Audit of the Department of City Development In Rem Property Management and Disposition

MARTIN MATSON
City Comptroller

STACEY MAZMANIAN
Audit Manager

City of Milwaukee, Wisconsin

August 2015

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Martin Matson
Comptroller

Glenn Steinbrecher, CPA
Deputy Comptroller

Aycha Sirvanci, CPA
Special Deputy Comptroller

Toni Biscobing
Special Deputy Comptroller

Office of the Comptroller

August 12, 2015

Honorable Tom Barrett, Mayor
The Members of the Common Council
City of Milwaukee
Milwaukee, WI 53202

Dear Mayor and Council Members:

The attached report summarizes the results of our audit of the Department of City Development's in rem property management and disposition processes. Audit procedures focused on 2014 transactions and activity. The objectives of the audit were to: 1) evaluate the adequacy and effectiveness of the internal controls within the department's foreclosed property management processes including inspection, marketing, maintenance, leasing and enforcement, revenue receipt and use of funds, and property disposition; 2) perform an analysis of the process from property acquisition to disposition to assess efficiency and identify bottle-necks; and 3) determine the accuracy of the inventory of City-owned properties available online and within the real estate database.

Through our audit procedures, we determined the internal controls within department's foreclosed property management and disposition processes are adequate and operating effectively. The audit also found that processes are efficient as possible with the current resources and policies in place. Lastly, audit testing verified the inventory of city-owned properties maintained internally and online is accurate. The audit report includes six recommendations to improve internal controls and one audit observation.

Audit findings are discussed in the Audit Conclusions and Recommendations section of this report, which is followed by management's response.

Appreciation is expressed for the cooperation extended to the auditors by the staff of the Department of City Development.

Sincerely,

Stacey Mazmanian, CIA, CGAP
Audit Manager

City Hall, Room 404, 200 E. Wells Street, Milwaukee, WI 53202 • Phone (414) 286-3321 • Fax (414) 286-3281
www.milwaukee.gov/comptroller

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I. Audit Scope and Objectives

The audit examined the Department of City Development's (DCD) property management and disposition processes for tax-foreclosed residential properties. The scope of the audit focused on procedures in place to promote efficiency, the timeliness and accuracy of listings and dispositions, and the utilization and application of rent revenue.

The objectives of the audit were to:

1. Evaluate the adequacy and effectiveness of the internal controls within the department's foreclosed property management processes including inspection, marketing, maintenance, leasing and enforcement, revenue receipt and use of funds, and property disposition;
2. Perform an analysis of the process from property acquisition to disposition to assess efficiency and identify bottle-necks; and
3. Determine the accuracy of the inventory of city-owned properties available online and within the real estate database.

This audit was conducted in accordance with generally accepted government auditing standards. Those standards require that the audit obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. Internal Audit believes that the evidence obtained provides a reasonable basis for the audit's findings and conclusions based on the audit objectives.

Audit methodology included developing an understanding of processes and controls for managing and disposing residential property acquired through in rem[1] tax foreclosure. The audit procedures developed to evaluate the processes and controls to meet the audit objectives included process walk-throughs, inspection of relevant control documentation, tests of controls, and detail testing. Procedures and tests performed included:

- Reviewing file documentation to confirm inspections were performed timely for acquired properties.

[1] In rem means an action is being taken against a property instead of a person (in personam). In rem literally translates to "against the thing." An in rem action to foreclose is a legal action to create a foreclosure sale. A foreclosed property is sold for fair market value, which may or may not be enough to cover the taxes due.

- Verifying the accuracy of property and tenant data to the source documentation.
- Verifying occupants signed a lease agreement or were issued a notice-to-vacate.
- Confirming the 5-day Notice to Pay or Vacate was legally served.
- Verifying rent payments received were applied timely and accurately.
- Reviewing paid invoices and related check registers to verify expenses paid were related to the management of in rem properties.
- Reperforming buyer background checks to confirm the accuracy of the results.
- Assessing the reasonableness and accuracy of the initial property marketing price.
- Verifying the disposition of a property to the source documentation.
- Confirming formal service contracts are in place to protect the City from liability due to poor vendor performance.
- Reviewing system access for appropriateness based on the principle of least privilege.

The scope of the audit excluded:

- Transactions outside of the audit period.
- Property maintenance activity performed by Public Works.
- Demolitions and the accuracy of the scopes of work prepared by the Department of Neighborhood Services (DNS).
- The legal process to acquire title as carried out by the City Treasurer and the City Attorney's Office.
- The impact on and accuracy of changes to the tax roll.
- Any parts of the foreclosure process performed by the Comptroller's Office (i.e., determining and recording tax deed sales).

Information obtained and reviewed included: internal policies and procedures where available, certain sections of the City Charter and Code of Ordinances, certain sections of the Wisconsin Statutes, property inspection reports, lease agreements, scopes of work, Notice of Inspection letters, notices to vacate, invoices, check registers, account reconciliations, pricing analyses, offers to purchase, vendor service contracts, and system user access lists. The audit period was September 2014 through December 2015.

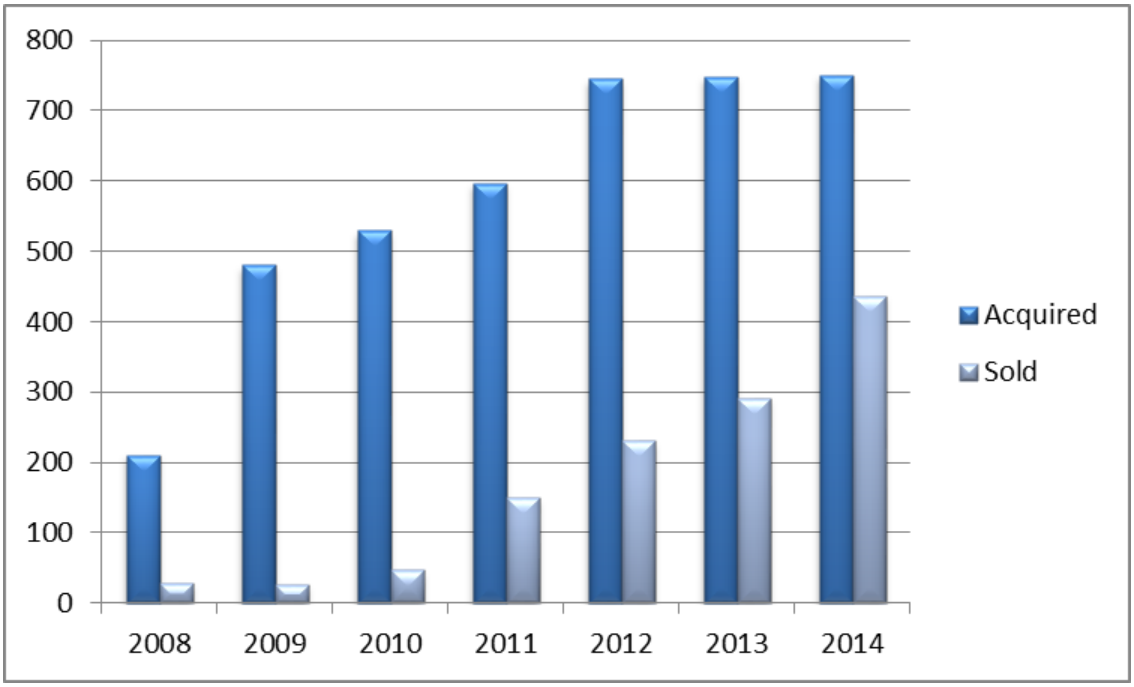
II. Organization and Fiscal Impact

The Department of City Development's Real Estate Division is responsible for the management, and disposition of properties acquired by the City through tax foreclosure. Management activities include inspecting the properties upon acquisition, setting and collecting rents, leasing, providing for necessary repairs, and boarding up unoccupied structures. Disposition activities include pricing and marketing the property, managing offers-to-purchase, and closing sales.

Milwaukee Code of Ordinances Chapter 304 governs the disposal of City real estate. Periodically, DCD submits to the local council member for direction lists of properties that are ready to be marketed. The local council member may designate parcels listed on the report to be withheld from disposition as provided in the report, removed from marketing restrictions, and/or set aside for notice of conveyance if the conveyance includes financing provided by the City, the housing authority, the redevelopment authority, or the Neighborhood Improvement Development Corporation.[2]

The current real estate inventory is approximately 1,150 properties. In 2008, it was just 110. The chart below illustrates the volume of acquisitions and sales for the past 7 years.

Chart 1 In Rem Acquisitions and Sales 2008 – 2014 (the number of acquisitions includes vacant lots)



[2] Milwaukee City Ordinance 304-49-3

If habitable, occupied properties are often rented to the current occupants until sold. If a property is not habitable and cannot be repaired, it is referred to DNS for demolition. If the property is not habitable but can be repaired, a scope of work is required for the repairs.

Real Estate puts 50 to 80 properties on the market every 60 days and they are careful not to flood the market. Sales continue to increase as the market improves. DCD has also started working with brokers and reduced deed restrictions to help increase sales.

III. Audit Conclusions and Recommendations

The audit assessed the effectiveness of procedures in place to promote efficiency, adequately control the timeliness and accuracy of listings and dispositions, and verified revenue and other funding is utilized and applied appropriately.

Through our audit procedures, we determined the internal controls within department's foreclosed property management and disposition processes are adequate and operating effectively. The audit also found that processes are efficient as possible with the current resources and policies in place. Lastly, audit testing verified the inventory of city-owned properties maintained internally and online is accurate.

The audit makes six recommendations:

1. Develop and document policies and procedures for property management and disposition processes.
2. License fee and rent payments should be collected by the DCD Finance and Administration Division.
3. Formalize the internal controls for rent revenue and expenditures.
4. Perform the background check for Lease-To-Own participants earlier in the process.
5. Cross-train back-up personnel for the database specialist.
6. Perform and document a periodic system access review.

This report includes one observation relating to earnest money received with offers-to-purchase. An observation may not constitute a recommendation, but should be taken under advisement. Additional details regarding the recommendations for improvement are provided in the following sections of this report.

A. Internal Controls

As part of the audit, we reviewed the property management and disposition processes including inspections, lease agreements, marketing and sales, revenue and expenditures, and the Lease-to-Own program.

Inspections

Each property is subject to two inspections. The first is a drive-by inspection that quickly assesses the condition of the property and is generally performed within two weeks of acquiring the property. The interior inspection is the second inspection and is scheduled with the DNS Neighborhood Improvement Program (NIP) inspector. During the inspection, the NIP inspector collects the information needed to create the scope of work. The DCD Property Manager collects the information needed to determine if a lease could be and should be offered to the current tenants if the property is occupied and habitable. If the property is not habitable, the tenants are issued a 28-day notice to vacate. Audit procedures found that inspections are performed for all acquired properties and performed timely. Specifically, drive-by inspections are performed within two weeks of acquisition and interior inspections and tenant interviews are performed within 4 weeks of the initial inspection.

Lease Agreements

If properties acquired through foreclosure are occupied, DCD may rent them to the occupants. A lease may be extended to the occupants if the property is habitable, the occupants are cooperative, and are able to pay the rent. There are no formal documented policies and procedures to guide the process. It is recognized that the process is subjective, however, policies provide the basis that would help support the department's decisions in the event of a contest or complaints of unfair treatment or favoritism if occupants are not treated equally.

Rent Revenue and Expenditures

Audit procedures included reviewing a sample of delinquent accounts. It is standard policy to serve a tenant with a notice to pay rent or vacate when the tenant has not paid rent for two months. Through testing we noticed that some tenants were not sent the notice until three-months delinquent. Again, this makes the City vulnerable to complaints of unfair treatment if notices to pay or vacate are not issued consistently.

Rent payments are collected by the Real Estate Division's Property Management Section. Receipts are issued for payments collected in person, but not for payments that are mailed in. The collected payments are then routed to Finance and Administration (Finance) for processing,

but a record of payments received is not kept and sent with the payments to Finance. Consequently, there is no record if a payment is lost or stolen on the way.

License fee and rent payments are deposited into the Redevelopment Authority's (RACM) general fund. This allows for more flexibility in expending the funds for related property maintenance costs. Per the Department of City Development, the use of a RACM account for license fee and rent revenue came from a Comptroller recommendation in 2007, however, neither DCD nor the Comptroller's Office had documentation to support the arrangement. While beneficial in some respects, working outside the City's budget and accounting processes make the funds vulnerable to misuse. In 2014, $956,930 in rent revenue was collected and $887,960 was expended for maintenance and repairs in 2014. As of May 31, 2015, rent revenue is on track to be about the same for 2015, with over $430,000 collected year-to-date.

Recommendation 1: Develop and document policies and procedures for property management and disposition processes.

Policies and procedures define expectations, promote consistency, aid in making effective decisions, enhance staff morale and productivity, serve as a training tool, and provide continuity. Management should develop, document, and communicate formal, comprehensive policies and procedures to govern the critical property management and disposition processes such as:

- Drive-by inspections
- Interior inspections and tenant interviews
- Repairs and maintenance
- Vacant properties
- Marketing
- Sales
- Other disposition
- Collection of license fees and rent and monitoring delinquent accounts
- Accounts payable
- Lease-to-Own Program

Recommendation 2: Payments should be collected by the Finance and Administration Division.

Having payments sent directly to Finance and Administration would reduce the risk of lost or stolen checks. Additionally, Property Management should start logging any payments received through the mail. A copy of the log and copies of receipts issued in-person should be routed periodically to Finance with the payments. This will provide a record of receipt if the payment is lost or stolen on the way.

Recommendation 3: Formalize the internal controls for rent revenue and expenditures.

The Department of City Development, the Redevelopment Authority, and the Comptroller's Office should work together to formalize the internal controls for rent revenue and related property maintenance expenditures. The internal controls should be communicated to the Common Council for permanent record.

Marketing and Sales

If a property is not habitable and cannot be repaired, the property is referred to DNS for demolition. If the property is habitable, or not habitable but could be repaired, DNS prepares the scope of work and the property is priced and marketed for sale. Properties are sold at fair market value regardless of the amount of taxes owed. Buyers must go through a licensed broker to make an offer-to-purchase and demonstrate they can make the required repairs before an offer is accepted. Occasionally, the City may accept an offer-to-purchase with the earnest money directly from the buyer when properties are not priced high enough to pay a broker fee.

Observation: Earnest Money Retained with Rejected Offers-to-Purchase.

Audit procedures included looking at a sample of rejected offers. During testing, we noticed that the money orders received as earnest money were retained with the rejected offers. While the amounts were small and the money orders were made payable to the City, risk of misappropriation would be further reduced if the money orders were returned to the prospective buyers when an offer-to-purchase is not accepted.

Lease to Own Program

Qualified and interested tenants are placed in the Lease-to-Own (LTO) program. The program refers tenants to a homebuyer counseling agency to prepare the tenants for homeownership. After successfully completing the program, the tenant can purchase the property for one dollar.

It is City policy that all buyers of City-owned property are subject to a background check before the offer-to-purchase is accepted. This ensures that buyers of in rem properties contribute to, and positively impact the City's efforts to revitalize and stabilize neighborhoods, strengthen property values, and improve quality of life. Currently, the background check for LTO participants is not performed until successful completion of the program. The program can take up to two years to complete.

Recommendation 4: Perform the background check earlier in the LTO process.

Perform the background check for Lease-to-Own participants during the application process before the tenant is accepted into the program.

B. Process Efficiency

Once a property is acquired, it goes through a series of two inspections before a disposition recommendation is made and submitted for aldermanic approval. The first inspection is known as a drive-by inspection. These are done as soon as possible to make an initial assessment of the condition and occupancy of the property and its neighboring properties. The properties are then assigned for the interior inspections. This includes a tenant interview if the property is occupied. The interior inspections must be coordinated with a DNS NIP inspector. A Notice of Inspection must be sent before the property can be inspected. The inspection letter is time sensitive. Per state law, tenants must be given adequate notice before an inspection.

Generally, Property Management staff do not take time off when DCD is working through an in rem list; however, there is no back-up staff for the database specialist. The database specialist is responsible for sending out the Notice of Inspection letters. If the database specialist were to be out of the office for an extended period of time, this could delay the marketing and sales of occupied in rem properties that have not yet been inspected. Properties identified as vacant can

be inspected immediately after the initial exterior inspections. Since the properties are not occupied, an inspection notice is not required.

Recommendation 5: Cross-train a back-up for the Database Specialist.
Management should cross train at least one individual to perform the time sensitive duties of the Database Specialist as they relate to the process of inspecting, marketing, and selling in rem properties.

It is a policy decision that all city-owned properties will be sold with rehabilitation requirements. The DNS NIP Inspector prepares a Scope of Work for all habitable tax-foreclosed properties, which indicates the repair work that must be done to bring the property into compliance with the City's building maintenance code and the applicable cost estimates. It takes about two weeks for DCD to receive the Scope of Work from DNS.

Once the Scope of Work is received, the property can be priced and listed for sale. Generally, properties are only available to owner occupant buyers for the first 30 days a property is listed. After 30 days, properties can be sold to investors. However, before the property can be listed, DCD must obtain approval from the local council member. The local council member must also approve each sale.

In summary, internal audit identified the following factors that affect the time it takes to get a property on the market:

1. DCD resources assigned to complete inspections
2. DNS resources assigned to complete inspections
3. State law requiring adequate notification before entry
4. Preparing the scope of work for the rehabilitation requirements of the sale
5. Obtaining aldermanic approval for property disposition

The following are factors that affect the time it takes for a property to sell once it is listed:

1. The strength of the real estate market
2. The neighborhood in which the property is located

3. Occupancy restrictions

With the current resources and policies in place, the length of time from acquisition to marketing to sale is reasonable. Internal Audit did not identify any inefficiencies. If desired, the duration could be shortened by adding more resources to perform inspections.

C. Property Inventory

The third and final objective of the audit was to determine the accuracy of the inventory of City-owned properties available online and within the real estate database. To do this Internal Audit examined the judgment documents to discern the acquired properties, traced a sample of dispositions to the source documentation, and evaluated system access controls.

The City's Content Management System (CMS), Titan, allows each department's authors to maintain their own content on the City of Milwaukee web site. The Real Estate Database houses the inventory of all City-owned property. It contains parcel information such as current address, tax key number, physical site and building characteristics, historical information (i.e., former owner, title/deed information and prior improvements) as well as disposition status, tenant information and sales information. The system tracks parcels from acquisition and also tracks all expenditures on a parcel, including management and demolition plus revenues.[3]

Testing results indicate the inventory of City-owned residential properties available online and maintained in the real estate database (REDB) is accurate, however, controls could be improved to ensure continued accuracy going forward. Internal Audit identified two REDB users (out of 30) with system access on February 12, 2015; both left city employment in 2013. Another user had editing capabilities and only needed read access based on job responsibilities. Finally, a fourth user had powerful admin-level access and only needed basic read/write access. Admin-level access allows the user to delete records.

The audit also identified one Titan CMS user who left employment six months earlier. Titan CMS is web-based and can be accessed from any internal or external computer. A user does not

[3] http://mintapps.ci.mil.wi.us/datainvreport/faces/index.jsp (Real Estate Database and Content Management System)

need to be on the City's network to update the web site. Periodic user access reviews would identify terminated employees or employees that no longer need access to these systems.

Recommendation 6: Perform and document a periodic system access review.

To strengthen controls surrounding access to the real estate database and the Titan Content Management System, management should:

1. Remove the excess access identified above.
2. Develop and implement a periodic access review including the following:
    a. Access should be reviewed at least annually for appropriate access levels and terminated or transferred employees.
    b. Documentation evidencing the reviews were completed and any changes made as a result of the reviews should be retained for a minimum of three years.

City of Milwaukee

Department of City Development
City Plan Commission
Redevelopment Authority of the City of Milwaukee
Neighborhood Improvement Development Corporation

Rocky Marcoux
Commissioner
rmarco@milwaukee.gov

Martha L. Brown
Deputy Commissioner
mbrown@milwaukee.gov

August 5, 2015

Mr. Martin Matson
Comptroller
City Hall, Room 404
200 E. Wells Street
Milwaukee, WI 53202

Dear Mr. Matson:

This letter provides the Department of City Development's response to the Audit of the Department of City Development In Rem Property Management and Disposition activities.

We appreciate the audit's conclusion that processes are efficient and internal controls are adequate and operating effectively. Overall, we believe the observations of the audit team will provide helpful guidance to the department in making further process improvements.

Recommendation 1: Develop and document policies and procedures for property management and disposition processes.
Though staff members consult a variety of written directives regarding the handling of tax-foreclosed property, notably the framework established by the Milwaukee Code of Ordinances, we agree it would be more efficient to assemble this information into a single policy and procedure manual. We anticipate completing this task by the end of the first quarter of 2016.

Recommendation 2: Payments should be collected by the Finance and Administration Division.
This recommendation regards rent payments mailed and delivered in person by tenants who occupy City-owned foreclosed properties. At present, tenants are directed to remit payments to the second floor reception desk at 809 N. Broadway. Payments are hand-carried by staff to accounting staff in the DCD Finance and Administration Division, whose offices are on the 3rd floor of the building.

We understand this recommendation is meant to ensure that no rent payments are lost or misplaced prior to delivery to accounting staff for recording and deposit. However, because there is no central reception desk that serves the third floor offices of the Finance and Administration Division, we believe customer service would be seriously compromised if tenants who chose to deliver their payments in person were directed to the third floor.

We are reviewing our processes and options regarding strategies to record and physically secure rent payments for the brief period they are held on the second floor, and will devise a plan for this purpose by the end of 2015.

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Milwaukee Business Information: www.choosemilwaukee.com

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Recommendation 3: Formalize the internal controls for rent revenue and expenditures.
Since 2007, at the recommendation of the Comptroller, rent revenue collected from tenants of tax-foreclosed properties has been deposited in a Redevelopment Authority account. Rent revenues have been separately accounted for and tracked; may be used only to offset property maintenance and management costs, and must be reported to the Comptroller at the end of each fiscal year. Attached to this letter is a memorandum that explains this arrangement in greater detail.

We agree with the recommendation to establish a written agreement between the Comptroller and the Redevelopment Authority to memorialize the internal controls that are already in place. We will work with the Comptroller to develop this agreement by the end of 2015.

Recommendation 4: Push up the background check for LTO participants.
This recommendation has been implemented. We now do the standard buyer background checks for tenants in the rent-to-own program twice: before accepting the tenant into the program, and prior to accepting the tenant's offer to purchase. Results of both checks are recorded on the Buyer Investigation Form.

Recommendation 5: Cross-train a back-up for the Database Specialist.
We expect to develop a cross-training program by the end of 2015.

Recommendation 6: Perform and document a periodic system access review.
This recommendation involves two actions: terminating or adjusting database access for several individuals, and instituting a periodic review of database access. The recommended termination or adjustment of database access has been completed by the Information Technology Management Division. By January 1, 2016, we will finalize a process to perform an annual review of database access per the second part of the recommendation.

Thank you for the opportunity to respond to these recommendations.

Sincerely,

Martha L. Brown
Deputy Commissioner

Attachment

City of Milwaukee Department of City Development

MEMORANDUM

TO: Martin Matson
Comptroller

FROM: Martha L. Brown
Deputy Commissioner

DATE: August 5, 2015

SUBJECT: Deposit of rent into RACM account

This memo provides background regarding the use of a Redevelopment Authority of the City of Milwaukee (RACM) account for rent revenue collected from tenants of City-owned tax-foreclosed property. It is our experience that the current arrangement, through which RACM collects the rents and expends them to maintain and repair foreclosed property, allows the department to be more flexible and reduces unnecessary bureaucracy and paperwork for both DCD and the Comptroller's office.

The recommendation to have RACM collect the rents came from the Comptroller back in early 2007. There were conditions attached to this arrangement:

1) Rent revenues must be separately accounted for and tracked. To accomplish this, they are deposited into a dedicated RACM account.
2) Rent revenues may be used only to offset property maintenance costs.
3) Rent revenues and associated expenses must be reported to the Comptroller at the end of each fiscal year.

Prior to 2007, DCD used the City's Financial Management Information System (FMIS) to invoice the rents; invoiced rents were booked as a receivable by the City. This created a number of issues:

- The City uses a modified accrual accounting method. In order to expend these revenues on the properties (as we do now), an expenditure appropriation must be placed in the City budget. This means that the Administration/Budget Office would have to increase the budget appropriation in the S209 Land Management Special Purpose Account by the revenue expected and recognized by the Comptroller. This would increase the City budget by at least $850,000-$1,000,000.

- If this amount was added to the City budget, it will also impact the Expenditure Restraint Program (ERP) imposed by the State of Wisconsin, which limits municipal budget expenditures. The current system allows the City to collect and expend this revenue without putting the City closer to its municipal expenditure limit imposed by ERP.

- The Comptroller has traditionally taken a very conservative approach to estimating revenues. Should these revenues be made part of the City budget, it is likely that the department would annually need to bring one or more excess revenue files to the Council, so that the additional revenue could be recognized and additional appropriations made to the department's S209 property account.

- If rents were paid to the City, with rent invoices generated through FMIS and invoiced rents booked as receivables, any rents that are not paid (for whatever reason) will have to be taken off the books every year by the Comptroller.

- We communicate annually with the Comptroller regarding any balance left in the rent account. The Comptroller provides direction as to whether the balance should be paid back to the City or rolled over and applied to maintenance and repair expenses the following year.