



U.S. Department of Agriculture



Office of Inspector General
Southwest Region

Audit Report

Request Audit of Oklahoma Rural Rental Housing Management Company

Report No. 04099-211-Te
April 2009



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Southwest Region

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April 28, 2009

REPLY TO

ATTN OF: 04099-211-Te

TO: Scooter Brockett Anita Kinyon
Acting Director Acting Director
Rural Development Rural Development
Texas State Office Oklahoma State Office

FROM: Timothy R. Milliken /s/
Regional Inspector General

SUBJECT: Request Audit of Oklahoma Rural Rental Housing Management Company

This report presents the results of our audit of an Oklahoma Rural Rental Housing Management Company operating in Oklahoma and Texas. The responses from the Acting Directors of the Oklahoma and Texas State Rural Development offices dated April 16, 2009, are included as exhibit C with excerpts, and the Office of Inspector General's (OIG) position incorporated into the relevant sections of the report.

Based on the responses, management decisions were not reached on any of the recommendations. Documentation and/or actions needed to reach management decisions for the recommendations are described in the OIG Position section of the report.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective action taken or planned and the timeframes for implementation for these recommendations. Please note that the regulation requires a management decision be reached for all recommendations within a maximum of 6 months from the date of report issuance. Final action on the management decisions should be completed within 1 year of the date of each management decision to preclude being listed in the Department's annual Performance and Accountability Report.

We appreciate your timely responses and the courtesies and cooperation extended to us by members of your staffs during the audit.

Executive Summary

Request Audit of Oklahoma Rural Rental Housing Management Company (Audit Report No. 04099-211-Te)

Results in Brief Rural Development's (RD) Rural Rental Housing (RRH) Program is designed to provide affordable housing for low- and moderate-income persons in rural areas by providing loans for construction or rehabilitation of RRH projects. Borrowers who receive loan funding either hire management companies to manage their projects or, after receiving RD's approval, self-manage the property. At the request of the Texas State RD office, the Office of Inspector General (OIG) initiated an audit to determine if a management company operating in Oklahoma and Texas was managing its housing projects—apartment complexes that are subsidized under RRH—in a manner that protected the Government's interest and the health and safety of tenants.¹

Of the 73 housing projects in Oklahoma and Texas affiliated with this company, we selected 5 projects for review. For the five projects reviewed, the management company received loan funding, rental assistance, and management fees for managing the projects from RD. In fiscal years 2004 and 2005 combined, the borrower received \$7,128,710 in loans and \$1,552,779 in rental assistance for the five projects. The management company received \$383,327 in management fees for the housing projects reviewed.²

Our audit identified numerous problems relating to management of the company's projects. Specifically, we determined that the management company:

- overcharged projects a total of \$44,158, including \$4,692 in late fees, \$4,200 for an unauthorized truck lease, and \$35,266 in excess costs for appliances that were purchased at prices from 13 to 57 percent above wholesale from a company owned by one of its employees;³

¹ In this case, RD considers the management company to be an identity-of-interest management agent because the management company (owned by one individual) has ownership interest in each of the limited partnerships that are listed as the owner and borrower for the projects. RD approved this type of management because the management fees were considered arm's-length transactions, and the identities of interest between the management company and the limited partnerships were disclosed to RD.

² See Background section for total amounts of loans, rental assistance, and management fees for all 73 projects.

³ See Finding 1. \$4,692 in late fees applied to all five sample projects. The \$4,200 truck lease applied to one sample project. The \$35,266 for inappropriate appliance prices applied to 3 of the sample projects, and 16 additional projects.

- did not maintain or manage projects' reserve accounts as required by Federal regulations;^{4, 5}
- was not complying with Federal regulations regarding the number of tenants who may live in apartments of various sizes;⁶
- exceeded the vacancy rate cap requirements in fiscal years 2004 and 2005;⁷ and
- was not adequately maintaining the projects with the result that numerous health and safety violations existed at certain projects.⁸

Overall, we found that the management company had not fulfilled its responsibilities, complied with Federal regulations, or adequately managed its projects.

Our finding was based not only on the deficiencies we found in the five projects reviewed, but also on the following, general management-related problems. The management company's records were so disorganized that we could not locate supporting documentation for certain transactions which may have increased the dollar effect for our findings. Also, the company was reusing old documents, including tenant information which contained some information protected under the Privacy Act. Further, we learned that the management company had instructed its site managers not to cooperate with, or speak to, RD area officials.

We concluded that the management company was not managing its projects in accordance with Federal regulations and that RD should further review the company and determine if it should continue in the program.

Recommendations In Brief

The Oklahoma and Texas State RD offices should:

- Initiate a review to determine if projects outside our sample were also affected by the problems we identified. Take appropriate corrective action to remedy any problems identified, such as

⁴ Title 7, *Code of Federal Regulations* (CFR), 1930-C, exhibit B, XVIII B(2)c, dated January 1, 2003.

⁵ See Finding 2.

⁶ See Finding 3.

⁷ See Finding 3.

⁸ See Finding 4.

withdrawing RD's approval for the management company to manage these projects. If RD concludes that the management company can continue to manage projects, then it must establish a higher degree of oversight for this management company.

- Instruct the borrower to require the management company to reimburse the applicable projects for the excess charges totaling \$44,158.
- Instruct the borrower to require the management company to correct the irregularities we identified in the projects' reserve accounts, including repaying any funds that may have been misused.
- More closely monitor vacancy and occupancy rates at this management company's RRH projects.
- Schedule additional RD inspections until projects are being adequately maintained.
- Instruct the borrower to require the management company to perform additional inspections of units and take action against tenants who violate the terms of the lease.

Agency Responses

In memoranda dated April 16, 2009, the Texas and Oklahoma State RD offices generally concurred with the findings and recommendations, and provided responses to the recommendations. One general request to change the wording in some of the recommendations was agreed to, and is so indicated in the applicable recommendations. The letters containing the general request and responses to each recommendation are included as exhibit C of the report.

OIG Position

Based on the responses from the RD State offices, we could not accept management decision for any of the recommendations. We have explained in the OIG Position section to the recommendations the actions that are needed for acceptance of management decision for each of the recommendations.

Abbreviations Used in This Report

CFR	<i>Code of Federal Regulations</i>
FmHA	Farmers Home Administration
MFIS	Multi-Family Information System
OIG	Office of Inspector General
RD	Rural Development
RRH	Rural Rental Housing
USDA	Department of Agriculture

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Background and Objective

Background

As the Department of Agriculture's (USDA) agency responsible for improving the quality of life for all rural Americans, Rural Development (RD) oversees the Rural Rental Housing (RRH) Program, which provides affordable housing for low- to moderate-income persons in rural areas. The agency accomplishes this mission by providing loans to construct RRH projects, and providing guidance to borrowers about requirements for operating projects.⁹

Borrowers who receive loan funding either hire management companies to manage their projects or, after approval by RD, self-manage the property. If the borrower hires a management company, the company is responsible for complying with all applicable laws, regulations, and loan covenants of the RRH Program. Borrowers and management companies are required to report on overall project operations by submitting annual reports to appropriate servicing offices.

For each multi-family housing project, a management plan must be developed and maintained by the owner/borrower that establishes the systems and procedures that will be employed at the project to ensure that project operations comply with Housing and Community Facilities Programs requirements. (Throughout this report, we will refer to the owner/borrower and the management company interchangeably when discussing the regulations, as these two entities have a mutual responsibility to comply with all applicable regulations.)

In general, loan funds may be used for constructing housing; purchasing and rehabilitating buildings that have not been previously financed by the agency; purchasing and installing equipment and appliances; and other sundry, related expenses.

For each of the projects in our sample, the owner/borrower formed a different limited partnership for each project.¹⁰ A limited partnership consists of two classes of partners—general partners and limited, or silent, partners. The general partner is responsible for the business' management, while a limited partner neither manages nor controls the business. For these projects, the management company is a general partner in each of these limited partnerships.

⁹ Farmers Home Administration (FmHA) Instruction 1930-C, dated August 30, 1993, and RD Handbooks 1-3560, 2-3560, and 3-3560, dated February 24, 2005.

¹⁰ In this case, the owner and borrower were one and the same.

In such circumstances, RD considers the management company to be what it terms an “identity-of-interest” management agent because of the management company’s ownership interests in all of the limited partnerships. “Identity-of-interest” means that there is a shared financial interest between the borrower and the management agent.

The general partner signs various documents for the projects (notes, mortgages, loan agreements, etc.) as both the president of the management company *and* as president of the limited partnerships that owns the projects. This type of arrangement is allowed by the regulations, and was approved by RD because the identity of interest between the management company and the limited partnerships was disclosed. However, it should be noted that the management plans signed by the management company and owners stated that the general partner in the owners’ organizations is the key contact person for the management company. The plan further stated that the management company must consult with the owner on all matters involving extraordinary expenses, including all purchases exceeding \$2,000, and changes in complex management or marketing. Therefore, for our five sample cases, the management company was its own contact for these decisions.

On June 15, 2005, the Texas State RD office requested that the Office of Inspector General (OIG) review a management company operating projects in Oklahoma and Texas. RD was concerned that this management company had been committing fraudulent acts and obtaining unauthorized assistance. A site visit by RD field office personnel had found that a unit had been occupied by a representative of the management company. This person had not been paying rent for 26 months, and RD’s records showed the unit to be vacant. Moreover, this unit was not designated as a nonrevenue-producing unit in the housing project’s management plan and there were eligible applicants on the project’s waiting list during the period in question. Furthermore, the project received \$11,700 in rental assistance for this unit while it was occupied by the management company’s representative.

Previous audit reports show that the management company has a history of not complying with RD regulations. In 1994, OIG audited the management company and found that it had claimed excessive expenses and had not timely performed necessary maintenance.¹¹ Similarly, in 1998, OIG audited the company and found that “the management company did not properly maintain tenant security deposit accounts.”¹²

¹¹ FmHA, Rural Rental Housing Program Management Operations, Audit Report No. 04600-28-Te, dated June 1994.

¹² Rural Housing Service, Rural Rental Housing Program, Audit Report No. 04801-13-Te, dated September 1998.

During the period of our audit, the management company managed 73 RRH projects in Texas and Oklahoma with a combined total of 1,913 revenue-producing units, of which 1,471 of those received rental assistance. In all, the borrower received loans totaling \$48,191,908 and rental assistance totaling \$9,682,895, and the management company received management fees totaling \$2,994,152.

Objective

Our objective was to determine if the management company was managing its housing projects in a manner that protected USDA-secured property and the health and safety of the tenants.

Findings and Recommendations

Section 1. Management Company Failed to Comply with Program Requirements

In the following findings, we describe how the management company failed to comply with a wide range of program requirements, including overcharging projects for unjustified expenses, failing to properly maintain reserve accounts, failing to follow Federal guidelines for unit occupancy, and failing to maintain projects according to health and safety standards.

Our ability to determine the full extent of these problems was made more difficult because the management company also failed in its responsibility to maintain adequate records. Federal regulations require management companies to “maintain records in a manner suitable for an engagement” and that the company “must be able to report accurate operational results” to RD.¹³ We found that the company’s records did not comply with these requirements. Records were not properly organized, or segregated, and there was insufficient supporting documentation for certain transactions.

We also found that the management company was not properly handling old documents, including tenants’ applications, and was reusing them. Some of these documents contained tenant information protected under the Privacy Act—names, social security numbers, birthdates, and medical and prescription information. We informed the management company that this information should not be reused, and were assured that, in the future, records with tenants’ private information would be destroyed and not recycled.

Finally, we found that the management was not always cooperating with agency officials. When one RD area official attempted to follow up on some issues mentioned in this report, the official learned that the management company had directed its site managers—those responsible for the day-to-day management of its projects—not to speak to RD. Since the management company is required to follow program regulations, and since it has agreed to cooperate with RD in the program documents it signed, instructing its site managers not to speak to RD is thus a violation of regulations and prevents RD officials from performing their duties.

¹³ 7 CFR 1930.22, dated January 1, 2003.

Given the issues identified in the following findings, OIG concluded that this management company was not effectively managing its projects. RD has the authority to initiate a review to determine if there are deficiency findings or compliance violations, and take enforcement actions if the violations are not corrected within a time period determined by the agency.¹⁴ OIG maintains that such a review is necessary so that RD can determine the full extent of the problems at the 73 projects managed by this company.

Finding 1 Management Company Overcharged Projects for Unjustified Expenses

For the projects we reviewed, we found that the management company overcharged projects for certain expenses, including late fees for utility and other bills, the unreasonable leasing costs for a truck, and appliances purchased from an employee's company at inflated rates. This occurred because the management company disregarded its responsibilities under the loan agreement and regulations.¹⁵ As a result, the company overcharged the projects a total of \$44,158 in unreasonable and unallowable costs.

Regulations require that expenses charged to projects must be reasonable, typical, and necessary and show a clear benefit to the residents of the property. Services and expenses charged to the property must show value added and be for authorized purposes.¹⁶

Management Company Used Program Funds to Pay Late Fees

For the five projects reviewed, the management company incurred late fees for not paying project bills on time, and then paid these fees from the projects' general operating and reserve account funds. This occurred because the management company neglected to differentiate between expenses legitimately attributable to the housing projects and expenses incurred due to its own inefficiency. As a result, the management company used project funds to inappropriately pay at least \$4,692 for late fees.¹⁷

¹⁴ 7 CFR 1930.119(b)(1)(i), dated January 1, 2003, and RD Handbook 2-3560.354, dated February 24, 2005.

¹⁵ 7 CFR 1930-C, exhibit B, XIII B 2a(1)(iii)(D)(3)(4), dated January 1, 2003, and RD Handbook 2-3560.256(c) and 3.8E, dated February 24, 2005.

¹⁶ 7 CFR 1930-C, exhibit A, III D, dated January 1, 2003, and RD Handbook 2-3560.102(i)(3)(iii), dated February 24, 2005.

¹⁷ The management company's records were incomplete, which prevented us from determining the full extent of the problem.

Regulations state that late fees charged to the borrower/management company may not be paid from funds designated for the project or from project income.¹⁸ They also state that it is inappropriate to bill the projects for practices that are inefficient.¹⁹

We found that the management company charged at least \$4,692 in late fees to these five projects, as the following table illustrates:

Project	Late Fees on Utility Bills	Late Fees on Other Bills	Totals
Project A	\$35	\$7	\$42
Project B	\$21	\$0	\$21
Project C	\$328	\$3,627	\$3,955
Project D	\$39	\$5	\$44
Project E	\$630	\$0	\$630
Totals	\$1,053	\$3,639	\$4,692

Of the 73 projects the company manages in Oklahoma and Texas, we arrived at this total by reviewing just 5 of the projects. Even for those five projects, the management company's failure to maintain complete records meant that we were unable to determine the full extent of this problem.

Management Company Charged Project for Unjustified Leased Truck

For 7 months in 2005, the management company shifted the cost for one of its leased trucks to the construction fund of project B. This occurred after the company's accountant resigned, which left the company with an extra leased truck. This truck was reassigned to another employee, whose leased truck was then used by a construction company doing work for project B. It charged the truck's lease to the project. As a result, project B incurred an unjustified expense of \$4,200.

The regulations state that only typical and reasonable expenses should be incurred for services rendered.²⁰

¹⁸ 7 CFR 1930-C, exhibit A, III F and H, and exhibit B, XIII B 2(a)(3)(4), dated January 1, 2003, and RD Handbook 2-3560.256(c), dated February 24, 2005.

¹⁹ 7 CFR 1930-C, exhibit B, IX D 5, dated January 1, 2003, and RD Handbook 2-3560.102(i)(4)(viii) dated February 24, 2005.

²⁰ 7 CFR 1930-C, exhibit A, III D, dated January 1, 2003, and RD Handbook 2-3560.102(a) dated February 24, 2005.

Records showed that from March 2005 to September 2005, the monthly lease of \$600 for this truck was paid from project B's construction fund. When asked, a company representative claimed the truck was needed for project B to transport workers to and from the project and to haul trash and pick up supplies.

Based on the records we reviewed and our interviews with the officials of the management company, we could not determine if the truck continued to be charged to a project from September 2005, when the company made its last charge to project B, and March 2006, when it requested RD's approval to charge the expense to project E.

In March 2006, the management company prepared a lease agreement for the same truck. It planned to use the truck to haul trash from project E. However, the RD area office in Stillwater, Oklahoma, would not approve the lease as a reasonable expense unless the company could show that 3 years of trash-hauling expense would exceed the truck's lease of \$31,000. In response, the company provided RD with estimates of how much it would cost to haul trash for 3 years. RD, however, concluded that the company's request was not valid because the expense of the rental truck was more than the cost to haul the trash. It therefore denied the request.

Management Company Purchased Appliances from a Company Owned by an Employee

During the course of our audit, Oklahoma State RD officials mentioned their concerns about how the management company was procuring appliances for many of its Oklahoma projects. For 19 housing projects—including 3 in our sample—we found that the management company had purchased \$184,680 in appliances from a company owned by one of its employees. Even though the management company could have purchased these appliances directly from the dealer at wholesale prices, it chose to purchase them from its employee's company at markups ranging from 13 percent to 57 percent. It passed this inflated cost on to the projects, but did not certify the exchange as an identity-of-interest transaction as required by RD's regulations. Because the management company did not follow RD's regulations, these 19 projects incurred improper and excess charges totaling \$35,266.²¹

²¹ This amount is the difference between the wholesale and retail prices of the appliances.

Management companies must disclose to RD identity-of-interest relationships (relationships where the borrower and the management agent share a financial interest), including circumstances where the management company is doing business with a company owned by one of its employees.²² Before RD will agree to such a relationship, management companies must demonstrate that the use of an identity-of-interest company is in the best interest of the housing project.²³

We found that the management company purchased appliances from an employee's company, and that this constituted a problematic and undeclared identity-of-interest relationship. The employee in question worked for the management company and maintained office space in the company's offices. When an Oklahoma State RD official telephoned the number listed on the appliance company's invoices, the employee who answered the phone did so as the management company's representative. OIG searched for independent telephone listings or Internet sites for the employee's appliance company but found none. In fact, Oklahoma State RD officials stated that the employee's company only did business with the management company—it transacted no business with other appliance dealers nor did it sell to the public. Oklahoma State RD officials further stated that this was an identity-of-interest relationship that should have been disclosed.

We reviewed the management company's identity-of-interest certifications and found that the management company did not have on file the relevant certifications, which meant that it did not properly disclose this relationship. Nor was this undisclosed identity-of-interest relationship in the best interest of the housing projects. According to Oklahoma State RD officials, the management company could have purchased these appliances directly from the dealer for \$149,414, but instead paid the employee's company \$184,680—a total markup of \$35,266.²⁴ These inflated prices were passed on to the projects receiving the appliances.

We concluded that this was a highly irregular transaction that violated RD's regulations. In addition to its dealing with the employee's appliance company (company A), the management company also does business with two other companies

²² 7 CFR 1930-C, exhibit B, V B 1, dated January 1, 2003, and RD Handbook 2-3560.102(j)(1)(vi), dated February 24, 2005.

²³ 7 CFR 1930-C, exhibit B, V H 2b, dated January 1, 2003, and RD Handbook 2-3560.102(g)(3)(iv), dated February 24, 2005.

²⁴ We were unable to find some of the dealer's vouchers to match the employee's charges to the management company.

(companies B and C) owned by the employee's son. The management company contracted company B to do construction for project B, and company C to do lawn work for various projects. Company B, owned by the employee's son, is the same entity that was using the leased truck we questioned earlier in this finding. This relationship was also undisclosed on the management company's identity-of-interest certification. The management company was also required to declare identity-of-interest relationships in the "Notes" to its audited financial statements; we reviewed these notes and found that the management company had not declared these identity-of-interest relationships.

When the Oklahoma State RD office learned of these highly irregular transactions, it directed its local office not to approve any additional purchases from company A. The management company official stated that company A would not be used for future transactions.

We concluded that the management company overcharged \$44,158 in excessive costs to these projects.

General Comment to Recommendations by Both the Oklahoma and Texas State RD Offices:

Both the Oklahoma and Texas State RD offices requested that OIG change its recommendations from "require the management company to..." to "require the borrower to..." Both State offices said that it would be difficult for the agency to require the management company to provide, reimburse, correct, etc., since it has no authority over the management company. The State offices said that they do, however, have agreements with and requirements for the borrower.

OIG Position

We understand RD's request, and will comply as applicable (see Recommendations 3, 5, 6, 9, 11, and 15).

Recommendation 1

Initiate a review to determine if projects outside our sample were also affected by the problems we identified. Take appropriate corrective action to remedy any problems identified, such as withdrawing RD's approval for the management company to manage these projects.

Agency Responses

Texas State RD Office:

We intend to review the projects managed by the management company outside OIG's sample to determine if similar problems exist. If additional problems are identified, we plan to initiate action to withdraw its management approval.

Oklahoma State RD Office:

We intend to review projects managed by the management company outside OIG's sample to determine if similar problems exist. If additional problems are identified, we plan to take appropriate corrective action to remedy any problems identified in accordance with current regulations. Oklahoma proposes to review 15 to 20 properties.

OIG Position

We agree with the intended review of additional projects, and agree with the Texas State RD office's plan to initiate action to withdraw the management company's approval if additional problems are identified. To reach management decision, you will need to provide the results of your review(s), and the action(s) taken or planned as a result of the review(s) with timeframe(s) for implementation.

Recommendation 2

If, in response to Recommendation 1, RD concludes not to withdraw its approval for this management company to manage these projects, then it must apply adequate oversight based on current authority.

Agency Responses

Texas State RD Office:

If additional problems are identified in our reviews of additional properties, we plan to initiate action to withdraw its management approval.

Oklahoma State RD Office:

Agree

OIG Position

To reach management decision, you will need to provide the results of your review(s), and the action(s) taken as a result of the review(s) with timeframe(s) for completion.

Recommendation 3

Instruct the borrower to require the management company to reimburse the applicable projects for the excess charges totaling \$44,158.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, provide documentation to show action(s) taken, results of such action(s), and timeframe(s) for completion.

Recommendation 4

If, in the future, the management company continues to manage projects, establish a review of its business relationships designed to verify that there are no undeclared identity-of-interest relationships.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, provide documentation of the additional review(s) established and actual or estimated timeframe(s) for completion.

Recommendation 5

Instruct the borrower to require the management company to produce records of the expenses it paid for all of its projects and determine if late fees were being charged to the projects we did not review. Collect any late fees charged to the projects identified during this review.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, you will need to provide the results of your review(s), and the action(s) taken as a result of the review(s) with timeframe(s) for completion.

Recommendation 6

Instruct the borrower to require the management company to produce records showing that it continually paid the leases for its vehicles and did not inappropriately pass on those costs to its projects. Seek recovery of any costs inappropriately passed on to the projects.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, you will need to provide the results of your review(s), and the action(s) taken as a result of the review(s) with timeframe(s) for completion.

Finding 2

Management Company Failed to Properly Maintain Reserve Accounts

For three of the five projects, we found that the management company was not properly maintaining reserve accounts. We noted three types of questionable transactions—the company failed to deposit funds, withdrew funds without RD’s approval and countersignature, and did not account for funds from an account. This occurred because the company failed to comply with Federal regulations concerning how these accounts should be maintained. The company also did not have checks with a second signature line requiring RD’s countersignature,

which would have helped prevent unauthorized withdrawals. As a result, \$1,494 was not deposited for the reserve account for one project; \$5,057 was withdrawn from the reserve accounts for three projects without the agency's prior approval; and documentation was not provided to show that \$35,430 was in one project's reserve account for more than an 18-month span. Although the \$35,430 was eventually returned to the reserve account, this case demonstrates that RD has an internal control risk because the owner or management companies can divert the funds from reserve accounts without RD knowing the accounts were depleted.

Federal regulations require that funds be deposited to a reserve account each month for each project. That reserve fund is to be used for extraordinary expenses, viz., expenses the agency evaluates on a case-by-case basis to determine if they are extraordinary. In order to use funds from the reserve account, the management company must have RD's approval and RD's countersignature on all withdrawals.²⁵

While the management company did establish reserve accounts for each project, we found three irregularities regarding how these accounts were managed:

- The company did not make required monthly deposits totaling \$1,494 into the reserve account for project A.
- The company withdrew a total of \$5,057 from the reserve accounts for projects A, D, and E, but did not receive approval before the withdrawal, nor did it obtain RD's countersignature. RD later approved the withdrawals of \$2,766 from the reserve fund for project E, but \$2,291 was not approved by RD, even though the agency, according to Federal regulations, must approve all withdrawals.
- The company did not provide documentation to account for \$35,430 from a separate reserve account it established for project D from December 2004 to June 2006. Records showed the amount was in the account prior to December 2004. We requested the management company provide this documentation, but the company could only produce records showing that this amount appeared back in the account in June 2006, 2 months after we began our audit.

We concluded that the management company was not effectively managing these reserve accounts.

²⁵ 7 CFR 1930-C, exhibit B, X D, dated January 1, 2003, and RD Handbook 2-3560, section 4-3, C, dated February 24, 2005.

Recommendation 7

Require, if the management company continues to manage projects, that checks for the company's reserve accounts clearly show that RD's countersignature is required for withdrawals (i.e., the checks should include two signature lines).

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, you will need to provide documentation showing that the borrower and management company have been notified of requirements that the management company must have RD's approval and RD's countersignature on all withdrawals.

Recommendation 8

Select a sample of the reserve accounts for other projects managed by the management company, and determine if the accounts were properly maintained, including verifying that all required deposits were made.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, you will need to provide the results of your review(s), and the action(s) taken as a result of the review(s) with timeframe(s) for completion.

Recommendation 9

Instruct the borrower to require the management company to deposit the \$1,494 in project A's reserve account.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, we need documentation showing that action was taken, the result of the action, and a timeframe for completion.

Recommendation 10

Review the \$2,291 withdrawn from projects A and D without agency approval to determine if approval should be given after the fact, or if these funds should be returned to the applicable reserve accounts.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, we need documentation showing that action was taken, the result of the action, and a timeframe for completion.

Recommendation 11

Instruct the borrower to require the management company to provide documentation to account for \$35,430 from project D's reserve account between December 2004 and June 2006.

Agency Responses

Texas and Oklahoma State RD Offices:

The State offices requested that OIG revise the recommendation because they believed it would be difficult to obtain documentation to account for \$35,430 from project D's reserve account between December 2004 and June 2006, if OIG was unable to obtain the documentation.

OIG Position

We revised the opening, but not the overall recommendation. The borrower/management company should have been able to account for these funds, and they have requirements to maintain and provide documentation to RD to participate in the program. If the borrower or management company cannot provide the information, it is another example of poor management. Therefore, to reach management decision, provide documentation that you instructed the borrower to provide the documentation, and provide us with their response.

Finding 3

Management Company Did Not Follow Federal Guidelines Concerning Unit Occupancy

For three of the five housing projects we visited, the management company allowed too many tenants to inhabit apartments too small for their needs, or was allowing tenants to receive Federal subsidies for apartments that were too large for their needs. This occurred because the management company did not follow Federal guidelines.²⁶ As a result, the company was not managing its properties as efficiently as possible, and was allowing some units to become overcrowded, with resulting health and safety risks.

Management companies are responsible for knowing and complying with regulations and guidelines covering family size and needs as they relate to unit size. Borrowers establish a management plan to inform RD of how they intend to manage the project.

Because RD housing units are federally subsidized, regulations require that households be matched with apartments that are appropriately sized for the household's needs.²⁷ If tenants are occupying an apartment that is too large for their needs, then available space is not being efficiently utilized; if tenants are occupying an apartment that is too small for their needs, then a potential health and safety hazard exists. The goal is to assist as many people as possible without overcrowding the unit or the projects.

Since every project is different, and apartment units within projects will vary, borrowers are required to establish occupancy policies for each project specifying the appropriate number of tenants who may

²⁶ 7CFR 1930-C, exhibit B, 2 c, Occupancy Policy and Guidelines, dated January 1, 2003.

²⁷ 7CFR 1930-C, exhibit B, VI D 1 m 2 a, dated January 1, 2003, and RD Handbook 2-3560, sections 5 and 6-21, dated February 24, 2005.

inhabit units of different sizes.²⁸ When establishing their project-specific policies, the borrowers are expected to follow Federal occupancy guidelines. The following Federal guidelines are based on the principle that no more than two persons should be required to occupy a bedroom²⁹ (as shown in the table below).

Number of Bedrooms	Occupancy Density Range	
	Minimum	Maximum
0	1	1
1	1	2
2	2	4
3	3	6
4	5	8
5	7	10

In emergency circumstances, these guidelines may be temporarily waived but, over the long-term, tenants occupying apartments that are too large must be relocated to smaller apartments as soon as possible, and vice versa.³⁰ If an apartment becomes available in a project and is more appropriately sized for a current tenant, then the management company must relocate that tenant before selecting a new tenant from the project’s waiting list.³¹

We found that the borrower had established occupancy policies for its projects that conformed to these guidelines, but that the management company did not, in practice, follow these policies. When we reviewed actual conditions at the management company’s projects, we found that three of the five projects we reviewed did not comply with Federal guidelines, as described in table above.³²

- Project B, with a total of 47 units, had a total of 2 units that were overoccupied and 12 units that were underoccupied;
- Project C, with a total of 48 units, had a total of 4 units that were overoccupied and 22 units that were underoccupied; and

²⁸ 7CFR 1930-C, exhibit B, VI D 1 m 2 b (2), dated January 1, 2003, and RD Handbook 2-3560, sections 5 and 6-21, dated February 24, 2005.

²⁹ 7CFR 1930-C, exhibit B, VI D 1 m 2 c, dated January 1, 2003, and RD Handbook 2-3560, sections 5 and 6-22, dated February 24, 2005.

³⁰ 7 CFR 1930-C, exhibit B, VI D 1 m 2 c, dated January 1, 2003, and RD Handbook 2-3560, sections 5, 6-21, and 6-22, dated February 24, 2005.

³¹ 7 CFR 1930-C, exhibit B, VI D 1 m 2 c, dated January 1, 2003, and RD Handbook 2-3560, sections 5 and 6.21, dated February 24, 2005.

³² These numbers do not include vacant units.

- Project E, with a total of 118 units, had a total of 17 units that were overoccupied and 50 units that were underoccupied.

Projects simultaneously had overoccupied and underoccupied units, indicating that tenants could be relocated to apartments that better suited their needs. For example, at one project, we found two units that had four people living in one-bedroom apartments, while many two- and three-bedroom units were only inhabited by one person, and some three-bedroom units only housed two people. If the management company had moved residents from an overcrowded one-bedroom apartment to an underoccupied two- or three-bedroom apartment, it could have brought the project closer to compliance with Federal guidelines.

When we spoke to a representative of the owner about the management policies and how the management company interpreted the owner's management policy, she stated that the company's occupancy policy derived from the training RD had provided through a third party:

“In our Stars training, we were told that 1 person = 50 square feet of sleeping area, a bedroom that is 100 square feet can sleep 2, a living room that is 150 sq. ft can sleep 3, and a dining room 50 sq ft can sleep 1, so that would be 6 people in a 1 bedroom.”

Based on our review of the training documentation, we found that the Stars training the management company had received did not include this rule. Instead, the training material referred the company to RD's handbook, which provides the Federal guidance based on number of bedrooms in a unit (see table above). Further, RD officials stated that the rule based on one person per 50 square feet of living space is incorrect. Not only did the management company's actual occupancy practice violate Federal guidelines, but it would result in overcrowding, as well as possible health, safety, and sanitation violations.

We also noted that, in 2004 and 2005, three of the five projects did not maintain a vacancy rate of less than 10 percent, as RD requires:³³

- Project A experienced a vacancy rate of 11 percent for 2004, and 20 percent for 2005;

³³ FmHA Instruction 1930-C, exhibit C, 1 X D 2, dated January 1, 2003, and RD Handbook 2-3560, section 4.26B, dated February 24, 2005.

- Project B experienced a vacancy rate of 30 percent for 2004, and 37 percent for 2005;³⁴ and
- Project C experienced a vacancy rate of 27 percent for 2004, and 14 percent for 2005.

Since 2005, however, RD has stopped subsidizing vacant units in subsidized housing projects in Oklahoma. This provides management companies with a direct incentive to fill as many units as they can.³⁵

Overall, we concluded that the management company was not complying with Federal regulations and guidance concerning vacancy rates and unit occupancy. RD officials were not aware of these problems until we brought them to their attention.

During this audit, we found that RD has a useful tool that could be used to enhance how the agency monitors vacancy and occupancy rates at RRH subsidized housing. Agency officials have access to the Multi-Family Information System (MFIS)—an automated system that allows the agency to manage the multi-family housing portfolio and ensure the proper use of Federal housing resources. Although we did not test MFIS to verify the accuracy of its data, we used data from this system and found that it provided useful data relating to vacancy and occupancy rates. We maintain that the Oklahoma and Texas State RD offices need to use MFIS to closely monitor management companies to identify those who fail to meet these vacancy and occupancy requirements.

If RD finds that management companies are not in compliance with regulations and guidance concerning vacancy and occupancy rates, it should develop workout agreements to remedy the problem. Continued noncompliance on the part of the management company should be met with sanctions as deemed appropriate by RD.

Recommendation 12

More closely monitor vacancy rates at this management company's projects to ensure that all Federal requirements are met. The Texas and Oklahoma State RD offices should obtain and review reports from MFIS, determine vacancy rates and, if necessary, have the management company develop a workout agreement. If the company fails to comply with these requirements, impose appropriate sanctions.

³⁴ Project B was under renovation in late 2004 and early 2005, which could account for some of the high vacancy rates.

³⁵ RD Handbook 2-3560, section 3.8B, dated February 24, 2005.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, provide us with your plan(s) of action, and a timeframe(s) for implementation.

Recommendation 13

Select, by reviewing reports from MFIS and performing regular visits, units operated by this management company to ensure that tenants are placed in appropriately sized apartments. If the Texas and Oklahoma State RD offices note that the company is continually failing to comply with this requirement, then they should impose appropriate sanctions.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, provide us with your plan(s) of action, and timeframe(s) for implementation.

Finding 4

Management Company Failed to Maintain Projects According to Health and Safety Standards

At two of the five projects we reviewed, we found that the management company was not adequately maintaining the projects, and that there were numerous health and safety violations. In addition, RD officials requested that we visit another project managed by the company that was not in our selected sample. We found similar health, safety, and maintenance violations at that additional project. These violations occurred because the management company was not managing the projects efficiently, did not timely respond to tenants' maintenance requests, and failed to fulfill its responsibilities under RD regulations. Using RD's inspection checklist—the document used by

local RD officials when they perform visits—we identified 74 health and safety deficiencies at only 1 of the 3 projects we visited, ranging from inoperable fire alarms to exposed electrical wiring.

The management plan states that the management company is responsible for supervising the day-to-day operations of the project, including arranging maintenance and assuring necessary fire, health, and safety inspections are conducted.

At the three projects we visited, however, we found that the management company was not maintaining the project according to RD standards.

Project B

We accompanied Hobart, Oklahoma, field office staff on an inspection of project B. Although the complex had been completely renovated in late 2004 through early 2005, we found many health, safety, and general maintenance concerns. Our inspection of both vacant and occupied apartments found that units were dirty, cluttered, and infested with roaches. We observed crumbling concrete; burns in the carpets or on floors; exposed wires running across the unit; and cracks in the walls indicating shifts in the foundation.

Problems such as the dirty unit and the burns on the carpet were attributable to tenants' behavior. However, the management company is required to monitor the condition of the units and ensure that tenants maintain their apartments so that they do not negatively affect "the livability of the project by threatening the health and safety of other persons or the rights to enjoy the premises."³⁶ If they fail to maintain their units according to regulations, the management company has the authority to evict them.³⁷ We found, however, that the management company had failed to exercise this authority, and was instead allowing tenants to negatively affect the livability of the units.

During the inspection, tenants at project B complained that the management company did not adequately respond to maintenance requests, and maintenance was not performed in a timely manner, if at all.

³⁶ FmHA Instruction 1930-C, exhibit B, section XIV A 1(b), dated August 30, 1993.

³⁷ FmHA Instruction 1930-C, exhibit B, section XIV A 1(b), dated August 30, 1993.

Project C

With the site manager's approval, we visited an apartment in project C and also inspected the grounds. This apartment had been vacant for about 2 weeks and had not yet been readied for another resident. In the apartment, we found mold, leaking water, and trash in the unit. When we inspected the grounds we were accompanied by a Texas RD local official and we noticed that the roof, doors, and windows needed repair, and that electrical wire boxes were open.

We later learned from RD officials that one unit at project C had burned. The management company had not cleared the debris 8 months later (see photo below).



During our visit to project C, we also noted that derelict vehicles—such as the truck pictured below—were abandoned in the parking lot.



Project H

RD officials also requested that we jointly inspect another project that was outside our sample. This project is not under the rental assistance program; however, RD financed the project and the management company is still required to follow RD regulations. Again, we found that the management company had failed to follow these regulations, and that there were numerous health, safety, and maintenance problems, including broken windows, uncovered wiring, decaying storage sheds, and roofs in need of repair.

Like project C, one of the buildings in project H had also burned. RD officials informed us that it had not been repaired or demolished 10 months later.



Overall, our inspection of only 1 of these 3 projects identified 74 health, safety, and/or maintenance deficiencies that had not been addressed by the management company, including:

- smoke alarms that did not work;
- bathtubs and sinks that needed caulking to prevent mold;
- cracks, holes, and fissures in the sheetrock;
- doors that did not work correctly or were damaged; and
- electrical wiring issues.

Based on the number of these deficiencies, we believe the management company was not complying with RD's regulations, fulfilling its responsibility to maintain its projects, or managing its projects in a way that conformed to reasonable habitation and rental management practices. (See exhibit B for additional photos of aforementioned deficiencies for the three projects.)

Recommendation 14

For all projects the management company continues to manage, schedule additional RD inspections until the agency is confident that the management company's projects are being adequately maintained.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, provide us with your plan(s) of action, and timeframe(s) for implementation.

Recommendation 15

Instruct the borrower to require the management company to perform additional inspections of units and take action against tenants who violate the terms of their lease by failing to maintain their apartments. If tenants do not comply, require the management company to evict them.

Agency Responses

Texas and Oklahoma State RD Offices:

Agree

OIG Position

To reach management decision, provide us with your plan(s) of action, and timeframe(s) for implementation.

Scope and Methodology

We reviewed the management company's operations for two RRH projects in Texas and three RRH projects in Oklahoma for fiscal years 2004 and 2005. Audit work was performed between April 20, 2006, and November 15, 2007, at the Texas State RD office in Temple, Texas; the Oklahoma State RD office in Stillwater, Oklahoma; RD servicing offices in Decatur, Texas, Hobart, Oklahoma, and Stillwater, Oklahoma; and the management company's office in Inola, Oklahoma.

We accomplished our audit objectives at these locations through interviews with officials; examination of the five projects' records; and analysis of the respective reserve accounts, operations and maintenance accounts, and the construction account. To verify expenses, we traced the invoices to the check registers and the general ledger. We also visited and inspected all five projects for visible maintenance problems. We did a thorough inspection of the quality and conditions of two of the projects and, for the other three projects, limited our inspection only to the outside of the buildings and the grounds. We photographed the conditions observed. We also visited a sixth project because the local servicing office official had some concerns about safety issues, and it was easily accessible from project C (see Finding 4 for more details).

Using RD's categories for classifying projects, we selected for review one project from each category, except for class C where we selected two projects:

- Class A projects are those with no unresolved findings or violations from prior RD reviews, such as project E.
- Class B projects are those with findings or violations, but that have approved, on-schedule workout agreements, such as project D.
- Class C projects are those with an unresolved finding or violation, and projects with an unresolved violation for less than 60 days from the date of Handbook Letter 301 (3560). Projects A and C fit this category.

- Class D projects are in monetary default and are delinquent for more than 60 days, and projects that are in nonmonetary default and have an unresolved violation for more than 60 days from the date of Handbook Letter 301 (3560). We found two projects in this category in Texas; however, both projects had been sold. Instead, we selected project B because it had recently been rehabilitated and did not fit in any of the above categories.

During the period of our audit, the management company managed 73 RRH projects in Texas and Oklahoma with a combined total of 1,913 revenue-producing units, of which 1,471 of those received rental assistance. In all, the borrower received loans totaling \$48,191,908 and rental assistance totaling \$9,682,895, and the management company received management fees totaling \$2,994,152.

The state of the management company's records prevented us from locating some documents that may have affected the dollar impact for some of the findings (see Finding 1).

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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Exhibit A – Summary of Monetary Results

FINDING	RECOMMENDATION	DESCRIPTION	AMOUNT	CATEGORY
1	3	Overcharged Projects for Unjustified Expenses ³⁸	\$44,158	FTBPTBU ³⁹ – Management or Operating Improvement/Savings
2	9	Reserve Account for Project A – Missing Deposits	\$1,494	FTBPTBU – Management or Operating Improvement/Savings
2	10	Reserve Account for Projects A and D – Improper Withdrawals	\$2,291	FTBPTBU – Management or Operating Improvement/Savings
2	11	Reserve Account for Project D - Certificate of Deposit Not Properly Accounted For	\$35,430	FTBPTBU – Improper Accounting
Total			\$83,373	

³⁸ Includes \$4,692 for late fees, \$4,200 for a leased truck, and \$35,266 for inappropriate appliance prices.

³⁹ Funds To Be Put To Better Use.

Exhibit B – Pictures Showing Projects' Maintenance, Safety, and Health Issues

Exhibit B – Page 1 of 11



Project B – Health and Maintenance – Water damage (which will eventually cause mold) and broken hinges in cabinet under kitchen sink



Project B – Safety and Maintenance - Bedroom closet



Project B – Maintenance and Health - Mold growing around tub



Project B – Maintenance - Wall separating at corner



Project B – Safety and Maintenance - Ceiling fan wiring left exposed



Project C – Health and Maintenance - Roof in need of repair



Project C – Health and maintenance - Trash on grounds



Project C – Maintenance - Window, screen, and blinds all in need of repair



Project C – Maintenance - Screen door in need of repair



Project C – Safety - Cable wires running from door to dish



Project C – Safety - Open electrical wire box



Project C – Maintenance - Laundry room dirty with tiles missing on the floor



Project C – Health – Wet carpet in vacant unit will eventually cause mold



Project C – Health - Floor in vacant unit laundry room
(Note mold growing along baseboard, on wall, and on tile)



Project H – Safety - Electrical boxes with exposed wires and bird nests



Project H – Safety and Maintenance - Screen hanging from window frame in upstairs unit



Project H – Health, Safety, and Maintenance - Storage units rotting and coming apart



Project H – Safety - Wires hanging from boxes



Project H – Health, Safety, and Maintenance - Hole in outside wall with siding missing



Project H – Safety and Maintenance - Broken window



Project H – Safety - Wires hanging outside of building



Project H – Health, Safety, and Maintenance - Roof in need of repair



United States Department of Agriculture
Rural Development
Texas State Office

TO: Tim Milliken
Senior Audit Manager
Office of Inspector General (OIG)
Southwest Region – Audits
Temple, Texas

APR 16 2009

SUBJECT: 04099-211-Te – Request Audit of Oklahoma Rural Rental Housing Management Company

We have reviewed the official draft report. As requested, we are providing our comments and requests.

We are requesting that you change your recommendations from “require the management company to...” to “require the borrower to...” It will be difficult for the Agency to require the management company to provide, reimburse, correct, etc., since we have no authority over them. We do, however, have agreements with and requirements for the borrower.

Following are our planned corrective actions, which respond to each of your recommendations.

Recommendation #1: We intend to review the projects managed by [redacted] outside your sample to determine if similar problems exist. If additional problems are identified, we plan to initiate action to withdraw their management approval.

Recommendation #2: If additional problems are identified in our reviews of additional properties, we plan to initiate action to withdraw their management approval.

Recommendations #3 – 10: Agree

Recommendation #11: Please revise. We may find it difficult to obtain documentation to account for \$35,430 from project D’s reserve account between December 2004 and June 2006 if OIG was unable to obtain the documentation.

Recommendations 12 – 15: Agree

If you have any questions, please contact Donna Freytag, Management Control Officer, at 254-742-9704.


SCOOTER BROCKETTE
Acting State Director

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United States Department of Agriculture
Rural Development
 State Office
 Stillwater, Oklahoma

TO: Tim Milliken
 Senior Audit Manager
 Office of Inspector General (OIG)
 Southwest Region – Audits
 Temple, Texas

APR 16 2009

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Following are our planned corrective actions, which respond to each of your recommendations.

Recommendation #1: We intend to review projects managed by [] outside your sample to determine if similar problems exist. If additional problems are identified, we plan to take appropriate corrective action to remedy any problems identified in accordance with current regulations. Oklahoma proposes to review 15 to 20 properties.

Recommendations #2 – 10: Agree

Recommendation #11: Please revise. We may find it difficult to obtain documentation to account for \$35,430 from project D’s reserve account between December 2004 and June 2006 if OIG was unable to obtain the documentation.

Recommendations 12 – 15: Agree

If you have any questions, please contact Anita Kinyon, Acting State Director at 405-742-1000, Tommy Earls, RH Program Director at 405-742-1073, or J. Le Ann Sims, Oklahoma Management Control Officer, at 405-742-1012.


 ANITA S. KINYON
 Oklahoma Acting State Director

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