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TO: Ellen R. Connolly, Director, Boston Multifamily Hub, 1AHMLA  
Henry S. Czauski, Deputy Director, Departmental Enforcement Center, CV

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

SUBJECT: Multifamily Project Deficiencies Resulted in More Than \$730,000 in Cost  
Exceptions for Moosup Gardens Apartments, Moosup, Connecticut

## **HIGHLIGHTS**

### **What We Audited and Why**

We audited the records for Moosup Gardens Apartments (project), a U.S. Department of Housing and Urban Development (HUD)-insured multifamily project in response to a request from HUD. Our audit objective was to determine whether the project's costs were accurately reported to HUD and in accordance with the regulatory agreement and HUD's requirements.

### **What We Found**

We identified questioned costs and opportunities for funds to be put to better use totaling more than \$730,000 ([see appendix A](#)). These cost exceptions were due to weak internal controls, lack of policies for related company transactions, and inadequate accounting procedures. As a result, the owners (1) repaid advances when the project was in a non-surplus-cash position, charged ineligible costs, and did not adequately support payments to their related company; (2) paid their related company more than \$230,000 in unreasonable and unsupported relocation services costs when the project was in a non-surplus-cash position; (3) included

more than \$280,000 in unreasonable and unsupported expenses in their HUD-insured mortgage cost certification; and (4) did not properly manage the HUD-assisted learning center.

### **What We Recommend**

We recommend that the director of HUD's Boston Multifamily Hub require the owners to (1) repay the project for ineligible use of operating funds while the project was in a non-surplus-cash position and pay down the project's mortgage for unsupported development costs; (2) repay the project for unreasonable and unsupported relocation costs; (3) make a principal payment to pay down the project's mortgage for unreasonable relocation costs and provide support for or make a principal payment to pay down the project's mortgage for unsupported operations expenses included in the mortgage amount HUD insured; and (4) establish and implement a business to plan which ensures that the learning center delivers effective programs in an economical and efficient manner and becomes self-sufficient without HUD funding.

Further, we recommend that HUD pursue administrative sanctions as appropriate against the responsible parties for the unreasonable and unsupported 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 owners a draft audit report on May 25, 2007, and held an exit conference on June 5, 2007, to discuss the draft report. We received the owners' written comments on June 12, 2007. The owners generally disagreed with our conclusions in Findings 1, 2, and 3 and agreed to provide additional support they believed would ultimately support some of the questioned costs. The owners generally agreed with Findings 4, 5, and 6 and; 1) agreed to revise their learning center business and financing plan, 2) repaid ineligible management fees, and 3) agreed to establish new contracting procedures. The complete text of the owners' response, along with our evaluation of that response, can be found in [appendix B](#) of this report.

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## BACKGROUND AND OBJECTIVES

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Moosup Gardens Apartments (project) is a multifamily 88-unit apartment complex located in Moosup, Connecticut, with 27 project-based Section 8 units and 61 units charged at market rates. In addition to the project-based Section 8 units the U.S. Department of Housing and Urban Development (HUD) provides vouchers for 11 market rents from the Housing Choice Voucher program.

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.<sup>1</sup> The owners financed the purchase and renovations, and 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 \$1.8 million in renovations completed in February 2005 included new appliances, repair of structural failures, replacement of siding, and upgrading of boilers. The owners also added a Neighborhood Network Computer Center (learning center) and community room.

The owners submitted a Mortgager's Certificate of Actual Cost (form HUD 92330) to HUD on March 31, 2005, to determine the amount of mortgage insurance HUD would provide.

Our overall audit objective was to determine whether the project's costs were accurately reported to HUD and in accordance with the regulatory agreement and HUD's requirements. Our specific audit objectives were to determine whether the owners (1) used operating funds to repay owner advances when the project was in a non-surplus-cash position and whether payments from development funds to related companies were eligible and adequately supported; (2) used project funds to pay their management company reasonable amounts for relocation services; (3) included reasonable costs in their HUD-insured mortgage certification; (4) properly managed, accounted for, and reported learning center costs; (5) charged the project correct management fees; and (6) had adequate contracting procedures to show that costs paid were reasonable.

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 the Department of Housing and Urban Development and or other Federal agencies.

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<sup>1</sup> See appendix D for a description of the project's related companies.

## RESULTS OF AUDIT

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### Finding 1: The Owners Repaid Advances When the Project Was in a Non-Surplus-Cash Position, Charged Ineligible Costs, and Did Not Adequately Support Payments to Their Related Company

The owners used \$125,000 in project operating funds to repay advances from their related company when the project was in a non-surplus-cash position. The owners also paid \$110,000 in project funds to their related managing member for ineligible and unsupported advances and operating costs. In addition, they did not adequately support payments of more than \$56,000 to their related company. The advances were made to cover operating shortfalls and were repaid due to weak internal controls and lack of policies for related company transactions. The ineligible and unsupported costs were caused by inadequate accounting procedures. As a result, more than \$291,000 in project operating funds was not available for project operations. In addition, HUD overinsured the project for the ineligible and unsupported acquisition costs (see [finding 3](#)).

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#### **The Owners Improperly Repaid Advances**

The owners' related companies advanced \$305,209 in working capital to the project during fiscal years 2004 through 2005. Vesta Equity 2003, the managing member for the project, advanced \$182,000 to the project's operating account to cover operating costs. Also, Vesta Corporation, a holding company, paid \$123,209 for acquisition costs for the project. All three companies share common ownership. Although HUD encourages owners to make operating advances to projects in critical situations, repayment for these advances must be made from surplus cash at the end of the annual period<sup>2</sup> unless HUD approves another method of payment. However, the owners repaid their related company \$19,000 from operating funds during construction and an additional \$106,000 following construction. The repayments were prohibited because the project did not have surplus cash and reported operating losses during fiscal years 2004 through 2005 totaling \$314,057.<sup>3</sup> The repayments occurred due to weak internal controls and the lack of policies regarding related company transactions.

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<sup>2</sup> Financial Operations and Accounting Procedures for Insured, HUD Handbook 4370.2, chapter 2-11A.

<sup>3</sup> The project did not have surplus cash during the construction period, December 23, 2003 through March 31, 2005 and reported a surplus cash deficit of \$56,096 at fiscal year end 2005.

### **The Owners paid their Management Company \$110,000**

The owners obtained \$110,000 from the state of Connecticut for the learning center and deposited the funds into the project's bank account on November 8, 2005. The next day, they paid \$110,000 to Vesta Equity 2003, their related managing member. We asked the owners to provide supporting documentation to show how the funds were used.<sup>4</sup> However, they only provided an email stating that the \$110,000 was for repayment of \$96,348 in advances the management company made in 2004 and 2005 to cover operating shortfalls, and \$13,652 was for staff costs. We determined that the operating shortfalls in 2004 and 2005 were primarily due to unreasonable relocation costs paid to the management company (see [finding 2](#)). Also, the owners provided no documentation to support the staff costs. Because the project was in a non-surplus-cash position the repayment of \$96,348 was an ineligible project expense and the \$13,652 was unsupported and must be repaid.

### **The Owners' did not Support \$56,877 in Development Costs**

The owners used \$123,209 of the project's development funds to repay their related company, Vesta Corporation, for acquisition costs but provided adequate support for only \$66,332. Therefore, we questioned the balance of \$56,877 as unsupported costs. The unsupported costs were paid to the owners' mortgage company and bank and may be eligible project costs. However, the owners did not provide approved invoices and documentation to clearly show (1) the amount paid (2) what the payments were for, (3) that the payments were authorized development costs, and (4) that the project benefited from the payments. These repayments were unsupported due to weak accounting procedures and the lack of controls to ensure compliance with the project's regulatory agreement and HUD regulations.

### **Conclusion**

The owners improperly repaid their related company \$125,000 for advances when the project was in a non-surplus-cash position. The owners also paid \$110,000 in project funds to their related company for ineligible and unsupported advances and operating costs. In addition, the owners did not support \$56,877 in costs paid from development funds to their related company. These problems occurred due

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<sup>4</sup> The owners' regulatory agreement with HUD allows the use of project funds only for reasonable operating expenses and necessary repairs when the project is in a non-surplus-cash position (regulatory agreement par 6b).

to weak internal controls and the lack of policies regarding related company transactions. The ineligible and unsupported payments were caused by inadequate accounting procedures and the lack of compliance controls. As a result, \$291,877 was not available to the project, and HUD overinsured the project's loan (see [finding 3](#)).

## Recommendations

We recommend that the director of HUD's Boston Multifamily Hub require the owners to

- 1A. Repay the project \$106,000 from non-project funds, for owner advances 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.
- 1B. Make a \$19,000 principal payment or establish an escrow with the lender from nonproject funds or the restricted account established under recommendation 2A to pay down the amount of overinsurance due to ineligible owner advance repayments during construction.
- 1C. Repay the project \$96,348 from nonproject funds, for the ineligible payments to Vesta Equity 2003, 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.
- 1D. Support or repay the project \$13,652 for the unsupported staff costs, 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.
- 1E. Provide support for the \$56,877 in development funds paid to Vesta Corporation or pay down the project's mortgage \$56,877 from nonproject funds for unsupported development costs.
- 1F. Establish written accounting procedures to ensure that transfers of owner funds to the project are properly classified and approved by HUD before transfer and repayment while the project is in a non-surplus-cash position.
- 1G. Establish and implement written procedures to maintain approved invoices and adequate documentation to support all project expenditures and transfers between related companies.

We also recommend the deputy director, Department's Enforcement Center

- 1H. Pursue all applicable administrative sanctions against the Owners and their related Management Agent and their principals, including, but not limited to suspension and debarment.<sup>5</sup>

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<sup>5</sup> "In implementing this recommendation, the deputy director should consider the issues reported in all of the findings in this report."



## RESULTS OF AUDIT

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### Finding 2: The Owners Paid Their Related Company Unreasonable and Unsupported Relocation Services Costs When the Project Was in a Non-Surplus-Cash Position

The owners paid their related company and vendors \$230,360 in unreasonable and unsupported fees for relocation services when the project was in a non-surplus-cash position. The costs were unreasonable and unsupported because they exceeded the \$55,000 HUD approved, and the owners failed to show that the amount paid did not exceed what would have been incurred in making arms-length purchases on the open market and maintain adequate records to support the rates and hours charged. These conditions were caused by weak internal controls for accounting and related party transactions. As a result, the \$230,360 in fees paid contributed to unnecessary operating losses, weakening the project's financial condition, and caused HUD to overinsure the mortgage (see [finding 3](#)).

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#### The HUD-Approved Amount for Relocation Costs Was Exceeded

The owners charged the project \$285,360 to relocate 48 tenants during renovations, \$230,360 more than the \$55,000 HUD approved.<sup>6</sup> This was an increase of more than 400 percent. The owners capitalized \$154,068 as development costs<sup>7</sup> and charged the remaining \$131,292 to project operations in violation of generally accepted accounting principles for consistency. Although a portion of the costs was subcontracted out to vendors, most of the costs were paid to their related company. A schedule of costs charged to the project follows:

Payee	Amount
Contracted moving and storage costs	\$10,921
Contracted relocation services	63,643
Related company relocation services	210,796
Total	\$285,360

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<sup>6</sup> Multifamily Summary Appraisal report, HUD form 92264, approved on December 4, 2003.

<sup>7</sup> On their Mortgagor's Certificate of Actual Cost, form HUD 92330, signed May 31, 2005, in support of their HUD-insured mortgage.

## **Related Company Costs Were Unreasonable and Unsupported**

The \$210,796 charged for related company relocation services was unreasonable and unsupported. The costs were unreasonable because they were based on inflated employee costs and estimated hours. For example, the owners paid one employee \$66 dollars per hour but charged the project \$190 per hour with no explanation for the difference. Also, the owners did not maintain records to show how many hours employees spent on relocation activities. The owners began charging the project on a monthly basis from January 2004 through March 2005; however, no detailed supporting documentation for the monthly journal entries was maintained. In addition, the documentation provided only consisted of a summary schedule by employee, along with estimated hours and a list of activities the owners' controller stated were performed (see [appendix C](#)).

The owners' regulatory agreement and certification with HUD required that amounts paid to related companies not exceed the costs that would be incurred in making arms-length purchases on the open market. However, the owners did not show that the rates, hours, and amounts charged were comparable to what would have been paid on the open market. Without this comparison, these costs are considered unreasonable and unsupported.

In addition, the owners included these unreasonable and unsupported relocation costs in the cost certification submitted to HUD, causing the HUD-insured mortgage to be overstated (see [finding 3](#)).

## **The Project Was in a Non-Surplus-Cash Position**

The owners reported project operating losses during 2004 and 2005 totaling \$314,057, which placed the project in a non-surplus-cash position. The unreasonable and unsupported relocation costs contributed to these losses. Federal statutes prohibit HUD-insured multifamily project owners from using project funds for 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. Since the owners paid their related company unreasonable and unsupported amounts for relocation services when the project was in a non-surplus-cash position, they may be subject to administrative sanctions.

## Conclusion

The owners paid their related company unreasonable and unsupported costs for relocation services when the project was in a non-surplus-cash position. These conditions were caused by weak internal controls over related party transactions and accounting. In addition, since some of the costs were capitalized and some were expensed to operations, the owners' inconsistent accounting treatment caused HUD to overinsure the mortgage (see [finding 3](#)) and contributed to unnecessary operating losses.

## Recommendations

We recommend that HUD require the owner to

- 2A. Reimburse the project the \$131,292 charged to operations for unreasonable and unnecessary relocation costs, 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.
- 2B. 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

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### Finding 3: The Owners Included Unreasonable and Unsupported Expenses in Their HUD-Insured Mortgage Cost Certification

The owners included \$229,868 in unreasonable and unsupported relocation costs (see [finding 2](#)) and \$50,403 in unsupported operating costs in the cost certification they provided to HUD. This problem occurred due to weak accounting controls over cash disbursements and related party transactions. As a result, HUD overinsured the project's mortgage by \$239,700.

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#### The Certification Included Unreasonable and Unsupported Costs

The owners reported \$284,868 in relocation costs on their cost certification for the mortgage to relocate tenants during the project's rehabilitation.<sup>8</sup> However, \$229,868 of the relocation costs were unreasonable and unsupported because they were based on inflated employee labor costs and not supported by invoices or other records showing the rates and hours charged (see [finding 2](#)). The owners also reported \$50,403 in unsupported repairs and maintenance costs and miscellaneous administrative and bad debt operating costs on their cost certification. HUD requires proper bills and receipts for all costs included in HUD-insured mortgages. The unreasonable and unsupported costs should not have been included in the cost certification because it overstated project costs and caused HUD to overinsure the project's mortgage.

#### The Mortgage Was Overinsured by \$239,700

The owners included \$280,271 in unreasonable and unsupported project costs on the mortgage certification. This increased the mortgage amount that HUD insured by \$239,700, calculated as follows:

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<sup>8</sup> Mortgagor's Certificate of Actual Cost, form HUD 92330, 5/31/05. The owners capitalized \$154,068 and expensed \$130,800 (total \$284,868). This amount differed by \$492 from the \$285,360 charged to the project through 9/30/06.

Description	Amount
Total land and improvements	\$ 5,104,978
Less: unreasonable and unsupported costs	(280,271)
Add: reported net operating loss during construction	6,050
Audited adjusted total land and improvements	\$ 4,830,757
Statutory percentage (90% of line 6)	\$ 4,347,681
Audited maximum insurable mortgage (in multiples of \$100)	\$ 4,347,600
HUD-approved maximum insurable mortgage	\$ 4,587,300
Overinsured amount	\$ 239,700

## Conclusion

The owners paid their related company an unreasonable and unsupported amount for relocation services and did not maintain adequate records to support other amounts charged to the project. This problem occurred due to weak accounting controls over cash disbursements and related party transactions. As a result, HUD overinsured the project's mortgage by \$239,700, placing HUD's insurance fund at unnecessary risk.

## Recommendations

We recommend that the director of HUD's Boston Multifamily Hub require the owners to

- 3A. Make a \$196,593 principal payment or establish an escrow with the lender from nonproject funds or the restricted account established under recommendation 2A to pay down the amount of overinsurance due to unreasonable relocation costs.<sup>9</sup>
- 3B. Provide support for or make a \$43,107 principal payment from nonproject funds to pay down the amount of overinsurance due to unsupported (1) repairs and maintenance costs expense, (2) miscellaneous administrative costs, and (3) bad debt expenses.<sup>10</sup>

<sup>9</sup> Only a portion of the \$229,868 in unreasonable relocation costs was in the amount insured. This amount was determined by the ratio of the unreasonable relocation costs to the total unreasonable and unsupported cost times the overinsured amount as follows:  $\$229,868 / \$280,271 \times \$239,700 = \$196,593$ .

<sup>10</sup> Only a portion of the \$50,403 in unsupported costs was in the amount insured. This amount was determined by the ratio of the unsupported costs to the total unreasonable and unsupported cost times the overinsured amount as follows:  $\$50,403 / \$280,271 \times \$239,700 = \$43,107$ .

- 3C. Establish accounting procedures to comply with the project's regulatory requirements governing the maintenance of bills and receipts.

## RESULTS OF AUDIT

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### Finding 4: The Owners Did Not Properly Manage the HUD-Assisted Learning Center

The learning center was managed improperly because the owners did not establish a viable business plan to obtain sufficient revenues to become self-sufficient without HUD funding. In addition, the owners did not adequately plan, provide, and evaluate learning center programs in accordance with HUD's requirements. They also reported incomplete and conflicting information to HUD on operating budgets and business plans and did not use \$110,000 in non-HUD funds received for startup costs as reported to HUD. As a result, the learning center may require additional HUD subsidies, and project funds were not used effectively to help subsidized residents obtain the necessary skills to become self-sufficient and attain jobs. Also, HUD did not have accurate and reliable information on which to base funding decisions and may have approved higher rent subsidies than were required for the project.

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#### **The Owners Did Not Obtain Sufficient Non-HUD Funding**

The owners did not show that they would receive sufficient funding to make the learning center self-sufficient without HUD funds. HUD encourages owners to use non-HUD funds for learning centers. HUD's intention is to be the last, most flexible piece of the funding and should be thought of as venture capital and not a guaranteed long-term source of funds. However, the owners did not obtain sufficient funding but, instead, used \$47,000 in HUD-assisted project funds for learning center costs during the first 10 months of 2006 and estimated that \$60,000 would be necessary to operate the center per year. To fund the costs, they applied for and received one grant for \$9,412 and plan to apply for more grants if they become available. In addition, the owners' business plan did not show that they would develop or receive sufficient funding to ensure that the center would be self-sufficient without HUD funding in the long term.

#### **Programs Were Not Adequately Planned, Provided, and Evaluated**

The owners did not adequately plan, provide, and evaluate learning center programs in accordance with HUD's requirements. HUD requires resident involvement in all phases of planning and implementation with a primary focus on resident jobs, job training, and job development.<sup>11</sup> The owners told HUD that project funds would be used to provide educational programs to 10 adults and 25

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<sup>11</sup> The Management Agent Handbook, 4381.5, chapters 9-2 and 9-2c.

children.<sup>12</sup> However, the owners provided no evidence that they identified tenants' education level, employment status, or computer literacy or otherwise identified a need for these programs. As a result, tenants did not attend the adult education programs offered, and project funds were not used as planned to provide adult education and help residents of insured and assisted housing attain jobs.

In addition, although the owners developed some goals and tracked attendance for its after school and summer programs, we could not verify that the programs achieved their goals because the owners did not establish and implement a tracking system to measure and report results. This problem occurred because the owners did not include training objectives in the business plan linked with action steps and expected results as required by HUD.

### **Incomplete and Conflicting Information Was Reported to HUD**

The owners reported incomplete and conflicting information to HUD. For example, they told HUD that a portion of the \$110,000 received from the state of Connecticut would be available for learning center operating expenses after startup costs were paid. However, they used development funds for startup costs and transferred the \$110,000 to their related company (see [finding 1](#)). In addition, the owners' business plan provided to HUD pledged \$60,000 in donations from their related company. However, the related company did not donate the \$60,000. As a result, project operating funds were required to fund the learning center.

The owners also submitted an incomplete budget-based rent increase request and operating budget<sup>13</sup> to HUD on February 20, 2006. The budget was incomplete and inconsistent because it did not include \$35,000 in grant funds the owners projected on the business plan submitted to HUD on February 21, 2006. As a result, the amount of project funds required to operate the learning center was overstated in the rent increase budget, and HUD may have approved higher rents than were required for the project.

In addition, the owners accrued \$60,000 in expenses payable to their contracted learning center provider in 2005 and reported it in their 2005 financial statements. However, during the course of our audit, the auditee's controller stated that the expense was not paid because the contract was terminated, and the costs were reversed on January 1, 2006. However, the audited financial statements were not adjusted.

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<sup>12</sup> Moosup Gardens Neighborhood Networks Business Plan, Fiscal Years 2006 to 2008, page 11. .

<sup>13</sup> Budget Worksheet, form HUD 92547-A, signed by owners on February 20, 2006.



## Conclusion

The learning center was improperly managed because the owners did not establish a viable business plan to become self-sufficient without HUD funding and deliver effective programs in an economical and efficient manner. They also did not determine the residents' training needs and reported incomplete and conflicting non-HUD sources of funds to HUD. As a result, the learning center may require HUD subsidies in the future, project funds were not used to help residents attain jobs, and HUD may have approved higher rents than were required for the project.

## Recommendations

We recommend that the director of HUD's Boston Multifamily Hub require the owners to

- 4A. Establish and implement a business plan to provide and evaluate learning center programs that meet tenant needs in accordance with HUD's requirements
- 4B. Establish and implement a written plan to make the learning center self-sufficient.
- 4C. Accurately report learning center operation costs, including all sources and uses of funds, to HUD when submitting operating budgets.

We recommend that the director of HUD's Boston Multifamily Hub

- 4D. Discontinue HUD approval to use operating funds for the learning center, thereby eliminating HUD's \$60,000 annual subsidy.
- 4E. Recalculate the amount of rent subsidy provided based on the reduced amount of learning center support.

## RESULTS OF AUDIT

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### Finding 5: The Owners Paid Their Related Management Company Ineligible Management Fees

The owners paid their related management company \$7,396 in ineligible management fees. This occurred because the project's contract with the owners' related management agent based the management fee on 6 percent of all collections from the property. However, HUD only approved fees at 6 percent of residential income and miscellaneous fees. In addition, the owners erroneously included interest rate reduction payments and excess rental income in their fee calculations that were not allowed by HUD regulations. As a result, \$7,396 in project funds was not available for project operations.

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#### **The Management Contract and Procedures Were Incorrect**

Management agents operating HUD-insured and HUD-assisted properties are paid management fees for their services. HUD approves the fees that may be paid out of project funds as provided for in project regulatory agreements and rental assistance contracts. Owners determine the actual amount of fees paid to the management agent. We determined that the owners' related management agent company, Vesta Management, overcharged the project \$7,396 for management fees during the period January 2004 through September 2006.

The overcharges occurred because the project's contract with the owners' related management agent based management fees on 6 percent of all collections from the property. However, HUD only approved fees based on 6 percent of residential income and miscellaneous fees.<sup>14</sup> Therefore, the commercial income the owners included in their calculation of management fees was not authorized. Also, additional overcharges occurred when the agent erroneously included interest rate reduction payments and excess rental income in its calculations, which were not allowable by HUD regulations.

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<sup>14</sup> Project Owners'/Management Agent's Certification, form HUD 9839.

We calculated the amount of ineligible fees charged as follows:

Description	2004	2005	2006 through Sep. 30	Total
Excess rental income	\$ 18,654	\$ 7,594	\$ 37,970	\$ 64,218
Interest reduction payments	0	53,389	0	\$ 53,389
Laundry income	3,818	1,838	0	\$5,656
Subtotal	\$ 22,472	\$ 62,821	\$ 37,970	\$123,263
Management fee rate	6%	6%	6%	6%
Ineligible fees	\$ 1,349	\$3,769	\$ 2,278	\$7,396

### The Owners Repaid the Project

Following our fieldwork the owners repaid the project \$7,396 and agreed to establish a new management agent agreement and new procedures to calculate the amount of management fees earned.

### Conclusion

The owners charged the project \$7,396 in ineligible management fees during the period January 2004 through September 2005. This occurred because the management agent's contract included fees on income items not approved by HUD. Additional overcharges occurred because the management agent included interest rate reduction payments and excess rental income in its calculations that were not allowable by HUD regulations. As a result, the project overpaid \$7,396, and these funds were not available for project operations.

### Recommendations

We recommend that the director of HUD's Boston Multifamily Hub require the owners to

- 5A. Repay the project \$7,396 from nonproject funds for ineligible management fees.
- 5B. Revise the management agreement and improve accounting procedures to ensure that management fee calculations are based solely on the HUD-approved amounts, thereby reducing future management fees an estimated \$3,038 per year (reduced outlays in calendar year 2007 based on calendar year 2006 overcharges through September 2006 annualized).

## RESULTS OF AUDIT

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### Finding 6: The Owners' Procurement Procedures Did Not Comply with HUD Regulations

The owners' procurement procedures did not comply with HUD regulations. This occurred because the owners and their management agent did not establish adequate contracting procedures. The owners' management agent stated that the project's on-site project manager was supposed to obtain three bids for each contract. However, it could not provide any bids to show that contracts were competitively awarded. We identified four contracts totaling \$240,868 charged to the project that were not supported by competitive bids to show that they were reasonable. If the owners and their management agent do not implement proper procurement procedures, future project funds may be wasted.

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#### Contracts Were Not Competitively Awarded

The owners certified to HUD in June in 2003 that they would obtain verbal or written cost estimates for goods and services, as necessary. However, the owners' management agent did not establish formal written contracting procedures to ensure that the cost estimates were obtained and documented. The management agent's unwritten policy was to obtain three bids for each service contract, but it did not maintain cost estimates for the bids. As a result, we could not determine the reasonableness of \$240,868 in project costs incurred from January 1, 2004, through October 31, 2006, as follows:

Service	2004	2005	2006 through Oct. 31	Total
Snow removal	\$27,574	\$57,420	\$19,154	\$104,148
Landscaping	\$15,720	\$15,746	\$12,567	\$44,033
Auditing <sup>15</sup>		\$8,500	\$9,500	\$18,000
Waste removal	\$23,942	\$27,238	\$23,507	\$74,687
Totals	\$67,236	\$108,904	\$64,728	\$240,868

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<sup>15</sup> Auditing costs for 2004 were less than \$5,000 and, therefore, not included in this table.

## **Conclusion**

The owners' procurement procedures did not comply with HUD regulations. This occurred because they did not establish and implement adequate procedures requiring documented cost estimates. As a result, they could not show that \$240,868 in project service costs was reasonable.

## **Recommendation**

We recommend that the director of HUD's Boston Multifamily Hub require the owners to

- 6A. Establish and implement formal written procurement procedures to document and ensure that services are competed and costs do not exceed amounts ordinarily paid for such goods and services.

## SCOPE AND METHODOLOGY

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We performed our audit of the project in accordance with generally accepted government auditing standards between August 2006 and February 2007. Our fieldwork was completed at Vesta Equity 2003 LLC's offices at 245 Hopmeadow Street, Weatogue, Connecticut, and the HUD Hartford field office hub in Hartford, Connecticut. Our audit covered the period December 23, 2003, through October 31, 2006. 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.
- Interviewed and held meetings with one project owner, his controller, selected project staff, the projects' independent public auditor, 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.
- Interviewed the owners' independent public auditor and reviewed supporting documentation to determine whether relocation services were reasonable and adequately supported.
- Interviewed the owners' independent public auditor and reviewed supporting documentation for the owners' Certificate of Actual Cost, form HUD 92330, to determine whether HUD overinsured the project's mortgage. We selected a nonrepresentative sample of accounts for detailed testing based on risk; and reviewed the rent free unit, bad debt, and miscellaneous administrative cost accounts, which comprised \$50,403 of the \$580,605 in operating costs charged to the project. Our results apply only to these accounts that we questioned in their entirety and were not projected to the total operating costs charged to the project.
- Interviewed the owners' learning center vice president and reviewed supporting documentation to determine whether the HUD-assisted center was managed properly.
- Reviewed supporting documentation for management fees to ensure that they were properly supported, calculated, and within HUD-approved limits.
- Reviewed the owners' contracting procedures to verify that they ensured that contracted project costs were reasonable.

# INTERNAL CONTROLS

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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.

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## 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 to related companies for relocation services.
- Controls over accounting and maintaining adequate support for project development and operating costs.
- Controls over the management of the project's learning center.
- Controls over the payment of management fees.
- Controls over the procurement of services exceeding \$5,000.

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 transfers of owner funds to the project were properly supported, classified, and approved by HUD before transfer and repayment (see [finding 1](#)).
- Accounting procedures did not ensure that payments to related companies for relocation services were reasonable and properly supported (see [finding 2](#)).
- Accounting procedures did not ensure that project development and operating costs were reasonable, properly classified, and adequately supported (see [finding 3](#)).
- Accounting procedures did not ensure that management fees were properly calculated and paid (see [finding 5](#)).
- Contracting procedures were not established and implemented to ensure that contract costs exceeding \$5,000 were reasonable (see [finding 6](#)).



## APPENDIXES

### Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Unreasonable or unnecessary 3/	Funds to be put to better use 4/	Cost exceptions
1A	\$106,000				\$106,000
1B	\$19,000				\$19,000
1C	\$96,348				\$96,348
1D		\$13,652			\$13,652
1E		\$56,877			\$56,877
2A			\$131,292		\$131,292
3A			\$196,593		\$196,593
3B		\$43,107			\$43,107
4D				\$60,000	\$60,000
5A	\$7,396				\$7,396
5B				\$3,038	\$3,038
Total exceptions	\$228,744	\$113,6361	\$327,885	\$63,038	\$733,303

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local policies or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

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

4/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes 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.

## Appendix B

# AUDITEE COMMENTS AND OIG'S EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments

VESTA CORPORATION

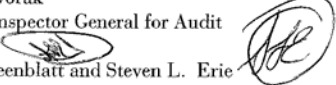
245 Hopmeadow Street  
Weatogue, CT 06089  
Main: 860.408.5400  
Fax: 860.408.5420  
Web: www.vestacorp.com



#### MEMORANDUM

**DATE:** June 12, 2007

**TO:** John A. Dvorak  
Regional Inspector General for Audit

**FROM:** Arthur Greenblatt and Steven L. Erie 

**SUBJECT:** HUD IG Audit of Moosup Gardens Apartments

We are writing in response to your Draft Audit Report, dated May 25, 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.

# Appendix B

## AUDITEE COMMENTS AND OIG's EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments

John A. Dvorak  
June 12, 2007

#### **FINDING 1 – Repaid Advances, Ineligible Costs and Inadequately Supported Payments**

Comment 1

**Advances by Owner.** As a framework for your consideration, we want to note: Vesta Corporation has advanced more than \$123,000 and Vesta Equity 2003, LLC, the managing member of the owner (not the property manager), has advanced more than \$239,000, to this property in order to carry it through periods of operating and development shortfalls. If we had not made these advances, multiple and extended delays in Section 8 (both HAP and voucher) subsidy receipts and funding of promised assistance from the State would have threatened this property's financial stability and ability to meet current obligations on several occasions. Total advances have amounted to \$362,000. Your draft report notes that we have advanced \$305,209. We understand that your audit was limited in scope and may have missed certain of those advances, and we will provide a comprehensive schedule upon request.

Comment 2

We also note that some of the funding advanced was required due to an unprecedented and unpredicted abatement of FHA insurance credit subsidy (as a result of Congressional delays) just as this acquisition/development was scheduled to close under specific contractual requirements.

We are proud to say that this project has succeeded and remained financially solvent due in large part to our stewardship and willingness to advance funds. Not a single required deposit to Replacement Reserves has been missed. We will also say that the staff of the HUD field office has on several occasions worked with great effort to resolve funding difficulties caused much higher up the governmental chain, and we have always thought of the Hartford office as our partner in every effort to rehabilitate, preserve and maintain this project as a financially stable source of affordable housing in this community.

Comment 3

**Surplus Cash.** As additional context for your ultimate conclusion, we point out that, although your draft report notes "operating losses" during fiscal years 2004 and 2005 totaling \$314,057, this number can be misleading when read with the remainder of the report as an indication of "surplus cash". As you know, "surplus cash" is a defined programmatic term, and the basis on which decisions are made with respect to owner distributions and, as you indicate in your draft findings, eligibility or ineligibility of payments or repayments of certain project liabilities, including owner advances. You will note from the independent audits of this project that there was negative surplus cash in 2004 of \$60,347, which in 2005 improved to negative \$56,096. (It is worthwhile to note that per the independent audit, the 2006 surplus cash was a positive \$5,829). We ask that the audit report be modified to reflect this as the true reflection of the property's "non-surplus cash" position rather than the much higher operating losses.

Comment 4

This point is not without effect. Each and every repayment of an advance reduced cash of the project used in calculating surplus cash. While not inaccurate, it appears disingenuous for the OIG to call for repayment of more than \$300,000 in repayments made while the project was in a "non-surplus cash position", when it is clear that a significantly lesser

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# Appendix B

## AUDITEE COMMENTS AND OIG's EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments

Comment 5

John A. Dvorak  
June 12, 2007

amount of repayment would have put the project in a positive surplus cash position, and as a result, negated many of the auditor's findings.

Finally, we further inform you of the reason for negative surplus cash in 2005. As you may know, and can confirm with the field office, there was an extended administrative processing delay that occurred with respect to our tenant vouchers. Although approved, and budgeted for as part of this property's financing and operational plan, vouchers were not provided in March, 2005, as expected. In fact, vouchers were not delivered for nine more months. Cumulatively, over this period, the property went without more than \$53,000 in rental receipts resulting from the voucher administrator not being in place during that period. Lost funding for this period has never been paid by HUD.

Comment 6

We understand that the OIG may be drafting its conclusions within its operational or programmatic constraints. We do ask, however, that a note of actual surplus cash shortfall and these circumstances be footnoted to the auditor's recommendations so that they may be properly evaluated as we address this report with field office staff. At the least, your recommendation that returned funds be placed in the project Replacement Reserves should be revised to recommend funds be deposited in the project operating account. Direction otherwise has no basis, in that Replacement Reserves have been fully funded as required by the Regulatory Agreement, and that cash not paid toward advances would have otherwise remained in and been expended from the project operating accounts.

Comment 7

**Advance Repayments.** The draft audit report indicates the following disallowed repayments in Finding 1:

\$125,000	- owner advances repaid during non-surplus cash position
\$ 96,000	- owner advances repaid during non-surplus cash position
\$ 13,652	- unsupported staff costs paid
\$ 24,000	- ineligible principal payments and LOC fees
\$ 85,000	- unsupported repayments of development costs

Comment 8

Again, we note that requiring repayment of \$221,348 (\$125,000 + \$96,348) because the repayments were made when the project was in a non-surplus cash position is extraordinary, when a far lesser repayment would be required to put the project in a positive surplus cash position during the period audited. By HUD's own definitions and methodology for determining surplus cash, not more than this smaller amount could be treated as disallowed repayment due to negative surplus cash condition of the property. This conclusion is even more extraordinary given that the draft audit report states that shortfalls during 2004 and 2005 were primarily due to "unreasonable relocation costs" noted in Finding 2. If we were to have not been paid the relocation costs cited there (\$131,000), the project would indeed have had positive surplus cash, even with full repayment of the \$221,348 advances noted here. Again, to recommend that all of the \$131,000 in finding 2 be repaid, is inconsistent with the recommendation that this \$221,348 also be repaid as a result of ineligibility due to "non-surplus cash".

Comment 9

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# Appendix B

## AUDITEE COMMENTS AND OIG's EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments

Comment 10

John A. Dvorak  
June 12, 2007

We ask that this be addressed in the final audit report recommendations.

With respect to unsupported costs of \$13,652 and \$85,000, we are gathering a full package of invoices and proof of costs that we will provide to either your office or the field office at your direction, and believe that these will be found to be supported expenditures.

Finally, as we have discussed, the \$24,000 of ineligible "principal payments" and "financing fees" directly correspond to payments made directly to the mortgagee and to a third party bank, which were included at the time of cost certification. As we discussed, this property's loan closed with two others, all with the same mortgagee. Per MAP guidelines during the financing closing process, the lender required that certain of its third party costs be paid by the borrowers. These payments were made to the lender, not directly to the third parties, also per the MAP guidelines from the first draw. All three borrowers were single-asset entities established solely to acquire and operate these projects, each without financial substance until the closing. As a result, we paid those costs. We have been frustrated along with you, as the mortgagee has been unable or unwilling to provide third party invoices to support the payments it required of us to move forward with the financing. After our discussions, the Mortgagee referred us to the first draw which lists \$70,450.00 in other fees. These pages of correspondence including the breakdown are attached. We believe we will be able to obtain the back-up invoices from the lender. We have given you all that the mortgagee has been able or willing to provide in the form of their breakdown of costs. We know that they have not responded to your direct requests.

We can only state that these costs were paid, that they were dictated by the FHA-lender, and that we have made and will continue every effort to convince the lender that they should provide invoices supporting the statement they have delivered. We ask that the property owner not be tagged with "ineligible" expenditures given these circumstances, and that the recommendation be modified accordingly, in the least, to provide additional time to obtain additional support from the lender.

#### **FINDING 2 – Payment of Unreasonable and Unsupported Relocation Costs While in Non-Surplus Cash Position**

Without repeating the discussions above, we again note that if the project had not paid the \$131,000 for relocation, it would have been in a positive surplus cash position, negating most of the findings and recommendations in Finding 1. A repayment of this amount and the amounts noted above are inconsistent with findings that result from non-surplus cash position, and redundant in their recommendation. We ask that this be noted in the final audit report and that findings be adjusted accordingly.

Comment 11

Comment 12

**Third Party Costs.** With respect to this finding specifically, you do confirm that HUD initially approved \$55,000 for relocation costs, and find this amount acceptable. At the time of that initial budgeting and determination it was estimated that 12 families would require relocation assistance. This would mean twenty-four moves, (twelve moves to

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## Appendix B

### AUDITEE COMMENTS AND OIG'S EVALUATION

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#### Ref to OIG Evaluation

#### Auditee Comments

John A. Dvorak  
June 12, 2007

temporary units, twelve moves back). Nevertheless, by the time this project's rehabilitation was completed 49 families required relocation assistance. This meant 81 moves as some of these families made only one move to a completed unit. The approved amount based on an estimate should not preclude expenditures exceeding that budgeted number as ineligible in these circumstances.

We ask that you also note that \$10,921 and \$63,643 were paid, as recognized in your draft audit report, to third party vendors. We have provided you with documentation from those third parties, and the increased relocation requirements for this preservation effort clearly justify those verifiable costs. At the least, this finding should be reduced by \$19,564 – the additional amount paid to third parties over that initially approved for relocation.

**Related Party Costs.** The OIG auditors were provided with our internal calculation of hours and rates charged for activity of our staff. Your example notes that one employee was paid \$66 per hour but charged at \$190 per hour. You note that we did not provide comparability data for these rates. You have concluded that, without comparability data, all of these costs are considered unreasonable and unsupported.

Your draft audit report is the first place we have seen the notation that lack of comparability data triggers a complete ineligibility of related party payments. As a result of this draft report our staff is now working on both an overhead allocation to demonstrate that the hourly charges for individuals were an accurate reflection of their true cost (salary alone does not cover overhead and benefits). In addition, we are investigating sources of comparability for the type and amount of relocation work performed.

Our billings to this property were in consideration of what we believed to be an accurate reflection of employee time, and to be an accurate reflection of each individual's worth as a professional. If our estimates were high or low, that will be borne out by the steps we are undertaking, and we ask for that opportunity. Given the results will be forthcoming and readily verifiable by HUD staff, the recommendation for full repayment of amounts charged should, in addition to being reduced as noted above, be modified to recommend that HUD be provided with support, and that only any amount not supported be repaid.

**FINDING 3 – Inclusion of Unreasonable and Unsupported Expenses in Cost Certification**

We ask that recommendation 3A be revised in accordance with the discussion above concerning relocation costs. In addition, we ask that recommendation 3A be revised to provide that any amount ultimately determined to be ineligible be deposited into project reserves, as we find it likely that the amount will be small, if any, and that prepayment of an FHA Insured mortgage with lockout and market investment expectations is likely impractical, if not impossible.

Comment 13

Comment 14

# Appendix B

## AUDITEE COMMENTS AND OIG'S EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments

Comment 15

John A. Dvorak  
June 12, 2007

With respect to recommendation 3B, we note that your characterization of a portion of \$50,403 as "rent-free unit" expense is incorrect. It should instead be repairs and maintenance expense totaling \$25,458 as we stated in our response of September 22, 2006. The balance is made up of bad debt and miscellaneous third party vendor expenses. We look forward to working with field office staff to provide full and complete documentation for these expenses in accordance with your recommendation.

#### **FINDING 4 – Properly Manage HUD Assisted Learning Center**

Vesta operates learning centers at several of its HUD-subsidized properties. These centers are important to us and to our communities. We have worked in their design and implementation in cooperation with each HUD office, and both our communities and tenants are grateful to us and to HUD for this support. At this property we have worked hard to obtain funding for this asset. We continue to do so. Within 30 days we will deliver a revised business and financing plan for our learning center. That may seem like a short period of time to develop a business plan and to evidence funding efforts from third parties, but it has been in the works for several months now, and we have been in continuous contact over that period with several benefactors. An immediate elimination of funding would require an immediate closing of the center.

Finally, your finding 4D indicates, if not clearly states, that all \$60,000 of learning center operating expenses were paid from federal rental subsidy. Note that this project is only 30% subsidized with project-based Section 8 (27 of 89 units). The subsidy contract for this project does not pay more than 30% of learning center costs (\$18,200, assuming your conclusion).

We ask that you revise this finding to reduce the amount of subsidy reduction it recognizes, and to recommend that the local office make a final determination on this center's value upon receipt, review and confirmation of our plan for a center that speaks as well of HUD as it does of our organization.

#### **FINDING 5 – Ineligible Management Fees**

As we have discussed, we agree that our management fees have been miscalculated. As we noted in our package to you the other day (copy attached), we have directed counsel to review all of our management agreements and to amend each as necessary to conform to your finding. We have also already delivered funds to the project in the amount of ineligible fees previously paid (evidence attached).

#### **FINDING 6 – Procurement Procedures**

We want to thank your auditors for pointing out an operational weakness that has likely caused some inefficiencies across our portfolio. We doubt that we have paid materially over market for snow removal or similar services, but we are not as certain as we will be once we fully implement the procurement policy as you have recommended. The written

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Comment 17

# Appendix B

## AUDITEE COMMENTS AND OIG's EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments

Comment 18

John A. Dvorak  
June 12, 2007

procurement procedure is already in draft, and will be provided, upon vetting and completion, to HUD staff and, at your request, to your office.

#### Conclusion

We thank you for this opportunity to review and respond to your draft audit, and respectfully request that you take this response into account prior to issuance of the final report, with appropriate modification to your recommendations. We again emphasize that a recommendation of repayment to the project of owner-advance repayments or other costs, found ineligible because the project was in a non-surplus cash position, and in an amount far exceeding that which would have resulted in positive surplus cash is irreconcilable to the basis for the finding and inequitable. Considering (i) that 2005 negative surplus cash was ultimately a result of a 9 month delay in voucher processing (\$53,000) (ii) that the owner did not increase rents to approved levels on unsubsidized tenants during this delay, (iii) that the owner has never received any retroactive payment, and (iv) that we made all advances to the property necessary to cover operational shortfalls resulting during this period, it is just adding insult to injury for HUD to now require return of advance repayments that far exceed the actual levels of negative surplus cash.

As we stated early on in this memo, we have contributed over \$362,000 to make up for project income and development cost shortfalls resulting in large part from funding delays. Our organization has a long history of support for our affordable housing properties, and we have not in the past hesitated in coming out of pocket to ensure financial and physical stability for the communities we serve. We hope to continue that kind of relationship with our tenants and with HUD.

In closing we again want to state that we appreciate the professional and courteous conduct of your staff during their time here. Although we have noted some specific objections to your draft findings above, your work has triggered our development and implementation of some important cost monitoring and oversight that would likely not have occurred without your efforts and this process.

Cc: Suzanne Baran  
David Jeannotte



# Appendix B

## AUDITEE COMMENTS AND OIG's EVALUATION

### Ref to OIG Evaluation

### Auditee Comments

**REILLY MORTGAGE GROUP, INC.**

ATTACHMENT 1 of 3  
2010 CORPORATE RIDGE, SUITE 1000  
McLEAN, VIRGINIA 22102  
(703) 760-4700  
FINANCIAL SERVICES

December 4, 2003

Via FAX, and Federal Express

Ms. Suzanne C. Baran, Director  
Multifamily Program Center  
HUD- Connecticut State Office  
One Corporate Center, 19<sup>th</sup> Floor  
Hartford, CT 06103-3220

ATTN: Ms. Janice Walker, MAP Team Leader  
Mr. Gary Golding, Mortgage Credit

RE: Moosup Gardens  
FHA #017-35271, Section 221(d)(4) Substantial Rehabilitation Application

Dear Ms. Baran,

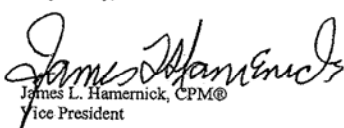
We are pleased to present for your review and concurrence the first draw for the initial loan closing for this above referenced property.

We have prepared the detail back up for the draw to reflect those items which have been prepaid, as noted, and those which will be disbursed out of loan closing proceeds.

The analysis for cash available to mortgagor, based upon the BLA calculation, is provided for your reference as well.

If you have any questions concerning the draw material, please contact us and we'll provide additional information as necessary.

If there are any questions concerning this project, please contact me at ph (703) 760-4743, fax (703) 287-0129, or email: [jhamernick@reilly.com](mailto:jhamernick@reilly.com). We look forward to the initial closing of the loan. Thank you again.

Respectfully,  
  
James L. Hamernick, CPM®  
Vice President

Enclosures

# Appendix B

## AUDITEE COMMENTS AND OIG's EVALUATION

### Ref to OIG Evaluation

### Auditee Comments

ATTACHMENT 2 of 3

	2264 Budget	% Allowed at Initial	Max at Initial	Paid to Date	To Be Paid at Closing	Total for Draw	Balance for later
Moscup Apartments First Draw at Initial Endorsement SW 12/3							
1) Construction Cost/HUD-62448							
2) Interest from to							
3) Architectural Design Fees	34,331.00	100%	34,331.00		34,331.00	34,331.00	0.0
4) Builder's Risk Insurance	55,000.00	100%	55,000.00				55,000.0
5) HUD/FHA Examination Fee	13,923.50	100%	13,923.50	13,923.50		13,923.50	0.0
6) HUD/FHA Inspection Fee	11,175.00	100%	11,175.00		11,175.00	11,175.00	0.0
7) HUD/FHA M I P	46,410.00	100%	46,410.00		46,410.00	46,410.00	0.0
8) Financing Fee	46,410.00	100%	46,410.00		46,410.00	46,410.00	0.0
9) Placement and GNMA Fee	27,111.00	100%	27,111.00		27,111.00	27,111.00	0.0
10) Title Insurance/Recording	12,000.00	100%	12,000.00		12,000.00	12,000.00	0.0
11) Legal Fees	50,000.00	75%	37,500.00	1,320	28,528.00	29,849.00	20,151.0
12) Organizational Fees	2,000.00	65%	1,300.00		1,300.00	1,300.00	700.0
13) Bond Premium	27,550.00	100%	27,550.00		16,275.00	16,275.00	11,275.0
14) Other Fees List	70,450.00	100%	70,450.00	23,721.00	15,705.00	39,426.00	31,024.0
15) Cash Available	1,981,000.00	100%	1,981,000.00		1,981,000.00	1,981,000.00	0.0
Totals	2,377,360.50		2,364,160.50	38,964.50	2,220,246.00	2,259,210.50	118,160.0

# Appendix B

## AUDITEE COMMENTS AND OIG's EVALUATION

### Ref to OIG Evaluation

### Auditee Comments

ATTACHMENT 3 of 3

Moosup Apartments Other Fees - Payments	12/2/03					(a)					(b)	(a + b)	Remainder per 2264 estimate
Line #	Description	Line Total	Payable to	Paid To Date	Check #	Document Reference	To Be Paid at Closing	Total Draw					
	A&E Cost Review	6,250.00	EMG	3,000.00	RMG53265		3,250.00	3,000.00					
							1,625.00	3,250.00					
	Appraisal/Market Study	9,000.00	CBRichardEllis	4,500.00	RMG52617		4,500.00	4,500.00					
				4,500.00	RMG54094		1,500.00	4,500.00					
	As-Built Survey	5,000.00						1,500.00					(1,500.00) overage
													5,000.00
	Building Permits	13,420.00		5,736.00	R2D19966			5,736.00					7,684.00
	Certification and Insurance	9,330.00						9,330.00					0
	Lead Based Paint	2,740.00	EMG	2,740.00	RMG53265			2,740.00					0
	Phase I Env/Im/Asbestos	3,250.00		2,500.00	RMG53265			2,500.00					
				250.00	RMG53265			250.00					
				495.00	RMG54097			495.00					5.00
	Preconstruction Survey and Program Development	14,960.00											14,960.00
	Stakeout Fee	6,500.00											6,500.00
		70,450.00		23,721.00			15,705.00	39,426.00					31,024.00
							23,721.00						31,024.00
							15,705.00						39,426.00
							39,426.00						70,450.00

# Appendix B

## AUDITEE COMMENTS AND OIG's EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments

06/06/2007 11:35 8606858810 + 918604085430 NO. 549 P01

**CITIZENS BANK**  
**MIDDLETOWN MAIN St. OFFICE**  
225 Main Street  
Middletown, CT 06457  
(860) 685-8800 (860) 685-8810 FAX  
Glenn A. Taylor, Manager, Assistant Vice President

**FAX**

**TO:** Christine or Jim **FROM:** Julie Traficanti

**FAX#:** 880-408-5430 **PAGES(incl.cover)** 3

**DATE:** 06/06/2007 **RE:**

Urgent  For Review  Please Comment  Please Reply

Christine,

Attached is the letter that states the wire transfer has been received.

Thank you,

Julie Traficanti

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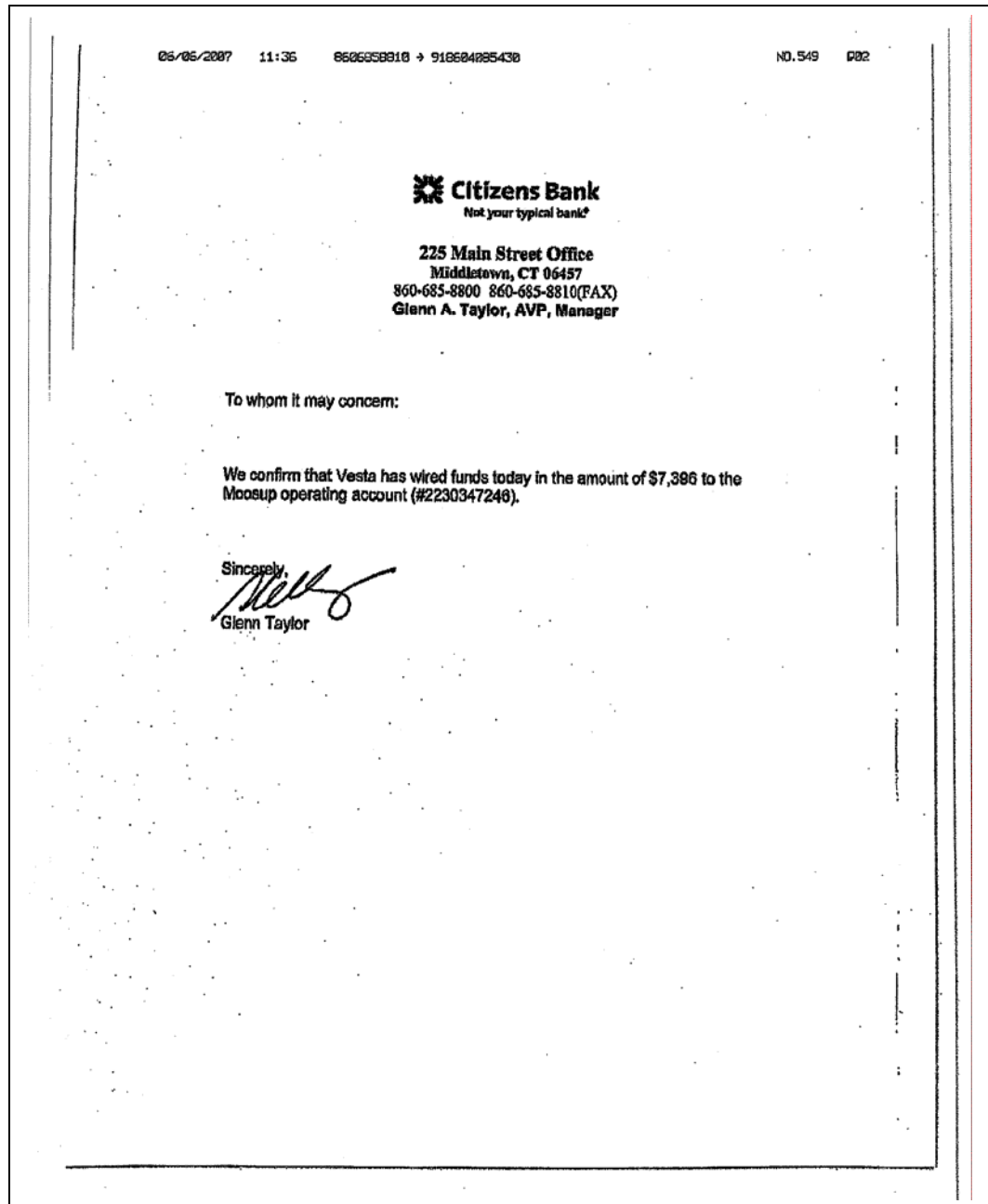
# Appendix B

## AUDITEE COMMENTS AND OIG's EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments



# Appendix B

## AUDITEE COMMENTS AND OIG's EVALUATION

### Ref to OIG Evaluation

### Auditee Comments

06/06/2007 11:35		060658810 + 918504085430		NO.549 503	
IMI3 06/06/07		DDA STATEMENT INQUIRY		10.29.46 PAGE 1	
VERTA MOOSUP LLC		ACCT NO. 022-000-0000-2230347246			
OPERATING ACCOUNT		DATE THIS STATEMENT 06/06/07			
245 HOPMEADOW STREET		DATE LAST STATEMENT 05/31/07			
*****DDA TRANSACTIONS*****					
BALANCE	CHECKS/OTHER DEBITS	DEPOSITS/OTHER CREDITS	BALANCE		
LAST STATEMENT	NO.	TOTAL AMOUNT	NO.	TOTAL AMOUNT	THIS STATEMENT
11981.95	6	3868.21	4	44198.00	52311.74
DATE	CHECK#	AMOUNT	TYPE	TRANSACTION DESCRIPTION	BALANCE
06/04		18457.00		CT HAP ACCOUNT JUN HAP	
06/04		14776.00		DEPOSIT	
06/04		10.00		DEPOSITED CK REFD FNS	
06/04		200.00		DEPOSITED CHECK REFD	
06/04	1708	1866.76		CHECK	
06/04	1709	689.00		CHECK	
06/04	1700	48.45		SUBSTITUTE CHECK	42400.74
06/05		3569.00		DEPOSIT	
06/05		1054.00		TO CHECKING 2230347254	44915.74
06/06		7396.00		INCOMING WIRE TRANSFER	52311.74

## Appendix B

### OIG Evaluation of Auditee Comments

- Comment 1** We could not verify the owners' claim that they advanced \$362,000 to the project because they reported \$335,209 in advances on their financial statements and our audit work verified the project received \$305,209. After our field work was complete, the owners provided bank statements showing \$362,390 was deposited into the project's bank accounts. However, the statements did not show source of funds and therefore, we could not verify the deposits were owner advances. We note that the amount advanced does not affect the amount of repayments that must be returned to the project.
- Comment 2** HUD encourages owners to advance funds to their projects in critical situations and we acknowledge that the owners advanced funds to the project. However, the owners did not maintain fully auditable records. Further, we note that advances made to the project may only be repaid from surplus cash as calculated at the end of the accounting period.
- Comment 3** We disagree the number in the report is misleading and believe the owners do not fully understand the requirements for owner advances, surplus cash, and our reason for including operating losses in the report. HUD requires owner advances be repaid only when there is surplus cash and repayment of such advances when the project is in a non-surplus cash position subjects the owners to penalties and sanctions.<sup>16</sup> It is important to note that HUD insured projects do not have surplus cash during the construction period because any net operating profits during construction are required to be used to fund the construction.<sup>17</sup>

Therefore, the project did not have surplus cash during the construction period, December 23, 2003 through March 31, 2005. The project also did not report surplus cash in their 2005 financial statements. Therefore, the 2004 and 2005 repayments questioned in the report were not made from surplus cash and must be repaid. Also, we included the operating losses in the report to show the project was losing significant money when the owners repaid themselves. We did not include the 2006 fiscal year end surplus cash position in the report because it is not relevant to the 2004 and 2005 repayments.

Upon further review we determined that \$19,000<sup>18</sup> of the \$125,000 in ineligible repayments we questioned in recommendation 1A was repaid to owners during the construction period and \$106,000 was repaid during operations. Therefore, we restated our recommendations 1A and 1B to require that the owners' repay the project \$106,000 from non-project funds for owner advances 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; and also pay

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<sup>16</sup> Financial Operations and Accounting Procedures for Insured, HUD Handbook 4370.2, chapter 2-11

<sup>17</sup> Mortgage Credit Analysis for Project Mortgage Insurance, HUD Handbook 4470.1 chapter 11-6k.

<sup>18</sup> Check numbers 178,210, 218, and 412.

## Appendix B

### OIG Evaluation of Auditee Comments

down the project's mortgage \$19,000 from non-project funds for ineligible owner advance repayments made during construction.

- Comment 4** The owners acknowledged the report was accurate and the project was in a non-surplus-cash position when they repaid the owner advances. Therefore, the owners repaid themselves in violation of their Regulatory Agreement with HUD and HUD regulations. See **Comment 3**. Our recommendations will restore these ineligible payments to the project.
- Comment 5** The owners' reason for the lack of surplus cash in 2005 is incomplete because they failed to mention the \$210,000 in unreasonable and unsupported relocation expenses paid to their related company which if not made, would have had a more substantial effect on surplus cash than the \$53,000 shortfall they attributed to HUD. In addition, we note that the project had net operating losses of more than \$300,000 during this period, much more than the \$53,000 in lost rents cited by the owners.
- Comment 6** We added footnote three to the report addressing the lack of surplus cash during construction and the auditee's calculation of surplus cash at fiscal year end 2005.
- Comment 7** We disagree that the ineligible repayments should be returned to the project operating account. After considering the owners' weak internal controls, we believe returning project funds expensed during operations to a restricted account should ensure they are expended in accordance with HUD's requirements. In addition, repayments made from operating funds during construction should be used to pay down the mortgage. See **Comment 3**.
- Comment 8** We could find no regulatory or programmatic basis for the owners claim that "not more than this smaller amount could be treated as disallowed repayment due to negative surplus cash condition of the property." Therefore, our recommendations remain unchanged except for recommendations 1A and 1B as noted in **Comment 3**.
- Comment 9** We disagree that we are inconsistent. All repayment made while the project was in a non-surplus cash position must be repaid. In addition, the owners' response is based on the hypothetical proposition of what would have happened if their company did not receive \$131,000 for unreasonable and unsupported relocation services charged to operations. The fact is their company received more \$210,000 from the project for unreasonable and unsupported relocation costs (See [finding 2](#) and [appendix C](#)). Further, the owners repaid \$19,000 in owner advances during construction which should be used to pay down the mortgage. See **Comment 3**.



## Appendix B

### OIG Evaluation of Auditee Comments

- Comment 10** Our initial draft report questioning \$24,827<sup>19</sup> of ineligible principal payments and financing fees costs and \$85,712 in unsupported costs has been revised based on additional supporting documentation provided in the auditee's response. As a result, we now consider \$56,877 in costs to be unsupported, which includes the \$24,827 previously questioned as ineligible. The auditee acknowledged they are attempting to obtain proper invoices for these payments and we acknowledge the mortgagee's failure to provide invoices. However, the auditee's regulatory agreement requires the auditee to maintain proper invoices to support all project payments. HUD should review any additional documentation the auditee may obtain and make a final determination whether to allow payment from project funds for these costs.
- Comment 11** We disagree that the findings are inconsistent. See **Comment 9**.
- Comment 12** By regulation HUD may or may not increase the \$55,000 initially approved for relocation expenses.<sup>20</sup> Therefore, during the audit resolution process HUD should determine whether they approve the additional costs and adjust the required repayment in recommendation 2A, if necessary.
- Comment 13** The owners provided no evidence the amount paid to their related company for relocation costs was reasonable or supported. We asked the owners on November 16, 2006 and other occasions to provide cost justifications for all related company services charged to the project to show the amount paid was reasonable. We have not received an adequate response to support the estimated hours and rates they used to charge the project \$210,796 for relocation services. Therefore, we continue to question the costs as unreasonable and unsupported in the report and recommendation 2A.
- Comment 14** The owners did not agree with recommendation 3A, however, they provided no evidence the relocation costs were reasonable or supported. Regarding the owners' statements on principal payment restrictions, HUD program officials advised us that rather than authorizing the principal prepayment provision or lock-out to be broken HUD may approve establishing an escrow with the lender to be used to pay down the mortgage when the lock-out expires. Therefore, we included this option in our recommendation 3A.

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<sup>19</sup> \$23,208.50 for a "deposit" paid to the mortgagee, plus \$1,620 paid to the bank for a working capital deposit/line of credit

<sup>20</sup> Multifamily Accelerated Processing Guide, Chapter 14.15 paragraph N 9 and Chapter 14.18 paragraph D 2.

## Appendix B

### OIG Evaluation of Auditee Comments

**Comment 15** We agreed and reclassified the \$25,458 in "rent-free unit" charges to \$25,458 in "repairs and maintenance expense" in the report and recommendation 3B repairs and maintenance expense. However, the costs still have not been supported.

**Comment 16** The owners agreed with our recommendations 4A and 4B to establish a revised business and financing plan the Moosup learning center. However, they did not address recommendation 4C to accurately report learning center operation costs, including all sources and uses of funds, to HUD when submitting operating budgets.

We did not revise the subsidy amount we questioned in recommendation 4D. The owners' comment that the project only receives a 30% federal subsidy does not consider HUD's interest rate subsidy and voucher subsidy. HUD provides mortgage insurance for all project units and provided more than \$70 thousand in interest rate reduction payments based on all units in 2006. HUD also subsidizes 11 residents with Housing Choice Vouchers in addition to the 27 project based Section 8 units. Thus, HUD clearly provides more subsidy than the auditee disclosed and we disagree that the amount of subsidy included in the operating budget be factored down.

**Comment 17** We concur the \$7,396 overpayment was deposited in the project's operating account. During audit resolution HUD should review the procedures, the repayment, and close the finding if they determine corrective actions are sufficient to correct condition and provide assurance they will not recur.

**Response 18** We have addressed each of the issues in the comments above and except for the minor changes noted in our previous comments, our findings and recommendations remain unchanged.

## SCHEDULE OF RELATED COMPANY RELOCATION SERVICES COSTS

**Moosup - Estimated Staff Costs**

		Period: Jan 2004 to Mar 2005			
(1) Work Performed		# Weeks	Estimated Hours Per Week	Hourly Rate	Estimated Total Costs
All	Vice President	64	8	175	\$ 89,600
1,2,6,11,12	Vice President	64	2	190	24,320
6,10,11,12	Controller Vice President	64	2	190	24,320
12	Accounting /Bookkeeper	64	4	35	8,960
6,10,11,12	Accounting / Asset Manager	12	6	125	9,000
7,8,10	Admin. Assistant / Property Mgmt	64	2	25	3,200
6,10,11,12	Accounting / Admin. Assistant	64	2	25	3,200
1 through 11	Regional Vice President				19,700
1 through 11	Maintenance Supervisor				16,881
6,10,11,12	Accounting / Asset Manager				11,615
					<u>\$ 210,796</u>

**Notes:**

- (1) See corresponding numbers on narrative for description of services rendered.
- (2) The original estimated number of tenants to be relocated was 13, (26 moves). The actual number of tenants moved turned out to be 48, (96 moves).
- (3) Unrelated third party costs increased significantly:
 

Original budget	\$ 30,000
Actual costs for 3rd Parties	\$ 74,564
- (4) All fees collected were subject CT sales tax of 6%, (\$8,819.64 in sales tax was paid).
- (5) Our original estimate for staff costs for relocation and all other coordination efforts during the development period was \$155,796. At completion, as a result of the significant increase in work performed, estimates of staff time were revised upwards.

Note: We redacted employee and contractor names from the controller's schedule and inserted job title and the third-party text boxes using Adobe software.

## SCHEDULE OF RELATED COMPANY RELOCATION SERVICES COSTS

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Explanation of work performed by Vesta Equity 2003 categorized as Relocation line item.

During the underwriting for the FHA mortgage, all parties to the transaction realized that it would be necessary to relocate residents. In fact 48 families were relocated out of their apartments and subsequently moved back upon completion of the work. Additionally, belongings, including furniture, of the remaining number of families required moving while work was being performed within their apartments.

The work performed by Vesta staff, both at the corporate office as well as additional staff and time for hourly personnel at the property, included, but was not limited to the following:

1. Coordinating with contractors to develop relocation plan in concert with rehabilitation scheduling and budgets;
2. Hand delivering written notices to residents, communication and coordination with residents to meeting timing and labor requirements of packing and physical moves;
3. Meeting with and coordinating among contractor, subcontractors and property management to resolve scheduling difficulties with varied construction delays and/or work schedule modifications;
4. Arranging utility and other service changeovers;
5. Inventorying resident belongings and furniture;
6. Maintaining cost controls for storage and service providers within project budgetary constraints;
7. Addressing the multitude of individual and varied tenant circumstances, and resolution of these matters within the needs of residents and contractors;
8. Qualification reviews for unit type redistribution upon relocation;
9. Meetings with tenants;
10. Transitioning of subsidy and payments;
11. Consulting with all parties and tenants to ensure project budget, lender project schedules, tenant family and work schedules and contractor access needs were each satisfied; and,
12. Billing and accounting services relating to above activities.

## Appendix D

### SCHEDULE OF RELATED COMPANIES

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The project, also known as Moosup Gardens Apartments and Vesta Moosup 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. Vesta Corporation is owned by RFD Acquisition Corporation. RFD Corporation is owned by J&Z Investment Company. 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. Vesta Equity 2003 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.