



U.S. DEPARTMENT OF
HOUSING AND URBAN DEVELOPMENT
OFFICE OF INSPECTOR GENERAL

**MEMORANDUM NO:
2013-LA-0801**

October 3, 2012

MEMORANDUM FOR: Charles S. Coulter, Deputy Assistant Secretary for Single Family Housing, HU

Tanya E. Schulze

FROM: Tanya E. Schulze, Regional Inspector General for Audit, Los Angeles Region, 9DGA

SUBJECT: HUD Paid for Unnecessary REO M&M III Field Service Manager Administrative Costs

INTRODUCTION

In conjunction with our external audit of Innotion Enterprises, Inc.,¹ we reviewed termite inspection passthrough costs that it submitted to the U.S. Department of Housing and Urban Development (HUD) for payment as part of its real estate-owned (REO) Management and Marketing III (M&M III) program field service manager contract. We selected Innotion's Las Vegas, NV, branch based on the size and scope of its contract with HUD. One of our objectives was to determine whether Innotion's Las Vegas, NV, branch met administrative requirements concerning passthrough cost reasonableness.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the review.

The Inspector General Act, Title 5 United States Code, section 8L, requires that OIG post its publicly available reports on the OIG Web site. Accordingly this report will be posted at <http://www.hudoig.gov>.

¹ OIG external audit of Innotion Enterprises, Inc. (report number 2012-LA-1010, issued September 12, 2012)

SCOPE AND METHODOLOGY

We performed our onsite review work at Innotion's Las Vegas, NV, branch office at 2749 North Lamb Boulevard, Las Vegas, NV between January and June 2012. The review generally covered July 1 to December 31, 2011, but was expanded when necessary. To accomplish our objective, we:

- Reviewed the management and marketing support services contract's field service manager performance work statement;
- Reviewed HUD regulations and reference materials for management and marketing support services;
- Reviewed passthrough costs for 158 termite inspections, representing 10 randomly selected transmittals in the 1S contract area (Arizona, Idaho, and Nevada);
- Obtained copies of invoices for actual termite inspections;
- Requested confirmation from termite companies on the actual amount paid for the inspections; and
- Interviewed appropriate staff from HUD, Innotion, and Innotion's subcontractors, including the company that performed the termite services.

We randomly selected 10 transmittals for termite inspections using a nonstatistical sample from a universe of 54. The sample represented a total of 183 termite inspections, of which we were able to confirm amounts for only 158 of the termite inspections.² The transmittals were pulled from HUD's P260 system, which is an Internet-based system that serves as the primary system of record for all REO case management transactions. We did not rely solely on information obtained from the P260 system. Information was verified through examination of documentation and re-verifications. We did not project our findings to the population using the sample.

We followed generally accepted government auditing standards. However, the results reported in this memorandum stemmed from our external audit of Innotion and its compliance with its contract when submitting passthrough costs to HUD; thus, this report is significantly reduced in scope and should not be considered a detailed analysis or assessment of HUD's internal controls and operations. These facts do not affect the significance of the condition identified in this memorandum.

We provided the discussion draft report to HUD on August 24, 2012 and received informal written comments on September 26, 2012. The discussion draft was revised in response to the informal comments. Based on the revised discussion draft, HUD declined to provide a formal written response.

² We were unable to confirm 4 of 19 termite companies regarding the amounts paid; however, the confirmations received from the other 15 companies were sufficient for the purposes of our review.

BACKGROUND

HUD has outsourced the disposition of its REO inventory to management and marketing contractors since 1999. To ensure the continued success of its disposition program and to further capitalize on the private sector's disposition expertise, in 2007, HUD conducted extensive market research on industry best practices surrounding the REO asset disposition process to structure the third generation of the contracting program, known as M&M III. Based on market research results for M&M III, HUD developed a disposition structure for the management and marketing of REO inventory that will streamline its operations, capitalize on the expertise of its potential contractors, and provide flexibility to meet changing market conditions in the REO industry.

HUD's Financial Control Manual, paragraph 13.3, Pass Through Costs for Field Service Managers, states that all costs of performance under this M&M III contract are the expense of the field service manager's contractor unless otherwise specifically identified as a passthrough expense in the contract. The contracting officer must determine whether costs are allowable and reasonable in accordance with the Federal Acquisition Regulation Part 31. The performance work statement, attachment 5, Allowable Pass Through Expenses, states that the contractor must be reimbursed for the actual cost of the service or item. It further defines actual cost as the amount paid by the contractor to the billing parties and that no administrative costs of the contractor are to be added.

On January 16, 1997, Innotion incorporated its business. HUD selected Innotion as its field service manager to cover four contract areas. However, our audit objective covered only one contract area, which includes Arizona, Idaho, and Nevada, with a contract effective date of July 1, 2011. From the contract effective date to April 24, 2012, Innotion submitted 54 termite inspection transmittals totaling \$95,567. Innotion initially used a subcontractor called Safeguard Properties, which scheduled termite inspections with Terminix. Safeguard charged Innotion \$125 per inspection. Innotion stated that Terminix did not have the capacity to keep up with the workload and was not willing to go to some remote areas to perform the inspections. As a result, Innotion switched to One Stop Environmental to order its termite inspections.

Innotion's principals became acquaintances with the president of One Stop, and One Stop's president owned another business in the same building as Innotion's Indiana office. Innotion was One Stop's only customer, and One Stop was formed in November 2010 to accommodate Innotion's REO needs. One Stop ordered all termite inspections for Innotion.

RESULTS OF REVIEW

HUD paid for unnecessary administrative costs of Innotion's subcontractor under HUD's field service manager contract. This condition occurred due to the unclear definitions of actual and administrative costs in HUD's contract with Innotion. Although the contract stated that Innotion could pay only the amount billed and not add its own administrative costs, it did not specifically disallow the payment of administrative costs incurred by a subcontractor, such as One Stop, that subcontracted Innotion's work to other termite inspection contractors. As a result, 30 percent

(\$4,914) of the termite inspection costs paid by HUD in our sample were for the administrative costs of Innotion's subcontractor. If HUD does not revise its field service manager contracts, it may continue to pay for unnecessary administrative costs for termite inspections and other passthrough costs submitted by its field service manager contractors.

Innotion Used HUD's Unclear Contract Language To Bill the Administrative Costs of Its Subcontractor

Innotion's field service manager contract with HUD permitted it to bill HUD for actual passthrough costs, including termite inspections. The performance work statement specified that Innotion must be reimbursed for the actual cost of the service or item. Further, the performance work statement defined actual cost as the amount paid by Innotion to the billing parties and stated that no administrative costs of Innotion were to be added.

Termite Inspection Costs Were Marked Up To Pay for Administrative Costs

Innotion did not conduct termite inspections in house and, instead, used One Stop to order and schedule all of its inspections. Since One Stop did not conduct termite inspections, it subcontracted all termite inspection work. One Stop's president stated that termite companies offered the company a discount from the regular price of termite inspections. In the cases reviewed, One Stop paid its subcontractors the discounted fee and billed Innotion the normal, nondiscounted rate. As a result, One Stop received its fees based on the discount offered by the termite companies.

For example, Western Exterminator Company normally charged \$75 for an inspection but charged One Stop only \$60. One Stop billed Innotion \$75 for the inspection. The \$75 billed to Innotion met the definition of actual cost in the field service manager contract. However, the \$15 difference between the billed amounts was a 20-percent markup for the administrative costs of One Stop.

In other instances, termite companies did not offer a discounted rate but, instead, adjusted the bill higher than the amount paid by One Stop. For example, Realty Pest Services invoiced One Stop \$100 for a termite inspection, but One Stop paid only \$80 to Realty Pest Services. Through this arrangement, invoices from One Stop and Realty Pest Services showed \$100 as the billed amount, while the actual cost of the termite inspection was only \$80, the same price offered to all Realty Pest Services customers. Realty Pest Services stated that this billing arrangement was not normal business practice but agreed to bill in this manner as requested by One Stop. In essence, it built in One Stop's administrative cost.

Administrative Costs Accounted for an Average of 30 Percent of Termite Inspection Costs

In our sample of 157³ termite inspections, \$4,914 (30 percent) of \$16,589 in passthrough costs billed to HUD were for One Stop's administrative costs. Since One Stop did not consistently bill the same markup to Innotion for termite inspections, the amount of administrative cost mark-up in our sample varied in both amount and percentage. For example, One Stop initially billed Innotion at a rate of \$125 per inspection, which resulted in a markup as high as 59 percent (\$74). However, after performing market research and developing a network of termite inspection companies, One Stop reduced this rate to 20 percent for most of the inspections in our sample.

Through Innotion's arrangement with One Stop, HUD paid for unnecessary administrative costs of at least \$4,914 for termite inspections for properties under its REO M&M III contract with Innotion and may have incurred such costs with other field service managers as well. We attribute this condition to unclear language in HUD's field service manager contract. If HUD does not revise its field service manager contracts, it may continue to pay for unnecessary administrative costs for termite inspections and other passthrough costs.

RECOMMENDATION

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing:

- 1A. Ensure that HUD is paying fair and reasonable prices for passthrough expenses by ascertaining that field service managers are awarding subcontracts based on obtaining bids from qualified vendors that include, but are not limited to, the entities that actually perform the work. If this change had been implemented before our review, HUD could have put at least \$4,914 to better use.

³ We were able to verify 158 inspections in our sample of 183. Of these 158 inspections, 157 included mark-ups for administrative costs.

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use <u>1/</u>
1A	\$4,914

- 1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. If HUD implements our recommendations, it will pay the field service managers the appropriate amounts for services that were provided for HUD REO properties. Funds to be put to better use represent the amount that HUD paid for administrative costs for termite inspections in our sample.