



Issue Date	March 12, 2007
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Audit Report Number	2007-NY-1003
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TO: Rosalinda Lamberty, Director, Multifamily Housing, 2CHM

FROM: *Edgar Moore*
Edgar Moore, Regional Inspector General for Audit, 2AGA

SUBJECT: Peregrine Health Management Company Used Project Funds for Ineligible, Unsupported, and/or Unnecessary Costs

HIGHLIGHTS

What We Audited and Why

We audited Peregrine Health Management Company (agent) pertaining to its management of the financial operations of Peregrine's Landing Senior Community (project). The audit was initiated based on a complaint, which alleged that the agent used project funds for nonproject costs, including tuition for the child of an employee of the agent, legal fees for non-project-related lawsuits, and salary to a former employee of the agent.

Our objectives were to determine whether the complaint allegations were valid and whether the agent was using project funds in accordance with its regulatory agreement and U.S. Department of Housing and Urban Development (HUD) requirements.

What We Found

We found merit to one of the complaint allegations (see appendix B), and the agent did not use project funds in accordance with its regulatory agreement and HUD requirements. It used \$116,798 in project funds for items that were ineligible, unsupported, and/or not necessary or reasonable for project operations. The questioned expenditures were associated with (a) non-project-related legal

fees, (b) project employee incentives, (c) consulting fees, (d) travel expenses, (e) cellular telephone fees, and (f) accounting fees. Further, project funds are being encumbered, as \$50,000 in funds and \$35,062 in a bond and associated interest are being held in addition to a \$5,475 account payable to cover non-project-related legal fees. In addition, the agent collected \$72,740 in excessive management fees that could have been avoided, and used project funds to pay the salary and benefits of one of its employees, resulting in ineligible costs of \$39,711.

What We Recommend

We recommend that the director of the Buffalo Office of Multifamily Housing instruct the owner and agent to develop procedures to ensure compliance with its regulatory agreement and HUD rules and regulations to ensure that project funds are expended only for reasonable and necessary expenses. We recommend that HUD require the owner and agent to reimburse the project for the ineligible and/or unnecessary costs associated with legal fees, employee incentives, consulting fees, travel, cellular telephone expenses, and accounting services. We also recommend that HUD require the owner and agent to submit supporting documentation to justify the unsupported employee travel costs to enable HUD to make an eligibility determination. All amounts determined to be ineligible should be reimbursed to the project from nonproject funds. We recommend that the owner and agent be required to unencumber the project by removing \$5,475 in accounts payable from the project's books and records and take appropriate action to prevent future payments of non-project-related legal expenses. Further, we recommend that HUD determine the disposition of \$85,062 in escrowed funds set aside for the developer-related lawsuit. HUD should consider removing the funds from the project's books and records so that the encumbered funds will be available for paying operating expenses. In addition, the owner and agent should be required to negotiate a management fee that is reasonable and commensurate with the services provided, and reimburse the project from nonproject funds for the excessive supervisory salary paid.

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 February 6, 2007. Agent officials did not agree with the findings and provided their written comments during the exit conference. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix C of this report.

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BACKGROUND AND OBJECTIVES

Peregrine's Landing, a New York State limited liability company (LLC), was organized on September 28, 2001, for the purpose of establishing, maintaining, and operating a 100-unit enriched housing facility located in Cheektowaga, New York, known as Peregrine's Landing Senior Community (project). Peregrine's Landing, LLC, operates under the provisions of Section 232 of the National Housing Act with mortgage insurance provided by the U.S. Department of Housing and Urban Development (HUD). The project (Project No. 014-43146) began its operations on January 16, 2004, when the owners received partial permission to occupy; however, construction was not completed until February 11, 2004.

Peregrine's Landing, LLC, entered into a management agreement with Peregrine Health Management Company (agent) to administer, manage, and supervise the project's residents for a 15-year period commencing with the month of occupancy. The management fee for these services was \$95,833 in 2004, \$225,000 in 2005, and is to increase by 3 percent each year thereafter, payable in equal monthly installments.

A lawsuit involving the owner and agent and an on-going lawsuit involving the developer could affect the success of the project (see appendix E).

The objectives of our audit were to determine whether the complaint allegations were valid and whether the agent used project funds in accordance with its regulatory agreement and HUD requirements.

RESULTS OF AUDIT

Finding 1: The Agent Used Project Funds to Pay Questionable Expenses That Were Not Necessary or Reasonable for Project Operations

The agent used \$116,798 in project funds to pay expenses that were ineligible, unsupported, and/or unnecessary/unreasonable. These expenses were paid during the period between December 23, 2003, and May 31, 2006, and were associated with (a) non-project-related legal fees, (b) project employee incentives, (c) consulting fees, (d) travel expenses, (e) cellular telephone fees, and (f) accounting fees. Further, project funds are being encumbered, as \$50,000 in funds held in escrow, a \$35,062 bond and interest payable, and a \$5,475 account payable are slated to be used to pay legal fees in non-project-related lawsuits. These problems occurred because the agent believed the charges were project related and not the responsibility of the agent. Consequently, the project may have been deprived of \$207,335 in funds that could have been used for reasonable and necessary operating expenses.

Non-Project-Related Legal Fees Were Charged to the Project

Legal fees of \$53,908 were paid by the agent from project funds for non-project-related lawsuits. Based on a May 12, 2003 file date, legal action was taken by the original lender against the developer of the project related to the financing of the project during development. The developer has an identity-of-interest relationship with the agent. As a result, the agent used project funds to pay litigation fees incurred totaling \$11,563. Since this lawsuit did not relate to project operations, the fees paid should be repaid to the project. In January 2005, the owner attempted to replace the agent with a new management entity (see appendix E). Consequently, the agent took legal action against the owner. The agent used \$42,345 in project funds to pay its portion of the expenses incurred as a result of the litigation. This represents an ineligible expense, and the \$42,345 should be reimbursed to the project from nonproject funds. In addition, the agent recorded an account payable of \$5,475 for the owner's portion of the fees that were incurred as a result of the litigation. Paragraph 9(c) of the agent's regulatory agreement with HUD provides that costs should be reasonable and necessary. Further, paragraph 4 provides that the agent should not encumber the project without HUD's approval (see appendix F). Since this payable is not related to the project, it is an ineligible project expense that should be removed from the project's books. If any of these legal fees have been paid since the date of our field work, HUD should pursue recovery of this amount.

Further, \$50,000 in project cash is being held in an escrow account, and \$25,000 in bonds payable was set aside for potential settlement of the lawsuit against the

developer. As of November 30, 2006, accrued interest payable on the bonds totaled \$10,062. HUD needs to make a determination as to whether the \$50,000 in escrow is project funds and therefore should be obtained from the title agent and returned to the project's operating account. In addition, HUD should determine whether the \$25,000 bond and \$10,062 bond interest payable should be removed from the project's books and records, as these amounts are encumbering the project and appear to be the responsibility of the owner. This would allow \$85,062 in encumbered ineligible funds to be available for paying operating expenses.

Expenditures for Project Employee Incentives Were Charged to the Project

Project employees received incentives totaling \$17,820 from the project's operating account. These special incentives included grocery store gift certificates, Christmas bonus checks, Christmas events, pizza and happy hour parties, and other incentives for the employees of the project. These incentives represent expenses unnecessary for project operations. The \$17,820 is ineligible and unreasonable; therefore, the agent should reimburse this amount to the project from nonproject funds.

Unnecessary Consulting Fees Were Charged to the Project

On November 28, 2005, the agent contracted the services of a consultant to function as an assistant on-site coordinator to provide additional supervisory services for the project, such as administration and management of project employees. The consultant performed services at the project for approximately three months from December 2005 through February 2006 and was paid from project funds. Through interviews with the agent and its employees, we determined that the consultant was actually contracted for the purpose of gaining experience for future employment at another project managed by the agent. The services provided by the consultant were a duplication of the services provided by the on-site coordinator employed full time by the project. As a result, \$9,754 in consulting service costs represents an unreasonable charge to the project and should be reimbursed from nonproject funds.

Travel Expenses Were Charged to the Project

During the period between January 22, 2004, and November 22, 2005, project funds were used to pay travel expenses for an employee of the agent. Examples of the travel expenses include overnight stays at hotels, mileage, tolls, and other travel-related expenses. Since these travel expenses were incurred by an employee of the agent, they should not have been paid from project funds. A total

of \$484 in ineligible costs was charged to the project and should be reimbursed from nonproject funds. Questionable travel expenses were also incurred by employees of the project. These expenses were for project employees to travel for meetings at the agent's office and to other projects managed by the agent. Contrary to HUD regulations, the agent could not provide adequate supporting documentation to demonstrate how these travel disbursements benefited the project or whether they were for necessary and reasonable operating expenses. Therefore, the expenses totaling \$2,109 are considered unsupported costs. We are requesting that the agent provide support for these expenses so that HUD can make an eligibility determination. The agent should be instructed to reimburse the operating account from nonproject funds for all expenses determined to be ineligible.

Cellular Telephone Fees Were Charged to the Project

Project funds were used to pay for cellular telephone service for an employee of the agent. The monthly fees totaled \$1,104. The fees incurred associated with this employee's cellular telephone use are the responsibility of the agent. Consequently, the \$1,104 represents an ineligible project expense and should be reimbursed from nonproject funds. Also, \$1,295 in project funds was used to pay for additional use and overage charges for project employees' cellular telephones. These funds represent unnecessary charges to the project that the agent should reimburse from nonproject funds.

Unnecessary and Unreasonable Accounting Fees Were Charged to the Project

Unnecessary and unreasonable accounting and auditing fees in the amount of \$30,324 were paid with project funds during the period between January 24, 2005, and May 31, 2006. Fees in the amount of \$23,655 were paid to the independent public accountant contracted by the agent to perform corrections and revisions to the project's internal financial statements. The corrections and revisions to the statements and cost certification schedules were done in preparation for audits. The amount of \$23,655 is considered excessive compared to having the adjustments performed by employees of the project. The fees also include \$6,669 in salary for an accountant whose services were contracted by the agent on March 15, 2006, to prepare the books and records for the 2005 financial audit. The \$30,324 is an unnecessary and unreasonable project cost because the adjustments to the general ledger were not recorded in a timely manner. These costs were for additional services that should not have been necessary.

Conclusion

The agent did not expend project funds in an efficient and effective manner. Consequently, the project was deprived of \$116,798 due to questionable expenditures (see appendix D). Further, \$5,475 in accounts payable should be removed from the projects books and HUD needs to make a determination whether \$85,062 in encumbered funds (consisting of \$50,000 held in escrow, a \$25,000 bond, and \$10,062 in accrued bond interest) should be returned to the project and/or removed from the project's books and records. This would allow the encumbered funds to be available to pay for operating expenses.

Recommendations

We recommend that the director of the Buffalo Office of Multifamily Housing instruct the owner and agent to

- 1A. Develop procedures to ensure compliance with all terms and conditions of its regulatory agreement and HUD rules and regulations that require project funds to be expended only for reasonable and necessary expenses. The procedures should also ensure that adequate supporting documentation for expenses is obtained and maintained.
- 1B. Reimburse the project's operating account from nonproject funds \$83,070 for ineligible costs (\$53,908 for legal fees, \$17,820 for employee incentives, \$9,754 for consulting fees, \$484 for travel expenses, and \$1,104 for cellular telephone expenses (see appendix D)).
- 1C. Provide supporting documentation for the \$2,109 in unsupported employee travel expenses that was charged to the project so that HUD can make an eligibility determination. If any of the amounts are deemed ineligible, the agent should be instructed to reimburse the operating account from nonproject funds.
- 1D. Take appropriate action to prevent payment of non-project-related legal expenses after our audit period, including the payment of the questionable accrued payable of \$5,475. This payable should be removed from the projects books and if any non-project-related legal expenses have been paid, the agent should be instructed to reimburse the operating account from nonproject funds.
- 1E. Reimburse the project's operating account from nonproject funds \$31,619 for unnecessary costs (\$1,295 in unnecessary cellular telephone expenses and \$30,324 in unnecessary accounting services costs (see appendix D)).

We also recommend that the director, Buffalo Office of Multifamily Housing,

- 1F. Determine the disposition of the escrowed funds and bonds (consisting of \$50,000 in cash, a \$25,000 bond and \$10,062 in accrued bond interest) set aside for the developer-related lawsuit. After determining the proper disposition of these funds HUD should determine whether to remove the funds from the project's books and records. This would allow \$85,062 in encumbered funds to be available for paying operating expenses.

Finding 2: Excessive Management Fees Were Collected from the Project

During the period between January 1, 2004, and April 30, 2006, the agent collected excessive management fees from the project. We attribute this deficiency to a negotiated management fee that exceeded the amount ordinarily paid for such services. In addition, the management contract did not provide for a fee that was consistent with the scope of services that were to be provided. As a result, the project was deprived of \$72,740, which could have been used for necessary and reasonable operating expenses.

The Owner and Agent Entered into a Fixed Fee Contract

Initial drafts of the proposed management agreement presented to HUD and the Internal Revenue Service provided for a proposed management fee equal to 6 percent of gross revenue annually, payable in 12 monthly installments. However, the Internal Revenue Service issued Revenue Procedure 97-13 regarding federal tax limitations that apply to management contracts between for-profit managers and not-for-profit owners. These regulations provided that the longest allowable term of a contract, including all renewal options, is 15 years. In addition, at least 95 percent of the compensation must be based on a fixed fee. The management agreement was revised, and on November 20, 2002, the agent and owner entered into a 15-year fixed fee management contract. The contract provided that the agent would be paid a management fee each month commencing the month the certificate of occupancy for the project was received. The fee would be prorated monthly on the following yearly pay schedule: \$100,000 in year one, \$225,000 in year two, and a 3 percent increase in the management fee annually from year three through the term of the contract.

Comparable Management Fees Did Not Exceed 6 Percent

The management fees collected by management companies of assisted living facilities of comparable size did not exceed 6 percent of gross revenue. We examined the contracts of four different management companies at three projects located in the area and found that these management fees were equivalent to between 4 and 6 percent of gross annual revenue. One management company's fee was 4 percent of gross revenue because it did not provide human resources as part of its scope of services. Our interview with an official of the management company indicated that its fee would have been closer to 6 percent if it provided such services.

The agent collected management fees in excess of 6 percent of gross annual revenue in years 2004 and 2005, which does not appear to be reasonable. The agent collected management fees equivalent to 6.8 percent of gross annual

revenue in 2004 and 7.8 percent in 2005. The management fee for 2006 is projected to be 6.8 percent of gross annual revenue. HUD officials concurred that the management fees collected by the agent should be renegotiated to reflect an amount comparable to the examples cited above.

The Management Fee Was Not Consistent with the Scope of Services Provided

The agent provided fewer services than comparable management companies that were being paid less as a percentage of gross annual revenue. For example, other management companies provided bookkeeping services. The contract for one comparable management company, which received 4 percent of gross annual revenue in fees, included a provision pertaining to the maintenance of complete and accurate books, records, and accounts in a manner reasonably satisfactory to the owner and in accordance with generally accepted accounting principles. The contract for another comparable management company, with a management fee of 5 percent of gross annual revenue, provided for an average of 45 hours per month of bookkeeping services.

The agent's contract did not require the agent to provide bookkeeping services as part of its fee. The contract only provided for the agent to establish accounting system procedures with respect to the project's books, accounts payable and receivable, ledgers, and other primary accounting records of the project. Further, the agent would train and supervise personnel in keeping and verifying the accuracy of the operating records. Thus, contrary to paragraph 9(c) of the regulatory agreement, which provides that payments for services shall not exceed the amount ordinarily paid for such services in the area where the services are rendered, the management fee paid to the agent was not consistent with the scope of services provided.

Excessive Management Fees of \$72,740 Could Have Been Avoided

During the period between January 2004 and April 2006, the agent was paid \$398,083 in management fees, which represents 7.3 percent of gross annual revenue. A management fee of 6 percent of gross annual revenue would have been more reasonable based on the initial management fee proposals and an analysis of comparable management companies. Management fees would have been \$325,343 at 6 percent of gross revenue. Thus, \$72,740 in management fees could have been avoided.

Year	Total gross revenue	Management fee paid	6 percent management fee	Excessive amount
2004	\$1,404,198	\$95,833	\$84,252	\$11,581
2005	\$2,877,651	\$225,000	\$172,659	\$52,341
2006	\$1,140,540	\$77,250	\$68,432	\$8,818
Total				\$72,740

Conclusion

The fixed fee management contract did not provide for a management fee that was consistent with comparable management contracts. As a result, the project was deprived of \$72,740 in project funds that could have been used for necessary and reasonable operating expenses. HUD agrees that the management fees are excessive and not consistent with other comparable projects; however, they believe that it is unrealistic to require repayment for the previously collected fees. HUD agrees that the management agreement should be renegotiated to reflect fees that are more comparable to the industry. As such, a reduction in the management fee would result in a cost savings of \$25,974 annually. The amount represents one year of management fees based on the management agreement, less the management fee calculated at 6 percent of gross revenue. The gross revenue amounts were obtained from the agent.

Recommendations

We recommend that the director of the Buffalo Office of Multifamily Housing instruct the owner and agent to

- 2A. Negotiate a management fee that is reasonable and commensurate with the services that are provided. The management fee should not exceed an amount ordinarily paid for such services, resulting in \$25,974 in cost savings.

We also recommend that HUD

- 2B. Review and approve the negotiated management fee to ensure that it is reasonable in relation to the services provided to the project.

Finding 3: The Agent Charged One Employee's Salary and Benefits to the Project

The agent used project funds to pay the salary and benefits of one of its employees. These expenses totaled \$39,711 and were incurred during the period from January 1, 2004, through April 30, 2006. This occurred because the agent circumvented HUD regulations regarding charging agent salaries to the project. Consequently, the project was deprived of \$39,711 in funds that could have been used for reasonable and necessary operating expenses.

Salary and Benefits of an Agent Employee Were Charged to the Project

The agent employed a project coordinator to perform supervisory services related to each of the agent's projects, one of which was Peregrine's Landing Senior Community. The supervisory services performed consisted of managerial-related duties, including overseeing financial transactions, approving purchases, performing quality assurance reviews, and overseeing personnel and the human resources function. However, the agent charged a portion of this employee's salary to the project as if this person were an employee of the project. Since the employee's duties as an employee of the project were not defined, we could not determine what services were provided for the \$39,711 that was charged to the project during the period.

HUD Handbook 4381.5, REV-2, provides that the management agent must absorb the costs of supervising and overseeing project operations from the management fee. Further, paragraph 9(c) of the regulatory agreement provides that the owner shall make no payment for services unless such services are actually rendered for the project and are reasonably necessary for its operation. Since the project coordinator is a member of the management agent's supervisory staff, the management agent circumvented HUD regulations by making this supervisory staff member an employee of the project to charge a portion of the employee's salary costs to the project.

The agent believed that the employee's responsibilities were specific to the project and that charging a portion of the employee's salary and benefits to the project was justified. However, the agent could not define the employee's job title or responsibilities as they related to the project. Consequently, the specific affiliation this employee had with project could not be determined.

Conclusion

The agent used project funds to pay a portion of the salary of one of its employees. Consequently, the project was deprived of \$39,711 in funds that could have been used for reasonable and necessary operating expenses. Therefore, if the agent ceases to charge a portion of this employee's salary to the project, a cost savings of \$15,886 can be realized. This amount represents one year of this employees biweekly salary.

Recommendations

We recommend that the director of the Buffalo Office of Multifamily Housing instruct the owner and agent to

- 3A. Reimburse the project's operating account from nonproject funds \$39,711 for ineligible costs related to the employee's salary that was charged to the project.
- 3B. Take appropriate action to ensure that the agent's employee salaries are not charged to the project in the future. By ceasing to charge this employee's salary to the project, a cost savings of \$15,886 per year will be realized.

SCOPE AND METHODOLOGY

Our review focused on whether the agent used project funds in accordance with its regulatory agreement and HUD requirements. To accomplish our objectives, we interviewed the complainant and HUD officials. In addition, we reviewed the regulatory agreement, applicable HUD regulations, the agent's certification, and the certifications of comparable agents. We reviewed the project's financial records and the audited financial statements prepared by the project's independent public accountant. We also reviewed information obtained from HUD's Real Estate Management System and Financial Assessment Subsystem.

The review covered the period January 1, 2004, through April 30, 2006, and was extended as necessary. We performed our audit work from May through October 2006 at the offices of the agent located in Syracuse, New York, and the project located in Cheektowaga, New York.

The review was conducted in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal controls were relevant to our audit 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 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 the following items are significant weaknesses:

- The agent did not have an adequate system to ensure compliance with laws and regulations relating to the payment of non-project-related costs and the collection of excessive management fees (see findings 1 and 2).
- The agent did not have an adequate system to ensure that resources were properly safeguarded when it charged questionable expenditures and salary costs to the project (see findings 1 and 3).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Unreasonable or unnecessary 3/	Funds to be put to better use 4/
1B	\$83,070			
1C		\$2,109		
1D	\$5,475			
1E			\$31,619	
1F				\$85,062
2A				\$25,974
3A	\$39,711			
3B				\$15,886
Total	\$128,256	\$2,109	\$31,619	\$126,922

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 polices 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 audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

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

4/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes cost reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. In this instance, if the agent implements our recommendation by negotiating a management fee that is commensurate with the services provided and ceases to charge the salary of the agent employee to the project, it will ensure a cost savings.

Appendix B

SUMMARY EVALUATION OF COMPLAINT ALLEGATIONS

Allegation 1

The complainant alleged that the agent used project funds to pay the private school tuition for the child of an employee.

Evaluation – This allegation is not valid. The agent did not pay the private school tuition costs of an employee’s child using project funds. The payment of the tuition was in the form of the employee’s compensation and not in addition to the employee’s salary. The employee elected to have a portion of the employee’s salary direct deposited to the school for the period September 2004 through April 2005. We do not take exception to the agent’s direct depositing a portion of the employee’s salary to the school to cover tuition costs.

Allegation 2

The complainant alleged that the agent used project funds for non-project-related lawsuits.

Evaluation – This allegation is valid. The agent paid \$11,563 in legal fees to defend a lawsuit between a former mortgagee and an entity unrelated to the project. In addition, the agent has restricted the use of \$50,000 in project funds and is holding \$35,062 in a bond and interest payable along with a \$5,475 account payable to be used to settle this dispute. The agent also paid \$42,345 in legal fees to defend itself in a lawsuit between the agent and the owner of Peregrine’s Landing, LLC. We take exception to the use of project funds for non-project-related lawsuits. The costs incurred for non-project-related lawsuits should not be borne by the project (see finding 1).

Allegation 3

The complainant alleged that the agent used project funds to pay salary to a former employee.


Evaluation – This allegation is not valid. Based on our review of the general ledger, payroll liabilities, and office salaries expense accounts, no material deficiencies were noted. The employee identified in the complaint was fired in 2005, and did not receive any further compensation from the project.

Appendix C

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments


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February 6, 2006

Ms. Karen Campbell
Regional Inspector General for Audit, 2AGA
U.S. Department of Housing and Urban Development
Office of Inspector General
26 Federal Plaza, Room 3430
New York, NY 10278-0068

Re: Response of Peregrine Health Management Company to Audit Report under cover of January 18, 2006

Dear Ms. Campbell:

By this letter, Peregrine Health Management Company (hereinafter "Management"), the Auditee, submits its response to be incorporated in its entirety as Appendix C to the Draft Audit Report (hereinafter "Report") submitted under cover of January 19, 2007. While, I respectfully disagree with the Report's findings and conclusions, I was very impressed by its thorough and sensitive analysis, as befitting your very professional staff. Allow me to say at the outset, I feel vindicated by your Report, as it was prompted by malicious accusations brought by [REDACTED] whose claims, in my opinion, violated a Temporary Restraining Order against interfering and undermining Peregrine Health Management Company's management of Peregrine's Landing Senior Living Community. Contrary to [REDACTED] explicit claim that I was embezzling funds for gain, your Report clearly concludes that I never directly or indirectly took personal advantage of my position with Peregrine's Landing.

Furthermore, I would like to add that while the Report is silent as to the quality of our management performance, allow me to mention that under our leadership, Peregrine's Landing has been a remarkable financial success, as evidenced by our dramatic lease up rate, the current 110% occupancy rate, and its waiting list, to say nothing about the quality of life of our residents enjoy and accolades we have received from The New York State Department of Health.

Turning now to the substance of the Draft Report, I will follow its order of findings in my response.

Finding 1: The Agent Used Project Funds to Pay Questionable Expenses That Were Not Necessary or Reasonable for Project Operations

Comment 1

Appendix C

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

Comment 1

Karen Campbell
Response of PHMC to Audit Report
February 6, 2007
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Non-Project-Related Legal Fees Were Charged to the Project:

The paragraph completely misstates facts and confuses issues. Based on the May 7, (not May 12), 2003, Summons and Complaint in the matter AMI Capital, Inc. v. Peregrine Development Corporation, Peregrine's Landing, LLC and Stephen S. Bowman, AMI sought payment of financing fees with regard to project acquisition of property and construction of the Peregrine's Landing facility. The fact that Peregrine Development Company was party to the lawsuit is irrelevant. The HUD-approved Management Agreement between Peregrine Health Management Company and Peregrine's Landing, LLC states at paragraph 4.1(f) regarding permissible expenses:

Expenses connected directly or indirectly with the design, acquisition, disposition and/or Operatorship of real and personal property devoted to, used or consumed in the business of the Facility. Such Facility expenses include, but are not limited to: property acquisition; construction; maintenance; repair; improvements; cost of premiums and/or liability insurance; brokerage commissions; consultant fees and expenses; independent contractors or agents; legal fees; equipment acquisitions; sale, mortgaging or leasing of Facility; and, any litigation or proceeding involving Facility or to which Operator is a party.

Based on the foregoing, any legal fees incurred with respect to AMI v. Peregrine Development, et al. are project expenses. There is no other legal interpretation.

Comment 2

The \$50,000 in project cash and \$25,000 in project D Bonds in escrow and which pertain to the lawsuit, were and remain properly escrowed following Initial Endorsement, when AMI refused those sums as payment of its financing fee, claiming greater payment was owed. At Final Endorsement, the HUD Secretary validated the continued encumbrance of the project for the purpose of reserving payment to AMI of the financing fees that were established at Initial Endorsement pending resolution of the lawsuit, by which satisfaction of AMI's claims presumably would be met. However, the matter has not yet been dismissed and therefore, the escrow agent has no instrument by which it is authorized to release the sums back to the project. As to \$10,062 in interest on the \$25,000 D bonds held in escrow until the matter is dismissed, management believes any liability related to D bonds should be recorded in the books and does not understand the Report's conclusion otherwise.

Comment 3

Regarding the lawsuit Peregrine Health Management Company, et al v. Peregrine's Landing, LLC and Barton Feinberg, Peregrine's Landing had to defend itself, and did so, which automatically qualifies legal expenses incurred in that defense as an eligible project expense. The settlement agreement reached in the matter required payment of all legal fees of all parties. Therefore, all legal and filing fees regarding the matter, past, present and future, are legitimate project expenses. There is no other legal interpretation.

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Furthermore, it should be noted that the accounting firm, Grimaldi & Nelkin, that completed the 2005 year-end audit for The Department of Housing and Urban Development, concluded the legal fees and interest were recorded properly. It should be also kept in mind that if a settlement agreement had not been reached, Peregrine Health Management Company would have pursued legal fees from Peregrine[s] Landing as remedy against damages incurred as a result of improper actions taken against it by Peregrine's Landing, LLC. It is Management's opinion that the latter course of action would have impacted the projected far more severely.

Comment 4

Expenditures for Project Employee Incentives Were Charged to the Project:

Regarding employee compensation, where does HUD draw the line? Would a company contribution to 403(b) plan or increased company health insurance contributions be non-project expense? Management is always struggling to retain employees. Employee bonuses and incentives are utilized as standard retention practice within the health care industry and the long-term care field specifically. Peregrine Health Management Company currently manages seven other facilities in New York State and provide in each of those facilities Christmas bonuses and incentives to improve morale and retain employees throughout our facilities. Recent examples are: pizza for employees who stayed overnight during the recent storm; lunch for staff who were mandated to stay double shifts because a flu epidemic ravaged residents and staff alike (please see the attached letter from a grateful family member). Bonuses and/or incentives are not windfalls for anyone. We believe employee incentives are a cost-effective form of compensation. If you compare our salaries at Peregrine's Landing to other like facilities in Western New York, they are among the lowest. The use of bonuses has been very effective at Peregrine's Landing in retaining good staff inexpensively. Considering that \$17,820 shared by 75 employees over 24 months for an average of \$90 per year per employee in staff recognition events, gift card to buy a Thanksgiving turkey, or company co-pay toward a Christmas party, HUD's interpretation of regulatory language to disallow the practice is petty, indeed. If you translate \$17,820 into two years of hours by hourly workers (staffing approximately 1500 hours per week), the bonuses equate to roughly \$.11 per hour. The employees are much more gratified by recognition for extraordinary service and sense of teamwork than they are by \$.11 an hour. I believe the auditors are out of their realm of expertise in making any conclusion regarding how to retain good employees. Had we followed a strategy of paying more wages to attract staff, the project would have spent far more than \$.11/per hour per employee. If we are mandated to cease employee Christmas parties, service recognition events, occasional pizza for gratis meals for mandated double shifts, etc., I promise the result would be a migration of qualified staff to other facilities that have incentive programs -- not only would we have to spend significant sums to regain and retrain staff, we will set a new precedent of being an uncreative and un-dynamic place to work. It should also be recognized that abandoning the incentive practice would require re-issuance of the Employee Handbook, wherein recognition incentives are discussed. I strongly recommend against HUD becoming the enforcer of the ban on employee incentives. In any event, Management should not be required to

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reimburse the project retroactively, since the project has received the benefit of the good will of its employees resulting from the incentive practice, and Management did not profit materially in any way.

Unnecessary Consulting Fees Were Charged to the Project:

Clearly the HUD-approved Management Agreement permits Management to retain consultants as needed (see paragraph 4.1 f). The consulting services in question were needed at a time when the Marketing Director/Admissions Director, [REDACTED], was out on maternity leave, and [REDACTED] was only working part time in case management. At that time, we were in need of support with case management and Quality Assurance and for a brief period of time utilized consultant services. Again, consulting services are clearly permitted under the Management Agreement.

Comment 6

Travel Expenses Were Charged to the Project:

Reimbursing employees at Peregrine's Landing while they travel to the Syracuse office is an eligible project expense and a necessary cost of doing business. Employees often travel to Syracuse or other locations for training, budget preparation, care and policy forums, etc. To deny this reimbursement, would be inconsistent with HUD's own travel reimbursements that I'm sure are made for their Auditors when they travel to Syracuse to review our files.

Comment 7

Celluar Telephone Fees, \$1,295.00:

In today's day and age, cell phones are a very standard expense to operate a facility successfully.

Comment 8

Accounting Fees, \$30,324.00:

Accounting consulting is a permitted expense under the HUD approved Management Agreement, as I am sure the HUD Buffalo office will confirm. The demands of Peregrine's Landing financing structure made for a remarkably complicated accounting challenge, far beyond the industry norms.

Comment 9

Conclusion, Finding 1

Peregrine Health Management Company paid project expenses efficiently and effectively as required. The project was not deprived of \$116,798 as those sums were spent on necessary project costs. Further, the \$90,537 noted as encumbered funds was approved by the Secretary, the funds must continue to be held in escrow pending dismissal of the underlying matter, and the interest noted is a project liability and recorded appropriately.

Comment 10

Recommendations Re Finding 1

1A. Peregrine Health Management Company is always expanding and developing procedures to ensure compliance with terms of the regulatory agreement and HUD rules and regulations. It believes it continues to make strides in this regard. Peregrine

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Health Management has in place supporting documentation procedures that are effective and which support all expenses.

1B. All of the items noted are legitimate project expenses and should not be reimbursed to the project.

1C. The \$50,000 in cash and \$25,000 in D Bonds (payable to AMI) must remain in escrow until the matter AMI v. Peregrine Development Company, et al., is dismissed. Accordingly, interest accruing on the D Bonds reserved for that purpose is recorded correctly.

1D. Attached is supporting documentation regarding the \$2,109 employee travel expenses.

1E. Legal expenses regarding all matters noted are project related.

1F. The costs, phone and accounting expenses noted are eligible project expenses and should not be reimbursed to the project.

Finding 2: Excessive Management Fees Were Collected from the Project

The Owner and Agent Entered into a Fixed Fee Contract

The management fee is fixed and is proper. As evidenced by the attached letter from legal council Attorney [REDACTED], initially it was proposed that Peregrine Health Management would receive a 6% gross revenue for the facility, however, both the Internal Revenue Service and the New York State Department of Health insisted on a flat fee structure. The fee stated in the Management Agreement was approved by HUD, the New York State Department of Health, and the Internal Revenue Service. Any attempt to recover fees paid according to terms of a valid and legally binding Management Agreement because of audit opinions rendered on what the fee structure should have been has no merit and is not enforceable.

Comparable Management Fees Did Not Exceed 6 Percent

Since a percentage fee was disallowed by both the IRS and the Department of Health, the flat fee stated in the agreement was based on an estimate of projected revenue. While I concede our fee exceeds 6% of the current gross revenue, it is a moot discussion in any event, as the contract is a legal document, reviewed and approved by HUD prior to initial endorsement and execution, and there was no contingency for recalculating the fee. Further, there may be a point in time when the fee is less than 6% of gross revenues. It is disingenuous of HUD or its auditors to require that we now: a) renegotiate the fee; and b) pay back any sums based on after-the-fact conclusions of what the fee should have been. I must reiterate, the Management Agreement was meticulously scrutinized by the reviewing officers at the Buffalo HUD office including [REDACTED] and [REDACTED], the New York State Department of Health, and the

Comment 11

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Internal Revenue Service. As a consequence, the Audit Report has no standing to render any opinion regarding the fee structure.

The Management Fee Was Not Consistent with the Scope of Services Provided

The auditors suggest that the scope of services provided are not comparable to those provided by other management companies for other owner/operators. Any discussion of property fees as it pertains to other projects is irrelevant. Bookkeeping expenses are permissible as stated in paragraph 9(c) of the Regulatory Agreement. Furthermore, the bookkeeper of the property is an employee of Peregrine's Landing and not of Management. The management fee charged is in accordance with the approved Management Agreement and is therefore appropriate.

Excessive Management Fees of \$72,740 Are Questionable.

The argument presented in this section is duplicative of argument noted earlier. The fees charged are in accordance with the Management Agreement and are therefore eligible project expenses.

Conclusion, Finding 2

The management fee charged is in accordance with the approved Management Agreement and is therefore appropriate, legally enforceable, and eligible as a project expense.

Recommendations, Finding 2

2A. The project should not be reimbursed from non-project funds the amount of \$72,740 as the project was properly charged management fees in accordance with the approved, executed Management Agreement.

2B. The Management Agreement is a valid contract approved by HUD at Initial Endorsement. Fees as stated therein are appropriate project expenses.

2C. The fee in the Management Agreement was reviewed and approved by HUD. It cannot now void a valid, approved, enforceable agreement.

Finding 3: The Agent Charged One Employee's Salary and Benefits to the Project.

Salary and Benefits of an Agent Employee Were Charged to the Project:

Peregrine Health Management Company placed a corporate employee on the Peregrine's Landing payroll to offset approximately 25% of the employee's salary for services rendered to Peregrine's Landing, initially in the performance of bookkeeping duties, but subsequently to handle human resources and risk management tasks, which are clearly not part of the Manager's responsibility. The business reason was simply an economic one. If we didn't use 25% of one of our off-site employees to provide these specific services, an additional full-time position would have been required on-site at a

Comment 12

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substantial increase in expense to the facility. The operator was aware of the decision as the employee in question has always been present on the employee roster, and the position itemized in the budget. Until this Report was produced, there have been no objections of this arrangement by the HUD Western New York office, Peregrine's Landing, LLC, or independent auditors, as all parties in question understood the economic benefits to Peregrine's Landing.

Conclusion, Finding 3:

The employee's salary is an appropriate project expense.

Recommendations, Finding 3:

3A. The project should not be reimbursed from non-project funds as it had the benefit of services rendered by the employee as a project eligible expense.

3B. The agent's employee's salaried work for the project was an eligible project expense. No agent employees are receiving compensation for non-project expenses.

Internal Controls: Significant Weaknesses:

In this section, the report concludes:

- The agent did not have an adequate system to ensure compliance with the laws and regulations relating to the payment of non-project-related costs and the collection of excessive management fees (see findings 1 and 2).
- The agent did not have an adequate system to ensure that resources were properly safeguarded when it charged questionable expenditure and salary costs to the project (see findings 1 and 3).

As noted in responses to Findings 1, 2 and 3, above, Peregrine Health Management Company acted appropriately in all matters. Property was safeguarded and expenses paid were legitimate project costs. Consequently, the findings stated regarding control are based on unsubstantiated opinion.

Appendix A.

Peregrine Health Management does not understand the value of a table that attempts to characterize project expenses in different shades of questioned costs when all expenses noted are eligible project expenses.

Appendix B

Allegation 1: Management agrees with the Report's conclusion.

Allegation 2: Management disagrees with the Report's conclusion. The allegation has no merit as expenses incurred regarding the lawsuits in question were entirely project related.

Comment 13

Comment 14

Comment 15

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Allegation 3: Management agrees with the Report's conclusion.

Comment 16

Appendix D – Summary of Ineligible, Unsupported, and Unnecessary Expenditures.

Peregrine Health Management Company states that all the expenses listed are appropriate project expenses.

Appendix E – Project Owner and Agent Relationship

The Temporary Restraining Order in the [REDACTED] matter speaks volumes as to the competence of the sole owner Peregrine's Landing, LLC, The Bennett Feinberg Foundation, and more specifically as to [REDACTED]. He has acted irresponsibly and without regard to the residents of the program, a conclusion also drawn by the Court. The Court has upheld Management's position in all respects.

I unequivocally stand behind any management decisions I have taken. Management has always acted in furtherance of the project's long-term goals. Additionally, Peregrine Development's significant investment in the project motivates me to insure the project is successful. I have every reason to believe that the contentious differences between owner and manager were resolved through legal settlement. In short, I believe in the financial and program viability of this project and am committed to its success.

Comment 17

Appendix F – Criteria

- A. Management has complied with the cited regulatory agreement at paragraph (9)(c). More specifically, all payments for services are legitimate project expenses and do not exceed the amount ordinarily paid for such services. The Audit Report's attempt to apply the language of this regulatory paragraph retroactively to an existing Management Agreement is not valid. Clearly the language was meant to regulate payment of day-to-day expenses of service providers. Management's fee was approved as a project expense at the outset and should not be renegotiated or penalized four years after it was approved.
- B. Management has complied with the cited regulatory agreement at paragraph (4)(a). More specifically, the project was not encumbered without HUD's knowledge, as the sums escrowed were noted in both cost certification and Final Endorsement, and carried forward on the project books since Final Endorsement.
- C. Management has complied with the cited regulatory agreement at paragraph (4)(b). More specifically, it has not assigned, transferred, disposed of, or encumbered any personal property of the project without the prior written approval of the secretary.
- D. Management has complied with the HUD Handbook 4370.2, REV-1, CHG-1, "Financial Operations and Accounting Procedures for Insured Projects,"

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paragraph 2-6(e). More specifically, all disbursements are supported by approved invoices/bills or other supporting documentation.

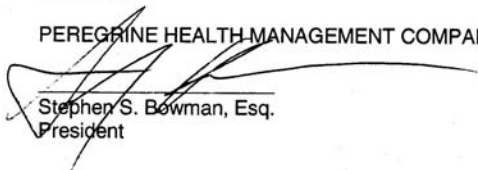
- E. Management attempted to comply with Internal Revenue Service Procedure 97-13, regarding federal tax limitations applicable to management contracts in that the longest allowable term of a contract, including all renewal options, is 15 years. However, HUD mandated the term of the agreement as a means to counter-balance the owner's (Peregrine's Landing, LLC) lack of experience.
- F. Management has complied with HUD Handbook 4381.5, "Management Agent Handbook," paragraph 3.1, which provides that the management agent must absorb the costs of supervising and overseeing the project operations from the management fee it receives. More specifically, the employer's services were not supervisory in nature, but were rendered as an employee of the project under the oversight of the administrator of the project, and not as an agent of Management. Additionally, it should be noted the employee was successful in a grant that resulted in a Department of Health award of \$65,588 to the project, more than returning the project's investment in her services.

Management's Conclusion

Although the Audit Report appears on its face to be substantial in its findings, a closer analysis reveals that its interpretations of regulatory paragraphs and HUD handbooks is flawed regarding the facts and existing agreements relevant here, and therefore its conclusions of impropriety are without merit. Peregrine Health Management Company did not use project funds for ineligible, unsupported and/or unnecessary costs. Nor did it encumber funds without the express permission of the Secretary to do so. Its management fee was approved by HUD, is appropriate, and is properly paid and expensed. The legal fees noted are eligible project expenses. Further, all the allegations which initiated the investigation are invalid. Consequently, Peregrine Health Management Company should not be required to reimburse any funds and, it has managed the Peregrine's Landing Senior Living Community asset substantially in compliance with all HUD regulations.

Sincerely,

PEREGRINE HEALTH MANAGEMENT COMPANY


Stephen S. Bowman, Esq.
President

Cc: Paul @ HUD c/o
Patrick Anthony

- Comment 1** The May 12, 2003 date used in the report pertains to the date for which the legal matter was filed. Further, the actions of the development company caused the legal expenses to be incurred. As such, this legal matter is between Peregrine Development Company and AMI Capital and does not relate to project operations. This is further evidenced by the August 3, 2005 court document that stipulated the release of all parties named in the lawsuit except Peregrine Development Company.
- Comment 2** As noted above, the lawsuit is against the developer. Further, we were not provided with evidence to support the claim that HUD validated the continued encumbrance of the project for purposes of reserving payment of financing fees to the lender. Placement fees of 1.5 percent of the loan amount were approved by HUD and paid to the lender, however the \$50,000 in cash and \$25,000 in D bonds and \$10,062 in bond interest are additional encumbrances payable to the project's original lender that HUD was not made aware, therefore HUD needs to determine the disposition of these encumbrances.
- Comment 3** It is our contention that the lawsuit did not pertain to the operations of the project. HUD Handbook 4370.2 REV-1 provides that the legal expense account, records legal fees or services incurred on behalf of the project (as distinguished from the mortgagor entity). For example, agents charge legal fees for eviction procedures to this account. Further, the regulatory agreement states that income and other funds of the project shall be expended only for the purposes of the project and the mortgagor shall make no payment for services...unless such services are reasonably necessary for its operation. The lawsuit between the agent and project owner is of a personal nature, as supported by agent official's description of the lawsuit in their response, whereas, officials for the agent refer to the legal matter as "contentious differences between owner and manager" (see page 27). Thus, the \$42,345 in project funds used to pay the agent's portion of legal fees should be reimbursed to the project, and the \$5,475 recorded as a payable for the owner's portion of the fees should not be paid and should be removed from the project's books.
- Comment 4** We do not discourage the agent from offering incentives to project employees, however, the incentives should not be paid from project funds. The employee incentives are unnecessary for project operations; thus, we consider the \$17,820 an ineligible expense.
- Comment 5** Our review determined that the nature of the work performed by the consultant was management related. Through interviews with the individual and agent officials, it was determined that the individual acted as an assistant on-site coordinator providing additional supervisory services for the project. The services provided were redundant and unnecessary, as the project has a full time on-site coordinator. Thus, the \$9,754 in consulting fees should be reimbursed to the project.
- Comment 6** The use of \$484 in project funds to reimburse employees of the agent for travel is an ineligible use of project funds, whereas the management agent should absorb

the costs incurred by its own employees. Further, costs incurred by employees of the project may be eligible project expenses; however, the nature of the \$2,109 in travel expenses incurred by employees of the project for travel to agent offices or other projects managed by the agent could not be determined from review of supporting documentation provided to us. As such, this amount has been deemed unsupported; agent officials need to provide HUD adequate supporting documentation so that HUD can determine whether the expenses were necessary for project operations. All expenses determined to be ineligible should be reimbursed to the project's operating account.

Comment 7 The \$1,104 in fees incurred by an employee of the agent are the responsibility of the agent and should not be paid from project funds. Further, the use of \$1,295 in project funds to pay additional use and overage charges in association with cellular service for employees of the project represents unnecessary expenses to the project since the charges represent fees over and above the monthly cellular service plan allowance.

Comment 8 The \$23,655 in accounting fees incurred by an independent public accountant to perform corrections to the project's financial statements and \$6,669 in salary for an accountant to prepare for the 2005 financial audit are considered unnecessary and unreasonable charges. These services should not have been necessary, or in the very least, if necessary, performed by project employees without incurring additional expenses to the project.

Comment 9 We disagree as per our comments above.

Comment 10 The agent did not expend funds in an efficient and effective manner, thus \$116,798 has been questioned. The agent did not adequately support the items in question and/or prove that HUD validated the continued encumbrance of the project via the bonds and interest. Lastly, in regards to the employee travel expenses, the supporting documentation provided with the auditee comments was the same documentation we reviewed while on-site, but which has been subsequently altered with handwritten annotations. As such, we conclude that no new documentation was provided to support whether the expenses were necessary and reasonable for project operations, thus the \$2,109 in employee travel expenses remain unsupported.

Comment 11 Based on the comparative analysis work we performed, it is evident that excessive fees were collected from the project. Specifically, management fees collected at comparable projects were between 4 percent and 6 percent of gross revenue, whereas the agent collected fees of 6.8 percent of gross revenue in 2004, 7.8 percent in 2005, and is projected to receive 6.8 percent in 2006. Further, the agent provided fewer services than the comparable management companies receiving less a percentage of gross revenue. This is clearly in violation of the regulatory agreement. The excessive \$72,740 in management fees could have been avoided. However, we have determined in conversations with HUD officials that it is unrealistic to require repayment for the previously collected fees pertaining to this situation. Therefore, we have revised recommendation 2A of

our report to recommend that the owner and agent be instructed to renegotiate a management fee that is reasonable and commensurate with the services that are provided. As such, a reduction in the management fee would result in a cost savings of \$25,974 annually to the project.

Comment 12 Our review determined that the responsibilities of this employee, performing in the capacity as the agent's project coordinator, included supervisory services for the project such as overseeing financial transactions, performing quality assurance reviews, and overseeing personnel and the human resources function. However, the responsibilities as an employee of the project were not adequately defined and/or could not be determined. As such, the \$39,711 in salary charged to the project is considered ineligible and should be reimbursed by the agent to the project's operating account.

Comment 13 The results of our audit determined that project funds were used to pay questionable expenses that were not necessary or reasonable for project operations, excessive management fees were collected from the project, and the agent charged one employee's salary and benefits to the project. Our findings are based upon our review of the regulatory agreement, applicable HUD requirements, the management agreement and certification, in addition to, documentation provided by the agent, including the project's financial records and the audited financial statements. Thus, our findings are not based on unsubstantiated opinion.

Comment 14 As detailed in findings 1 through 3 the expenses noted are not eligible project expenses. Appendix A categorizes the questioned costs in conjunction with the report's recommendations, and is a summary of the significance of these issues.

Comment 15 Our review determined that allegation 2 is valid, whereas the agent used project funds for non-project-related lawsuits. Accordingly, we concluded that costs incurred for non-project-related lawsuits should not be borne by the project (see finding 1).

Comment 16 We disagree as per our comments above.

Comment 17 We disagree as per our comments above.

Appendix D

SUMMARY OF INELIGIBLE, UNSUPPORTED, AND UNNECESSARY EXPENDITURES

Check date	Check number	Description	Ineligible @	Unsupported @	Unnecessary @
July 19, 2004	1379	Legal fees for developer lawsuit	\$ 5,000.00		
Jan. 12, 2005	1752	Legal fees for developer lawsuit	1,563.00		
Aug. 15, 2005	2205	Legal fees for developer lawsuit	5,000.00		
Jan. 04, 2006	2576	Agent's legal fees for owner/agent dispute	13,000.00		
Jan. 07, 2006	2524	Agent's legal fees for owner/agent dispute	27,843.00		
May 22, 2006	2939	Agent's legal fees for owner/agent dispute	<u>1,502.00</u>		
		Total legal expenses	\$53,908.00		
Dec. 23, 2003	1197	Lunch	60.00		
Jan. 10, 2004	Petty cash	Party supplies	26.00		
Jan. 10, 2004	Petty cash	Breakfast	8.00		
Jan. 10, 2004	Petty cash	Liquor	149.00		
Jan. 10, 2004	Petty cash	Lunch	21.00		
Jan. 10, 2004	Petty cash	Lunch	12.00		
Jan. 29, 2004	1009	Party supplies/food/liquor	472.00		
Feb. 25, 2004	Petty cash	Lottery tickets	20.00		
Mar. 31, 2004	Petty cash	Party supplies	9.00		
May 01, 2004	1023	Wedding gift	170.00		
May 28, 2004	Petty cash	Bonus gift certificates	60.00		
May 28, 2004	Petty cash	Lunch	41.00		
June 28, 2004	Petty cash	Bonus gift certificate	20.00		
June 28, 2004	Petty cash	Lunch	18.00		
July 25, 2004	Petty cash	Bonus gift certificate	40.00		
July 25, 2004	Petty cash	Lunch	40.00		
Sept. 17, 2004	1506	Lunch	49.00		
Sept. 17, 2004	1507	Lunch	22.00		
Sept. 30, 2004	1538	Lunch	33.00		
Sept. 30, 2004	Petty cash	Bonus gift certificate	20.00		
Oct. 29, 2004	Petty cash	Bonus gift certificate	20.00		
Nov. 11, 2004	1602	Christmas party	200.00		
Nov. 17, 2004	Petty cash	Bonus gift certificate	20.00		
Nov. 30, 2004	Petty cash	Christmas party	50.00		
Nov. 30, 2004	Petty cash	Party supplies	21.00		
Dec. 08, 2004	1669	Christmas gift cards	3,230.00		
Dec. 10, 2004	1688	Christmas bonus check	150.00		
Dec. 10, 2004	1690	Christmas bonus check	150.00		
Dec. 10, 2004	1691	Christmas bonus check	150.00		
Dec. 11, 2004	1608	Christmas party	1,824.00		
Jan. 05, 2005	1729	Gift	22.00		
Jan. 11, 2005	Petty cash	Bonus gift certificate	40.00		
Jan. 31, 2005	Petty cash	Bonus gift certificate	20.00		
Apr. 25, 2005	1960	Bonus gift certificate	20.00		
Apr. 26, 2005	Petty cash	Gifts	25.00		
May 20, 2005	2057	Bonus gift certificate	90.00		
July 27, 2005	2141	Party supplies	313.00		
July 27, 2005	2141	Party supplies	39.00		
July 28, 2005	2183	Bonus gift certificate	25.00		

Check date	Check number	Description	Ineligible @	Unsupported @	Unnecessary @
Aug. 15, 2005	2217	Bonus gift certificate	\$ 20.00		
Aug. 23, 2005	Petty cash	Bonus gift certificates	75.00		
Sept. 21, 2005	2306	Bonus gift certificate	25.00		
Nov. 30, 2005	2451	Parking Dec. 2005	49.00		
Dec. 17, 2005	2458	Christmas party	2,116.00		
Dec. 20, 2005	1275	Christmas bonus check	2,500.00		
Dec. 21, 2005	2510	Christmas bonus check	100.00		
Dec. 21, 2005	2511	Christmas bonus check	100.00		
Dec. 21, 2005	2512	Christmas bonus check	100.00		
Dec. 22, 2005	2513	Parking Jan. 2006	49.00		
Jan. 20, 2006	2593	Christmas gifts	87.00		
Jan. 27, 2006	2605	Parking Feb. 2006	49.00		
Feb. 02, 2006	2644	Lunch	108.00		
Feb. 14, 2006	2696	Christmas bonus gift certificates/party	3,360.00		
Feb. 22, 2006	2703	Parking Mar. 2006	49.00		
Mar. 01, 2006	2704	Christmas party liquor/coffee	93.00		
Mar. 21, 2006	2781	Bonus gift certificate	20.00		
Mar. 23, 2006	2784	Parking Apr. 2006	49.00		
Mar. 28, 2006	2814	Banquet	1,000.00		
Apr. 07, 2006	2844	Christmas party	103.00		
Apr. 21, 2006	2888	Bonus gift certificate	20.00		
Apr. 24, 2006	2891	Parking May 2006	49.00		
		Total employee incentives	\$17,820.00		
Dec. 16, 2005	2486	Contracted services performed before Dec. 16, 2005	981.00		
Dec. 27, 2005	2529	Contracted services Dec. 19-23, 2005	980.00		
Jan. 04, 2006	2577	Contracted services Dec. 12-30, 2005	1,716.00		
Jan. 11, 2006	2586	Contracted services Jan. 2-6, 2006	833.00		
Jan. 24, 2006	2594	Contracted services Jan. 9-20, 2006	1,912.00		
Jan. 31, 2006	2637	Contracted services Jan. 23-27, 2006	980.00		
Feb. 10, 2006	2666	Contracted services Jan. 30-Feb. 3, 2006	980.00		
Feb. 17, 2006	2700	Contracted services Feb. 6-10, 2006	980.00		
Mar. 03, 2006	2727	Contracted services Feb. 13-14, 2006	392.00		
		Total consulting fees	\$9,754.00		
Jan. 22, 2004	1240	Agent employee travel	347.00		
June 07, 2004	1333	Agent employee travel	137.00		
July 07, 2004	1364	Travel to agent		\$ 290.00	
Oct. 13, 2004	1559	Travel to agent hotel costs		135.00	
Nov. 02, 2004	1588	Travel to agent		133.00	
Nov. 16, 2004	1637	Agent employee travel		131.00	
Apr. 26, 2005	Petty cash	Travel to agent		83.00	
Sept. 21, 2005	2290	Travel to agent-sponsored meeting		259.00	
Sept. 21, 2005	2283	Travel to agent-sponsored meeting		92.00	
Oct. 03, 2005	2330	Travel to agent-sponsored meeting		61.00	
Nov. 22, 2005	2422	Travel to agent-sponsored meeting		925.00	
		Total travel expenses	\$484.00	\$2,109.00	
Feb. 13, 2004	1014	Additional use charges Jan. 19, 2004			\$ 14.00
Apr. 06, 2004	1174	Additional use charges Mar. 19, 2004			10.00
Apr. 28, 2004	1239	Additional use charges Apr. 19, 2004			4.00
June 01, 2004	1326	Additional use charges May 19, 2004			19.00
June 30, 2004	1382	Additional use charges June 19, 2004			21.00
Aug. 02, 2004	1421	Additional use charges July 19, 2004			27.00

Check date	Check number	Description	Ineligible @	Unsupported @	Unnecessary @
Sept. 03, 2004	1496	Additional use charges Aug. 19, 2004			4.00
Sept. 30, 2004	1541	Additional use charges Sept. 19, 2004			13.00
Nov. 02, 2004	1611	Additional use charges Oct. 19, 2004			3.00
Nov. 29, 2004	1662	Additional use charges Nov. 19, 2004			\$ 12.00
Jan. 05, 2005	1737	Additional use charges Dec. 19, 2004			45.00
Feb. 01, 2005	1796	Additional use charges Jan. 19, 2005			84.00
Mar. 14, 2005	1895	Agent's plan and additional employee use charges Feb. 19, 2005	\$ 106.00		81.00
Apr. 08, 2005	1955	Agent's plan and additional employee use charges Mar. 19, 2005	48.00		14.00
June 02, 2005	2064	Agent's plan and additional employee use charges Apr. 19 & May 19, 2005	99.00		542.00
July 14, 2005	2136	Agent's plan and additional employee use charges June 19, 2005	195.00		59.00
July 28, 2005	2182	Agent's plan and additional employee use charges July 19, 2005	55.00		47.00
Sept. 21, 2005	2304	Agent's plan and additional employee use charges Aug. 19, 2005	89.00		35.00
Oct. 03, 2005	2347	Agent's plan and additional employee use charges Sept. 19, 2005	76.00		28.00
Nov. 01, 2005	2389	Agent's plan and additional employee use charges Oct. 19, 2005	61.00		26.00
Dec. 16, 2005	2488	Agent's plan and additional employee use charges Nov. 19, 2005	48.00		38.00
Dec. 29, 2005	2569	Agent's plan and additional employee use charges Dec. 19, 2005	48.00		15.00
Jan. 31, 2006	2638	Agent's plan and additional employee use charges Jan. 19, 2006	52.00		38.00
Mar. 03, 2006	2735	Agent's plan and additional employee use charges Feb. 19, 2006	54.00		48.00
Mar. 28, 2006	2828	Agent's plan and additional employee use charges Mar. 19, 2006	63.00		26.00
Apr. 28, 2006	2897	Agent's plan and additional employee use charges Apr. 19, 2006	54.00		19.00
June 05, 2006	2986	Agent's plan and additional employee use charges May 19, 2006	<u>56.00</u>		23.00
		Total cell phone expenses	\$1,104.00		\$1,295.00
Jan. 24, 2005	1776	Accounting services for additional IPA* work			15,428.00
Jan. 30, 2006	2634	Accounting services for additional IPA work			3,690.00
Mar. 15, 2006	2754	Accounting services through Mar. 10, 2006			420.00
Mar. 17, 2006	2755	Accounting services for additional IPA work			2,850.00
Mar. 20, 2006	2756	Accounting services Mar. 11-19, 2006			595.00
Mar. 28, 2006	2822	Accounting services Mar. 20-24, 2006			683.00
Apr. 07, 2006	2833	Accounting services Apr. 3-6, 2006, plus 11 hrs.			1,050.00
Apr. 25, 2006	2892	Accounting services Apr. 7-23, 2006			630.00
May 02, 2006	2902	Accounting services Apr. 24-30, 2006			385.00
May 08, 2006	2907	Accounting services May 1-8, 2006			1,068.00
May 17, 2006	2916	Accounting services May 9-14, 2006			560.00
May 22, 2006	2950	Accounting services for additional IPA work			1,687.00
May 24, 2006	2953	Accounting services May 15-21, 2006			438.00
May 31, 2006	2963	Accounting services May 22-26, 2006			<u>840.00</u>
		Total accounting fees			\$30,324.00
		Subtotal	\$83,070.00	\$2,109.00	\$31,619.00
		Grand total of questioned costs			\$116,798.00

* IPA=independent public accountant.

@ =All check amounts have been rounded.

Appendix E

PROJECT OWNER AND AGENT RELATIONSHIP

The independent public accountant for the project, along with HUD field office staff, has concerns about the success of the project due to the relationship that exists between the owner and the agent. Further, the capital investment made by the entities influences the notion of who has a vested interest in the project. In addition, the owner's attempt to replace the agent and a later injunction against the owner increase concerns regarding how the resolution of such matters will impact the project.

The relationships among the developer, owner, and agent are unique to this project. Peregrine Development Company (developer) proposed a project that included Peregrine's Landing, LLC, as the owner and Peregrine Health Management Company as the agent. Although similar in name, Peregrine's Landing, LLC, is not related to the developer or the agent. Peregrine's Landing, LLC, is a not-for-profit entity and qualifies as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code. The sole member of the company is the Bennett-Feinberg Foundation. Peregrine's Landing, LLC, licensed to operate an enriched assisted living facility, did not have the necessary experience and was later required to obtain an experienced operator or agent. Thus, Peregrine's Landing, LLC, entered into a 15-year management agreement with Peregrine Health Management Company in November 2002. Peregrine Health Management Company has an identity-of-interest relationship with the developer and is a for-profit organization.

Peregrine Development Company provided more than \$707,500 toward the financing of the project and continues to have a financial interest in the project. Peregrine Development Company deferred \$580,000 due to it for a portion of the development fee and the land purchase price and accepted Series 2002D bonds in lieu of payment.

The project was primarily financed through the issuance of bonds. In November 2002, \$7,795,000 in tax-exempt facility revenue bonds, Series 2002A, and \$1,380,000 in taxable facility revenue bonds, Series 2002B, were issued. The \$9,175,000 mortgage loan is insured by the Federal Housing Administration. In addition, \$1,175,000 and \$725,000 in subordinated Series 2002C and 2002D bonds were issued for financing a portion of the costs of the project and payment of certain development and financing fees. In conjunction with the issuance of the Series 2002A, 2002B, and 2002C bonds and the establishment of an operating deficit reserve fund, the construction contractor provided \$335,000 in letters of credit to fund the transaction. The project was financed in this manner because Peregrine's Landing, LLC, was a not-for-profit entity but did not have the necessary capital. The lack of capital investment by Peregrine's Landing, LLC, raises concerns over its ability to support the project.

In January 2005, Peregrine's Landing, LLC, the project owner, attempted to replace the agent. During that process, Peregrine's Landing, LLC, provided an acceptable replacement agent to HUD. However, the owner could not get approval of the replacement agent from the subordinated Series 2002C bondholder representative. In addition, on May 5, 2005, Peregrine

Health Management Company and two board members of the Bennett-Feinberg Foundation filed a complaint against Peregrine's Landing, LLC, and a temporary restraining order was issued on May 6, 2005, against Peregrine's Landing, LLC, in regard to terminating the agent contract. On July 28, 2005, a preliminary injunction was issued against Peregrine's Landing, LLC. Officials for Peregrine Health Management Company contend that the lawsuit has been settled, however, we were not provided with a fully executed settlement agreement. Further, as of date of this report, there was no evidence in Erie County records to reflect that the lawsuit been discharged. In conclusion, due to the owner/agent conflict, ownership concerns, and the amount of debt service, it is questionable whether the project can be successful.

Appendix F

CRITERIA

- A. HUD regulatory agreement, paragraph (9)(c), provides that the mortgagor shall make no payment for services, supplies, or materials unless such services are actually rendered for the project or such supplies or materials are delivered to the project and are reasonably necessary for its operation. Payments for such services or materials shall not exceed the amount ordinarily paid for such services, supplies, or materials in the area where the services are rendered or the supplies or materials furnished.
- B. HUD regulatory agreement, paragraph (4)(a), provides that the mortgagor shall not, without the prior written approval of the secretary of housing and urban development (secretary), transfer, dispose of, or encumber any of the mortgage property. Any such transfer shall be only to a person or persons or corporation satisfactory to an approval by the secretary, who shall, by legal and valid instrument in writing, to be recorded or filed in the same recording office in which conveyances of the property covered by the mortgage are required to be filed or recorded, duly assume all obligations under this agreement and under the insured note and mortgage.
- C. HUD regulatory agreement, paragraph (4)(b), provides that the mortgagor shall not, without the prior written approval of the secretary, assign, transfer, dispose of, or encumber any personal property of the project, including rents, and shall not disburse or pay out any funds except for usual operating expenses and necessary repairs.
- D. HUD Handbook 4370.2, REV-1, CHG-1, "Financial Operations and Accounting Procedures for Insured Projects," paragraph 2-6 (e), provides that all disbursements from the regular operating account (including checks, wire transfers, and computer-generated disbursements) must be supported by approved invoices/bills or other supporting documentation. Paragraph 4-4 provides that the legal expense account, records legal fees or services incurred on behalf of the project (as distinguished from the mortgagor entity). For example, agents charge legal fees for eviction procedures to this account.
- E. Internal Revenue Service Procedure 97-13, regarding federal tax limitations applicable to management contracts between for-profit managers and not-for-profit owners, provides that the longest allowable term of a contract, including all renewal options, is 15 years. In addition, at least 95 percent of the compensation must be based on a fixed fee.
- F. HUD Handbook 4381.5, "Management Agent Handbook," paragraph 3.1, provides that the management agent must absorb the costs of supervising and overseeing project operations from the management fee it receives. Further, paragraph 3.15 (b)(6)(a) provides that if fee amounts are not acceptable under the procedures set forth in this chapter, the owner and agent must refund to the project any excessive fees collected.