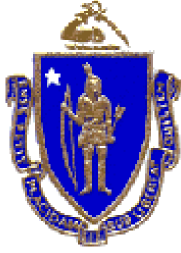

The Commonwealth of Massachusetts

Office of the Inspector General

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November 7, 2011

Mr. Peter J. Adams
Chairman, Board of Selectmen
Grafton Memorial Municipal Center
30 Providence Road
Grafton, MA 01519

Mr. John P. Carney
Chairman, Zoning Board of Appeals
Grafton Memorial Municipal Center
30 Providence Road
Grafton, MA 01519

Subject: Chapter 40B Developer Profits – Hilltop Farms Development, LLC

Dear Chairmen Adams and Carney:

This Office has completed its review of the Cost Certification and the associated limited dividend determination for the Hilltop Farms housing development that was built under provisions of M.G.L. c. 40B, the state's affordable housing legislation or Comprehensive Permit Law. The Comprehensive Permit Law contains a dividend cap that limits a developer's profit. In this program that profit cap was 20% of total development cost. Hilltop Farms was developed through a single purpose development entity, Hilltop Farms Development, LLC, created by Pulte Homes Inc. /PulteGroup, Inc. ("Pulte"). In contrast to the developer's Cost Certification that represented to the town of Grafton that there were no excess profits, this Office has identified approximately $8.5 million of excess profits. Under the provisions of the law, Pulte owes any and all excess profit to Grafton.

At the end of a M.G.L. c. 40B project, the developer is required to submit a document called a Cost Certification. This document is the developer's certification that its costs and revenues to develop the project were as stated. From this Cost Certification any profit above 20% of the total development costs is to be passed on to the municipality to promote additional local affordable housing opportunities.

Pulte's Cost Certification was not calculated based on existing Chapter 40B guidance. Rather than follow the existing guidance, Pulte purportedly followed the terms of the Regulatory Agreement executed between itself and the subsidizing bank. Notwithstanding the fact that the Regulatory Agreement did not comport with existing guidance, Pulte did not consistently abide by the language of the Regulatory Agreement nor did it follow generally accepted accounting

principles to arrive at its Cost Certification. Pulte's maverick approach to the project's accounting facilitated the shielding of significant excess profits from the Town of Grafton and instead directed all these excess profits to Pulte's owners and management.

Pulte is headquartered in Bloomfield, Michigan and is one of the largest home builders in the country. In this case, Pulte underreported its development profits primarily through a process of expense padding. This included reclassifying and redefining profits into elements of development costs and by over accruing expenses. As an example, Pulte's Cost Certification included a cost for land acquisition that was $6.9 million more than what it had actually paid for the site. Not only was this method not allowed under Chapter 40B rules and guidelines in existence at the time the project was approved and the site purchase and sales agreement was executed, but the inflated land value was transacted on the Cost Certification through a one sided accounting entry that violated provisions of generally accepted accounting principles.

We also found that development costs were padded through an over-accrual of expenses. Based on a small test sample of accounts, this Office identified over $800 thousand of expenses accrued by Pulte that had no subsequent cash payment or disbursement. In order to identify any additional potential over-accruals of expenses, this Office requested that Pulte provide a listing of all expense accruals included in the Cost Certification financial reports that had no subsequent associated cash payments/disbursements. After numerous requests, Pulte has not provided this basic financial accounting information.

In an attempt to expedite the review process and to ensure a common understanding of the financial results for the development, this Office has repeatedly requested that Pulte's accounting personnel be made available for discussions with this Office. Pulte, through its lawyer, refused these requests.

This Office also requested pertinent tax related information for the developer/development. The developer indicated that it is impossible to cull the reported activity from existing databases. In addition, Pulte has taken the position that the parent's tax worksheets and tax returns are outside this Office's jurisdiction and somehow not relevant to our scope of inquiry.

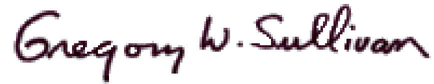
The impediments to our review generated by Pulte further elevate the level of concern this Office has regarding Pulte's reported financial position for the development and the extent of actual excess development profits derived by the Hilltop Farms Development, LLC project and owed to the Town of Grafton.

In July 2011, this Office provided a draft report of our findings to Pulte for review and comment. The developer initially responded with a set of written questions that we answered in writing and subsequently the developer provided additional information and written comments to the draft report. We have appended this correspondence as well as the Office's response to the developer's August 2011written comments.

I hope that this report will be useful to the Town of Grafton in its efforts to recover excess profits owed to the town. I also hope that this information is useful to the town in planning and implementing future affordable housing developments.

I would be happy to arrange a meeting with you in order to discuss these findings and recommendations in more detail. If you have any questions or concerns, or if I can be of other assistance, please do not hesitate to call.

Sincerely,



Gregory W. Sullivan
Inspector General

Enclosures

CC: Reid A. Blute, Hilltop Farms Development, LLC
Paul D. Wilson, Esq., Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C.
The Honorable Martha Coakley, Attorney General
Amy Pitter, DOR Commissioner
Daniel C. Hill, Esq., Special Town Counsel
Steven Carvalho, DHCD Acting Director
Aaron Gornstein, CHAPA Executive Director

Overview of Hilltop Farms

The Hilltop Farms housing development is situated on approximately 69 acres in Grafton, Massachusetts and includes a total of 256 attached townhouse condominium homes. A total of 64 homes (or 25 percent of the total housing units) are targeted for buyers whose incomes do not exceed 80 percent of the local area median income. This complies with the minimum requirement for a development utilizing the benefits afforded through the Chapter 40B development process.

Hilltop Farms was developed by Hilltop Farms Development, LLC (sole member - Pulte Homes of New England, LLC) under provisions of Chapter 40B the state's affordable housing law. Chapter 40B encourages the development of affordable housing by granting developers waivers from zoning and other local ordinances and bylaws in return for an agreement from the developer to provide a percentage of the units to income qualified affordable buyers and a commitment from the developer to earn a limited development profit. Under Chapter 40B, those developers who benefit from the advantages of the law are limited to a reasonable profit on the affordable housing projects they develop. Although these Chapter 40B profits are limited, they are typically significantly greater than what a for-profit developer could expect to earn from developing housing under existing local zoning bylaws.

Hilltop Farms Development, LLC is a single purpose development entity created by Pulte Homes Inc/PulteGroup, Inc. ("Pulte"). Pulte is headquartered in Bloomfield, Michigan and is one of the largest home builders in the country. During the four year (2004-2007) period of construction, marketing and sales for the Hilltop Farms housing development, Pulte reported combined corporate revenues of approximately $50 billion and associated profits totaling approximately $1 billion.

The Salem Five Cents Savings Bank issued a Project Eligibility/Site Approval Letter for the project in August 2001. The approval letter indicated that the bank considered the project to be eligible for financing under the New England Fund of the Federal Home Loan Bank of Boston. Within two weeks after receipt of the Project Eligibility determination, the developer, through its attorneys, Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C. ("Mintz") submitted a Comprehensive Permit Application to the Zoning Board of Appeals ("ZBA") for the town of Grafton. On September 20, 2001 the ZBA opened the public hearing on the Comprehensive Permit and on January 30, 2003 the ZBA issued a Comprehensive Permit. Approximately one year later (January 6, 2004), the land for the building site was transferred to Hilltop Farms Development, LLC from Stephie M. Kuczinski for an agreed upon purchase price of $900,000. Pulte and Ms. Kuczinski had entered into the purchase and sale agreement for the site in August 2000. The agreement included a termination provision if Pulte believed that it would be unable to obtain approval for 45 buildable lots. On March 25, 2004 Hilltop Farms Development, LLC and the Citizens' Housing and Planning Association ("CHAPA") entered into a monitoring services agreement for the project. The developer also entered into a Regulatory Agreement with the Salem Five Cents Savings Bank on June 28, 2004.

The ZBA on three separate occasions (April 27, 2004, September 8, 2005, and, October 27, 2005) approved modifications to the Comprehensive Permit that were requested by the developer. The April 2004 changes included extending the time period for obtaining building permits and gaining approval of the form of the Regulatory Agreement. The September 2005 change included modifying the language of the deed rider. The October 2005 change accepted modifications to storm drainage for the site.

The town began issuing building permits for the project in June 2004 and continued through May 2007. Home sales began in December 2004 and ran through 2007 with the final sale taking place on November 29, 2007. The developer reported a total of $75,830,641 in sales revenue. The market unit sales (192 units) accounted for $66,424,561 of the total revenue and the affordable unit sales (64 units) accounted

for the remaining $9,406,080 in project revenue as reported by the developer in its Cost Certification Report.

Within three months of the final home sale, the developer's auditors, McGladrey & Pullen, LLP ("McGladrey") issued an independent auditor's report or Cost Certification report (dated February 11, 2008) that reflected the financial results of the development. On August 25, 2008 CHAPA, the monitoring agent for the project issued a monitoring services letter to the ZBA indicating that they had completed a review of the Cost Certification audit. There were no excess profits identified in either the McGladrey or the CHAPA reports. If there had been any excess profits these would have been owed to the town of Grafton.

Project Timeline

Highlighted below is a timeline summary of the key events for the Hilltop Farms housing development.

- March 5, 1999 – Housing Appeals Committee issues the *Stuborn* decision finding that the New England Fund of the Federal Home Loan Bank of Boston conforms to the comprehensive permit system
- August 3, 2000 – Purchase and Sale Agreement executed between Stephie M. Kuczinski and Pulte Home Corporation of New England
- February 16, 2001 – Hilltop Farms Development, LLC is formed under an applicable limited liability company act for the state of Michigan
- August 13, 2001 – Project Eligibility Letter issued by Salem Five Cents Savings Bank
- August 22, 2001 – Comprehensive Permit Application submitted to Grafton ZBA
- September 20, 2001 – ZBA opens public hearing on Comprehensive Permit
- October 28, 2002 – ZBA conducts financial pro forma review of the project
- November 14, 2002 – ZBA public hearing is closed
- January 30, 2003 – ZBA issues Comprehensive Permit
- February 14, 2003 – Department of Housing and Community Development issues "Guidelines for Housing Programs in Which Funding is Provided Through a Non-Governmental Entity"
- February 20, 2003 – Comprehensive Permit appeal period ends
- January 6, 2004 – Land is transferred to Hilltop Farms Development, LLC from Stephie Kuczinski for $900,000
- March 25, 2004 – Monitoring Services Agreement executed between Hilltop Farms Development, LLC and CHAPA
- April 27, 2004 – ZBA approves modification of Comprehensive Permit
- June 28, 2004 – Regulatory Agreement executed between Hilltop Farms Development, LLC and the Salem Five Cents Savings Bank
- September 8, 2005 – ZBA approves modification of Comprehensive Permit
- October 27, 2005 – ZBA approves modification of Comprehensive Permit
- November 29, 2007 – Sale closed on final unit in development
- February 11, 2008 – Pulte Homes of New England LLC provides Representation Letter to McGladrey
- February 11, 2008 – McGladrey issues independent auditors/Cost Certification report for the project
- August 25, 2008 – CHAPA (Monitoring Agent) notifies the ZBA that the Cost Certification review has been completed

Investigative Focus and Summary Findings

The Office of the Inspector General (OIG) conducted an investigation to determine the effectiveness of the Chapter 40B Cost Certification oversight process and accuracy of Hilltop Farms Development, LLC's reported profits. This investigation was similar in nature to other reviews this Office has conducted regarding the limited dividend requirement mandated for home ownership housing developments constructed under provisions of the state's affordable housing law (Chapter 40B).

In conducting this investigation this Office obtained and reviewed thousands of documents from various sources including, but not limited to: the developer, the town of Grafton, the subsidizing bank, the monitoring agent, the developer's auditors, and the developer's Chapter 40B consultant. Our detailed observations and findings from this review are incorporated in subsequent sections of this report.

In summary, we found that the Cost Certification/oversight process for the Hilltop Farms housing development was ineffective and resulted in an inaccurate representation of reported developer profit. Conflicting and contradictory standards and accounting methodologies were used, inadequate disclosures were provided and unreliable information was generated. The process lacked independence and a reasonable level of skepticism.

The flawed Cost Certification process resulted in the developer under-reporting approximately $8.5 million in excess profits to the town of Grafton. This was done primarily through a process of padding project costs (reclassifying/redefining profits into elements of development costs and by over accruing expenses). These inflated expenses do not represent bona fide project costs or actual/expected cash outflows and as such conflict with generally accepted accounting principles, existing Chapter 40B laws/rules/guidelines and the spirit of the Chapter 40B legislation.

The developer, contrary to its own representations and those of its auditor, failed to follow the rules/guidelines laid out by the Department of Housing and Development ("DHCD"), specifically, DHCD's 1999 *Stuborn* decision decided by DHCD's Housing Appeals Committee ("HAC") and the "Guidelines for Housing Programs in Which Funding is Provided Through a Non-Governmental Entity" published by DHCD in February 2003.

The developer contradicted itself by also claiming that it followed the language of the Regulatory Agreement (executed on June 28, 2004 between Hilltop Farms Development, LLC and the Salem Five Cents Savings Bank) the terms of which are inconsistent with the existing Chapter 40B rules and guidelines. As discussed in detail below, one cannot follow the terms of the Regulatory Agreement and still be in compliance with the NEF guidelines and the *Stuborn* decision.

Our investigation revealed that the developer did not consistently follow either of these standards. At times the developer's Cost Certification used provisions stated in the Regulatory Agreement, at other times it utilized direction from the NEF Guidelines or the MHP Guidelines and in still other situations it followed neither of the Regulatory Agreement nor the NEF/MHP guidelines but followed some hybrid position. This variable compliance was to the developer's financial benefit as it resulted in understating the actual profits from the development and thus reporting no excess profits owed to Grafton. We determined that at least $8.5 million in excess profits would be owed to Grafton if the Cost Certification had been consistently prepared in accordance with existing Chapter 40B laws, rules and guidelines; whereas, uniform adherence to the Regulatory Agreement would have generated approximately $17.1 million of excess profits.

The developer's Cost Certification reflected a land cost of $7.8 million which was $6.9 million more than what it actually paid for the site and $7.4 million more than what Grafton had assessed the land for property tax purposes. This inflated valuation although allowed under the Regulatory Agreement was incompatible with both the *Stuborn* decision and the associated LIP guidelines that limit the land value to the lower of the actual cost or the as-is appraised value.

Although the Regulatory Agreement provided for the exclusion from development costs of all related party transactions, the developer's Cost Certification did not abide by this restriction. Of the approximate $50 million in related party transactions only $202,699 (representing interest payments for a related party development loan) was excluded from the developer's Cost Certification. All the other related party transactions were included as development costs through the Cost Certification. This treatment, although contrary to the Regulatory Agreement, was in line with other affordable housing programs and the MHP Guidelines.

There was approximately $2.5 million reported in the Cost Certification as administrative and overhead costs. These costs represented allocated payments to the developer's owner and totaled exactly 4% of the total development costs. The Regulatory Agreement provided for this level of allowable administrative and overhead expense however this was limited only for payments or transactions to unrelated entities. The Cost Certification did not abide by the terms of the Regulatory Agreement as these costs represented related party transactions and therefore should not have been included as allowable development costs. For a development of this scope, the Chapter 40B guidelines identify $343,000 as a reasonable level of developer overhead. With respect to these overhead costs, the developer did not follow either the Regulatory Agreement or the NEF Guidelines, but took a hybrid approach which was the most beneficial to its own finances.

As demonstrated above, the Cost Certification process did not consistently follow any singular methodology. In determining land costs the developer utilized the most liberal interpretation of the Regulatory Agreement terms that would provide it with the highest monetary benefit. These Regulatory Agreement terms regarding land value were diametrically opposed to the *Stuborn* decision and the LIP Guidelines. With respect to related party transactions the Cost Certification process failed to follow the Regulatory Agreement in excluding these related party transactions from development costs. This treatment of related party transactions that was more in line with Chapter 40B rules and guidelines as opposed to the Regulatory Agreement resulted in a more beneficial financial situation for the developer. The Cost Certification process did not follow either the Regulatory Agreement or the Chapter 40B rules in dealing with administrative and overhead costs. The methodology followed was a hybrid that proved to be the most advantageous for the developer.

The developer's August 2011 response to this Office's draft report makes assertions that are inconsistent with those made previously. As highlighted above, the developer in its Cost Certification report had identified significant related party activities involving transactions including a disclosure that affiliates of the developer had provided development and construction services. Such services included land development and general contracting services. In its August 2011response to our draft findings, the developer now takes the position that this Office has the facts wrong and that it was independent companies, unrelated to the developer or its affiliates that constructed the development, performed the site preparation, and carried out other tasks that this Office has purportedly wrongly labeled as related party transactions.

This most recent statement made by the developer lacks credulity. This Office had previously independently confirmed that the $776,265 in brokerage commissions, the $159,970 in closing costs and the $2,540,603 in administrative and overhead costs that the developer had originally portrayed as related party transactions were in fact related party transactions. In addition, this Office had also obtained an

explanation from the developer that confirmed that all the expenditures (approximately $48 million) related to land development, general contracting and architectural design and engineering services were all transacted by related entities and not directly by the developer. Although the developer had previously self-reported these related party transactions, the developer failed to exclude any of these related party transactions from the total development costs for the project as required by its own Regulatory Agreement.

Based on a review of the developer's general ledger, this Office determined that contrary to the developer's current representations, many of the expenses claimed in the Cost Certification went directly to cover payroll and other overhead expenses for a developer related entity. In addition to common overhead items such as telephone expenses and office supplies, this Office identified approximately $2.25 million in salary and other payroll related expenses for employees of Pulte Homes New England, LLC. Details of these related party transactions were never disclosed by the developer through its Cost Certification report and its subsequent response to our draft findings.

As highlighted above, the developer's Cost Certification contained significant overhead costs that the developer did not properly disclose. While the developer "buried" these major overhead costs under various development cost categories in the Cost Certification, the developer at the same time claimed $2,540,603 (the maximum allowed under the Regulatory Agreement) in development costs under an Administrative and Overhead account in the Cost Certification. Notwithstanding the fact that these administrative and overhead costs represented related party transactions, this Office finds it disturbing that the developer included significant overhead costs in the Cost Certification, in excess of limits specified in the Regulatory Agreement, without proper disclosure and by burying or hiding these overhead costs under other development related accounts.

It is troubling that the developer did not properly disclose all the related party transactions and offered conflicting statements and misrepresentations about them. Moreover, the developer's selective and inconsistent application of the terms of the Regulatory Agreement in determining and reporting the profits for the development is disconcerting and cause for alarm.

New England Fund – Operative Guidance

The New England Fund ("NEF") of the Federal Home Loan Bank of Boston provides member financial institutions with advances to support housing and community development initiatives that benefit moderate income households and neighborhoods. The Federal Home Loan Bank of Boston, simply put, is a bank for banks, cooperatively owned by more than 450 private New England financial institutions.

In 1998, the Barnstable ZBA challenged the validity of an NEF financed developer (Stuborn Ltd. Partnership) as a qualified subsidy for a Comprehensive Permit (Chapter 40B) project. In *Stuborn Ltd. Partnership v. Barnstable Board of Appeals ("Stuborn")*, the Barnstable ZBA sought to bar developments financed through NEF from qualifying as Chapter 40B affordable housing developments. Barnstable lost. In March 1999, the DHCD through the Housing Appeals Committee ("HAC") sided with the developer, finding that the NEF qualified as a valid subsidy for a Comprehensive Permit. In 2007, the Supreme Judicial Court of Massachusetts affirmed the HAC's ruling in *"Middleborough vs. Housing Appeals Committee"*.

In *Stuborn*, the Barnstable ZBA had asserted that the NEF was not a subsidy program and that the developer was not a limited dividend organization, contrary to the requirements of the Comprehensive Permit Law and Regulations. One contention of the Barnstable ZBA was that since the NEF program did not require that a developer's profits be limited, a developer using the NEF as a subsidy source would not qualify as a limited dividend organization and therefore would not be in compliance with the requirements of Chapter 40B.

In their review of the case, the HAC determined that the developer in fact would be executing a Regulatory Agreement that would limit the developer's profits to 20 percent of total development costs and that this profit limitation was the same one used in the DHCD Local Initiative Program. The HAC concluded that the Stuborn Limited Partnership was a limited dividend organization based on its finding that the developer's profit limitation was consistent with that of other affordable housing programs that complied with the requirements of Chapter 40B and this profit limitation was enforceable by means of a regulatory agreement that would be executed prior to construction.

The *Stuborn* decision reinforced the rule that before proceeding with any Chapter 40B housing development, pro forma financial statements and projections must be reviewed to ensure that profit margins accurately portray the project's financial feasibility while remaining within established profit limitations. The HAC determined that it was necessary and proper for the local ZBA to review these financial projections for such accuracy. Also, with respect to project finances, the *Stuborn* decision held that a ZBA might well require the developer to prepare a full compilation and certification of total development costs (net of related party expenses) and total revenues on a federal income tax basis.

As a result of the *Stuborn* case, the NEF became an approved funding source and NEF member banks began issuing site approval letters for low or moderate-income developments. This resulted in multiple applications to many ZBA's for comprehensive permits.

By 2002 the DHCD recognized that unlike conventional housing subsidy programs in which a state or federal agency administers and approves every aspect of financing, design, and construction, the Federal Home Loan Bank of Boston did not impose such oversight over the NEF. In the NEF program, many of these decisions were left to the local ZBA. It was also recognized that most municipalities did not have local standards that detailed reasonable requirements for low or moderate income housing development and many did not have the capacity to undertake the responsibilities of administering such houses once built.

In order to address these shortcomings, the DHCD on February 14, 2003 issued the "Guidelines for Housing Programs in Which Funding is Provided Through a Non-Governmental Entity" ("NEF Guidelines"). These guidelines were specifically established for subsidizing agencies like the NEF. These guidelines were intended to establish a procedure to allow participation by non-governmental entities while ensuring that the process by which Chapter 40B housing developments are negotiated, built, sold and remain affordable are consistent with the spirit of the statute.

The NEF Guidelines addressed both the issue of limited dividend organization and that of land valuation and/or allowable acquisition costs that are at the heart of Hilltop Farms' misrepresentations to Grafton.

The NEF Guidelines provided for the following profit limitation:

> *"For ownership housing, to limit profit to all such partners or owners to no more than twenty percent of total allowable development costs, and such other sums as the Project Administrator may determine constitute a developer's contribution to the project provided that calculation of total allowable development costs shall not include any fee paid to the developer."*

The NEF guidelines, recognizing the monetary value of a Chapter 40B Comprehensive Permit, make it clear that developers may not inflate their land acquisition costs by using an appraisal that includes the value of a Comprehensive Permit:

> *"For purposes of calculating total development costs and profit, an independent appraisal is required to determine the allowable acquisition cost. Allowable acquisition cost shall not be unreasonably greater than the current appraised fair market value under existing zoning without a comprehensive permit in place. Economic benefits of the comprehensive permit shall accrue to the development and shall not be used to substantiate an acquisition cost that is unreasonably greater than fair market value under existing zoning."*

Hilltop Farms – Regulatory Agreement

On June 28, 2004 Hilltop Farms Development, LLC and the Salem Five Cents Savings Bank executed the Regulatory Agreement for the Hilltop Farms development. This Regulatory Agreement was executed more than 16 months after the DHCD had published the NEF Guidelines. Incorporated in the Regulatory Agreement was a Dividend Limitation section which, in part, provided the following:

> *"The Allowable Profit shall be measured as the excess of certified income less any brokerage fees and commissions and selling expenses over certified costs and less all development costs related to the Project including costs incurred by the developer as administrative and overhead expenses which do not exceed four percent of total development costs, excluding such administrative and overhead costs. Acceptable development costs include, but are not limited to, the cost of site acquisition, defined as that land value which can be underwritten by the Project and which can be supported by the subsidizing entity's appraisal upon which its construction loan is based."*

Through this Regulatory Agreement, Hilltop Farms Development, LLC represented, covenanted, and warranted that it would not violate or, as applicable, had not violated any provision of law, rule or regulation, or any order of any court or other agency or governmental body.

In fact, however, the Regulatory Agreement executed between Hilltop Farms Development, LLC and the Salem Five Cents Savings Bank violated the rules of the *Stuborn* decision, the LIP Guidelines, the New England Fund and the spirit of the Chapter 40B statute, all of which require that a Chapter 40B developer's profit be limited to no more than 20 percent of total allowable development costs. Total allowable development costs cannot include any fee paid to the developer. Nevertheless, contrary to the published rules, Hilltop Farms Development, LLC's total development costs contained some of its profits or fee in the calculation.

In addition, the existing Chapter 40B rules/guidelines (*Stuborn* decision/LIP Guidelines) consistently provide that for purposes of the Allowable Profit calculation, the land value should be based on either the amount paid during the last arms-length transaction or the value under pre-existing zoning, whichever is lower. However, the language in the Regulatory Agreement that defines acceptable development costs to include the appraised land value of the site (with a comprehensive permit in place) directly contradicts the Chapter 40B rules/guidelines and represents an outrageous and misguided attempt to redefine an element of developer's profit or fee into an expense or cost element. Left unchecked, this scheme would allow the developer to pad its expenses with monies it never expended.

During the timeframe when the Hilltop Farms Regulatory Agreement was developed and executed, the common practice for handling developer overhead in NEF financed Chapter 40B projects was to exclude this category as an allowable development cost and recognize this as part of the overall 20 percent development fee/profit for the project. Notwithstanding this common practice, the executed Hilltop Farms Regulatory Agreement called for the inclusion of up to 4 percent of total development costs for developer overhead and administrative costs as an allowable development cost.

Based on this provision Hilltop Farms Development, LLC, at the end of the project, submitted a cost certification report reflecting $2,540,603 in overhead and administrative expenses for the project. This amount calculated to be exactly 4 percent of the total development costs as reported by the developer in the Cost Certification and was the maximum allowed under the language of the Regulatory Agreement, assuming of course, as reflected below, that these costs were not paid to related entities.

In November 2005 the Massachusetts Housing Partnership published the Local 40B Review and Decision Guidelines ("MHP Guidelines") that were endorsed by the four state agencies (including the DHCD) that finance affordable housing developed through Chapter 40B. These guidelines addressed numerous issues including developer overhead as a component of development costs as opposed to developer fee/profit. Based on the MHP Guidelines reasonable developer overhead for the Hilltop Farms project would be limited to $343,000 or $2,197,603 less than what was reflected in the Hilltop Farms LLC Cost Certification.

The Regulatory Agreement also included language, negotiated between Grafton and Hilltop Farms Development, LLC that, if followed would have given an unfair financial advantage to Grafton at the developer's detriment.

> *"Developer agrees that the profit to the Developer or to the partners, shareholders, or other owners of Developer or of the Project shall not exceed twenty percent (20%) of certified development cost, net of related party transactions of the project (the "Allowable Profit")."*

The exclusion of "related party transactions" from the calculation of development expenses is much broader than the language from the NEF guidelines and the standard language incorporated in other NEF Regulatory Agreements, which state "allowable development costs shall not include any fee paid to the developer."

This use of the broader exclusion of costs could capture any event or condition that Hilltop Farms Development, LLC recorded which involved a payment by or to an entity related to Hilltop Farms Development, LLC. In the Hilltop Farms development project, related entities played a significant role in the development of the project, including providing general contracting, land development, architectural design and engineering services. Therefore, the exclusion of all these related party transactions – as opposed to just the associated development fee – would result in a major shift of profits away from the developer to the town. However, the developer in preparing its Cost Certification ignored the requirement to exclude all "related party transactions" from total development costs.

In other words, having signed a Regulatory Agreement that improperly benefited the developer in one section and improperly assisted the town in another, the developer chose only to follow the terms that benefited it and ignored the terms that advantaged the town. On the one hand and in compliance with the Regulatory Agreement, Hilltop Farms Development, LLC claimed as a development cost the appraised value of the site which was $6.9 million more than what it had actually paid for the parcel; but on the other hand and contrary to the Regulatory Agreement, Hilltop Farms Development, LLC did not exclude any of the approximate $50 million of related party transactions from total development cost. The result of these actions was an increase in reported development costs with a complimentary reduction in development profits, thus avoiding any reported excess profits that would be payable to the town.

Evolution of the Hilltop Farms Regulatory Agreement

On August 23, 2001 as part of the Comprehensive Permit application process, Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C. ("Mintz") on behalf of their client, Hilltop Farms Development, LLC submitted copies of a model Regulatory Agreement to the Grafton ZBA. With respect to the dividend limitation, this Regulatory Agreement reflected the standard or common "boilerplate" language found in other NEF financed home ownership projects from this timeframe which states generally that the Developer agrees that its profit shall not exceed twenty percent of total development costs exclusive of development fees (the "Allowable Profit"). However, shortly before Mintz submitted Hilltop Farms Development, LLC's Comprehensive Permit application to the Grafton ZBA, the developer sought guidance from Stockard & Engler & Brigham, LLC, a consulting firm specializing in affordable housing planning and development.

In March, 2001 Robert Engler one of the firm's principals, wrote to the Hilltop Farms Development, LLC:

> *"What is clear already from the information you provided is that your profit margin is too high for limited dividend status under Chapter 40B (20%)."*

In April 2001, Hilltop Farms again sought Mr. Engler's advice on its revised draft budget:

> *"Bob, check this draft budget out. Please advise, we have a few questions.*
> *1) Can we get an appraisal of the land to increase the land Acquisition?*
> *2) Can Pulte sell to Hilltop LLC?*
> *3) Who does the audit and when? What is the process . . . ."*

Mr. Engler responded:

> *". . . I also lowered the development overhead to 2% from 4% as this is a big project and we haven't yet had development overhead accepted as a separate expense under the NEF Program as previous projects just carried the total 20% developer fee. I think you can make a case that it is separate from a fee, but the lower the number the better. Overhead at 2%, or 1M, seemed like a good start.*
>
> *In terms of your questions, I offer the following responses:*
>
> *1. land value can be plugged in at what you consider the existing commercial value to me; if the Town (or its consultant questions it, you might have to provide documentation at that time, but our documents say that it is the value determined by the construction lender based on the completed project which may be a higher number). You might want this number in the budget when it gets discussed so that you won't be accused of showing a low number to the ZBA and a high number when the 3rd party monitoring agent comes out to verify the costs. The higher number will drop you profit margin down, which is okay.*
>
> *2. Pulte can use Hilltop as the contractor or a joint venture partner or it could sell to them after the permits are in place. Any new developer has to be passed back before the ZBA but if the development doesn't change from what is permitted, the ZBA shouldn't care.*
>
> *3. The monitoring agent will review after project completion. . . ."*

As a result, on July 9, 2002, nearly a year after the original submission, Hilltop Farms Development, LLC submitted a revised Regulatory Agreement to the Grafton ZBA. This revised Regulatory Agreement incorporated Stockard & Engler & Brigham, LLC's unusual/creative accounting strategy formulation that increased the land value to an appraised amount; this formulation served to increase the allowable development costs by $6.9 million more than what the developer had actually paid for the site or by nearly $7.4 million more than what Grafton had valued the site for property tax purposes. The revised Regulatory Agreement also included a provision that would permit Hilltop Farms Development, LLC to inflate development cost to 4 percent of total development costs versus 2 percent as suggested by Stockard & Engler & Brigham, LLC.

> *"The Allowable Profit shall be measured as the excess of certified income, less any brokerage fees and commissions and selling expenses over certified costs and less all development costs related to the Project including costs incurred by the developer as administrative and overhead expenses which do not exceed four percent (4%) of total development costs, excluding such administrative and overhead costs. Acceptable development costs include, but are not limited to, the cost of site acquisition, defined as that land value which can be underwritten by the Project and which can be supported by the subsidizing entity's appraisal upon which its construction loan is based."*

Over the next year and a half attorneys for Hilltop Farms Development, LLC and the Town of Grafton hammered out a variety of issues related to the Comprehensive Permit and the Regulatory Agreement. Among other things, those negotiations included discussions about what would be included or excluded from the development cost calculation. On April 27, 2004, the ZBA granted modifications to the Comprehensive Permit that included an approval as to the form of the Regulatory Agreement that excluded "related party transactions" from the definition of development costs rather than the standard exclusion of "development fees."

This change resulted in a broader exclusion of costs. In this particular development where related entities played such a significant role in the development of the project including providing general contracting, land development, architectural design and engineering services; exclusion of all these related party "transactions" as opposed to just the associated development "fee" would result in a major shift of profits away from the developer to the town. As is discussed in subsequent sections of this report, Hilltop Farms Development, LLC in preparing its Cost Certification for the project did not comply with this provision of the Regulatory Agreement.

On June 28, 2004 the Regulatory Agreement with this new language was executed between the developer and the Salem Five Cents Savings Bank. The executed Regulatory Agreement was inconsistent with other affordable housing programs (i.e. DHCD's LIP) and did not properly limit the developer's profit in accordance with the requirements of the NEF, the *Stuborn* decision and the spirit of the Chapter 40B legislation. Contrary to Chapter 40B rules and guidelines, the Regulatory Agreement on the one hand provided for an inflated land valuation and an unreasonably high level of developer overhead on the other hand it excluded all related party transactions thus potentially disallowing actual bona fide development costs from the profit calculation.

Certified Cost and Income Statement

At the conclusion of the project, Hilltop Farms Development, LLC was required to deliver a final Certified Cost and Income Statement to the Monitoring Agent. A Certified Cost and Income Statement is an itemized statement, certified by the developer, of total development costs together with a statement of gross sales revenue from the project received by the developer. It is through this Cost Certification process that a developer accounts for its profits. The developer is obligated to pay the local municipality any profits in excess of the agreed upon program limit.

On Feb. 11, 2008, Hilltop Farms Development, LLC's Certified Public Accountants, McGladrey, issued an Independent Auditor's Report. McGladrey's report indicated that they had audited the developer's schedules of Chapter 40B Maximum Allowable Profit from Sales and Total Chapter 40B Project Costs and that in their opinion these financial schedules presented fairly, in all material respects, the developer's Chapter 40B Maximum Allowable Profit from Sales and Total Chapter 40B Project Costs in conformity with guidelines prescribed by CHAPA and the DHCD. This representation was not accurate.

McGladrey also specified that the schedules were prepared in conformity with accounting practices prescribed by the requirements of CHAPA, MGL Chapter 40B, DHCD Regulations (760 CMR31.00) and the "Guidelines for Housing Programs in Which Funding is Provided Through a Non-Governmental Entity" (the NEF Guidelines) also issued by the DHCD. The notes to the financial statements included a section titled "Basis of Presentation" that also purported to reinforce that these financial schedules were prepared based on the requirements of the NEF Guidelines. They, in fact, were not so prepared.

Included in McGladrey's audit work-papers was a Representation Letter from the developer to McGladrey reiterating the developer's compliance with the NEF Guidelines. Representation letters are typically required at the completion of an auditor's fieldwork and prior to the issuance of the financial statements with the auditor's opinion. The purpose of these letters is to emphasize that the financial statements are management's representations and thus management has the primary responsibility for their accuracy. Notwithstanding the developer's Representation Letter to its auditors it is clear that the developer did not comply with the NEF Guidelines.

The McGladrey audit report for Hilltop Farms Development, LLC reflected total income for the project of $75,830,641 and total project costs of $66,055,688 resulting in a net reported profit for the project of $9,774,953 – or 14.8 percent of total development costs. Since this profit was less than 20 percent of total project costs, the developer's flawed certification process determined there were no excess profits owed to the town of Grafton.

Although both McGladrey and the developer claimed to have followed all relevant laws, guidelines and regulations in developing the Cost Certification, McGladrey's audited financial schedules, in fact, relied on an inflated land value of $7.8 million (in comparison the town of Grafton for local property tax purposes had assessed the site's value for fiscal 2002 at $402,800) to minimize Hilltop Farms' profits. The $7.8 million adds the value of the Comprehensive Permit to the $900,000 Hilltop Farms actually paid for the land, a calculation that is prohibited by the NEF Guidelines and the *Stuborn* decision. This revised land valuation methodology employed by the developer through the use of a creative accounting strategy that redefines profit or fee as expense is in conflict with the NEF Guidelines, the *Stuborn* decision (including DHCD's LIP) and is at odds with the intent and spirit of affordable housing legislation.

While McGladrey and the developer adhered to the Regulatory Agreement when it benefited Hilltop Farms Development, LLC, they failed to exclude (although required by the Regulatory Agreement) the

following related party transactions that would have lowered development costs, increased the developer's profit and required Hilltop Farms to pay significant excess profits to the Town of Grafton:

- $776,265 paid in real estate commissions when the sole owner acted as the selling broker for Hilltop Farms units;
- $159,970 in closing costs paid to a related party;
- $2,540,603 for administrative and overhead costs paid to the developer's owner;
- significant costs related to land development, general contracting, architectural design and engineering services provided by affiliates of the developer were included as allowable development costs and the value of these related party transactions were not separately disclosed or reported with an associated monetary value. We estimated these costs to be in excess of $48 million.

Including reasonable and bona fide construction/development costs, commissions, closing costs, administrative and overhead costs - whether or not they are paid to a related party – is proper under the pertinent Chapter 40B guidelines including the NEF. However, it is troubling that the developer utilized provisions in the Regulatory Agreement when it was beneficial to its own financial position – such as the inflated land valuation – but failed to follow other Regulatory Agreement terms - such as the exclusion from certified development costs of all related party transactions - when adherence to these conditions would have hurt the developer's finances.

The developer's Cost Certification should at least have been prepared using a consistent methodology. Given that it was not, it is extremely troubling that the developer's Cost Certification did not highlight and address the significant contradictions between the Regulatory Agreement and the existing Chapter 40B rules and guidelines including; the *Stuborn* decision, the LIP Guidelines and the NEF/MHP guidelines. Both the developer and the auditor had an obligation to alert users of this financial information of this incongruence.

Monitoring Agent's Cost Certification Review

On March 25, 2004 Hilltop Farms Development, LLC entered into a Monitoring Services Agreement with the Citizens' Housing and Planning Association, Inc. ("CHAPA"). The Monitoring Services Agreement recognized that "pursuant to the guidelines of the NEF (emphasis added) for comprehensive permit projects, the Comprehensive Permit and the Regulatory Agreement, the Developer may not receive profit in excess of 20 percent of total development costs of the Project".

In order to perform its cost monitoring responsibilities, CHAPA contracted with the public accounting firm of Daniel Dennis & Company, Inc. ("Dennis") to conduct a review of the Cost Certification audit prepared by McGladrey. This review by Dennis was conducted using specific "agreed upon procedures" which included but were not limited to the following actions:

- Review the requirements of the applicable subsidy program, (NEF Guidelines), the executed Comprehensive Permit and the executed Regulatory Agreement to determine the allowable profit level and other restrictive language relating to land values, overhead and related party expenses;
- Review the Cost Certification and the land appraisal report and determine the methodology used to determine the land value;
- Review the soft costs to ensure that they are fully documented and are reasonable by comparison to the MHP Guidelines;
- Review all related party transactions to determine if they are reasonable and in accordance with CHAPA and MHP guideline limitations, and
- Review the Cost Certification notes to determine that the related party disclosures are included in the notes, that the nature and amounts of the related party activities are detailed and that the disclosures appear to be consistent with other project documentation.

On August 25, 2008 CHAPA notified Grafton's ZBA that the review of the Cost Certification audit was complete. CHAPA provided the Grafton ZBA with a copy of the developer's audit that had been prepared by McGladrey and a copy of the report documenting Dennis' review of the audit. CHAPA also informed the Grafton ZBA that there were no excess profits owed to the town. CHAPA said the developer's profit was 14.93 percent (versus the 14.80 percent claimed by the developer in their Cost Certification audit). The difference was an $84,974 adjustment made by CHAPA/Dennis to impute additional sales revenue pertaining to certain housing units that had been sold to related parties.

Although CHAPA and Dennis were supposed to review the requirements of the NEF Guidelines, the Comprehensive Permit and the Regulatory Agreement to determine the allowable profit level and any other restrictive language relating to land values, overhead and related party expenses, the CHAPA/Dennis audit does not mention the radical conflicts between the Regulatory Agreement and the Chapter 40B rules and guidelines including the *Stuborn* decision, the LIP Guidelines and the NEF Guidelines. There is no documentation in the review package or in Dennis' work-papers highlighting these significant differences. Nor was there evidence of discussions at CHAPA and/or with Dennis about how to resolve these conflicts.

CHAPA's review report makes no mention of either the *Stuborn* decision or the LIP Guidelines that provide authoritative direction regarding limitations to the land value for the development site. The Cost Certification review report offers conflicting information about whether CHAPA required Hilltop Farms Development, LLC to comply with the limited dividend requirements of Chapter 40B and applicable sections of the NEF Guidelines. In one section the report indicated that based on Chapter 40B and the NEF Guidelines the project was a qualified limited dividend project and that the developer's profit was limited to an amount not to exceed 20 percent of the project's development costs. However, in another section of the same Cost Certification review report Dennis said that the NEF Guidelines were not used to

determine the profit limitations, writing that due to the project commencing prior to the issuance of the NEF Guidelines which were issued in February 2003 and the MHP Guidelines which were issued in November 2005, these guidelines were used only to determine the reasonableness of the costs incurred with respect to the 20 percent dividend limitation and were not determined to be authoritative literature applicable to this project.

Land valuation should have been in accordance with the *Stuborn* decision and the companion LIP Guidelines as the purchase and sale agreement for the site was executed in August 2000 or approximately 18 months after the *Stuborn* decision. Other development costs should have been in compliance with the NEF Guidelines, given the fact that actual construction of the project began well over a year after the NEF Guidelines were published as did the execution of both the Regulatory Agreement and the Monitoring Services Agreement. CHAPA, Dennis, Hilltop Farms Development, LLC and McGladrey all should have consistently followed the NEF Guidelines - just as Hilltop Farms Development, LLC had claimed it had done in its Representation Letter and McGladrey had asserted in its Independent Auditor's Report.

When looking at land value CHAPA/Dennis followed the language in the Regulatory Agreement as opposed to the NEF Guidelines or the LIP Guidelines referenced in the *Stuborn* decision. Although the developer actually paid $900,000 for the land, the Monitoring Agent accepted the $7.8 million appraised value of the site (with a Comprehensive Permit) claimed in the developer's Cost Certification. This Office has determined that there was no statutory, regulatory or program guidance to support this creative but abusive position.

Like Hilltop Farms Development, LLC and McGladrey, CHAPA/Dennis elected to follow the language in the Regulatory Agreement when determining land costs but chose not to exclude related party transactions when determining Hilltop Farms' allowable development costs. The monitoring agent's inconsistent application of the Regulatory Agreement always seemed to benefit the developer at the expense of the town of Grafton.

We found no evidence that CHAPA/Dennis attempted to identify or even size all business transactions in which parties related to the developer were involved. Rather than quantify and exclude the related party transactions as required by the Regulatory Agreement, it appears that the cost monitoring efforts used traditional Chapter 40B program definitions and limitations.

In fact, the CHAPA/Dennis cost monitoring report noted that $5,494,736 in related party transactions were included in the Cost Certification's determination of allowable profit. Rather than excluding these transactions from the total development cost for the project as required by the Regulatory Agreement, CHAPA/Dennis chose to review these related party transactions (such as sales commissions paid to related parties) against the guidance provided through the MHP guidelines.

CHAPA/Dennis also allowed the $2,540,603 in administrative and overhead costs claimed by the developer and reflected in McGladrey's Cost Certification audit. This amount calculated to be exactly 4 percent of the total development costs as reported by the developer and was consistent with the maximum allowed under the language in the Regulatory Agreement, assuming of course that these costs were not paid to related parties. As was previously noted, developer overhead was typically not allowed as a separate cost category for NEF financed projects but was considered to be part of the developer's 20 percent fee. In 2005 the four state agencies that finance affordable housing endorsed the MHP Guidelines that addressed many development issues including developer overhead.

As part of the cost monitoring efforts for Hilltop Farms, Dennis' work-papers reflect the MHP Guidelines as a reference point for allowable developer overhead costs. According to the MHP Guidelines reasonable

overhead cost for a project of this size would be $343,000 or only approximately 13.5 percent of the amount claimed by the developer through the Cost Certification. In addressing this issue of developer overhead, Dennis' work-papers indicate that CHAPA's executive director advised Dennis that the entire $2,540,603 claimed by the developer as overhead should be accepted through the cost monitoring efforts. This Office reviewed the work-papers from both McGladrey and Dennis and determined that the entire $2,540,603 in claimed administrative and overhead costs was based on related party transactions and, therefore, under the Regulatory Agreement should not be considered in the determination of allowable profit. Again, CHAPA/Dennis allowed Hilltop Farms Development, LLC to inconsistently follow the Regulatory Agreement only when it benefitted the developer.

CHAPA/Dennis also ignored the Regulatory Agreement's provision about related party transactions when it examined brokerage commissions and closing costs. CHAPA/Dennis, allowed a total of $1,451,020 in brokerage commissions to be included as development costs despite the fact that only $674,755 represented payments to third parties (the remaining $776,265 represented payments to related parties). Similarly, CHAPA/Dennis also allowed Hilltop Farms to claim $159,970 in closing costs that were paid to a related entity as part of its development costs.

In both instances, the CHAPA/Dennis cost monitoring report followed MHP Guidelines and did not exclude the related party transactions. While the MHP Guidelines are the correct authority here, the inconsistency of CHAPA/Dennis is troubling.

In addition, although the Regulatory Agreement excluded all related party transactions, there was no attempt made by the developer through the Cost Certification process to identify and disclose the full magnitude of the related party transactions associated with the actual construction and development of the site. This Office estimated that these related party transactions totaled approximately $50 million.

Project Budget Pro-Forma

In the fall of 2002, the developer provided the Grafton ZBA with a pro forma budget as required by the *Stuborn* decision. The pro forma budget was supposed to demonstrate that the project was financially feasible, while remaining within the profit limitations established for the project.

On October 28, 2002, the Grafton ZBA – assisted by a financial consultant – conducted a formal review of the project pro forma for the Hilltop Farms development. This pro forma budget, dated September 26, 2002, showed a 271 unit housing development with project revenue of $61,866,290; total development costs of $56,659,218; and, an associated profit of $5,207,072 or 9.19 percent of total development costs.

The September 2002 financial statements reflected a land acquisition cost of $900,000 (the actual agreed upon arm's length purchase price) as opposed to the appraised value (with a Comprehensive Permit in place) of $7.8 million the developer claimed in the Cost Certification several years later. The developer also included a cost of $1,110,965 (or 2 percent of total development cost) as development overhead in this budget pro forma. The ZBA's consultant recommended that the ZBA follow the traditional approach that recognized and allowed development overhead as part of the development fee, which includes both profit and overhead and not as a separate cost or expense line item. At the time of Cost Certification the developer claimed a development overhead cost of $2,540,603 (or 4 percent of total development cost) versus the zero value advocated through the pro forma review.

During our investigation, this Office requested that the developer provide all project pro forma financial statements including but not limited to those submitted to the town of Grafton and to the Salem Five Cents Savings Bank. Similarly we requested from the town and from the bank all project pro forma financial statements in their possession.

In addition to the September 26, 2002 pro forma provided to the Grafton ZBA, the developer provided this Office with eight earlier project pro forma budgets. The oldest pro forma budget provided by the developer was dated April 2001. Seven of these pro forma financial statements (dated from April 4, 2001 through June 25, 2001) reflect plans for a 311 unit development and an associated profit ranging from 8.3 percent to 20 percent. The eighth pro forma, dated July 9, 2002, reflects a 271 unit development plan with a 6.28 percent profit.

As was previously highlighted, the developer's Chapter 40B consultant, Stockard & Engler & Brigham, LLC, in March 2001 had communicated its concern to the developer regarding the project's profit margin being too high for limited dividend status under Chapter 40B. This Office was not provided with the associated financial information that had previously been submitted by the developer to its consultant. Also not provided to this Office was the information provided to the Salem Five Cents Savings Bank that was used in their Construction Loan Request Report (see below) reflecting a significantly higher profit percentage than was presented to the town and allowed under Chapter 40B. This financial information that the developer shared with its bankers and its consultants showed that projected earnings exceeded program limits and would have signaled an excess in profits that would be owed to the town.

The town of Grafton provided copies of the developer's budgets dated September 26, 2002 and July 9, 2002. The Salem Five Cents Savings Bank provided only one pro forma budget, the June 25, 2001 budget showing a 20 percent profit. The bank also provided this Office with their Construction Loan Facility Report showing approval of the construction loan by both the bank's Loan Committee and their Board of Investment. Attached to the Construction Loan Facility Report was a Construction Loan Request Report, dated January 26, 2004. This report included a profitability analysis for the project that highlighted a net income (before taxes) of $17,094,000 or 31.5 percent of total development costs. This analysis included

the land cost at the inflated appraised valuation of $7.8 million. If the land was accounted for at its actual acquisition value of $900,000 the resulting profit would have been $23,994,000 or 50.6 percent of total development costs versus the 20 percent maximum the developer is allowed to keep. Under this financial plan, Hilltop Farms Development, LLC would have owned the town of Grafton $14,414,400.

The financial information that the developer gave the Salem Five Cents Savings Bank to secure its construction loan should have been given to the town of Grafton, McGladrey, CHAPA and the Office of the Inspector General.

OIG Findings Regarding the Cost Certification Process

A primary objective of the Chapter 40B financial Cost Certification process is to provide interested parties (including host municipalities that have an economic interest in the financial results of the development) with fair, complete, and accurate financial information regarding the cost, income and profitability of these affordable housing developments. It is a reasonable expectation that users of this financial information should be able to rely on these Cost Certification reports and their financial schedules to provide adequate disclosures and independent financial determinations. Use of clear, sound, consistent and unequivocal standards regarding the underlying accounting methodologies and related program guidelines is essential.

This Office's investigation into the Cost Certification process for the Hilltop Farms housing development revealed inadequate oversight practices that have contributed to a significant underreporting of actual profit for the development. The Cost Certification process for Hilltop Farms failed to provide an accurate and reasonable reflection of the financial results of the development. The associated financial statements were derived based on the use of conflicting and contradictory standards and lacked adequate disclosures. Due to these shortcomings in the Cost Certification process, users of this financial information, such as the town of Grafton, are unable to rely on this information presented in the financial statements.

By adhering to the developer's unconventional and non-conforming accounting rules, both McGladrey (who was hired by the developer) and CHAPA (which is supposed to provide an objective assessment), determined that there were no excess profits identified in either the McGladrey audit report or the CHAPA monitoring report. This Office reexamined the financial data provided by the developer using the Chapter 40B compliance standards in place at the time the project was constructed: the *Stuborn* decision and the LIP Guidelines were used for land valuation and the NEF/MHP guidelines were used for the other aspects of the project including costs for construction, marketing and sales. Using these compliance standards, this Office determined that the developer owes the town of Grafton over $8.5 million in excess profits.

The adjustments proposed by this Office include:

- a reduction of $6,900,000 in development costs in order to bring the land acquisition cost in line with actual expenditures;
- a reduction of $818,527 for various development costs accrued by the developer that had no subsequent associated cash disbursement/expenditure;
- a reduction of $2,197,603 to reflect developer overhead at the MHP guideline prescribed level;
- and, an increase of $84,974 in sales revenue in order to reflect at market rate sales prices housing units sold to related parties as previously determined by CHAPA.

These adjustments are summarized in an attached Schedule of OIG Proposed Adjustments (based on compliance with existing Chapter 40B rules and guidelines).

It is reasonable for users of financial statements including Cost Certification reports to expect that expenses claimed represent actual or expected cash outflows that have occurred or will occur as a result of the construction/development activities associated with the project. This is in line with generally accepted accounting principles, Chapter 40B rules and guidelines and in the spirit of the enabling legislation. In plain terms, there is a compelling expectation that claimed project expenses represent the actual cost of development (capped in some cases within reasonable/allowable limits).

The developer's use of an inflated land cost as a development expense is at odds with commonly accepted accounting principles and with existing Chapter 40B rules and guidelines. The developer's position is also

at variance with the spirit of the Chapter 40B legislation. This abusive land valuation methodology advocated by the developer appears to be nothing more than an attempt to pad expenses by redefining profit or fee as a project expense and thus reduce the potential for any identified excess development profit that would be owed to the town of Grafton.

In addition to the inflated land costs incorporated through the cost certification process, this Office learned that the developer's financial schedules were based on budget or forecast information as opposed to actual expenditures. As reflected in the McGladrey audit work papers, the developer's financial results for the project included a substantial "lump" of accrued costs. Based on testing a small sample of expense accounts[1], this Office identified $818,527 in accrued project expenses that had no subsequent associated cash disbursement and therefore the actual cost of development reported through the Cost Certification process was overstated by at least this amount. It is disconcerting that the Cost Certification process (including both the McGladrey audit and the CHAPA cost monitoring report) did not identify and adjust for these inflated costs.

Related party transactions are common in the development of affordable housing as they are throughout the business world. While the vast majority of related party transactions are perfectly normal, the special relationship inherent between the parties involved creates potential conflicts of interest that can result in actions which benefit the related parties at the expense of other stakeholders. Some related party transactions may be the direct result of the relationship. Without that relationship, the transaction might not have occurred at all or might have had substantially different terms.

In the context of Chapter 40B housing developments, since related party transactions are usually entered into without the benefit of a competitive bidding process and since higher reported development costs provide an opportunity/incentive for additional profits to be retained by an unscrupulous developer, it is imperative that the host municipalities, as major stakeholders, understand all related party costs. This includes a clear understanding of all associated overhead, general conditions and profit built into these relationships.

Clearly, another reasonable expectation for users of financial statements is that transactions between related parties be appropriately disclosed. Adequate disclosure of related party transactions is essential for understanding the underlying financial statements. Proper disclosure would include a description of the transactions themselves, consisting of such relevant information as the dollar amounts of all related party transactions and the relationship of the parties to one-another. The McGladrey audit report and the CHAPA cost monitoring review report did not adequately disclose all these related party transactions. The assertions made through the Cost Certification process that the developer followed the terms of the Regulatory Agreement that specified that the developer agreed to limit profit to 20 percent of certified development cost, net of related party transactions further reinforces the need to provide a complete and transparent accounting of all related party transactions since each one would affect the level of excess profit.

Notwithstanding the fact that the Regulatory Agreement excludes related party transactions as development costs, it is absurd that a development overhead charge of $2,540,603 paid to the owner of the developer would be considered as a reasonable development cost. As stated before, NEF projects had traditionally not allowed for development overhead as a separate development cost line item but had assumed this to be part of the 20 percent profit limitation. Even the MHP guidelines that are referenced throughout the Cost Certification process as a reasonableness measure for various cost elements would

[1] Six general ledger accounts (Legal Fees; Construction Phase Engineering; Municipal Fees; Inspectional Fees; Irrigation System; and, Land Warranty Reserve) representing $1,793,354 or 2.7 percent of the total development costs claimed by the developer through the Cost Certification were tested.

limit these developer overhead costs for a project of this scope to $343,000. It is incredulous that such a significant difference in cost, especially when generated through a related party transaction, would be deemed reasonable and then be reported as a certified development cost through the Cost Certification process.

This Office also estimated (see attached Schedule of OIG Proposed Adjustments – based on the Regulatory Agreement) the associated excess profits assuming a consistent application and observance of the Regulatory Agreement and determined that if in fact, the developer had excluded all related party transactions from its development costs; Hilltop Farms would have owed the Town of Grafton more than $17.1 million in excess profits. However, since the Regulatory Agreement violated the existing Chapter 40B rules and guidance, the Regulatory Agreement is not the proper tool to determine Hilltop Farms Development, LLC's excess profits.

The Cost Certification process for the Hilltop Farms development failed to provide a reasonable level of professional skepticism and oversight that one should expect. The process neglected to question the validity of the Regulatory Agreement and to independently determine if this agreement violated any of the existing Chapter 40B laws, rules and guidelines. Financial determinations were based on inconsistent standards: in some cases abiding by terms of the Regulatory Agreement; in other cases following established Chapter 40B rules and guidelines; and, yet in other cases taking an unchartered or hybrid position. In its financial determinations, the Cost Certification process appeared to lack independence and to be biased in favor of the developer. The process did not provide adequate disclosures that would be useful to third parties with financial interests in the project. The Cost Certification process presented conflicting statements such as purported adherence to both the NEF Guidelines and the Regulatory Agreement – both mutually exclusive.

Based on this Office's review of the Hilltop Farms project and other similar Chapter 40B developments that we have examined, it is the opinion of this Office that although much of the responsibility for underreporting development profit can be attributed directly to developer abuse of the system, this abuse unfortunately is enabled by recurring audit and oversight weaknesses in the Cost Certification process. Independent oversight of Chapter 40B development profits plays a critical role in the program's obligatory system of disclosure. Independence is at the core of integrity and the integrity of the Cost Certification process is essential to the well being of the affordable housing legislation or Chapter 40B.

Arguably, one of the most significant shortcomings of the Cost Certification oversight process is its reliance on nominally "independent" auditors who are, in fact, hired and paid by developers - the parties they are evaluating. It is unfortunate but it should not be surprising that quite often the financial portrait developed and reported on by these auditors serve the interests of the party who hired and paid them. An equally significant deficiency of the Cost Certification oversight process is the use as monitoring agents of organizations such as CHAPA whose ongoing work includes representing the interests of for-profit developers. In the opinion of this Office this creates natural conflicts and further negatively impacts the overall independence of the Cost Certification oversight process.

On a positive note, it is the opinion of this Office that many of the audit failures that currently plague the Chapter 40B Cost Certification oversight process can be remedied by simply substituting the host municipalities in place of the developers as the parties that select and hire the independent auditors and monitoring agents. Although developers would still be required to fund these oversight activities, the hiring of these auditors by the host municipalities would allow for a more independent and robust Cost Certification process. This Office anticipates that this change would result in the exercise of a higher level of professional skepticism on the part of the auditors than what currently occurs.

Recommendations

In order to address the numerous issues and concerns identified through our investigation this Office recommends the following actions:

1) The town of Grafton should consider taking appropriate civil actions in order to pursue the excess profits associated with the Hilltop Farms development project;
2) DHCD should immediately amend the Cost Certification process for all Chapter 40B projects to require that municipalities select the financial auditors. DHCD should continue to require that each project's developer pay for its Cost Certification audit.
3) The DHCD, due to potential conflict of interest concerns, should ensure through appropriate guidance and direction that only independent entities serve in the role of cost monitoring agents for Chapter 40B development projects. Organizations with ties to the lending and development community should not be permitted to engage in this process.

HILLTOP FARMS
PROPOSED ADJUSTMENTS TO COMPLY WITH CHAPTER 40B RULES & GUIDELINES
ATTACHEMENT – SCHEDULE 1

	COST CERTIFICATION	OIG ADJUSTMENTS	ADJUSTED BALANCE
Sales:			
Market Unit Sales	$66,424,561	(4) $84,974	$66,509,535
Affordable Unit Sales	9,406,080		9,406,080
Total Unit Sales	**$75,830,641**	**$84,974**	**$75,915,615**
Project Costs			
Land	$7,800,000	(1) -$6,900,000	$900,000
Residential Construction	38,633,497		38,633,497
Site Preparation	10,930,372	(2) -$475,224	10,455,148
Landscaping	534,160		534,160
Engineering	1,068,828	(2) -76,770	992,058
Legal – Real Estate	627,000	(2) -266,533	360,467
Title and Recording	20,249		20,249
Administrative & Overhead	2,540,603	(3) -$2,197,603	343,000
Marketing	1,035,494		1,035,494
Real Estate Taxes	34,072		34,072
Construction Loan Interest	313,792		313,792
Utilities	170,299		170,299
Brokerage Commissions	1,451,020		1,451,020
Closing Costs	896,302		896,302
Total Project Costs	**$66,055,688**	**$9,916,130**	**$56,139,558**
Computed Profit from Sales	**$9,774,953**	$10,001,104	**$19,776,057**
Profit %	**14.80%**		**35.2%**
Allowable Profit @ 20%	$13,211,138		$11,227,911
Excess Profit	**$0.00**		**$8,548,146**

Adjusting Entries:
(1) To reflect the cost of land acquisition at actual purchase price paid
(2) To reduce for accrued development expenses that had no subsequent cash payment/disbursement
(3) To reduce developer's administrative & overhead expenses to comply with limits reflected in MHP Guidelines
(4) To impute sales revenue at fair market rates for housing unit sales made to related parties as determined by CHAPA monitoring review

HILLTOP FARMS
PROPOSED ADJUSTMENTS TO COMPLY WITH REGULATORY AGREEMENT
ATTACHEMENT – SCHEDULE 2

	COST CERTIFICATION	OIG ADJUSTMENTS	ADJUSTED BALANCE
Sales:			
Market Unit Sales	$66,424,561	(4) $84,974	$66,509,535
Affordable Unit Sales	9,406,080		9,406,080
Unrealized Gain on Land	0.00	(1) 6,900,000	6,900,000
Total Unit Sales	**$75,830,641**	**$6,984,974**	**$82,815,615**
Project Costs			
Land	$7,800,000		$7,800,000
Residential Construction	38,633,497		38,633,497
Site Preparation	10,930,372	(2) -$475,224	10,455,148
Landscaping	534,160		534,160
Engineering	1,068,828	(2) -76,770	992,058
Legal – Real Estate	627,000	(2) -266,533	360,467
Title and Recording	20,249		20,249
Administrative & Overhead	2,540,603	(3) -$2,197,603	343,000
Marketing	1,035,494		1,035,494
Real Estate Taxes	34,072		34,072
Construction Loan Interest	313,792		313,792
Utilities	170,299		170,299
Brokerage Commissions	1,451,020		1,451,020
Closing Costs	896,302		896,302
Total Project Costs	**$66,055,688**	**-$3,016,130**	**$63,039,558**
Computed Profit from Sales	**$9,774,953**	**$10,001,104**	**$19,776,057**
Related Party Transactions	**Not Applicable**	**(5)-$49,752,656**	**-$49,752,656**
Total Project Costs Net of Related Party Transactions	**Not Applicable**	**-$49,752,656**	**$13,286,902**
Allowable Profit @ 20% of Project Costs	**$13,211,138**		**$2,657,380**
Excess Profit	**$0.00**		**$17,118,677**

Adjusting Entries:

(1) To recognize unrealized gain associated with increase in historical cost of land acquisition to value of the land with a comprehensive permit in place
(2) To reduce for accrued development expenses that had no subsequent cash payment/disbursement
(3) To reduce developer's administrative & overhead expenses to comply with limits reflected in MHP Guidelines
(4) To impute sales revenue at fair market rates for housing unit sales made to related parties as determined by CHAPA monitoring review
(5) To net out related party transactions from development costs (Construction Services - $38,633,497; Land Development Services - $9,539,924; Brokerage Commissions - $776,265; Administrative & Overhead - $343,000; Architectural Design/Engineering Services - $300,000; Closing Costs - $159,970). Since the developer did not provide this Office with a schedule of all related party transactions, this Office estimated the related party land development, general contracting, architectural design and engineering costs at the lower of the dollar amount reflected in the executed contractual agreements versus the total amount reflected in the developer's Cost Certification Report.

Questions about Inspector General's Draft Report on Hilltop Farms Cost Certification

1. The Regulatory Agreement Accounting:

   a. Why add "Unrealized Gain on Land" of $6.9 million? Do c. 40B accounting rules allow or require this?

   b. Why disallow $50 million as related expenses? Aware that construction /site preparation/etc. was done by independent companies?

   c. How does Inspector General calculate $818,527 in accrual expenses?

   d. Aware that Hilltop spent most of those accrued funds?

2. The Guidelines Accounting:

   a. For land cost, why not use appraised value of $3.1 million?

   b. If construction/etc. was done by related parties, then isn't Hilltop is entitled to 14% Builder's Profit/Builder's Overhead/General Requirements?

The Regulatory Agreement Accounting:

a. Why add "Unrealized Gain on Land" of $6.9 million? Do c. 40B accounting rules allow or require this?

This issue was discussed during our last phone conversation. We do not know of any accounting rules 40B or other that would allow a one-sided accounting entry, similar to what was advocated through the Regulatory Agreement. Generally accepted accounting practices would require land to be recorded at historical cost. In situations where assets are required to be reflected at current value any appreciation or impairment to the asset's value is recognized with an offsetting gain or loss transaction. Existing C40B rules/guideline (Stuborn and NEF) reinforced that the developer should not have used this inflated land valuation.

b. Why disallow $50 million as related expenses. Aware that construction/site preparation/etc. was done by independent companies?

Again, I believe this issue was discussed during our most recent phone call. The Regulatory Agreement called for the exclusion of all related party transactions and not just the exclusion of development fees. Further as indicated by the developer through the cost certification process; affiliates of the developer provided development and construction services including land development, general contracting, architectural design and engineering. All these transactions that were incurred by these related entities (either directly or indirectly) were excluded based on the language in the Regulatory Agreement that addressed all related party transactions.

c. How does Inspector General calculate $818,527 in accrued expenses?

As was also discussed during our phone conversation, this figure was derived from the information provided by your client. We selected 6 general ledger accounts for testing. These accounts as reflected in the McGladrey audit work-papers contained significant accruals. We requested that your client provide all expenditures made against these accruals since November 30, 2007. Based on the information provided by your client we arrived at the $818,527 in accrued expenses that had no subsequent disbursement. Our understanding was that if your client had an issue with these determinations they would provide a full analysis of all accrued expenses and back-up supporting all subsequent payments made against these accruals. Nothing has been provided.

d. Aware that Hilltop spent most of those accrued funds?

See response above – Have not seen any additional details from your client.

The Guidelines Accounting

a. For land cost, why not use appraised value of $3.1 million?

The Chapter 40B guidelines (LIP/Stuborn) provide that land must be valued at the lower of the last arms length transaction or value under pre existing zoning. For purposes of our report we accepted the $900,000 that was actually paid for the land as the value to be used for profit determination. We also acknowledge that there was other data available that this land value of $900,000 may have been higher than the as-is value appraised value under existing zoning. The NEF guidelines also do not support an increase in land value above what was actually paid for the land as this would represent a fee or profit to the developer.

b. If construction/etc. was done by related parties, then isn't Hilltop entitled to 14% Builder's Profit/Builder's Overhead/General Requirements?

In line with this guideline we accepted as allowable development costs the overhead costs reflected in the general ledger including the various salary related and office related expenses attributed to the related entities.

Response of Hilltop LLC to Draft Report of Inspector General Provided on July 22, 2011

Executive Summary

The Inspector General's Draft Report on the Hilltop Farms Cost Certification is incorrect on many points, but its two most glaring and significant inaccuracies account for nearly $60 million of certified costs that were disallowed in the Inspector General's investigation. The majority of these inaccuracies stem from the fact that the Inspector General did not correctly apply the requirements of the Regulatory Agreement as required by Massachusetts law.

First, the Inspector General makes a $6.9 million error regarding the land value. The Regulatory Agreement that governed this development (negotiated by the Town of Grafton and the developer, which laid out the rules for the development and its accounting) said that the land value shown in the Cost Certification should be the value "supported by the subsidizing entity's appraisal on which the construction loan is based." It is undisputed that this value was $7.8 million. The Inspector General would instead use a $900,000 figure that he says is required by state-wide Guidelines that now govern Chapter 40B developments, but those Guidelines weren't adopted until years after the Town and the developer negotiated their Regulatory Agreement, the Town approved the development, the developer obtained financing, and the development was well underway. Even if the $900,000 were required by the Guidelines (which it is not), the Guidelines, by law, cannot override the agreed-upon Regulatory Agreement.

Second, the Inspector General mischaracterizes and disallows most of the expenses of building the Hilltop development – nearly $50 million – as "related party expenses" due to his misinterpretation of the language in the Regulatory Agreement. In fact, those funds were paid to unrelated independent companies, who did the site preparation and construction work for market prices through arms-length transactions. These costs are allowed under the Regulatory Agreement.

The Inspector General also claims that Hilltop, the independent Certified Public Accounting firm that prepared the Cost Certification, and the second independent Certified Public Accounting firm that reviewed the Cost Certification, should not have followed the rules set out in the Regulatory Agreement approved by the Grafton Zoning Board of Appeals. The Inspector General's assertion that the Cost Certification should comply with later-adopted Guidelines is simply wrong. In fact, Massachusetts law required that the Regulatory Agreement be followed, although the Inspector General did not mention this law in his draft report. But, in any event, even if another cost certification were done following the later-adopted Guidelines, that cost certification would show a Hilltop profit well under the 20% maximum profits limit and would not result in the any "excess profits" asserted by the Inspector General.

For each of these reasons and others, explained in more detail in the following comments, the Inspector General's draft report on the Hilltop Farms, LLC Cost Certification is incorrect because it does not follow Massachusetts law.

Discussion

The Inspector General's review of the Cost Certification of Hilltop Farms LLC contains two overarching errors, as well as a series of factual mistakes.

The first basic problem is that the Inspector General has done exactly what he wrongly accuses Hilltop of doing: his Draft Report was not "prepared using a consistent methodology." *See* Draft Report at 13. In fact, Hilltop did follow a consistent methodology – the methodology required by law. In contrast, the Inspector General prepared two alternative versions of Hilltop's Cost Certification, each "based on the use of conflicting and contradictory standards." *Id.* at 19. And, to make matters worse, the Inspector General based many of his "adjustments" to Hilltop's numbers on mistakes about the facts, including most notably a $50 million error in categorizing legitimate third party expenses as "related party costs."

The second major error is the Inspector General's decision to altogether ignore the relevant law. The Inspector General's central position is that the independent Certified Public Accountant firm hired by Hilltop and the monitoring agent's independent Certified Public Accounting firm that reviewed the Cost Certification should have followed Chapter 40B Guidelines that did not exist when Hilltop won approval and obtained financing for its development. If Hilltop had done that, it would have violated the law. However, even if the Inspector General's resort to those Guidelines had been legally correct, his conclusion is still wrong, because a properly done cost certification following those Guidelines would merely have confirmed that Hilltop earned a profit of 15%, still less than the 20% allowed, and therefore owes no "excess" profits to the Town of Grafton.

I. The Inspector General Does Not Question the Accuracy of Hilltop's Accounting of Its Sales Proceeds, or of the Expenses It Incurred.

Before reviewing the Inspector General's errors, Hilltop will point to one area of agreement between Hilltop and the Inspector General. The Inspector General's Draft Report about Hilltop's Cost Certification accepts Hilltop's reported sales proceeds figures, and the overwhelming majority of its reported expenses, as accurate. Rather than questioning the numbers, the Inspector General quarrels with how Hilltop's independent Certified Public Accountants used those numbers in the Cost Certification. The Inspector General's general agreement with Hilltop's figures for its sales proceeds, and for its costs incurred, has the salutary effect of focusing the disagreement on issues of law, not issues of accounting.

In light of the Inspector General's agreement with Hilltop's reports of its proceeds and expenses, Hilltop will focus on the areas in which it and the Inspector General disagree, namely the Massachusetts law that goes unmentioned in the Draft Report and the Inspector General's mischaracterization of certain undisputed Hilltop expenses.

II. If Hilltop Followed the Guidelines Rather Than the Regulatory Agreement, as the Inspector General Suggests, Hilltop Would Have Broken the Law.

At the time Hilltop obtained the two necessary approvals of its project – from a subsidizing entity under a federal housing subsidy program, and from the Grafton Zoning Board of Appeals – there existed no Guidelines for Hilltop to follow in calculating its profits. So Hilltop did what was common practice in that pre-Guidelines era: it negotiated with the experienced lawyer representing

the Grafton Zoning Board about what the rules should be, and incorporated those rules into a Regulatory Agreement signed by the federal program's subsidizing entity and approved by the Grafton Zoning Board. When Guidelines were later adopted, their rules varied in some respects from the negotiated rules in the Regulatory Agreement, most notably on the issue of how to value the land in calculating profits. From those differences spring the Inspector General's unhappiness.

In preparing the Cost Certification, Hilltop's independent Certified Public Accounting firm made clear that, whenever the agreed-upon Regulatory Agreement established a rule, it followed that rule. *See* McGladrey & Pullen Cost Certification dated February 11, 2008 ("McGladrey Cost Certification") at Note 1 ("The Regulatory Agreement requires that any profit from the sale of the residential units shall not exceed 20% . . ."); *id.* ("As required by the Regulatory Agreement, the accompanying schedules reflect total development costs of all 256 units and gross sales revenue . . . "); *id.* ("Land cost has been recorded at its appraised value in accordance with the Regulatory Agreement"); *id.* at Note 4 ("In accordance with the Regulatory Agreement, the owner is entitled to be reimbursed for administrative and overhead expenses . . ."). In reviewing the McGladrey Cost Certification, the independent Certified Public Accountant retained by the monitoring agent, Daniel Dennis & Company, similarly followed any requirements set out in the Regulatory Agreement. *See, e.g.*, Daniel Dennis & Company Accountants' Agreed Upon Procedures Report dated July 2008 ("Dennis Report") at 5 ("The allowable acquisition value of a site as specified in the Regulatory Agreement is defined as . . ."); *id.* at 6 ("The Regulatory Agreement applicable to this Project limits the amount of developer overhead claimed to 4% of the total development costs . . .").

Both McGladrey and Dennis also referred to later-issued Chapter 40B Guidelines, but *not* because those Guidelines applied to the Hilltop Cost Certification. To the contrary, as the Dennis Report pointed out, "These guidelines [are] not considered authoritative as they were not in existence at the time of approval of the Project." *Id.* Therefore, in areas where the governing Regulatory Agreement was silent, the two independent Certified Public Accountants referred to the Guidelines only as indicators of the reasonableness of costs charged to the Project. *See id.*

The Inspector General says that the collective decision of Hilltop and two independent Certified Public Accounting firms to follow the negotiated rules of the Regulatory Agreement was "outrageous and misguided." Draft Report at 8. It was not. In fact, that course of action was required by law.

The legal analysis is straightforward, and can be stated in three sentences. Massachusetts law states that developers that obtained a determination of project eligibility after July 22, 2002 must follow the Guidelines in preparing their cost certifications. Hilltop obtained its determination of project eligibility well before that date. Therefore Hilltop must follow its Regulatory Agreement, negotiated with and approved by the Grafton Zoning Board of Appeals, in preparing its Cost Certification.

But for its key omission of any mention of the governing law, the Inspector General's Draft Report supports this conclusion. As the Inspector General states in the Draft Report, Hilltop obtained its subsidy financing from Salem Five Cents Savings Bank ("Salem Five") through the New England Fund subsidy program ("NEF") of the Federal Home Loan Bank of Boston. *Id.* at 1. As the Inspector General further states, Salem Five "issued a Project Eligibility/Site Approval Letter for the project in August 2001." *Id.*

The Inspector General also accurately describes what happened next: "By 2002 the DHCD [Massachusetts Department of Housing and Community Development] recognized that unlike conventional housing subsidy programs in which a state or federal agency administers and approves every aspect of the financing, design, and construction, the Federal Home Loan Bank of Boston did not impose such oversight over the NEF." *Id.* at 6. As a result, the Inspector General points out, "[T]he DHCD on February 14, 2003 issued the Guidelines for Housing Programs in Which Funding is Provided Through a Non-Governmental Entity (the 'NEF Guidelines')." *Id.* at 7.

What the Inspector General fails to mention is that Massachusetts state law divides Chapter 40B projects into those that must follow the Guidelines, and those that are to be governed by their regulatory agreements. On December 20, 2002, more than a year after Hilltop obtained its project eligibility determination, DHCD adopted new regulations that said that projects obtaining subsidy funding from a non-governmental source would now obtain determinations of project eligibility from a public or quasi-public agency rather than a Federal Home Loan Bank member bank, and that projects obtaining such public and quasi-public agency project eligibility determinations would be governed by guidelines to be issued later by DHCD. 760 CMR 30.01(2)(g)(2002). DHCD's 2002 regulations went on to specify, by date of project eligibility determination, which projects would be governed by the Guidelines: "all applications for comprehensive permits that receive determinations of Project Eligibility (Site Approval) dated after July 22, 2002." 760 CMR 31.10 (2002). As the Inspector General concedes in the timeline in his Draft Report, Hilltop's determination of project eligibility was issued more than a year before this date: "August 13, 2001 -- Project Eligibility Letter Issued." Draft Report at 3.

DHCD's adoption of these regulations is missing from the timeline in the Inspector General's Draft Report. *See id.* In fact, the Inspector General's Draft Report nowhere mentions these DHCD regulations, even though they are the governing law.

Instead, the Inspector General contends that Hilltop and the two independent Certified Public Accounting firms were required to apply the 2003 NEF Guidelines because "actual construction of this project began well over a year after the NEF Guidelines were published." *Id.* at 15. Then, contradicting himself, the Inspector General says that Hilltop and the two independent Certified Public Accounting firms also should have followed other "MHP Guidelines" adopted even later, in November 2005, *see, e.g., id.* at 9; *id.* at Schedule 2 note 3, even though these MHP Guidelines did not exist when "actual construction of this project began" in 2004. *See* Draft Report at 1 ("during the four year (2004-2007) period of construction..."). The Inspector General's position is not only internally inconsistent, but simply wrong. Massachusetts law states that the date that matters is the date on which the project received its determination of project eligibility, not when "actual construction of this project began."

Because the Guidelines do not apply to projects such as Hilltop's which received their determinations of project eligibility before July 22, 2002, the rules about profit limitation and calculation must come from another source. The Inspector General actually identifies that source. His Draft Report describes a 1999 decision (the *Stuborn* decision) by an agency within DHCD, the Housing Appeals Committee, which ruled that a project funded through the NEF program of the Federal Home Loan Bank would be eligible for a comprehensive permit if the developer "would be executing a Regulatory Agreement that would limit the developer's profits to 20%." *Id.* at 6. In such cases, the Inspector General points out, "[T]his profit limitation was enforceable by means of a regulatory agreement that would be executed prior to construction." *Id.* In short, if a project's date

of determination of project eligibility made the Guidelines inapplicable, the Regulatory Agreement governs.

III. The Inspector General's "Adjustments" to the Cost Certification Under the Regulatory Agreement Are Incorrect.

Even while insisting, contrary to Massachusetts law, that Hilltop and the two independent Certified Public Accounting firms should have ignored the Regulatory Agreement, the Inspector General prepared his own version of an accounting following that Regulatory Agreement. *See* Proposed Adjustments to Comply with Regulatory Agreement, Schedule 2 to Draft Report. In that accounting, the Inspector General reaches the unjustified conclusion that Hilltop invested years of effort, and more than $60 million, to earn profits that would go almost entirely to the Town of Grafton. The Inspector General arrives at this conclusion by creating an accounting that does everything *but* follow the requirements of the Regulatory Agreement.

1. Administrative and Overhead Expenses

Consider first the administrative and overhead cost item. As the Inspector General concedes, the Regulatory Agreement allowed such costs, up to a cap of 4% of total development costs. Draft Report at 8. In preparing the Cost Certification, Hilltop's independent Certified Public Accountant determined administrative and overhead costs were $3,494,972, which exceeded 4% of the total development costs. McGladrey Cost Certification at Note 4. Therefore, as required by the Regulatory Agreement, the independent Certified Public Accountant disallowed nearly $1,000,000 of these expenses, counting as overhead and administrative costs only $2,540,603, or 4% of the total development costs. *Id.* The independent Certified Public Accountant for the monitoring agent arrived at the same $2,540,603 administrative and overhead cost, also by applying the 4% limitation in the Regulatory Agreement. Dennis Report at 6.

In his Schedule 2, in which he says he is following the Regulatory Agreement rather than the Guidelines, the Inspector General nearly eliminates the $2,540,603 administrative and overhead cost altogether, disallowing $2,197,603. He does this not because the two independent Certified Public Accounting firms misread the Regulatory Agreement, or miscalculated the 4% figure. His decision to disallow nearly $2.2 million in costs, he explains in a footnote, is "[t]o reduce developer's administrative & overhead expenses to comply with limits reflected in the MHP Guidelines." Schedule 2 to Draft Report at Note 3. In other words, while purporting to adjust the cost certification "to comply with the Regulatory Agreement," *see* title of Schedule 2 of Draft Report, the Inspector General is ignoring the Regulatory Agreement and instead following the MHP Guidelines.

2. Land Value

With regard to another substantial cost item, land, the Inspector General does the same thing, but in a less direct and open fashion. On this subject, the Regulatory Agreement said the following: "Acceptable development costs include, but are not limited to, the cost of site acquisition, defined as that land value which can be underwritten by the Project and which can be supported by the subsidizing entity's appraisal on which the construction loan is based." Draft Report at 11. It is undisputed that this land value – a post-permit land value -- is $7.8 million, the value placed on the land by the independent appraiser retained by the subsidizing entity, Salem Five, on which Salem Five based its construction loan. *Id.* at 12. So, in accordance with the Regulatory Agreement, Hilltop's independent Certified Public Accountants used this appraisal to value the land at $7.8

million. McGladrey Cost Certification at Note 1 ("Land cost has been recorded at its appraised value in accordance with the Regulatory Agreement"). The independent Certified Public Accounting firm retained by the monitoring agent agreed with this number. Dennis Report at 5-6 (quoting the Regulatory Agreement, and stating that "as a result, ... we determined that fair value of the land recorded in the *Cost Certification* was $7,800,000, which agreed with the value in the real estate appraisal report ... performed by a certified appraiser").

The Inspector General contends that the independent Certified Public Accounting firms instead should have used a $900,000 pre-permit number that, in his view, would have been required by the later-adopted Guidelines. Draft Report at 20. (As will be shown below, the Inspector General is incorrect in asserting that $900,000 is the required figure even under the Guidelines.) The Inspector General even goes so far as to suggest that, in using the land value required under the Regulatory Agreement approved by the Town of Grafton, Hilltop and the two independent Certified Public Accounting firms took an "abusive position." *Id.* at 15.

In so saying, the Inspector General reverses his own public positions directly to the contrary. For example, in a 2007 letter to the Chairs of the Massachusetts Senate and House Committees on Housing, the Inspector General stated, "Any issues pertaining to land value differences should be decided at the beginning of the process, not the end," Letter from Inspector General Gregory W. Sullivan to the Honorable Susan Tucker and the Honorable Kevin Honan dated Oct. 23, 2007 at 3 -- and the mechanism for agreeing on how to handle such issues at the beginning of the process rather than the end, the Inspector General said in the same letter, was the regulatory agreement: "The regulatory agreement executed by the developer and the subsidizing agency outlines the developer's responsibilities. The regulatory agreement will detail key elements or responsibilities for the project." *Id.* at 1-2. The Inspector General has gone even further, stating in 2006 that he had been told that "many regulatory agreements governing NEF-financed projects during the time period of 2000-2003 require the use of 'post permit' land value," and that if he ever reviewed the cost certification for such a project, "this Office would not take exception to this methodology," so long as the "municipality has freely and knowingly entered into such an understanding as a signatory to the regulatory agreements." Letter from Inspector General Gregory W. Sullivan to Aaron Gornstein, Executive Director of CHAPA, dated Dec. 6, 2006 at 3.

Hilltop is one of those NEF-financed projects that received its determination of project eligibility during the time period of 2000-2003 (that is, before the Guidelines had been issued), whose regulatory agreement, negotiated with and approved by the Town "at the beginning of the process, not the end", "require[d] the use of 'post-permit' land value." Yet not only does the Inspector General reverse himself by "taking exception to this methodology," he now calls it "abusive."

Notwithstanding the Inspector General's flip-flop, in Schedule 2 to the Draft Report, which is his version of a cost certification based on the Regulatory Agreement, the Inspector General does allow as an expense the $7.8 million land cost figure required by the Regulatory Agreement. But then, contrary to the Regulatory Agreement, he invents a way to offset all but $900,000 of that cost. The Inspector General's tactic is to arbitrarily add $6.9 million to the "Sales" side of the equation, not because this figure was the product of unreported sales, but instead because it was a so-called "Unrealized Gain on Land."

The effect of this so-called "Unrealized Gain" of $6.9 million is to reduce the actual land value from $7.8 million to $900,000 -- the very figure that the Inspector General says is required

under the Guidelines. But in Schedule 2, the Inspector General purports to be following the Regulatory Agreement, not the Guidelines. The Regulatory Agreement does not mention anything about recognizing any so-called "Unrealized Gain"; it says that the sales side of the equation shall consist of the "certified income," that is, the proceeds of actual sales of homes. (In fact, the concept of "Unrealized Gain on Land" appears nowhere in the Guidelines either.) It is no surprise, therefore, that this Inspector General invention is unjustified -- indeed, not even discussed -- in the Draft Report itself.

3. Related Party Transactions

The Inspector General's inventiveness in preparing his version of a Regulatory Agreement cost certification does not end there. The Regulatory Agreement says that profits "shall not exceed twenty percent (20%) of certified development cost, net of related party transactions of the project." Draft Report at 9. That provision was intended to prevent Hilltop from hiring its affiliates to do work on the project and paying those affiliates inflated amounts which exceed what that work would have cost in an arms-length transaction, thereby driving up the expenses of the project and reducing the reported profits. But the Inspector General re-interprets this language, using it to entirely disallow as costs "any event or condition that Hilltop Farms, LLC recorded which involved a payment by or to an entity related to Hilltop Farms, LLC." Draft Report at 9. Then, in Schedule 2, where he purportedly makes adjustments to the Cost Certification required by the Regulatory Agreement, the Inspector General disallows, as "Related Party Transactions," \$49,752,656 of the total project costs of \$63,039,558. A footnote to Schedule 2 explains that the Inspector General is disallowing every penny of the \$38 million cost of construction; nearly 90% of the \$11 million cost of site preparation; and several other smaller but still substantial items of cost.

In fact, the Inspector General has his facts wrong; independent companies, unrelated to Hilltop or its affiliates, constructed the Development, performed the site preparation, and carried out other tasks which the Inspector General has wrongly labeled as "Related Party Transactions." Work done by outside companies, at market prices through arms-length transactions, simply does not qualify as "related party transactions." These costs are allowed under the Regulatory Agreement.

4. Accruals

In his other adjustments to the Cost Certification under the Regulatory Agreement, the Inspector General does get one thing right – at least in theory, even if his numbers are wrong. In calculating the expenses of the Hilltop development, both independent Certified Public Accounting firms included accruals for additional expenses that Hilltop then reasonably expected to spend in the future, which is in full compliance with generally accepted accounting principles. The Inspector General disallowed \$818, 527 of such expenses. *Id.* at 19. He does not quite say that Hilltop did not expend those funds after the date of the Cost Certification; instead, because Hilltop could not quickly and easily produce the proof he demanded at the level of individual vendors and dollar amounts, the Inspector General assumed that all of the accrual expenses "had no subsequent cash payment/disbursement." Schedule 2 to Draft Report at Note 2. In fact, however, Hilltop Farms did spend a good deal, but not all, of those funds. If the Cost Certification were redone now, with the benefit of hindsight Hilltop would reduce that expense. The result, however, would change the profit percentage very little, moving it slightly above 15% -- in other words, far from the 20% range of "excess profits." Indeed, even if the Inspector General were correct that Hilltop did not spend one penny of those accrued expenses, its profit would still have been well below 20%.

Two reputable independent Certified Public Accounting firms independently decided that Hilltop's profit on the Hilltop Farms project, computed following the rules set out in the Regulatory Agreement, was a little less than 15%. The Inspector General's conclusion in Schedule 2 to the contrary, that Hilltop made a 148% profit (a profit of $19,776,057 on project costs of $13,286,902), and must turn nearly all of that profit over to the Town of Grafton, is entirely unsupportable.

IV. Even if the Cost Certification Followed the Guidelines, Hilltop Earned No Excess Profits

It is not clear why the Inspector General even prepared his wildly inaccurate version of a Regulatory Agreement cost certification, given his insistence that "the Regulatory Agreement is not the proper tool to determine Hilltop Farms, LLC's excess profits." Draft Report at 21. Instead, the Inspector General asserts, Hilltop and the two independent Certified Public Accounting firms should have "used the Chapter 40B compliance standards in place at the time the project was constructed: the *Stuborn* decision and the NEF Guidelines." *Id.* at 19. If that is the Inspector General's position, he himself is unfaithful to it, because in several instances he also applies not just "the NEF Guidelines" adopted in 2003, before Hilltop began construction, but the MHP Guidelines adopted afterwards in 2005. So, in the analysis that follows, Hilltop will apply both sets of Guidelines, as the Inspector General did.

In his version of a Guidelines-based cost certification, the Inspector General says he is making four adjustments to Hilltop's Cost Certification. *Id.* In fact, one of those adjustments, an $84,974 increase in sales revenue, is already contained in the Hilltop Cost Certification, having been made by Hilltop's own independent Certified Public Accountants and substantially confirmed by the monitoring agent's independent Certified Public Accountants. *See* McGladrey Cost Certification at 5; Dennis Report at 10. So the Inspector General actually suggests only three adjustments.

1. <u>Administrative and Overhead Expense</u>

As to one adjustment, a reduction of developer administrative and overhead expenses of $2,197,603, the Inspector General is correct. The MHP Guidelines (adopted in 2005, well after Hilltop's construction was underway) are much more conservative about this category of expense than was the Regulatory Agreement. So, if the MHP Guidelines did govern this Cost Certification -- which, of course, they do not -- then that item of expense should be reduced.

2. <u>Accruals</u>

As to another item, the Inspector General's treatment of accruals, the Inspector General is only partially correct. The Inspector General asserts that the Cost Certification showed an accrual for future expenses totaling $818,527. *Id.* His numbers are a little off, but for purposes of this response, Hilltop will accept them. As described above, the Inspector General would disallow this entire amount of expense, because he could find no proof of subsequent expenditure of any of these accrued dollars. *Id.* In fact, Hilltop did spend most of these funds, but Hilltop will assume, for purposes of argument, that the Inspector General is correct, and that the entire $818,527 expense should be disallowed.

3. Land Value

As to the final, and largest, Inspector General adjustment, concerning land cost, the Inspector General is again only partially correct. The Inspector General would reduce the land cost from the $7.8 million appraised value figure required by the Regulatory Agreement to $900,000, the amount of Hilltop's actual expenditure. *Id.* at 12. The Inspector General is correct that the Guidelines would not allow the use of a post-comprehensive permit appraised value. But the Inspector General's substitute number is inaccurate, and in fact far too low, under the very Guidelines that he purports to be following.

The Inspector General contends that the NEF Guidelines "limited the land value to the lower of the actual cost or the as-is appraised value without a Comprehensive Permit." *Id.* at 5. He is wrong. The NEF Guidelines actually state, "For purposes of calculating total development costs and profit, an independent appraisal is required to determine the allowable acquisition cost. Allowable acquisition cost shall not be unreasonably greater than the current appraised fair market value under existing zoning without a comprehensive permit in place." NEF Guidelines at 13. The MHP Guidelines updated that concept without changing its substance, providing, "The allowable acquisition value of a site for purposes of Chapter 40B is the fair market value of the site excluding any value relating to the possible issuance of a comprehensive permit (the As-Is Market Value)," MHP Guidelines at 13, to be determined by appraisal under the "uniform, appraisal-based Land Acquisition Value Policy." *Id.*

At the time Hilltop submitted its request for its determination of project eligibility -- the relevant date, according to the Guidelines, *see id.* -- Hilltop's land was worth $3.1 million under existing zoning without a comprehensive permit in place. Hilltop established that value by commissioning an independent appraiser to perform an appraisal. Hilltop provided that appraisal to the Inspector General. In ignoring it, the Inspector General is failing to follow the Guidelines that he insists that Hilltop should have followed.

4. Builder's Profit, Builder's Overhead, and General Requirements

Finally, while professing adherence to the Guidelines in making these three downward adjustments in Hilltop's costs (resulting in upward adjustments to its profits), the Inspector General ignored the Guidelines when they would have allowed Hilltop to claim additional expenses unauthorized under the Regulatory Agreement (which would have resulted in downward adjustments to its profits). It is ironic that the Inspector General therefore engages in precisely the behavior of which he wrongly accuses Hilltop and the two independent Certified Public Accounting firms -- the Inspector General's "methodology followed was a hybrid that proved to be the most advantageous" to the Inspector General's position. Draft Report at 5.

One very substantial example will suffice. In his version of a Cost Certification under the Regulatory Agreement, the Inspector General disallows nearly $50 million of Hilltop's costs because, he says, all construction, most land development, and various other services, were performed by entities related to Hilltop. Draft Report, Schedule 2, Note 5. If that were so, the Guidelines would allow Hilltop to claim expenses for Builder's Profit, Builder's Overhead, and General Requirements, up to a total cap of 14% of construction costs. MHP Guidelines at 15. Yet the Inspector General fails to give Hilltop credit for this multi-million dollar item of expense in his Guidelines-based version of a Cost Certification, undoubtedly because it would dramatically reduce Hilltop's profits had he followed the Guidelines in their entirety.

Ultimately, of course, the fact that the Inspector General appears to have picked and chosen which Guidelines to apply, and misinterpreting even the ones he does apply, is irrelevant. Massachusetts law prohibited Hilltop from following the Guidelines. But even if the Guidelines had applied, a cost certification that followed the Guidelines in full, rather than only when convenient, would have shown that Hilltop's profits still did not exceed 20%. Thus, under a Guidelines analysis as well, Hilltop did not earn any "excess profits."

V. Conclusion

The Inspector General's draft report is full of errors. In preparing the Cost Certification, Hilltop and the two independent Certified Public Accounting firms followed the Regulatory Agreement Hilltop negotiated with experienced counsel for the Town of Grafton, as they were required to do by Massachusetts law which the Inspector General fails to mention. The conclusions of the independent Certified Public Accounting firms that Hilltop's profit did not exceed 20% were accurate.

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This Office's Response to Pulte's Concerns re Draft Report

In its response to this Office's draft report, Pulte indicated disagreement with this Office's findings. Pulte, in addition to identifying differences of opinion with respect to the guidance sources that governed Chapter 40B development projects during this time period, also highlighted concerns regarding the application and interpretation of accounting methodologies and practices followed by this Office in determining the excess profits for the development.

Our response below details the methods we used to review the limited dividend requirements for the Hilltop Farms development. Included is a summary table by Cost Certification account category that details the adjustments made to the Cost Certification by this Office and the basis for making these adjustments. The summary table provides two views; one is based on conformance with the Housing Appeals Committee case law and applicable Chapter 40B rules and the other view is based on adherence to the language of the Regulatory Agreement.

Overall, we conclude that Pulte utilized a Regulatory Agreement that was inconsistent with existing Chapter 40B case law and applicable Chapter 40B rules. In addition, Pulte inconsistently applied the terms of the Regulatory Agreement. These inconsistencies allowed Pulte to claim inflated and unwarranted development costs that had the intended consequence of shifting excess profits from the town of Grafton to Pulte. This developer abuse of the Chapter 40B limited dividend requirement adversely impacted Grafton's affordable housing development efforts as Pulte withheld approximately $8.5 million in excess profits that should have been targeted for additional local affordable housing opportunities in the town.

Guidance on Land Valuation

Stuborn and LIP Exist as Guidance at the Time Pulte Negotiates the Regulatory Agreement

In 1990, the Legislature established the Local Initiative Program (LIP) as a means to stimulate the production of affordable housing opportunities. The DHCD published guidelines for the LIP that provided guidance for land valuation methodologies. In 1999, DHCD's Housing Appeals Committee (HAC) decided *Stuborn Ltd. Partnership v. Barnstable Board of Appeals* (*Stuborn*) (Case #98-01). *Stuborn* set out the applicable rules and guidance related to the profit limitations and calculation for an NEF financed Chapter 40B development project. The *Stuborn* decision and LIP Guidelines were in effect when the developer entered into the contractual purchase and sales agreement (August 3, 2000) for the development site and were also in effect when the Hilltop Farms development obtained both its Site Eligibility Letter and its Comprehensive Permit. *Stuborn* and LIP were the sources of guidance at the time Pulte negotiated its Regulatory Agreement for the Hilltop Farms development.

Pulte selectively applied the HAC's findings from the *Stuborn* decision. Pulte indicated that it has fully complied with *Stuborn's* limited dividend organization requirement through the singular act of signing a Regulatory Agreement that stipulates a profit limitation for the development at 20% of total development costs. However, *Stuborn*, in addition to requiring the execution of a Regulatory Agreement that limits a developer's profits to 20% of total development costs, also provides that methods to determine a project's

profit limitation be consistent with that of other affordable housing programs that meet the requirements of Chapter 40B. *Stuborn* specifically references DHCD's LIP. Pulte did not adhere to this *Stuborn* tenet.

The Regulatory Agreement for the Hilltop Farms development included language advocated by Pulte that redefined site acquisition costs and acceptable development costs to include an appraised land value that was later determined to be $6.9 million more than was actually paid for the site. This creative redefinition and transformation of profit into expense is abusive and does not comply with *Stuborn's* requirement that the profit calculation be consistent with other affordable housing programs such as DHCD's LIP program.

The LIP program limits the land value to the lower of (a) the last arm's-length transaction or (b) the value under pre-existing zoning. Based on *Stuborn* the maximum land acquisition value that could reasonably be claimed as a development cost for the Hilltop Farms development is $900,000 (the price actually paid for the site by the developer) and not the inflated $7,800,000 claimed by the developer through the Cost Certification process. The methodology followed by Pulte allowed it to shield up to $8,280,000 ($6,900,000 x 1.2) of excess profits. This is contrary to existing guidance and the public policy goal of limiting a developer's dividends to 20% of the total project cost.

This Office has relied on *Stuborn* and the associated LIP Guidelines as the authoritative source for guidance in determining the appropriate adjustments to land value for the determination of the development's profit limitations.

Pulte Abandons Normal Accounting Practices in Favor of Self-Serving Interests

Moreover, contrary to *Stuborn*, Pulte's land valuation calculation did not adhere to reasonable accounting standards. Contrary to all basic accounting standards and generally accepted accounting principles, Pulte established the inflated land valuation through an illicit one-sided accounting entry.

Besides accounting rules that call for a two sided entry (double-entry accounting) another tenet of the *Stuborn* decision states that development costs and revenues be compiled on a federal income tax basis. This further supports that it would be reasonable to expect that an increase to the land's value should be accounted for through an increase in its basis that from an accounting perspective would require an associated transaction to recognize the gain associated with this asset revaluation.

In its response to our draft report, Pulte suggests that this Office, "invented" a way to offset all but $900,000 of the land value. The advent of the double-entry accounting principle was codified in the 15th century by Luca Pacioli. Double-entry accounting is a basic and fundamental rule of accounting. Each accounting transaction requires at least two accounts. This system was established to assist in the prevention of errors and fraudulent transactions in the financial records of commercial and governmental enterprises.

Use of the double-entry accounting principle to record the land at the appraised value (as per the Regulatory Agreement for the Hilltop Farms development), shields up to $1,380,000 in excess profits from the town of Grafton. However, this $1,380,000 pales when compared with the $8,280,000 profit shift Pulte has attempted to attain through its one-sided accounting entry.

In summary, Pulte's use of an inflated land value as a development cost that was nine times greater than what was actually paid is at odds with commonly accepted accounting principles and with the existing

Chapter 40B rules and guidelines including the *Stuborn* decision and the companion LIP Guidelines. Pulte's methodology is also at odds with the spirit of the Chapter 40B legislation. There is no statutory, regulatory or program guidance to support Pulte's land valuation methods. Pulte's methodology is nothing more than an attempt by Pulte to pad expenses by redefining profit or fee as a project expense and thus reduce the potential for any development profit that would be owed to the town of Grafton under the limited dividend requirement.

Guidance on Related Party Transactions

It is the opinion of this Office that the NEF Guidelines and the Massachusetts Housing Partnership ("MHP") Guidelines are applicable to certain aspects of the development activities for the Hilltop Farms development – specifically those phases of the project where financial commitments occurred after the publication of the guidelines. Highlighted below are several reasons that support this Office's determination that the profit margin for the Hilltop Farms development was inaccurately and inappropriately calculated.

- Pulte executed the Regulatory Agreement with the subsidizing bank approximately 16 months after the NEF Guidelines were published;
- Pulte, in its February 11, 2008 Representation Letter to its auditor (McGladrey), acknowledged its responsibility for the fair presentation of the financial results of the project in conformity with the NEF Guidelines;
- McGladrey in its audit opinion letter stated that the schedules for the Hilltop Farms development audit were prepared in accordance with the NEF Guidelines. However, the auditor did not ensure compliance of the project to these standards;
- The Regulatory Agreement includes representations that Pulte will not violate or as applicable has not violated any provision of law, rule or regulation, or any order of any court or other agency or governmental body;
- Pulte executed the Monitoring Services Agreement with the Monitoring Agent approximately 13 months after the NEF Guidelines were published;
- The Monitoring Services Agreement references the guidelines of the NEF and the profit limit of 20% of total development costs of the project;
- The NEF Guidelines were published sixteen months before actual construction began on the project;
- MassHousing, in its role as Project Administrator for NEF financed projects, applies new guidelines such as the MHP Guidelines on a prospective basis to those aspects of a project that occur after the effective date of new guidelines; and,
- At the October 28, 2002 hearing in Grafton where the project pro forma budget was reviewed by the Grafton Zoning Board of Appeals, Pulte's representative, in response to concerns raised over expenses reflected in the pro forma testified that *"We will have to comply with NEF's regulations, whatever they are at that time, and we will do that."* Pulte's testimony acknowledges a prospective application of new requirements.

Pulte Flip-Flops to Serve its Financial Interest

Notwithstanding Pulte's February 2008 representation to its auditors that acknowledged its responsibility for the fair presentation of the financial results of the project in conformity with the NEF Guidelines, Pulte has now asserted that the NEF Guidelines should not be considered authoritative as they were not in existence at the time of the project's site eligibility approval. Pulte also contends that Massachusetts state law divides Chapter 40B projects into those that must follow the NEF guidelines and those that are to be governed by their regulatory agreements. Neither of these assertions reflects the case at hand.

The DHCD authorized MassHousing to be the Project Administrator for projects where funding, such as in this case, is provided through a non-governmental entity such as the NEF of the Federal Home Loan Bank of Boston. Contrary to the position advocated by Pulte, MassHousing has applied new guidelines such as the MHP Guidelines on a prospective basis to those aspects of a project that occurred after the effective date of these new guidelines. This is a reasonable approach that recognizes new realities and provides clarity and consistency while not penalizing any of the interested parties on a retroactive basis for those development activities occurring before enactment of the new rules. Pulte's argument is contrary to this practice.

Moreover, this Office disagrees with Pulte's contention that Massachusetts state law divides Chapter 40B projects into those that must follow the Guidelines and those that are to be governed by their regulatory agreements. It is the opinion of this Office that all projects should/would be governed by their regulatory agreements, assuming of course that these regulatory agreements do not violate published rules and guidelines for such projects. The Hilltop Farms Regulatory Agreement is contrary to published rules and guidelines.

Pulte's Practice of Accounting for Related Party Transactions Contradicts Operative NEF &MHP Guidelines

With respect to the exclusions of related party transactions and other aspects of the project that occurred after the issuance of the comprehensive permit and the execution of the Regulatory Agreement, this Office relied on the NEF Guidelines (that were in place at the time the Regulatory Agreement was finalized) and the subsequently issued MHP Guidelines. Reliance on the MHP Guidelines conforms to current practices employed by DHCD's Project Administrator which allow for the prospective implementation of guidelines. Admittedly, this prospective implementation of the MHP Guidelines is beneficial to the developer's interests over those of the municipality, however, this Office believes that this practice is in keeping with the spirit of the Chapter 40B legislation and is more in line with the guidelines and rules of other affordable housing programs.

Pulte's position that the NEF and MHP Guidelines should not be considered as operative guidance with respect to related party transactions is baffling. This is especially bewildering since by following the terms of the Regulatory Agreement as opposed to complying with the NEF and MHP Guidelines, Pulte would owe nearly twice as much in excess profits or approximately $17 million to the town of Grafton.

Pulte's Failure to Properly Disclose and Account for Related Party Transactions

In its response, Pulte maintains that this Office mischaracterized and disallowed most of the expenses of building the Hilltop Farms development – nearly $50 million – "related party expenses;" due to this

Office's misinterpretation of the language in the Regulatory Agreement. The developer claims that this Office categorized legitimate third party expenses as "related party costs." This Office contends that in evaluating the project's limited dividend in accordance with the Regulatory Agreement we were faithful to the language stipulated in the Regulatory Agreement.

However, as repeatedly stated, this Office does not believe that the accounting methodologies advocated through the Regulatory Agreement are valid or justifiable as they grossly conflict with and are in violation with established Chapter 40B laws, rules, and guidelines. This is true for both the inflated land valuation provision inserted in the Regulatory Agreement that provides an unwarranted windfall to Pulte and the provision that excludes related party transactions from development costs which in turn results in a loss to Pulte and an unjustified benefit to the town of Grafton. Neither of these conditions incorporated in the Regulatory Agreement are consistent with terms of other affordable housing programs, such as the LIP, that meet the requirements of Chapter 40B as directed by *Stuborn*.

Although land valuation is addressed specifically through the *Stuborn* decision and the associated LIP Guidelines, there is no comparable guidance in *Stuborn* or in the subsequent NEF Guidelines specifically regarding related party transactions. Rather than exclude all related party transactions from development costs in determining the dividend limitation for the Hilltop Farms project this Office applied the guidance provided through the MHP Guidelines that were published in 2005. We believe this to be a reasonable approach and one that is consistent with other affordable housing programs. This prospective implementation of the MHP Guidelines is consistent with the practices followed by DHCD's current Project Administrator (MassHousing) for other NEF funded projects.

Although this prospective application of the MHP Guidelines is potentially detrimental to financial claims that the town of Grafton may have against Pulte (based on the language of the Regulatory Agreement) this Office believes that this interpretation is in keeping with the spirit of the Chapter 40B legislation and is consistent with other affordable housing programs. Excluding reasonable and bona-fide development costs strictly on the basis that a related party either directly or indirectly incurred the transactional cost would be punitive to Pulte and would allow for an unwarranted shift in profits to the town of Grafton.

As explained in our report, Pulte failed to consistently follow the terms of the Regulatory Agreement and net out the related party transaction costs from the total development costs for the project. The only self-identified related party transactions that Pulte excluded from the Cost Certification were the $202,699 in related party interest. Ironically, Pulte's related party transactions were recorded in its Cost Certification in a manner consistent with the MHP Guidelines and in conflict with the Regulatory Agreement espoused by Pulte as the operative agreement.

Accrued Expenses

Pulte's Response Indicates it is not Comprehending this Office's Basis for Corrections

Although, for purposes of its response, Pulte accepted the $818,527 adjustment made by this Office with respect to the over-accrual of expenses; it is, however, apparent that Pulte is not clear as to the basis for the corrections. Pulte suggests that this Office assumed that all accrued expenses had no subsequent cash payment/disbursement based on Pulte's inability to quickly and easily produce the proof that we requested, which was at the level of individual vendors and dollar amounts. Pulte speculated that it was

because of this shortcoming that this Office disallowed the entire amount of accrued expense. This is not accurate.

Although Pulte did not provide this Office with the requested invoices and cancelled checks to support the subsequent cash disbursements/expenditures made against the accrued expenses, Pulte did provide account listings that summarized the associated accounting transactions including the disbursements/expenditures made against these accruals. The records provided to this Office by Pulte reflect only $56,116 in subsequent cash payments of the total $874,643 in accruals tested.

Based on Pulte's information, this Office concluded that the accrued expenses claimed by Pulte in its Cost Certification were overstated. This Office proposed an adjustment of $818,527 ($874,643 (total accruals in the sample of accounts tested) - $56,116 (subsequent cash disbursements identified by Pulte)) to reduce inflated development costs claimed by Pulte in its Cost Certification for the sample of accounts tested. Also supporting this conclusion is Pulte's response to this Office's draft findings which in part states the following: *"If the Cost Certification were redone now, with the benefit of hindsight Hilltop would reduce that expense."*

Given the results from the limited sample of accounts tested, this Office requested that Pulte provide a schedule representing the universe of all accrued expenses (by vendor/$ amount) reflected in the Cost Certification report along with an identification of all expenditures paid after December 1, 2007 through the present against these accrued balances. Pulte has not provided this information and has instead indicated that this would be unduly burdensome, cumbersome and costly to produce. It is difficult to accept that a sophisticated multi-billion dollar corporation would have trouble easily identifying all its expense accruals and subsequent payments. Based on the test results from our limited sample of accounts and Pulte's hesitancy to provide additional accrual details, this Office is concerned that there may be additional expense padding reflected in Pulte's Cost Certification.

Sales of Housing Units to Related Parties

Pulte in commenting on the draft report suggested that the $84,974 adjustment proposed by this Office for the purpose of increasing sales revenue should be eliminated as this revenue was supposedly already included in the Cost Certification. Pulte purportedly added it through an adjusting entry made by its own independent Certified Public Accountants (McGladrey).

Although McGladrey as part of its audit had added an additional $90,600 to sales revenue for sales of market rate units made to related parties bringing the total sales revenue reflected in the Cost Certification report to $75,830,641, the monitoring agent's (CHAPA) subsequent review of the Cost Certification determined that the related party sales should be increased by an additional $84,974. This adjustment by CHAPA brought the total sales for the project from $75,830,641 to $75,915,615. It is this unrecorded adjustment in the Cost Certification report, identified by the monitoring agent, which this Office has proposed in our report findings as an increase to the project's total sales revenues.

Previous Public Positions Taken by this Office

This Report Remains Consistent with Other Report Positions Taken by this Office

Pulte's response suggested that certain positions in this report depart from positions this Office has taken in its other published reports of M.G.L. c. 40B projects. In support of its position, Pulte selectively cited excerpts from public letters issued by this Office in December 2006 and October 2007. The segments cited were truncated by Pulte rather than presented in their entirety. If presented in their entirety it would be obvious that the Office has not reversed positions.

It is still the opinion of this Office that all potential issues including land valuation should be addressed as early as possible during the process and key elements/responsibilities of a project should be memorialized in a Regulatory Agreement. Implicit in this statement is that the Regulatory Agreement should not violate any existing law, rule, or regulation, or any order of any court or other agency or governmental body. It is also still the position of this Office that municipalities should be signatories to the Regulatory Agreement. This Office's letters cited by Pulte have consistently stated that the land acquisition values reported by Chapter 40B developers in their financial statements should be the fair market value without the benefit of a comprehensive permit.

With respect to the Hilltop Farms development, the town of Grafton was not a signatory to the Regulatory Agreement, and as previously highlighted, the Regulatory Agreement executed between Pulte and the subsidizing bank, violated existing Chapter 40B guidance, in particular the provision in the Regulatory Agreement that called for the land valuation at the post comprehensive permit value.

The developer failed to reference this Office's December 2007 letter regarding a Chapter 40B development in Billerica. This Billerica project was remarkably similar to the Hilltop Farms project. Its Regulatory Agreement contained comparable language that defined acceptable development costs to include: *"… the cost of site acquisition defined as that land value, which can be underwritten by the Project and which can be supported by the subsidizing entity's appraisal upon which the construction loan is based."* Also similar to the Hilltop Farms development, the Site Eligibility approval for this Billerica development preceded the publication of the NEF Guidelines; however, the Regulatory Agreement for the project was executed between the developer and the NEF subsidizing bank after publication of the NEF Guidelines.

In evaluating this Billerica project in 2007 this Office made similar findings/conclusions as we have today with respect to the Hilltop Farms development. With respect to the Billerica project we concluded that: *"The language (in the Regulatory Agreement) especially that which related to land valuation runs counter to the legislative intent of Chapter 40B, current guidance and then existing practices/guidance."* Also, with respect to this Billerica development this Office further concluded that *"It is outrageous that the developer and his attorney would even suggest claiming as an allowable development expense a land cost nearly four (4) times what was actually paid."*

Our findings and conclusions regarding the land valuation for the Hilltop Farms project are similar and consistent with our public position taken in December 2007 with respect to the Billerica development. Probably the only notable difference is that the Billerica developer had attempted to claim a land cost nearly four (4) times or $1.7 million more than what had actually been paid whereas Pulte claimed a cost

nearly nine (9) times or $6.9 million more than what it had actually paid for the Hilltop Farms development site.

SUMMARY – OIG PROPOSED COST CERTIFCATION ADJUSTMENTS

Cost Cert. Account Categories	Chapter 40B Rules	Regulatory Agreement
Land	CC Value: $7,800,000 Adjustment: -$6,900,000 Adj. Value: $900,000 Basis: Stuborn/LIP Guidelines	CC Value: $7,800,000 Adjustment: $0.00 to Land & $6,900,000 to Unrealized Gain – see below Adj. Land Value: $7,800,000 Basis: Double Entry Accounting & Stuborn
Unrealized Gain on Land	CC Value: $0.00 Adjustment: NA Adj. Value: $0.00 Basis Stuborn/Lip Guidelines	CC Value: $0.00 Adjustment: + $6,900,000 Adj. Value: $6,900,000 Basis Double Entry Accounting & Stuborn
Site Prep/Engineering/Legal Real Estate	CC Value: $12,626,200 Adjustment :- $818,527 Adj. Value: $11,807,673 Basis: GAAP - Accruals	CC Value: $12,626,200 Adjustment: - $818,527 Adj. Value: $11,807,673 Basis: GAAP – Accruals
Sales	CC Value: $75,830,641 Adjustment: + $84,974 Adj. Value: $75,915,615 Basis: CHAPA Adjustment	CC Value: $75,830,641 Adjustment: + $84,974 Adj. Value: $75,915,615 Basis: CHAPA Adjustment
Administrative & Overhead	CC Value: $2,540,603 Adjustment: -$2,197,603 Adj. Value: $343,000 Basis: MHP Guidelines	CC Value: $2,540,603 Adjustment: -$2,540,603 Adj. Value: $0.00 Basis: Related Party Transaction
Closing Costs	CC Value: $896,302 Adjustment: NA Adj. Value: $896,302 Basis: MHP Guidelines	CC Value: $896,302 Adjustment: -$159,970 Adj. Value:$736,332 Basis: Related Party Transaction
Brokerage Commissions	CC Value: $1,451,020 Adjustment: NA Adj. Value: $1,451,020 Basis: MHP Guidelines	CC Value: $1,451,020 Adjustment: - $776,265 Adj. Value: $674,755 Basis: Related Party Transaction
Residential Construction	CC Value: $38,633,497 Adjustment: NA Adj. Value: $38,633,497 Basis: MHP Guidelines	CC Value: $38,633,497 Adjustment: -$38,633,497 Adj. Value: $0.00 Basis: Related Party Transaction
Site Preparation	CC Adj. Value: $10,455,148 Adjustment: NA Adj. Value: $10,455,148 Basis: MHP Guidelines	CC Adj. Value: $10,455,148 Adjustment: -$9,539,924 Adj. Value: $915,224 Basis: Related Party Transaction
Engineering	CC Adj. Value: $992,058 Adjustment: NA Adj. Value: $992,058 Basis: MHP Guidelines	CC Adj. Value: $992,058 Adjustment: -$300,000 Adj. Value: $692,058 Basis: Related Party Transaction