To:        Ken Wade, Eileen Fitzgerald, Jeffrey Bryson and Michael Foster

From:    Frederick Udochi

cc:        Michael Butchko, Robert Burns, Ron Johnston, Mia Bowman

Date:    December 23, 2008

Subject:  Audit Review: Network Disaffiliations Process

Within the context of the Internal Audit Plan for Fiscal Year 2008, please find below an Internal Audit report pertinent to the Corporation’s Network Disaffiliations process. Please review and let me know if you have any comments or questions. Thank you.
Executive Summary

Audit Review of Network Disaffiliations Process

<table>
<thead>
<tr>
<th>Business Function and Responsibility</th>
<th>Report Date</th>
<th>Period Covered:</th>
</tr>
</thead>
</table>

Assessment of Internal Control Structure

<table>
<thead>
<tr>
<th>Effectiveness and efficiency of operations</th>
<th>Generally effective.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Recommendations in specific areas are noted below.</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Reliability of Reporting</th>
<th>Generally effective.</th>
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<table>
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<tr>
<th>Compliance with Applicable Laws and Regulations</th>
<th>Generally effective.</th>
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This report was conducted in accordance with the International Standards for the Professional Practice of Internal Auditing.

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1 Legend for Assessment of Internal control Structure: 1. Generally Effective: The level and quality of the process is satisfactory. Some areas still need improvement. 2. Inadequate: Level and quality of the process is insufficient for the processes or functions examined, and require improvement in several areas. 3. Significant Weakness: Level and quality of internal controls for the processes and functions reviewed are very low. Significant internal control improvements need to be made.
### Summary of Observations and Recommendations

<table>
<thead>
<tr>
<th>Summarized Observation; Risk Rating</th>
<th>Management Agreement with Observation (Yes/No)</th>
<th>Internal Audit Recommendation</th>
<th>Management Accepts IA Recommendation (Yes/No)</th>
<th>Management’s Response to IA Recommendation</th>
<th>Estimated Date of Implementation</th>
<th>Internal Audit Comments on Management Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. It was observed that during the disaffiliation process of NeighborWorks® America, the state of issued a dissolution letter, resulting in an involuntary dissolution. NeighborWorks® America was not informed by the NWO of this dissolution status.</td>
<td>Yes.</td>
<td>It is recommended that the verification of a NWO’s state status is performed as part of the Corporation’s monitoring process.</td>
<td>No.</td>
<td>NWOs are required by their network charter to remain in good standing under applicable laws and regulations of the state where originally chartered. NWOs are also required to provide verification of their nonprofit status via the annual submission of IRS-Form 990. Additionally, the NWO's auditor verifies the corporate status of the organization’s legal standing to do business in its State, and the auditor will document the same in the Note to the Financial Statements. In terms of grants, the Investment and Grant Agreement requires that the NWO “is in good</td>
<td>n/a</td>
<td><strong>This recommendation was intended for those organizations solely going through the disaffiliations process and was assigned a “low” risk rating on review. Management’s response indicates that it considers the risk minimal in view of the other compensating controls in existence. IA does not dispute Management’s response and decision.</strong></td>
</tr>
</tbody>
</table>

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2 The observations and recommendations in this section are summarized at a high level for informational purposes. To obtain a full, detailed explanation of each, please refer to the “Observations and Recommendations” section. Management’s response is directly related to the detailed observations and recommendations noted in the “Observations and Recommendations” section.
standing or existence in the jurisdiction in which it was organized and is qualified to do business in all jurisdictions in which it currently operates. The NeighborWorks organization shall notify NeighborWorks America immediately if such status changes.” Lastly, it is important to note that during disaffiliations, NeighborWorks America does not provide grants to the organization being disaffiliated.
Risk Rating Legend:

Risk Rating: **HIGH**

A serious weakness which significantly impacts the Corporation from achieving its corporate objectives, financial results, statutory obligations or that may otherwise impair the Corporation’s reputation.

Risk Rating: **MODERATE**

A control weakness which could potentially undermine the effectiveness of the existing system of internal controls and/or operational efficiency, integrity of reporting and should therefore be addressed.

Risk Rating: **LOW**

A weakness identified which does not seriously detract from the system of internal control and or operational effectiveness/efficiency, integrity of reporting but which should nonetheless be addressed by management.

<table>
<thead>
<tr>
<th>Management Response to Audit Review Recommendations</th>
<th>Network Disaffiliations Process</th>
</tr>
</thead>
<tbody>
<tr>
<td># Of Responses</td>
<td>Response</td>
</tr>
<tr>
<td>----------------</td>
<td>----------</td>
</tr>
<tr>
<td>0</td>
<td>Agreement with the recommendation(s)</td>
</tr>
<tr>
<td>1</td>
<td>Disagreement with the recommendation(s)</td>
</tr>
</tbody>
</table>
I. Objective

The objective of the audit was to obtain assurance that disaffiliations of NeighborWorks® Organizations (NWOs) are adequately carried out with appropriate recoveries, transfers and close out documentation, in accordance with corporate procedures.

II. Scope

The scope of the audit was limited to NWOs who were disaffiliated from the NeighborWorks® network between August 1, 2007 and July 31, 2008.

III. Background

The NeighborWorks® brand has increasingly become a critical property asset to the Corporation and as a result, it is important for the members of the NeighborWorks® network to remain in good financial and operational standing with NeighborWorks® America and within the communities in which they serve. In pursuit of this standard, there are occasions when organizations are disaffiliated from the network due to the inability to sustain such standards after various attempts by the Corporation to mitigate them. NeighborWorks® Organizations may be disaffiliated by the corporation for a variety of reasons which include, but are not limited to, the following:

- NWO failure to meet obligations stated in the NeighborWorks® America charter agreement;
- NWO violation of the capital fund agreement with NeighborWorks® America;
- NWO failure to accomplish the terms stated in the provisional charter status and therefore failing to emerge from provisional status; and
- NWO volunteers to relinquish its NeighborWorks® charter.

The Corporation has developed a protocol for the district offices to follow while working together with the Division of Field Operations, Organizational Assessment Division (OAD), Office of General Counsel (OGC), Internal Audit and Division of Development and Communications. This includes both written correspondence to the NWO and an appointment of a workout task group who monitors various steps of the disaffiliation process. These processes were reviewed by Internal Audit for completeness and adherence to the guidelines of the Disaffiliations section in the “Policies and Procedures on the Evolution of the NeighborWorks® Network”. (See Appendix A).
IV. METHODOLOGY

Internal Audit obtained a listing of all organizations disaffiliated from the NeighborWorks® network between 8/1/07 – 7/31/08, from the Division of Field Operations. Five out of a total of nine for the period (55%) were judgmentally selected by Internal Audit for review. The organizations reviewed were:

<table>
<thead>
<tr>
<th>Date of Disaffiliation</th>
<th>Name</th>
<th>City/ State</th>
<th>NeighborWorks® District Office</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/22/07</td>
<td>Broadway-Fillmore NHS</td>
<td>Buffalo, NY</td>
<td>Northeast District</td>
</tr>
<tr>
<td>10/22/07</td>
<td>Kensington Bailey NHS</td>
<td>Buffalo, NY</td>
<td>Northeast District</td>
</tr>
<tr>
<td>12/17/07</td>
<td>Housing Development Corporation of the Clinch Valley</td>
<td>Oak Ridge, TN</td>
<td>Great Lakes District</td>
</tr>
<tr>
<td>12/27/07</td>
<td>Black Rock Riverside</td>
<td>Buffalo, NY</td>
<td>Northeast District</td>
</tr>
<tr>
<td>5/1/08</td>
<td>NHS of North Texas</td>
<td>Fort Worth, TX</td>
<td>Rocky Mountain District</td>
</tr>
</tbody>
</table>

During the course of our review no significant deviations from the protocol or other observations were noted.

V. OBSERVATIONS

1. A discrepancy was observed during the disaffiliation process of [text redacted]. During NeighborWorks® America’s disaffiliation process, the state of [text redacted] had issued an involuntary dissolution letter [text redacted] to [text redacted] in June 2007 for failure to file periodic reports to the Secretary of the State of [text redacted]. (See Appendix B) This effectively also made [text redacted] not in “good standing”, but also ineligible for grant awards from the Corporation. [text redacted] was technically non-existent, for a period of time; it also made [text redacted] invalid for the same period of time. Although the NWO subsequently rectified this anomaly, NeighborWorks® America was not informed by the NWO of this dissolution. It should be noted that the dissolution was subsequently rectified due to the proper filing of papers which reinstated [text redacted] as an active corporation. The risk to the Corporation would be extending grants or making agreements with corporate entities technically non-existent, which did not occur in this case.

Currently, the verification of an organization’s state status is not a procedure that NeighborWorks® America conducts during the disaffiliations process.
VI. RECOMMENDATIONS

1. It is recommended that for NWO’s undergoing a disaffiliation process and using a d/b/a name, that at a minimum, the Corporation ensures on a quarterly basis, that the NWO is in good standing with the state of incorporation. Verifications of “good standing” status can be conducted through an inquiry with the corresponding Secretary of State offices, and are usually easily accessible via internet. Although fees vary for each state, the cost to obtain this information is usually minimal (less than $3 per request). The corporation should consider documenting this in the policies and procedures and/or grant agreements.

Conclusion: Based on the testwork performed, appropriate controls and procedures appear to be in place for the Network Disaffiliations process. We would like to extend our appreciation to the Division of Field Operations and the district offices visited for their assistance during our review.
Disaffiliation of a NeighborWorks® organization (“NWO”) may occur for a variety of reasons, including but not limited to, the following:

- NWO failure to meet obligations under the charter agreement between Neighborhood Reinvestment Corporation (“NR”) and the NWO;
- NWO violation of the capital fund agreement between NR and the NWO;
- NWO failure to meet the terms of provisional charter status and failing to emerge from provisional status; and
- NWO voluntarily relinquishes its charter to NR.

A. Determining Status

1. The district director, in consultation with the director of field operations, places the organization on provisional status. The Organizational Assessment Division, Office of General Counsel (“OGC”) and the Chief Operating Officer (who will inform other key managers) are all notified of this decision. A letter is sent to the NWO advising them of their provisional status and any steps that can be taken for corrective action that will avoid disaffiliation. (See Appendix G, Sample Provisional Status Letter.)

2. A Memorandum of Understanding that delineates timelines, assigns roles and responsibilities, and outlines reporting requirements enabling the organization to avoid disaffiliation is signed with the organization. (See Appendix H, Sample Provisional Memorandum of Understanding.)

3. The district monitors the progress of the MOU. If its objectives are achieved, the district and the director of field operations make a determination as to whether disaffiliation must be pursued or not. If the objectives of the MOU are not achieved, a disaffiliation letter is sent to the disaffiliating organization outlining the disaffiliation protocol. (See Appendix J, Sample Letter of Disaffiliation.)

The district director in a conference call and/or meeting comprised of a representative from the OGC, director of field operations, and the Internal Audit Director will converse to determine whether or not recovery of NR capital funds is likely, and if so, whether or not it will be cost-effective to pursue. The district director consults with the director of development and communications to draft a set of talking points regarding the disaffiliation.

If recovery is likely and cost-effective, NR will commence efforts to recover the capital grants in accordance with the disaffiliation protocol. If recovery is not feasible, OGC will notify the NWO of the outstanding capital grant balance and restrictions on its use. In accordance with the disaffiliation protocol OGC will formally terminate NR’s relationship with the NWO.
B. Appointment of a Workout Task Group

When NR has determined to disaffiliate a NWO, the director of field operations, in consultation with the OGC will appoint a workout task group to include a member of NR’s internal loan committee, among others. The task group will determine appropriate roles and responsibilities of each of its members, including responsibility for capital grant fund disposition, and will commit this understanding to writing. The task group is charged with developing a disaffiliation/disposition plan (“workout plan”) that includes recommendations regarding the allocation, transfer, sale and disposition of all capital grant funds subject to recovery by NR. The workout plan will be reviewed and approved by NR’s officers.

C. Task Group Guidance

It should be noted that while NR is interested in recovery of cash assets in the capital grant fund, NR will assume ownership of real property or loan portfolios only as a last resort. In instances where the capital grant funds are in the form of real property or loan receivables, the task group will attempt to identify other disposition methods. If there is another NWO with the capacity and interest to assume such real property or loans, the task group will develop a proposal for asset transfer with incentives, if appropriate. Such incentives may include partial loan forgiveness or loan restructuring. (Note that loan forgiveness will result in taxable income to the borrower.) In some instances, especially if there is not a willing NWO, a local government or non-network affiliated community-based organization may be approached.

As part of the workout plan, the task group will make a determination regarding the optimal disposition of loan receivables. If the loans are to be transferred to another local or NWO entity, specific terms and procedures will be agreed to in consultation with that entity, committed to writing and retained in the close-out file. (see Appendix K, Sample MOU for Transfer of Loan Portfolio Between Two Chartered Organizations)

If NHSA is deemed the most appropriate servicer and/or assignee of loans, appropriate documents will be forwarded to NHSA, which will commence appropriate procedures to accept assignment and service of the loans. Appropriate procedures include acceptance of NR policies relating to foreclosure on loans and possibly making certain payments to NR for transfer of performing loans. When developing the workout plan, the task group shall consider the appropriate level and timing of NHSA’s participation in the disaffiliation process.

For example, the Task Group shall consider utilizing NHSA’s expertise at reviewing loan documentation and assessing loan portfolio value. This expertise may make it appropriate to make NHSA responsible for leading the team to review loan portfolios and to coordinate the assignment to another NWO, NHSA or elsewhere. NR would take an oversight role for the purpose of protecting NR interests.

As part of the workout plan, the task group will determine the most appropriate allocation of all NR capital grant funds and will propose any incentives that the task group believes are reasonable and appropriate to ensure effective transfer of such funds and sound long-term oversight.

The relationship is closed out after notifying the organization of any acceptable uses of any funds invested; determining the disposition of loan funds and loan transfers (see Appendix L, Disposition
of Loans Receivable); determining the disposition of real estate investments (see Appendix M, Disposition of Real Estate Investments); and obtaining a close-out audit on the accountability of all Neighborhood Reinvestment assets.
Appendix B

Office of the Secretary of State

INVolUNtARY DISSOLuTION
OF

File Number:

The Secretary of State hereby determines and finds the following:

1. That the corporation is required to file the periodic report specified by Article 1396-9.01 of the Texas Non-Profit Corporation Act.
2. That the corporation has failed to file the periodic report prescribed by law when the same has become due.
3. That the corporation forfeited its right to conduct affairs in this state for failure to file said report.
4. That the corporation was mailed notice of such forfeiture following a period of not less than thirty (30) days of the requirement to file said report and simultaneously therewith given an additional period of not less than one hundred twenty (120) days to correct the delinquency.
5. That the corporation has failed prior to such involuntary dissolution to correct the neglect, omission or delinquency.

It is therefore ordered, as prescribed by Article 1396-9.02E of the Non-Profit Corporation Act, that the domestic corporation be involuntarily dissolved or the certificate of authority of a foreign corporation be revoked without judicial ascertainment.

Dated: June 6, 2007

Secretary of State