Audit Report

District Inspector General for Audit
Northwest/Alaska District

Nationwide Audit of

USE AND DISPOSITION OF RESIDUAL RECEIPTS

OFFICE OF MULTIFAMILY HOUSING PROGRAMS

2000-SE-119-0003
September 29, 2000

U.S. Department of Housing and Urban Development
District Inspector General for Audit
Federal Office Building, Suite 125
909 First Avenue
Seattle, WA 98104-1000

audit report

Issue Date 29 September 2000	
Audit Case Number 2000-SE-119-0003	

MEMORANDUM FOR: Shaun Donovan, Deputy Assistant Secretary for Multifamily Housing Programs, HT

Frank E. Baca

FROM: Frank E. Baca, District Inspector General for Audit, 0AGA

SUBJECT: Final report of nationwide audit
Use and disposition of residual receipts
Office of Multifamily Housing Programs

This final report contains the results of our recent audit of the use and disposition of residual receipts. We initiated the audit based on information obtained during the financial audit for Fiscal Year 2000. The purpose of the audit was to determine if HUD: (1) considers using residual receipts as a source of funds when housing assistance payments (HAP) contracts expire and are renewed, (2) has adequate controls in place to ensure that funds in residual receipts accounts are properly returned to HUD when property owners opt out of the Section 8 program, and (3) was aware of the amount of residual receipts being generated by uninsured assisted properties.

The report contains four findings that indicate HUD should utilize and improve controls over residual receipts. Currently, HUD does not consider or use residual receipts as a source of funds when renewing expiring Section 8 HAP contracts for insured multifamily properties. In addition, the review disclosed one case where, due to inadequate HUD controls, a former property owner prepaid an insured property's mortgage and withdrew $64,369 in residual receipts. Also, unlike other major Section 8 contracts for multifamily properties, current regulations for properties in the Loan Management Set-Aside (LMSA) program do not allow HUD to recover residual receipts at contract termination. Finally, HUD does not receive financial information about uninsured Section 8 assisted properties managed by State Housing Agencies that generate significant residual receipts.

Within 60 days, please give us a status report for each recommendation in the report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the review.

If you have any questions, please call me or Bill Taylor, Senior Auditor at (206) 220-5360.

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Executive Summary

Based on information obtained during the financial audit for Fiscal Year 2000, we initiated an audit of the use and disposition of multifamily properties' residual receipts. We wanted to determine if HUD: (1) considers using residual receipts as a source of funds when housing assistance payments (HAP) contracts expire and are renewed, (2) has adequate controls in place to ensure funds in residual receipts accounts are properly returned to HUD when property owners opt out of the Section 8 program, and (3) was aware of the amount of residual receipts being generated by uninsured assisted properties.

For limited distribution properties and properties owned by nonprofit organizations, HUD requires the property owner to deposit any excess earnings into a separate bank account with the lender (mortgagee). These excess funds are termed "residual receipts" and are subject to HUD's control. For properties subject to the revised Section 8 rules, the use and disposition of the residual receipts are controlled by the HAP contracts and must be returned to HUD upon termination of the HAP contracts. For properties under the old Section 8 rules, the Regulatory Agreement gives HUD direct control over the use of residual receipts. However, when the mortgage is paid off, the residual receipts go to the property owner.

Audit results

HUD should consider residual receipts as a source of funds when renewing expiring Section 8 contracts

HUD does not use residual receipts as a source of funds when renewing expiring Section 8 Housing Assistance Payments contracts for insured multifamily properties. This occurred because HUD guidance does not require HUD staff to consider using residual receipts as a possible funding source when renewing expiring Section 8 contracts. As a result, HUD is committing additional funds for Section 8 HAP to properties that have millions of dollars in residual receipts accounts under HUD's direct control. Using residual receipts as a supplemental source of funding gives HUD additional funds to assist more customers.

We recommend that you require HUD staff and those responsible for contract renewals to consider using residual receipts as a source of funds when renewing expiring Section 8 HAP contracts.

HUD does not have adequate controls to ensure residual receipts are properly safeguarded

The review disclosed one case where, due to inadequate HUD controls, a former property owner prepaid an insured property's mortgage and withdrew $64,369 in residual receipts. The funds should have stayed with the property and been remitted to HUD upon termination of the HAP contract. In the absence of adequate controls, there may be other instances where a similar situation occurred or will occur. HUD does not have adequate controls in that: (1) HUD does not have specific requirements for lenders (mortgagees) to maintain a property's residual receipts account after the mortgage is paid off; (2) HUD guidance on the disposition of residual receipts is incomplete; and (3) there is uncertainty and confusion among HUD project managers regarding when residual receipts should be remitted to HUD.

We recommend that you recover the $64,369, determine if there have been any other mortgage prepayments where residual receipts should have stayed with the property, and take appropriate action to recover those funds. We also recommend you strengthen controls and issue guidance to safeguard residual receipts.

The Loan Management Set-Aside Program should be subject to the same residual receipts rules as other Section 8 programs

Unlike other major Section 8 contracts for multifamily properties, current regulations for properties in the Loan Management Set-Aside (LMSA) program do not allow HUD to recover residual receipts at contract termination. As a result, property owners may realize windfall profits when the mortgage is paid off. HUD could use recovered residual receipts to assist other properties. According to property financial information in the Real Estate Assessment Center's (REAC) database, there are 645 LMSA assisted properties that have balances in their residual receipts accounts totaling over $81 million. It appears HUD did not revise Section 8 rules for LMSA properties because these were financially troubled properties and HUD did not expect these properties to accumulate residual receipts.

We recommend that you revise the Section 8 regulations for LMSA assisted properties that would affect *new* contracts to require a property's residual receipts be returned to HUD upon termination of the HAP contract.

HUD does not monitor residual receipts for uninsured, assisted properties administered by State Housing Agencies

HUD does not receive financial information about uninsured Section 8 properties managed by State Housing Agencies that generate residual receipts. As a result, HUD management is not aware of or monitoring millions of dollars accumulating in uninsured properties' residual receipts accounts that will be remitted to HUD when Section 8 HAP contracts terminate. This occurred because HUD does not require State Housing Agencies to provide financial information, specifically on residual receipts, for uninsured, assisted properties.

We recommend that you require State Housing Agencies to provide HUD with financial information on residual receipts balances for uninsured assisted multifamily properties. Also, determine if HUD has authority to use the residual receipts accumulating in uninsured, assisted property accounts prior to termination of the HAP contracts.

HUD generally agreed with draft report

We met with the Deputy Assistant Secretary for Multifamily Housing Programs to discuss the audit results on August 11, 2000. On August 18, 2000, we provided our draft report to the Deputy Assistant Secretary and other designated HUD officials for written comments. We received written comments from HUD by facsimile on September 27, 2000 and incorporated the comments as we deemed appropriate. The Deputy Assistant Secretary generally agreed with the draft audit report. HUD's comments are in Appendix A of this report.

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Abbreviations

CFR	Code of Federal Regulations
CNA	Capital Needs Assessment
FASS	Financial Assessment Subsystem
FHA	Federal Housing Administration
GAO	General Accounting Office
HAP	Housing Assistance Payments
LMSA	Loan Management Set-Aside
OGC	Office of General Counsel
OIG	Office of Inspector General
OMHAR	Office of Multifamily Housing Assistance Restructuring
REAC	Real Estate Assessment Center

Introduction

Background

Residual receipts and multifamily properties with HUD-insured mortgages (insured properties)

HUD insures mortgages for certain housing complexes (multifamily properties) under various sections of the National Housing Act. When providing mortgage insurance, HUD enters into a Regulatory Agreement with the property owner, whereby the owner agrees to rent some or all of the apartments to families or individuals needing assistance, such as low or moderate income families, the elderly, and the disabled. Under some mortgage insurance Regulatory Agreements, HUD restricts the amount of earnings owners may withdraw from the property accounts. Arrangements of this type are referred to as "limited distribution" properties. For limited distribution properties and properties owned by nonprofit organizations, HUD requires the property owner to deposit any excess earnings into a separate bank account with the lender (mortgagee). These excess earnings are termed "residual receipts" and are subject to HUD's control.

Regulatory Agreements for insured multifamily properties define residual receipts as funds generated by the property that remain after making the mortgage payment, paying all liabilities and operating expenses of the property, any authorized distribution, and setting aside funds for long-term maintenance items.

Specifically, the Regulatory Agreement states that residual receipts are:

> "...funds that remain after provision for: (a) the payment of all amounts due or required to be paid under the terms of any mortgage insured or held by the Commissioner *(of the FHA- Federal Housing Administration)*; (b) all amounts due to the Reserve for Replacements Fund; (c) funds for the payment of all operating and maintenance expenses, security deposits held, taxes, assessments, fixed charges due or accrued, insurance; and (d) liabilities currently due and

> arising as a result of necessary expenditures incident to the normal operations of the project…."

The Regulatory Agreement for insured properties also states that the residual receipts are controlled by HUD (FHA Commissioner); however, it does not state what the disposition of the residual receipts will be at the termination of the Regulatory Agreement.

Residual receipts and multifamily properties that receive HUD rental assistance (assisted properties)

In addition to insuring the mortgage on multifamily properties, HUD will usually enter into contracts with owners of these insured properties to provide rental assistance to the families and individuals renting apartments. HUD will provide rental assistance or subsidies by means of a Housing Assistance Payments contract under the Section 8 program. Under a Section 8 HAP contract, HUD will pay the owner part (usually the rent less 30 percent of the tenant's adjusted monthly income) of the tenant's monthly rent, and the tenant will pay the remaining portion of the rent. Many insured properties governed by a Regulatory Agreement are also assisted properties governed by a HAP contract. Depending on what HUD and the owner agree upon, the HAP contract may cover all housing units in the property (100 percent Section 8) or some lesser percentage of the housing units.

Prior to a 1980 regulatory revision, the Section 8 HAP contracts did not have any provisions regarding residual receipts; as such, HUD's control over a property's residual receipts account was the Regulatory Agreement. However, neither the Regulatory Agreement nor the Section 8 HAP contract contained any provisions regarding disposition of the residual receipts account at the termination of Regulatory Agreement. As a result, funds in the residual receipts account would go to the owner when the Regulatory Agreement ended (when the mortgage was paid) whether or not a HAP contract was still in effect.

The 1980 regulatory changes (per 24 CFR Parts 880 and 881) required that residual receipts be paid to HUD when the HAP contract was terminated (regardless of whether or not a Regulatory Agreement was still in effect). The applicable Section 8 regulation applies even if the HAP contract does not specifically contain the repayment provision but selection to receive assistance was made after 1980 and incorporates by reference the applicable regulations.

The 1980 changes applied to Section 8 new construction and substantial rehabilitation HAP contracts for assisted properties that are limited distribution or owned by nonprofits. The revision only applies to 100 percent Section 8 properties. Also, the revision does not include HAP contracts for assisted properties under the Loan Management Set-Aside program (24 CFR Part 886). Therefore, residual receipts generated by less than 100 percent Section 8 properties or properties under the LMSA program are paid to the owner upon termination of the HAP contract.

Residual receipts and uninsured housing complexes that receive Section 8 assistance

HUD will often provide Section 8 rental assistance to housing complexes that do not have their mortgages insured by HUD. These assisted uninsured properties have HAP contracts similar to insured properties, but do not have Regulatory Agreements with HUD. State Housing Agencies administer Section 8 HAP contracts for uninsured properties (24 CFR 883). The 1980 regulatory revisions apply to these HAP contracts in the same way as they apply to insured properties. The HAP contracts for these uninsured properties are long-term (most of them 30-year) contracts, and the majority of them will not begin to expire for another 10 years. Nevertheless, any residual receipts generated by these properties will be remitted to HUD.

Over 14,000 HAP contracts for insured properties will expire in the next six years

When HAP contracts expire, property owners have the option of renewing the HAP contract or opting out of the Section 8 program. If an owner does opt out, it is HUD's responsibility to make sure that the lender remits any residual receipts due to HUD. According to HUD database records[1], in the next six years starting in the year 2000, over 14,000 HAP contracts for insured multifamily properties will expire. Further, per HUD guidance on renewals of expiring Section 8 contracts, HAP contracts renewed in FY 1999 were renewed for only one year; and HAP contracts renewed in FY 2000 can be renewed for five years or less. In the next five years, these HAP contracts will expire, and will either be renewed again subject to appropriations or the owner will opt out and HUD will need to recover any residual receipts due.

It is also important to note that HUD is in the process of contracting out the administration of all Section 8 HAP contracts, primarily to public housing authorities and state agencies (as previously discussed, state agencies already administer HAP contracts relating to uninsured properties). HUD will need to be aware of what contractors are doing regarding the use and recovery of residual receipts that belong to HUD.

Over half a billion dollars are in insured properties' residual receipts accounts

As of February 6, 2000, the REAC[2] database showed that 4,215 properties had residual receipts account balances exceeding $1,000. The total amount in the 4,215 residual receipts accounts exceeded half a billion dollars and 1,706 properties had balances over $50,000. In addition, over 2,000 properties had revenues that exceeded obligations ("surplus cash") totaling over $100 million, the majority of which (about $76 million) should be deposited into residual receipts accounts during the first 60 days after the end of the fiscal year.

[1] Information was obtained from HUD's Section 8 expiring contracts database.
[2] REAC's database only contains information for those insured multifamily properties that submitted annual audited financial statements; as such, the information may not include all insured multifamily properties. Financial information contained in REAC's database was used for background or informational purposes only, and was not verified except for the sample properties cited in the report. Also, REAC's database does not include financial information for uninsured properties.

Audit Objectives, Scope, and Methodology

Objectives: We wanted to determine if HUD:

- considers using residual receipts as a source of funds when HAP contracts expire and are renewed,
- has adequate controls in place to ensure that funds in residual receipts accounts are properly returned to HUD when property owners opt out of the Section 8 program, and
- was aware of the amount of residual receipts being generated by uninsured assisted properties.

Scope: The audit includes multifamily properties that:

- are limited distribution or nonprofit properties,
- are subject to the regulations at 24 CFR Parts 880, 881, 883, 885, or 886 related to receiving Section 8 assistance under the HAP contract with HUD, and
- generate residual receipts.

Methodology: To accomplish these objectives, we:

- reviewed laws, regulations, and other criteria relating to residual receipts.
- obtained financial information from REAC for insured, Section 8 assisted multifamily properties that maintained residual receipts accounts to select properties for review.
- determined what management controls HUD has in place to ensure that residual receipts are returned to the Department when appropriate.
- judgmentally selected 25 insured multifamily properties with either significant residual receipts listed in the REAC database or that had residual receipts and had opted out of the Section 8 program to understand the opt out process, and for further review.

- reviewed an additional random sample of 40 insured multifamily properties from a universe of 1,062 properties identified in the REAC database as having over $1,000 in residual receipts that should be subject to the revised Section 8 rules.

- obtained the Regulatory Agreement, HAP contract, HAP renewal contracts (if appropriate), and the most recent financial statement information on file for the 65 judgmental and random sample properties from the appropriate HUD field offices to ensure property information in REAC's database was reasonable and accurate, and to identify any significant differences between the database and field office records.

- reviewed the sample properties to determine if and how HUD had used residual receipts, and if residual receipts had been recovered when appropriate.

- reviewed four properties under the LMSA program. Obtained from the Seattle multifamily office each property's Regulatory Agreement, HAP contract, and the most recent annual audited financial statements. Interviewed the mortgage lenders for each of the properties to determine disposition of residual receipts when the owners opted out of the LMSA program.

- interviewed HUD project managers from at least ten field offices for sample properties to gain an understanding of what project managers know about residual receipts in regard to the contract renewal process and prepayment or opt out process. Interviewed project managers where a significant issue was identified during the review of specific project information.

- contacted three State Housing Agencies (Oregon, Idaho, and Massachusetts) who administer Section 8 assistance for uninsured multifamily properties to determine how many properties generate and maintain residual receipts accounts, and what the balances in those accounts were.

- performed an onsite review at Oregon Housing Agency to determine what information the agency provided to HUD regarding residual receipts.

Our audit covered insured multifamily properties administered by HUD offices nationwide and uninsured, assisted multifamily properties subject to revised Section 8 rules administered by selected state housing agencies. Our field work was performed from March to August 2000.

We conducted our audit in accordance with generally accepted government auditing standards.

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HUD Should Consider Residual Receipts as a Source of Funds When Renewing Expiring Section 8 Contracts

HUD does not use residual receipts as a source of funds when renewing expiring Section 8 Housing Assistance Payments (HAP) contracts for insured multifamily properties. This occurred because HUD guidance does not require HUD staff to consider using residual receipts as a possible funding source when renewing expiring Section 8 contracts. As a result, HUD is committing additional funds for Section 8 HAP to properties that have millions of dollars in residual receipts accounts under HUD's direct control. Using residual receipts as a supplemental source of funding gives HUD additional funds to assist more of its customers.

Regulatory Agreements give HUD control over residual receipts

The Regulatory Agreement for insured multifamily properties gives HUD control over the use of residual receipts. Regulatory Agreements for limited distribution and nonprofit multifamily properties include specific language about residual receipts.

Regulatory Agreements for low-moderate income insured properties under Section 221(d)(3), Section 221(d)(4), and Section 236 of the National Housing Act state that:

> "Project owners shall establish and maintain, in addition to the reserve fund for replacements, a residual receipts fund by depositing thereto, with the mortgagee, within sixty days after the close of any fiscal year, any residual receipts, as that item is defined herein. Residual receipts shall be under the control of the Commissioner, and shall be disbursed only on the direction of the Commissioner, who shall have the power and authority to direct that such fund, or any part thereof, be used for such purpose as he may determine." (paragraph 2(c))

Regulatory Agreements for elderly/handicapped insured properties under Section 202 state that:

> "The mortgagor additionally shall deposit into the reserve fund for replacements within 60 days after the end of each fiscal year, any residual receipts realized from the operation of the mortgaged property." (paragraph 5)

HUD's Office of General Counsel has determined that even though residual receipts may be deposited into the reserve for replacement account, those funds retain their character as residual receipts under HUD control.

Revised Section 8 regulations state residual receipts go to HUD at contract termination

Prior to a 1980 regulatory revision, the Section 8 Housing Assistance Payments contracts were silent on the subject of residual receipts. The Regulatory Agreement was HUD's only control over an insured property's residual receipts account. In 1980, HUD amended the regulations to state that "…upon termination of the Contract, any excess [residual receipts] funds must be remitted to HUD." (24 C.F.R. § 880.205(e) and § 881.205(e)) The amended regulations apply only to properties selected for Section 8 assistance after November 5, 1979 (New Construction 24 CFR 880.104(a)) or February 20, 1980 (Substantial Rehabilitation 24 CFR 881.104(a)). Paragraph 25-11 of HUD Handbook 4350.1, REV-1 contains similar language. Note that HUD does not consider a HAP contract to be "terminated" if the contract expires but is renewed. A HAP contract termination occurs only when the contract expires and is not renewed (for example, if the owner elects to opt out of the contract), or if HUD terminates the contract for other reasons, such as contract violations.

HUD did not consider residual receipts as a source of funds when renewing expiring HAP contracts

Congress appropriates additional funds to ensure that rental subsidies are maintained when Section 8 HAP contracts expire and need to be renewed. Each HUD multifamily office has project managers[3], who are responsible for renewing expiring Section 8 contracts. Audit staff interviewed 25 HUD project managers from 19 multifamily offices. All 25 project managers stated that they did not consider using residual receipts as a source of funds when renewing expiring Section 8 HAP contracts. Of 61 insured multifamily properties with residual receipts balances reviewed, 11 of the properties had expiring HAP contracts that HUD renewed in Fiscal Years 1999 or 2000[4]. According to their financial statements, these 11 properties had residual receipts balances totaling over $30 million:

[3] Project managers include HUD staff who reserve funding and are identified as funding specialists in some offices.
[4] The HAP contract for a 12th property (Southpoint Villa; project no. 143-35040) was in the process of being renewed at the time of our review. Southpoint Villa had $826,043 in residual receipts as of 12/31/97.

Property Name	Property Number	Number of Units	Section of Act	Date of Renewal	Residual Receipts Balance as of	Residual Receipts Balance
Eastview Towers	031-35155	205	221(d)(3)	11/27/99	12/31/98	$14,325,290
Lutheran Manor	034-38009	196	231	4/1/00	9/30/99	$4,933,454
St. Joseph Apartments	033-EH007	204	202	4/1/00	9/30/99	$4,595,791
Wilikina Apartments	140-35071	119	221(d)(3)	3/29/00	6/30/99	$4,289,256
Jack HallWaipahu	140-35081	144	221(d)(3)	3/21/00	12/31/98	$1,619,934
ML King Apts.	127-35004	120	221(d)(3)	10/1/99	7/31/99	$389,990
Eastern Parkway	012-57049	64	221(d)(4)	5/2/00	12/31/98	$144,880
The Highlander	171-35029	102	221(d)(3)	10/1/99	12/31/98	$143,369
Canterbury Court	171-44028	124	236	10/1/99	9/30/99	$128,121
Fir Tree Park	127-35201	60	221(d)(3)	9/1/99	9/30/99	$95,223
Harborview	042-EH001	100	202	3/12/00	3/31/98	$18,637
Total Residual Receipts						**$30,683,945**

HUD could have used residual receipts to significantly reduce a $6.8 million financial commitment

At the time of contract renewal, six of the eleven properties had residual receipts balances that exceeded the amount of HUD's financial commitment ($5,004,000) under the HAP renewal contracts. If considered as a source of funds, the residual receipts could have been used in part or in total to offset HUD's financial commitment under the HAP renewal contracts. In addition, the remaining five properties had available residual receipts totalling $792,099, which could have offset a portion of HUD's financial commitment.

Property Name	Date of Renewal Contract	Expiration of Renewal Contract[5]	Amount of Residual Receipts	Amount of Commitment for HAP	Residual Receipts in Excess of Commitment
Eastview Towers	November 27, 1999	November 26, 2000	$14,325,290	$1,751,000	$12,574,290
Lutheran Manor	April 1, 2000	March 31, 2001	$4,933,454	$850,000	$4,083,454
St. Joseph Apartments	April 1, 2000	March 31, 2001	$4,595,791	$478,000	$4,117,791
Wilikina Apartments	March 29, 2000	March 28, 2001	$4,289,256	$694,000	$3,595,256
Jack Hall Waipahu	March 21, 2000	September 20,2000	$1,619,934	$1,140,000	$479,934
Canterbury Court	October 1, 1999	September 30, 2000	$128,121	$91,000	$37,121
Total commitment for six properties				**$5,004,000**	
ML King Apts.	October 1, 1999	September 30, 2000	$389,990	$560,000	($170,010)
Eastern Parkway	May 2, 2000	May 1, 2001	$144,880	$688,000	($543,120)
The Highlander	October 1, 1999	September 30, 2000	$143,369	$230,000	($86,631)
Fir Tree Park	September 1, 1999	August 31, 2000	$95,223	$124,500	($28,777)
Harborview	March 12, 2000	March 31, 2001	$18,637	$248,400	($229,763)
Residual receipts available for five properties			**$792,099**		
Total Amount of Commitment for HAP				**$6,854,900**	

[5] The contracts for 10 of the projects were renewed for one year. The contract for Jack Hall Waipahu was renewed for only six months, but will be extended an additional six months to provide OMHAR time to finish processing the renewal.

Although not used for renewals, HUD sometimes uses residual receipts to reduce assistance to properties

Although residual receipts have not been used to reduce HUD's financial commitment under Section 8 HAP renewal contracts, project managers have used residual receipts to reduce HUD's financial commitment or investment in insured properties. For example:

- The project manager for Wilikina Apartments approved release of the property's residual receipts to payoff the property's mortgage balance of $2,142,707 in May 2000. As a result, HUD's Office of Multifamily Housing Assistance Restructuring (OMHAR) will determine the property's rents without including debt service. This will reduce the amount of assistance HUD will provide to the property in the future. In the agreement with HUD to prepay the mortgage, the owner agreed to renew its Section 8 contract whenever it expires until the year 2018. Even after paying off the mortgage, the property still maintains over $2 million in its residual receipts account.

- In September 1999, the project manager for ML King Apartments authorized the property owner to use its residual receipts to pay down a flexible subsidy loan, which was accumulating interest each year. This money comes back to HUD and will be available to other properties for other such loans.

- The Seattle office instructed the owner of Henry M. Jackson Apartments (#127-EH018), a Section 202 property, to use residual receipts, in lieu of a rent increase, to cover a budget shortfall of $32,307 for Fiscal Year ending September 30, 1995.

Use of residual receipts depends on the adequacy of a property's reserve for replacement account and future financial needs

The relatively short length of Section 8 HAP renewal contracts and the scarcity of funding for HAP increase pressure on HUD to consider other possible sources of funding without jeopardizing properties' financial or physical condition. Properties with accumulated residual receipts offer such a source. However, all property needs and funding, such as the property's reserve for replacement fund, must be considered.

The property's Regulatory Agreement provides for regular monthly deposits into a reserve for replacement fund. Owners use reserve for replacement funds primarily for capital improvements. HUD guidance states that all owners should strive to reach some minimum threshold for the reserve fund for replacements. HUD strongly recommends that owners target a minimum amount to be held in the reserve fund that would equal or exceed the greater of (1) the initially established monthly deposit times 144 (12 years), or (2) at least $1,000 per unit (paragraph 11 in Chapter 4, *Reserve Fund for Replacements*, of HUD Handbook 4350.1 REV-1). The 11 properties included in our analysis had reserve for replacement balances in excess of $1,000 per unit, prior to renewing their expiring HAP contracts:

Property Name	Number of Units	Fiscal Year End Dates	Balance in Reserve for Replacements	Reserve Amount per Unit
Eastview Towers	205	12/31/98	$1,119,352	**$5,460**
Lutheran Manor	196	9/30/99	$520,313	**$2,655**
St. Joseph Apartments	204	9/30/99	$620,294	**$3,040**
Wilikina Apartments	119	6/30/99	$684,089	**$5,749**
Jack HallWaipahu	144	12/31/98	$544,642	**$3,782**
ML King Apts.	120	7/31/99	$317,826	**$2,649**
Eastern Parkway	64	12/31/98	$120,975	**$1,890**
The Highlander	102	12/31/98	$200,212	**$1,963**
Canterbury Court	124	9/30/99	$285,615	**$2,303**
Fir Tree Park	60	9/30/99	$82,426	**$1,374**
Harborview	100	3/31/99	$839,751	**$8,398**

The balances in the properties' reserve for replacement accounts appear to be sufficient for any major repair or unforeseen emergency given: (1) all properties were inspected prior to renewal of the expiring HAP contract and received passing scores and (2) the HAP contracts were renewed only for a period of from six months to one year. For these properties, residual receipts could provide additional funds to reduce HUD's financial commitment when renewing expiring HAP contracts. As with the reserve for replacement account, HUD may consider maintaining a minimum balance in a property's residual receipts account, such as $500 per unit as statutorily mandated for Section 202 properties.

HUD's written guidance did not require staff to consider using residual receipts as a possible funding source when renewing HAP contracts

Paragraph 25-9 of HUD Handbook 4350.1 REV-1, Multifamily Asset Management and Project Servicing, specifies for what residual receipts may be used. For properties subject to the revised Section 8 regulations ("post-1980" provisions), the Handbook states that project managers may use residual receipts to reduce operating deficits when legitimate cash flow deficits exist and to make mortgage payments for an actual or imminent default (paragraph 25-10). However, the Handbook does not mention using residual receipts as a means of reducing funds needed for the renewal of Section 8 HAP contracts.

Likewise, HUD's guidance, in Notices H 98-34 and H 99-36 concerning insured multifamily Section 8 contracts expiring in Fiscal Years 1999 and 2000, does not require project managers to consider residual receipts to reduce a property's HAP when expiring HAP contracts are renewed. The Notices only address HUD recovery of residual receipts funds if the owner opts out or chooses to terminate the HAP contract. The Director of the Office of Business Products in Headquarters' Office of Multifamily Housing agreed that residual receipts should be considered as a source of funds for renewing expiring Section 8 contracts since residual receipts have been used in lieu of rent increases in the past. He said the absence of such guidance in Notice 99-36 must have been an oversight.

The 25 project managers interviewed stated that they follow HUD guidance in the appropriate Notices and do not consider residual receipts as a source of funds when renewing expiring contracts. However, HUD management did comment that a property's residual receipts provided an additional source of funds to be used as allowed in paragraph 25-9 of Handbook 4350.1 REV-1.

HUD has authority to use residual receipts to reduce housing assistance payments

For properties selected to receive assistance after the regulatory revision in 1980, federal regulations give HUD the authority to "...reduce housing assistance payments or for other project purposes. Upon termination of the contract, any excess funds must be remitted to HUD." (24 CFR 880.205(e) and 881.205(e)) For example, the Seattle Office's Chief of Loan Management issued a memorandum to Loan Specialists dated January 2, 1992, requiring them to consider the use of residual receipts as an alternative to approving rent increases for Section 202 Direct Loan properties. The memorandum was in response to an Office of Inspector General audit report issued in September 1991, to prevent payment of unnecessary subsidies or property expenses.

The federal regulations are silent regarding the use and disposition of a property's residual receipts prior to the 1980 regulatory revision. However, the Regulatory Agreements do give HUD the power and authority to direct residual receipts to be used for such purpose as HUD may determine. In addition, since residual receipts consist of excess assistance payments after all required financial obligations have been met, including any agreed to owner distribution, HUD should use these funds rather than let them accumulate indefinitely.

For the many expiring Section 8 HAP contracts for properties subject to the 1980 revision, HUD could reduce the amount of additional funding needed for contract renewals. Based on a review of only 11 properties, HUD could have used as much as $5 million of residual receipts to offset funds needed to renew the expiring Section 8 contracts. For properties not subject to the 1980 revision, it is also important that HUD use residual receipts funds whenever possible because residual receipts revert to the property owner once the mortgage is paid off.

Conclusion

Under the terms of the Regulatory Agreement and the Section 8 HAP contacts, HUD has the power and authority to direct that property residual receipts be used for such purpose as HUD may determine. According to financial information in HUD's REAC database, the balances in property residual receipts accounts exceed half a billion dollars for over 4,000 insured and assisted properties. If considered as a source of funds, residual receipts could be used in part to offset HUD's financial commitment under HAP renewal contracts. Using existing residual receipts as a supplemental source of funding gives HUD the opportunity to provide assistance to more customers.

HUD's comments

Multifamily Housing provided comments to this finding's recommendations. HUD cited Paragraph 25-9, Chapter 25, HUD Handbook 4350.1, Multifamily Asset Management and Project Servicing, which states how residual receipts may be used. HUD will consider issuing additional guidance on the use of residual receipts as a source of funds. The guidance will consider the most efficient way to approach the recommendation as monthly draws (for Housing Assistance Payments) would be a workload management issue.
HUD also agreed to issue guidance establishing a minimum residual receipts balance equal to the amount determined in a Capital Needs Assessment (CNA) or instruct field offices to make a determination on the physical needs based on the latest REAC inspection report.

OIG response

We agree HUD should issue additional guidance on the use of residual receipts as a source of funds. However, the guidance should require use of residual receipts as a source of funds if a project is in good physical and financial condition. Workload is a consideration, but HUD could authorize a mortgagee to release the appropriate amount of residual receipts monthly for the term of the HAP renewal contract rather than having to do so each month.

We do not agree that the residual receipts balance should be equal to the amount of capital needs or the property's physical needs since reserve for replacement funds are specifically set aside to address capital improvements. Also, per Paragraph 25-10 in HUD Handbook 4350.1, projects subject to 1979/1980 revised Section 8 regulations can only use residual receipts for reducing operating deficits and making mortgage payments when a mortgage default is actual or imminent.

Recommendations:

We recommend that you:

1A. Provide specific guidance to property managers to perform an analysis of each insured multifamily property's financial and physical needs, including consideration of a property's residual receipts as a source of funds when renewing expiring Section 8 HAP contracts.

1B. Establish a minimum residual receipts balance to be maintained by properties.

HUD Does Not Have Adequate Controls to Ensure Residual Receipts are Properly Safeguarded

The review disclosed one case where, due to inadequate HUD controls, a former property owner prepaid an insured property's mortgage and withdrew $64,369 in residual receipts. The funds should have stayed with the property and been remitted to HUD upon termination of the Housing Assistance Payments (HAP) contract. In the absence of adequate controls, there may be other instances where a similar situation occurred or will occur, resulting in significant amounts of residual receipts funds not being properly safeguarded. HUD does not have adequate controls in that: (1) HUD does not have specific requirements for lenders (mortgagees) to maintain a property's residual receipts account after the mortgage is paid off; (2) HUD guidance on the disposition of residual receipts is incomplete; and (3) there is uncertainty and confusion among HUD project managers regarding when residual receipts should be remitted to HUD.

Prior to the 1980 regulatory revision, residual receipts went to owners upon mortgage payoff

Prior to a 1980 Section 8 program regulatory revision, the only HUD control over the residual receipts account was contained in the Regulatory Agreement between HUD and the property owner. The Section 8 HAP contracts did not have any provisions regarding residual receipts. The Regulatory Agreement allowed HUD to use residual receipts for whatever purposes HUD determined. However, the Regulatory Agreements were silent regarding final disposition of residual receipts. Therefore, prior to the 1980 revision, when the property owner paid off the mortgage, the lender remitted to the owner any funds in the residual receipts account.

The 1980 regulatory revision stated that residual receipts would go to HUD upon termination of the HAP contract

In 1980, HUD amended the regulations for certain Section 8 assisted insured multifamily properties[6], and assisted, uninsured properties. The revision added language regarding residual receipts. Included in the new provision was a requirement that "Upon termination of the contract, any excess [residual receipts] funds must be remitted to HUD." (24 C.F.R. 880.205(e), 881.205(e), and 883.306(e)) The amended regulations applied only to properties selected to receive Section 8 assistance after November 5, 1979 for new construction and February 20, 1980 for substantial rehabilitation.

[6] The revision applies to two major insured multifamily Section 8 programs: new construction and substantial rehabilitation. The only major insured multifamily Section 8 program that the revision does not cover is the LMSA program (see Finding 3).

HUD Handbook 4350.1 REV-1, *Multifamily Asset Management and Project Servicing*, states that "When a project's Section 8 contract expires, is terminated, or any extensions are terminated, HUD will request the project owner to return to HUD the unused balance of funds remaining in the residual receipts account at the time of the contract's termination." (Section 25-11)

Notices H 98-34 and H 99-36 for HAP contracts expiring in Fiscal Years 1999 and 2000, respectively, also address residual receipts if the property owner chooses to opt out of the Section 8 program. Notice H 98-34 reminds the owner that for 1980 and later contracts, HUD has the contractual right to require the lender to return to HUD the unused balance of funds remaining in the residual receipts account at the time of the HAP contract's termination. Notice H 99-36 states that the HUD multifamily office or Program Center Director must notify the Section 8 Financial Management Center and the Fort Worth Accounting Center once an owner's decision to opt out is final or HUD terminates any Section 8 HAP contract. Any remaining subsidy, as well as funds in an applicable residual receipts account, must be returned to HUD.

One property owner paid off the mortgage and withdrew $64,369 in residual receipts

A review of 40 randomly selected multifamily properties subject to the revised Section 8 rules, disclosed a situation that illustrated HUD's need to strengthen controls over the disposition of residual receipts. The former owner of one property prepaid the mortgage and was paid the balance in the residual receipts account even though the HAP contract remained in effect under the new owner. This violated HUD's revised regulations which require that final disposition of residual receipts (1) occur only upon termination of the HAP contract and (2) be paid to HUD.

Horizon Towers

Horizon Towers (FHA #074-35165) was the only property in our random sample of 40 properties whose mortgage was prepaid. The former owner prepaid the property's mortgage in 1999. According to the project manager, HUD Headquarters handled the prepayment.

Horizon Towers, with a HAP contract that took effect on May 1, 1981, falls under HUD's revised Section 8 rules that require any residual receipts to be paid to HUD when the contract terminates. The HAP contract will expire on April 30, 2001, and the project manager stated that the current property owner has indicated he will not renew the HAP contract when it expires.

The former owner prepaid the mortgage, and on December 1, 1999, HUD and the former owner entered into a HAP Contract Assignment and Consent Agreement. Under the Agreement, HUD consented to transfer ownership of the HAP contract (HAP contract IA05-0040-003) from the former owner to the new owner.

The former owner improperly received $64,369 in residual receipts

Also on December 1, 1999, the former owner wrote to the lender stating that the sale of Horizon Towers had closed and instructed the lender to close various property accounts, including the residual receipts account. On December 2, 1999, the lender issued a check for $82,298.81 to the former owner, which included the balance in the residual receipts account of $64,368.84. The former owner confirmed he received the residual receipts, and that the funds were not returned to the property. The project manager stated that as of June 29, 2000, the property did not have any residual receipts even though the HAP contract remains in effect.

The HAP Contract Assignment and Consent Agreement for Horizon Towers does not include any reference to the property's residual receipts. However, the Contract Assignment and Consent Agreement had the following caveat which may allow HUD to recover residual receipts disbursed to the former owner:

> "Nothing herein contained shall act as a release or waiver of any claim which may arise in connection with the Assignor's failure to have faithfully discharged all its duties and responsibilities under the Contract."

Even so, unless the former owner voluntarily returns the residual receipts funds, HUD may need to pursue litigation to recover the residual receipts that should have rightfully stayed with the property.

HUD does not have adequate controls to ensure residual receipts are properly safeguarded

HUD does not have adequate controls in that: (1) HUD does not have specific requirements for lenders (mortgagees) to maintain a property's residual receipts account after the mortgage is paid off; (2) HUD guidance on the disposition of residual receipts is incomplete; and (3) there is uncertainty and confusion among HUD project managers regarding when residual receipts should be paid to HUD.

No specific requirements for lenders to maintain the property's residual receipts account after the mortgage is paid off

The payoff of Horizon Towers' mortgage illustrates a control weakness over residual receipts when a property's mortgage is paid off and the HAP contract remains in effect. HUD needs to include a stipulation in its prepayment process, which ensures that residual receipts stay with properties that will continue to receive assistance under HAP contracts subject to the revised rules. Also, assignment of an existing HAP contract to a new owner should include a similar stipulation concerning existing residual receipts staying with the property.

The lender's (mortgagee's) payoff specialist stated that the Regulatory Agreement was the only document she was aware of that gave HUD control over the property's residual receipts account. The payoff specialist was not aware of any requirement that specific HUD approval was needed for the former owner to close the residual receipts account, once the mortgage was paid off and the Regulatory Agreement was no longer in effect. Consequently, the lender disbursed the funds to the former owner at the former owner's request.

Audit staff provided the payoff specialist with the relevant part of the property's Section 8 HAP contract, which states that upon termination, any excess funds (residual receipts) must be remitted to HUD. The payoff specialist said that the lender was not party to the HAP contract and therefore, was not bound by it. In addition, HUD's project manager believed that the Regulatory Agreement controlled the disposition of a property's residual receipts. It was her understanding that if the Regulatory Agreement was silent, the residual receipts would go to the property owner.

HUD guidance on the disposition of residual receipts is incomplete

Although HUD's revised regulations, Handbook provisions, and Notices state that residual receipts must be remitted to HUD, the guidance is not sufficient to ensure HUD collects and properly accounts for residual receipts funds upon termination of Section 8 contracts.

Notice 99-36 states that if an owner prepays the mortgage prior to termination of a 100 percent subsidized HAP contract under the new regulations, any balance in the residual receipts account at the time of the insurance termination must continue to be held in trust by a depository and under the control of HUD. However, the guidance does not state how to ensure the residual receipts account will remain in trust, given that the Regulatory Agreement is no longer in effect and the account is an owner account, which would not be subject to FHA regulatory requirements after payoff.

Notice H 99-36 also states that the HUD Multifamily Hub or Program Center Director must notify the Fort Worth Accounting Center once an owner's decision to opt out is final or HUD terminates any Section 8 HAP contract. However, HUD accounting staff in Fort Worth told us they do not know anything about residual receipts. Any returned funds are classified by HAP contract number and are not specifically identified as to the type of funds.

A Headquarters official commented that HUD has been "loose" on collection of residual receipts, but has been tightening up the collection process. In the past, the official did not believe there were many residual receipts funds due to HUD.

HUD's project managers are uncertain about when residual receipts should be remitted to HUD

During the review, audit staff contacted 25 project managers from 19 different HUD field offices. The amount of experience for project managers ranged from 1.5 months to 17 years, and

12 of the 25 project managers have three years or less experience as project managers. The project managers expressed uncertainty and confusion about residual receipts and related controls:

- Fourteen project managers stated they did not know when residual receipts should be returned to HUD,
- Five stated that the residual receipts would come back when the mortgage was paid off,
- Four stated that the residual receipts would come back to HUD when the HAP contract terminated,
- One stated that residual receipts did not come back to HUD, and
- One project manager was a funding specialist who did not perform other project manager duties and was not familiar with residual receipts.

In addition, of the 25 project managers: (1) nine believed the Regulatory Agreement controlled disposition of residual receipts; (2) eight project managers believed the HAP contract controlled disposition of residual receipts; (3) two stated that both the HAP contract and Regulatory Agreement control the disposition of residual receipts; (4) five project managers did not know; and (5) one was not familiar with residual receipts.

The responses from the project managers indicate that even experienced staff do not understand the rules that control the disposition of residual receipts. With HUD moving toward contracting out the administration of Section 8 contracts, the new administrators' staff will need to understand what residual receipts represent and the specific, interrelated contracts and rules that control disposition of these funds.

HUD's comments

HUD agreed to make efforts to recover the $64,369, plus interest from the former owner of Horizon Towers and look at projects that have prepaid and have filed electronic financial statements with HUD through the REAC FASS system.

HUD will send an e-mail reminder and formal guidance to all multifamily Hub and program centers regarding oversight and collection of residual receipts as related to prepayments. Also, Multifamily Housing will consider issuing guidance to the field offices that requires, as a condition of prepayment, setting up an account for residual receipts that would remain under HUD control until HAP termination.

In addition, HUD will issue a Notice with the appropriate instructions in regard to handling residual receipts for properties subject to the revised Section 8 rules. HUD has issued Section 8 contract renewal guidance and will provide additional guidance on this matter.

Finally, Multifamily Housing will coordinate with the Fort Worth Accounting Center to develop an efficient and effective way of verifying deposit of residual receipts.

OIG response

We agree with HUD's comments, except that HUD must do more than consider issuing guidance to safeguard residual receipts during prepayment. As stated in the finding, HUD must require owners to transfer any residual receipts to a designated property account under HUD control as a condition of prepayment for insured properties with HAP contracts subject to the revised Section 8 rules to safeguard those funds.

Recommendations:

We recommend that you:

2A. Recover the $64,369 plus any related interest from the former owner of Horizon Towers by whatever means are appropriate and put the funds into a property account under HUD control for the duration of the HAP contract.

2B. Determine if there have been any other mortgage prepayments in which project owners have received residual receipts that should have stayed with the project and been remitted to HUD at contract termination and if so, take appropriate action to recover those funds.

2C. Require owners to transfer any residual receipts to a designated property account under HUD control as a condition of prepayment for insured multifamily properties with HAP contracts subject to the revised Section 8 rules.

2D. Ensure that property owners and lenders understand owner responsibilities, contract provisions, and related requirements regarding residual receipts subject to the revised Section 8 rules.

2E. Ensure that project managers and contract administrators understand residual receipts disposition requirements including: identifying the documents, regulations, and related requirements that control disposition of residual receipts; how to identify insured projects subject to the revised Section 8 rules and requirements; and the specific actions to safeguard residual receipts in any given situation.

2F. Require project managers/contract administrators to confirm that any residual receipts due to HUD are received by the Fort Worth Accounting Center.

The Loan Management Set-Aside Program Should be Subject to the Same Residual Receipts Rules as Other Section 8 Programs

Unlike other major Section 8 contracts for multifamily properties, current regulations for properties in the LMSA program do not allow HUD to recover residual receipts at contract termination. As a result, property owners may realize windfall profits when property mortgages are paid off. HUD could use recovered residual receipts to assist other properties. According to property financial information in the REAC database, there are 645 LMSA assisted properties that have balances in their residual receipts accounts totaling over $81 million. It appears HUD did not revise Section 8 rules for LMSA properties because these were financially troubled properties and HUD did not expect them to generate residual receipts.

A regulatory provision to recover residual receipts was not applied to the LMSA program

The primary goal of the special allocations program (the LMSA program), one of HUD's Section 8 Housing Assistance Payments programs, is to reduce claims on HUD's insurance fund by aiding those FHA-insured or Secretary-held properties with immediately or potentially serious financial difficulties (24 CFR 886.101(b)).

The regulations for the Section 8 LMSA program do not say anything about residual receipts. As such, residual receipts for the LMSA program are governed by provisions of the Regulatory Agreement, which allow HUD to use residual receipts while the Agreement is in effect (i.e., while the mortgage is being paid). However, once the mortgage is paid off, the lender will remit funds in the residual receipts account to the owner.

A 1980 regulatory revision for three other major Section 8 programs for insured and uninsured multifamily properties allowed HUD to recover funds from residual receipts accounts, when the Section 8 HAP contracts terminate. Under limitation on distributions, the Section 8 regulations for new construction, substantial rehabilitation, and State Housing Agencies state:

> "Upon termination of the Contract, any excess funds must be remitted to HUD." (24 CFR 880.205(e), 881.205(e), and 883.306(e))

Residual receipts totaling $166,086 went to three owners who opted out of the LMSA program

To determine if residual receipts funds were going to property owners when mortgages were prepaid and properties opted out of the Section 8 program, we obtained the opt out and prepay report for Section 8 multifamily projects for the Northwest/Alaska multifamily office. From this report, audit staff judgmentally selected four multifamily properties under the LMSA program that had residual receipts at the time the owner prepaid the mortgage and opted out of the Section 8 program. Each property's Regulatory Agreement, HAP contract, and most recent annual audited financial statements on file at the Seattle HUD office were obtained and reviewed. Lenders (mortgagees) for three of the properties said they remitted the residual receipts to the property owners at the time of prepayment and opt out. For one property (Atwood Apartments), the lender assigned the mortgage to HUD. HUD paid off the mortgage and, as part of the assignment process, the Atwood Apartments' residual receipts accounts were disbursed to HUD.

The lenders for the three properties (excluding Atwood Apartments) provided information about the amounts paid for each property's residual receipts at the time of prepayment and opt out.

Property Name	**FHA Number**	**Termination & Prepayment Date**	**Date of Checks**	**Residual Receipts Balance**
International Apts.	127-35078	October 31, 1997	May 21, 1997	$107,618
Assembly Apts.	127-35151	September 12, 1997	September 23, 1997	$55,288
Capitol House	127-35215	May 7, 1998	May 28, 1997	$3,180
Total				**$166,086**

Under current regulations, HUD was unable to collect the $166,086 in residual receipts that the lenders remitted to property owners at the time of prepayment and opt out.

LMSA regulations were not revised because HUD did not expect these properties to generate residual receipts

Unlike Section 8 regulations for new construction and substantial rehabilitation properties, the regulations for LMSA properties do not allow HUD to recover residual receipts when HAP contracts terminate.

It is unclear why HUD did not include the same regulatory provisions for LMSA properties as it did for other major Section 8 multifamily programs. According to the regulations, the LMSA program's primary goal is to reduce claims on the Department's insurance fund by aiding those FHA-insured or Secretary-held properties with immediate or potentially serious financial difficulties. It may be that HUD did not believe these problem properties would ever generate residual receipts. However, the financial information in the REAC's database showed 645 LMSA properties with at least $20,000 in their respective residual receipts accounts. This indicates that HUD's assistance more than adequately addressed any potentially serious financial difficulties for those properties.

For 100 percent assisted properties, the residual receipts funds are derived from HUD assistance. Therefore, the limited distribution owner has already received the negotiated 6 or 10 percent return on equity (no return on equity for non-profits). Any residual receipts that the owner received would be a windfall profit. The property owner does not need funds in excess of those provided by HUD to support the property, avoid financial difficulties, and realize the agreed to return on equity. As with any assisted property, HAP contracts for LMSA properties may continue indefinitely and residual receipts funds may continue to accumulate. However, according to an experienced HUD official, there have not been any new LMSA assisted contracts for a number of years.

We understand that HUD cannot change the rules for existing LMSA HAP contracts. However, in our opinion, HUD should change LMSA regulations that would affect any new LMSA contracts. This change would allow HUD to recover any residual receipts under HAP contracts subject to the revised regulations at contract termination, as is currently required for new construction and substantial rehabilitation properties subject to the revised rules.

HUD's comments

HUD commented that it will ascertain the residual receipts' balances for the LMSA projects. The risk of losing affordable housing to owners who, rather than agree to return their residual receipts to the Department, would choose to opt out of the Section 8 program, may not be worth the amount of residual receipts recovered. Based upon analysis, Multifamily Housing will work with the Office of General Counsel to amend applicable regulations, if appropriate. Multifamily Housing will also consider issuing guidance as specified in its response to recommendation 1A and will evaluate whether this change in contract terms will conflict with efforts to retain project based units.

OIG response

This finding's primary focus is to change regulations prospectively for new properties that would receive assistance under the LMSA program to be consistent with the new construction and substantial rehabilitation regulations. We do not agree that changing the LMSA regulations for *new* properties would pose any risk of losing affordable housing since we are not recommending any change that would affect properties currently receiving assistance under existing LMSA contracts. As stated in the finding, properties provided Section 8 assistance under the LMSA program have accumulated significant residual receipts even though the intent of the LMSA program was to reduce claims on HUD's insurance fund by aiding properties with immediate or potentially serious financial difficulties.

Recommendations:

We recommend that you:

3A. Revise the Section 8 regulations for properties new to the LMSA Section 8 Program to require a property's residual receipts be returned to HUD upon termination of the HAP contract.

3B. Require contract administrators to consider a LMSA property's residual receipts as a source of funds when the property's expiring HAP contract is renewed.

HUD Does Not Monitor Residual Receipts for Uninsured, Assisted Properties Administered by State Housing Agencies

HUD does not receive financial information about uninsured Section 8 properties managed by State Housing Agencies that generate residual receipts. This occurred because HUD does not require State Housing Agencies to provide financial information on residual receipts for uninsured, assisted properties. As a result, HUD management is not aware of or monitoring millions of dollars accumulating in uninsured properties' residual receipts accounts that will be remitted to HUD when Section 8 Housing Assistance Payments (HAP) contracts terminate.

Good internal control includes monitoring and safeguarding of assets

The Standards for Internal Control in the Federal Government, issued by the General Accounting Office (GAO), cite monitoring and physical control over vulnerable assets as good internal control measures. Monitoring helps federal agencies assess the quality of performance over time. Also, the Government Performance and Results Act of 1993 states that "Federal managers are seriously disadvantaged in their efforts to improve program efficiency and effectiveness, because of insufficient articulation of program goals and inadequate information on program performance."

The GAO Standards for Internal Control also include physical control over vulnerable assets as one of several control activities that helps ensure that management's directives are carried out:

> "An agency must establish physical control to secure and safeguard vulnerable assets. Examples include security for and limited access to assets such as cash, securities…which might be vulnerable to risk of loss or unauthorized use. Such assets should be periodically counted and compared to control records."

Uninsured, assisted properties are subject to the 1980 regulatory revisions

As discussed in the Introduction, HUD often provides Section 8 rental assistance to multifamily housing complexes that do not have HUD-insured mortgages. These uninsured, assisted properties have Section 8 HAP contracts, but no Regulatory Agreements with HUD. The HAP contracts for these properties are administered for HUD by State Housing Agencies and include contracts subject to the revised Section 8 rules (24 CFR 883). As such, any residual receipts generated by these uninsured properties must be remitted to HUD upon termination of the HAP contracts. However, the majority of these uninsured HAP contracts are 30 year contracts and will not start expiring until 2010.

A review of three State Housing Agencies found that uninsured, assisted properties generate significant amounts of residual receipts

We contacted three State Housing Agencies who administer Section 8 assistance for uninsured multifamily properties to determine how many properties generate and maintain residual receipts accounts, and what the balances in those accounts were.

The Oregon Housing and Community Services, Massachusetts Housing Finance Agency, and Idaho Housing and Finance Association administer the Section 8 programs for uninsured properties in their respective states. The uninsured, assisted properties administered by the three agencies include limited distribution properties subject to the revised regulations. Also, the properties have 30-year HAP contracts, except for four properties administered by Massachusetts Housing (one 20-year, and three 40-year contracts). Except for the 20-year contract that expires in 2004, the earliest any of the other contracts begin expiring is October 2010.

According to property records, the 77 uninsured, assisted properties administered by the three agencies have generated $40,767,286 in residual receipts, with balances ranging from zero to $5,306,466:

State Agency	***No. Properties***	***Residual Receipts***
Oregon	13	$6,144,276
Massachusetts	52	$33,766,429
Idaho	12	$856,581
Totals	77	$40,767,286

In addition, Massachusetts Housing currently is in dispute with several property owners over $8,194,868 which Massachusetts Housing believes should be deposited in residual receipts accounts.

HUD does not receive financial information on uninsured properties

Representatives from the Oregon, Massachusetts, and Idaho State Housing Agencies said they do not provide HUD with any financial information on uninsured, assisted properties. HUD officials at the Portland and Boston offices confirmed that no financial information for uninsured, assisted properties is provided to HUD by the State Housing Agencies.

HUD does not require State Housing Agencies to provide financial information on uninsured, assisted properties

HUD officials in the Portland office (which oversees both Oregon Housing and Idaho Housing) and Boston office (which oversees Massachusetts Housing) commented that they were not aware of any (1) current requirements that State Housing Agencies provide HUD with any financial information about uninsured properties, or (2) HUD database that has financial information for uninsured, assisted properties. HUD officials added that HUD would not need any financial information for assisted, uninsured properties for monitoring purposes since there was no insurance risk of default.

HUD needs to monitor and safeguard residual receipts

HUD officials are correct in stating that the uninsured properties do not pose a risk to the insurance fund. However, the residual receipts are a valuable cash asset, an asset that should be controlled and safeguarded. Since Section 8 assistance is provided via a HAP contract subject to the revised Section 8 rules, the residual receipts generated by uninsured properties will be remitted to HUD upon termination of the HAP contracts. Even though the HAP contracts will not start expiring for another 10 years, the accumulated balances in the 77 uninsured properties mentioned above, already total $40,767,286. However, HUD currently does not receive or maintain any financial information concerning uninsured, assisted properties' residual receipts.

Conclusion

From a safeguarding of assets and planning standpoint, this lack of financial information concerning residual receipts funds, maintained by these uninsured properties, is a significant weakness in HUD's management systems.

HUD's Director of the Office of Housing Assistance & Contract Administration Oversight stated that HUD did not currently have funds budgeted to develop a database for residual receipts information for uninsured properties. However, he agreed that monitoring such information would be a good idea since the amount of funds was significant.

However, requiring State Housing Agencies to submit annual reports to the appropriate HUD office would provide HUD with the necessary information.

Since the residual receipts will continue to accumulate in these project accounts for the duration of the HAP contracts, it would be prudent for HUD to determine if there is a mechanism available to utilize these funds, which are in essence HUD's funds, prior to contract termination.

HUD's comments

HUD commented that the requirement for State Housing Agencies to provide information on residual receipts is not in the Contract Administrator's contract. However, HUD will determine if the contracts can be amended to include this requirement. Also, HUD will obtain a legal opinion to determine if HUD has authority to use the residual receipts in uninsured, assisted property accounts prior to termination of the HAP contracts.

OIG response

We do not agree that a contract amendment is necessary. Based on information obtained from the three state housing agencies, information on residual receipts generated by uninsured, assisted properties was readily available. Issuing a notice to the state housing agencies requiring this information to be provided annually should be sufficient.

Recommendations:

We recommend that you:

4A. Require State Housing Agencies and any other organization that administers Section 8 contracts for uninsured multifamily properties to provide financial information on residual receipts balances to HUD, at least annually.

4B. Obtain a legal opinion to determine if HUD has authority to use the residual receipts accumulating in uninsured, assisted property accounts prior to termination of the HAP contracts.

Management Controls

In planning and performing our audit, we considered HUD's management controls relating specifically to our objectives to determine our auditing procedures and not provide assurance on management controls.

Management controls over program operations include the policies and procedures that management has implemented to reasonably ensure that a program meets its objectives. The components of management control are interrelated and include integrity, ethical values, competence, and the control environment, which includes establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring. The entity's management is responsible for establishing and maintaining adequate systems of management controls.

Relevant controls

For the purpose of our review, we determined the management controls relevant to our objectives were HUD's policies, procedures, and practices relative to:

- the use and disposition of multifamily properties' residual receipts when renewing expiring Housing Assistance Payments (HAP) contracts.

- the safeguarding of residual receipts when either property owners prepay insured mortgages and the property continues to receive assistance under a HAP contract subject to the revised Section 8 rules, or HAP contracts subject to the revised Section 8 rules terminate.

- receiving and monitoring financial information related to residual receipts, generated by uninsured, assisted properties whose HAP contracts are administered by State Housing Finance Agencies.

Scope of work

We evaluated the management control categories listed above by assessing control design, implementation, and effectiveness.

A significant control weakness exists if the controls do not give reasonable assurance that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data is obtained, maintained, and fairly disclosed in reports.

Assessment results

Based on our review, we identified the following weaknesses in HUD's management controls:

- HUD does not consider residual receipts as a source of funds when renewing expiring Section 8 HAP contracts (see Finding 1).
- HUD does not have adequate controls to ensure residual receipts are properly safeguarded (see Finding 2).
- HUD does not monitor residual receipts for uninsured, assisted properties administered by State Housing Agencies (see Finding 4).

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

SEP 27 2000

MEMORANDUM FOR: Frank E. Baca, District Inspector General for Audit, OAGA

FROM: Shaun Donovan, Deputy Assistant Secretary for Multifamily Housing Programs, HT

SUBJECT: Draft Report of Nationwide Audit
Use and Disposition of Residual Receipts
Office of Multifamily Housing Programs

This memorandum responds to the subject draft audit report dated August 18, 2000. We have provided comments by finding and ask for your consideration of this response prior to issuance of the final audit report.

FINDING

1. HUD should consider residual receipts as a source of funds when renewing expiring Section 8 contracts

Recommendation:

1A. Provide specific guidance that requires property managers and those responsible for renewing expiring Section 8 contracts to consider using residual receipts as a source of funds when renewing expiring Section 8 contracts and performing an analysis of each insured multifamily properties' financial/physical needs.

Response:

HUD Handbook 4350.1, Multifamily Asset Management and Project Servicing, Chapter 25, Paragraph 25-9 states " Except for projects subject to the 1979/80 revised Section 8 regulations, withdrawals from the residual receipts may be used to reduce operating deficits when legitimate cash flow deficits exist, i.e., offset increased operating expenses instead of increasing rental rates. For projects subject to the revised Section 8 regulations, residual receipts may be used to reduce operating deficits, offset increased operating expenses and make mortgage payments when a mortgage default is actual or imminent. The Housing Commissioner may direct that all or a portion of the funds in a project's residual receipts account may be used to reduce Housing Assistance Payments or for other project purposes.

HUD will consider issuing additional guidance on the use of using residual receipts as a source of funds. This guidance will take into consideration the most efficient way to approach this recommendation as monthly draws on the residual receipt account for this purpose would be a workload management issue.

The Office of Housing Assistance and Grant Administration requested a legal opinion from OGC as to whether the Department can require the Owner to use residual receipts to cover project expenses instead of granting the owner the annual OCAF as provided by statue.

Recommendation:

1B. Establish a minimum residual receipts balance to be maintained by properties.

Response:

Housing will issue guidance establishing residual receipts balance to be equal to the amount of capital needs established in the Capital Needs Assessment (CNA) or, if there is no CNA, instruct field offices to make a determination on the physical needs by using the latest REAC physical inspection report.

FINDING

HUD does not have adequate controls to ensure residual receipts are properly safeguarded.

Recommendations:

2A. Recover the $64,369 plus any related interest from the former owner of Horizon Towers by whatever means are appropriate and put the funds into a property account under HUD control, for the duration of the HAP contract.

Response:

Efforts will be made to recover the $64,369, plus interest, from the former owner of Horizon Towers.

2B. Determine if there have been any other mortgage prepayments in which project owners have received residual receipts that should have stayed with the project and been remitted to HUD at contract termination and, if so, take appropriate action to recover those funds.

Response:

HUD will look at projects that have prepaid and have filed electronic financial statements with HUD through the REAC FASS system.

2C. Require owners to transfer any residual receipts to a designated property account under HUD control as a condition of prepayment for insured multifamily properties with HAP contracts subject to the revised Section 8 rules.

Response:

An e-mail reminder regarding oversight and collection of Residual Receipts as it relates to mortgage prepayments (see attachment 1) will be sent to all MF Hub and Program Centers. This guidance will also be issued in a more formal format.

Additionally, Multifamily Housing will consider issuing guidance to the field offices that requires, as a condition of prepayment, an account for residual receipts to be deposited into that would remain under HUD control until HAP termination.

2D. Take appropriate measures to ensure that property owners and lenders understand owner responsibilities, contract provisions, and related requirements regarding residual receipts subject to the revised Section 8 rules.

Response:

HUD will issue a Notice with the appropriate instructions with regard to the handling of residual receipts on projects subject to the revised Section 8 rules.

2E. Ensure that project managers and contract administrators understand residual receipts disposition requirements including: identifying the documents, regulations, and related requirements that control disposition of residual receipts; how to identify insured properties subject to the revised Section 8 rules and requirements; and specific actions to safeguard residual receipts in any given situation.

Response:

HUD has issued Section 8 contract renewal guidance and will provide additional guidance on this matter.

2F. Require project managers/contract administrators to confirm that any residual receipts due to HUD are received by the Fort Worth Accounting Center.

Response:

Multifamily Housing will coordinate with the Fort Worth Accounting Center to develop an efficient and effective way of verifying deposit of residual receipts.

FINDING

The Loan Management Set-Aside Program should be subject to the same residual receipts rules as other Section 8 programs

3A. Revise the Section 8 regulations for LMSA assisted properties that would affect new contracts to require a project's residual receipts be returned to HUD upon termination of the HAP contract.

Response:

HUD will ascertain the balances in the residual receipts account of the LMSA projects. The risk of losing affordable housing to owners who, rather than agree to return their residual receipts to the Department, would choose to opt out of the Section 8 program, may not be worth the amount recovered from balances in the LMSA residual receipts accounts. Data has been requested to verify these balances. Based upon analysis, Multifamily Housing will work with the Office of General Counsel to amend applicable regulations if appropriate.

3B. Require contract administrators to consider a LMSA property's residual receipts as a source of funds when the property's expiring HAP contracts are renewed.

Response:

Multifamily Housing will consider issuing this guidance as specified in response to recommendation 1A. Multifamily Housing will evaluate whether this change in contract terms will conflict with efforts to retain project based units.

FINDING

HUD does not monitor residual receipts for uninsured, assisted properties administered by State Housing Agencies.

Recommendations:

4A. Require State Housing Agencies and any other organization that administers Section 8 contracts for uninsured, assisted multifamily properties to provide financial information on residual receipts balances to HUD, at least annually.

Response:

This requirement is currently not in the Contract Administrators contract; however, HUD will confer with the Office of Procurements and Contracts to Redetermine if the contracts can be amended to include this requirement.

4B. Obtain a legal opinion to determine if HUD has authority to use the residual receipts accumulating in uninsured, assisted property accounts prior to termination of the HAP contracts.

Response:

HUD will obtain an opinion for the Office of General Counsel on this matter.

If you have any questions or wish to discuss the above, please contact Beverly Miller of my staff on 202.708.1320, Ext. 2598.

Attachments

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Distribution

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Deputy Secretary
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DAS for Administrative Services, Office of the Executive Secretariat
DAS for Intergovernmental Relations
Deputy Chief of Staff for Policy
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Special Counsel to the Secretary
Special Assistant to the Deputy Secretary for Project Management
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Senior Advisor to the Secretary, Office of Public Affairs
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Director, Office of Departmental Operations and Coordination
Acting Director, Real Estate Assessment Center
Director, Office of Multifamily Assistance Restructuring
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