Issue Date	February 4, 2008
Audit Report Number	2008-BO-1004

TO: James Barnes, Acting New England Hub Director, Multifamily Housing, Boston Regional Office, 1AHMLA
Henry S. Czauski, Deputy Director, Departmental Enforcement Center, CV

FROM: John A. Dvorak, Regional Inspector General for Audit, Region 1, 1AGA

SUBJECT: Multifamily Project Deficiencies Resulted in More Than $1.1 Million in Cost Exceptions for Mohegan Commons, Norwich, Connecticut

HIGHLIGHTS

What We Audited and Why

We audited Vesta Mohegan, LLC (Mohegan Commons), after completing an audit of the owners' related project, Vesta Moosup, LLC (Moosup Gardens). The Moosup Gardens audit (OIG Audit Report Number 2007-BO-1006) disclosed cost exceptions totaling more than $700,000 related to unauthorized distributions and repayments of owner advances while in a non-surplus-cash position and unreasonable payments to identity-of-interest (related) companies. Our audit objective was to determine whether the owners used project funds in accordance with the regulatory agreement.

What We Found

The owners did not use project funds in accordance with the regulatory agreement. We identified questioned costs and opportunities for funds to be put to better use totaling $1,194,242 (see appendix A). Specifically, the owners (1) used $58,342 in project funds for unnecessary and unreasonable operating costs;

(2) included more than $593,000 in unreasonable relocation costs, and other questionable costs in the cost certification, causing the U.S. Department of Housing and Urban Development (HUD)-insured mortgage to be overinsured by $341,160; and (3) repaid $200,947[1] in member advances when the project was in a non-surplus-cash position. These cost exceptions were due to weak internal controls, a lack of policies for related company transactions, and inadequate accounting procedures. These violations of the regulatory agreement may subject the owners to monetary penalties.

What We Recommend

We recommend that the Acting New England Hub Director for Multifamily Housing require the owners to (1) repay the project for the questioned operating costs from nonproject funds, (2) make a principal payment or establish an escrow with the lender from nonproject funds to pay down the amount of overinsurance, and (3) reimburse the project from nonproject fund sources for the ineligible member advance repayments, and remove the unreasonable member advances accrued from the project's accounting records.

Further, we recommend that HUD pursue sanctions as appropriate against the responsible parties for the unreasonable disbursements cited in this report.

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

Auditee's Response

We provided the draft audit report to the owners on December 20, 2007, and requested a response by January 15, 2008. We discussed the draft audit report at an exit conference on December 21, 2007, and received the owners' written comments on January 15, 2008, after the owners were granted two extensions. The owners generally disagreed with the report findings.

The text of the owners' response, along with our evaluation of that response, can be found in appendix B of this report. Please note that the referenced attachments were not included in the report because of their size, but are available upon request.

[1] $259,804 - $58,857 reimbursed as of April 2007.

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BACKGROUND AND OBJECTIVES

Mohegan Commons (project) is a multifamily, 184-unit apartment complex located in Norwich, Connecticut. The project receives Section 8 rental assistance from the U.S. Department of Housing and Urban Development (HUD) for 88 subsidized units, and the owners charge market rental rates for the remaining 96 units. The project also receives interest reduction payments under Section 236 of the National Housing Act (Act).

The owners, HDASH, LLC, and its related company Vesta Equity 2003, LLC,[2] purchased the property in December of 2003 and embarked on substantial unit rehabilitations. The owners financed the purchase and renovations, and HUD insured the mortgage through Section 221(d)(4) of the Act. The Act authorizes HUD to insure lenders against loss on mortgage defaults and assists owners in the construction or rehabilitation of housing for eligible families by making capital more readily available.

The project remained operational during the rehabilitation period; and the $6.9 million in renovations, completed in August of 2005, included new doors and windows, kitchen and bathroom cabinets, bathroom accessories, new appliances and fixtures, drywall, electrical fixtures, and paint. The heating and hot water systems were also segregated for operation that is more efficient. Exterior work included new sidewalks, sealing the parking lot, landscaping, site lighting, and upgrading the closed circuit television monitoring system. The owners also added a Neighborhood Network Computer Center (learning center) and community room.

The owners submitted their final “Mortgagor’s Certificate of Actual Cost” (form HUD-92330) to HUD on March 28, 2006, to determine the amount of mortgage insurance HUD would provide. The original mortgage amount was approximately $9.2 million. As of December 18, 2007, the unpaid principal balance was approximately $8.9 million, and the owners were current on their mortgage payments.

Our audit objective was to determine whether the owners used project funds in accordance with the regulatory agreement. Specifically, we wanted to determine whether the owners/management agent (1) obtained goods and services that were reasonable and necessary project expenses and whether the costs were properly supported, (2) included only reasonable and adequately supported costs on the “Mortgagor’s Certificate of Actual Cost,” and (3) repaid any advances or loans to their related companies when the project was in a non-surplus-cash position.

The issues identified in our report deal with administrative and internal control activities that we feel are necessary to bring to the owners’ attention now. Other matters regarding the owners’ management may remain of interest to our office as well as other federal agencies. Release of this report does not immunize any individual or entity from future civil, criminal, or administrative liability or claim resulting from future action by HUD and/or other federal agencies.

[2] See appendix C for a description of the project’s related companies.

RESULTS OF AUDIT

Finding 1: The Owners Charged More Than $60,000 for Services That Were Unnecessary and Unreasonable for Operating and Maintaining the Project

The owners charged the project $60,907 for services that were unnecessary and unreasonable for operating and maintaining the project. This amount included charges of $32,287 for unnecessary Internet service provided to all tenant units and $28,620 to pay their related management company for unreasonable temporary employee services. This condition occurred when the project was in a non-surplus-cash position. These unnecessary and unreasonable charges were incurred because of inadequate accounting procedures and management controls. These charges contributed to operating losses and the project's non-surplus-cash position and may subject the owners to sanctions under the federal equity skimming statutes.

Owners Charged More Than $32,000 for Unnecessary Internet Services

The owners paid a vendor $32,287 from project operating funds to provide Internet services to the project's 184 housing units during the period July 1, 2005, through August 31, 2007. The owners provided the services as an additional amenity to attract new tenants and to further the goals of the project's learning center, which also provided Internet access and educational opportunities to residents. The service agreement with the vendor also provided no-cost local phone and cable service for the property's exercise and social rooms and no-cost local phone, facsimile, and Internet service for the property's main office. Although the project obtained some no-cost benefits, Internet service at the unit level was not necessary for operating or maintaining the project. Therefore, the costs were not eligible project costs and must be repaid to the project because the owners' regulatory agreement with HUD requires that project funds be used only for reasonable expenses necessary for the operation and maintenance of the project.[3]

[3] "Regulatory Agreement for Multifamily Housing Projects," form HUD-92466, approved on December 9, 2003.

Owners Charged More Than $28,000 for Temporary Employee Services

The owners' related management company also charged the project $28,620 for unreasonable temporary employee services. It charged $2,565 during the rehabilitation period and $26,055[4] after normal operations began. The costs were unreasonable because they were already paid for as part of the management agent's fee.[5] In addition, the owners did not maintain records to show who provided the services, what services they provided, or whether the services were actually provided. This condition occurred due to inadequate accounting procedures and weak management controls.

Project Was in a Non-Surplus-Cash Position

The project was in a non-surplus-cash position for the entire period of review. Federal statutes prohibit HUD-insured multifamily project owners from using project funds for unreasonable and unnecessary expenses when the project is in a non-surplus-cash position. A major concern of HUD's mortgage insurance programs is the inappropriate use of project funds, which can contribute to mortgage defaults, the need for additional financial assistance from HUD, and losses to HUD through the sale of devalued foreclosed properties. In addition, an inappropriate and willful use may be subject to civil money penalties. Since the owners paid for these unnecessary and unreasonable expenses when the project was in a non-surplus-cash position, they may be subject to these penalties.

Conclusion

The owners charged the project $60,907 for services that were unnecessary and unreasonable to operate and maintain the project. These charges occurred due to inadequate accounting procedures and management controls and weakened the project's financial position. The project incurred more than $516,000[6] in operating losses during 2004 and 2005. The questioned charges in this finding, the more than $593,000 in unreasonable relocation costs paid to the owners' related companies (finding 2), and reduced occupancy rates during construction contributed significantly to these operating losses. The $58,342[7] charged after

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[4] The project paid $8,565 in cash and accrued $17,490 in payables ($8,565 + $17,490 = $26,055).
[5] "The Management Agent Handbook," HUD Handbook 4381.5, REV-2, section 6.39(b)(9).
[6] $228,202 in losses during 2004 and $287,923 during 2005 (before depreciation expenses).
[7] $32,287 for Internet service charges and $26,055 for temporary employee service charges total $58,342.

normal operations began should be repaid to the project operating account and removed from the project's accounting records, and the $2,565 charged during construction should be repaid to reduce the HUD-insured mortgage (see finding 2). Since the owners charged these unreasonable costs when the project was in a non-surplus-cash position and increased the profitability of their related companies by allowing excessive charges from the related companies to the HUD project, the owners may be sanctioned under the federal equity skimming statutes.

Recommendations

We recommend that the Acting New England Hub Director for Multifamily Housing require the owners to

1A. Repay the project's operating fund $40,852[8] from nonproject sources and remove $17,490[9] in payables from its accounting records for the unnecessary and unreasonable project costs. The repayment should be deposited into the project's replacement reserve account or another restricted account that requires HUD approval for the release of funds.

1B. Implement adequate written procedures and controls to ensure that future disbursements for project expenses comply with the regulatory agreement and HUD's requirements.

1C. Obtain an unrelated management agent to manage the project.[10]

We also recommend that the Director of the Departmental Enforcement Center

1D. Pursue all administrative and/or civil monetary penalties against the owners, their related management agent, and their principals for the regulatory agreement violations disclosed in this report.[11]

[8] $32,287 paid for Internet services and $8,565 paid for temporary employee services total $40,852.
[9] Accrued for temporary employee services.
[10] In implementing recommendation 1C, HUD should consider all of the issues discussed in this report.
[11] In implementing recommendation 1D, the Deputy Director should consider all the issues discussed in this report.

RESULTS OF AUDIT

Finding 2: The Owners Included Unreasonable and Unnecessary Expenses in Their HUD-Insured Mortgage Cost Certification

The owners included more than $593,000 in unreasonable relocation costs in their cost certification. The costs were unreasonable because the owners

- Exceeded the amount that HUD initially approved for relocation services,
- Did not show that their related company incurred costs, and
- Failed to show that the amount paid did not exceed what would have paid on the open market.

The owners failed to maintain adequate records for the amounts charged to their related companies. In addition, the owners included more than $118,000 in unreasonable operating costs including unpaid and unnecessary interest payments and excessive salary costs in their operating statement. This condition occurred due to weak accounting controls over cash disbursements and related party transactions.

HUD disallowed some of the relocation costs during its final cost certification; however, these costs caused HUD to overinsure the mortgage by more than $341,000, contributed to unnecessary operating losses, and may subject the owners to sanctions under the federal equity skimming statutes.

Related Company Costs Were Unreasonable

The $593,793 charged for related company relocation services[12] was unreasonable. The costs were unreasonable because they exceeded the $119,231 HUD approved.[13] HUD initially approved the owners to charge the project an average of $4,258 per tenant to move 28 tenants. However, the owners charged the project an average of $9,125 per tenant to move 92 tenants, a volume increase of more than 200 percent and a cost increase of more than 600 percent, with no credible explanation for the cost disparity. The costs were also unreasonable because one related company incurred no costs, yet it billed the project $324,123. In addition, the owners could not show that the costs paid to their companies were comparable to costs that would

[12] On their "Mortgagor's Certificate of Actual Cost," form HUD-92330, signed March 28, 2006, in support of their HUD-insured mortgage.
[13] "Multifamily Summary Appraisal Report," form HUD-92264, approved on December 3, 2003.

have been paid on the open market as required by their regulatory agreement[14] and certification to HUD.[15]

In addition, the $593,793 in improper relocation costs charged to the project was capitalized as part of the building improvements, and should be removed from the project's balance sheet. The $343,939 paid to the owners' related companies must be returned to the project and the $249,854 recorded as an account payable must be removed from the project's books.

The unreasonable relocation costs were due to weak internal controls for accounting and related party transactions. For example, the related companies did not enter into a contract to establish the scope and cost of work to be performed. In addition, they did not maintain adequate records to support the costs they incurred. The owners' related companies' records also did not show which employees provided services, what services they provided, or the number of hours they spent providing these services. The project maintained invoices for some of the costs charged; however, invoices were missing for $170,100 in charges.

Owners Charged the Project More Than $118,000 in Unreasonable and Unnecessary Operating Costs

The owners included $118,710 in improper charges on the "Statement of Project Operations" they certified and submitted to HUD in support of their HUD-insured mortgage as follows:

Description	Amount
Learning center startup costs	$60,000
Loan interest to related company	38,211
Bad debts	17,934
Related company temporary employee costs	2,565
Total	**$118,710**

- The $60,000 in learning center startup costs was not paid.

- The owners supported only $40,633 of the $58,567 in bad debt expense they reported. This condition occurred due to weak internal controls for accounting and the owners' failure to maintain adequate records for bad debts. Specifically, the project's books and records did not identify which tenants

[14] "Regulatory Agreement for Multifamily Housing Projects," form HUD-92466, approved on December 9, 2003.
[15] "Project Owner's/ Management Agent's Certification," form HUD-9839-B, signed July 29, 2003.

were responsible for the debts, how much they owed, the nature of the debt, or how much they repaid. Therefore, the remaining $17,934 in bad debt expense was unsupported.

- The $38,211 in loan interest was not recorded on the project's records and was not paid.

The inappropriate related company temporary employee costs were discussed in finding 1.

The Mortgage Was Overinsured by More Than $341,000

The owners included $593,793 in unreasonable relocation costs on the cost certification they submitted to HUD. HUD disallowed $333,458 in relocation expenses and allowed credits of $8,894 and $44,240 during final cost certification. Our audit identified $379,045[16] in additional unreasonable and unsupported costs that increased the mortgage amount HUD insured by $341,160, calculated as follows:

Description	Amount
Total land and improvements	$10,504,431
Less: HUD disallowed unreasonable relocation costs	(333,458)
Add: HUD miscellaneous credits	8,894
Less: unreasonable and unsupported costs	(379,045)
Audited adjusted total land and improvements	9,800,822
Statutory percentage (90% of line 6)	8,820,740
Audited maximum insurable mortgage (in multiples of $100)	8,820,700
Add: HUD adjustment for Section 8	44,240
Audited maximum insurable mortgage	8,864,940
HUD-approved maximum insurable mortgage	9,206,100
Overinsured amount	**$341,160**

Project Was in a Non-Surplus-Cash Position

The project was in a non-surplus-cash position for the entire period of review. Federal statutes prohibit HUD-insured multifamily project owners from using

[16] $260,335 ($593,793 - $333,458) + $118,710 = $379,045.

project funds for unreasonable expenses when the project is in a non-surplus-cash position.

The project also incurred more than $516,000[17] in operating losses during 2004 and 2005. The more than $593,000 in unreasonable relocation costs paid to the owners' related companies (finding 2), and reduced occupancy rates during construction contributed significantly to these operating losses.

A major concern of HUD's mortgage insurance programs is the inappropriate use of project funds, which can contribute to mortgage defaults, the need for additional financial assistance from HUD, and losses to HUD through the sale of devalued foreclosed properties. In addition, an inappropriate and willful use may be subject to civil money penalties. Since the owners paid their related companies unreasonable amounts for relocation services when the project was in a non-surplus-cash position, they may be subject to these penalties.

Conclusion

The owners paid more than $593,000 in unreasonable costs to their related companies for relocation services, and included this cost in their cost certification as building improvements when the project was in a non-surplus-cash position. In addition, the owners included more than $118,000 in unreasonable and unsupported operating costs in their cost certification. These conditions were caused by weak internal controls over related party transactions and accounting. In addition, these costs contributed to unnecessary operating losses and caused HUD to overinsure the mortgage by $341,160.

Recommendations

We recommend that the Acting New England Hub Director for Multifamily Housing require the owners to

2A. Repay the project $343,939 paid to the owners' related companies from nonproject funds, with the amounts reimbursed placed in the project's reserve for replacement or a restricted capital account that requires HUD approval for release of the funds, and reduce the building improvements account for the same amount.

[17] $228,202 in losses during 2004 and $287,923 during 2005 (each before depreciation expenses).

2B. Remove the $249,854 accounts payable for relocation costs to the owners' related companies from the project's books and reduce the building improvements account for the same amount.

2C. Make a $341,160 principal payment or establish an escrow with the lender from nonproject funds to pay down the amount of overinsurance, with the amounts reimbursed placed in the project's reserve for replacement or a restricted capital account that requires HUD approval for the release of the funds due to unreasonable costs during construction.

2D. Implement adequate written procedures and controls to ensure that future disbursements for project expenses comply with the regulatory agreement and HUD's requirements.

RESULTS OF AUDIT

Finding 3: The Owners Repaid More Than $259,000 in Advances When the Project Was in a Non-Surplus-Cash Position

The owners repaid $259,804 in advances when the project was in a non-surplus-cash position[18] and without HUD approval. The owners paid expenses directly on the project's behalf and advanced other cash to the project's accounts to cover operating shortfalls. However, owners can only repay the advances from available surplus cash. The improper repayments of the advances were due to weak internal controls and a lack of policies for related company transactions. The repayments negatively influenced the project's precarious financial condition. In addition, these violations reduced the availability of cash needed for project operations and may jeopardize the future financial operations and physical condition of the project.

Owners Improperly Repaid Member Advances

During the period December 23, 2003 (the project's inception), through December 31, 2006, the owners improperly repaid $259,804 for member advances. The owners paid expenses on the project's behalf and advanced other funds during this period to cover operating shortfalls. However, the project was in a non-surplus-cash position during this period. Owners can only repay the advances made for reasonable and necessary operating expenses from surplus cash at the end of the annual or semiannual period unless otherwise approved by HUD.[19] Repayment of owner advances when the project is in a non-surplus-cash position or without HUD approval is a violation of the regulatory agreement and may subject the owners to criminal and civil monetary penalties.

More Than $58,000 Was Returned to the Project's Bank Accounts

The financial analysts from the HUD Real Estate Assessment Center (REAC) identified $58,857 in unauthorized member advance repayments and referred the matter to the HUD Departmental Enforcement Center (DEC). DEC required the owners to reimburse the project. The owners repaid the amount questioned in

[18] "Surplus cash" is the cash remaining after all necessary and reasonable expenses of the project have been paid or funds have been set aside for such payment.
[19] "Financial Operations and Accounting Procedures for Insured Multifamily Projects," HUD Handbook 4370.2, REV-1, CHG-1, paragraphs 2-6.E and 2-11.A.

April 2007. Therefore, the balance of improper member advance repayments was $200,947.[20]

Project Financial Performance Was Rated High Risk

The HUD Real Estate Assessment Center (REAC) division rated the project's financial performance as a high risk to HUD. The REAC review of the underlying financial ratios for the last two years of annual financial statements, which measures a project's performance based on standards that are objective, uniform, and verifiable, indicated significant deficiencies. HUD had also notified the owners of serious compliance issues including the unauthorized repayments of owner advances noted above, unauthorized management fees, and late submission of their 2006 financial statements. The high risk is of concern to HUD, which must maintain public trust in the management of assets funded with HUD financial assistance.

Conclusion

The project owners improperly repaid their related companies $259,804 for advances when the project was in a non-surplus-cash position. This action was a violation of the owners' regulatory agreement with HUD. However, the owners repaid $58,857, leaving a balance of $200,947. These problems occurred due to weak internal controls and the lack of policies regarding related company transactions. As a result, these funds were not available for normal project operations and contributed to the high risk rating by REAC. This condition may also jeopardize the future financial operations and physical condition of the project.

Recommendations

We recommend that the Acting New England Hub Director for Multifamily Housing require the owners to

3A. Reimburse the project $200,947[21] from nonproject fund sources for the ineligible member advance repayments. The reimbursement should be deposited into the project's replacement reserve account or another restricted account that requires HUD approval for the release of funds.

[20] ($259,804 - $58,857).
[21] $259,804 in total member advance repayments less $58,857 reimbursed in April 2007.

SCOPE AND METHODOLOGY

Our audit generally covered the period December 23, 2003, through December 31, 2006, but we expanded it when necessary. We conducted our fieldwork from April through November 2007. We carried out our audit work at the management agent's office in Weatogue, Connecticut, and the local HUD Hartford (Connecticut) field office.

To accomplish our audit objectives, we

- Reviewed federal laws and regulations and the owners' regulatory agreement with HUD and obtained an understanding of the owners' corporate structure as it relates to the project.
- Reviewed the project management files at the local HUD field office.
- Interviewed and held meetings with the project owners, controller, selected project staff, and HUD personnel and officials.
- Reviewed the project's financial statements and independent public accountant's reports.
- Reviewed supporting documentation for related company loans and advances to ensure compliance with HUD's requirements.
- Reviewed supporting documentation for the owners' cost certification, form HUD-92330, to determine whether HUD overinsured the project's mortgage.
- Reviewed supporting documentation for management fees to ensure that they were properly supported, accurately calculated, and within HUD-approved limits.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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:

- Controls over the repayment of owner advances and related party transactions.

- Controls over payments, accounting, and maintaining adequate support for project development and operating costs.

- Controls over the payment of management fees.

- Controls over compliance with applicable laws and regulations and provisions of contracts or grant agreements.

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:

- Controls over payments, accounting, and maintaining adequate support for project development and operating costs (see finding 1 and finding 2).

- Controls over payments to related companies for relocation services to ensure that they were reasonable and properly supported (see finding 2).

- Controls over the repayment of owner advances and related party transactions (see finding 3).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unreasonable or unnecessary 2/	Funds to be put to better use 3/	Total
1A		$40,852	$17,490	$58,342
2A		$343,939		$343,939
2B			$249,854	$249,854
2C		$341,160		$341,160
3A	$200,947			$200,947
Totals	$200,947	$725,951	$267,344	$1,194,242

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/ 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.

3/ 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 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. For recommendations 1A and 2B, if our recommendations are implemented, the project will not repay its management agent for unreasonable and unnecessary accrued temporary employee services, or repay its members for unreasonable accrued relocation costs once the project realizes surplus cash.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

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MEMORANDUM

DATE: January 14, 2008

TO: John A. Dvorak
Regional Inspector General for Audit

FROM: Arthur Greenblatt and Steven L. Erie

SUBJECT: HUD OIG Audit of Mohegan Commons

We are writing in response to your Draft Audit Report, dated December 20, 2007, describing certain matters considered by your audit team during its inspection of our records.

We must begin by thanking you and your associates for their courtesy and thoroughness throughout the audit process. This was a good opportunity for our accounting and other staff, and for the two of us, to discuss and analyze our record keeping methods, as well as our method of tracking costs for the work we do. We both now have a superior understanding of our internal accounting mechanisms, and will certainly benefit from this during future project development and program implementation. Please note that your review has been the catalyst for our direction to internal staff that they evaluate our current cost accounting methods and record keeping programs for expenditures, as well as development of a more comprehensive procurement policy. We also note that your review has been the catalyst for greater scrutiny of financial statements prepared by our independent auditors.

That aside, we are taking this opportunity to address each of your findings, and to hopefully provide some additional information that will assist in their resolution. We differ on several points contained in your draft findings and believe that, upon review, the information noted below will be the basis on which certain of your conclusions can be modified. Your draft presents serious matters that require comprehensive responses.

1

Comment 1

John A. Dvorak
January 14, 2008

FINDING 1 – The Owners Charged More Than $60,000 for Services That Were Unnecessary and Unreasonable for Operating and Maintaining the Project

A. Owners Charged More Than $32,000 for Unnecessary Internet Services

The owner disagrees with this part of Finding 1. The $32,287 covered a 25 month period for 182 apartment units. This amounts to $7.10 per apartment per month.

We have reviewed all of the Section 8 handbooks and although we have found nothing that specifically states that internet service is an allowable expense to be paid from rents, there is also nothing in the handbooks that states that internet service is not an allowable expense.

Internet service for residents cannot be categorized as an unreasonable and unnecessary expense in the 21st century. HUD's own literature relating to its Neighborhood Networks speaks to this in many different ways. HUD began its Neighborhood Networks initiative in 1995 with a vision, "to create an initiative that promotes self sufficiency and delivers computer access to low- and moderate-income residents living in privately-owned HUD-insured and assisted multifamily housing." Ten years later, in 2005, it was found that, "low income youth are eight times less likely to use a computer at home as compared to children in families earning $75,000 or more a year." Further, as shown in HUD's literature for Neighborhood Networks, HUD contemplated that at some time after the beginning of its initiative (1995), it would have to figure out a way to provide internet access in residents' apartments.

Although we could not find anything directly on point either in the positive or negative concerning the inclusion of internet access for residents' apartments in operating expenses, during our research we did find relevant policy on HUD's Public and Indian Housing web site. It defines tenant services as follows: "Tenant services are services provided by the PHA, for the benefit of residents, to support a wholesome living environment. This might include the PHA hiring a tenant services staff to provide community agency referrals or advice as to resource for job training placement; providing transportation and admission fees for recreation sites or health clinics, supplying materials and equipment for games or arts and crafts; contracting with others to furnish services, such as a child care center. Tenant services are a routine operating expense of the PHA that is paid from operating funds."

It is common knowledge that HUD's policy is not to simply be concerned about the sticks and bricks of housing. Quite the contrary, HUD's housing policy goes beyond providing decent, safe, and sanitary dwelling units. As the above quote states, HUD's housing policy is meant to include a "wholesome living environment", including educational, recreational, and personal advancement services, all of which are available on the internet.

2

Comment 2

Comment 3

Owner paid internet access is a marketing tool that makes this property more competitive; lowering vacancy rates, attracting new residents, and stabilizing tenancy. All of which is a HUD goal. Accordingly, this expense reduces the expense of vacancy, marketing, and turnover. The cost of additional maintenance staff, leasing staff and revenue loss to handle these additional expenses would far exceed the cost of providing internet access.

Further on the point of Internet access, HUD was advised that the owner would be providing internet access to the residents during the FHA application process.

Also, the auditors noted that the internet contract provides free phone, fax, and internet for the project's main office. Without the contract, the project would have incurred the expense of those items and would have been required to purchase them on an individual basis. The annual cost for those services would have been approximately $3,300 or $6,875 for the 25 month audit period.

B. Owners Charged More than $28,000 for Unreasonable and Unsupported Temporary Employee Services

The owner disagrees with the part of the finding that states that these charges are part of the management fee. These charges were not for the temporary help contemplated HUD Handbook 4381.5, Rev. – 2, Section 6.39(b)(9). These charges were for additional employees required at the project during the audit period and are not part of the management fee. The owner concurs that during the audit period, inadequate controls were in place so as to provide support for the provision of evidence to show who provided the services, when, and the reasonableness of the amount charged.

The owner has put in place such controls with the help of the Reznick Group.

C. Conclusion

The owner disagrees with the statement that the project had operating losses of more than $920,000 during 2004 and 2005. That appears to be an excessive and disingenuous statement of the project's financial condition. That number includes depreciation, a non-cash event. The real operating loss number during that period was $516,125 ($228,202 for 2004 and $287,923 for 2005). Years 2004 and 2005 were the development period. The cause for the $516,125 operating loss was the controlled (reduced) occupancy due to units being vacant so that substantial rehabilitation for long term project physical stability could be carried out within the units (which was the precise goal of the work being done). This "finding" indicates that the project's lack of surplus cash was somehow caused by the other findings noted above. In fact, and in accordance with normal operating procedure for successful preservation, the project did not have surplus cash as a result of temporary vacancy required to actually perform this preservation work. This paragraph concerning non-surplus cash should be struck from this finding as it appears only as an indication of a

Comment 4

Comment 5

misunderstanding of the rehabilitation and construction funding process. It is also a wrongful indication of owner and manager's lack of ability, which is strongly contradicted by post-rehabilitation project operations.

Although to a lesser degree than the planned vacancy, late funding of the enhanced vouchers contributed to the operating loss during '04 and '05. HUD recognized this at final closing.

It should be pointed out that operating income for 2006 was a positive $227,796. Operating income for 2007 is expected to be in the range of that in 2006.

D. Recommendations

Recommendation 1A

The owner disagrees with recommendation 1A that repayment should be made.

As noted above, the cost of internet service is a modern requirement for lower income families that would otherwise lack this vital tool. Additionally, this cost was offset by the savings on office expenses that would have otherwise been incurred had it not been for the internet contract. Finally, this recommendation should be reduced given that temporary employee costs were incurred appropriately.

It should also be noted that at no time during the audit period or to this date has the owner missed any loan payment or reserve funding. In fact, at this time all loan payments, reserve payments, and unrelated third party vendor payments are current.

Recommendation 1C

With regard to recommendation 1C, we were shocked. This organization has managed HUD-subsidized properties throughout the country for decades. Indeed, we have won awards for some of our work. Our most recent REAC score that we received just last week was a 92. Our most recent MOR scores for this project and one of the companion projects that we acquired and rehabbed at the same time we did this project were "satisfactory" and "above average." Your recommendation appears as a mandate to the Field Office that management be replaced at this property. That is a determination that should be made at the Field Office level by experienced personnel with whom we work on a daily basis and with whom we have combined efforts for affordable housing preservation and operation. Respectfully, while the OIG auditors are well versed in their discipline, they are not front-line or operational supervisory personnel with experience necessary for this mandate. We ask that recommendation 1C be revised to direct that the owner cooperate with HUD staff to 'evaluate' property management and to determine if it should be replaced—rather than recommending that they "require the owners to obtain an unrelated management agent to manage the project." We will support our Field Office and Hub in their evaluation and

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determination on this matter. Your mandate is beyond the experience and expertise of those who have evaluated our finances—but not our actual property operation, and the challenges of maintaining safe, decent, and affordable housing in this community. This recommendation must be modified to indicate to the Field Office that this is not a mandate.

FINDING 2 – The Owners Included Unreasonable and Unsupported Expenses in Their HUD-Insured Mortgage Cost Certification

A. Related Company Costs Were Unreasonable and Unsupported

At the outset, the owner was using the services of an independent third party relocation consultant, HOU. The contract with HOU including its cost was approved by HUD during FHA underwriting. The contract and the approved cost were based on the estimate of required moves. As this is not an exact science, both HUD and the owner knew that the number of families requiring temporary relocation was an estimate at the time it was made and that the number of moves could go up or down depending upon the circumstances at the time of the required move. The key variables were the amount of rehab being performed within the dwelling unit and the number of family members, their ages, their medical condition, and their temperament. During the course of construction, problems arose with HOU involving coordination and staffing. The owner determined that the better way to complete the required work on a timely and less costly basis was for its affiliates to take over the work that had been performed by HOU. The audit states that the number of required moves increased above the original estimate of 28 moves to 92 moves. The audit states that HUD approved the charge of $4,258 per move. It, therefore, follows that such amount is reasonable and should be allowed for each move. Accordingly, the owner relocated a total of 92 units and should be allowed to charge $4,258 per tenant or $391,736 for relocation. This seems quite straight forward and has nothing to do with lack of internal controls.

B. Owners Charged the Project $151,479 in Unreasonable and Unsupported Operating Costs

The owner disagrees that the $60,000 in learning center start-up cost was not paid. Originally and at the time of the cost certification for this project the owner had a contract with (QVCC) to provide instruction services at the Learning Center. The $60,000 was listed on the cost certification to be paid within 45 days of closing. At some time between the cost certification and final closing QVCC asked to be released from the contract. The owner did so and entered into an agreement with EastConn to take the place of QVCC. Payments to QVCC and EastConn were made as follows:

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	2005	2006	2007	Total
QVCC	$----------	$18,305.09	$----------	$18,305.09
EastConn	$----------	$32,419.88	$48,396.60	$80,816.48

(See attached backup and support)

Additional support for bad debt expense is attached. Accordingly, the unsupported amount, which was an accounting allowance, should be $40,000.

C. The Mortgage Was Overinsured by $370,660

As stated above, the owner disagrees with this finding.

D. The Project Was in a Non-Surplus-Cash Position

As noted above, we disagree with the draft Audit's characterization of operating losses (a significant portion of which are non-cash events) as an indication of project financial instability. The project has never been in any kind of financial jeopardy or foreclosure, and has never missed a mortgage payment or accrued excessive payables. Operating losses during rehabilitation such as this is normal.

E. Conclusion.

The owner disagrees with this conclusion for the reasons stated above.

Recommendations

2A

The owner disagrees with this amount as stated above.

2B

The owner has implemented written procedures and controls with the help of the Reznick Group.

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Comment 14

Comment 15

Comment 16

Comment 17

Comment 18

FINDING 3 – The Owners Repaid More Than $400,000 in Advances When the Project Was in a Non-Surplus-Cash Position and Accrued More Than $254,000 in Unreasonable Relocation Costs

A. Owners Improperly Repaid Member Advances

The owner strongly disagrees with this finding.

At the initial closing (Draw 1) and shortly thereafter (Draw 3) HUD authorized the repayment of advances in the amount of $352,341.76. (Backup and support are attached.)

B. Project Financial Performance Was Rated High Risk

The owner strongly disagrees with this portion of this finding.

(1) The project had in excess of $200,000 in operating income in 2006;
(2) The project is expected to have in excess of $200,000 in operating income when the 2007 books are closed;
(3) The project has never missed a loan payment or a reserve account funding and third party payables are current;
(4) HUD's May 2007 Management & Occupancy Review was satisfactory; and
(5) It is expected that the 2007 year end statement for the project will evidence positive surplus cash.

C. Conclusion

The owner disagrees with this conclusion for the reasons stated above.

D. Recommendations

Recommendation 3A

The owner disagrees with this amount. As stated above, HUD authorized repayment of advances in excess of this finding.

Recommendation 3B

As noted in Finding 2, these costs of relocation were incurred as a result of actual relocation requirements of units that were more than triple the number originally estimated and planned for in initial project budgeting. This finding should be revised accordingly.

OIG Evaluation of Auditee Comments

Comment 1 We do not dispute the owners' comments that HUD's policy promotes providing tenant services to provide a wholesome environment. However, the costs must still meet the test of necessity and reasonableness. Further, the owners stated that HUD was advised that the owners would be providing Internet access to the residents during the application process. HUD program officials advised us that they were only aware of and approved Internet access for residents through the computers located in the new learning center. HUD program officials were not made aware of nor did they approve subsidizing Internet access to individual units. We coordinated this issue with HUD program officials throughout the audit, and continue to maintain our position that Internet costs to individual units were not necessary/reasonable project costs.

We concur that amount of unreasonable Internet costs requiring repayment may be reduced by the value of the services provided at no cost. However, the owner's response provided no documentation to support the value of these services. In addition, the contract between the owners and Internet provider provides for both parties to share in the profits obtained related to the sale or use of names of residents for purposes of third party vendor marketing. Therefore, if the owners received any income from the sales of these services the income received should be paid returned to the project or used to offset the amount requiring repayment.

Therefore, we continue to question the costs as unreasonable in the report and recommendations 1A.

Comment 2 The owners' response provided no evidence to show which employees provided these services, the services they provided, the amount of time they spent, or the associated costs. The owners' records clearly showed that the temporary employee costs were for "… additional staff to cover sick time, special projects, and vacation" and the amount charged was "an estimated amount upon which sales tax is charged," which were paid for as part of the management fee. We do not understand how the owners could make the statement that "these charges were for additional employees required at the project during the audit period" when they do not know who the employees were, what services they provided, and how much time they worked for the project. Therefore, our audit position remains unchanged.

Comment 3 We concur that reduced occupancy rates during construction reduced project income and contributed to operating losses. However, we do not concur that HUD's delayed funding of more than $44,000 for enhanced vouchers contributed significantly to the operating losses. We also continue to maintain that the unreasonable relocation costs contributed significantly to these losses and the project's non-surplus-cash position. Thus, we changed the report to read, "The project incurred more than $516,000 in operating losses during 2004 and 2005.

The questioned charges in this fining, the more than $593,000 in unreasonable relocation costs paid to the owners' related companies (finding 2), and reduced occupancy rates during construction contributed significantly to these operating losses." We also concur that the project did have positive income in 2007, but still sustained an operating loss after depreciation expenses.

Comment 4 We continue to question the costs as unreasonable in the report and recommendation 1A (see comments 1 and 2). We concur that if the owners provide verifiable evidence to support a reasonable cost for the free business phone, facsimile, and Internet services currently being provided to the project, they could be considered an offset to our questioned costs. However, if the owners received any income from the sales of services provided to Mohegan Common tenants because of the profit sharing provisions of the contract between the owners and Internet provider, the amount requiring repayment may be reduced accordingly.

Comment 5 Based on the nature of the related party relocation costs questioned, and the totality of the deficiencies in this report, our recommendation remains unchanged.

Comment 6 We do not concur with the owners reasoning that based on the amount HUD approved they should have been allowed to charge $391,736 to the project for relocation services. The owners' related companies should have charged the project only for the costs they actually incurred, could support, and HUD approved. During our audit and in their written comments the owners did not provide documentation to support the more than $593,000 dollars their related companies charged the project for relocation services nor justify why their related company charged the project more than $323,000 dollars when it did not have any employee costs. Nonetheless, the owners maintain that their companies should have been paid for relocation services. We cited the owners' lack of internal controls because they failed to maintain adequate records to support their charges. For example, the owners' related companies did not show which employees provided services, what services they provided, or the number of hours they spent providing these services. In addition, the project maintained invoices for some of the costs charged; however, invoices were missing for $170,100 in charges. Therefore, we continue to maintain the related company relocation costs were unreasonable and the owners' internal controls require improvement.

Comment 7 The owners signed and certified the cost certification for costs incurred prior to August 19, 2005, the cost certification date. The owners included $60,000 for "Learning center start-up costs incurred as of the cost certification date." The invoices provided in the owners' response are for costs incurred after the cost certification date, thus, are not eligible for inclusion in the cost certification, and should not have been included in the mortgage amount that HUD insured. Therefore, our conclusion and recommendations remain unchanged.

Comment 8 The owners provided supporting documentation to show the project incurred $40,633 in bad debts during the cost certification period of December 23, 2003, through August 19, 2005. Therefore, we reduced the amount of questioned bad debt costs to $17,934 ($58,567 reported on the cost certification - $40,633 in bad debts actually incurred) and adjusted their effect on the mortgage amount HUD insured.

Comment 9 We maintain that the mortgage was overinsured. However, we reduced the amount to $341,160 based on the reduced amount of questioned bad debt expenses. See comments 6, 7, and 8.

Comment 10 We concur the project's mortgage was current. However, the project also was in a non-surplus-cash position and incurred more than $920,000 in losses after deprecation and more than $516,000 before depreciation during 2004 and 2005. Thus, we changed the report to read, "The project also incurred more than $516,000 in operating losses during 2004 and 2005. The more than $593,000 in unreasonable relocation costs paid to the owners' related companies and reduced occupancy rates during construction contributed significantly to these operating losses." See also comment 3.

Comment 11 We maintain our conclusion and the conditions noted in this finding. See comments 6-9.

Comment 12 We maintain our recommendation, and renumbered it from 2A to 2C. See comments 6 and 7.

Comment 13 The owners' response provided no support to show they implemented adequate written procures and controls. Therefore, we maintain our recommendation and renumbered it from 2B to 2D.

Comment 14 We reviewed the development costs cited in the owners' attachment. We concur that advances repaid from the project's development account for supported preacquisition costs are eligible. We reduced the total amount questioned accordingly. However, all advances repaid from the project's operating account are ineligible and must be reimbursed. In addition, the owners did not support the $110,000 repayment on 11/14/2005 from the project's development account, and must be reimbursed. Because the development account is closed, the remaining balance to be repaid for preacquisition costs can only be repaid from surplus cash at the end of the fiscal period.

Comment 15 The project's financial performance was analyzed and rated by HUD's Real Estate Assessment Center division. The HUD review is based on an analysis of the underlying financial ratios for the last two years of annual financial statements, which measures a project's performance based on standards that are objective, uniform, and verifiable, indicated significant deficiencies.

Comment 16 We reduced the total amount of questioned costs accordingly (see comment 14). However, we maintain the significance of our finding.

Comment 17 We reduced the total amount of questioned costs accordingly (see comment 13).

Comment 18 We do not concur with the owners' reasoning that based on the amount HUD approved they should have been allowed to charge $391,736 to the project for relocation services. The owners' related companies should have charged the project only for the costs they actually incurred, could support, and HUD approved. See comment 6.

In addition, we moved this recommendation to remove the account payable to from Finding 3, Recommendation 3B to Finding 2, Recommendation 2B.

We also added related Recommendation 2A requiring the owners to repay the project $343,939 and reduce the building improvements account for the same amount.

Appendix C

SUMMARY OF RELATED COMPANIES

Mohegan Commons (the project), also known as Vesta Mohegan, LLC, is owned by HDASH, LLC (99 percent) and Vesta Equity 2003, LLC (1 percent). HDASH is owned by two members, "the owners."

Vesta Corporation performs no functions for the project and is the parent holding company for its wholly owned subsidiaries, Vesta Equity Corporation and Vesta Management Corporation. RFD Acquisition Corporation owns Vesta Corporation. J&Z Investment Company owns RFD Corporation. J&Z Investment Company's shareholders are the project owners' family members (70 percent) and nonrelated investors (30 percent).

Vesta Equity Corporation performs no functions for the project but owns Vesta Equity 2003, LLC. Vesta Equity 2003, LLC, was created to perform management functions on behalf of the project.

Vesta Management Corporation is the legal entity that manages the project's day-to-day operations such as renting apartments, collecting rents, maintenance, and other daily property operational tasks.