
AUDIT REPORT



DUTCHTOWN CARE CENTER REVIEW OF PROJECT DISBURSEMENTS

ST. LOUIS, MISSOURI

2002-KC-1001

March 29, 2002

OFFICE OF AUDIT, GREAT PLAINS
KANSAS CITY, KANSAS



Issue Date	March 29, 2002
Audit Case Number	2002-KC-1001

TO: Herman Ransom, Director, Office of Multifamily Housing, Kansas City Hub, 7AHM

Roger E. Niesen

FROM: Roger E. Niesen, District Inspector General for Audit, 7AGA

SUBJECT: Dutchtown Care Center - #085-43066-NC-PM
St. Louis, Missouri

We have completed an audit of Dutchtown Care Center's use of project funds to determine if the owners complied with the terms of their Regulatory Agreement. Dutchtown is a Section 232 insured nursing home located in St. Louis, MO.

Our report contains three findings with recommendations requiring action by your office. The three findings address misuse of project funds totaling \$844,771 between March 1997 and May 2000. Dutchtown improperly used \$484,253 in project funds to repay owner advances when the project did not have surplus cash. Dutchtown also paid \$308,559 in project funds to provide a salary to one of the owners. Dutchtown did not have HUD's consent to make these distributions. In addition, project funds totaling \$51,959 were paid for other ineligible or unsupported purposes. Although Dutchtown generated surplus cash in 2001, it did not have any surplus cash during the periods it made the unauthorized distributions and inappropriate expenditures.

Within 60 days please give us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact me at (913) 551-5870.

Executive Summary

We have completed an audit of Dutchtown Care Center. The objective of our audit was to determine whether the owners of Dutchtown Care Center complied with the terms of the Regulatory Agreement, as well as all applicable statutes, regulations, handbooks and other requirements of HUD. We decided to conduct an audit of Dutchtown because its financial statements had indications of equity skimming.

We found that Dutchtown improperly used \$484,253 in project funds to repay owner advances when the project did not have surplus cash. Dutchtown also paid \$308,559 in project funds to provide a salary to one of the owners. Salary paid to an owner is prohibited unless HUD has approved the salary as essential to project operations. In addition, project funds totaling \$51,959 were paid for other ineligible or unsupported purposes.

These actions violated Dutchtown's Regulatory Agreement and increased the risk to HUD's mortgage insurance fund. The requirement to generate surplus cash before distributions are made provides assurance to HUD that owners efficiently and effectively operate and properly maintain projects.

Distributions to Owners

The owners of Dutchtown Care Center inappropriately paid \$484,253 from project funds to themselves and their affiliates between March 1997 and February 2000. The owners disregarded HUD's requirements and advice from their own cost certification auditors that distributions other than from surplus cash were improper. The owners made these distributions in order to repay funds that the owners had advanced to the nursing home between November 1994 and July 1997. When a project is in a non-surplus cash position, HUD guidelines prohibit repayment of owner advances unless prior approval is obtained. When the owners took these distributions, Dutchtown had never had surplus cash. The improper distributions increased the risk to the HUD mortgage insurance fund.

Salary to Owner

Dutchtown's operating funds were inappropriately used to pay a salary to one of the owners to serve as the administrator and subsequently assistant administrator. The duties of the administrator and assistant administrator are the same and are similar to those required of the identity-of-interest management agent. These payments were made during a period when the same owner was paid over \$500,000 for services rendered as the management agent. The project paid the salary even though HUD had notified the owners that using project operating funds to pay a salary to the project's principals was prohibited. Under HUD

Ineligible Expenses

guidelines, owner salaries other than approved management fees are considered distributions that can only be paid out of surplus cash. The improper payments increase the risk to the HUD insurance fund and could set an undesirable precedent for other project owners.

The owners of Dutchtown Care Center used project funds to pay \$51,959 for purchases that were not supported to be reasonable or necessary project expenses. These expenses included car payments for vehicles driven by the owners, sports team season tickets, former nursing home legal expenses, credit card purchases of food, gas, auto parts and repairs, rental cars, department store shopping, and other purposes that could not be shown to be project related. The owners said they believed the purchases were eligible project expenses, even though they could not produce documentation to support how the purchases were reasonable and necessary operating expenses. Dutchtown's Regulatory Agreement requires all project funds be used for reasonable and necessary operating and maintenance expenses of the project, with the exception that distributions from surplus cash can be used for any purpose. Using project funds for other than reasonable and necessary expenses increases the risk to HUD's mortgage insurance fund.

We recommend that the Director, Office of Multifamily Housing, Kansas City Hub, takes all appropriate action to correct these deficiencies and to prevent them from occurring in the future. At a minimum, the Director should require Dutchtown to obtain HUD's approval before making any surplus cash distributions for the next three years. During this period, HUD should also review all project expenditures to ensure there are no ineligible payments before granting approval for surplus cash distributions. If ineligible expenses are found, distributions should be denied and appropriate administrative or civil actions taken. HUD should also require the owners to develop and implement procedures to ensure they abide by Dutchtown's Regulatory Agreement and HUD's guidelines regarding: future distributions of project funds; payment of expenses from project funds; and maintenance of documentation to support the amount and eligibility of expenses.

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Introduction

The Department of Housing and Urban Development insured, under the 232 program, a \$4,221,500 mortgage to construct Dutchtown Care & Rehabilitation Center. The owner of Dutchtown Care & Rehabilitation Center is A.F.T., Inc., a corporation registered in the State of Missouri. The officers and sole shareholders of A.F.T. are a married couple.

Dutchtown Care Center was built to replace another nursing home that formerly occupied the same site. The initial closing for the loan to construct Dutchtown Care Center took place on December 7, 1995. On that date, the owner signed a Regulatory Agreement with HUD. Residents first occupied the new nursing home on March 12, 1997. Final Endorsement of the mortgage took place on September 21, 1998.

Dutchtown Care Center has 120 beds and is located in the city of St. Louis. The nursing home had a net loss of \$81,102 in its fiscal year ending March 31, 2000. Its net income for the fiscal year ending March 31, 2001 was \$440,211.

Audit Objectives

The overall audit objective was to determine whether the owners of Dutchtown Care Center have complied with the terms of the Regulatory Agreement, as well as all applicable statutes, regulations, handbooks and other requirements of HUD.

Audit Scope and Methodology

To achieve our objective, we reviewed the project's bank statements, canceled checks, general ledgers, invoices, management agreement, and financial statements. We also interviewed the owners, the controller, and the financial statement auditors.

We performed our audit work from June 2000 through August 2000. The audit covered the period March 12, 1997 through April 30, 2000. We extended the review, where appropriate, to include other periods. The Audit was conducted in accordance with generally accepted government auditing standards. In August 2000 after we completed our audit work, we provided our conclusions to HUD's attorneys for a legal review. Subsequently, we provided draft findings to the owners of Dutchtown on February 11, 2002 and received the owners' responses to our findings on March 6, 2002. After receiving the owner's comments, we revised our recommendations to allow HUD maximum flexibility in resolving the deficiencies we identified. We provided a copy of this final report to the owners of Dutchtown Care Center.

The Owners Took Distributions When the Project Had Negative Surplus Cash

The owners of Dutchtown Care Center inappropriately paid \$484,253 from project funds to themselves and their affiliates between March 1997 and February 2000. The owners disregarded HUD's requirements and advice from their own cost certification auditors that distributions other than from surplus cash were improper. The owners made these payments in order to repay funds the owners had advanced to the nursing home between November 1994 and February 1997. When a project is in a non-surplus cash position, HUD guidelines prohibit repayment of owner advances unless prior approval is obtained. When the owners took these distributions, Dutchtown did not have nor ever had surplus cash. The improper distributions increased the risk to the HUD mortgage insurance fund.

Program Requirements

Dutchtown Care Center is governed by a Regulatory Agreement that says except for payments made from surplus cash, all payments must be for reasonable operating expenses and necessary repairs. Payments from surplus cash may be used for any purpose, but only after the amount of surplus cash is calculated at the end of a fiscal period.

HUD Handbook 4370.2 says owner advances made for reasonable and necessary operating expenses may be repaid from surplus cash at the end of the annual or semi-annual period. Repayment of owner advances when the project is in a non-surplus cash position will subject the owner to criminal and civil monetary penalties.

Handbook 4370.2 also says that to encourage owners to make advances to projects in critical situations, the Department may approve on a case-by-case basis requests to make advances and for repayment of such advances. Prior HUD approval is required for an owner to receive repayment on a monthly basis.

The Owner's Made Advances And Repaid Themselves

The owners and two of their affiliates made advances to Dutchtown from 1994 through 1997. The owners did not disclose these advances to HUD in documents related to their September 30, 1998 final endorsement of the mortgage.

Dutchtown used project funds to repay these advances from April 1997 through February 2000. This was done by making payments from project accounts directly to the

owners, their affiliates, and to third parties on the owners' behalf. The amounts of these payments were then deducted from the balance of advances shown as having been made to Dutchtown. This process continued until these advances were fully repaid in February 2000.

At the time the repayments were made, Dutchtown did not have surplus cash. Dutchtown's financial statement auditors calculated surplus cash at March 31, 1998, 1999, and 2000, and in each case it was a negative amount. Additionally, in a November 18, 1997 note to the owners, the cost certification auditors informed the owners that advances could only be repaid from surplus cash.

The payments made to reimburse these advances were ineligible distributions of operating funds that violated Dutchtown's Regulatory Agreement and HUD's requirements. These payments increased the risk to HUD's mortgage insurance fund. The requirement to generate surplus cash before distributions can be made helps ensure HUD owners efficiently and effectively operate and properly maintain projects.

The Current Surplus Cash
Position Is Not
Guaranteed

After our audit field work was completed, the owners indicated that the improper distributions were not a concern since they had positive surplus cash as of March 31, 2001. However, we believe the fact that Dutchtown generated surplus cash in 2001 does not ensure the project is operating efficiently and effectively or will continue to do so. It also does not dismiss the fact that the owner's knowingly violated their Regulatory Agreement over a four-year period.

We examined the conditions that led to Dutchtown's March 31, 2001 positive surplus cash totaling \$679,859 and found 69 percent (\$471,346) of the surplus cash was the result of non-recurring income that Dutchtown received in fiscal year 2001. This non-recurring revenue was from a settlement reached with a contractor, reimbursement from Medicaid for a prior period, and a special nursing home distribution from the State legislature.

Surplus cash in one year does not guarantee Dutchtown is operating effectively or will sustain this level of operation in future years. We believe HUD should monitor Dutchtown's expenditures and require Dutchtown to obtain HUD's

permission prior to making surplus cash distributions for a specified period in the future to ensure Dutchtown is operating effectively and in accordance with its Regulatory Agreement.

Auditee Comments

Excerpts from Dutchtown's comments on our draft finding follow. Appendix A, page 19, contains the complete text of the comments.

Dutchtown acknowledges the owner took distributions when the project had negative surplus cash. However, Dutchtown believes it is a timing issue since they currently have surplus cash. Also, Dutchtown asserted that contrary to our findings, the owner was required by Gershman Investment Corporation and HUD to make advances during the construction period to cover change orders and construction and lease up overruns in excess of \$400,000. Further, Dutchtown explained that surplus cash had been calculated incorrectly for three years, and the correct surplus cash figures were less negative than the original figures. Dutchtown says that our comment that \$471,346 of the surplus cash was the result of non-recurring income is absolutely wrong. The Nursing Home Reimbursement Act and the Nursing Facility Acceptance Corporation have been around since the mid-1990's. The facility has received the funds every year since it opened.

OIG Evaluation of Auditee Comments

Dutchtown is correct in stating that if it would not have violated its Regulatory Agreement, it would have had the opportunity to generate positive surplus cash at the end of the period following its ineligible distributions. However, since it did violate the regulations, it did not have positive surplus cash. Thus HUD's risk was increased during the period when distributions were taken with no assurance a positive surplus cash position would be reached. The statement that the owners were required to make the advances is not relevant. We did not take issue with why the owners made the advances. Our finding deals with the manner in which the advances were repaid when there was no confirmation that the project had surplus cash or had received HUD's prior permission to repay the advances. Also, even though surplus cash had been incorrectly calculated, the corrected the figures

were negative. Finally, our treatment of the Nursing Home Reimbursement payments as non-recurring was consistent with information we received from Dutchtown's financial statement auditor and the Missouri Department of Social Services. We revised our draft recommendations to allow HUD maximum flexibility in resolving this issue.

Recommendations

We recommend the Director, Office of Multifamily Housing, Kansas City Hub:

- 1A. Takes all appropriate actions to correct the ineligible distributions and to prevent them from occurring in the future. At a minimum, the Director should:
 - (1) For the next three years, require Dutchtown to obtain HUD's approval before distributing surplus cash.
 - (2) Prior to approving any distributions, review Dutchtown's expenditures for ineligible items and deny the distribution of surplus cash and take appropriate administrative or civil action if ineligible distributions are found.

Dutchtown Improperly Paid \$308,559 To An Owner

Dutchtown's operating funds were inappropriately used to pay a salary to one of the owners to serve as the administrator and subsequently as the assistant administrator. The duties of the administrator and assistant administrator are the same and are similar to those required of the identity-of-interest management agent. These payments were made during a period when the same owner was paid over \$500,000 for services rendered as the management agent. The owners paid the salary even though HUD had notified them that using project operating expenses to pay a salary to the project's principals was prohibited. Under HUD guidelines, owner salaries other than approved management fees are considered distributions that can only be paid out of surplus cash. The improper payments increase the risk to the HUD insurance fund and could set an undesirable precedent for other project owners.

Program Requirements

Dutchtown Care Center's Regulatory Agreement requires all distributions be limited to the extent of surplus cash available as of and after the end of an annual or semiannual fiscal period. Although Dutchtown was permitted to compute surplus cash semiannually, it only calculated surplus cash annually.

HUD Handbook 4370.2 says a distribution is any withdrawal or taking of cash or any assets of a project other than for the payment of reasonable expenses necessary to the operation and maintenance of the project. The term distributions includes, for example, supervisory fees paid to general partners and any salaries or other fees paid to the sponsor or mortgagor, unless those salaries or fees have been approved by HUD as essential to the operation of a project (e.g., a management fee approved by HUD and paid on an Owner-Managed project).

Owner Salary

A husband and wife team owns the corporation that controls Dutchtown. Dutchtown's husband-owner served as the paid administrator for Dutchtown from March 1997 through May 1998. After a full-time administrator was hired in June 1998, the husband-owner held the position of assistant administrator. The owner was paid a salary of approximately \$100,000 as administrator and continued to receive this same amount as assistant administrator, while

the new administrator earned about \$67,000.

The job descriptions for the administrator and assistant administrator are identical. Additionally, the duties included in their job descriptions are similar to those of the management agent. The management agent is an identity-of-interest corporation also under control of the husband and wife team. The husband signed the management contract for the management agent and received \$539,231 for management agent services provided over the same period he was paid \$308,559 as administrator and assistant administrator. HUD guidelines prohibit the owner from receiving any salary or fee unless specifically approved.

HUD notified the owners prior to these payments being made that owner salaries were prohibited. HUD sent a letter to the mortgagee and the identity-of-interest owner entity in June 1997, that denied their request to use working capital escrows to pay a salary to the owner. The letter says, "HUD's guidelines prohibit including in the project operating expenses any salary paid to the project's principals."

Dutchtown did not have surplus cash at any time during the period these salary payments were made. Dutchtown's financial statement auditors calculated surplus cash at March 31, 1998, 1999, and 2000, and found, in each case, that surplus cash was a negative amount. As a result, the salary paid to the owner as administrator and assistant administrator is contrary to HUD's instructions and guidelines, and constitutes a diversion of project funds.

Auditee Comments

Excerpts from Dutchtown's comments on our draft finding follow. Appendix A, page 19, contains the complete text of the comments.

Dutchtown indicated that our finding is based on the erroneous conclusion that the administrator and management agent perform the same functions. All nursing homes are required by law to have a state licensed administrator, whose license is posted on the wall, who is responsible for day to day running of the nursing home. The management company has the authority and responsibility for the management and

over all operation of the facility. These are separate and distinct responsibilities. Who better to act as administrator to help in the initial lease up of the facility than someone with a vested interest in attracting good residents for the long term benefit of the project than the owner? Also, Dutchtown said the Auditors must have thought they were auditing a multifamily housing project, not a nursing home. Further, Dutchtown said HUD's refusal to use working capital escrows for the administrator's salary is not unusual during the lease up period and does not necessarily prove anything.

OIG Evaluation of Auditee Comments

Our finding is based on the fact that salary payments to owners are prohibited except with prior HUD approval such as when a project is self managed and the owner is not paying a fee to a management agent. In this case, the owner was the identity of interest management agent, so he was already being paid a fee to manage the project. Additionally, the owner did not request HUD's approval to receive a salary. If the owner chooses to act as administrator because he feels he is best suited to run the nursing home, he should not draw a salary. The owner can reimburse himself for his efforts using surplus cash distribution procedures. These procedures were designed to encourage owners with a vested interest in a project to run it more effectively. The HUD-OIG Auditor used the Regulatory Agreement and HUD Handbook 4370.2 as criteria to audit Dutchtown. Both are applicable to insured, Section 232 nursing home projects. Finally, in a letter to Dutchtown regarding the use of working capital escrows to pay the owner an administrator salary, HUD said salary payments to an owner are also prohibited from operating expenses. We revised our draft recommendations to allow HUD maximum flexibility in resolving this issue.

Recommendations

We recommend the Director, Office of Multifamily Housing, Kansas City Hub:

- 2A. Takes all appropriate actions to correct the ineligible distributions and to prevent them from occurring in the future. At a minimum, the Director should:

(1) Require Dutchtown to cease paying a salary to the owner, and restrict future payments to owners to the amount of available surplus cash following an annual or semiannual calculation.

The Owners Made Purchases that Were Not Reasonable or Necessary

The owners of Dutchtown Care Center used project funds to pay \$51,959 for purchases that were not supported to be reasonable or necessary project expenses. These expenses included car payments for vehicles driven by the owners, sports team season tickets, former nursing home legal expenses, credit card purchases of food, gas, auto parts and repairs, rental cars, department store shopping, and other purposes which could not be shown to be project related. The owners said they believed the purchases were eligible project expenses, even though they could not produce documentation to support how the purchases were reasonable and necessary operating expenses. Dutchtown's Regulatory Agreement requires all project funds be used for reasonable and necessary operating and maintenance expenses of the project, with the exception that distributions from surplus cash can be used for any purpose. Using project funds for other than reasonable and necessary expenses increases the risk to HUD's mortgage insurance fund.

Program Requirements

The Regulatory Agreement says that project funds must be used to pay amounts required by the mortgage, make required reserve deposits, pay reasonable expenses necessary to the operation and maintenance of the project, and repay owner advances authorized by the Secretary's administrative procedures and approved by the mortgagee. Any other distributions can only be paid out of surplus cash that exists as of the end of a semi-annual or annual fiscal period. Dutchtown opted to only calculate surplus cash at the close of each annual fiscal period.

Unallowable Purchases

The owners of Dutchtown used project funds: to make car payments for vehicles driven by the owners; for sports team season tickets; to pay former nursing home legal expenses; to pay credit card purchases of food, gas, auto parts and repairs; and to pay for rental cars, department store shopping, and other purposes that could not be shown to be reasonable and necessary operating or maintenance expenses.

The Project Paid Costs That Were a Management Agent Responsibility

Acting as management agent, the owners used project funds to pay for vehicles leased for their use. From March 1998 through May 2000, the project paid \$5,753 for these vehicles. In addition, during this same period the project paid car-related expenses, such as gas and repairs, totaling \$8,214. The management contract says that Dutchtown is

The Project Paid Costs
That Were Not
Reasonable Or Necessary

to pay a management fee, but Dutchtown will not pay expenses of the management company unless specified in the contract. The contract does not state the project will provide transportation for the management company. The contract states that the management agent will supply, at its sole cost, all equipment, tools, materials, and supplies necessary or appropriate to perform its duties. Therefore, vehicle expenses should have been paid out of management fees, not project funds.

Between October 1998 and April 2000, the project paid \$15,545 for tickets to various St. Louis sporting events. The Controller said the tickets were used as an employee fringe benefit. The owners offered them to employees who had done exceptional work. The owners said these tickets were also offered to patients and responsible parties of patients.

The owners also used project funds to pay \$3,472 in legal expenses for a nursing home that was formerly located on the site. In addition, Dutchtown paid for the same expenses twice. Dutchtown paid a credit card company \$945 for purchases made on behalf of Dutchtown and then reimbursed an owner for the same expenses. Further, the owners used their credit cards to purchase food, items from department stores and other miscellaneous purchases totaling \$5,334 and used project funds to pay their credit card bills. Although Dutchtown had in its files the credit card statements listing the transactions, it did not have receipts documenting how these purchases were legitimate project expenses.

Dutchtown wrote checks totaling \$11,418 to various payees, but did not have documentation such as invoices and receipts to support that the payments were project-related. Among these payments were checks payable to members of the owners' family, cash, and sports organizations. HUD requires that all payments be adequately supported with documentation.

The Regulatory Agreement's spending requirements are in place to protect the Department's interest. Not following or improperly applying the requirements increases the risk to the HUD mortgage insurance fund. The following table itemizes the unallowable purchases:

Unallowable Purchases	Amount
Vehicles	\$5,753
Vehicle gas, stereo, repair	\$8,214
Sports	\$15,545
Relates to another project	\$3,472
Payments to owners	\$1,367
Restaurants	\$4,060
Miscellaneous (includes shopping)	\$1,780
Unsupported	\$11,418
Donation	\$350
TOTAL	\$51,959

Auditee Comments

Excerpts from Dutchtown's comments on our draft finding follow. Appendix A, page 19, contains the complete text of the comments.

Dutchtown disagrees with our conclusion that purchases of \$51,959 were not reasonable or necessary expenses, except for the \$945 paid twice which was a mistake. Dutchtown claims that HUD and the OIG should not be micro managing a successful project. If the expenses were disallowed, then the owners claim they would have an even larger surplus cash amount to be distributed to the owners. The owners are expending funds that they feel will provide long term benefits to the facility. The owners said that although certain items may appear to be questionable, the best authority for what are ordinary and necessary expenses are the owners, since ultimately monies expended are just reducing their surplus cash distributions, and the proof is in the profitability of the project.

OIG Evaluation of Auditee Comments

We believe that HUD should hold all insured projects to the requirements set forth in the Regulatory Agreement. The Regulatory Agreement limits the type of expense that can be made from project operating funds and requires a surplus cash computation before distributions can be made. We commend Dutchtown on attaining surplus cash in March 2001, but emphasize that past performance is not a guarantee of continued future success. That is why these requirements

exist. The regulatory agreement is structured to protect tenants and reduce HUD's risk from a non-recourse loan. We revised our draft recommendations to allow HUD maximum flexibility in resolving this issue.

Recommendations

We recommend the Director, Office of Multifamily Housing, Kansas City Hub:

3A. Takes all appropriate actions to correct the ineligible distributions and to prevent them from occurring in the future. At a minimum, the Director should require Dutchtown to:

(1) Stop paying non-project type expenses from project funds.

(2) Develop and implement procedures that ensure only eligible expenses are paid from project funds, and that documentation is maintained to support the eligibility and the amount of operating funds expended.

Management Controls

In planning and performing our audit, we considered the management controls of Dutchtown Care Center to determine our auditing procedures, not to provide assurance on the controls. Management controls include the plan of organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Management Controls

We determined the following management controls were relevant to our audit objectives:

- Assuring safeguarding of resources.
- Assuring compliance with laws and regulations.

We assessed the relevant controls identified above.

It is a significant weakness if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet an organization's objectives.

Significant Weaknesses

Based on our review, we believe the following items are significant weaknesses:

The owners took distributions, in violation of Dutchtown's Regulatory Agreement, when the project did not have surplus cash (see Finding 1).

Dutchtown paid \$308,559 to an owner for a salary that was duplicative and violated HUD's instructions (see Finding 2).

The owners made purchases that were not reasonable or necessary expenses of the project (see Finding 3).

Follow Up On Prior Audits

This is the first audit of Dutchtown Care Center performed by the Office of Inspector General.

Auditee Comments

The letter responding to our findings is printed below. Exhibits attached to this letter are excluded since they are not necessary for understanding the comments.

ROSENBLUM, GOLDENHERSH, SILVERSTEIN & ZAFFT, P.C.

ATTORNEYS AT LAW

STANLEY H. ROSENBLUM
1922-2001

ROBERT E. GOLDENHERSH*
HENLE L. SILVERSTEIN
GENE M. ZAFFT
CARL C. LANG
RICHARD S. BENDER†
MICHAEL A. MARKENSOHN
ROGER M. HERMAN
THOMAS A. DUDA
JOSHUA M. SCHWOLER†††
MICHAEL D. QUINLAN†
EDWARD J. HOLMES†

DAVID T. WOODS
JALAINE N. WHEELER
LUKE J. MANGAN†
DAVID S. LANG††
VINCENT R. KRINKLER
RUTH N. KELSO

† Also Licensed in Illinois
†† Also Licensed in Florida
††† Also Licensed in Massachusetts and Illinois
* Of Counsel

7733 Forsyth Boulevard
Fourth Floor
St. Louis, Missouri 63105-1812
Telephone 314-726-6868
Facsimile 314-726-6786
Website www.rgsz.com

2 Park Place Professional Centre
Belleville, Illinois 62226
Telephone 618-234-9900

Rolwes & Platt of Counsel
Three First National Plaza
Suite 3600
Chicago, Illinois 60602-4283
Telephone 312-377-4384
Mr. Lang's Direct Dial Number
(314) 726-6869 Ext. 230
e-mail address: cdl@rgsz.com

March 6, 2002

CERTIFIED RETURN RECEIPT REQUESTED

Mr. Roger E. Niesen
District Inspector General for Audit
U.S. Department of Housing and
Urban Development
Great Plains District, 7AGA
Gateway Tower II – 5th Floor
400 State Avenue
Kansas City, Missouri 66101-2406

Re: Dutchtown Care Center
Project No. 085-430066

Dear Mr. Niesen:

Please be advised that we represent A.F.T., Inc. the owner of Dutchtown Care Center referenced above and are responding to your letter of February 11, 2002.

From a global standpoint, L. Charles Hester, Director of the St. Louis Multifamily Program Center of HUD, did write a letter dated October 1, 2001, dealing with many of the same issues as your Audit findings, we responded to the HUD letter by our letter of October 24, 2001 ("Response Letter"), a copy of which is attached hereto as Exhibit A hereto. We actually met with Mr. Hester and other members of his staff on October 26, 2001, and discussed his letter, our Response Letter and I believe we resolved our differences. You certainly may check with Charles Hester at HUD, but we discussed the fact that Dutchtown was the first HUD Project owned by the Daakes, that Surplus Cash to them meant cash in the bank (they did not knowingly violate the Regulatory Agreement), the timing problems of repaying the advances before the appropriate determination of Surplus Cash, and basically assured Mr. Hester and his staff that Dutchtown is a very successful HUD Project and the mistakes of the past were now corrected.

Finding 1

As to your findings that the Owner took distributions when the Project had negative Surplus Cash, technically you are correct, but practically speaking it is a timing issue. Contrary to your

ROSENBLUM, GOLDENHERSH,
SILVERSTEIN & ZAFFT, P.C.

Mr. Roger E. Niesen
District Inspector General for Audit
March 6, 2002
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findings, the Owner was required by Gershman Investment Corp. and HUD to make advances during the construction period to cover change orders and construction and lease up overruns in excess of \$400,000. The original calculations of Surplus Cash for March 31, 1998, 1999 and 2000 were on advice from HUD calculated on HUD Form 93486, which is a Multifamily Housing Form, and not appropriate for a nursing home, copies of which are attached to my Response Letter of October 24, 2001 to Mr. Hester. It was only after numerous discussions with HUD, A.F.T.'s CPA and Gershman, we determined on September 15, 2000 (3 years after the nursing home opened) that government account receivables were includible because the Project is a nursing home which dramatically changed the calculation of Surplus Cash. The CPA recalculated Surplus Cash for 1999 and 2000 to be a negative \$54,635 and negative \$58,303 per Exhibit B of the October 24, 2001 Response Letter. This is a huge difference from the \$484,253 which your report sets forth and keep in mind that as of March 31, 2001 the Surplus Cash was a positive \$679,859. The comment that \$471,346 of the Surplus Cash was the result of non-recurring income is absolutely wrong. The Nursing Home Reimbursement Act ("NFRA") and Nursing Facility Acceptance Corporation ("NFAC") have been around since the mid-1990's. Dutchtown pays a \$7.30 per patient day NFRA tax to the State of Missouri and receives back a portion of the tax in the form of the NFAC reimbursement. The facility has received the funds every year since it opened, continues to receive the NFAC funds in February, 2002. To exclude the NFAC income but continued to expense the NFRA tax is a real miss matching of income and expense, and makes no sense. This comment illustrates the lack of understanding of nursing home operations by your auditor. As of the date of this letter, there is well over \$200,000 in cash in the bank and Surplus Cash is in excess of \$180,000. Dutchtown continues to operate profitably.

We absolutely do not agree with putting \$484,253 into the replacement account for 3 years. The Daakes repaid approximately \$235,000 during the period November 25, 1998 through March 31, 1999. If they waited until April 1, 1999, there would have been Surplus Cash of \$180,000, and then been able to repay \$180,000 without violating the Regulatory Agreement. They repaid themselves another \$165,000 during the year ending March 31, 2000. Again, if they waited until April 1, 2000, they could have repaid most of their advances without violating the Regulatory Agreement. This was a timing issue that has now been corrected, and the Daakes understand they can only disburse funds to themselves out of Surplus Cash on a semi-annual basis.

Finding 2.

As to your findings that Dutchtown improperly paid \$308,559 to the Owner, the basis for this finding is the erroneous conclusion that the Administrator and management agent perform the same functions. All nursing homes are required by law to have a state licensed administrator, whose license is posted on the wall, who is responsible for day to day running of the nursing home, such as hiring and firing nurses, aids, maintenance people, cooks, kitchen and dining room help, dealing with residents and responsible parties. The management company has the authority and

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responsibility for the management and over all operation of the facility, including insuring the facility is in compliance with all applicable rules and regulations pertaining to nursing homes, hire and fire the Administrator and Director of Nursing, and authority to establish fiscal policies. These are separate and distinct responsibilities. Who better to act as Administrator to help in the initial lease up of the facility than someone with a vested interest in attracting good residents for the long term benefit of the facility than Tom Daake? The Administrator's salary to Tom Daake was clearly essential to the initial operation of the Project, and in fact Tom worked several months without pay until the Project had sufficient cash flow to pay him. Clearly, the GSA Auditor must have thought they were auditing a multifamily housing project, not a nursing home. Also, HUD's refusal to use working capital escrows which are for specific uses such as debt service, taxes and insurance, for administrator's salary is not unusual during the lease up period and does not necessarily prove anything other than HUD wanted to hold the escrow in reserve only for the stated limited purposes for which it was established.

Obviously, we disagree with your recommendation to repay \$308,559 in salary paid to Tom Daake into Dutchtown's reserve for replacement.

Finding 3

As for the Owners purchases of \$51,959 that were not reasonable or necessary expenses, we also disagree, except for the \$945 paid twice which was a mistake. HUD and the GSA should not be micro managing a successful project. If the expenses were disallowed, then we would have even a larger Surplus Cash to be distributed to the Owners. The Owners are expending funds that they feel will provide long term benefits to the facility. Sporting tickets reward or endear the facility with employees, residents and responsible parties of residents to build good will for the Project. Car expenses are necessary to run errands to pick up items for the facility, transport patients or employees and other necessary and ordinary business related items. A detail response and business purpose explanation to each of the questioned items is available upon request.

In conclusion, we acknowledge a technical violation of the Regulatory Agreement in the repayment of advances prior to determination of Surplus Cash. The technical violation was due to a lack of understanding of the documents by Owners who were involved in their first HUD Project. The violation caused no damage to the Project and the violation has been corrected. The Owners now understand the meaning of "Surplus Cash", the ramifications thereof, and the mistake will not happen again. However, your suggested recommendation is inappropriate, the punishment clearly does not fit the crime, since the technical violation is corrected and no damage has been caused to the Project. I could understand your recommendation if the Project were in default, but here we have a successful HUD project that HUD, the Owners and the community are proud to be apart of.

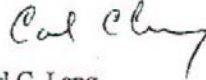
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As to the other recommendations, we totally disagree and feel the auditor does not fully understand the operations of a nursing home. Although certain items may appear to be questionable, the best authority for what is ordinary and necessary expenses are the Owners, since ultimately monies expended are just reducing their Surplus Cash distributions, and the proof is in the profitability of the Project.

If you have any questions or comments, we would be more than willing to sit down and discuss these matters further with you.

Very truly yours,



Carl C. Lang

CCL/jo

cc: Tom and Adele Daake
Gershman Investment Corp.
L. Charles Hester

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