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New England Office of Region Inspector General
for Audit, 1AGA
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Memorandum No: 2003-BO-0801
December 20, 2002

MEMORANDUM FOR: Frederick Tombar III, Acting Deputy Assistant Secretary for
Multifamily Housing Programs, HT

FROM: Barry L. Savill, Regional Inspector General, Office of Audit, 1AGA

SUBJECT: Review of the Office of Housing's Use of the Financial Assessment Subsystem

INTRODUCTION

We have completed a survey of the Office of Housing's use of financial statement assessments generated by HUD's Real Estate Assessment Center (REAC) on multifamily properties located in New England. The purpose of our review was to evaluate the usage of audited financial statements by multifamily housing staff in selected New England areas.

Our survey was limited to the 1,124 active rental projects in New England who submitted their financial statements at least once between December 31, 1998 and December 31, 2001. We examined the data associated with the 1,124 projects and further isolated our review to a core sample of 60 projects located within the New England Hub. Our work revealed that the Office of Housing needs more time to fully implement the use of REAC's Financial Assessment Subsystem (FASS) in order to assess whether FASS is useful to Housing's objective of improving multifamily portfolios. Consequently, at this time, we are terminating further work in this area pending Housing's plan to more fully implement the FASS program. If the Office of Housing continues its recent efforts to provide clearer guidance and targeted training, these changes will facilitate the use of FASS as an effective tool in the monitoring process of HUD's multifamily housing portfolio.

Should you or your staff have any questions, please contact Cristine M. O'Rourke, Assistant Regional Inspector General or me at (617) 994-8380.

METHODOLOGY AND SCOPE

In conducting the survey, we:

- Reviewed applicable HUD regulations, policies, and related guidance regarding the review of annual financial statements, project monitoring, and the Financial Assessment Subsystem (FASS);
- Interviewed personnel within the Office of Multifamily Asset Management, the Real Estate Assessment Center (REAC), PriceWaterhouseCoopers, and the New England Multifamily Housing Hub and Program Centers to gain an understanding of the FASS, its usefulness and limitations, scheduled enhancements and suggested improvements;
- Evaluated the appropriateness, completeness, timing, and extent of training accomplished, in progress or planned;
- Utilized: (a) the Real Estate Management System (REMS), (b) the FASS, (c) Multifamily Data Mart (MFDM), and (d) the Housing Enterprise Real Estate Management System (HEREMS) to identify the total number of active multifamily projects in New England as of January 31, 2002 (2,553 projects) and isolated those projects required to submit annual financial statements (1,380 projects);
- Extracted the financial statements for projects that either were non-rental or had fiscal year ends prior to 12/31/1998 from the total projects required to submit annual financial statements to establish our universe of 1,219 projects;
- Identified 95 projects that, according to the REMS, were required to submit annual financial statements to the REAC; but had not submitted their annual financial statements as of February 11, 2002 and determined if these non-filing project owners were notified of the non-submission, and were assessed civil monetary penalties for not filing;
- Examined averaged financial statement performance rating and the number of compliance flags cited for the 1,124 projects that actually submitted their annual financial statements. The 1,124 projects had: (1) a fiscal year ended between December 31, 1998 through December 31, 2001 and (2) at least one successful electronic submission of their annual financial statements to the REAC for review;
- Utilizing Computer-Assisted Audit Techniques, narrowed our universe to only those projects with at least three consecutive years worth of annual financial statement data, resulting in a total of 761 rental projects;
- Generated a nonstatistical sample of 60 projects from the 761 rental projects throughout New England for testing;

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- Utilizing REMS data as of June 18, 2002, determined: (1) the timeliness of annual financial statement submission, (2) REAC's processing time, and, (3) for projects with compliance issues, the turnaround time for owner's responses;
 - Limited our testing to only 46 projects in Massachusetts and Connecticut due to time constraints and our judgment that further testing would not alter our results. We reviewed the FASS data in the REMS, prepared questions on the financial conditions noted, and individually interviewed nineteen Project Managers in the Massachusetts Multifamily Housing Hub and Connecticut Multifamily Housing Program Center between May 21, 2002 and June 14, 2002 responsible for 46 of the projects in our sample to determine whether:
 - a. Repeat financial conditions were cited from one year to the next;
 - b. The compliance conditions were mitigated within prescribed timeframes; or
 - c. The Housing staff took any action to prevent repeat financial conditions if so possible.
 - Obtained a listing from the Enforcement Center identifying the settlements that HUD received from non-filing project owners and the judgments awarded by the court to HUD from non-filing project owners for the period December 31, 1998 through December 31, 2001 including the name of the respective project, the date and amount of the civil monetary penalty, and the year for which the penalty was assessed.

Our review period covered December 31, 1998 through December 31, 2001 and was extended, as appropriate, to meet our objectives. We conducted the survey from December 2001 to July 2002.

BACKGROUND

HUD, through its Office of Housing, administers a variety of programs to increase the supply of affordable low-income and moderate-income multifamily housing stock through the construction and subsidizing of privately owned multifamily properties. An individual property may have one or more loans insured by HUD, one or more rental subsidy contracts funded by HUD or some combination of loans and subsidies. Most of HUD's programs require submission of an annual financial statement from each participating property to assure the property is operating in a manner that:

- Minimizes any federal financial risk exposure for the Office of Housing direct loans, insured mortgage financing or capital grant investments;
- Sustains the project in good repair and condition as a source of decent, safe and sanitary low-income or moderate-income housing; and
- Maintains affordable rent levels and tenant admission policies.

HUD Centralized Certain Functions

Under its HUD 2020 reform plan announced June 1997, HUD began creating several Centers to handle processing across functions on a national level. Two of these Centers, the Real Estate Assessment Center (REAC) and the Enforcement Center, also address the collection, analysis and utilization of financial statements from multifamily properties.

Established in 1998, the REAC is responsible for collecting and assessing annual financial statements on multifamily projects and providing information to Project Managers concerning compliance deficiencies and performance risks. Also established in 1998, the Enforcement Center addresses HUD's mission of protecting the public trust by handling the violation of statutes, regulations, or other HUD requirements. To handle these violations, the Enforcement Center personnel need access to all data about a property. According to the Memorandum of Agreement between the Office of Housing and the REAC executed November 9, 1999, the Office of Housing is ultimately responsible for the long-term, day-to-day loan and project oversight for HUD's multifamily housing portfolio. The Office of Housing personnel at Headquarters, the Hubs and Program Centers also utilize the financial statement analyses to determine the financial health of properties, protect HUD from financial loss, ensure proper use of revenue and subsidies and assess owner compliance with business agreements including Regulatory Agreements, Housing Assistance Payment Contracts and Use Agreements.

The Financial Statement Collection and Review process

In accordance with the September 1, 1998 final rule on Uniform Financial Reporting Standards for HUD Housing Programs, project owners are required to electronically submit audited and unaudited financial statements to the REAC. The Regulatory Agreement or Housing Assistance Payments (HAP) contract between HUD and the property owner govern the type of financial statement required. When a project submits its financial statements, the REAC uses a computer system called the Financial Assessment Subsystem (FASS) to complete an automated compliance review and a performance risk assessment. The REAC financial analysts review the compliance deficiencies to determine if the automated assessment is complete, is accurate, and/or needs to be referred. The REAC makes referrals to either the Multifamily Housing Hubs/Program Centers or the Enforcement Center when apparent compliance violations meet agreed-upon thresholds.

Depending on the referral action, either the Multifamily Housing Hubs/Program Centers or the Enforcement Center is responsible for follow-up action, resolution, and closure. Based on the automated FASS assessment and the REAC analyst’s review, there are four possible referral outcomes:

Referral Outcome	Referral Process
Close with no compliance condition.	The FASS closes financial review in the REMS and sends a “No Conditions” letter to the project owner’s FASS Coordinator.
Refer to Enforcement Center for non-compliance conditions.	The FASS generates a “Conditions” letter that is available to the Enforcement Center analyst. The analyst may edit the letter and send it as the first step of pursuing voluntary compliance or a necessary enforcement action.
Refer to Enforcement Center due to an existing Enforcement Center case.	If a project has an active Enforcement Center case pending, the FASS automatically refers the financial submission to the Enforcement Center.
Refer to Multifamily Housing Hub/Program Center for non-compliance conditions.	The FASS generates a “Conditions” letter that is electronically mailed to the project owner’s FASS Coordinator. Multifamily Housing Hub/Program Center is responsible for obtaining an acceptable resolution and closing the issues identified in the financial submission in the REMS.

The FASS interfaces with the Real Estate Management System (REMS), which provides Project Managers at the Multifamily Housing Hubs/Program Centers and the Enforcement Center with the ability to access the FASS data. The REMS is the official source of data on the multifamily portfolio of insured and assisted properties. The REMS provides automated support to collect and maintain accurate data and enables the Multifamily Housing Hubs/Program Centers and the Enforcement Center staff to perform servicing functions and implement enforcement actions, where needed. The REMS contains critical data on each property's location, size, ownership, financing, and assistance contract(s).

Additionally, the FASS assesses the financial performance and management performance of multifamily projects. According to the REAC Multifamily Housing Project Financial Assessment Guide for HUD Staff (Guide), the financial performance assessment measures the relative financial strength of a project and potential risks to HUD. The management performance assessment measures the projects’ efficiency in collecting rents and minimizing bad debts. Together, the financial and management performance analyses provide the Multifamily Housing Hubs/Program Centers with a valuable asset management tool that can be used to identify weaknesses in HUD’s multifamily housing portfolio. The FASS uses ratio analysis to measure the financial performance and the amount of tenant accounts receivable and bad debt expenses to measure management performance.

Purpose of the FASS

The purpose of the FASS is to make the financial review process more efficient and effective by:

- Electronically collecting financial statements;
- Tracking overdue submissions;
- Ensuring financial statements are complete and accurate;
- Automatically calculating financial compliance checks and performance ratios;
- Identifying owners who are not complying with HUD requirements;
- Identifying projects that pose a financial risk to HUD; and
- Reducing workload through automation.

Essentially the REAC provides financial statements and analyses of these statements through the FASS to the REMS where the Multifamily Housing Hub/Program Center and the Enforcement Center personnel can access and utilize this information. HUD's ability to monitor and manage its portfolio depends on timely and accurate project and portfolio level assessment information. By automating the submission of annual financial data for multifamily properties funded by HUD, the FASS supports HUD's goal of using consistent, timely and appropriate financial data to manage its multifamily housing portfolio.

RESULTS OF REVIEW

The Office of Housing needs more time to fully realize the benefits of the Financial Assessment Subsystem (FASS) as an effective tool to improve the multifamily housing portfolio.

FASS Provides Financial and Managerial Assessments of HUD's Multifamily Housing Stock

Working together, the REAC and the Office of Housing developed and implemented the FASS to improve the availability of annual financial data on multifamily housing projects funded throughout HUD. HUD utilizes this data to:

- Determine the financial health of properties in their various portfolios;
- Protect the Department from financial loss;
- Ensure proper use of revenues and federal subsidies; and
- Assess owner compliance with Business Agreements (e.g., Charters, Use Agreements, Regulatory Agreements, Housing Assistance Payment Contracts, etc.).

In June 2002, the Office of Housing indicated to its personnel that, since REAC's inception in 1998, the FASS has:

- Received and reviewed over 74,000 financial statements;
- Identified over \$163 million in unauthorized distributions;
- Recovered over \$80 million in funds; and

- Collected over \$1 million in civil monetary penalties.

As of January 31, 2002, HUD had 2,553 active privately owned multifamily housing projects in New England. We limited our review to rental projects that were required to submit annual financial statements electronically to REAC. We identified 95 projects, however, that according to the REMS were required to submit annual financial statements to the REAC, but as of February 11, 2002, had not submitted their annual financial statements. We analyzed the electronic data of the remaining 1,124 projects that submitted their annual financial statements to the REAC at least once between December 31, 1998 and December 31, 2001.

We narrowed the 1,124 projects to focus on those projects with at least three years of electronic submissions to the REAC resulting in 761 projects. From those 761 projects, we generated a sample of 60 projects and reviewed: (1) the timeliness of annual financial statements' submissions, (2) REAC's processing time, and (3) for projects with compliance issues, the owner's turnaround for their responses.

Utilizing information contained in the REMS on June 18, 2002, we found improvements in: (1) the quantity and timeliness of financial statement submissions; (2) the timeliness of the REAC review; and (3) the timeliness of the project owner's responses, as illustrated by the table below:

Annual Financial statements submitted for periods ending	Average days between annual financial statements due date and date annual financial statements received	Average days between date annual financial statements received and date REAC letter sent	Average days between response due date and response received date
December 31, 1998	185	199	162
January to December 1999	116	37	90
January to December 2000	55	25	30
January to December 2001	-12 Note ¹	3	Note ²

We individually reviewed 46 of the 60 projects in our sample within the Massachusetts and Connecticut Program Centers. Of the 46 projects, we noted compliance conditions for twenty-three projects.

Status	Frequency	Comments
Received within 30 days	7	1 of 7, letters not in project files. 1 of 7, issue invalid and closed by Project Manager. 5 of 7, letters received on time.
Received after 30 days or not at all	13	4 of 13, letters not in project files. 1 of 13, Project Manager unaware that a response was due. 1 of 13, response received late after Project Manager inquiry. 7 of 13, reason for lateness is unknown.
Referred to Enforcement Center and no response due	3	3 of 3, no response required due to referral.
Total	23	

¹ A negative number identifies that the owner submitted the financial statement before its due date

² As of our cut-off date, the information was not yet available.

Lack of Consistent Guidance on Requirements and Elements

Between February 2000 and June 2002, HUD issued limited guidance on the FASS requirements and data elements and offered limited training on the uses and benefits of the FASS. HUD conducted a two-day training session with the New England Multifamily Housing Hubs/Program Centers in February 2000 and provided additional training regarding the FASS data on January 31, 2002 via a satellite broadcast.

During the February 2000 training, the Multifamily Housing personnel received the REAC Multifamily Housing Project Financial Assessment Guide for HUD Staff (Guide). This Guide identified the actions needed to address compliance issues and certain performance-related issues. Although this Guide provided appropriate and complete procedures and processes to address compliance issues, the Guide lacked sufficient guidance on how to address issues identified in the performance assessments. This Guide described the REAC's process for assessing a project's performance, but lacked clear direction on how to use performance ratings as a tool to review projects. This Guide stated that Project Managers should examine the underlying ratios and financial statements of a project if it is in the red (rating between 10-59) or yellow (rating between 60-69) risk zones and that they should consider examining a financial submission and performing additional checks if:

- The local program center had prior compliance problems with a particular owner or management agent;
- An onsite management review indicated the owner may be diverting funds;
- The REAC or mortgagee physical inspections indicated major unresolved physical problems; or
- The project was financially troubled (delinquent or in default, assigned, etc.).

This Guide also stated that any additional reviews performed by a Project Manager should supplement the REAC review, not duplicate it. The contradiction between these statements in the Guide does not provide substantive instruction to the Project Managers needing guidance. Project Managers must continually re-prioritize their tasks to address the changing issues inherent in their workload. Without clearly defined guidance delineating when to review the annual financial statements, actively reviewing the annual financial statement submissions may not become a priority resulting in no reviews at all or reviews that are not timely.

Limited Training Provided on FASS' Uses and Benefits

On January 31, 2002, the Office of Housing presented a satellite broadcast with written materials where they advised the Multifamily Housing personnel that those projects with ratings in the red or yellow risk zones would receive a FASS-generated project action in the REMS. These project actions are available to the responsible Project Manager through the REMS. The broadcast and written materials advised Project Managers that they should determine which performance ratios rated poorly, examine the financial statements to determine the exact nature of the underlying

problem and take appropriate action to improve the financial health of the project. The broadcast, however, did not clearly mandate the necessity of a review nor did it define timing and extent of the reviews.

We interviewed nineteen Project Managers from the Massachusetts Multifamily Housing Hub and Connecticut Multifamily Housing Program Center between May 21, 2002 and June 14, 2002. These nineteen Project Managers indicated that they had not received any guidance on: (1) when to review the REMS for the FASS results or (2) what to do with those projects rated in the red or yellow risk zones. As a result, the Project Manager's review of the FASS results varied from individual to individual with some Project Managers opting not to review the FASS results at all. Other Project Managers stated that they independently reviewed the REMS periodically for the FASS data.

The limited guidance and training resulted in the Project Managers not reviewing the FASS assessment results with any consistency or continuity from one Project Manager to another. On February 7, 2002, the Director, Office of Asset Management – Multifamily Housing, advised that the field offices lack financial analysts and the existing staff were given only basic training on financial assessments.

The Office of Housing Recently Issued Guidance and Training is in Progress or Planned

On June 5, 2002, the Office of Housing released a Memorandum identifying the submission and review requirements and REMS data dependencies for annual financial statements. The purpose of this Memorandum was to provide guidance, clarification, and instructions regarding:

- Financial statement submission;
- Financial statement review requirements;
- Overdue tracking;
- Extensions;
- Waivers; and
- Deferments.

The Memorandum indicated that the Office of Housing is developing a guidebook to incorporate all existing policy relating to annual financial statements review and submission and that the included instructions are intended to provide interim guidance until the guidebook is published.

The Memorandum also clarified that the Project Managers **must** review all financial statements referred to the Multifamily Housing Hubs/Program Centers and stated that the Project Manager's should not rely solely on the REAC assessment and analysis to detect instances of noncompliance. This Memorandum provided the following guidance with respect to project actions related to the FASS performance issues:

If, during the automated MF-FASS review, no compliance problems are noted, but the financial performance rating is red or yellow, REMS generates a Project Action to inform the Project Manager that potential financial performance problems exist. The Project Manager must examine each of these properties to determine why they were rated poorly and

whether or not any actions should be taken to improve the financial performance, such as rent increases, etc. Once the Project Manager assesses the problem and takes appropriate corrective action, the Project Action should be closed in REMS if the owner is in full compliance.

The Memorandum delineated the referral process and its effect on the Project Managers' review of annual financial statements. This Memorandum, however, did not clearly define the level of review required by the Project Managers and may foster continued inconsistency in the review process. Clarification of the June 5, 2002 Memorandum and definition of the level of review required by the Project Managers for projects referred to Multifamily would benefit the Office of Housing.

Multifamily Housing conducted training at the Boston Hub during the first week of August 2002. The Director advised that the Office of Housing was working with the REAC to schedule additional training at all Hubs. As of August 7, 2002, Housing has scheduled FASS training for the following Multifamily Housing Hubs/Program Centers: 1) Cleveland, 2) Chicago, 3) Detroit, 4) New York, and 5) Denver. The Director further advised that the Office of Housing was working on comments to the planned guidebook mentioned in the June 5, 2002 Memorandum and it expects to complete and distribute the guidebook to the Multifamily Housing Hubs/Program Centers in 2003.

Incomplete and Inaccurate Data in the REMS

The June 5, 2002 Memorandum stresses that the effective operation of the FASS reporting system depends on the Project Manager's careful attention to details—including assuring that the REMS data for project and owner information is complete and accurate at all times. The Office of Housing has found that there are often errors in this area and, through this Memorandum, provides examples so that each Project Manager has a reference point for accurate completion of the data requirements.

Project owners are unable to submit annual financial statements if the required elements are incorrect or missing in the REMS. Eleven separate data entry elements must be accurately completed so that project owners or their designees can submit annual financial statements without interruption.

On September 28, 2001, the OIG's Information Systems Audit Division issued an audit report numbered 2001-DP-0003 on the REMS. The audit concluded that the REMS application controls need strengthening to improve its functionality and data reliability. Specifically, the audit found:

- Incomplete or erroneous data in REMS;
- Users do not utilize the system consistently or to its fullest potential; and
- Data is at risk of being lost or inaccessible due to inadequate change control procedures.

That REMS audit report provided six recommendations including the recommendation that HUD: (1) analyze the REMS database be performed to identify opportunities for automated edit procedures, and (2) document the REMS operational policies and procedures for distribution to the REMS users. The Office of Housing concurred with the audit recommendations.

Our review confirmed that information input into the REMS by the Project Managers was not always completely accurate. We identified 95 New England projects where financial statements are required but, as of February 11, 2002, annual financial statements had not been submitted. Subsequently, when we examined the actions taken by HUD as of June 6, 2002, we found:

Actions	Frequency
Project Referred to Enforcement Center	37
Statements not due by February 11, 2002	29
Project is not Required to Submit	11
Financial Statements Submitted after 2/11/02	9
Project had not submitted financial statement and had not been referred to Enforcement Center	7
Mortgage Prepaid so financial statement is no longer required	1
Duplicate project in REMS	1
Total	95

We also noted that, of those 95 projects, nineteen percent or 18 projects needed additional data or corrected data in order to submit annual financial statements as follows:

- Four projects did not have a fiscal year end date;
- Seven projects needed input or correction of their "Date owner assumed financial responsibility" data element; and
- Seven projects were incorrectly labeled as required to submit annual financial statements.

For those projects with missing or incorrect data elements, the REAC would not be able to identify that the annual financial statements were overdue. As a result, the REAC was unable to implement the appropriate referral to the Enforcement Center or work with the owner to successfully submit their annual financial statements electronically. Further, the seven projects that were incorrectly identified as required to submit annual financial statements were at risk of being unnecessarily referred to the Enforcement Center for non-submission.

Our discussions with the respective Project Managers regarding the inaccuracies in the REMS led to correction of the REMS data elements. Some Project Managers did not know what information should be input into specific fields in the REMS in order for the project owners to successfully submit their annual financial statements electronically to the REAC.

For example, the FASS uses the cost certification cut-off date to establish the date the owner assumes financial responsibility on a new project and the starting point for when annual financial statements are required. One Project Manager inputted the permission-to-occupy-date instead of

the cost certification cut-off date. This Project Manager's reasoning was that the cost certification cut-off had not been done prior to partial occupancy so he input the date of permission-to-occupy instead. We are not aware of any guidance indicating an alternate date to enter in lieu of the cost certification cut-off date in the date owner assumed financial responsibility field. As a result, this project owner is not yet required to submit annual financial statements to the REAC, but the project could be referred to the Enforcement Center for non-submission.

To illustrate the opposite effect, two different Project Managers did not input the cost certification cut-off dates during May 2000 for two different projects. The annual financial statements for these two projects are overdue. Because of the missing information in the REMS, the REAC was unaware of the financial statements' absence. After our discussions with these Project Managers, they added the data to the REMS.

Project Managers Reluctant to Rely on the FASS as a Monitoring Tool

To fully realize the usefulness of the FASS as a monitoring tool, Project Managers need to use FASS. Through interviews with Project Managers in the Massachusetts and Connecticut Multifamily Offices, we determined that usage of the FASS data varies because of the level of guidance and training received from the Office of Housing and, at times, their reluctance to rely on the system. During our interviews in May and June 2002, the Project Managers indicated that they had not received any guidance on when to review the REMS for the FASS results of their projects or on what to do with those projects rating in the red (10-59) or yellow (60-69) risk zones. Project Manager's responses regarding the usefulness of the financial statement reviews and the FASS varied dramatically from person to person. Of the sixteen Project Managers that we interviewed:

- Eleven found the FASS to be useful to some degree;
- Two indicated that they did not use the FASS;
- One indicated that the FASS was not necessarily useful because the information is part of something larger;
- One stated that the FASS was not useful by itself because of the need to know the property and clients; and
- One stated that the FASS only confirms what the respective Project Managers already know.

The Project Managers also cited limitations of the FASS restricting its usefulness:

Limitation	Frequency
Difficulty accessing the REMS and frustration with the overall slowness of the REMS.	6
The FASS chart of accounts is less detailed than the hardcopy financial statements.	6
Pro-forma letters have less impact than individual letters from Project Managers due to incorrect and invalid details.	3
Inability to contact the REAC Analyst who performed assessment.	3
No comparability between different fiscal years or against other similar projects.	3

In summary, the Office of Housing is taking steps to take advantage of the Financial Assessment Subsystem (FASS); but needs more time to implement FASS as an effective tool for monitoring the multifamily housing portfolio.

Appendix A

DISTRIBUTION OUTSIDE OF HUD

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