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Office of Inspector General
Midwest Region

Audit Report

Rural Housing Service Rural Rental Housing Project Management

Report No. 04016-0001-Ch
SEPTEMBER 2004



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



DATE: September 30, 2004
REPLY TO

ATTN OF: 04016-0001-Ch

SUBJECT: Rural Rental Housing Project Management

TO: Russell T. Davis
Administrator
Rural Housing Service

ATTN: John Purcell
Director
Financial Management Division

This report presents the results of our follow up audit of the Rural Rental Housing Program Joint Initiative. Your response to the draft report dated September 29, 2004, is included in its entirety as exhibit B with excerpts and the Office of Inspector General's position incorporated into the relevant sections of the report.

We agree with your management decisions for Recommendations Nos. 1, 2, 3, 6, and 11. Please follow your agency's internal procedures in forwarding final action to the Office of the Chief Financial Officer.

Management decision has not been reached for Recommendations Nos. 4, 5, 7, 8, 9, and 10. In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective action taken or planned and the timeframes for implementation for these recommendations. Please note that the regulation requires a management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance, and final action to be taken within 1 year of each management decision.

//s//

ROBERT W. YOUNG
Assistant Inspector General
for Audit

Executive Summary

Rural Rental Housing Project Management

Results in Brief

The Office of Inspector General and the Rural Housing Service (RHS) combined efforts in 1999 to identify and prosecute the worst offenders who had defrauded the Rural Rental Housing (RRH) Program while neglecting the physical living conditions of tenants residing in multifamily housing properties. The joint Initiative¹ by the two agencies disclosed serious abuse by some owners and management agents, and demonstrated the results that could be achieved when working together to combat abuse. As a result of the Initiative, RHS committed to implementing 20 regulatory and policy changes that would strengthen its monitoring of owners and management agents.

We performed this review to evaluate RHS' progress in implementing the 20 measures. We found that RHS had been working on regulatory and policy changes since 1999, and plans to issue new RRH Program regulations in September 2004. However, at the time of our review, RHS officials planned to address only 14 of the measures committed to after the Initiative. (See exhibit A.) The five measures that will not be implemented, or not implemented as committed to, are summarized below: (One measure cannot be implemented until the regulations are issued.)

- Development of a multi-State review team.
- Owner certification of reported financial information.
- Requirements for copies of contracts for identity-of-interest companies.
- Annual inspections of apartment complexes.
- Coordination with State and local authorities to inspect RRH properties.

We consider the implementation of these measures as critical to preventing program abuse, and improving the integrity of the RRH Program, a program identified as a high-risk area by the Office of Management and Budget. Some measures also need additional strengthening to deter fraud and abuse. For example, all RRH properties should be subject to attestation engagements based on agreed-upon procedures. The abuse identified by the Initiative, over \$4.2 million misused by 18 owners and management agents, may continue unless these measures are included in program regulations.

The measures are also needed to correct the serious physical deterioration of RRH properties, some of which affected the health and safety of tenants, identified during the Initiative. RHS officials did create quality maintenance standards, and implementation of those standards should provide sufficient

¹ Evaluation Report 04801-0006-Ch, Uncovering Program Fraud and Threats to Tenant Health and Safety, March 1999.

guidance to owners, management agents, and servicing officials on maintaining RRH properties. However, RHS officials plan to continue their requirement for comprehensive inspections every 3 years. In between the comprehensive inspections, they plan to perform limited inspections of the exterior of apartment complexes on an annual basis. But those inspections, termed "walk-about" inspections, are exterior reviews, and will not detect interior problems and will not include interviews with tenants. Some of the worst conditions uncovered during the Initiative were made by these means.

**Recommendations
In Brief**

RHS officials need to implement the measures committed to during the Initiative and additional measures necessary to mitigate the risk of owners and management agents misusing RRH funds. These measures include; (1) the reestablishment of the Enforcement Team to examine suspected abusive activities; (2) requirements and procedures for the use of the Multi-Family Housing Information System to monitor owners and management agents; and (3) the development of guidance and procedures for analyzing identity-of-interest cost data submitted by owners and management agents. We also recommend that RHS officials perform thorough and comprehensive inspections every year of all RRH properties.

Agency Response

In its response dated September 30, 2004, RHS generally agreed with the recommendations in the report. We have incorporated applicable portions of RHS' response, along with our position, in the Findings and Recommendations section of the report. The agency's response is included in its entirety as exhibit B of the report.

OIG Position

Based on RHS' responses, we have reached management decisions on Recommendations Nos. 1, 2, 3, 6, and 11. Management decisions have not been reached for Recommendations Nos. 4, 5, 7, 8, 9, and 10. Management decisions can be reached on these recommendations once RHS has provided us with the information specified in the report sections OIG Position.

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Background and Objectives

Background

The Rural Rental Housing (RRH) Program provides rental apartments to tenants with low incomes in rural areas. An owner or their agent manages each apartment complex and is responsible for overseeing accounts that contain funds derived from Government subsidy and tenant rental payments. There are approximately 18,000 apartment complexes and over 449,000 RRH units nationwide. Over 700,000 tenants reside in these units. The most recently available figures show the Government provided almost \$1.3 billion in rental assistance and interest credit subsidies for tenants residing in those units. In addition, USDA has almost \$12 billion invested in loans to owners of RRH properties.

Over the years, the Office of Inspector General (OIG) has identified owners and management agents involved in schemes to defraud RRH apartment complexes. Typically, owners and agents charge unallowable and unsupported costs to apartment complexes. This activity is commonly referred to as “equity skimming” and may jeopardize the financial viability of an apartment complex. Further, the lack of financial resources can endanger the Government’s security interest through the physical deterioration of apartment complexes, and create health and safety hazards for tenants. As a result, the Office of Management and Budget identified RRH as a high-risk program.

The Office of Inspector General and the Rural Housing Service (RHS) combined efforts in 1999 to identify and prosecute the worst offenders who had defrauded the RRH Program while neglecting the physical living conditions of tenants residing in multifamily housing properties. The joint Initiative disclosed serious abuse by some owners and management agents, and demonstrated the results that could be achieved when working together to combat abuse. As a result of the Initiative, RHS officials committed to developing and strengthening numerous management controls over owners and their agents to prevent or detect the misuse of funds. RHS officials’ goal was to implement these measures into agency regulations and policy by November 1999.

The Initiative determined that 18 owners and management agents (out of 32 selected) had misused over \$4.2 million in RRH funds. The improper charges were for duplicate costs; costs that clearly did not benefit RRH apartment complexes; or were for costs not supported by invoices, receipts, canceled checks or other supporting documentation. The owners also diverted income and withdrew funds from reserve and tenant security deposit accounts without approval and for unauthorized purposes.

At the time of the Initiative, and currently, RHS provided guidance to owners and management agents on unallowable operating expenses in written procedures that were unclear and contained conflicting information. This guidance was included in program regulations, agency instructions, and agency loan agreements. Further, agency regulations did not clearly prohibit specific types of charges. Also, oversight of owner and management agent financial activities consisted primarily of independent audits. Thus, the OIG and RHS teams involved in the Initiative concluded that controls over borrowers and management agents were inadequate to prevent and detect the misuse of funds.

Objectives

To evaluate RHS' progress in implementing corrective actions committed to at the conclusion of the joint Initiative in 1999, and whether those actions were adequate to improve integrity in the RRH Program.

Findings and Recommendations

Section 1. RRH Funds Still Vulnerable to Theft and Misuse

RHS committed to implementing 17 measures to curb financial abuse by owners and management agents after the Initiative. These measures included: (1) a review guide for independent public accountants that focused on high-risk transactions, (2) the development of an Enforcement Team that would identify and review high-risk activities, (3) use of its Multi-Family Housing Information System (MFIS) to monitor misuse of funds and physical deterioration of apartments, and (4) specific requirements for identity-of-interest companies. (See exhibit A for a list of all 17 financially related measures.)

Since 1999, RHS officials have been working on corrective actions and plan to incorporate 13 of the financial measures into agency regulations or policy. However, they do not plan to incorporate or implement four measures related to financial abuse. RHS officials need to implement all measures as committed to after the Initiative, and develop additional controls to further curb financial abuse in the RRH Program.

RHS officials plan to implement some critical measures. For example, RHS and OIG are currently working with the American Institute of Certified Public Accountants to prepare a guide to be used by independent public accountants performing attestation engagements of RRH properties. The guide will require the use of agreed-upon procedures in future engagements to focus on high-risk transactions and increase the likelihood of detecting financial abuse. RHS officials also plan to implement measures that will be used to closely monitor the activities of identity-of-interest companies. One measure will require that identity-of-interest companies receive agency approval to provide goods and services to apartment complexes. Another measure will require access to records maintained by identity-of-interest companies.

Finding 1

No Specific Citations on Eligible and Ineligible Costs

RHS' proposed regulations do not prohibit specific types of charges to RRH apartment complexes. After the Initiative, RHS planned to incorporate stricter language into its regulations that would prohibit common unallowable charges and practices, and clearer definitions of unallowable costs. This commitment was made to promote greater acceptance of cases for criminal prosecution.

Our review disclosed that RHS' proposed regulations continue to provide general or vague guidance regarding unallowable costs. For example, the proposed regulations on project management state "the management fee may compensate the management entity only for the specifically identified bundle of services to be provided to the housing project."² The citation does not identify the specific services to be performed for the management fee. Another citation states, "allowable expenses include those expenses that are directly attributable to housing project operations and are necessary to carry out successful operations."³ This citation also does not identify specific types of allowable or unallowable costs.

RHS did develop guidance⁴ for its field staff that provides numerous examples of specific costs and services that can be charged to RRH properties. The Administrative Notice lists 27 categories of costs and services to be provided as part of the management fee. These include supervision of overall operations, supervision of on-site staff, maintenance of project books and records, training provided to on-site staff, preparation of annual budgets, and preparation of required year-end reports.

The Administrative Notice also lists costs and services to be paid from RRH property accounts such as: Direct personnel costs for staff assigned directly to the project site; legal fees directly related to the project; outside accounting and auditing fees, if required by RHS; repair and maintenance costs for the property; and other specific costs (which includes a list of 19 items). RHS officials informed us that in July 2004 they incorporated this guidance into agency handbooks and regulations.

We concluded that the Administrative Notice provides adequate guidance to RHS field staff for monitoring charges by owners and management agents. However, in order to promote a greater acceptance of "equity-skimming" cases for criminal prosecution, RHS needs to incorporate this information into its regulations. Based on our experience during the Initiative, some U.S. Attorney Offices will not prosecute financial abuse unless agency regulations clearly prohibit specific types of charges.

Recommendation No. 1

Incorporate into regulations the specific requirements for owners and management agents on eligible and ineligible costs included in Administrative Notice 3911.

² 7 CFR 3560.102 (i), proposed rules dated June 2, 2003.

³ 7 CFR 3560.303 (b) (1), proposed rules dated June 2, 2003.

⁴ Administrative Notice No. 3911, dated October 29, 2003.

Agency Response

RHS will incorporate AN 3911 into the 3560 regulations as part of the interim final rule by January 31, 2005.

OIG Position

We accept RHS' management decision for this recommendation. To reach final action, RHS needs to provide a copy of the appropriate sections of the interim final rule to OCFO.

Finding 2

Insufficient Independent Audit Requirements

In response to OIG concerns both prior and subsequent to the Initiative, RHS proposed revising the requirements for an independent audit from 25 or more units to 16 or more units. In addition, RHS proposed that audits be performed in accordance with Government Auditing Standards and include agreed-upon procedures for high-risk transactions. Projects with less than 16 units would not be required to have an independent audit and would submit annual financial statements certified by the borrower. They also agreed to incorporate into proposed regulations that projects with less than 16 units could be subject to an audit with agreed-upon procedures.

RHS officials informed us that it was cost prohibitive to perform audits on management complexes with less than 16 units. Those officials stated that if RHS required audits, it would significantly increase rents for smaller properties. We agree that it is more difficult for small apartment complexes to absorb the cost of independent audits without an increase in rental rates. However, since review and compilation engagements (the types of engagements currently required for projects with less than 16 units) do not include verification procedures, there is no assurance that owners and management agents are accurately reporting the financial condition of apartment complexes.

To provide this assurance, RHS needs to require an attestation engagement based on agreed-upon procedures for apartment complexes with less than 16 units. In fact, all apartment complexes would benefit from a narrowly focused engagement using agreed-upon procedures. While this action was not proposed after the Initiative, we consider it to be a critical internal control in detecting misused funds. This type of engagement would include procedures that test transactions for accuracy and verify that the transactions are supported by legitimate receipts, invoices, cancelled checks, or other supporting documents.

We recognize that this would be more costly to small apartment complexes on an annual basis. However, RHS could require engagements for these properties for periods greater than 1-year. The period could be determined by the size of the property. For instance, apartment complexes with between 12 and 24 units could be audited at 2-year intervals, and apartment complexes with less than 12 units could be audited at 3-year intervals. Independent public accountants could test transactions for the entire period (2 or 3 years) and provide effective coverage for detecting abusive schemes. This method would provide RHS with assurance on the accuracy of reported financial activities.

Recommendation No. 2

Require that all RRH properties be subject to attestation engagements based on agreed-upon procedures.

Agency Response

RHS will incorporate language into the 3560 interim final rule, which requires borrowers to submit annual financial reports including a report based on the agency engagement requirements, by January 31, 2005.

OIG Position

We accept RHS' management decision for this recommendation. To reach final action, RHS needs to provide a copy of the appropriate sections of the interim final rule to OCFO.

Finding 3

Agency Enforcement Team Disbanded

RHS had established an Enforcement Team to conduct reviews of high-risk owners and management agents. However, RHS disbanded the Enforcement Team after completing only two reviews. Both reviews had significant findings, including unallowable expenses, an undisclosed identity-of-interest company, overpayment of management fees, and inadequate maintenance of properties. RHS officials used a review guide, committed to and developed after the Initiative, during the two reviews. Other agency officials informed us that the Enforcement Team was disbanded because they were not receiving requests from State officials to perform reviews. However, we view the Enforcement Team as a critical management control that should be reestablished to ensure integrity in the RRH Program. The agency informed us that they plan to reestablish the Enforcement Team next year, and that the team will take a proactive approach to identify program abuse.

Recommendation No. 3

Reestablish the Enforcement Team.

Agency Response

RHS will reestablish the Enforcement Team by January 31, 2005.

OIG Position

We accept RHS' management decision for this recommendation. To reach final action, RHS needs to provide documentation to OCFO that they have established a viable Enforcement Team.

Finding 4

Multi-Family Housing Information System Needs Improvements

RHS officials committed to modifying the Multi-Family Housing Information System (MFIS) to allow field office staff to more closely monitor and scrutinize the activities of owners and management agents during supervisory visits. The MFIS database includes tenant and financial data, such as income and expenses for apartment complexes submitted by owners and management companies. In addition, it contains the results of physical inspections performed at the apartment complexes by servicing officials. RHS officials redesigned MFIS after the Initiative so that it could be used to evaluate individual RRH apartment complex costs, and compare costs to other properties in a State or geographical area. However, we found that there was no guidance to ensure MFIS was used and there were few controls to ensure that data was accurate and complete.

Program and staff managers can use MFIS reports to identify problems and trends occurring within the program. MFIS creates year-to-year variance analyses of financial information submitted by owners and management agents. It also consolidates submitted cost data and creates regional and state budget cost averages. As a result, RHS officials can compare budgeted data submitted by borrowers to historical budget cost averages for reasonableness.

In a separate audit, OIG performed a review that disclosed that insurance cost data entered into MFIS was inaccurate and incomplete. We found that the errors led to inaccurate historical budget cost averages, thereby reducing the data's value for comparison to budgeted costs submitted annually by owners and their agents. The system has since been redesigned, but agency officials informed us that the only controls to ensure accuracy of data are the automatic subtotals, totals, the calculation of variances, and periodic variance analysis on the entry of monthly revenues and expenses. These controls are

effective, but don't ensure that data entered into MFIS is accurate. Another control, performed at the end of the fiscal year, is a report of any RRH property with a line item amount over one million dollars, which would be very unlikely in the RRH Program. According to agency officials, this catches 30-50 errors annually.

RHS also had no field data controls to ensure the accuracy and integrity of data. For example, the fields for expenses allow entry of eight digits, even though expenses would not require eight digits. In this instance, field size should be limited to the maximum number of digits for expenses.

Since MFIS is intended as a monitoring tool that uses cost averages, it is necessary for agency officials to ensure that the information is accurate. RHS needs to establish control procedures that would ensure the accuracy of the financial data entered into MFIS.

RHS officials also have not provided specific guidance to State and field offices on using MFIS data to monitor owner and management agent activities. Thus, field offices may not be using MFIS in a consistent manner and in accordance with agency policies. An expired, unnumbered Administrative Notice, required State and field offices to periodically review reports to monitor program activities. But no further guidance was given regarding the use of MFIS to monitor expenses. As a result, we see very little change in RHS' procedures to detect and prevent financial abuse.

The Enforcement Team should also use the MFIS database. After the Initiative, RHS officials stated that the effort to fight fraud would be supported by modifications to MFIS that would enable review teams to zero in on those owners and management agents most likely to abuse the program. RHS has not developed requirements for the Enforcement Team to use MFIS in this manner.

Recommendation No. 4

Establish and implement controls over financial data entered into MFIS to ensure its accuracy, such as field size limits.

Agency Response

RHS will obtain an annual report identifying any line item greater than one million dollars. This will be completed by January 31, 2005.

OIG Position

We do not accept RHS' proposed action for this recommendation. The stated proposal does not vary from existing agency procedures. To reach a management decision RHS needs to implement controls, such as edit checks and field length controls over the entry of financial data into MFIS. Currently there are few controls over data entry and, therefore, inaccurate amounts can be entered.

Recommendation No. 5

Establish procedures instructing States on the required use of MFIS as a monitoring tool, including the implementation of controls to ensure that States use MFIS as instructed.

Agency Response

RHS' Handbook No. 3, Loan Servicing, contains procedures on the use of MFIS as a monitoring tool and servicing goals that are used to ensure agency staff uses MFIS.

OIG Position

We do not accept RHS' proposed action for this recommendation. The procedures in RHS' handbook are not required to be followed by the States. Further, the handbook does not define the servicing goals used to ensure that State officials use MFIS to review budgets and actual expenses submitted by borrowers. To reach a management decision RHS needs to define and document the required use of MFIS as a monitoring tool, and establish oversight procedures to monitor States' use of MFIS as instructed.

Recommendation No. 6

After re-establishing the Enforcement Team, require that the Team use MFIS to detect abusive owners and management agents.

Agency Response

RHS will create an action plan for the Enforcement Team, which will include the use of MFIS and criteria to identify abusive owners and management agents for review. This will be completed by March 31, 2005.

OIG Position

We accept RHS' management decision for this recommendation. To reach final action, RHS needs to provide a copy of the action plan to OCFO.

Finding 5***Inadequate Identity-of-Interest Requirements***

The Initiative disclosed that owners and management agents commonly used identity-of-interest companies to divert funds from RRH projects. For example, management companies used identity-of-interest companies to charge RRH projects for work that was never done, and to inflate the actual cost of products and services. A significant amount of the \$4.2 million in diverted funds uncovered during the Initiative were misused in this manner.

To stem this abuse, RHS committed to nine measures related to identity-of-interest companies. (See exhibit A.) Some of these measures were: (1) Requiring owners to certify to the accuracy of reported financial information, (2) legislation to enact civil penalty provisions to recoup diverted funds, (3) requiring agency approval of identity-of-interest companies before they could provide goods and services to RRH properties, and (4) requiring that owners and management agents provide access to records of identity-of-interest companies.

RHS has obtained legislation for civil penalty provisions. RHS officials informed us that these provisions are being incorporated into agency regulations. However, they were unable to provide us with specific timeframes for completion. RHS officials plan to incorporate into agency regulations provisions stating that owners and management agencies must provide access to records of identity-of-interest companies.

RHS also proposed requiring owners to certify to the accuracy of reported financial information. Borrowers and management companies submit to RHS forms RD 1930-7⁵ and 1930-8,⁶ which contain financial information related to project operations. At the time of our review, the proposed form RD 1930-8 contained a certification statement, while the current form RD 1930-7 did not contain a certification statement. RHS did not have a proposed form RD 1930-7. Further, RHS officials had not drafted the identity-of-interest form, which was designed to demonstrate that costs were beneficial to RRH projects. The owner should certify to the accuracy of all documentation provided to RHS, and the document should include a certification statement. At the time of our audit, agency officials stated that they were still working on the draft regulations and associated forms and exhibits.

RHS also proposed in the Initiative, that it would require owners to ensure that identity-of-interest companies provide contracts of business with RRH apartment complexes. RHS officials proposed to review the contracts to

⁵ Multi-Family Housing Project Budget

⁶ Multi-Family Housing Borrower Balance Sheet

determine if the identity-of-interest company was performing a legitimate service or providing materials at a reasonable price. This requirement has not been included in the proposed regulations because agency officials considered it to be a proposal and not a mandated action. RHS did include a provision in its' handbook which states that field offices may require justification of a contractual relationship with an identity-of-interest company.

RHS' proposed regulations also require that all identity-of-interest companies be disclosed, and that the owner or management agent certify and provide documentation that using them is in the best interest of the project. RHS will then determine if costs are as low as, or lower than, arms-length open-market purchases. RHS' draft ⁷ handbook also states that the owner must attach to the management entity profile a fee schedule of goods and services for identity-of-interests companies. RHS has provisions to review the management profile before approving the management plan. However, RHS had not provided guidance to servicing officials stating what an owner or its agent should submit to demonstrate a cost saving benefit to an RRH project, and how servicing officials would evaluate the fee schedule provided by the owner.

Recommendation No. 7

Require the owners and management agents to sign a certification statement that the documentation provided to RHS on the identity-of-interest disclosure form is accurate, complete, and up-to-date.

Agency Response

RHS will implement RD Form 3560-13. RHS will modify RD Forms 3560-13, 3560-30, and 3560-31, all identity-of-interest disclosure forms, by adding a full disclosure statement to each form. These actions will be completed by January 31, 2005.

OIG Position

We do not accept RHS' proposed action for this recommendation. To reach a management decision, RHS needs to include the certification penalty statement that is currently used on Form RD 1930-8 on all three forms, (RD Forms 3560-13, 3560-30, and 3560-31).

⁷Draft Asset Management Handbook, HB-2.3560, Chapter 3, Section 1, 3.5.

Recommendation No. 8

Develop and implement guidance and procedures for analyzing identity-of-interest cost data submitted by owners and management agents.

Agency Response

RHS will implement RD Form 3560-13. RHS will modify this form and RD Forms 3560-30 and 3560-31, also identity-of-interest disclosure forms, by adding a full disclosure statement to each form. These actions will be completed by January 31, 2005.

OIG Position

We do not accept RHS' proposed action for this recommendation. To reach a management decision RHS needs to clarify in its handbook the requirement for acceptable evidence that the use of an identity-of-interest company is in the best interest of the property. In conjunction with this, RHS needs to provide States instructions to evaluate and analyze submitted identity-of-interest costs to determine if they are beneficial to RRH properties.

Recommendation No. 9

Require identity-of-interest companies to provide copies of contracts for all services and supplies provided to RRH projects.

Agency Response

RHS does not believe that requiring copies of contracts for all identity-of-interest companies is practical. RHS requires borrowers and management agents to prove that identity-of-interest companies are in the best interest of the property. RHS plans to rely on an identity-of-interest disclosure form that will include a fee schedule. RHS also plans to enhance the supervisory process to cover more identity-of-interest issues, including adding additional questions to the review form.

OIG Position

We do not accept RHS' proposed action for this recommendation. In an effort to reduce the risk of identity-of-interest abuse and increase the ability to prosecute those identified, RHS agreed in the OIG Initiative to require management companies to submit contracts with identity-of-interest companies as part of the approval process. RHS has now determined that the contracts are not necessary, and will rely on a fee schedule. However, RHS did not explain how this would work. RHS needs to provide OIG with additional information to evaluate before we can reach a management decision.

Section 2. Inspection Procedures Need Improvement

Finding 6

Based on the large number of RRH properties with physical deterioration and health and safety hazards identified during the Initiative (360 of 637 had physical deterioration and 50 had health and safety hazards), RHS officials proposed four critical measures to identify and correct these conditions. (One measure, the modification of MFIS, was also included in section 1.) These measures included developing quality maintenance standards, performing annual physical inspections of all apartment complexes, incorporating the results of inspections into MFIS for monitoring by servicing offices, and coordinating with State and local authorities when properties experienced health and safety hazards and seriously deferred maintenance. RHS' goal was to implement these measures into agency regulations by November 1999.

The serious physical deterioration and health and safety hazards observed during the Initiative may persist because RHS has not required annual comprehensive (interior and exterior) inspections and has not developed procedures to coordinate with State and local authorities. Agency officials stated that they do not have enough staff to perform a comprehensive review of every property every year. These officials also stated that there were no current plans to develop procedures to coordinate with State and local authorities because they considered this issue to be a proposal and not a measure that was mandated by the Initiative.

Our review disclosed that RHS had developed, and was planning to implement, the new quality standards for maintaining the physical condition of RRH properties. We reviewed the new standards and concluded that they provided sufficient guidance to owners and management agents on maintaining RRH properties, and provided a sound benchmark for agency officials to follow when inspecting and servicing those properties.

RHS had also modified MFIS and will require that all inspection results be input into the system. RHS had created a new form that provides detailed guidance for inspecting the interior and exterior of apartment complexes. The new form should be more effective than the prior form used by RHS servicing officials. RHS has also commissioned a study by an independent consulting firm to determine the overall condition of RRH properties. The firm will provide recommendations on long-term capital needs of RRH properties and agency actions necessary to protect the Government's security interests.

RHS officials do not, however, plan to implement comprehensive annual inspections as committed to after the Initiative. They attributed this to insufficient staff. Instead, RHS will continue with triennial inspections. In between the triennial inspections, RHS requires only “walk-about” inspections on an annual basis, if necessary. Agency policy describes the “walk-about” inspection as an exterior physical inspection that is not intended to inspect for full compliance with all applicable maintenance standards, unless severe exterior deterioration exists. RHS has been performing these types of inspections for several years and officials stated that more deficiencies have been identified than in the past. We did not perform field visits. Therefore, we cannot agree with, or dispute, this statement.

We have two concerns regarding “walk-about” inspections. First, a “walk-about” inspection, as described in agency policy, will not detect physical deterioration that can only be identified by observations of the interiors of apartments and through interviews with tenants. Some of the worst conditions uncovered during the Initiative were made by these means. For example, tenants at one complex complained of severe mold in their apartments.

We also identified serious roof problems at many apartment complexes after observing water stains on the ceilings of some units. In one instance, a leaky roof led to the ceiling collapsing in several units of one apartment complex. When we entered these units, we observed insulation and other debris on the floor and black mold on the carpeting. Some units were unoccupied, but others were occupied even though there was mold on the carpeting. These problems would not have been detected by exterior inspections and illustrate the need to perform comprehensive inspections on an annual basis.

Our second concern is that the agency does not require comprehensive inspections every year. The policy the agency plans to implement states, “If the Servicing Office completes a physical inspection and has no findings regarding the physical status of a project, the following annual walk-about may be omitted.” Instead of requiring comprehensive annual inspections as proposed, RHS maintained its 3-year requirement for comprehensive inspections of both the interior and exterior of apartment complexes, the same requirement that was in place at the time of the Initiative.

RHS officials informed us that the decision to deviate from the original commitment was made because of insufficient field staff to perform comprehensive inspections of almost 18,000 apartment complexes each year. We understand this concern and agree that quick inspections would be less time consuming to perform. However, comprehensive inspections are crucial to ensure that deferred maintenance is identified before it becomes a serious

problem and serious deterioration does not affect the health and safety of tenants.

An alternative solution is to base the timing of inspections on other criteria, such as the age of a property. Using this criterion, a recently constructed or rehabilitated property would be inspected every 2 or 3 years, while an older complex would be inspected every year. In theory, a recently constructed or rehabilitated property would be less susceptible to deterioration and, therefore, would not need to be inspected as frequently as an older property. This requirement would preserve resources and still effectively monitor the conditions of RRH properties.

Another measure RHS committed to after the Initiative was to coordinate with State and local authorities when serious deterioration or health and safety hazards existed at RRH properties. RHS officials informed us that they had not yet addressed this proposal, and were unsure whether it would ever be implemented into agency policy. Agency officials stated that although it was in the Initiative report as a proposal, they did not consider it to be a mandated action. We consider this measure to be an important component for ensuring that owners and their agents comply with agency requirements for maintaining RRH properties. Coordination with these authorities is also crucial to the safety of tenants, and in pressuring owners and their agents to correct serious deterioration, as well as efficiently using RHS' limited resources.

Recommendation No. 10

Perform annual comprehensive inspections of RRH properties as necessary, based on criteria such as past inspections, or the age of an apartment complex.

Agency Response

RHS acknowledges that the walk-about will not detect physical deterioration that is only discovered by viewing the interior of tenants' units. Since OIG did not inspect any properties since the walk-about began, RHS is reluctant to require annual comprehensive inspections. Therefore, RHS will review the effectiveness of their walk-about inspections and provide the results to OIG. RHS will provide an action plan by April 30, 2005, and the results of their review by September 30, 2005.

OIG Position

We do not accept RHS' proposed action for this recommendation. OIG did not inspect RRH properties as part of this review because there was no reason to believe that conditions had changed since the Initiative. To reach a

management decision RHS needs to perform comprehensive inspections more frequently than every three years or provide evidence that serious physical deterioration and health and safety issues no longer exist.

Recommendation No. 11

Develop and implement guidelines for coordination with State and local inspection authorities.

Agency Response

RHS will incorporate guidelines into the handbooks to coordinate with State and local authorities when health and safety issues exist. This will be completed by April 30, 2005.

OIG Position

We accept RHS' management decision for this recommendation. To reach final action, RHS needs to provide OCFO with documentation that the guidelines have been incorporated into the handbook.

Scope and Methodology

Our audit was a follow-up review to the OIG and RHS joint Initiative completed in 1999. The Initiative focused on 32 owners and management agents in 13 States that were considered high-risk for misappropriating funds based on criteria developed by OIG and RHS. RHS planned specific corrective actions to RRH Program regulations because of the Initiative. We examined and assessed RHS' completed revisions to those regulations, and proposed revisions scheduled to be implemented in September 2004.

To accomplish our objective, we analyzed existing and proposed regulations, policies, and procedures, related to the RRH Program. Our analysis consisted of a comparison between RHS' planned corrective actions at the conclusion of the initiative in 1999 and the current, or proposed, regulations. Whenever our comparison identified differences between planned corrective actions and current, or proposed, regulations, we evaluated the issue and assessed its impact on the RRH Program. We also interviewed agency officials whenever necessary to clarify agency actions. We performed our work at RHS' Headquarters offices in Washington, D.C.

We conducted our audit from November 2003 through February 2004, in accordance with Government Auditing Standards.

Exhibit A– Status of Agency Proposed Actions

Page 1 of 2

Initiative Issue	Proposed Action	Completed
Difficulty of Prosecution	Incorporate stricter language into regulations to prohibit common unallowable charges	Yes <u>1</u> /
	Require owners and management agents to certify compliance of management agreements	Yes
	Provide extensive training on revised regulations	No <u>1</u> /
Misuse of RRH Funds	Development of multi-state review team to identify high-risk owners and management agents	No <u>2</u> /
	Development of review guide that will focus on high-risk transactions	Yes
	Complete review of all owners and management agents every 3 years	Yes
	Revision of guide used by independent public accountants during attestation engagements	Yes <u>3</u> /
Modification of Housing Information System	Update management information system to include monitoring misuse of funds and physical deterioration of apartment complexes	Yes <u>4</u> /
Identity-of-Interest Abuse	Owners must certify accuracy of reported financial information	No
	Establishing civil penalties for misuse of program funds	Yes
	Identity-of-Interest (IOI) companies must be approved by RHS	Yes
	IOI companies must provide specific charges and cost comparisons	Yes
	IOI companies must provide RHS with copies of contracts for intended services	No
	IOI companies must agree to special audit requirements	Yes
	Require IOI companies to provide access to records	Yes
	Perform cost comparisons of IOI charges with comparable businesses	Yes
	Owners must use competitive bidding for all purchases or repairs over \$5,000	Yes

1/ Included in Proposed Regulations in July 2004

2/ To Be Completed After Implementation of 3560 Regulations

3/ Enforcement Team Established, But Then Disbanded

4/ Currently Being Revised in Coordination With OIG

5/ This Issue Was Counted in Both Section 1 and 2 of the Report

Exhibit A- Status of Agency Proposed Actions

Page 2 of 2

Initiative Issue	Proposed Action	Completed
Physical Deterioration of RRH Project (nonfinancial)	Annual inspection of apartment complexes	No <u>6/</u>
	New quality standards for apartment complexes	Yes
	Guidelines for coordinating with State and local authorities to inspect RRH properties	No

6/ Not Implemented as Proposed After Initiative

Exhibit B - Agency Response

Exhibit B - Page 1 of 6



United States
Department of
Agriculture

Rural Development

Operations and
Management

Washington, DC
20250

SEP 30 2004


SUBJECT: Rural Housing Service
Rural Rental Housing Project Management
(Audit No. 04016-001-CH)

TO: Robert W. Young
Assistant Inspector General
for Audit
Office of Inspector General

Attached for your review is the Rural Housing Service's response to the official draft for the subject audit.

This response is being submitted for inclusion in the final report and your consideration to reach management decision on the recommendations.

If you have any questions, please contact Steven Maged of my staff at 692-0330.


JOHN M. PURCELL
Director
Financial Management Division

Rural Development is an Equal Opportunity Lender. Complaints of
discrimination should be sent to: Secretary of Agriculture,
Washington, DC 20250



Exhibit B - Agency Response

Exhibit B - Page 2 of 6



United States Department of Agriculture
Rural Development

Rural Business-Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

SEP 29 2004

TO: John M. Purcell
Director
Financial Management Division

FROM: Jackie J. Gleason
Deputy Administrator
Multi-Family Housing

A handwritten signature in black ink, appearing to read "Jackie J. Gleason", written over a horizontal line.

SUBJECT: Audit Report 04601-0001-Ch
Rural Rental Housing Project Management

This memorandum is to request management decision in response to the subject report. This report was to evaluate RHS' progress in implementing 20 regulatory and policy changes that resulted in the Office of the Inspector General (OIG) and Rural Housing Service Joint Initiative in 1999.

It should be noted that during this audit, the Agency has been aggressively working on issuing the 3560 interim final rule that will implement numerous outstanding OIG issues. During the entrance conference of this audit, this issue was discussed with OIG and the Agency acknowledged that many of the issues that OIG would review were being implemented in the new interim final rule.

The interim final rule is currently being reviewed by OMB and the Agency anticipates the rule to be published in the next 30-60 days. Once the interim final rule is published, there will be a 30-day period prior to the rule being implemented.

The following is the Agency's response to the eleven OIG recommendations.

Recommendation No. 1 - Incorporate into regulations the specific requirements for owners and management agents on eligible and ineligible costs included in Administrative Notice 3911.

Agency Response - The Agency is in agreement with this recommendation. The Agency will provide OIG with sections of the 3560 interim final rule pertaining to the eligible and ineligible costs. *Timeframe - January 31, 2005.*

Recommendation No. 2 - Require that all RRH properties be subject to attestation engagements based on agreed-upon procedures.

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Secretary of Agriculture, Washington, DC 20250

Exhibit B – Agency Response

Exhibit B – Page 3 of 6

Agency Response - The Agency is in agreement with the recommendation. The interim final rule requires the borrowers to provide the Agency with a report based on the Agency engagement requirements. It should be noted that OIG has taken the lead in preparing the agreed-upon procedures. The Agency is waiting for OIG to complete its work. Due to the delays of this document, the Agency will not be able to implement this requirement for the FY 2004 financial period; it will be implemented for the FY 2005 financial period.

1. The Agency will provide sections of the 3560 interim final rule describing the report requirement for the borrower to submit annual financial reports including the engagement requirements. *Timeframe - January 31, 2005*
2. The Agency will provide the engagement once OIG has completed its work. *Timeframe - January 31, 2005.*

Recommendation No. 3 - Reestablish the Enforcement Team.

Agency Response - The Agency is in agreement with this recommendation. Handbook No. 3, "Loan Servicing," provides for the reestablishment for the Enforcement Team. The handbook provides the objective and associated requirements for States to submit requests for the Team to review.

It should be noted that during the past few years, the Portfolio Management Division has experienced major staff turnover due to retirements. During the past year, the Division has filled all vacancies and has requested additional staff to maintain the integrity needed for servicing of the MFH properties. With the new staff, we believe it would be appropriate to develop an Action Plan to establish criteria to evaluate borrowers that would receive a review by the Enforcement Team.

1. The Agency will provide the sections of the handbook pertaining to the Enforcement Team. *Timeframe - January 31, 2005.*
2. The Agency will provide an Action Plan to address how the team will evaluate and develop criteria used to identify borrowers for review by the Enforcement Team. *Timeframe - March 31, 2005.*

Recommendation No. 4 - Establish and implement controls over financial data entered into MFIS, such as field size limits, to ensure its accuracy.

Agency Response - The Agency agrees that integrity of the financial data entered into MFIS is important. It should be noted that keypunch error would occasionally happen.

The current field size for the financials are thirteen characters (which includes two decimal positions). The Agency does not agree that changing current field sizes is a workable solution. With properties ranging from two units up to over 500 units, changing field sizes would be problematic.

However, the Multi-Family Housing Portfolio Management Division (MHPMD) will issue a memo to St. Louis IT staff requiring that a report be issued identifying any line item (other than subtotals) that exceeds \$1,000,000. This report will be issued annually prior to the system running a "norms" report. The report will be sent to MFHPMD for review. If needed, MFHPMD will contact the appropriate State Office for additional review.

Exhibit B – Agency Response

Exhibit B – Page 4 of 6

It is important to note that the Agency has enhanced the supporting computer systems to accept financial data electronically from the borrowers and management agents. This procedure was implemented March 12, 2004.

The Agency will provide documentation of a memo to St. Louis, IT staff for the required report. *Timeframe - January 31, 2005.*

The Agency has provided documentation for borrowers and management agents to submit financial data electronically. Attached is Administrative Notice dated March 12, 2004. *Request management decision and final action for this item.*

Recommendation No. 5 - Establish procedures instructing States on the required use of MFIS as a monitoring tool, including the implementation of controls to ensure that States use MFIS as instructed.

Agency Response - The Agency is in agreement with this recommendation. Handbook No. 3, "Loan Servicing" contains two sections regarding this: 1) the procedures on the use of MFIS as a monitoring tool and 2) implementation of control will be through the Servicing Goals which will be the reporting process to assure that MFIS is being used.

The Agency will submit the sections of the handbook that addresses this issue. *Timeframe - January 31, 2005.*

Recommendation No. 6 - After re-establishing the Enforcement Team, requires that the Team use MFIS to detect abusive owners and management agents.

Agency Response - See Response to Recommendation No. 3 regarding the Action Plan.

Recommendation No. 7 - Require the owners and management agents to sign a certification statement that the documentation provided to RHS on the identity-of-interest disclosure form is accurate, complete, and up-to-date.

Agency Response - The Agency is in agreement with this recommendation. The Agency will be implementing one new form and has modified two existing forms with the new rule regarding identity-of-interest companies.

The first new form is RD Form 3560-13, "Owner's and Management Agent Certification". This form is required for all management agents and borrowers. On this form, the management agent and borrower must disclose if there is any identity of interest relationship. If any changes should occur, the management agent and borrower must submit a new form.

The second form is RD Form 3560-30, "Certification of No Identity of Interest". This form states that there is no identity of interest. If there are any changes, the management agent and borrower must submit a new form.

The third form is RD Form 3560-31, "Identity of Interest Disclosure/Qualification Certificate". This form states that there is an identity of interest and requires full disclosure including a fee schedule for any identity of interest companies. If there are any changes, the management agent and borrower must submit a new form.

The Agency has added full disclosure statements on all of these forms and believes that better documentation will be provided with the use of these forms.

The Agency will submit the three forms RD Form 3560-13, 3560-30 and 3560-31.
Timeframe - January 31, 2005.

Recommendation No. 8 - Develop and implement guidance and procedures for analyzing identity-of-interest cost data submitted by owners and management agents.

Agency Response – See Agency’s response to Recommendation No. 7.

Recommendation No. 9 - Require identity-of-interest companies to provide copies of contracts for all services and supplies provided to RRH projects.

Agency Response - The Agency does not believe that requiring copies of contracts for all identity-of-interest companies is practical. See the Agency’s Response for Recommendation No. 7 relating to the three forms that will be required as part of the new rule regarding identity-of-interest companies.

The Agency does require borrowers and management agents to prove that identity-of-interest companies are in the best interest of the property.

The Agency believes that it would be adequate to enhance the supervisory (management) review process to concentrate more review covering identity-of-interest issues.

The Agency is working on retooling the supervisory (management) review form to include additional questions regarding contracts of identity-of-interest issues and will submit the form for final action. *Timeframe - September 31, 2005.*

Recommendation No. 10 - Perform annual comprehensive inspections of all RRH properties, or justify less than annual comprehensive inspections with alternative criteria, such as the results of past inspections, or the ages of the apartment properties.

Agency Response - The Agency currently performs annual physical inspections of all RRH properties. These annual physical inspections are referred to as “walk-about” which means that the Servicing Official inspects the grounds and common areas of the property. This includes but is not limited to site offices, community rooms, laundry rooms, interior and exterior hallways. The Agency acknowledges that the report cites that this type of a review “will not detect physical deterioration that can only be identified by observations of the interiors of apartments and through interviews with tenants.” However, the Agency does not believe that the OIG report adequately addressed this issue. OIG acknowledged that they did not inspect any of the properties using the current protocol or review any of the annual physical inspection reports using the current protocol. Therefore, the Agency does not believe it would be appropriate to require the Servicing Offices to perform “annual comprehensive inspections” based on this report.

It is important to note that the 1999 Joint Initiative was targeted to borrowers with financial, management and physical problems. It is not valid to extrapolate the findings of the OIG report to the portfolio as a whole when the report was based on a biased sample.

However, the Agency will review the effectiveness of the current protocol and then discuss the findings/results with OIG.

The Agency will provide OIG with an Action Plan describing how the Agency will

review the current protocol and recommendations for improving the process.

Timeframes - The Action Plan will be developed and submitted to OIG by April 30, 2005. The results will be submitted to OIG by September 31, 2005.

Recommendation No. 11 - Develop and implement guidelines for coordination with State and local inspection authorities.

Agency Response - The Agency is in agreement that guidelines will be incorporated into the Handbooks to address when the Agency should coordinate with State and local inspection authorities when health and safety issues exist at a property. It should be noted that not all jurisdictions might have inspection authorities; therefore, this requirement will only be for locations where there are inspection authorities in place.

The Agency will provide sections of the rule pertaining to Servicing Office requirements to coordinate with State and local inspection authorities. *Timeframe - April 31, 2005*

If you have any questions, please contact either Stephanie White, Director, MHPMD at 720-1615 or Janet Stouder, Deputy Director, MHPMD at 720-9728.

Attachment

Informational copies of this report have been distributed to:

Agency Liaison Officer (4)

U.S. Government Accountability Office (1)

Office of Management and Budget (1)

Office of the Chief Financial Officer

Director, Planning and Accountability Division (1)