



Issue Date January 29, 2007

Audit Report Number 2007-KC-0002

TO: Charles H. Williams, Deputy Assistant Secretary for Multifamily Housing Programs, HT

//signed//

FROM: Ronald J. Hosking, Regional Inspector General for Audit, 8AGA

SUBJECT: HUD Can Improve Its Use of Residual Receipts to Reduce Housing Assistance Payments

HIGHLIGHTS

What We Audited and Why

We reviewed the US Department of Housing and Urban Development's (HUD) use of multifamily projects' residual receipts to reduce housing assistance payments. This review was a followup to a September 2000 audit (Report #2000-SE-119-0003). Our objective was to determine whether HUD used multifamily projects residual receipts to reduce housing assistance payments.

What We Found

HUD can improve its use of residual receipts to reduce housing assistance payments. It did not provide detailed guidance to ensure that project managers and contract administrators understood they could use residual receipts in lieu of subsidy payments. As a result, HUD did not use more than \$36 million in available residual receipts to reduce housing assistance payments for the 10 new regulation projects that we reviewed.

What We Recommend

We recommend that HUD provide more detailed guidance to its field offices and contract administrators that will identify when projects have residual receipts that are sufficient to fund housing assistance payments and provide and annually update a list of projects that indicates when project residual receipts are sufficient to fund subsidy payments.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

The deputy assistant secretary agreed with the audit report and its recommendations. His office provided written comments to the draft report on January 10, 2007 and provided its proposed management decisions on January 19, 2007. We concurred with the proposed management decisions. The complete text of HUD's response, along with our evaluation of that response, is in appendix B of this report.

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BACKGROUND AND OBJECTIVES

When insuring multifamily property mortgages, the U. S. Department of Housing and Urban Development (HUD) usually contracts with owners to provide rental assistance under a housing assistance payments contract. Project income consists of tenant payments and HUD's rental assistance. Owners use these funds to pay the project's mortgage payments, operating expenses, reserve for replacement deposits, and any allowable distributions. When project income for nonprofit and limited distribution projects exceeds expenses, the project has excess earnings, or residual receipts.

Before 1980, HUD's housing assistance payments contracts did not contain any provisions regarding residual receipts. A project's regulatory agreement gave HUD control over the use of the residual receipts. However, HUD terminates the regulatory agreement when an owner pays off a project's insured mortgage and any funds still in the residual receipts account go to the owner. In 1980, HUD changed the Section 8 regulations for 100 percent assisted new construction and substantial rehabilitation projects. Under the new regulations, the housing assistance payments contract outlines the use and disposition of residual receipts. The contract states that HUD must approve all withdrawals from residual receipts. This includes using residual receipts to reduce housing assistance payments. HUD's Section 8 renewal policy states that at any time during the fiscal year, project managers or contract administrators may use all or part of a project's residual receipts to reduce housing assistance payments for projects subject to the new regulations.

For insured projects, HUD requires project owners to make monthly deposits into a reserve for replacement account to help defray the cost of replacing capital items. The project's regulatory agreement states the initial monthly amount the owner must deposit into the account and HUD adjusts the amount as needed over time. The owner must obtain HUD approval to release funds from this account.

In September 2000, the Office of Inspector General (OIG) issued a nationwide audit report on the use and disposition of residual receipts. HUD and the OIG reached agreement on all of the audit's recommendations. The audit report led to a June 28, 2002 Office of General Counsel legal opinion. While HUD can approve using residual receipts for a number of project needs such as making mortgage payments and reducing operating deficits, the legal opinion added using residual receipts to reduce housing assistance payments. This review was a followup to the prior audit.

Our objective was to determine whether HUD used multifamily projects residual receipts to reduce housing assistance payments.

RESULTS OF AUDIT

Finding 1: HUD Can Improve Its Use of Residual Receipts

HUD can improve its use of residual receipts to reduce housing assistance payments. It did not provide detailed guidance to ensure that project managers and contract administrators understood they could use residual receipts in lieu of subsidy payments. As a result, HUD did not use more than \$36 million in available residual receipts to reduce housing assistance payments for the 10 new regulation projects that we reviewed.

HUD Can Improve Its Use of Residual Receipts

While residual receipts have multiple uses, HUD can improve its use of residual receipts to reduce housing assistance payments. Of the 10 new regulation projects reviewed (see scope and methodology for sample selection), project managers or contract administrators did not use residual receipts to reduce housing assistance payments for any of the projects. Seven of 10 project managers stated they did not consider using residual receipts to reduce assistance payments. The remaining three project managers stated that they did consider using residual receipts but did not actually use them. We also contacted three contract administrators who stated that they did not consider using residual receipts to reduce assistance payments.

We found one project, which was not in our sample, where the project manager did use residual receipts each month to reduce housing assistance payments. The project manager coordinated with the contract administrator to transfer the amount of the monthly voucher from the project's residual receipts account to the operating account. For 2004 and 2005, the project manager released \$333,900 from residual receipts as rental income in lieu of housing assistance payments.

HUD's Guidance to Field Offices Was Not Adequate

HUD did not provide detailed enough guidance to ensure that project managers and contract administrators understood they could use residual receipts to reduce in lieu of subsidy payments. HUD's Section 8 renewal policy states that at any time during a project's fiscal year if project funds are sufficient for project operations, reserve requirements, and eligible distributions, project managers or contract administrators may use residual receipts to reduce housing assistance payments. Based on our interviews with project managers, supervisors, and

contract administrators, we determined that there was a lack of understanding as to who makes and implements the decision to use residual receipts to reduce housing assistance payments.

Twenty-two of the 26 project managers and contract administrators that we contacted did not consider using residual receipts to reduce housing assistance payments at any time. Eleven of 19 project managers and supervisors referred the decision to contract administrators. However, project managers are responsible for releasing residual receipts, not the contract administrators.

HUD Did Not Use More Than \$36 Million to Reduce Subsidy Payments

Although HUD can use residual receipts for multiple project purposes, HUD did not use residual receipts in lieu of subsidy payments for any of the projects in our sample. For 10 new regulation projects, HUD did not use more than \$36 million in available residual receipts to reduce housing assistance payments. Each of the projects had at least \$1.5 million in its respective residual receipts account at the end of its most recent fiscal year. In addition, each project was in good physical condition and seven of the projects had at least \$4,000 per unit in their reserve for replacement accounts for capital needs (see appendix C).

While the housing assistance payments contract is in effect, HUD's use of residual receipts can benefit the Section 8 program and other assisted projects. For new regulation, 100 percent-assisted projects, residual receipts can provide a source of funds at no additional cost to the government. HUD can use residual receipts rather than budgeted funds making additional funds available for underfunded projects.

However, when a new regulation contract terminates, HUD cannot use the recaptured residual receipts for the Section 8 program to assist other projects. The recaptured funds go to the United States Treasury.

HUD's policy is to use residual receipts to reduce housing assistance payments when a project manager or contract administrator determines project funds are sufficient to meet project obligations. Increased emphasis and detailed guidance to the field offices will help HUD use residual receipts to reduce housing assistance payments.

Recommendations

We recommend that the deputy assistant secretary for multifamily housing programs:

- 1A. Provide more detailed guidance to field offices and contract administrators that will identify when projects have residual receipts that are sufficient to fund housing assistance payments. If HUD follows this recommendation, it will have more than \$36 million available to reduce future subsidy payments, thereby putting those funds to better use.
- 1B. Provide and annually update a list of projects to the field offices and contract administrators that indicates when project residual receipts are sufficient to fund housing assistance payments.

SCOPE AND METHODOLOGY

Our review covered the period from December 2004 through June 2006.

To accomplish our objectives, we reviewed a previous audit report, Office of General Counsel legal opinions, and HUD regulations and guidance. For the 20 assisted multifamily properties in our sample, we reviewed the regulatory agreements, housing assistance payments contracts and renewals, physical inspections, and annual financial statements. In addition, we interviewed hub directors, project managers, supervisors, and contract administrators.

HUD's database contained more than 10,600 multifamily projects nationwide. However, only 5,215 projects had residual receipts. The residual receipt balances for these projects totaled more than \$506 million. From these projects, we identified 81 projects with residual receipt balances of at least \$1 million. Sixty-two of the 81 projects were insured, elderly projects that were 100 percent assisted. From the 62 projects, we selected a geographically dispersed sample of 20 projects to review. We selected the 20 sample projects with the highest residual receipt balances.

HUD's database did not identify whether the projects received assistance under old or new regulation housing assistance contracts. During the review, we found that 10 projects had old regulation housing assistance contracts and 10 projects had new regulation housing assistance contracts.

We did not project the results of our review to the universe of projects.

We used computerized data from HUD's real state management system solely for background information and to identify projects for review. Therefore, we did not perform any tests to assess the reliability of the data. For our review, we obtained and used project information, audited financial statements, and documentation from HUD files.

For the 10 new regulation projects, we classified more than \$36 million as funds to be put to better use (see appendix C). To make this classification, we conservatively estimated that \$4,000 per unit in project reserves was sufficient to meet project needs considering HUD's minimum reserve balance is \$1,000 per unit. Project reserves consist of both residual receipts and reserve for replacement funds.

We performed our audit work in our office from July 28 to October 20, 2006. We briefed HUD management in Washington DC on September 8 and October 12, 2006.

We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the organization is achieving the following objectives:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal controls were relevant to our audit objectives:

- HUD's policies, procedures, and practices for the use of residual receipts to reduce housing assistance payments.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

We did not identify any significant weaknesses.

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use 1/
-----------------------	----------------------------------

1A

\$36,692,718

- 1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. This includes reduction in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. We estimated \$4,000 per unit as a sufficient amount of project reserves before considering residual receipts to reduce housing assistance payments. Project reserves consist of both residual receipts and reserve for replacement funds. Based on our calculation, 10 new regulation projects have residual receipts totaling \$36,692,718 available to reduce housing assistance payments. We do not anticipate incurring any significant costs associated with implementing the recommendations.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments




OFFICE OF HOUSING

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

JAN - 7 2007

MEMORANDUM FOR: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

FROM: 
Charles H. Williams, Deputy Assistant Secretary
Office of Multifamily Housing, HT

SUBJECT: Draft Audit Report

Comment 1

You have asked for our comments regarding your draft report, which you requested a presentation at the exit conference on January 10, 2007, if possible. Following are comments prepared from our review of the draft.

Also, as we discussed at the exit conference, please change the title of the report and language in the report to reflect the inclusive nature of the existing policy with respect to the use of residual receipts which may be used for housing assistance payment funding and other project needs.

Page 4 of the draft, first paragraph

Your report uses the phrase, "...For limited distribution and nonprofit properties receiving Section 8 assistance, HUD requires property owners to deposit residual receipts into a separate bank account under HUD control."

Comment 2

The Section 8 Renewal Guide citation is, "should an owner elect to prepay the mortgage before the termination of a HAP Contract, and the owner has a 100% subsidized HAP Contract under the new regulations, any balance remaining 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."

The statement in the report should either be changed to be consistent with the handbook guidance or removed.

Page 4 of the draft, fourth paragraph

Your report says, "This review was a follow-up to the prior audit to determine whether HUD has following this policy. Our objective was to determine whether HUD used multifamily projects residual receipts to reduce housing assistance payments."

www.hud.gov

espanol.hud.gov

Ref to OIG Evaluation

Auditee Comments

Comment 3

The phrase, “following this policy” refers to an OGC opinion. The current policy is HUD can use residual receipts to fund HAP payments. The use of Residual Receipts is determined by project needs. Where project needs may be unfunded from Reserves for Replacement, HUD can use Residual Receipts to fund those needs. Reducing housing assistance payments is not the only use of Residual Receipts and using Residual Receipts for other project purposes or continuing to hold them as reserves for potential project needs does not represent a violation of policy.

We request that this section of the report be rewritten to reflect the potential multiples uses of Residual Receipts for project purposes and the value of maintaining adequate reserves for project needs. The objective of this policy is to maintain the affordable housing.

Page 5 of the draft, third paragraph

Comment 4

Why was a project outside of the audit sample used as a finding? What sampling was done outside of those stated in the report?

Page 6 of the draft – Recommendations

We recommend that the Deputy Assistant Secretary for Multifamily Housing Programs:

1A. Provide more detailed guidance to field offices and contract administrators to establish a baseline for reserve accounts, document an analysis of whether or not to use residual receipts to reduce housing assistance payments, and coordinate duties. If HUD follows this recommendation, it will have more than \$36 million available to reduce future subsidy payments, thereby putting those funds to better use.

1B. Develop and implement procedures to monitor the field offices and contract administrators to ensure they follow the guidance to use residual receipts to reduce housing assistance payments.

The findings in the draft were from a sample provided at OIG’s request. Multifamily Housing has subsequently done a more thorough analysis of the database of all projects to determine the extent of possible available funds. From that review it was determined that the majority of funds available to implement this recommendation are concentrated in a few projects. In segmenting the database the following criteria was used:

1. Reserves for Replacement and Residual Receipts had to exceed \$4,000 per unit and exceeded \$1 million; and
2. Residual Receipts had to exceed HAP funding for one full year.

Comment 5

Based upon those criteria it was determined that there are just over 50 projects that meet these criteria. Given the number of projects that will be affected, Multifamily Housing requests that the recommendation be re-written as follows:

Ref to OIG Evaluation

Auditee Comments

1A. Provide more detailed guidance to field offices and contract administrators that will identify when projects have residual receipts that are sufficient to fund HAP payments. If HUD follows this recommendation, it will have more than \$36 million available to reduce future subsidy payments, thereby putting those funds to better use.

1B. Provide and annually update a list of projects the field offices and contract administrators that indicates when project residual receipts are sufficient to fund HAP payments.

The management plan to implement these recommendations will be written to reflect the considerations of project needs and alternative uses of Residual Receipts including their use for reduction in HAP payments.

OIG Evaluation of Auditee Comments

- Comment 1** We changed the report's title to be more proactive.
- Comment 2** We deleted this statement from the Background and Objectives section of the report.
- Comment 3** We reworded this statement to indicate that residual receipts have multiple uses.
- Comment 4** We addressed this comment at the exit conference.
- Comment 5** We agreed with HUD's changes to the report's recommendations and changed them accordingly. HUD will identify projects with sufficient residual receipts at the Headquarters level, not the field office level.

Appendix C

SCHEDULE OF PROJECTS WITH RESIDUAL RECEIPTS TO REDUCE HOUSING ASSISTANCE PAYMENTS

Property Name	ST	Fiscal year end	Residual receipts balance	Reserve for replacement balance	Minimum reserve balance - \$4K per unit	1/ Residual receipts needed to meet minimum	Residual receipts available to reduce subsidy payments	Type	Units
Paumanack Village II	NY	July 31, 2005	\$ 10,596,759	\$1,021,368	\$ 504,000	\$ -	\$ 10,596,759	Nonprofit	126
UAW Senior Citizen Center	IL	Dec. 31, 2005	\$ 6,293,948	\$ 615,778	\$ 864,000	\$ 248,222	\$ 6,045,726	Nonprofit	216
Boyd McGuiness	NJ	Dec. 31, 2005	\$ 4,859,494	\$1,138,145	\$ 844,000	\$ -	\$ 4,859,494	Limited	211
Pilot Cove Manor	NY	Dec. 31, 2005	\$ 2,664,380	\$ 806,262	\$ 524,000	\$ -	\$ 2,664,380	Nonprofit	131
Cambridge Arms II	OH	Dec. 31, 2005	\$ 2,352,600	\$ 674,084	\$ 428,000	\$ -	\$ 2,352,600	Limited	107
West Town Housing	IL	Dec. 31, 2005	\$ 2,403,515	\$1,245,203	\$ 560,000	\$ -	\$ 2,403,515	Limited	140
Lakeview Arms	NY	Dec. 31, 2005	\$ 1,906,587	\$ 885,238	\$ 288,000	\$ -	\$ 1,906,587	Limited	72
Smith-Beretania Apts.	HI	Dec. 31, 2005	\$ 2,183,400	\$ -	\$ 656,000	\$ 656,000	\$ 1,527,400	Limited	164
Angelus Plaza II	CA	Aug. 31, 2005	\$ 3,262,577	\$4,583,934	\$1,328,000	\$ -	\$ 3,262,577	Nonprofit	332
Copperwood I	TX	Dec. 31, 2005	\$ 1,523,680	\$ 150,000	\$ 600,000	\$ 450,000	\$ 1,073,680	Limited	150
Totals			\$ 38,046,940			\$1,354,222	\$36,692,718		

1/ We adjusted residual receipts in this column downward, as needed, to ensure a minimum reserve amount of \$4,000 per unit was available for project needs. We calculated \$4,000 per unit as a sufficient amount of project reserves before considering residual receipts to reduce housing assistance payments. Project reserves consist of both residual receipts and reserve for replacement funds.