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AUDIT  
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TO: Tammye Trevino  
Administrator  
Housing and Community Facilities Program

ATTN: John Dunsmuir  
Acting Director  
Financial Management Division

FROM: Gil H. Harden  
Assistant Inspector General for Audit

SUBJECT: Rural Development's Project Cost and Inspection Procedures for the Rural Rental  
Housing Program

This report represents the results of our audit of the Rural Rental Housing Program's project cost and inspection procedures. Our audit evaluated the Rural Housing Service's internal controls over Rural Rental Housing (RRH) owners' financial operations, as well as its inspection process. The agency response to the official draft, dated September 6, 2012, is included at the end of the report and the Office of Inspector General's position, with excerpts, is incorporated into the Findings and Recommendations section of the report. Based on the response, we have reached management decision on all seven recommendations and no further response is necessary.

Please follow your agency's internal procedures in forwarding documentation for final action to the Office of Chief Financial Officer. In accordance with Departmental Regulation 1720-1, final action should be completed within 1 year of each management decision to prevent being listed in the Department's annual Performance and Accountability Report.



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# Rural Development's Project Cost and Inspection Procedures for the Rural Rental Housing Program

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## Executive Summary

The United States Department of Agriculture (USDA), through its Rural Development mission area, administers the Rural Rental Housing (RRH) Program. The RRH Program was established to provide affordable multi-family rental housing to low and moderate-income families, the elderly, and persons with disabilities living in rural areas. Rural Development manages the program through its Rural Housing Service (RHS) national office in Washington, D.C., and through 47 State and more than 250 area offices across the nation.

Rural Development provides financing to individuals, public agencies, cooperatives, and profit and non-profit organizations to construct and operate RRH properties. In December 2011, Rural Development's portfolio consisted of more than 14,700 RRH properties with outstanding loans totaling almost \$11 billion. Rural Development had provided over \$1 billion in rental assistance subsidies to more than 800,000 tenants residing in the properties in fiscal year (FY) 2011.

The purpose of this audit was to evaluate the agency's internal controls designed to ensure that owners accurately report the financial operations, and maintain the physical condition, of properties participating in the RRH Program. We concluded that the agency's controls were inadequate to detect any misuse of RRH Program funds by borrowers and their management agents.<sup>1</sup> We also determined that agency policies and procedures needed strengthening to ensure that owners repair physical deterioration of properties detected by agency inspections.<sup>2</sup>

Nationwide, Rural Development uncovered only a small percentage of cases where owners had not complied with agency financial requirements during calendar years (CY) 2007 through 2009, despite a history of abuse in the program. The agency's key internal control to detect any misuse of funds, attestation engagements<sup>3</sup> performed by independent certified public accountants (IPAs), uncovered only 108 instances of noncompliance<sup>4</sup> during the performance of about 28,000 engagements (0.4 percent) during CYs 2007 through 2009. In contrast, audits performed by the Office of Inspector General (OIG) have historically identified a much higher percentage of misused RRH Program funds. For instance, OIG and RHS performed a joint evaluation in 1999 that uncovered \$4.2 million in misused funds by 56 percent (18 of 32) of the owners.<sup>5</sup>

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<sup>1</sup> For purposes of our report, we refer to the borrower, or recipient of the loan from Rural Development, as well as any agents the borrower hired to manage the property, collectively as the "owner."

<sup>2</sup> Our audit was postponed after January 2009 in order to perform other high priority audits related to natural disasters and the American Recovery and Reinvestment Act of 2009. We resumed work on a regular basis in July 2011.

<sup>3</sup> An attestation engagement includes a series of procedures (agreed-upon procedures) to be executed by independent certified public accountants to ensure multi-family housing properties are in sound financial condition and in compliance with the RRH Program's financial management requirements.

<sup>4</sup> A noncompliance issue does not always involve the misuse of funds.

<sup>5</sup> OIG Evaluation Report 04801-0006-Ch, *Rural Housing Service Rural Rental Housing Program: Uncovering Program Fraud and Threats to Tenant Health and Safety*, dated March 1999. We conducted the evaluation in

We concluded that the attestation engagements were ineffective for several reasons. Owners had not hired IPAs to perform attestation engagements for all required properties. In CY 2006, owners had not obtained engagements for almost 34 percent (4,167 of 12,332) of the RRH properties that required them.<sup>6</sup> The number of engagements not performed in CY 2007 was slightly less at 31 percent (3,918 of 12,416). RHS national officials stated that attestation engagements were not always being performed because they were too expensive for some properties.

In 2007, RHS national officials also decreased the number of agreed-upon procedures to be used by IPAs during attestation engagements from 11 to 3. RHS national officials stated that they decreased the number of procedures because IPAs performing CY 2006 engagements complained that the measures were time-consuming and did not specify the level of required testing. However, some of the deleted procedures were critical to the detection of any misused RRH funds by owners. In our view, this action significantly diminished the ability of IPAs to detect misuse of program funds during attestation engagements.

RHS requires owners to hire IPAs to perform attestation engagements, rather than having RHS officials perform them. This requirement can lead to situations involving conflicts of interest. In the past, we identified several instances where IPAs had other business relationships with owners. When we discussed RHS contracting directly with IPAs, RHS national officials stated that the option of contracting directly with IPAs to perform attestation engagements for all RRH properties was not viable because it was cost prohibitive for the agency. As an alternative, we recommend that RHS reduce the number of properties required to be examined each year, and use a risk-based approach to select properties for attestation engagements. Since most owners have multiple properties, an examination of a few properties should provide sufficient knowledge of the owner's financial activities. This policy could reduce the amount of Government subsidies to RRH properties, remove the potential for conflicts of interest with owners, and potentially provide agency officials with better results.

After owners have reported the financial activities of RRH properties, the agency relies solely on attestation engagements to detect any misuse of funds. Consequently, weaknesses with this control increase the risk that owners will misuse program funds. Further, the loss of program funds reduces the amounts available to repair and maintain properties, which can negatively impact the physical condition of properties. The physical deterioration of RRH properties adversely affects the health and safety of tenants and decreases the value of the Government's security interest.

Our audit found that owners had not properly maintained 192 of the 319 RRH properties we visited during our audit.<sup>7</sup> The 192 properties had significant maintenance, health, and/or safety deficiencies. Rural Development State officials had identified the deficiencies at 44 of the

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accordance with *Quality Standards for Inspections*, issued in March 1993 by the President's Council on Integrity and Efficiency.

<sup>6</sup> RHS national officials provided us with these nationwide statistics, which they extracted from the Multi-Family Information System.

<sup>7</sup> The properties were located in the State of Indiana.

properties during prior year inspections, but were unable to compel owners to make repairs and comply with agency requirements. We attributed this to unclear guidance on the type of administrative action that State officials should take against noncompliant owners. Further, the agency did not have a graduated schedule of penalties to impose on owners when civil sanctions were the appropriate action.

We evaluated the actions agency officials took for each of the 44 cases and concluded that they had properly notified owners of the findings and violations, and the requirement to submit a corrective action plan within 30 days. However, despite the existence of agency follow up procedures, the owners of 66 percent of the properties with reported findings and violations had not responded to the agency's letters.<sup>8</sup> We generally found that owners did propose corrective action each year, but never actually repaired the physical deterioration. We also found that agency officials generally took no further administrative action.

Rural Development State officials said they had not pursued civil monetary penalties for these cases because the agency's policy did not clearly delineate when and under what conditions these actions should be taken, and the appropriate penalty fee. The officials also said they were reluctant to pursue actions such as foreclosure and debarment of owners because it might displace tenants living in the apartment complexes. They added that the actions were complicated, time consuming, involved a lengthy process (foreclosure action can take as long as 3 years), and, at times, were unreasonable in proportion to the finding or violation. Thus, they generally chose to work with owners to resolve physical deficiencies, rather than create an adversarial relationship with them by taking additional administrative actions.

Our analysis of Rural Development's regulations confirmed some of the agency officials' statements. For instance, the regulations state that civil monetary penalties can be imposed up to \$25,000 per violation. However, the regulation does not stipulate under what specific conditions these remedies should be used against owners. It also does not provide a schedule that matches findings and violations to specific amounts for each infraction, and a graduated scale for increased penalties for noncompliance after specified periods of time. RHS national officials agreed with our conclusions and informed us that they were updating the monetary penalty regulations.

## **Recommendation Summary**

We recommended that RHS either perform its own examinations of owner financial activities or contract directly with IPAs to perform attestation engagements of select RRH Program properties. The agency should select properties based on high-risk indicators of potential misuse of funds. We also recommended that RHS reinstitute the agreed-upon procedures eliminated from the attestation engagement requirements in 2007.

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<sup>8</sup> This occurred for 29 of 44 properties.



We recommended that RHS clarify agency guidance on the type of administrative action to take against noncompliant owners, and when to take the action. We also recommended that the agency develop and implement a graduated schedule of punitive measures to be taken when owners do not comply with agency requests to correct findings and violations.

## **Agency Response**

In its response to our report, RHS officials expressed concerns about the audit's scope and methodology; however, they are going to implement corrective actions for each of the findings and recommendations.

## **OIG Position**

The agency's concerns regarding the scope and methodology of our audit do not reflect all of the factors we considered in formulating our conclusions. One concern RHS officials had was that we included only one State and one management company in our audit, which was insufficient to formulate conclusions regarding the program as a whole. As stated in the report, we have performed numerous nationwide audits of the RRH Program that identified major internal control weaknesses and exposed significant misuse of program funds. We performed those audits in many States and included numerous management companies across the nation. These audits provided us with extensive knowledge of the policies, procedures, and internal controls that RHS officials implemented regarding the RRH Program. Government auditing standards permit us to reduce the scope and methodology of an audit based on that knowledge. Thus, our past knowledge from work involving many States and management companies along with the results from the one State in our current audit were sufficient, in our judgment, to formulate our conclusions regarding the agency's existing controls.

RHS officials stated that we would not provide guidance for the agency's implementation of the 11-step audit procedures for IPAs, and did not address this issue in the report. We disagree. We coordinated development of the procedures with the American Institute of Certified Public Accountants. This included consulting with numerous large IPA firms that routinely participated in the RRH Program. We also fielded numerous calls from IPAs subsequent to implementation of the procedures to answer questions. Further, we routinely met with RHS officials to discuss the process. These issues were not raised in our report because they were not relevant to our conclusion regarding the 11 procedures and whether the reduction in those procedures strengthened or weakened the control.

The agency's response states that our recommendations did not consider efforts underway by RHS officials to align financial reporting to other Federal agencies. We disagree because our recommendations do not address the agency's financial reporting process. Rather, they address the agency's controls to validate the accuracy of the financial reports once they are submitted by entities participating in the RRH Program. Also, at our final meeting, RHS officials stated the initiative had stalled, and there was no progress or relevant details they could provide for our consideration. We also asked them for alternative suggestions to improve the program's internal controls, but they had nothing for us to consider.

Finally, the agency requested that we remove references to the alignment of IPA engagements in the report because it suggests that accurate engagements can only occur if paid for by the Government. We recommended this change for two reasons. First, as explained in detail in the report, the agency could directly reduce the number of engagements, which would significantly reduce costs to the program. Second, the action would reduce the appearance of a conflict of interest during the performance of IPA attestation engagements.

## Background and Objectives

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### Background

The Rural Development mission area within the USDA is responsible for administering the Rural Rental Housing (RRH) Program. The agency administers the RRH Program through the Rural Housing Service (RHS) national office in Washington, D.C., 47 State offices, and more than 250 area offices. The RRH Program was established to provide affordable rental housing to low and moderate-income families, the elderly, and persons with disabilities living in rural areas. Rural Development provides financing to individuals, public agencies, cooperatives, and profit and non-profit organizations to construct and operate RRH- funded apartment complexes.

In fiscal year (FY) 2011, Rural Development had more than 14,700 RRH properties in its loan portfolio. The outstanding loan balance on those properties amounted to over \$10.9 billion as of December 2011. The properties housed over 800,000 tenants. The Government provided more than \$1 billion in rental assistance and over \$647 million in interest credit subsidies to owners on behalf of eligible tenants in FY 2011.

The owners of apartment complexes financed through the RRH Program may hire a management company to operate their properties.<sup>9</sup> The owners and their agents are responsible for complying with all applicable laws, regulations, and loan covenants pertaining to the RRH Program.<sup>10</sup> According to regulations, RRH property owners can realize a return on their initial investment, capped at 8 percent of an owner's equity contribution.<sup>11</sup> Owners can also gain Federal tax credits to offset their tax liability.<sup>12</sup> The management agent can receive a monthly fee from the property's operating account (ranging from \$44 to \$64 per unit) for administrative costs such as salary, bookkeeping, supervising staff, and submitting financial reports to Rural Development.<sup>13</sup> The property's rental income is to be used for operating and maintenance expenses, and to fund reserve accounts for capital improvements (e.g., major repairs or upgrades, such as a new roof).<sup>14</sup> Rental income includes rental assistance subsidy payments from Rural Development to RRH property accounts on behalf of qualifying tenants.<sup>15</sup>

RHS requires attestation engagements<sup>16</sup> and physical property inspections<sup>17</sup> to ensure properties are financially sound, and in compliance with the program's requirements. RHS also requires

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<sup>9</sup> For purposes of our report, the borrower, or recipient of the loan from Rural Development, as well as any agents hired by the borrower to manage the property, will collectively be captured under the term "owner."

<sup>10</sup> 7 CFR 3560.101, dated November 26, 2004. Rural Development officials must approve the agent in advance.

<sup>11</sup> 7 CFR 3560.68(a), dated November 26, 2004.

<sup>12</sup> 7 CFR 3560.63(c)(1), dated November 26, 2004.

<sup>13</sup> 7 CFR 3560.102(i), dated November 26, 2004, and *Multi-Family Housing Asset Management Handbook 2-3560*, Chapter 3 (Attachment 3-F), dated February 24, 2005.

<sup>14</sup> 7 CFR 3560.65, dated November 26, 2004, and *Multi-Family Housing Asset Management Handbook 2-3560*, Chapter 3.8(D), dated February 24, 2005.

<sup>15</sup> *Multi-Family Housing Asset Management Handbook 2-3560*, Chapter 4.3(A) and 8.2(A), dated February 24, 2005.

<sup>16</sup> 7 CFR 3560.308(a)(3) and (d)(1), dated November 26, 2004. An attestation engagement includes a series of procedures (agreed-upon procedures) to be executed by independent certified public accountants to ensure multi-

owners to submit annual reports on the financial condition of every property. Every property must annually file reports that cover the budget, income, expenses, and the balance sheet.<sup>18</sup> All properties with 16 or more units are required to undergo attestation engagements using “agreed-upon procedures.”<sup>19</sup> These specific agreed-upon procedures include tests to verify compliance with agency requirements, and must be completed by an independent certified public accountant, licensed by a State Board of Accountancy. Properties with 24 or more units must also undergo an independent audit of the financial statements performed in accordance with *Government Auditing Standards*.<sup>20</sup>

Rural Development State and area office personnel inspect RRH properties every 3 years to ensure that tenants are living in decent, safe, and sanitary conditions.<sup>21</sup> Properties with unresolved physical findings are inspected every year until the owner fixes the deficiencies. If the inspection finds deficiencies termed findings or violations, owners are asked to make timely repairs. A finding is a failure to meet physical standards that indicate a widespread occurrence or pattern of physical problems that typically should not surface with sufficient routine maintenance. A violation is a physical deficiency that is elevated either by its severity or the lack of timely corrective action by the owner.<sup>22</sup>

If findings or violations are identified during a property inspection, Rural Development officials are required to send a preliminary letter to the owner that requests a response within 30 days. The owner’s response must include the procedures and time frames for making repairs. If no response is received from the owner within 30 days, Rural Development officials are required to send a servicing letter that initiates the beginning of a 60-day period before the owner is considered in default. A second letter is to be sent after 15 days if the owner has not responded to the first servicing letter. The second letter informs the owner of the date by which he/she will be considered delinquent. The agency will send a third letter if the owner has not responded after another 15 days. The third letter warns the owner of the impending default with terms of the loan agreement, and that the owner will be subject to penalties and foreclosure if the findings or violations are not corrected in 15 days.<sup>23</sup> Federal regulations allow Rural Development to initiate liquidation, criminal penalties, or civil sanctions against noncompliant owners.<sup>24</sup>

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family housing properties are in sound financial condition and in compliance with the RRH Program’s financial management requirements.

<sup>17</sup> *Multi-Family Housing Asset Management Handbook 2-3560*, Chapter 9.9, dated December 17, 2008. Rural Development staff inspects RRH properties’ grounds and buildings to ensure the property is being sufficiently maintained, and that tenants have decent, safe, and sanitary housing.

<sup>18</sup> Rural Development Form 3560-7, *Multiple Family Housing Project Budget*, and Form 3560-10, *Multiple Family Housing Borrower Balance Sheet*.

<sup>19</sup> The *Agreed Upon Procedures* report includes the certified public accountant’s conclusions, based upon the tests that were conducted. The report is provided to the property owner at the conclusion of the engagement.

<sup>20</sup> 7 CFR 3560.308(a)(3) and (d)(1), dated November 26, 2004, and *Multi-Family Housing Asset Management Handbook 2-3560*, Chapter 4.32 (D), dated October 4, 2007.

<sup>21</sup> *Multi-Family Housing Asset Management Handbook 2-3560*, Chapter 9.9, dated December 17, 2008.

<sup>22</sup> *Multi-Family Housing Asset Management Handbook 2-3560*, Chapter 10.7 and 10.8, dated February 24, 2005.

<sup>23</sup> *Multi-Family Housing Servicing Handbook 3-3560*, Chapter 10.10(A), dated February 24, 2005.

<sup>24</sup> 7CFR 3560.452(e) and 7 CFR 3560.461(a)(1)and(2), dated November 26, 2004.

Rural Development officials record all findings and violations in the Multi-Family Housing Information System (MFIS). RRH properties are assigned a classification in MFIS based on the adequacy of financial information and the results of physical inspections. The properties are classified from A to D, based on the financial and physical conditions of the property. Properties classified as “A” are considered to be in good financial and physical condition. Properties classified as “D” have been issued all three servicing letters, are in default, and are subject to foreclosure or other administrative action.<sup>25</sup>

The Office of Inspector General (OIG) has performed numerous nationwide audits of the RRH Program in the past.<sup>26</sup> The audits have identified major internal control weaknesses, which allowed owners to inflate expenses, charge fictitious costs, and misappropriate reserve account funds. The audits also disclosed that it was common for owners to use related parties, otherwise known as identity-of-interest companies, to misuse program funds.<sup>27</sup> We found that owners diverted RRH funds to these companies, which oftentimes resulted in the physical deterioration of properties and underfunded reserve accounts. The physical deterioration occurred because there were insufficient funds to properly maintain the structures.

## **Objectives**

We conducted this audit to evaluate RHS’ internal controls over RRH owners’ financial operations and to determine if RHS’ inspection process adequately identified and resolved maintenance issues, including those related to the health and safety of tenants

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<sup>25</sup> *Multi-Family Housing Asset Management Handbook 2-3560*, Chapter 9.7, dated March 17, 2010.

<sup>26</sup> For example, OIG audited 13 property owners as part of OIG’s Audit Report 04600-0047-CH, *Farmers Home Administration Rural Rental Housing Program Management Operations*, Washington, D.C, dated September 1994, and 32 property owners in Evaluation Report 04801-0006-Ch, *Uncovering Program Fraud and Threats to Tenant Health and Safety*, dated March 1999.

<sup>27</sup> 7 CFR 3560.11, dated January 1, 2005, and November 17, 2009, defines an identity-of-interest as a relationship between applicants, borrowers, grantees, management agents, or suppliers of materials or services.

## Section 1: Controls Over RRH Property Finances and Physical Condition

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### Finding 1: Attestation Engagements Did Not Detect Misuse of Funds

Rural Development uncovered only a small percentage of cases where owners had not complied with agency financial requirements during calendar years (CY) 2007 through 2009,<sup>28</sup> despite a history of problems in the program. We determined that the agency's key internal control, attestation engagements performed by independent certified public accountants (IPAs), was ineffective for several reasons. First, attestation engagements were not performed on a significant number of RRH property operating accounts. Second, in 2007, RHS national officials decreased the number of agreed-upon procedures that IPAs used from 11 to 3. Some deleted procedures were critical to detect the misuse of funds. Finally, attestation engagements were administered by the owners, rather than agency officials. In effect, the owners were responsible for implementing a control designed to detect their own wrongdoing. Past OIG audits have shown that ineffective financial controls have a negative impact on the physical condition of properties and the living conditions of tenants.

RHS requires owners of RRH properties to deposit rental income<sup>29</sup> into accounts, to be used for the operating expenses and capital reserves of properties. Agency regulations state that allowable operating expenses include items such as those related to repairs, maintenance, and administrative costs of an RRH property. The operating expenses must also be reasonable, typical, and necessary for the property.<sup>30</sup> To ensure that owners have not misspent funds in operating and reserve accounts, RHS requires them to contract with IPAs to conduct attestation engagements annually for each RRH property with 16 or more units.<sup>31</sup>

IPAs performed 27,747 attestation engagements of RRH properties between CYs 2007 and 2009. From those engagements, they reported 108 instances of noncompliance with agency financial requirements (0.4 percent of all engagements).<sup>32</sup> In contrast, Office of Inspector General (OIG) audits have historically identified a much higher rate of financial noncompliance and misuse of RRH funds. For instance, OIG and RHS uncovered \$4.2 million in funds misused by 56 percent (18 of 32) of the owners examined during a joint evaluation in 1999.<sup>33</sup> The 32 owners were identified as high risk. We have discussed this issue with RHS national officials since at least

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<sup>28</sup> The agency identified 108 instances of noncompliance during CY's 2007 through 2009 out of about 28,000 engagements checking for the misuse of funds.

<sup>29</sup> This includes rental assistance subsidies Rural Development provides to owners on behalf of eligible tenants, and rent payments made by tenants directly to owners.

<sup>30</sup> 7 CFR 3560.102(a), dated November 26, 2004.

<sup>31</sup> 7 CFR 3560.308(a)(3), dated November 26, 2004.

<sup>32</sup> A noncompliance issue does not always involve the misuse of funds.

<sup>33</sup> OIG Evaluation Report 04801-0006-Ch, *Rural Housing Service Rural Rental Housing Program: Uncovering Program Fraud and Threats to Tenant Health and Safety*, dated March 1999. We conducted the evaluation in accordance with *Quality Standards for Inspections* issued in March 1993 by the President's Council on Integrity and Efficiency.

1994 when we performed a nationwide audit of the RRH Program.<sup>34</sup> At that time, we identified significant misuse of RRH funds by owners and recommended among other measures that RHS (1) contract directly with IPAs to conduct audits of selected RRH properties, and (2) revise the audit program used by IPAs to include an emphasis on high-risk areas of RRH operations. RHS national officials agreed to implement the two recommendations, but did not accomplish the task. In 2004, we again reported our concerns about continuing misuse of RRH Program funds.<sup>35</sup> As in past nationwide audits, we recommended that the agency require all RRH properties be subject to attestation engagements using agreed-upon procedures. RHS national officials agreed with our recommendation, and we agreed to prepare the agreed-upon procedures to be used during the attestation engagements. Subsequently, we developed 11 agreed-upon procedures to be used by IPAs during attestation engagements.<sup>36</sup> We had used the 11 procedures to identify misuse of funds during our earlier audits. We designed the procedures to focus IPA efforts on high-risk transactions, such as those involving related party (i.e., “identity-of-interest”) companies, which were commonly used to inflate expenses or bill properties for services that the company never rendered.

RHS national officials implemented the 11 agreed-upon procedures for use during the CY 2006 reporting cycle. As part of this audit, we evaluated the agency’s overall control process to identify the effectiveness of using the attestation engagements to detect the misuse of funds. The following sections describe our analysis and conclusions regarding the control weaknesses causing the lack of findings by IPAs.

#### *Engagements Not Performed for All RRH Properties*

We concluded that the effectiveness of the control was weakened because some owners did not engage IPAs to examine financial operations at all required properties. Our analysis disclosed that owners had not hired IPAs to perform required attestation engagements for about 34 percent (4,167 of 12,332) of all RRH properties during CY 2006. RHS national and Rural Development State officials stated that attestation engagements were not performed because they were too expensive for some properties. Those officials informed us that the rate of compliance gradually improved in subsequent years. The number of submitted attestation engagement reports was 10,302 in CY 2009.<sup>37</sup> Therefore, the level of non-compliance was reduced by half to 17 percent over a 3-year period. However, more than 2,000 properties were still not in compliance with RHS’ requirement in CY 2009.

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<sup>34</sup> OIG Audit Report 04600-0047-Ch, *Farmers Home Administration Rural Rental Housing Program Management Operations, Washington, D.C.*, dated September 1994.

<sup>35</sup> OIG Audit Report 04016-0001-Ch, dated September 30, 2004.

<sup>36</sup> OIG’s role in developing the agreed upon procedures are consistent with the Government Accountability Office’s Government Auditing Standards and the Inspector General Act.

<sup>37</sup> In CYs 2006 through 2009, the number of engagement reports submitted by owners increased from 8,165 to 10,302.

### *RHS Reduced the Number of Agreed-Upon Procedures for Attestation Engagements*

For CY 2007 and subsequent years, RHS national officials reduced the number of agreed-upon procedures for attestation engagements from 11 to 3. RHS national officials stated that they decreased the number of procedures because IPAs performing CY 2006 engagements complained that the measures were time-consuming and did not specify the level of required testing. RHS national officials stated that, since only 43 of 8,165 (0.5 percent) of the CY 2006 attestation engagements identified a deficiency, they concluded the procedures were unproductive and, without informing OIG, deleted some to address the IPAs' concerns. However, the RHS national officials had no analysis or other documentation to support the IPAs' contentions.

We examined the changes and concluded that RHS national officials had deleted key procedures that would identify any misuse of funds. The deleted procedures included: (1) the comparison of the total amount paid from the operating and maintenance account to the general ledger and the Expense Schedule submitted to Rural Development; (2) the comparison of maintenance expenses to Federal regulations for eligibility and reasonability; (3) the requirement to verify that identity-of-interest companies were actual businesses; (4) an examination of the caretaker agreement for compliance with requirements; (5) the confirmation that owners solicited bids from independent companies when they used identity-of-interest companies to procure goods and services for the properties; (6) a determination that selected contractor companies were not undisclosed identity-of-interest companies; and (7) confirmation by independent verification that identity-of-interest companies exist and provide services to the general public. (See exhibit A.)

Eliminating these procedures may improve the timeliness of attestation engagements. However, in our view, they are critical procedures that need to be performed to identify any misuse of funds. We have used these procedures in our prior work to identify and highlight the misuse of funds. Overall, we concluded that RHS needs to restore all 11 agreed-upon procedures to improve the ability of IPAs to identify misuse of RRH Program funds.

### *Property Owners' Responsibility for Hiring IPAs Poses a Conflict of Interest*

Property owners are responsible to implement attestation engagements. Owners select the IPA, work with the IPA on the engagement, pay for the attestation engagement services, provide records and documentation to the IPAs, and receive the results. Commonly, owners also work with the IPA on other financial services the firms provide. The business generated by the attestation engagement requirement, for other financial services, and audits of larger properties can be lucrative. In our view, this could affect IPAs' efforts to find financial mismanagement by owners. The owners' prominent role creates the potential for conflicts of interest and weakens the agency's key financial control, particularly since the process was established to detect owners who exploit the program.



We used the 11 agreed upon procedures at two RRH properties to determine their effectiveness.<sup>38</sup> Our testing identified significant misuse of funds during a 2-year period that included nearly \$153,000 in unallowable expenses, multiple undisclosed identity-of-interest companies, and incomplete and disorganized financial records. In contrast, the IPA reported no deficiencies or undisclosed identity-of-interest companies in its attestation engagement reports for these same two properties. We found signs of weaknesses in the IPA's approach to performing this work. For example, the IPA used negative confirmations, a weak form of transaction testing. With a negative confirmation, no response from a vendor is viewed as agreement that everything is correct. In our opinion, this is an inappropriate procedure because an identity-of-interest company will likely not reply to a negative confirmation. The extent of the discrepancies that we found at these two properties compared to the IPAs' "No Findings" reports shows that the attestation engagement as a financial control was not effective at identifying or alerting the agency to the misuse of funds for these properties. However, due to timing differences between the time we performed our work and when the firms performed their work, we were unable to assess whether the IPA had conducted the engagements with due diligence.<sup>39</sup>

We also reviewed 220 engagements performed for Indiana RRH properties, covering CYs 2006 and 2007, and found some additional weaknesses with the work performed.<sup>40</sup> We observed additional engagements that used negative confirmations, and some IPA results that simply stated "No Finding" next to each procedure, without explaining how the IPA arrived at that conclusion.<sup>41</sup> This highlights the weak design of this financial control. RHS national officials agreed that the firms' independent engagements have been ineffective at detecting the misuse of program funds.

We conclude that to improve results, RHS national officials should either establish an internal team to perform financial reviews on a full-time basis, or contract directly with IPAs to perform attestation engagements. The implementation of either of the two measures would ensure that the financial activities of all properties participating in the RRH Program are subject to examination. Currently, as we reported, a significant number of owners are not hiring IPAs to perform the attestation engagements. RHS national officials have periodically used internal review teams in the past with success to examine the financial activities of RRH Program properties. However, RHS national officials stated that impending staff reductions would make it difficult to perform financial examinations using agency staff. Further, they said that the cost of performing examinations internally would outweigh the benefits.

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<sup>38</sup> OIG Audit Report 04601-0020-Ch, *Rural Rental Housing Program – Audit of a Rural Rental Housing Company in Indiana*, dated May 2011. According to this report, "We judgmentally selected the management company for audit, based on its location, small size, and concerns brought to our attention by agency officials." This company was also under investigation for its business activities in another State.

<sup>39</sup> Due diligence is the care that a prudent person might exercise in the examination and evaluation of risks affecting a business transaction.

<sup>40</sup> We selected 2 years of file information for 154 properties for a total of 308 possible engagements. We found that 28 of 308 properties did not have enough units to warrant an engagement, and 60 other properties required one, but no engagement reports were submitted by the owners.

<sup>41</sup> We did not audit the IPAs' practices or determine if due diligence was exercised in these engagements.

RHS national officials also stated that the option of contracting directly with IPAs to perform attestation engagements for all RRH properties was not viable because it was cost prohibitive for the agency. As an alternative, we recommend that RHS reduce the number of properties required to be examined each year, and use a risk-based approach to select properties for attestation engagements. Since most owners have multiple properties, an examination of a few properties should provide sufficient knowledge of an owner's financial activities. This policy would dramatically reduce the overall cost to the Government, remove the potential for conflicts of interest with owners, and potentially provide agency officials with better results.

We have found a direct correlation between the physical deficiencies of the properties and the misuse of program funds. A risk-based selection would also allow RHS to direct its limited resources toward engagements that provide better results. For example, depending on the risk model, RHS national officials may only have to evaluate 10 percent of all RRH properties (1,242 engagements, costing approximately \$5 million) instead of nearly all properties,<sup>42</sup> as is currently required (12,416 engagements for approximately \$50 million).<sup>43</sup> While the agency would incur higher review costs under the system, our analysis indicates considerable net savings to the Government at the program level. The funds to pay for the engagements currently come from the operating accounts (receipts from rent and Government subsidy payments) of the RRH properties. RHS national officials agreed that the independent engagements have not been effective, and are interested in exploring alternatives to improve the program. However, they continued to express concern regarding the availability of funds and staff to implement our proposed recommendations.

## **Recommendation 1**

Examine RRH property finances using either agency review teams or by contracting directly with IPAs to perform attestation engagements using agreed-upon procedures.

## **Agency Response**

Agency officials stated they have limited resources which would make it extremely difficult to examine property finances by either agency review teams or by contracting directly with IPAs. In addition, their response for Recommendation 3 indicates the agency has been working with the White House's Domestic Policy Council and its Rental Policy Working Group on an initiative to reduce duplication of requirements on customers, eliminate conflicting administrative requirements, and align program requirements in the affordable rental housing industry. Agency officials plan to implement this cross-agency standardization that is now underway with other Federal agencies by June 30, 2013.

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<sup>42</sup> Based on counts from FY 2010, 12,416 of 15,723 (79 percent) properties required an attestation engagement.

<sup>43</sup> Rural Development national officials estimated an attestation engagement cost of \$4,000. For the FY 2010 count of 12,416 properties, the total cost would be approximately \$50 million.

## **OIG Position**

We accept management decision for this recommendation.

## **Recommendation 2**

Implement a risk-based approach to evaluations that selects properties by reliable indicators of financial misuse, including owner use of identity-of-interest companies, neglected properties, and prior problems.

## **Agency Response**

Agency officials agree with the recommendation and that high-risk properties should receive closer evaluation of financial performance. In their response to Recommendation 3, agency officials also indicated that in their work with the White House's Domestic Policy Council and the Rental Policy Working Group, the Federal agencies have discussed a risk-based threshold wherein property owners combined Federal loans and assistance subsidies exceed \$500,000. Adoption of similar standards will reduce the burden on project budgets, as multiple reports become unnecessary.

## **OIG Position**

We accept management decision for this recommendation.

## **Recommendation 3**

Reinstitute the original 11-step agreed-upon procedures for use by IPAs during attestation engagements or agency review teams.

## **Agency Response**

The agency has been working with the White House's Domestic Policy Council and the Rental Policy Working Group on an initiative to reduce duplication of requirements on customers, eliminate conflicting administrative requirements, and align program requirements in the affordable rental housing industry. To achieve the mandate, agency and HUD officials have agreed to cross-agency standardization on both the format of financial reporting and the audit guidelines governing that reporting. Agency officials feel they can exceed OIG requirements through adoption of the HUD OIG's Consolidated Audit Guide.

## **OIG Position**

We accept management decision for this recommendation.

## **Finding 2: Owners Had Not Repaired Physical Deterioration at RRH Properties**

Owners had not properly maintained 192 of the 319 RRH properties we visited during our audit.<sup>44</sup> The 192 properties had significant maintenance, health, and/or safety deficiencies. Rural Development State officials had identified the deficiencies at some of the properties during prior year inspections, but were unable to compel owners to make repairs and comply with agency requirements. We attributed this to unclear guidance on the type of administrative action that State officials should take against noncompliant owners. Further, the agency did not have a graduated schedule of penalties to impose on owners when civil sanctions were the appropriate action. The physical deterioration of RRH properties adversely affects the health and safety of tenants and decreases the value of the Government's security interest.

Rural Development requires owners participating in the RRH Program to maintain properties in a decent, safe, and sanitary manner for tenants.<sup>45</sup> To ensure that owners comply with this requirement, Rural Development State and area officials perform physical inspections of RRH properties at least every 3 years. The inspection process is designed to ensure that the physical condition of RRH properties meets minimum standards and that there are no conditions that would threaten the health or safety of tenants. When physical deterioration, health, or safety issues are found, Rural Development area officials inspect RRH properties every year.<sup>46</sup>

Rural Development State officials classify deficiencies as either findings (minor physical deterioration) or violations (escalated findings due to severity of physical deterioration or health and safety issues). When agency officials observe findings and violations, they notify owners by letter about the issue(s) and the requirement(s) for corrective action. The owners must respond within 30 days in writing with a plan to correct findings and violations. However, any issues dealing with health and safety must be resolved within 10 days.

When owners do not respond within the required timeframe or the response does not include adequate corrective actions, agency officials must send the first servicing letter that directs them to immediately correct the issues. If no response, a second letter is to be sent after 15 days if the owner has not responded to the first servicing letter. The second letter informs the owner of the date by which he/she will be considered delinquent. Finally, for owners who continue to be unresponsive, or do not provide an adequate plan to correct the issue(s), agency officials are required to send a third letter notifying them that they are in default with terms of their loan agreement and subject to penalties up to and including foreclosure. The penalties could include the initiation of liquidation proceedings, criminal actions, or civil sanctions.<sup>47</sup>

Over the past two decades, OIG has performed several nationwide audits of the RRH Program, as well as numerous audits of individual property owners. Those audits have continually uncovered widespread physical deterioration of properties, and health and safety hazards for the

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<sup>44</sup> The properties were located in the State of Indiana.

<sup>45</sup> 7 Code of Federal Regulations (CFR) 3560.103(a) (3), dated November 26, 2004.

<sup>46</sup> 7 CFR 3560.103(a) (3), dated November 26, 2004, and *Multi-Family Housing Asset Management Handbook 2-3560*, Chapter 9, 9.9(c), dated December 19, 2007.

<sup>47</sup> 7 CFR 3560.461(b) (2) (i), dated November 26, 2004.

tenants residing in the properties. For instance, in 1994, OIG reported that owners had neglected the physical condition at 9 of 15 RRH properties visited during the audit. The 15 properties were managed by 13 different agents.<sup>48</sup> In 1999, OIG and RHS conducted a joint evaluation of the program. The joint teams inspected 637 properties nationwide and reported that 360 of those properties needed repairs.<sup>49</sup> The joint teams also found more than 50 instances of conditions that posed a health or safety hazard for the tenants.

In more than 15 years of past audits we found many instances when owners did not repair the properties and allowed them to further deteriorate. For example, we audited one owner's 73 RRH properties three times over a 15-year period. We repeatedly found misspent program funds, physical deterioration of the properties, and health and safety hazards for the tenants.<sup>50</sup> The owner made no effort to repair the properties after each audit, and agency officials did not follow procedures to enforce Federal regulations.

For our current audit, we visited 319 properties in one State to determine if the types of conditions noted during prior audits continued to exist. We found that 192 of the 319 properties (60 percent) had at least one violation such as damaged and worn roofs, damaged interior walls and ceilings, and exterior wood siding with severe deterioration. In some cases, the exterior wood siding at properties was so deteriorated that it had begun to rot and grow mold. We concluded that violations at 125 of the 192 properties posed health and safety hazards for tenants. The violations included issues such as unprotected equipment and chemicals that posed a danger to tenants, especially children, and detached hand rails on stairs and walkways. We observed instances of detached hand rails at 30 properties, including senior citizen apartment complexes. (See exhibit B for examples of photographs taken during our visits.)

To determine if agency officials were identifying violations similar to those found during our site visits in the State, we examined 279 inspection reports prepared by them for 147 RRH properties during a 4-year period (CYs 2005 through 2008).<sup>51</sup> We found that they identified violations at 44 of the 147 properties (30 percent). The types and nature of the findings and violations were generally similar to those we observed during our site visits to properties (even though they reported them less frequently). In fact, some violations were exactly the same as those we identified during our visits. For example, one property we visited had severely deteriorated exterior wood siding. Rural Development State officials had reported the same condition at the property during its previous two inspections. We concluded that agency officials were generally identifying and reporting findings and violations at the properties.

We also evaluated the actions agency officials took to ensure that owners correct the findings and violations identified during the inspection process, which we deemed to be a critical factor. In each of the 44 reported cases, they properly notified owners of the findings and violations and the requirement to submit a corrective action plan within 30 days. However, the owners

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<sup>48</sup> OIG Audit Report 04600-0047-Ch, *Farmers Home Administration Rural Rental Housing Program Management Operations*, Washington, D.C., dated September 1994.

<sup>49</sup> OIG Evaluation Report 04801-0006-Ch, *Uncovering Program Fraud and Threats to Tenant Health and Safety*, dated March 1999.

<sup>50</sup> The most recent was OIG Audit Report 04099-0211-Te, *Request Audit of Oklahoma Rural Rental Housing Management Company*, dated April 2009.

<sup>51</sup> We visited 114 of the 147 properties during our audit.

routinely failed to respond to the agency's letters. Our analysis disclosed that the owners did not respond to the agency's letters for 66 percent of the properties with reported findings and violations.<sup>52</sup> In the previous example, agency officials sent letters to the owner requesting corrective action for the violations after each inspection. The owner proposed corrective action each year, but did not repair the damage and agency officials took no further administrative action.

Rural Development State officials said they had not pursued civil monetary penalties for these cases because the agency's policy did not clearly delineate under what conditions these actions should be taken, and the appropriate penalty fee. The officials also said they were reluctant to pursue actions such as foreclosure and debarment of owners because it might displace tenants living in the apartment complexes. They added that the actions were complicated, time-consuming, involved a lengthy process (foreclosure action can take as long as 3 years), and at times were unreasonable in proportion to the finding or violation. Thus, they generally chose to work with owners to resolve physical deficiencies, rather than create an adversarial relationship with them by taking additional administrative action.

Our analysis of Rural Development's regulations confirmed some of the agency officials' statements. The regulations state that civil monetary penalties can be imposed up to \$25,000 per violation. However, the regulation does not stipulate under what specific conditions these remedies should be used against owners. It also does not provide a schedule that matches findings and violations to specific amounts for each infraction, and a graduated scale for increased penalties for noncompliance after specified periods of time. RHS national officials agreed with our conclusions and informed us that they were updating the monetary penalty regulations. They have revised the regulation and it is progressing through the Department's clearance process. They estimate that the proposed rule will be published in the Federal Register this fall.

RHS national officials also stated that, because of their concern about the declining physical condition of many RRH properties, they instructed State officials to intensify servicing on Class "D" properties.<sup>53</sup> RHS' intention was to evaluate the properties to determine the appropriate servicing action (e.g., workout plan, fine, penalty, foreclosure, etc.). They added that it would be preferable for State officials to develop workout plans with owners, but recognized that liquidation of some properties may need to be the ultimate course of action. Rural Development State officials provide updates of ongoing servicing actions to the national office during monthly conference calls. RHS national officials, in turn, have recorded the actions in a spreadsheet on the agency's SharePoint system.<sup>54</sup>

We agree with RHS national officials' efforts to ensure that properties considered to be in default are either repaired to an acceptable standard or removed from the program in a timely manner. However, the instruction provided to State officials in May 2011, which OIG deemed as

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<sup>52</sup> This occurred for 29 of 44 properties.

<sup>53</sup> RHS Administrator's unnumbered letter, dated May 2011. Properties classified with a "D" status have been issued all three servicing letters, and are considered to be in default and subject to foreclosure.

<sup>54</sup> SharePoint is an information technology platform for customized websites and applications that support specific organizational needs.

effective, expired in May 2012, and agency officials did not believe it would be cost efficient to reevaluate properties categorized as Class “D” in RHS’ Multi-Family Housing Information System (MFIS) to determine the needed course of action on a regular basis. Thus, State officials may not take similar action against owners who allow properties to deteriorate in the future. RHS needs to incorporate this requirement into the agency’s overall policy guidance.

We are also concerned about RHS’ monitoring of actions taken by State officials. RHS’ information includes only the last current status of any remaining actions for the property, not a running record of all actions taken by State officials. Thus, they are unable to determine the historical status of properties and whether State officials have taken appropriate measures to improve conditions. The agency’s MFIS database has the ability to maintain all actions taken by State officials. However, RHS national officials noted, based on a special review performed because of the May 2011 instruction to field staff, that State officials were not always updating the system to reflect current conditions for the properties. RHS national officials need to develop and implement procedures to monitor the administrative actions taken by State officials to correct outstanding findings and violations at RRH properties. This will provide better assurance that appropriate measures are being taken to improve the physical condition of neglected RRH properties.

#### **Recommendation 4**

Clarify agency guidance on the type of administrative action to take, and when to take the action, against noncompliant owners.

#### **Agency Response**

Agency officials agree to issue guidance in the form of a handbook revision to the Rural Development field staff on the types of administrative action to take and when to take action regarding noncompliant owners by March 31, 2013.

#### **OIG Position**

We accept management decision for this recommendation.

#### **Recommendation 5**

Develop and implement a graduated schedule of punitive measures to be taken when owners do not comply with agency requests to correct findings and violations.

#### **Agency Response**

Agency officials agree to develop and implement a graduated scale of appropriate measures and incorporate the guidance in HB-2-3560 by June 30, 2013.

## **OIG Position**

We accept management decision for this recommendation.

## **Recommendation 6**

Require RHS to incorporate the evaluation of properties categorized as Class “D” in MFIS to determine the needed course of action into the agency’s overall policy guidance.

## **Agency Response**

Agency officials previously issued an unnumbered letter (UL) that incorporates the evaluation of properties categorized as Class “D” into the agency’s overall policy guidance. A reissuance of the UL was issued on August 28, 2012. The Agency agrees that this guidance is necessary and will incorporate it into HB-2-3560 by March 31, 2013.

## **OIG Position**

We accept management decision for this recommendation.

## **Recommendation 7**

Develop and implement procedures to monitor the administrative actions taken by State officials to correct outstanding findings and violations at RRH properties.

## **Agency Response**

Agency officials agree to develop and implement procedures to monitor the administrative actions taken by State officials to correct outstanding findings and violations. These procedures will include revisions to the Management Control Review Guide and the State Internal Review Guide to address timeliness of the required follow-up to findings and violations. Revisions will be completed by September 30, 2013.

## **OIG Position**

We accept management decision for this recommendation.



## Scope and Methodology

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We conducted our audit at RHS' national office in Washington, D.C., the Rural Development Indiana State office, and at Rural Development's four area offices in Indiana.

Rural Development had 14,746 properties participating in the RRH Program as of December 2011. The tenants residing in those properties received over \$1 billion in rental assistance subsidy during FY 2011. The owners of those properties received an additional \$647 million in interest credit subsidy during FY 2011. The period of our audit included CYs 2005 through 2008.<sup>55</sup>

We judgmentally selected the State of Indiana because past audits had identified both physical deterioration of RRH properties and the misuse of funds by owners. There were 555 RRH properties located in the State of Indiana at the time of our audit. We visited 319 of those properties to observe physical conditions. We selected properties from each of the State's four area offices. The number of properties we selected for each area office was proportionate to the number each had compared to the total properties in the State. To minimize travel time, we judgmentally selected properties based on their proximity to area offices and to each other.

We analyzed 279 inspection reports that Rural Development State officials had prepared for 147 RRH properties during CYs 2005 through 2008. The reports represented the two most recent inspections performed by Rural Development State officials during the period of our audit. We judgmentally selected properties with multiple structures and those properties where Rural Development State officials expressed concern about physical deterioration.

We analyzed 220 attestation engagement reports issued by independent certified public accountants for 154 RRH properties during CYs 2006 and 2007. We judgmentally selected the reports based on property size (i.e., if they were greater than 16 units) and concerns expressed by Rural Development State officials regarding the financial operations of the properties.

In addition to the items mentioned above, we also performed the following steps to accomplish our objectives:

- Reviewed applicable laws and Federal regulations, and Rural Development's policies and procedures;
- Reviewed past OIG audit and investigative results for the RRH Program;
- Reviewed internal controls over properties' costs, inspections, and actions agency officials had taken on past OIG recommendations to correct findings; and
- Interviewed RHS national officials and Rural Development State and area officials, site managers, and tenants.

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<sup>55</sup> We selected calendar years because Rural Development requires owners to report the financial operations on a calendar year basis.

We performed our audit fieldwork from October 2008 through January 2012. This audit was postponed after January 2009 in order to perform other high priority audits related to natural disasters and the American Recovery and Reinvestment Act of 2009. We resumed work on a regular basis in July 2011.

We conducted this performance audit in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

RHS national officials provided data to us from MFIS. However, we make no representations regarding the accuracy or reliability of that data. We did not assess the accuracy of the data because an evaluation of information system controls was not part of our audit objectives.

## Abbreviations

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CY .....	Calendar Year
CFR .....	Code of Federal Regulation
FY .....	Fiscal Year
IPA .....	Independent Certified Public Accountants
MFIS .....	Multi-Family Information System
OIG .....	Office of Inspector General
RHS .....	Rural Housing Service
RRH .....	Rural Rental Housing

## Exhibit A: Original and Revised Agreed-Upon Procedures

<b>11 Agreed-Upon Procedures</b> (In Effect for Reporting CY 2006 Activity)	<b>Revised Agreed-Upon Procedures</b> (In Effect for Reporting CY 2007 to Present Activity)
<ol style="list-style-type: none"> <li>1. Compare the total amount paid from the operating and maintenance bank account to the total amount of cost reported on the general ledger and Form RD 3560-7, Part II. <u>*/</u></li> <li>2. Examine selected receipts, invoices, cancelled checks, etc., that support operating and maintenance expenses presented on Form RD 3560-7, Part II, to ensure they were actually incurred during the ongoing operations of the project. The practitioner should focus on line items 1-10 and 19-32.</li> <li>3. Compare selected operation and maintenance records pertaining to expenses on Form RD 3560-7, Part II, to rural development regulations for eligibility and reasonableness. Practitioners should use professional judgment in determining the reasonableness of charges. <u>*/</u></li> <li>4. Confirm payments with selected vendors for operating and maintenance expense items from Form RD 3560-7, Part II. <u>*/</u></li> <li>5. Confirm with the financial institution year-end reserve account balance on Form RD 3560-7, Part II, and that there are no encumbrances of reserve account funds.</li> <li>6. Calculate the number of reserve account withdrawals from the bank statements. This number is to be included in the engagement report.</li> <li>7. Examine the caretaker agreement for compliance with Rural Development requirements. <u>*/</u></li> <li>8. Examine documents to confirm that owners/management companies solicited bids from independent companies for services/materials that were provided by identity-of-interest companies. <u>*/</u></li> <li>9. Determine who owns selected contractor companies from applicable State agency and compare to RRH project owner and management company ownership names to uncover undisclosed identity-of-interest companies. <u>*/</u></li> <li>10. Compare the address on selected work orders, delivery documents, invoices, remittance notices, etc., to the RRH project address to ensure that services/supplies were provided to the appropriate property.</li> <li>11. Confirm by independent verification that identity-of-interest companies exist and provide services to the general public. <u>*/</u></li> </ol>	<ol style="list-style-type: none"> <li>1. Examine selected receipts, invoices, cancelled checks, etc. that support administrative; and operating and maintenance expenses presented on Form RD 3560-7, Part II, line items 1-10 and 19-32 to determine they were incurred as part of the ongoing operations of the project. Examine a sample of documents for: (i) existence of invoice and agreement on transaction amount; (ii) no alteration of invoice or duplicate invoice number; (iii) agreement of shipping/work address; and (iv) examine invoice description for non-eligible expenses.</li> <li>2. Confirm the balance in the replacement reserve account presented on Form RD 3560-7, Part II and confirm that no amounts were encumbered by the financial institution that holds the accounts. Determine that all balances are within the Federal Deposit Insurance of the Securities Investor Protection Corporation insurance limits, as applicable. Determine that the total withdrawals from the bank statements agree to the total withdrawals authorized by Rural Development on Form RD 3560-12. Compare the invoices and cancelled checks to the approved withdrawal.</li> <li>3. Obtain an identity-of-interest company listing and Form RD 3560-31 from Rural Development and determine that the services provided and approved fees, if applicable, agree to the actual services and fees charged to the project. For each identity-of-interest company, examine a sample of invoices to determine that the expenses for the approved services are what is being charged to the project. Consider whether or not any undisclosed identity-of-interest companies were incidentally disclosed during the engagement.</li> </ol>

\*/ Procedures from the 11 agreed-upon procedures that were not fully addressed in the revised version.

## **Exhibit B: OIG's Photographs of Problems at RRH Properties**

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Photo A: Apartment building with deteriorated wood siding. The siding is falling off and the exterior wall has deteriorated and needs painting or replacement. Siding problems of this nature are considered a program violation.



Photo B: Hole in the side/roof of the apartment building due to missing siding. The hole is large enough for animals to enter the attic area of the structure. Tenants reported that birds were living in between the ceiling and the roof of the building. This deficiency would be classified as a program violation.

## **Exhibit B: OIG's Photographs of Problems at RRH Properties**

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Photo C: A broken banister that has become detached from the structure and is no longer safe for tenants to use. This is a health and safety issue that would be classified as a program violation.



Photo D: A chainsaw left unsecured and unattended on the porch of a unit where children reside. This device was not locked or secured by the tenant. This is a health and safety issue that would be classified as a program violation.



**USDA'S  
RURAL HOUSING SERVICE  
RESPONSE TO AUDIT REPORT**







United States Department of Agriculture  
Rural Development

September 7, 2012

**SUBJECT:**   OIG Audit – Official Draft – Rural Rental Housing Program Project Cost  
                  and Inspection Procedures (Audit No. 04601-018-CH)

**TO:**        Gil H. Harden  
               Assistant Inspector General for Audit  
               Office of Inspector General

Attached for your review is a response dated September 6, 2012, from Bryan Hooper, Deputy Administrator, Multi-Family Housing Programs, concerning audit recommendations in the above subject official draft report.

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

If you have any questions, please contact Arlene Pitter Bell of my staff at (202) 692-0083.

/S/ JOHN L. DUNSMUIR

JOHN L. DUNSMUIR  
Acting Director Financial Management Division

Attachment

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Washington, DC 20250-9410 or call (800) 795-3272 (voice) or (202) 720-6382 (TDD).



United States Department of Agriculture  
Rural Development

September 6, 2012

TO: John Dunsmuir  
Acting Director  
Financial Management Division

FROM: Bryan Hooper \S\ Bryan Hooper  
Deputy Administrator  
Multi-Family Housing Programs

SUBJECT: Rural Rental Housing Program Project Cost and Inspection Procedures  
(Audit No. 04601-0018-Ch)

This memorandum is in response to the above-referenced official draft report.

In our discussions with the Office of the Inspector General (OIG) concerning the draft report, Multifamily Housing Programs (MFH) explained its concerns about the audit scope and methodology. Despite these issues, we believe some of the recommendations have merit and we are taking steps to address those.

Our concerns about the report:

- 1) MFH has about 15,000 multifamily properties in every state and territories; this audit covered MFH properties in only one state.
- 2) We believe the management company selected for audit is not representative of management companies in the rest of the extensive multifamily housing portfolio. OIG elected to audit one management company out of 104 that manage properties in the state; the management company is tied for 19<sup>th</sup> in terms of property volume (2 properties) on the list of companies that manage RD properties in the state; and, the management company was the subject of an OIG investigation in an adjacent state. Yet OIG extrapolated findings from that audit to all the properties in the MFH portfolio.
- 3) OIG recommends that the Agency return to a financial reporting process that has not been demonstrated by independent public accountants (IPAs) to be effective or useful. OIG reviewed financial report engagements that consisted of an 11-step agreed-upon procedure (AUP) process that was originally included in program regulations published in 2005. The 11-step process was in place for two years while the Agency attempted to implement the procedure. After the Agency was unable to obtain guidance from OIG about how to implement the 11-step process, we provided explicit instructions and guidance for a 3-step process, which we believe incorporated the bulk of the 11-step process with less confusion.

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- 4) The Agency required financial audits of properties with 24 or more apartment units, in accordance with generally-accepted affordable housing industry standards. OIG's report does not discuss why the Agency found it necessary to change from the 11-step process, but recommends instead that we return to that requirement.

The Agency did not take lightly its responsibility to implement the AUP from 2005. Indeed, efforts over a two-year period by the agency to address lack of guidance from OIG are ignored in the report. Although the report characterizes the lack of implementation as IPAs complaining it was "too time consuming", the majority of IPAs, including the Affordable Housing Association of Certified Public Accountants, expressed confusion about the AUP requirements. We looked to OIG for assistance since the AUP was incorporated into program regulations at their recommendation. OIG refused to assist the agency. After two years, the Agency took responsibility to identify the financial information it needed to make informed decisions about property performance, and undertook a collaborative effort with field staff, private IPAs, RD's Financial Management Division staff, Department OCFO, and OIG, to develop a modification of the requirement, with substantial guidance and instructions for IPAs. OIG's report makes no mention of this effort in its criticism that "...fewer reports than required were received those years (2006 and 2007)". OIG should recognize the efforts undertaken by the Agency in the absence of assistance from OIG.

Since 2010, the Agency has been involved in an initiative of the White House Domestic Policy Council's Rental Policy Working Group to align certain regulatory requirements, such as financial reporting, among USDA, HUD and Treasury's Low Income Housing Tax Credit Program. These alignment efforts consist of adopting similar compliance and reporting requirements across-the-board at all agencies. OIG has been aware of our involvement in this effort; yet the report recommends a financial reporting process completely out of step with HUD or tax credit agencies.

Finally, the report does a disservice to the accounting industry as a whole by stating that: "The business generated by the attestation engagement requirement, for other financial services, and audits of larger properties can be lucrative. In our view, this could affect their [IPAs'] effort to find financial mismanagement by owners." This statement suggests that IPAs would provide a more honest financial report if paid by the government than by property owners. The Agency suggests OIG delete such references from the report before it is published.

### **Recommendation No. 1**

Examine RRH property finances using either agency review teams or by contracting directly with IPAs to perform attestation engagements using agreed-upon procedures.

### **Agency Response**

The Agency discussed with OIG that limited Agency resources would make it extremely difficult for the Agency to perform either process. The Agency also discussed the Alignment efforts now underway with other federal agencies. See response for Recommendation No. 3.

## **Recommendation No. 2**

Implement a risk-based evaluation approach that selects properties by reliable indicators of financial misuse, including owner use of identity-of-interest companies, neglected properties, and prior problems.

### **Agency Response**

The Agency agrees that high-risk properties should receive closer evaluation of financial performance. See response for Recommendation No. 3.

## **Recommendation No. 3**

Reinstitute the original 11-step agreed-upon procedures for use by IPAs during attestation engagements or agency review teams.

### **Agency Response**

Since early 2010, the Agency has been working with the White House's Domestic Policy Council and their Rental Policy Working Group on an initiative to reduce duplication of requirements on customers, eliminate conflicting administrative requirements, and align program requirements in the affordable rental housing industry. It is becoming more common that a property will have multiple federal funding sources, so any effort to reduce the financial and regulatory burden on the property is important to its financial health. Properties with funding from different Federal programs may have to submit duplicative financial statements and have multiple audits prepared according to different audit standards. Owners with large portfolios, including high-capacity mission-driven owners, also incur significant and unnecessary staff and infrastructure costs when properties across their portfolio are required to file financial reports in different formats and submit audits according to different guidelines.

To achieve the mandate, the Agency and HUD have agreed to cross-agency standardization on both the format of financial reporting and the audit guidelines governing that reporting. USDA will adopt the financial reporting protocol of HUD (which HUD requires of the 23,298 properties it either guarantees or subsidizes). We believe use of the HUD Inspector General's Consolidated Audit Guide will go beyond the AUP recommended by OIG and provide the Agency with additional information on internal controls, distribution to owners, and equity skimming. We believe we can exceed USDA OIG requirements through adoption of the HUD OIG's Consolidated Audit Guide.

The agencies have also discussed a risk-based threshold wherein property owners, regardless of profit status, would be required to provide such a report if their combined federal loans and assistance subsidies exceed \$500,000. Adoption of similar standards will reduce the burden on project budgets, as multiple reports become unnecessary.

Therefore, the Agency will issue guidance in the form of a handbook revision to implement the cross-agency standardization.

Estimated completion date: June 30, 2013

**Recommendation No. 4**

Clarify agency guidance on the type of administrative action to take, and when to take the action, against noncompliant owners.

**Agency Response**

The Agency agrees to issue guidance in the form of a handbook revision to the RD field staff on the types of administrative action to take and when to take action regarding noncompliant owners.

Estimated completion date: March 31, 2013

**Recommendation No. 5**

Develop and implement a graduated schedule of punitive measures to be taken when owners do not comply with agency requests to correct findings and violations.

**Agency Response**

The Agency agrees to develop and implement a graduated scale of appropriate measures and incorporate the guidance in HB-2-3560.

Estimated completion date: June 30, 2013

**Recommendation No. 6**

Require RHS to incorporate the evaluation of properties categorized as Class “D” in MFIS to determine the needed course of action into the agency’s overall policy guidance.

**Agency Response**

The Agency has previously issued an unnumbered letter (UL) that incorporates the evaluation of properties categorized as Class “D” into the agency’s overall policy guidance. A reissuance of the UL was issued on August 28, 2012. The Agency agrees that this guidance will be incorporated into HB-2-3560.

Estimated completion date: March 31, 2013.

**Recommendation No. 7**

Develop and implement procedures to monitor the administrative actions taken by State officials to correct outstanding findings and violations at RRH properties.

**Agency Response**

The Agency agrees to develop and implement procedures to monitor the administrative actions taken by State Officials to correct outstanding findings and violations. These procedures will include revisions to the Management Control Review Guide and the State Internal Review Guide to address timeliness of the required follow-up to findings and violations. These processes are on a department-schedule for revision and are next due in FY2014.

Estimated completion date: September 30, 2013.

If you have any questions regarding this, please contact Stephanie White at (202) 720-1615 or Janet Stouder at (202) 720-9728.

Attachments

Informational copies of this report have been distributed to:

Government Accountability Office

Office of Management and Budget

Office of the Chief Financial Officer  
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