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2008-BO-1005

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 $2.8 million in Cost Exceptions for Windham Heights Apartments, Windham, Connecticut

HIGHLIGHTS

What We Audited and Why

We audited Vesta Windham Heights, LLC (Windham Heights), 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 and/or management agent 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 more than $2.8 million (see appendix A). These cost exceptions were due to weak internal controls, a lack of policies for related company transactions, and inadequate accounting procedures. Specifically, the owners and management agent (1) used more than $171,000 for services that were unnecessary and unreasonable to operate and maintain the project and when the project was in a non-surplus-cash position; (2) included unreasonable and unnecessary costs in their cost certification, causing the U.S. Department of Housing and Urban Development (HUD) to overinsure the mortgage by more than $598,000; and (3) repaid more than $800,000 in advances when the project was in a non-surplus-cash position. These violations, which included charging the project more than $1.3 million for unreasonable relocation services when the project was in a non-surplus-cash position, 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 ineligible use of operating funds for unreasonable and unnecessary costs charged to the project, (2) make a principal payment or establish an escrow with the lender from nonproject funds to pay down the amount of overinsurance, and (3) repay the project for ineligible repayments to their related companies.

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. 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 auditee on December 20, 2007, and requested a response by January 16, 2008. We discussed the draft audit report at an exit conference on December 21, 2007, and received the auditee's written comments on January 16, 2008. The auditee generally disagreed with the report.

The text of the auditee's 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.

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BACKGROUND AND OBJECTIVES

Windham Heights (project) is a multifamily 350-unit apartment complex located on 22 acres in Windham, Connecticut, with 345 project-based Section 8 units and five units supported with housing choice vouchers.

The owners, HDASH, Limited Liability Corporation (LLC), and its related company Vesta Equity 2003, LCC, purchased the property in December of 2003 and embarked on substantial rehabilitations. The owners financed the purchase and renovations, and the U.S. Department of Housing and Urban Development (HUD) insured the mortgage through Section 221(d)4 of the National Housing Act (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, and the $13 million in renovations completed in July of 2005 included gutting and reconstruction of 92 termite-damaged units. Interior work included new doors, 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 more efficient operation. Exterior work included new sidewalks, sealing the parking lot, landscaping, site lighting, and upgrading the closed circuit television monitoring system.

The owners submitted a "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. HUD insured the project's mortgage for $17.1 million based on the documentation provided.

Our audit objective was to determine whether the owners and/or management agent 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 were costs 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.

RESULTS OF AUDIT

Finding 1: The Owners Charged More Than $171,000 for Services That Were Unnecessary and Unreasonable for Operating and Maintaining the Project

The owners charged the project more than $171,000 for services that were unnecessary and unreasonable for operating and maintaining the project. This amount included charges of $67,326 for unnecessary Internet service provided to all tenant units, $66,015 for unnecessary social activities, and $38,160 to pay their related management company for unreasonable temporary employee services when the project was in a non-surplus-cash condition. These unnecessary and unreasonable charges occurred due to 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 $67,326 for Unnecessary Internet Services

The owners paid a vendor $67,326 in project operating funds to provide Internet services to the project's 350 housing units. They paid $5,292 during construction[1] and $62,034 after normal operations began.[2] The services were provided 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, fax, 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 HUD-insured project funds be used only for reasonable expenses necessary for the operation and maintenance of the project.[3]

[1] December 23, 2003, through September 4, 2005.
[2] September 5, 2005, through August 31, 2007
[3] "Regulatory Agreement," form HUD-92466, paragraph 6b.

Owners Charged $66,015 for Unnecessary Food/Entertainment

The owners charged the project $66,015 for trips to an amusement park, bus transportation, snacks, and disc jockeys. They charged $30,259 during construction and $35,756 after normal operations began. The costs were incurred because the owners continued several community programs and activities that the previous owners had established. However, these costs were not necessary for the operation or maintenance of the project.

The Owners Charged $38,160 for Unreasonable Temporary Employee Services

The owners' related management company also charged the project $38,160 for unreasonable and temporary employee services. It charged $14,310 during construction and $23,850 after normal operations began.[4] 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 or whether the services were actually provided. This condition occurred due to inadequate accounting procedures and weak management controls.

Conclusion

The owners charged the project $171,501 for services that were unnecessary and unreasonable to operate and maintain the project. This condition occurred due to inadequate accounting procedures and management controls, weakened the project's financial position, and contributed to operating losses of more than $275,000[6] during 2004 and 2005. The $121,640 charged after normal operations began should be repaid to the project operating account, and the $49,861 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 condition, they are subject to sanctions under the federal equity skimming statutes.

[4] The project paid $7,950 and accrued $15,900 in payables to the owner's related company during operations.
[5] "The Management Agent Handbook," HUD Handbook 4381.5, paragraph 6.39b (9).
[6] $298,091 in losses in 2004 + $22,680 in profits in 2005 = $275,411 in losses.

Recommendations

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

1A. Repay the project $105,740[7] from nonproject fund sources and remove the $15,900[8] in payables for temporary employee services from its accounting records for the unnecessary and unreasonable operating 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.[9]

We also recommend that the Director of the Departmental Enforcement Center

1D. Pursue all administrative and/or civil monetary penalties for the regulatory agreement violations disclosed in this report.[10]

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[7] $62,034+35,756+$7,950.
[8] Accrued for temporary employee services.
[9] In implementing this recommendation, HUD should consider all of the issues discussed in this report.
[10] In implementing this recommendation, the Deputy Director should consider all of the issues discussed in this report.

RESULTS OF AUDIT

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

The owners included more than $1.3 million 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 been 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 $364,000 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 $598,000, contributed to unnecessary operating losses, and subjects the owners to sanctions under the federal equity skimming statutes.

Related Company Costs Were Unreasonable

The $1,301,123 charged for related company relocation services[11] was unreasonable. The costs were unreasonable because they exceeded the $425,769 HUD approved.[12] HUD initially approved the owners to charge the project an average of $3,108 per tenant to move 137 tenants. However, the owners charged the project an average of $8,243 per tenant to move 214 tenants, an increase of more than 150 percent and a cost increase of more than 400 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 $635,756. In addition, the owners could not show that the costs paid to their companies were comparable to costs that would have been

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

paid on the open market as required by their regulatory agreement and certification to HUD.[13]

In addition, the $1,301,123 in improper relocation costs was capitalized as part of the building improvements, and should be removed from the project's balance sheet. The $999,348 paid to the owners' related companies must be returned to the project and the $301,775 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 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 $307,435 in charges.

Owners Charged the Project $364,110 in Unreasonable and Unnecessary Operating Costs

The owners also included $364,110 in unreasonable and unnecessary charges on the "Statement of Project Operations" they certified and submitted to HUD in support of their HUD-insured mortgage as follows:

Description	Amount
Loan interest to related company	$138,995
Salary costs for manager	$115,254
Learning center startup costs	$60,000
Entertainment and food	$ 30,259
Related company temporary employee costs	$ 14,310
Internet service for all housing units	$ 5,292
Total	$364,110

- The $138,995 in loan interest was not recorded on the project's records and was not paid.

- The $115,254 in manager salary was already paid for as part of the management fee. The manager's costs were also unnecessary because the project maintained and paid for an on-site manager during the construction

[13] "Project Owner's/ Management Agent's Certification," form HUD-9839-B, signed July 29, 2003

period to manage the day-to-day operations of the project. In addition, the owners charged this project and two other HUD-insured projects $200,546 on their cost certifications for the same employee's salary, an overbilling of $84,239.

- The $60,000 in learning center startup costs was not entered in the project's books and records and was not paid.

The inappropriate entertainment and food, Internet, and temporary employee costs were discussed in finding 1.

The Mortgage Was Overinsured by $598,700

The owners included more than $1.3 million in unreasonable relocation costs on the cost certification they submitted to HUD. HUD disallowed $999,907 in relocation expenses and $9,211 in other costs during final cost certification. Our audit identified $665,326[14] in additional unreasonable and unnecessary costs that increased the mortgage amount HUD insured by $598,700, calculated as follows:

Description	Amount
Total land and improvements	$20,066,948
Less HUD-disallowed unreasonable relocation costs	$(999,907)
Less other HUD-disallowed costs	$(9,211)
Less unreasonable and unnecessary costs	$(665,326)
Audited adjusted total land and improvements	$18,392,504
Statutory percentage (90% of line 6)	$16,553,254
Audited maximum insurable mortgage (in multiples of $100)	$16,553,300
HUD-approved maximum insurable mortgage	$17,152,000
Overinsured amount	$598,700

The Project Was in a Non-Surplus-Cash Position

The project incurred more than $275,000[15] in operating losses during the construction period. The more than $1.3 million in unreasonable relocation costs paid to the owner's related companies and reduced occupancy rates during construction contributed significantly to these operating losses. Federal statutes prohibit HUD-insured multifamily project owners from using project funds for

14 $1,301,123 - $999,907 = $301,216 + $364,110 = $665,326.
15 $298,091 in losses in 2004 + $22,680 in profits in 2005 = $275,411 in losses.

unreasonable 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. Also, 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 included more than $1.3 million in unreasonable costs paid to their related companies for relocation services in their cost certification as building improvements when the project was in a non-surplus-cash position. In addition, the owners included more than $364,000 in unreasonable 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 $598,700.

Recommendations

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

2A. Repay the project $999,348 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.

2B. Remove the $301,775 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 $598,700 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.

Finding 3: The Owners Repaid More Than $800,000 in Advances When the Project Was in a Non-Surplus-Cash Position

The owners repaid more than $800,000 in advances when the project was in a non-surplus-cash position[16] and without HUD approval. The owners paid expenses directly on the project's behalf and also 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 $806,530 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.[17] 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 owner to criminal and civil monetary penalties.

Project Financial Performance Was Rated High Risk

HUD's Real Estate Assessment Center (REAC) 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 unauthorized repayments of owner

[16] "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.
[17] HUD Handbook 4370.2, REV-1, CHG-1, "Financial Operations and Accounting Procedures for Insured Multifamily Projects," paragraphs 2-6.E and 2-11.A.

advances, 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 $806,530 for advances when the project was in a non-surplus-cash position. This repayment violated the owners' regulatory agreement with HUD. These actions 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 $806,530 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.

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 selected project costs to ensure that they were reasonable, necessary, and properly supported.

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 payments to vendors and related companies for operating costs.
- Controls over accounting and maintaining adequate support for development costs.
- Controls over the repayment of owner advances and related party transactions.

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:

- Accounting procedures did not ensure that operating costs were reasonable, necessary, and properly supported (see findings 1 and 2).

- Accounting procedures did not ensure that development costs were reasonable, properly classified, and adequately supported (see finding 2).
- Accounting procedures did not ensure that transfers of owner funds to the project were properly supported, classified, and approved by HUD before transfer and repayment (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		$105,740	$15,900	$121,640
2A		$999,348		$999,348
2B			$301,775	$301,775
2C		$598,700		$598,700
3A	$806,530			$806,530
Totals	$806,530	$1,703,788	$317,675	$2,827,993

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 16, 2008

TO: John A. Dvorak
Regional Inspector General for Audit

FROM: Arthur Greenblatt and Steven L. Erie

SUBJECT: HUD OIG Audit of Windham Heights

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 16, 2008

FINDING 1 – The Owners Charged More Than $171,000 for Services That Were Unnecessary and Unreasonable for Operating and Maintaining the Project

A. Owners Charged $67,326 for Unnecessary Internet Services

The owner disagrees with this part of Finding 1. The $67,326 covered a 25 month period for 350 apartment units. This amounts to $7.69 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 resources 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

Owner paid internet access is also 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 $3,900 or $8,125 for the 25 month audit period.

For the various reasons set forth above, the owner believes that this level of internet service is necessary to maintain the project.

B. Owners Charged $66,015 for Unnecessary Food/Entertainment

The owners disagree that the $66,015 charge for food/entertainment is unnecessary. These expenditures took place over a 24-month period for a project in which more than 400 children reside. This comes to an average of $6.88 (or less) per month per child.

First, the Auditor's tone in this finding is that these charges were an extravagance. The charges were not primarily for trips to an amusement park. Quite the contrary. The project has an after-school program which includes a mentoring program with the mentors being University of Connecticut students. The project also has a program for children during school vacations, including the long summer vacation. These programs run throughout the year and, though there might be spikes in the charges due to periodic field trips, the charges are incurred throughout the year. These programs not only enhance the lives of our resident children, but have the additional effect of reducing vandalism and increasing project marketability. We believe that it is naïve to say that the cost of these benefits are not necessary.

As stated in our response to finding 1A, HUD's housing policy is meant to include a "wholesome living experience." These programs do just that.

The payment of the $66,015 went to several third party vendors. The purchases were all for the children of the project and their teachers, mentors, and chaperones. The expenditures were related to an after school and summer program that has been operating at the project for a number of years, including for a period of time before owner acquired the project. The expenditure was mostly for after school snacks, supplies, bus service for

Comment 3

Comment 4

John A. Dvorak
January 16, 2008

field trips, admission to different recreation sites, and pizza parties. All of these contributed to the wholesome living environment.

Without the after school programs and these expenditures, who knows what these kids would be doing. It is fair to say if the project did not have this program and its expense, it would have to incur other costs and expenses that would far exceed this $66,015 over a two year period.

For the various reasons set forth above, the owner believes that the charges for children's programs are necessary to maintain the project.

C. Owners Charged More than $38,160 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.

D. Conclusion

The owner disagrees with the statement that the project had operating losses of more than $320,000 during 2004 and 2005. That number includes depreciation, a non-cash event. The real operating income number during that period was <$297,365> <$309,203> for 2004 and $11,568 for 2005). Years 2004 and 2005 were the development period.
The cause for the $297,365 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 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.

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John A. Dvorak
January 16, 2008

It should be pointed out that operating income for 2006 was a positive $204,040. Operating income for 2007 is expected to be in the range of that in 2006.

E. **Recommendations**

Comment 5

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. The costs of the children's programs are also a reasonable and necessary expense. 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.

Comment 6

Recommendation 1B

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

Comment 7

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 score which was received only a short time ago was "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 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

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Comment 8

Comment 9

John A. Dvorak
January 16, 2008

recommendation must be modified to indicate to the Field Office that this is not a mandate.

FINDING 2 – The Owners Included Unreasonable and Unsupported Costs 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 only 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 137 moves to 214 moves. The audit states that HUD approved the charge of $3,108 per move. It, therefore, follows that such amount is reasonable and should be allowed for each move. Accordingly, the owner relocated a total of 214 units and should be allowed to charge $3,108 per tenant or $665,112 for relocation. This seems quite straight forward and has nothing to do with lack of internal controls.

B. Owners Charged the Project $364,110 in Unreasonable and Unsupported Operating Costs

The owners disagree with this as stated in this finding 2 and finding 1 and should be modified accordingly.

1. $60,000 in Learning Center startup 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:

	2004	2005	2006	2007	Total
EastConn	$1,875.00	$960.00	$8,125.73	$28,100.89	39,061.62

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Comment 10

Comment 11

Comment 12

Comment 13

(See attached backup and support)

2. Salary Costs for Manager

The salary costs were not for the property manager. The property manager's role throughout the entire audit period and continuing to this day was to manage normal operations. She had nothing to do with the added complexities and required duties generated by the addition of substantial rehabilitation and everything that went along with it. The amount of $115,254 during the long term development period was paid to the person in charge of the coordination of construction, relocation, and day-to-day property management. To the extent that there was an over-billing on account of two companion projects undergoing construction and relocation at the same time, that was clearly an error. However, the $115,254 was both reasonable and necessary and should not be disallowed in its entirety.

3. Entertainment and Food

See above

4. Internet Service

See above

C. The Mortgage Was Overinsured by $598,700

As stated above, the owner disagrees with this finding.

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

As noted above, we strongly 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 these are normal and expected. Such losses are different from what is a legitimate concern – losses when a project is fully operational. As shown above, the project has been in a positive income position in both years it has been fully operational.

E. Conclusion.

The owners disagree with this conclusion and the amount of "unreasonable operating costs" should be reduced. The stated amount that "caused HUD to over insure the mortgage" should also be reduced.

Comment 14

Comment 15

Comment 16

Comment 17

Comment 18

F. Recommendations

The owner disagrees with this recommendation as stated above.

2A. We disagree with this recommendation and this amount should be modified as stated above.

2B. The owner has implemented recommendations and controls with the help of the Reznick Group.

FINDING 3 – The Owners Repaid More Than $1 Million in Advances When the Project Was in a Non-Surplus-Cash Position and Accrued More Than $363,000 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 $609,445.59. (Backup and support are attached.)

Additionally, $296,000 of owner advances were the direct result of late Section 8 rent payments. These advances were made so that mortgage payments and vendor payments could be made on a timely basis. It was always intended that these advances would be short term in nature and would be repaid when the Section 8 payments became available. The standard procedure is for the owner to request HUD's permission for the advance and subsequent repayment. HUD's normal response is to use project reserve funds first. The owner did not make such a request. However, reserve for replacement fundings did not begin until after the development period ended so that option was not available to us. The owner should not be penalized for making the advances and then repaying them when the reason for the advance was to deal with HUD's tardiness in making a monthly Section 8 payment, which advance prevented the mortgage or vendor payments to be delinquent.

B. Liability for Member Advances Contained Unreasonable Relocation Costs

The owner disagrees with this finding as stated above and it should be modified accordingly.

C. Project Financial Performance Was Rated High Risk

Comment 19

Comment 20

Comment 21

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 September 2007 Management & Occupancy Review was "above average".

D. Conclusion

The owners disagree with this conclusion as stated above and it should be modified accordingly.

E. Recommendation

Recommendation 3A

The owner disagrees with this amount. As stated above.

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 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 is to promote providing tenant services that 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 owner 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 a necessary/reasonable project cost.

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 returned to the project or used to offset the amount requiring repayment.

We continue to question the costs as unreasonable in the report and recommendation 1A.

Comment 2 We do not dispute the owners' comments that HUD's policy is to promote providing tenant services that provide a wholesome environment. However, the costs must still meet the test of necessity and reasonableness. Further, the owners provided no evidence to support their claim that entertainment and food costs were necessary and in fact reduced vandalism and increased occupancy rates. If the owners are concerned about vandalism they may consider additional security costs that are allowable project expenses. Therefore, we continue to question the costs as unnecessary/unreasonable in the report and recommendation 1A.

Comment 3 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' books and 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. In addition, the owners provided no evidence they established adequate controls to account for and charge for their employees' time. Therefore, our audit position remains unchanged.

Comment 4 We concur that reduced occupancy rates during construction reduced project income and contributed to operating losses. However, we continue to maintain that the project would not have incurred losses if the owners did not charge the project more than $1.3 million for unreasonable relocation services.

We also concur the project had an operating profit of $22,680 before depreciation in 2005. We do not concur the project had a net operating loss before depreciation of $309,203 in 2004. We maintain the operating loss was $298,091 as reported on their audited profit and loss statement.

Therefore, we adjusted the report to read, "The project incurred more than $275,000[18] in operating losses during the construction period. The more than 1.3 million in unreasonable relocation costs paid to the owner's related companies and reduced occupancy rates during construction contributed significantly to these operating losses."

Comment 5 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 6 The owners' response provided no support to show they implemented adequate written procures and controls. Therefore, we maintain our recommendation 1B.

Comment 7 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 8 We do not concur with the owners' reasoning that based on the amount HUD approved they should have been allowed to charge $665,112 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 $1.3 million dollars their related companies charged the project for relocation services nor justify why their related company charged the project more than $635,000 dollars when it did not have any

[18] $298,091 in losses in 2004 + $22,680 in profits in 2005 = $275,411 in losses.

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 $307,435 in charges. Therefore, we continue to maintain the related company relocation costs were unreasonable and the owners' internal controls require improvement.

Comment 9 The owners signed and certified the cost certification[19] for costs incurred prior to September 4, 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 for 2006 and 2007 are for costs incurred after the cost certification date and thus, are not eligible for inclusion in the cost certification and should not have been included in the mortgage amount that HUD insured. The 2004 and 2005 invoices to transport students from the learning center to a park and a school were not learning center start-up costs; and were not eligible to be included as a capitalized item on the cost certification. Therefore, our conclusion and recommendations remain unchanged.

Comment 10 We interviewed the employee during our audit and confirmed that a significant amount of her duties required payment from the management fee. The duties that required payment as part of the management fee included preparing budgets, recruiting, hiring, and supervising project personnel, and training project personnel, monitoring project performance and operations, analyzing and solving project problems, and keeping the owner abreast of project operations. In addition, the project already maintained and paid for an on-site manager during the construction period. Thus, paying for an additional manager's salary, the entertainment and food, and internet services from operating funds was unreasonable and unnecessary project cost. Therefore, our conclusion and recommendation remain unchanged.

Comment 11 We maintain the mortgage was overinsured by $598,700. See comments 1, 2, 3, 8, 9, and 10 for the reasons that including this amount results in the mortgage being overinsured.

Comment 12 We concur the project's mortgage was current. However, the project also was in a non-surplus-cash position and incurred more than one million dollars in losses after deprecation[20] and more than $275,000 before depreciation during 2004 and 2005.

[19] Certificate of Actual Construction Costs HUD form 92330
[20] $606,015 in 2004 + $475,921 in 2005 = $1,081,936

Comment 13 We maintain the Mortgage was overinsured by $598,700. See comments 1, 2, 3, 8, 9, and 10 for the reasons that including this amount results in the mortgage being overinsured.

Comment 14 We maintain our recommendation, and renumbered it from 2A to 2C. See comments 1, 2, 3, 8, 9, and 10 that supports the basis for this recommendation.

Comment 15 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 16 We reviewed the development costs cited in the owners' attachment. We concur that advances repaid from the project's development account for supported pre-acquisition 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 $110,000 repayment on November 14, 2005, from the project's development account was not supported and must be reimbursed. Because the development account is closed, the remaining balance to be repaid for pre-acquisition costs can only be repaid from surplus cash at the end of the fiscal period. Furthermore, since the owners did not request HUD approval to repay member advances for the late Section 8 payments, the related repayments are ineligible.

Comment 17 We maintain that relocation costs charged by the owners' related companies were unreasonable. See comment 8 for basis that costs were unreasonable.

Comment 18 The project's financial performance was analyzed and rated by HUD's Real Estate Assessment Center division. The 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 19 We reduced the total amount of questioned costs accordingly (see comment 16). However, we maintain the significance of our finding.

Comment 20 We reduced the total amount of questioned costs accordingly (see comment 16).

Comment 21 We disagree with the owners' reasoning that based on the amount HUD approved, they should have been allowed to charge $665,112 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 8 for the basis that this cost should not have been charged.

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

Windham Heights (the project), also known as Windham Heights, 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.