Issue Date	September 29, 2008
Audit Report Number	2008-KC-0007

TO: Beverly J. Miller, Director, Office of Asset Management, HTG

//**signed**//
FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7 AGA

SUBJECT: HUD Inappropriately Authorized the Use of Residual Receipts in Lieu of Reserve for Replacement or Operating Funds

HIGHLIGHTS

What We Reviewed and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) use of residual receipts in lieu of reserve for replacement funds between January 1, 2004, and March 31, 2008. We identified this as a potential issue in a prior audit, report #2007-KC-0002. The objective of this audit was to determine whether HUD appropriately authorized residual receipt withdrawals in lieu of reserve for replacement funds for new regulation multifamily projects.

What We Found

HUD inappropriately authorized the use of more than $3.2 million in residual receipt funds for new regulation multifamily projects for ineligible costs. Regional and field office staff nationwide were either not familiar with or overlooked the residual receipt use requirements for new regulation multifamily projects. As a result, HUD lost $3.2 million that it could have used more effectively for additional housing subsidies and other authorized taxpayer purposes.

What We Recommend

We recommend that HUD, on a project-by-project basis for the 14 projects reviewed, ensure that the project reimburses the residual receipts account with reserve for replacement or operating funds, unless this action negatively affects the project. In addition, HUD needs to direct regional and field office staff to fully understand and comply with the requirements regarding the use of residual receipts for new regulation multifamily projects. Finally, HUD needs to follow up with the regional and field offices' staff in six months to ensure that they are using residual receipts for allowable expenses.

Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the discussion draft of the audit report to HUD on August 27, 2008, and requested its comments by September 26, 2008. HUD provided its written response and a complete management decision on September 24, 2008, and agreed with the finding and each recommendation.

The complete text of HUD's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

Congress authorized the Section 8 program in 1974, and the U.S. Department of Housing and Urban Development (HUD) developed the program to provide rental subsidies for eligible tenant families residing in newly constructed, rehabilitated, and existing rental and cooperative apartment projects. HUD's Office of Multifamily Housing has oversight responsibility for approximately 30,000 insured or assisted properties with more than 2.5 million units. Of these units, more than 1.2 million units are Section 8-assisted units located in more than 17,000 properties.

HUD contracts with project 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 if the project is insured, and any allowable distributions. When project income for nonprofit and limited distribution projects exceeds expenses, the project has excess earnings, or residual receipts.

Before 1979/1980, HUD's housing assistance payments contracts did not contain provisions regarding residual receipt use. In 1979/1980, HUD changed the Section 8 regulations for 100 percent-assisted new construction and substantial rehabilitation projects. The new regulation housing assistance payments contracts outline the use and disposition of residual receipts. In addition, the new regulations are outlined in HUD Handbook 4350.1, Multifamily Asset Management and Project Servicing, as well as 24 CFR (*Code of Federal Regulations*) Parts 880, 881, and 883.

The above sources explain that the project will remit any remaining residual receipts to HUD at the end of the project's housing assistant payments contract. It also explains that projects subject to the revised 1979/1980 Section 8 regulations that request residual receipt withdrawals will be considered if such requests are for the purposes of reducing operating deficits or making mortgage payments when a default is actual or imminent. Projects can also pay housing assistance and service coordinator-related fees with residual receipts. The new regulations state that the field office will disapprove requests for other purposes.

The objective of the review was to determine whether HUD appropriately authorized residual receipt use in lieu of reserve for replacement funds for new regulation multifamily projects on a nationwide basis.

RESULTS OF REVIEW

Finding: HUD Inappropriately Authorized the Use of More Than $3.2 Million in Residual Receipt Funds for Ineligible Costs

HUD inappropriately authorized the use of more than $3.2 million in residual receipt funds for ineligible costs. Regional and field office staff nationwide were either not familiar with or overlooked the residual receipt use requirements for new regulation multifamily projects. As a result, HUD lost more than $3.2 million that it could have used more effectively for additional housing subsidies and other authorized taxpayer purposes.

HUD Inappropriately Authorized the Use of Residual Receipts

HUD staff inappropriately authorized new regulation multifamily projects to use residual receipt funds for ineligible costs. For 10 of the 14 projects tested, multifamily staff allowed new regulation project owners to use residual receipts in lieu of reserve for replacement funds for capital expenditures and operating-related costs. These ineligible costs included painting, management fees, kitchen renovations, installing slate over concrete walkways, repairs to elevators, window replacements, and the construction of a new pier. These expenditures contradict 24 CFR Parts 880 and 881 and the detailed procedures in HUD Handbook 4350.1, which state that for those projects subject to the revised 1979/1980 Section 8 regulations, requests for withdrawals will be considered if such requests are for two specific purposes: reducing operating deficits or making mortgage payments when default is actual or imminent. Finally, the handbook states that the field office will disapprove requests for other purposes.

HUD Was Not Familiar with or Overlooked the New Regulations

Regional and field office staff nationwide were either not familiar with or overlooked the residual receipt use requirements for new regulation multifamily projects. Each of the project managers for these 14 projects stated that they used HUD Handbook 4350.1 as their main source to manage their projects and to perform their job duties. Twelve of them (86 percent) were not familiar with the difference between old regulation and new regulation multifamily projects regarding residual receipt use. Two of them were familiar with the residual receipt use requirements for new regulation multifamily projects, but both project managers overlooked the requirements, and the field office officials authorized the ineligible costs. One of the project managers stated that there was no difference in the regulations for new rule versus old rule multifamily projects regarding residual receipt use. After talking with regional and field multifamily office staff nationwide, it was evident that most staff was not knowledgeable about the new regulations and residual receipt use requirements.

HUD Could Have Used the $3.2 Million for Other Eligible Costs

Because of HUD's action, it lost more than $3.2 million in residual receipt funds that it could have used for additional housing subsidies and other eligible taxpayer purposes. For example, HUD can use excess residual receipt funds to reduce housing assistance payments from appropriated funds for new regulation projects. HUD can then make the saved appropriated funds available to other new regulation projects. Finally, when a new regulation Section 8 contract terminates, HUD remits the residual receipts to the United States Treasury. When HUD improperly authorizes the use of residual receipts, it deprives the federal government of funds it is owed.

Recommendations

We recommend that the Director of HUD's Office of Asset Management

1A. Ensure that each of the 14 projects reviewed reimburses the residual receipts account with reserve for replacement or operating funds, unless this action negatively affects the project. If every project is able to reimburse its residual receipts account, the total transfer for the 14 projects will be $3,203,135.

1B. Direct regional and field office staff to fully understand and comply with the requirements regarding the use of residual receipts for new regulation multifamily projects.

1C. Follow up with the regional and field offices in six months to ensure that they are not using residual receipts for ineligible costs.

SCOPE AND METHODOLOGY

Our review period was from January 1, 2004, to March 31, 2008. We expanded the period as needed to evaluate historical and current information pertinent to our review. We limited the audit to a sample of new regulation Section 8 multifamily projects.

To achieve our objectives, we reviewed a previous HUD Office of Inspector General (OIG) report (#2007-KC-0002), data obtained from HUD's computer systems, and applicable federal regulations. We also interviewed HUD officials from its Office of Multifamily Housing, hub directors, project managers, team leaders, and supervisors.

We selected our sample from a HUD-provided list showing that as of July 2006, more than 10,000 nonprofit or limited distribution projects had residual receipt activity between the fiscal year ends June 30, 2004 and December 31, 2005. From that list, we selected the 22 new regulation projects with the highest residual receipt balances and added the three new regulation projects identified in HUD OIG report #2007-KC-0002. After performing our preliminary audit work and reviewing the first 14 project files we received from HUD, we concluded that the conditions disclosed in this report existed across regional offices. We, therefore, reduced our sample size to include only those first 14 projects.

We used computerized data from HUD's Integrated Real Estate Management System solely for background information and to identify projects for review. Therefore, we did not perform tests to assess the reliability of the data. For the 14 new regulation Section 8 multifamily projects in our sample, we reviewed pertinent documentation including regulatory agreements, agreements to enter into housing assistance payments contracts, housing assistance payments contracts and renewals, notification of selection letters, and residual receipt draw requests and authorizations from the project files.

We performed our audit work on site in New York and in our Denver office from May to August 2008. We briefed HUD management in Washington, DC, on the results of our review on July 25 and August 1, 2008.

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

INTERNAL CONTROLS

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

- 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:

- Controls over ensuring that residual receipts for new regulation multifamily projects are authorized for allowable expenses.

We assessed the relevant control 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

Based on our review, we believe the following item is a significant weakness:

- HUD staff inappropriately authorized the use of residual receipts for new regulation multifamily projects for ineligible costs.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/
1A	$3,203,135

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local policies or regulations.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

Comment 1

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

OFFICE OF HOUSING

SEP 2 4 2008

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

FROM: Beverly J. Miller, Director, Office of Asset Management, HTG

SUBJECT: Proposed Management Decisions Regarding the Recommendations from the Audit Titled, "HUD Inappropriately Authorized the Use of Residual Receipts in Lieu of Reserve for Replacement Funds"

This memorandum provides our proposed management decision for addressing the recommendations of this audit as reported in the draft report. The Office Asset Management proposes the following management decisions for the audit recommendations from the above-referenced audit. Please provide us with your confirmation of acceptance or contact us at your earliest convenience should you wish to discuss any concerns.

Recommendation 1.A: Ensure that each of the 14 projects reviewed reimburses the residual receipts account with reserve for replacement funds or operating funds, unless this action negatively affects the project. If every project is able to reimburse its residual receipts account, the total transfer for the 14 projects will be $3,203,135.

Proposed Management Decision for Recommendation 1.A. We concur with the recommendation.

Corrective Actions	Target Date	Documentary Evidence
The Office of Asset Management will instruct the affected field offices to contact the project owners and management regarding the amounts to be charged against the project Reserve for Replacement account and will transfer these amounts to project Residual Receipts. If such a transfer would result in negatively impacting the project, the field office managing the project will provide a memorandum to the Office of Asset Management detailing the impact, and will provide the appropriate support.	11-15-08	Copies of the memorandums to the field offices.

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Recommendation 1.B: Direct regional and field office staff to fully understand and comply with the requirements regarding the use of residual receipts for new regulation multifamily projects.

Proposed Management Decision for Recommendation 1.B. We concur with the recommendation.

Corrective Actions	Target Date	Documentary Evidence
The Office of Asset Management will issue a memorandum to all field office management instructing them on the proper use of residual receipts for new regulation multifamily projects. This memorandum will be placed on HUD's intranet Web page for field office guidance – miscellaneous. This memorandum will also be discussed at an upcoming Asset Management Hub Directors Conference call.	11-15-08	A copy of the memorandum and attendance by an OIG HQ representative at the appropriate Asset Management Hub Directors Conference call.

Recommendation 1.C: Follow up with the regional and field offices in six months to ensure that they are not using residual receipts for ineligible costs.

Proposed Management Decision for Recommendation 1.C: We concur with the recommendation.

Corrective Actions	Target Date	Documentary Evidence
Hub Directors will survey their program centers and will certify to the Office of Asset Management that they are not using residual receipts for ineligible costs.	5-15-09	Asset Management staff will maintain a file of these certifications for later reference.

OIG Evaluation of Auditee Comments

Comment 1 HUD's Office of Asset Management (HUD) concurs with all recommendations and provided OIG with a written response in the form of a management decision. If HUD implements the corrective actions outlined in the proposed management decision, the finding identified in this audit report should no longer be an issue for HUD.