AUDIT REPORT

USE OF PROJECT FUNDS

TIMBERLAKE CARE CENTER
KANSAS CITY, MISSOURI

2004-KC-1002

March 10, 2004

OFFICE OF AUDIT, REGION 7
KANSAS CITY, KS

Table of Contents

audit report

Issue Date	March 10, 2004
Audit Case Number	2004-KC-1002

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

FROM: Ronald J. Hosking, Acting Regional Inspector General for Audit, 7AGA

SUBJECT: Use of Project Funds
Timberlake Care Center
Kansas City, Missouri

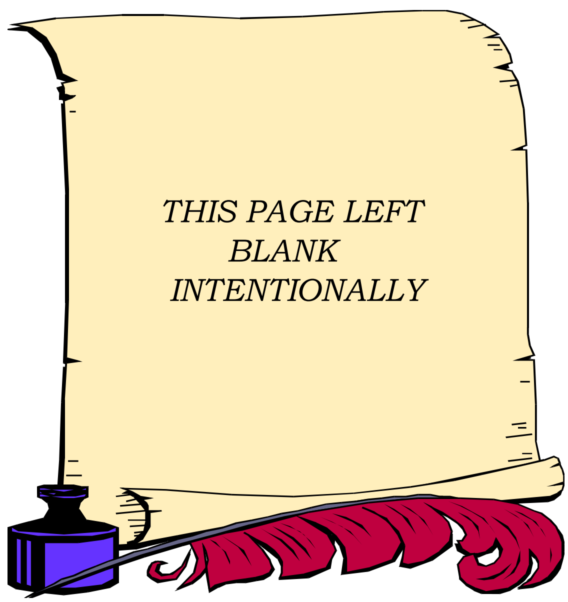
We have completed an audit of Timberlake Care Center, a Section 232 Nursing Home located in Kansas City, Missouri. We selected the project based on an audit request from your office that indicated there were unallowable disbursements from project funds. Our overall audit objective was to determine if the owner/management agent used project funds in accordance with applicable requirements.

Our report contains two findings with recommendations requiring oversight by your office. The first finding addresses unsupported and/or unallowable disbursements made during the audit period. The second finding addresses Timberlake Care Center's failure to perform monthly bank reconciliations.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide us, for each recommendation without management decisions, 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. Additional status reports are required at 90 days and 120 days after report issuance for any recommendation without a management decision. 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.

Table of Contents


THIS PAGE LEFT
BLANK
INTENTIONALLY

Executive Summary

We have completed an audit of Timberlake Care Center, a Section 232 Nursing Home located in Kansas City, Missouri. We selected the project based on an audit request from the Office of Multifamily Housing, Kansas City Hub, which indicated there were unallowable disbursements from project funds. Our overall audit objective was to determine if the owner/management agent used project funds in accordance with applicable requirements.

Timberlake Made Unsupported and/or Unallowable Disbursements

Timberlake Care Center made payments for other than reasonable operating expenses and necessary repairs of the project. Timberlake paid $76,192 in unsupported and/or unallowable disbursements from the operating account during fiscal years 2002 and 2003. Timberlake's owner did not alter property operations to ensure HUD rules and regulations were followed after Timberlake obtained HUD insured financing in August 2001. As a result, funds that should have been used to pay the operating expenses of the property were used for unsupported and/or unallowable purposes, contributing to Timberlake's negative surplus cash position.

Timberlake Did Not Perform Bank Reconciliations

Timberlake Care Center did not reconcile the operating account bank statements to the general ledger each month to ensure the amounts balanced. Over the two-year audit period, the operating account general ledger balance was understated by $17,590. Timberlake's staff was aware that the operating account bank statements did not reconcile to the general ledger balance. However, they did not know how to correct the problems, and therefore, took no action.

We provided a discussion draft of our audit report to the auditee following the audit. We held an exit conference with the auditee on January 29, 2004. The auditee provided written comments to our findings on March 1, 2004. We incorporated excerpts of the comments into our report as appropriate. The complete text of the comments is contained in Appendix B.

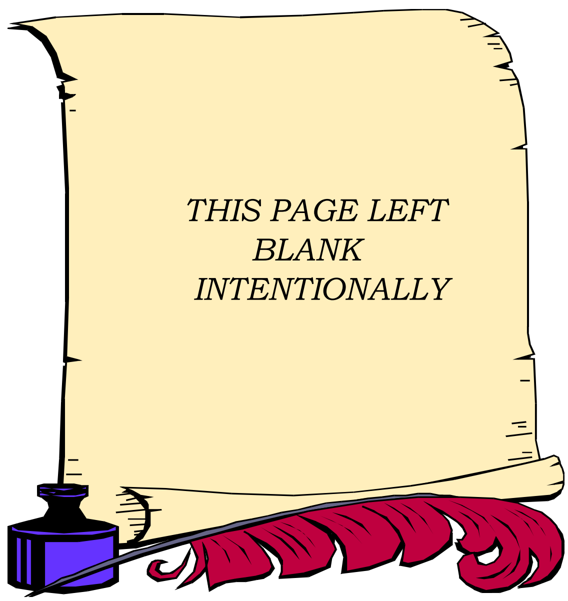
Recommendations

We recommend that the Director, Office of Multifamily Housing, Kansas City Hub, ensure Timberlake Care Center owners develop and implement policies and procedures to control funds in accordance with HUD requirements, and require that Timberlake's operating account be reimbursed $76,192 for the unsupported and/or unallowable disbursements paid during our audit period.

Table of Contents

We also recommend that the Director ensure Timberlake Care Center owners provide adequate support for the adjusting entry to cash made at the end of fiscal year 2002, and properly correct the fiscal year 2003 general ledger, or repay Timberlake's general operating account the amount that cannot be supported up to $17,590. Finally, we recommend that the Director verify that Timberlake Care Center owners are correctly reconciling the bank statements to the general ledger each month, and if they are unable to determine how to identify and resolve all reconciling items, have obtained outside assistance in doing so.

Table of Contents


THIS PAGE LEFT
BLANK
INTENTIONALLY

Introduction

Mission Lake Convalescent Center, Inc. owns and operates a 150-bed licensed nursing facility doing business as Timberlake Care Center in Kansas City, Missouri. The Project is financed with a mortgage loan insured by the U.S. Department of Housing and Urban Development (HUD), under Section 232 of the National Housing Act. The mortgage was endorsed on August 16, 2001. Timberlake Care Center is an owner-managed property.

We selected Timberlake Care Center for review based on an audit request from HUD's Office of Multifamily Housing, Kansas City HUB. The request was sent in regards to a management review performed at Timberlake Care Center on July 30, 2003. The management review indicated there were unallowable disbursements made from project funds. As a result of this review, HUD requested an extensive review of Timberlake's books and records created after August 15, 2001.

Audit Objectives

Our overall audit objective was to determine if the owner/management agent used project funds in accordance with applicable requirements. Specifically, our audit objectives were to determine whether all cash transactions were recorded in the project's books for fiscal years 2002 and 2003, to determine if funds disbursed from the project accounts to the owner/management agent were for allowable and supported purposes, and to determine if other funds disbursed from the project accounts were for allowable and supported purposes.

Audit Scope and Methodology

We performed on-site work from September through November 2003. During our audit, we interviewed HUD program staff to obtain background information on the project, and to obtain more details related to the Office of Housing's audit request. We interviewed the project's owner and management staff to gain an understanding of the staff's responsibilities and operational processes. We also interviewed the project's independent certified public accountant to obtain financial data.

To determine whether project funds were used in accordance with applicable requirements, we reviewed HUD project files for background information, including the Regulatory Agreement, Management Certification, and Management Review performed by HUD in July 2003. We reviewed Timberlake's bank statements, cash receipts and deposits, and general ledgers from Fiscal years 2002 and 2003 to perform a Proof of Cash analysis. We also reviewed check registers and invoices along with the above information for those items selected in our sample for further review.

Our sample included all payments made to the owner/management agent or any principles of the owner/management agent and/or related parties during fiscal years 2002 and 2003, all payments made to those accounts identified in the HUD audit referral, the five largest payments each year recorded in each "high risk" account identified by scanning the general ledger that had not already been chosen for review, all payments to cash, to employees (for other than payroll expenses), and to other related parties (including identity-of-interest vendors or contractors), the largest disbursement made each month, and 20 disbursements from each fiscal year selected at random from the remainder of all payments not previously selected. Further, we reviewed Reserve for Replacement Withdrawals and the project's year-end financial statements for the periods ended May 31, 2002 and 2003.

The audit covered the period from August 15, 2001, the date Timberlake Care Center obtained a HUD insured mortgage, through May 31, 2003. We conducted the audit in accordance with generally accepted government auditing standards.

Table of Contents

Timberlake Care Center Made Unsupported and/or Unallowable Disbursements from Operating Funds

Timberlake Care Center made payments for other than reasonable operating expenses and necessary repairs of the project. Timberlake paid $76,192 in unsupported and/or unallowable disbursements from the operating account during fiscal years 2002 and 2003. Timberlake's owner did not alter property operations to ensure HUD rules and regulations were followed after Timberlake obtained HUD insured financing in August 2001. As a result, funds that should have been used to pay the operating expenses of the property were used for unsupported and/or unallowable purposes, contributing to Timberlake's negative surplus cash position.

HUD Regulations

HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multi-Family Projects, Chapter 2, states that the regular operating account "is used to pay operating expenses of general administration including mortgage payments, management fees, utilities, and maintenance." Project funds are to be used for the following purposes only: 1) to make mortgage payments; 2) to make the required deposits to the Reserve Fund for Replacements; 3) to pay reasonable expenses necessary for the operation and maintenance of the project; and 4) to make distributions of surplus cash permitted and to repay owner advances authorized by HUD.

The Regulatory Agreement between HUD and Timberlake Care Center, Paragraph 6, states that "Owners shall not without prior written approval of the Secretary: (b) Assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs, and (e) Make, or receive and retain, any distribution of assets or any income of any kind of the project except surplus cash."

Unsupported and/or Unallowable Disbursements

Timberlake Care Center made payments for other than reasonable operating expenses and necessary repairs of the project. Timberlake paid a total of $76,192 in unallowable and/or unsupported disbursements from the operating account during fiscal years 2002 and 2003.

Unallowable Disbursements

During fiscal year 2002, all of Timberlake Care Center's disbursements that we reviewed were adequately supported; however, they paid $26,272 in unallowable disbursements as follows (See Appendix C, Fiscal Year 2002, for details of transactions)

- Four disbursements to Allstate Insurance Co. to insure four of the owner's personal vehicles, totaling $1,944.
- Eight disbursements to the owner's personal Amoco credit card for purchases unrelated to the property, totaling $1,656.
- Two disbursements to Citibank VISA for food purchases unrelated to the property, totaling $75.
- Nine disbursements to General Motors Acceptance Corporation for leases on two of the owner's personal vehicles, totaling $8,352.
- Nine disbursements to Smith Trust that were for debt unrelated to the property, totaling $6,637.
- Four disbursements to Mass Mutual Life Insurance to pay the monthly premium of $1,500 for a life insurance policy on the owner, totaling $7,500.
- Two disbursements related to repairs on the owner's personal vehicles, totaling $108.

During fiscal year 2003, Timberlake Care Center paid $44,397 in unallowable disbursements(see Appendix C, Fiscal Year 2003, for details of transactions) as follows:

- Four disbursements to Allstate Insurance Co. to insure four of the owner's personal vehicles, totaling $1,338.
- Eight disbursements to the owner's personal Amoco credit card for purchases unrelated to the property, totaling $1,640.

Table of Contents

- Four disbursements to Citibank VISA for food purchases unrelated to the property, totaling $276.

- Thirteen disbursements to General Motors Acceptance Corporation for leases on two of the owner's personal vehicles, totaling $13,066.

- Eleven disbursements to Smith Trust that were for debt unrelated to the property, totaling $8,112.

- Nine disbursemetns to Mass Mutual Life Insurance to pay the monthly premium of $1,500 for a life insurance policy on the owner, totaling $13,500.

- Two disbursements related to repairs on the owner's personal vehicles, totaling $1,076.

- One disbursement to O'Conner Heating and Cooling to pay for repairs to the owner's personal air conditioner, totaling $5,390.

Unsupported Disbursements

Also during fiscal year 2003, Timberlake Care Center paid $5,523 in unsupported disbursments (see table below for each of these disbursements).

Check #	Payee	Date	Amount	Unsupported
3404	Rea Law Office	12/18/2002	$2,000	$ 1,520
3803	Rea Law Office	2/11/2003	$2,003	$ 2,003
4082	Rea Law Office	4/14/2003	$2,000	$ 2,000
A		**TOTALS**	$6,003	**$ 5,523**

Owner Did Not Change Mode of Operation

During the first several years of operation, Timberlake Care Center was financed with a conventional loan. During this time, there were no restrictions on the operating funds. Since August 15, 2001, when the loan was refinanced as a HUD insured loan through the Section 232 loan program, the owner of Timberlake continued to operate the property as if it were still financed thorugh a conventional loan program. The operations of the property were not altered to ensure HUD rules and regulations were being followed.

Disbursements Impact Financial Position

As a result, funds that should have been used to pay the operating expenses of the property were used for unsupported and/or unallowable purposes during a time when Timberlake was in a negative surplus cash position.

Auditee Comments

Excerpts from Timberlake Care Center's comments on our draft audit report follow. Appendix B contains the complete text of the comments.

Summary:

A) There were eight disbursements, totaling $3,282 to Allstate Insurance Company in 2002 and 2003 for insurance on the owner's personal vehicles. Timberlake stated that this practice was discontinued immediately and the owner agreed to repay the total amount.

B) There were 16 disbursements, totaling $3,296 to the owner's personal Amoco credit card in 2002 and 2003. Timberlake maintains that much, if not most, of the fuel expense was used in connection with the business but was not documented. To correct the problem, they currently document the use and where the fuel goes. Timberlake has asked our office to consider reducing the total amount owed.

C) There were six disbursements to Citibank VISA, totaling $351, for food purchases unrelated to the property in 2002 and 2003. Timberlake's owner agreed to repay the total amount.

D) There were 22 disbursements to GMAC, totaling $21,418, for the leases on two of the owner's personal vehicles in 2002 and 2003. Timberlake maintains that the payments are for one car and one truck. The truck is used exclusively by the nursing home in maintenance/supply and seems an obvious appropriate expense. Timberlake also claims that the car is used by the owner in representing Timberlake with their providers, contract doctors, and HMO affiliates. They claim this is a legitimate "company car" and is almost standard practice in their industry.

Timberlake claims, regardless of the above information, the accumulated amount of car payments were deducted from the owner's salary at the end of calendar years 2002 and 2003. They also stated that the owner has been personally making the payments since September

Table of Contents

2003, so this is no longer an issue. Timberlake provided a copy of their ledger and claimed that the ledger shows the car payments being deducted out of the owner's salary.

E) There were 20 disbursements to Smith Trust, totaling $14,749, for debt unrelated to the property made in 2002 and 2003. Timberlake claims that the note was for land that the nursing home is partially built on and that it became an unsecured note only after the acquisition of a HUD-insured mortgage kept Timberlake from carrying the second mortgage. Timberlake claims that common sense shows HUD should be delighted to have access to these five acres and that the value of the property would be substantially decreased, or perhaps not even viable, without the property. Therefore, they maintain that Timberlake should continue to make the payments and the owner should not have to pay back the $14,749.

F) There were 13 disbursements to Mass Mutual Life Insurance, totaling $21,000, for life insurance premiums on the owner. Timberlake claims this is intended to be "key man" insurance in order for Timberlake to be able to continue if something were to happen to the owner. They claim 25% of the proceeds are assigned directly to Timberlake and the remaining 75% are assigned to family members with instructions on how to proceed in the will. According to their attorney, this is common practice and Timberlake continues to make the payments.

G) There were four disbursements to repair the owner's personal vehicle, totaling $1,184, in 2002 and 2003. Timberlake's owner agreed to repay the total amount.

H) There was one disbursement for O'Conner Heating and Cooling, totaling $5,390, in 2003. Although Timberlake claims the bill included some property repairs, they have no documentation to substantiate percentages, so Timberlake's owner agreed to repay the total amount.

I) Timberlake paid $5,523 in unsupported disbursements to Rea Law Office in 2003. Timberlake claims that the law office is their legal council on all legal matters that affect Timberlake/Mission Lake. They provided additional billings from the law office that they claim support these payments, and stated that all monies paid to Rea Law Office since the inception of the HUD-insured mortgage are legitimate Mission Lake expenses.

OIG Evaluation of Auditee Comments

Our evaluation of auditee comments addresses each of the above sections in which Timberlake Care Center disagreed with our recommendations:

B) Timberlake Care Center had a business account with Amoco that was used to purchase fuel for nursing home vehicles. The amount disallowed will not be reduced because the owner made the above purchases on his personal account, not the business account. Therefore, we will not alter our recommendation for the $3,296 to be repaid by the owner.

D) The disbursements included in our finding did not include payments for a truck. The payments were for two of the owner's personal cars. HUD Handbook 4370.2, states that project funds are to be used for the following purposes only: 1) to make mortgage payments; 2) to make the required deposits to the Reserve Fund for Replacements; 3) to pay reasonable expenses necessary for the operation and maintenance of the project; and 4) to make distributions of surplus cash permitted and to repay owner advances authorized by HUD. Therefore, payments for the owner's personal vehicles are not allowable.

Timberlake provided an account activity report for their Auto Expense - Officer's Vehicle Account for fiscal year 2003. They did not provide information from fiscal year 2002, and did not provide any payroll information showing the claimed deductions from the owner's salary. The information provided is not enough to reduce the disallowed amount; therefore, we will not alter our recommendation for $21,418 to be repaid by the owner.

E) Timberlake explained in our exit conference that the nursing home initially sat on the land in question; however, prior to the HUD insured mortgage being

Table of Contents

closed, the 5 acre tract was surveyed into the property used to secure the HUD insured mortgage, and the original loan for that land was converted to an unsecured note. Therefore, the note does not cover the property the building is currently sitting on. Also, the loan from Smith Trust is unsecured. Therefore, we will not alter our recommendation for the $14,749 to be repaid by the owner, and suggest the owner discontinue using operating funds to pay this note.

F) No documentation was provided by Timberlake to support their claim that the insurance policy benefits the nursing home. We asked them to provide more information on the policy so we could determine if it was an asset to the property. They did not provide any new information in their written comments; therefore, we will not alter our recommendation for the $21,000 to be repaid by the owner, and suggest the owner discontinue using operating funds to pay the premiums.

I) The additional billings provided by Timberlake do not provide enough information to separate the bills that legitimately relate to Timberlake project operations and those that relate to the owner, and the ownership entity, Mission Lake. Therefore, we will not alter our recommendation for the $5,390 in unsupported disbursements to be repaid by the owner, and suggest the property discontinue using operating funds to pay for legal services not specifically related to project operations.

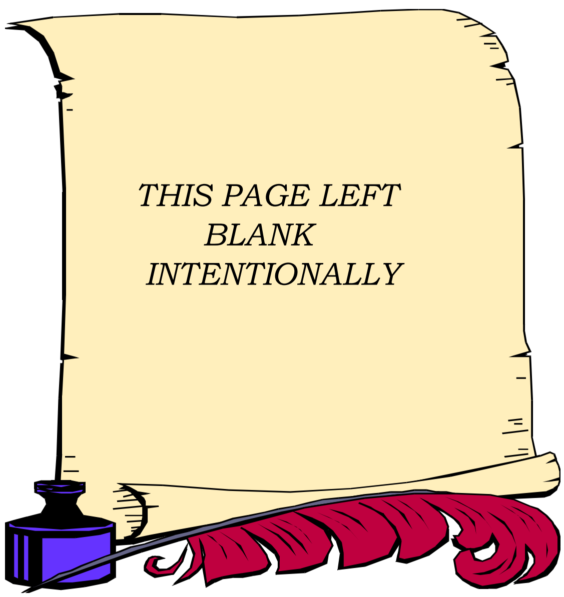
Recommendations

We recommend the Director, Office of Multifamily Housing, Kansas City Hub ensure Timberlake Care Center owners:

1A. Develop and implement policies and procedures to control funds in accordance with HUD requirements.

1B. Reimburse Timberlake Care Center's operating account for the $76,192 in unsupported and/or unallowable disbursements paid during fiscal years 2002 and 2003.

Table of Contents


THIS PAGE LEFT
BLANK
INTENTIONALLY

Timberlake Did Not Reconcile Bank Accounts

Timberlake Care Center did not reconcile the operating account bank statements to the general ledger each month to ensure the amounts balanced. Over our two-year audit period, the operating account general ledger balance was understated by $17,590. Timberlake's staff was aware that the operating account bank statements did not reconcile to the general ledger balance. However, they did not know how to correct the problems, and therefore, took no action.

HUD Requirements

HUD Handbook 4370.2, REV-1, Financial Operations and Accounting Procedures for Insured Multi-Family Projects, Chapter 2-12, Cash Management Controls, Section A, Receipt Controls, states that bank statements shall be reconciled promptly to the formal accounting records. Section B, Disbursement Controls, states that a monthly reconciliation shall be performed to ensure that all checks disbursed are accounted for (i.e. cashed, outstanding, or void).

Bank Accounts Were Not Reconciled

Timberlake Care Center did not reconcile the operating account bank statements to the general ledger each month to ensure the amounts balanced. Timberlake staff reviewed the bank statements each month to compile a list of outstanding withdrawals and deposits, and to determine what the ending balance should be in the operating account; however, this amount was never reconciled with the general ledger balance.

General Ledger Balance Was Incorrect

Timberlake made an unsupported adjusting entry to the operating account at the end of fiscal year 2002 for $18,419 to correct the irreconcilable balance. In addition, the general ledger balance was understated at the end of fiscal year 2003 by $829. Therefore, over the two-year period $17,590 in the operating account general ledger balance was unsupported.

Staff Did Not Know How to Correct Problems

Timberlake Care Center's accounting staff was aware that the operating account bank statements did not reconcile to the general ledger balance. However, they did not know how to bring them in balance. Therefore, they took no action. The staff stopped performing the reconciliations during fiscal year 2002. They are currently trying to determine how to correctly balance the general ledger to the bank statements. It is important for Timberlake to reconcile bank accounts to ensure all funds are correctly disbursed and accounted for.

Auditee Comments

Excerpts from Timberlake Care Center's comments on our draft audit report follow. Appendix B contains the complete text of the comments.

Summary: Timberlake Care Center claims extensive training has recently been provided to its employees and, as of January 2004, the operating account reconciles to the general ledger. In the future, any variance will be investigated and errors will be corrected immediately.

Timberlake claims that the adjusting entry to cash made in May 2002 related to improper recording of actual payroll nets to the cash account done by the previous accounting manager. They provided payroll and general ledger detail that illustrates that operating cash account for net payroll in the general ledger detail is not what is reflected in the actual payroll detail; however, the payroll detail does match the reconciled bank account.

OIG Evaluation of Auditee Comments

We commend Timberlake for taking the necessary steps to train its employees in this area and on its plan to investigate any variance and immediately correct errors. Although Timberlake provided documentation showing discrepancies between the operating cash account for net payroll in the general ledger and the actual payroll detail, they did not correlate this amount to the $18,419 adjusting entry to cash that was made in May 2002. The payroll discrepancy shown by the information provided by Timberlake is $103,568. Therefore, we will not alter our recommendation for Timberlake to provide adequate support for the $18,419 adjustment to cash made at the end of fiscal year 2002, and properly correct the fiscal year 2003 general ledger, or repay the general operating account the amount that cannot be supported up to $17,590.

Based on Timberlake's statement claiming they have obtained outside assistance to provided training on reconciling the bank statements to the general ledger, and are currently doing this, we will alter our recommendation to request the Director, Office of Multifamily Housing, Kansas City Hub, verify that Timberlake Care Center is correctly reconciling the bank statements to the general ledger each month and, if they are unable to determine how to identify and resolve all reconciling items, has obtained outside assistance in doing so.

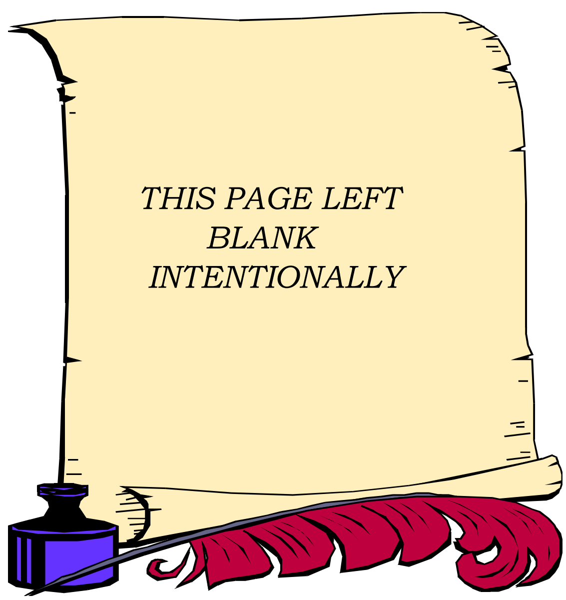
Recommendations

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

2A. Ensure that Timberlake Care Center owners provide adequate support for the $18,419 adjustment to cash made at the end of fiscal year 2002, and properly correct the fiscal year 2003 general ledger, or repay Timberlake Care Center's general operating account the amount that cannot be supported up to $17,590.

2B. Verify that Timberlake Care Center owners are correctly reconciling the bank statements to the general ledger each month, and if they are unable to determine how to identify and resolve all reconciling items, have obtained outside assistance in doing so.

Table of Contents


THIS PAGE LEFT
BLANK
INTENTIONALLY

Management 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:

- Controls over cash disbursements.
- Controls over financial recording and reporting.

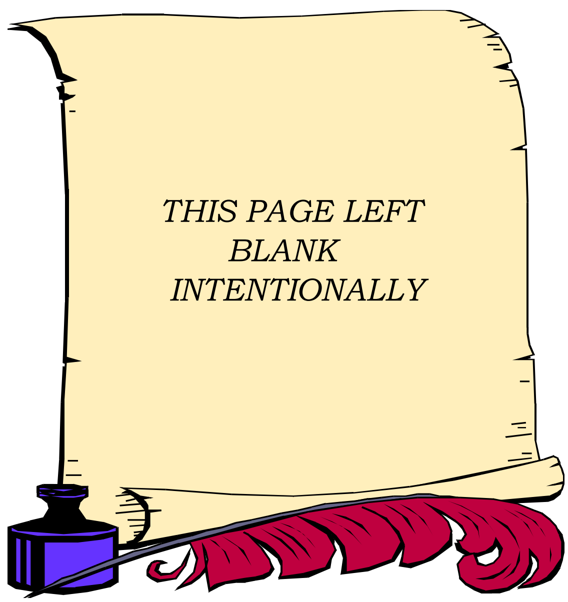
We assessed the relevant controls identified above.

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:

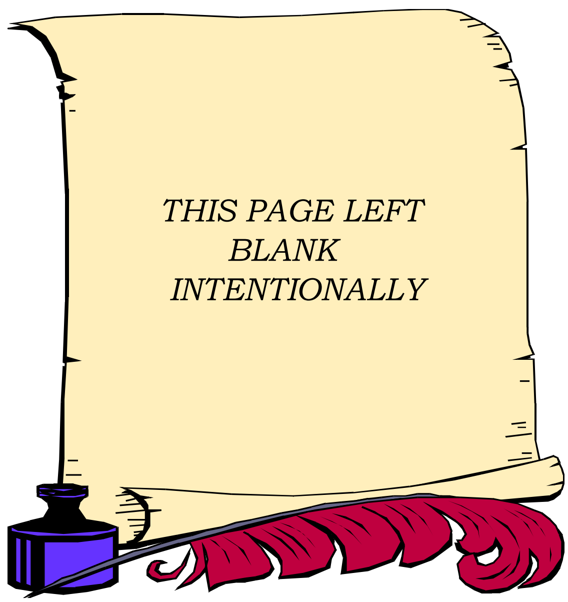
- Timberlake did not have policies and procedures in place to ensure that payments were made only for reasonable operating expenses and necessary repairs of the project. Timberlake made unsupported and/or unallowable disbursements from the operating account during fiscal years 2002 and 2003. (See Finding 1).
- Timberlake did not reconcile the operating account bank statements to the general ledger each month to ensure the amounts balance, and that all cash transactions are properly recorded in the project's books for fiscal years 2002 and 2003 (Finding 2).


THIS PAGE LEFT
BLANK
INTENTIONALLY

Follow Up On Prior Audits

This is the first Office of Inspector General audit of Timberlake Care Center, a Section 232 Nursing Home located in Kansas City, Missouri.

Table of Contents


THIS PAGE LEFT
BLANK
INTENTIONALLY

Schedule of Questioned Costs and Funds Put to Better Use

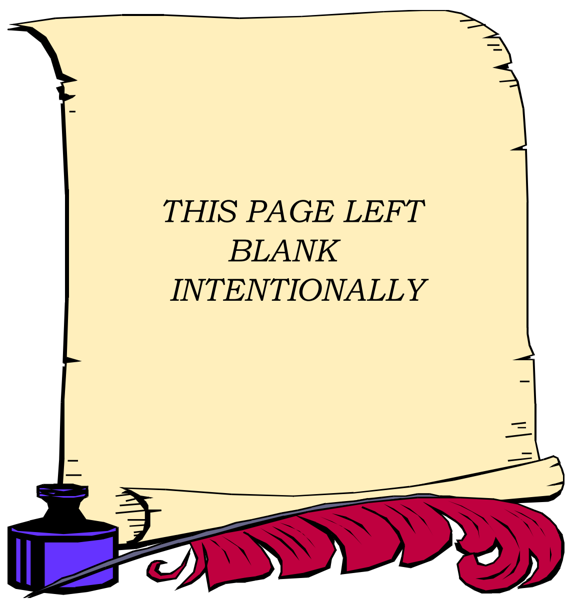
Recommendation Number	Type of Questioned Cost: Ineligible 1/	Type of Questioned Cost: Unsupported 2/	Funds Put to Better Use 3/
1B	$70,669	$5,523	
2B		$17,590	

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 costs charged to a HUD-financed or HUD-insured program or activity and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the costs. Unsupported costs require a future 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/ Funds Put to Better Use are costs that will not be expended in the future if our recommendations are implemented.

Table of Contents


THIS PAGE LEFT
BLANK
INTENTIONALLY

Auditee Comments

Timberlake
CARE CENTER

12110 Holmes Road
Kansas City, MO 64145

Tele: (816) 941-3006
Fax: (816) 942-8049

Response

Audit Report

TO: Office of Inspector General
Department of Housing and Urban Development
Office of Audit, Region 7
Kansas City, Missouri

FROM: Timberlake Care Center
Kansas City, Missouri

February 26, 2004

APPENDIX

ITEM I-D	OFFICER'S VEHICLE EXPENSE
ITEM I-I	REA LAW OFFICE STATEMENT
ITEM II-B	GENERAL LEDGER-PAYROLL DETAIL

Narrative Analysis

Content of Response: To put our response in perspective, let us offer what has occurred in the HUD process itself thus far in our relationship. This is relevant in being able to offer a holistic explanation of apparent transgressions of HUD policies as relates to loans such as ours.

A) There was no deliberate attempt to violate any HUD requirement in our operations. On page five of your report under the heading "Owner Did Not Change, Mode of Operation" this conclusion is drawn: During the first several years of operation, (This would be in fact 18 years) Timberlake Care center was financed with a conventional loan. "During this time, there were no restrictions on the operating funds. Since August 15, 2001, when the loan was refinanced as a HUD insured loan through the Section 232 loan program, the owner of Timberlake continued to operate the property as if it were still financed through a conventional loan program. The operations of the property were not altered to ensure HUD rules and regulations were being followed."

B) The reason the rules and regulations were not being followed verbatim is that there were no new criteria given by HUD that business operations should be changed. There was no discussion, no "rule book," no in-service education, and no interface of any kind that would imply changing business practices that had been in place for 18 years. It would seem, at the very least, we are mutually responsible for the current non-deliberate violations of HUD loan intent.

C) What did happen? Our first introduction to HUD practices and expectations occurred like this: At the end of the first year, we were informed that there was an audit about to take place by our HUD Project Manager, and shortly thereafter, a "reac" inspection occurred- neither of which we knew anything about or what they were for in the process. We did not receive documentation before the "reac" visit but told the fellow since he was here, to go ahead and do whatever he was supposed to do. This was far from formal and still confusing as to how this fit into some scenario. At this juncture our project manager, Mary Ann Garcia, came to do the management audit. It was obvious to us and her that we knew nothing of specific HUD requirements as she pointed out specific payments and procedures that did not fly by HUD standards. None of these new expectations were major. We were told therefore that the first audit was to be a "learning experience" in order to bring our practices into HUD conformity.

At about the middle of the fore mentioned audit and "learning experience," we were informed by your office (OIG) that we were going to be the subject of a long term complete audit. As I explained to your staff at the time, we were totally surprised and still confused by the whole process and at how this "learning experience" turned into something that sounded very serious as well as very demanding on our small business. We had no opportunity to respond to the first audit and answer concerns raised before the second audit was already underway. So began several months of daily contact with OIG accounting investigators. (We have a two person business office and myself involved in operations to interface with all of these demands.)

D) Worthy of consideration is the fact that Mr. Walters has contributed a great deal to Timberlake during this same audit period that was not recognized by HUD auditing processes because no one knew he needed to do so. This too is due to the

Table of Contents

informality that existed in these matters for the previous 18 years. Even since the advent of our HUD loan, he has informally contributed things we needed for specific projects such as furniture, book cases, bird cages, etc., that were not officially booked for credit.

Of particular note because of its financial significance, when a large section of the Timberlake roofing system needed to be replaced and we did not have the cash flow to support the job, he used his personal funds of about $ 36,000.00 to get the job done. We never suspected he could not recoup the funds until this audit process began. (Although we would like to keep the issue "on the table," we understand the appropriate place to turn on this issue is with our project manager.) However, this example does show how naïve we were about the whole process as the HUD regulations began to cut both ways.

Table of Contents

Addressing Specific Issues of Findings

I. Timberlake Care Center made payments for other than reasonable operating expenses and necessary repairs of the project. (Total $ 76,192.00 during fiscal years 2002 and 2003.) Since the same essential issues were raised for both years, the explanations and corrections for both years will be discussed as one. As stated in the narrative analysis, the reason that these same practices continued into 2003 was that until the first actual audit occurred in 2003, we had no actual knowledge of what HUD loan expectations were. As the audit unfolded, we made corrections immediately as we were instructed.

A) Four disbursements to Allstate Insurance Company in 2002 ($ 1944.00) and four disbursements in 2003 ($ 1338.00) that included insurance for the owner's personal vehicle. This practice was discontinued immediately and the total sum will be repaid. To be repaid: $ 3282.00.

B) Eight disbursements in 2002 ($ 1656.00) and eight disbursements in 2003 ($ 1640.00) to the owner's personal Amoco credit card for purchases unrelated to the property.

This issue is not as clear cut as the owner's car, truck, and bus are frequently used by Timberlake in our day to day business. Our correction was to start documenting the use and where the fuel goes. Much, in fact probably most, fuel expense was used in connection with the business but was not documented. Potential Liability for 2002 and 2003 for Amoco credit card: $ 3296.00. We would appreciate your consideration in reducing this total amount. Your figure will be repaid.

Table of Contents

C) Two disbursements in 2002 ($ 75.00) and four disbursements in 2003 ($ 276.00) to Citibank Visa. To be repaid: $ 351.00.

D) Nine disbursements in 2002 ($ 8,352.00) and thirteen disbursements in 2003 ($ 13,066.00) to General Motors Acceptance Corporation for leases on two vehicles.

As per the initial narrative analysis, I would appreciate your further consideration of this item.

The lease is in the name of Mission Lake Corporation. There is one car and one truck. The truck is used exclusively by the nursing home in our maintenance/supply departments and seems an obvious appropriate expense. The owner/operator/CEO of Mission Lake Corporation (Mr. Walters) uses the automobile in representing our business with our providers, our contract doctors, our HMO affiliates such as Coventry and Humana, our prospective employees, etc.) as well as providing backup transportation for our residents and staff when called upon to do so. In fact, many of my past nursing home affiliations also provide me with an automobile as the administrator. This is a legitimate "company car" and is almost standard practice in our industry. As the Chief Operating Officer and the primary facilitator for all of our business, to furnish that transportation would appear to be a legitimate and necessary expense of the corporation.

Be that as it may, the current situation is as follows: The truck that may be in question is paid off and belongs to Mission Lake. At the end of calendar year 2002 and again at the end of Fiscal Year 2003, the accumulated amount of car payments were deducted from Mr. Walters salary and he personally paid the taxes on that money. Since this became such a controversial issue at the time of our first audit, Mr. Walters' now directly pays for his automobile and it does not go through Mission Lakes' accounting system. It is our position that these monies ($ 21,418.00) have already been paid by Mr. Walters and, since September of 2003, he continues to personally makes these payments to remove any doubt about the process. As explained above, we also believe it should perhaps have not been an issue at all. (Please see appendix for copy of our ledger showing car was deducted out.)

E) Nine disbursements to Smith Trust in 2002 ($ 6,637.00) and eleven disbursements in 2003 ($ 8,112.00) for debt/according to the auditor unrelated to the property.

The questionable payment and the Smith Trust obligation is for five acres of property that Timberlake is partially built on. The note is in the name of Mission Lake Corporation has been in place for many years. The only change that occurred was during the HUD loan application period when we were told that encumbered property could not be financed. The Smith Trust representatives were understanding enough to remove the lien on the property and accept an unsecured note on the property. This also met the Smith Trust desires to keep this as a part of their investment portfolio. We continue to make the Smith Trust payment through the corporation.

It would seem the common sense of the situation would be that HUD, as the current lien holder, would be delighted to have access to these five acres. The five acres have gained in value substantially in the past few years. The value of the property would substantially be decreased, or perhaps not even viable, without the property.

Table of Contents

We strongly believe that the corporation should continue to make the payments and there are no reasonable grounds for this money to be repaid by Mr. Walters. This would be a potential mutual problem. ($ 14,749.00)

F) Four disbursements in 2002 ($ 7,500.00) and nine disbursements in 2003 ($ 13,500.00) to Moss Mutual Life Insurance to pay a monthly premium of $ 1,500.00 for a life insurance policy on the owner.

This is intended to be "key man" insurance on Mr. Walters in order for Timberlake to be able to continue if something were to happen to him. Twenty-Five per cent of the proceeds are assigned directly to Timberlake and the remaining 75% assigned to family members with instructions how to proceed in the will. According to our attorney, this is common practice and the policy was taken out by Mission Lake. The corporation continues to make the payments.

G) Two Disbursements in 2002 ($ 108.00), tow disbursements in 2003 ($ 1,076.00) related to repairs on the owner's personal vehicles. Repay $ 1,184.00.

H) One disbursement to O'Conner Heating and Cooling in 2003 ($ 5,390.00) that concerned repairs to owner's personal air conditioner.

Although this bill did include some repairs for Timberlake as well, we have no way to substantiate percentages. Repay $ 5,390.00.

Table of Contents

I) In fiscal year 2003, Timberlake paid $ 5,523.00 in unsupported disbursements to Rea Law Office. (12/18/02= $ 1,500.00; 2/11/03= $ 2,003.00; 4/14/03= $ 2,000.00.)

Rea Law Office is our legal council on all legal matters that effect Timberlake/Mission Lake. With our on going dialogue with local, State, and Federal regulatory agencies, as well as internal business matters, it is constant and diverse.

We originally gave the auditors substantiation for these billings that accounted for all but the specifics except for the $ 5,523.00 in question. Since that time, Rea Law Offices sent us a specific billing for the dates in question which you will find attached.

All monies paid to Rea Law Offices since the inception period of our loan with HUD are legitimate Mission Lake expense and are accounted for in the process. (These expenses were appropriate before the HUD period as well, but now we request more specific billing to meet HUD requirements.) (Please see appendix for a copy of the billing statement in question.)

Section I Closing Statement: Payments made for other than reasonable operating expenses and necessary repairs of the project.

We have presented responses to each of the issues that were brought into question by the audit process. We have attempted to explain our position, and provide additional information and factual material. In the final analysis, it is very clear that $ 13,503.00 should be paid back to the operating account this year by Mr. Walters. We would appreciate your consideration of the additional items as not being violations of HUD accounting code.

Narrative Analysis page 9

II. Second Finding: Timberlake's failure to perform monthly bank reconciliations. Over the two-year audit period. (The operating account general ledger balance was understated by $ 17,590.)

A) Corrective Action

Beginning in March of 2003, we hired a consulting CPA to do on-site training with business office staff. The staff and CPA reviewed proper accounting practices and helped us supplement our policies and procedures as needed. The last 16 hours of training occurred on January 19 and 20, 2004, and the prime focus was the balancing of the general ledger to the operating account. Staff were also taught the methodology of isolating and correcting discrepancies.

As of January, 2004, the operating account balanced to the general ledger. Henceforth, each month the reconciled bank balance will be compared to the operating cash in the general ledger. This is an implicit part of the monthly closing procedures. Any variance will be investigated and any found error corrected immediately.

B) Specific finding (As relates to the $ 17,590.00 operating account general ledger balance being understated over a two year period.)

There was an $ 18,419.00 adjusting entry made in May of 2002, that related to improper recording of actual payroll nets to the cash account done by the previous accounting manager. We have enclosed payroll and general ledger detail that clearly illustrates that operating cash account for net payroll in the general ledger detail is not what is reflected in the actual payroll detail. Payroll detail does in fact match the reconciled bank account. (Please see appendix for general ledger detail.)

Table of Contents

Narrative Analysis page 10

III. In Closing: The Good News

A) The audit process itself has been very instructive as to HUD policy. It clearly identified some short-comings in our record keeping and financial policies and procedures we will be better-off for it in the long run.

B) As to the findings of the audit, (especially since we did not know there was going to be one!) there was no implicit desire to conceal any of our dealings. Considering the millions of dollars worth of goods, services, and people resources the 3 of us purchase and coordinate each year, having $ 76,00.00 be in question is pretty good.

C) Our relationship with our HUD project manager is very positive as we began to understand the expectations and the program well enough to ask the right questions.

D) Timberlake Care Center has spent a great deal to "re-invent" itself during the last 6 months as far as business program and practice is concerned. We saw our first positive financial response in January and expect to be back in the black financially by April.

Hopefully at the conclusion of this process we will emerge together in a partnership that is truly a win-win relationship.

Respectfully submitted,

Douglas E. Holt, MSW, HFA
Administrator

APPENDIX

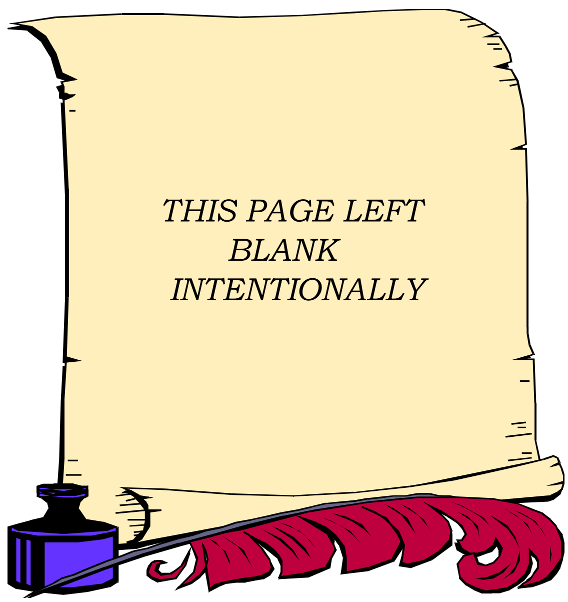
ITEM I-D OFFICER'S VEHICLE EXPENSE

ITEM I-I REA LAW OFFICE STATEMENT

ITEM II-B GENERAL LEDGER-PAYROLL DETAIL

Please Note: Due to space considerations, the appendices to the auditee's response are not included in this report, but are available on request.

Table of Contents


THIS PAGE LEFT
BLANK
INTENTIONALLY

Schedule of Unallowable Disbursements

Fiscal Year 2002

Check #	Date Written	Date Cleared	Payee	Amount	Comments
31461	9/12/2001	9/17/2001	Allstate Insurance Co.	$ 581.00	Personal Vehicles
31710	10/19/2001	10/25/2001	Allstate Insurance Co.	$ 581.18	Personal Vehicles
1005	12/21/2001	12/31/2001	Allstate Insurance Co.	$ 285.91	Personal Vehicles
1931	5/10/2002	5/15/2002	Allstate Insurance Co.	$ 496.17	Personal Vehicles
31460	9/12/2001	9/19/2001	Amoco	$ 206.75	Unrelated Expense
31590	10/9/2001	10/15/2001	Amoco	$ 244.17	Unrelated Expense
31779	11/2/2001	11/8/2001	Amoco	$ 159.15	Unrelated Expense
32026	12/7/2001	12/14/2001	Amoco	$ 133.05	Unrelated Expense
1251	1/18/2002	1/24/2002	Amoco	$ 127.23	Unrelated Expense
1516	3/6/2002	3/12/2002	Amoco	$ 455.73	Unrelated Expense
1806	4/10/2002	4/17/2002	Amoco	$ 79.79	Unrelated Expense
2025	5/23/2002	5/31/2002	Amoco	$ 250.03	Unrelated Expense
1817	4/17/2002	4/24/2002	Citibank VISA	$ 21.03	$1,128.05 Check Amt.
1939	5/10/2002	5/16/2002	Citibank VISA	$ 54.20	$174.52 Check Amt.
31407	9/1/2001	9/11/2001	GMAC	$ 927.96	Personal Vehicles
31601	10/9/2001	10/12/2001	GMAC	$ 927.96	Personal Vehicles
31830	11/8/2001	11/14/2001	GMAC	$ 927.96	Personal Vehicles
32025	12/7/2001	12/12/2001	GMAC	$ 927.96	Personal Vehicles
1189	1/10/2002	1/17/2002	GMAC	$ 927.96	Personal Vehicles
1357	2/6/2002	2/13/2002	GMAC	$ 927.96	Personal Vehicles
1527	3/6/2002	3/12/2002	GMAC	$ 927.96	Personal Vehicles
1746	4/5/2002	4/12/2002	GMAC	$ 927.96	Personal Vehicles
1955	5/10/2002	5/15/2002	GMAC	$ 927.96	Personal Vehicles
31394	9/5/2001	9/14/2001	Smith Trust	$ 737.41	Unrelated Debt
31612	10/10/2001	10/17/2001	Smith Trust	$ 737.41	Unrelated Debt
31834	11/8/2001	11/15/2001	Smith Trust	$ 737.41	Unrelated Debt
32014	12/7/2001	12/13/2001	Smith Trust	$ 737.41	Unrelated Debt
1171	1/3/2002	1/16/2002	Smith Trust	$ 737.41	Unrelated Debt
1336	2/4/2002	2/13/2002	Smith Trust	$ 737.41	Unrelated Debt
1572	3/6/2002	3/15/2002	Smith Trust	$ 737.41	Unrelated Debt
1777	4/5/2002	4/17/2002	Smith Trust	$ 737.41	Unrelated Debt
1998	5/10/2002	5/20/2002	Smith Trust	$ 737.41	Unrelated Debt
Transfer	2/28/2002	N/A	Mass Mutual Life	$ 3,000.00	Personal Insurance
Transfer	3/29/2002	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
Transfer	4/29/2002	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
Transfer	5/28/2002	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
31873	11/15/2001	11/19/2001	Superior Buick Cadillac	$ 80.26	Personal Vehicles
32037	12/13/2001	12/17/2001	Jiffy Lube	$ 27.99	Personal Vehicles
			TOTAL	**$26,271.97**	

Table of Contents

Fiscal Year 2003

Check #	Date Written	Date Cleared	Payee	Amount	Comments
2519	8/1/2002	8/7/2002	Allstate Insurance Co.	$ 144.39	Personal Vehicles
2557	8/9/2002	8/15/2002	Allstate Insurance Co.	$ 161.89	Personal Vehicles
3189	11/21/2002	11/26/2002	Allstate Insurance Co.	$ 962.64	Personal Vehicles
3235	12/6/2002	12/11/2002	Allstate Insurance Co.	$ 69.41	Personal Vehicles
2097	6/5/2002	6/12/2002	Amoco	$ 281.87	Unrelated Expense
2423	7/25/2002	8/5/2002	Amoco	$ 223.95	Unrelated Expense
2561	8/19/2002	8/19/2002	Amoco	$ 177.98	Unrelated Expense
3137	11/25/2002	11/25/2002	Amoco	$ 102.33	Unrelated Expense
3237	12/6/2002	12/11/2002	Amoco	$ 325.59	Unrelated Expense
3579	1/24/2003	2/3/2003	Amoco	$ 168.99	Unrelated Expense
3693	2/6/2003	2/12/2003	Amoco	$ 208.01	Unrelated Expense
3927	3/12/2003	3/20/2003	Amoco	$ 150.92	Unrelated Expense
2754	9/11/2002	9/17/2002	Citibank VISA	$ 69.25	$1,450.00 Check Amt.
3144	11/10/2002	11/26/2002	Citibank VISA	$ 84.00	$681.29 Check Amt.
3245	12/6/2002	12/10/2002	Citibank VISA	$ 84.75	$249.32 Check Amt.
4033	4/9/2003	4/15/2003	Citibank VISA	$ 38.36	$254.87 Check Amt.
2115	6/5/2002	6/12/2002	GMAC	$ 927.96	Personal Vehicles
2303	7/10/2002	7/17/2002	GMAC	$ 927.96	Personal Vehicles
2576	8/9/2002	8/16/2002	GMAC	$ 927.96	Personal Vehicles
2710	9/5/2002	9/12/2002	GMAC	$ 927.96	Personal Vehicles
2916	10/7/2002	10/16/2002	GMAC	$ 927.96	Personal Vehicles
3181	11/19/2002	11/26/2002	GMAC	$ 978.15	Personal Vehicles
3260	12/6/2002	12/17/2002	GMAC	$ 978.15	Personal Vehicles
3503	1/8/2003	1/16/2003	GMAC	$ 978.15	Personal Vehicles
3718	2/6/2003	2/19/2003	GMAC	$ 978.15	Personal Vehicles
3890	3/7/2003	3/19/2003	GMAC	$ 978.15	Personal Vehicles
4039	4/9/2003	4/17/2003	GMAC	$ 978.15	Personal Vehicles
4238	5/19/2003	5/27/2003	GMAC	$ 978.15	Personal Vehicles
4041	4/9/2003	4/15/2003	GMAC	$ 1,579.10	Personal Vehicles
2157	6/5/2002	6/26/2002	Smith Trust	$ 737.41	Unrelated Debt
2309	7/10/2002	7/17/2002	Smith Trust	$ 737.41	Unrelated Debt
2730	9/5/2002	9/30/2002	Smith Trust	$ 737.41	Unrelated Debt
2980	10/7/2002	10/11/2002	Smith Trust	$ 737.41	Unrelated Debt
3187	11/21/2002	12/4/2002	Smith Trust	$ 737.41	Unrelated Debt
3307	12/6/2002	12/13/2002	Smith Trust	$ 737.41	Unrelated Debt
3532	1/8/2003	1/23/2003	Smith Trust	$ 737.41	Unrelated Debt
3767	2/6/2003	2/20/2003	Smith Trust	$ 737.41	Unrelated Debt
3903	3/7/2003	3/27/2003	Smith Trust	$ 737.41	Unrelated Debt
4075	4/9/2003	4/14/2003	Smith Trust	$ 737.41	Unrelated Debt
4215	5/7/2003	5/15/2003	Smith Trust	$ 737.41	Unrelated Debt
Transfer	10/28/2002	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
Transfer	11/29/2002	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
Transfer	6/28/2002	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance

Table of Contents

Transfer	7/29/2002	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
Transfer	8/28/2002	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
Transfer	9/30/2002	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
Transfer	1/28/2003	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
Transfer	5/28/2003	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
Transfer	2/28/2003	N/A	Mass Mutual Life	$ 1,500.00	Personal Insurance
32224	10/28/2002	11/1/2002	Major Cadillac	$1,039.50	Personal Vehicles
32320	5/15/2003	5/20/2003	Valvoline Instant Oil Change	$36.56	Personal Vehicles
32318	5/10/2003	5/13/2003	O'Conner Heating & Cooling	$5,389.70	Unrelated Expense
			TOTAL	**$44,397.55**	

Table of Contents