the three HUD subsidized projects $10,000 for the expenses of a consultant**.
   Agent contends this is a front-line expense. The contract with the vendor was based on a contingent fee being paid based on savings that were realized by the projects. This was mistakenly allocated to only the two projects mentioned. It should have been allocated across all 10 of the projects that benefitted from the cost savings resulting from the vendor services. It was reversed out prior to the completion of the 2008 audit and the projects were credited $5,000 each.
2. **Costs Not Adequately Supported: $498,643**
   a. **The Agent lacked adequate documentation to support $498,643 charged to the three projects during the projects' fiscal years 2006 through 2008.**
   Agent is in litigation with former outside accountant/bookkeeper who had control of all invoices and payment for the projects in the years in question. Agent is trying to compel said accountant/bookkeeper to turn over all records in their possession. Many of the expenses in question were paid by the outside accountant/bookkeeper who maintained the actual documentation in his office. The outside accountant/bookkeeper has also withheld all of the books and records of the Agent for the years being audited, as well as the methodology and backup for the allocations. As discussed above, the parties as awaiting a court stipulated settlement that will result in the release of those

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Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

documents at which time the Agent will produce the required substantiation. In the event that the settlement is not finalized, the Agent has instituted an alternate plan to produce the required documentation.

3. **Management Fee Incorrectly Calculated: $12,903 (net)**
   a. **The Agent incorrectly calculated management fees for the three HUD-subsidized projects. Specifically it charged Mt. Pleasant project excess management fees of $30,539 and undercharged $17,636 for Lucille C. Clark and casita Park projects.**
   Agent was mistakenly calculating a per-unit-per-month management fee instead of a percentage of the rents collected. Agent believed it was operating according to HUD guidelines with no intention of either overcharging or undercharging the projects. We now understand that the methodology Agent used was incorrect and are in the process of correcting this discrepancy. Agent believes there was an underpayment of management fees from all three projects in 2008 and once the fees have been recalculated it is Agent's intention to offset the overpayment buy Mt. Pleasant.

4. **Reserve for Replacement Not Administered Properly**
   a. **The Agent did not insure that the monthly deposits were made to the projects reserve for replacement accounts as required and inadvertently made withdrawals from these accounts without HUD approval.**
   These projects were all running cash flow deficits for the periods in question. Rents were/are insufficient to cover all expenses and reserves. Agent advanced money to all of these projects to meet operating expenses. The reason the reserves were not funded was because there was insufficient cash flow to do so. On October 6, 2009 Agent sent a letter to HUD requesting a retroactive and prospective suspension of these payments until such time as budget based rent increases are submitted by Agent and approved by HUD.

Comment 4

5. **Annual Unit Inspections Not Conducted as Required**
   a. **Unit inspections were not completed for the 94 units at Casita Park in 2008.**
   This was due to a transfer of personnel and inspection of all units at all projects was performed prior to 2008 and in 2009.It should also be noted that the other two projects were inspected in 2008. Agent considers the missed inspection in 2008 to be an aberration. All units at all projects will be inspected annually.

6. **Procurement Not Always Made in a Prudent Manner**
   a. **The Agent did not prepare cost estimates, solicit bids, or execute a contract with two bookkeepers who provided services to the three HUD-subsidized projects during the audit period at a cost of $18,850 and $43,505 in the years 2006 and 2007.**
   Agent engaged [redacted] in late 2008 to manage the back office operations of these projects. At the same time it hired a new Chief Financial Officer who is very experienced with HUD regulations. This combination will ensure that, going forward, procurement is handled according to HUD regulations.

7. **Financial Statements Not filed in a Timely Fashion**
   a. **Section 11(f0 of the regulatory agreement requires that financial statements be submitted to HUD 60 days after the project' fiscal year end.**
   As was previously mentioned in Agent's response to 2 above, the audits were delayed because of the difficulty in getting the required books, records and documentation to support an audit. The former accountant/accounting firm charged with preparing the workpapers for use by the auditors did not turn over such documents as requested. Agent recreated a great deal of this work internally and enabled the Mt. Pleasant 2008 to be filed and Casita Park and Lucille C. Clark's 2008 audits are expected to be submitted by December 31, 2009.

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OIG Evaluation of Auditee Comments

Comment 1 While an owner may engage an outside accountant/bookkeeper or management agent to maintain its financial books and records, HUD Handbook 4370.2, section 2-3(a) requires that books and records be maintained in reasonable condition for proper audit. The owner and its Board are ultimately responsible for the maintenance of these records, and the situation that exists is the result of improper controls over the accounting records.

Comment 2 Conflicting information on what documentation was and was not turned over to the agent and owner was received during the course of our audit; however, an assessment of the merits of the litigation and the position of the parties to the litigation was not within the scope of our audit.

Comment 3 We did not review or test controls over financial activity since the agent instituted its revised procedures; however, we discussed the controls and the revised procedures with the agent, which if implemented, should provide adequate controls. However, HUD needs to evaluate the procedures implemented to ensure that the proper controls have been established.

Comment 4 The agent has taken, or has agreed to take, actions to implement the recommendations noted in the seven issues discussed.