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Audit of a Rural Rental Housing Management Company Located in Indiana

Audit Report 04601-20-Ch
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AUDIT
NUMBER: 04601-20-Ch

TO: Tammye Trevino
Administrator
Rural Housing Service

ATTN: John Purcell
Director
Financial Management Division

FROM: Gil H. Harden /s/
Assistant Inspector General
for Audit

SUBJECT: Audit of a Rural Rental Housing Management Company Located in Indiana

This report presents the results of our audit of Apartment Complexes A and B, located in [], Indiana, which were participating in Rural Development's Rural Rental Housing Program. Your written response to the official draft report, dated April 22, 2011, is included in its entirety at the end of this report. Excerpts from the response and the Office of Inspector General's position are incorporated into the relevant sections of the report. Based on the information in your written response, we have reached management decision on all five recommendations. Please follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer.

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

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Audit of a Rural Rental Housing Management Company Located in Indiana

Executive Summary

This report presents the results of our audit of Apartment Complexes A and B, located in [], Indiana, which were participating in Rural Development's Rural Rental Housing (RRH) Program. The primary objective of our audit was to determine if the [] (the management company), had accurately reported the financial activities of Apartment Complexes A and B during calendar years 2005 through 2007. We also evaluated the management operations of the apartment complexes, which included the physical maintenance of the properties, and the management company's use of reserve account funds.

We initiated this audit as part of a nationwide examination of the RRH Program.¹ The objective of our nationwide audit is to evaluate the effectiveness of internal controls over the management operations of properties participating in the RRH Program. In accomplishing this objective, we focused our attention on two key internal control components: those designed to ensure that owners and management agents accurately reported costs charged to the operating accounts of apartment complexes and those designed to ensure that capital reserve accounts were funded and used in accordance with agency guidelines. We plan to issue a separate report for the nationwide audit which will address broader RRH Program matters.

Our audit of the two apartment complexes disclosed almost \$153,000 in unallowable charges made to the operating accounts for the period of our audit. This included over \$121,000 charged to the complexes by four companies that had an identity-of-interest² (related-party) relationship with the management company. The management company had not disclosed the use of the four companies to Rural Development officials and had not received their approval to use the companies, as required by Federal regulations.³ Further, the management company did not provide adequate evidence to corroborate that the charges were for allowable expenses incurred by the complexes. Statements made by some tenants, and our observations, contradicted statements made by management company officials and the services listed on invoices provided by the identity-of-interest companies to support charges reported to Rural Development. Thus, we concluded that the charges were unallowable and should be reimbursed by the owner to the operating accounts of the two apartment complexes.

The management company also did not have sufficient evidence to support the propriety of almost \$32,000 in other costs charged to the operating accounts of the complexes. For these charges, we were unable to determine what work was performed and by what company, or if the company that performed the work had an identity-of-interest relationship with the management company. The charges were not supported by invoices, receipts, or other evidence to verify that

¹ Audit Number 04601-0018-CH, Rural Rental Housing Program Project Cost and Inspection Procedures.

² 7 CFR 3560.11, dated January 1, 2005, and November 17, 2009, defines an identity-of-interest as a relationship between applicants, borrowers, grantees, management agents, or suppliers of materials or services.

³ 7 CFR 3560.102 (j) (1) (vi), dated January 1, 2005, and February 6, 2009, states that the owner and the management agent will not purchase goods and services from identity-of-interest companies until the relationship has been disclosed to, and approved by, the agency, and it has been determined that the costs are as low as or lower than arms-length, open-market transactions.

the work was for legitimate purposes. Management company officials did not provide us with evidence to support the charges.

We also identified problems with the reserve accounts for the two complexes.⁴ First, the management company had not funded the accounts as required by Federal regulations and the loan agreement. We determined that the accounts were underfunded by at least \$18,700 as of October 2009. Management company officials stated that there were insufficient funds in the operating accounts of the properties to fully fund the reserve accounts. In our view, there would have been sufficient resources in the operating accounts to fund the reserve accounts if the management company had not charged almost \$153,000 in unallowable costs to the properties. The second issue we had was that reserve funds had not been placed into a bank account that required the signature of an agency official before funds could be released from them. Agency officials agreed that the lack of agency signatory authority for the accounts was a serious issue and informed us that they had notified the management company of this deficiency on October 26, 2007. However, the management company had not added agency signatory authority to the accounts.

Agency officials were not aware of the unallowable charges because the required year-end audit engagements performed by an independent practitioner did not identify any problems, exceptions, or undisclosed identity-of-interest companies. The agency's key internal control to ensure the propriety of financial operations is the requirement for an independent audit engagement and an engagement using agreed-upon procedures. These engagements are to be performed by independent practitioners who are licensed certified public accountants who are required to adhere to the standards and principals of the American Institute of Certified Public Accountants' Code of Conduct and Bylaws, and applicable State Boards of Accountancy.

Finally, we visited both apartment complexes and observed conditions that warranted immediate attention to prevent further deterioration or where there was a threat to the safety of tenants. For instance, we observed at both apartment complexes that the exterior wood trim and siding needed to be painted or stained. In some areas, the wood siding had become severely worn and rotted. (See exhibit C, photograph numbers 1 through 6.) The damage appeared so extensive that all of the siding may need to be replaced for both buildings. The interiors of the buildings were generally dirty and had not been properly maintained by the management company. The entrance to one building was very dirty and had a large stain on the carpeting. (See exhibit C, photograph number 7.) These conditions were prevalent throughout the apartment complex. One tenant we interviewed informed us that her unit had not been painted and the carpeting had not been replaced in the 12 years she had resided in the complex.

The management company should have used the almost \$153,000 in unallowable costs it charged to the properties to repair the physical deterioration of the property and then to fully fund the reserve account balances. Any additional funds could have reduced rental rates for the tenants and rental assistance⁵ from the government. We initially met with agency officials in November

⁴ 7 CFR 3560.65, dated January 1, 2005, and May 4, 2010, states that to meet major capital expenses of a housing project, borrowers must establish and fund a reserve account. At a minimum, the borrower must agree to make monthly contributions to the reserve account at the rate of 1 percent annually of the amount of the total development cost until the reserve account equals 10 percent of the total development cost.

⁵ 7 CFR 3560.11, dated January 1, 2005, Rental Assistance: The portion of the approved shelter cost paid by the agency to compensate a borrower for the difference between the approved shelter cost and the tenant contribution

2009 to discuss our findings and recommendations, including removal of the management company from the RRH Program. Agency officials agreed with our findings and recommendations. Those officials stated that the management company had not been previously removed from the program because the owner did not support changing management of the properties. Thus, agency officials needed to use non-monetary default procedures to foreclose on the properties and change ownership and management. The foreclosure process, however, would have temporarily removed the property from the program and disqualified it for rental assistance, which would have increased rent payments for the tenants.

On December 14, 2009, agency officials notified us that they had required the ownership of the apartment complexes to terminate the management company. The owner of the apartment complexes terminated the management company on January 7, 2010. According to agency officials, on February 16, 2010, a new management company assumed responsibility for the apartment complexes.

Recommendations Summary

We recommended that Rural Development seek recovery of the \$152,970 in unallowable costs charged by the management company. We also recommended that Rural Development require a new management agent for the two complexes and refer the current management company and its principals to the Suspension and Debarment officials for possible action. In addition, we recommended that Rural Development require the owner of Apartment Complexes A and B to submit an acceptable work-out agreement to correct the physical deficiencies and to replenish the reserve accounts to required levels. If these requirements are not met, we recommended that the agency take foreclosure action and transfer ownership of the property.

Agency Response

In their response dated April 22, 2011, Rural Development officials generally agreed with our findings and recommendations. Their response acknowledges that while the owner is ultimately responsible, the management company performed the infractions and, therefore, will be issued a demand letter for repayment of the \$152,970. Rural Development has already taken action to replace the management company, and will submit both the company and its principals to the Suspension and Debarment official for consideration. They will also enter into a work-out agreement with the owner to correct the physical deficiencies and underfunded reserve accounts. We have incorporated applicable portions of their response, along with our position, after each recommendation. Rural Development's response is included in its entirety at the end of this report.

OIG Position

We agree with the agency's proposed corrective actions and have reached management decision on all five recommendations in the report.

when such contribution is less than the basic rent.

Background & Objectives

Background

The Rural Housing Service, an agency within the Rural Development mission area, is responsible for administering the Rural Rental Housing (RRH) Program. The agency administers the RRH Program through its national office in Washington, D.C., and through 47 Rural Development State and over 481 area and local offices. The RRH Program was established to provide affordable rental housing to low and moderate-income families, the elderly, and persons with disabilities. Rural Development provides financing to individuals, public agencies, cooperatives, and profit and non-profit organizations to construct and operate RRH apartment complexes. The Code of Federal Regulation (CFR) Title 7: Part 3560 provides guidance to owners and their management agents about the requirements for operating and maintaining RRH apartment complexes. Owners and management agents are responsible for complying with all applicable laws, regulations, and loan agreements of the RRH Program.

RRH apartment complex owners may hire management agents to operate their property. Those agents are responsible for complying with all applicable laws, regulations, and loan covenants of the RRH Program. Owners and management agents are required to report on the overall financial operations of RRH properties by submitting annual reports to the appropriate agency servicing office. The annual financial reports include: (1) Rural Development Form 3560-7, "Multiple Family Housing Project Budget," which reports income and expenses for the current year and estimates income and expenses for the upcoming year; (2) Rural Development Form 3560-10, "Multiple Family Housing Borrower Balance Sheet," which includes a project's balance sheet for the current and prior year; (3) an Agreed-Upon Procedures report (for projects with 16 or more units), which is to be completed by an independent practitioner who is a certified public accountant that is licensed by a State Board of Accountancy and includes tests used to verify owner and management agent compliance with applicable agency requirements; and (4) an independent audit of the financial statements (for projects with 24 or more units), which is to be completed by an independent practitioner in accordance with generally accepted government auditing standards.

The Rural Development Indiana State Office and its five area offices administer the RRH Program in Indiana. Nationwide, Rural Development has provided almost \$12 billion to finance about 16,500 apartment complexes participating in the RRH Program. A total of 555 RRH properties are located in the State of Indiana. There are 121 management companies that manage the 555 RRH apartment complexes in Indiana. In fiscal year 2008, Rural Development provided more than \$478 million in rental assistance to low and moderate income tenants nationwide through the RRH Program. This included more than \$9 million to properties located in Indiana. Rural Development requires owners and management companies to use these funds to reduce rent levels for low-income tenants.

Rural Development loaned \$412,000 to the [] in 1976 and 1977 to finance the construction of Apartment Complex A. In 1980, Rural Development loaned \$589,170 to the [] to construct Apartment Complex B. Effective January 2004, [] entered into

a contract with the [] (the management company), to manage Apartment Complexes A and B.

The Office of Inspector General (OIG) has performed numerous audits of the RRH Program.⁶ Those audits identified major internal control deficiencies within the RRH Program, which allowed management agents to inflate expenses, charge fictitious costs, and misappropriate reserve account funds. A common method for this abuse was through the use of related-party companies (termed identity-of-interest companies by agency officials). We have found that the misuse of funds, usually involving identity-of-interest companies⁷ used to divert project funds, oftentimes results in the physical deterioration of RRH apartment complexes and underfunded reserve accounts. The physical deterioration occurs because there are insufficient funds to properly maintain the structures. For instance, damage at properties is not repaired and the exterior of buildings is not painted.

Objective

The objective of our audit was to determine if the management agent accurately reported the financial activities of Apartment Complexes A and B to Rural Development. This included verification that (1) charges to the operating accounts were for legitimate expenses incurred for the apartment complexes; (2) transactions involving identity-of-interest relationships were completed and disclosed as required by Federal regulations; (3) reserve accounts were properly maintained and used in accordance with agency requirements; and (4) the physical condition of the properties was maintained in compliance with agency standards.

⁶ OIG audited 45 management companies in 1994 and 1999 and found that 31 of those management companies had misused funds. See OIG Audit Report 04600-47-CH, September 1994, and OIG Evaluation Report 04801-6-CH, March 1999.

⁷ 7 CFR 3560.11, dated January 1, 2005, and November 17, 2009, defines an identity-of-interest as a relationship between applicants, borrowers, grantees, management agents, or suppliers of materials or services.

Section 1: Misuse of Funds and Physical Deterioration of Apartment Complexes

Finding 1: Unallowable Charges Made to Operating Accounts

The management company charged almost \$153,000 in unallowable costs to the operating accounts of Apartment Complexes A and B during the years 2005 through 2007. Agency officials were not aware of the unallowable charges because the required year-end audit engagements that were performed by an independent practitioner did not identify any exceptions or undisclosed identity-of-interest companies. Consequently, there were insufficient funds to repair damage and maintain the properties in accordance with regulations established by Rural Development.

We questioned the validity of the charges and concluded that they were unallowable for two reasons. The primary reason was that the management company did not provide sufficient evidence to support the charges. We requested the general ledgers and accounting records, to include invoices, receipts, bank statements, and cancelled checks, that supported charges reported for the properties. The management company provided us with records that included general ledgers, cancelled checks, and invoices. The records were not organized and incomplete, and we were unable to reconcile the account balances listed in the ledgers to the documentation. Agency requirements state that owners must maintain records in a manner that can be audited by the agency, its agents, and independent practitioners.⁸

The second reason involved charges for services made by four companies that had undisclosed identity-of-interest relationships with the management company.⁹ Agency regulations state that the use of identity-of-interest companies be disclosed to, and approved by, Rural Development officials prior to providing services to properties participating in the RRH Program.¹⁰ The following sections describe our concerns regarding the unallowable charges.

Charges Made by Undisclosed Identity-of-Interest Companies

The majority of the maintenance services provided to the apartment complexes were from four companies. During past audits of other management companies, we found that they routinely used identity-of-interest companies to perform such services. At the onset of this audit, agency officials informed us that management company officials were approved to use one identity-of-interest company in 2005, but it was not one of the four companies listed on the invoices.

When we questioned management company officials about ownership of the four companies, they were initially vague and unclear about any relationship with them. However, we identified,

⁸ 7 CFR 3560.302 (e), dated January 1, 2005, and February 6, 2009.

⁹ 7 CFR 3560.11, dated January 1, 2005, and November 17, 2009, defines an identity-of-interest as a relationship between applicants, borrowers, grantees, management agents, or suppliers of materials or services.

¹⁰ 7 CFR 3560.102 (j) (1) (vi), dated January 1, 2005, and February 6, 2009, states that the owner and the management agent will not purchase goods and services from identity-of-interest companies until the relationship has been disclosed to, and approved by, the agency, and it has been determined that the costs are as low as or lower than arms-length, open-market transactions.

through a State of Indiana website, that the management agents were the principal owners of the companies.¹¹ After further inquiry, the management agents acknowledged that they had a personal and financial interest in the companies. They did not provide us with evidence of agency approval to use the identity-of-interest companies in performing maintenance and repairs at the apartment complexes. An agency official confirmed that the management company had not disclosed the use of the four companies. Therefore, we concluded that the management company had not disclosed the identity-of-interest companies as required by Federal regulations.¹²

The four undisclosed identify-of-interest companies charged \$121,402 (see exhibit B) to the accounts of the apartment complexes. The invoices for those charges did not adequately describe the work performed by the four companies. Thus, we asked management company officials for work orders, receipts, or time sheets to verify that charges were actually incurred and provided at a cost comparable to charges by an independent company. Management company officials stated that they could not provide such documentation because the work was general, such as cleaning hallways. However, the management company should have maintained time sheets and logs to document the type of work performed and the dates and times when it was completed. If they had maintained this type of documentation, we could have compared their charges to those of independent companies.

When we questioned management officials about the records to support the invoices, they were generally evasive, vague, or contradictory in their answers. For instance, one management official initially stated that there was no documentation to support the invoices in the records. However, he contradicted that statement later in the conversation when he said that if we showed him an invoice, he could tell us if there were supporting documents for it. When we questioned the owner of the management company at a later date about specific invoices, he stated that the individual who handled the records for that year was not available. Thus, he could not provide documents to support the invoices in question.

It is likely that some of the work claimed was not performed by the identity-of-interest companies. For example, invoices from two identity-of-interest companies included charges for snow removal from the walkways of the apartment complexes. However, during our interviews with tenants, none could remember seeing individuals associated with the management company shoveling the snow. Several tenants explained that they shoveled snow and spread salt themselves on the sidewalk leading to the parking lot. Further, the tenants said that snow was removed from the parking lot after snowstorms by a private company and not individuals associated with the management company. We determined the existence of the private companies based on information provided to us by the tenants and confirmed with an individual at one of the companies that it had actually removed snow at the complexes. We found one payment from the operating account to the private company in the amount of \$75. We also found another payment for snow removal to one of the identity-of-interest companies around the same date for \$200.

¹¹ Performed a search through The State of Indiana Business Entity Search at www.in.gov.

¹² 7 CFR 3560.102 (g), dated January 1, 2005, and February 6, 2009, states that owners and management agents must disclose to the agency all identity-of-interest relationships with firms and receive agency approval to use such firms prior to entering into any contractual relationships with such entities that involve agency funds.

Also, there were many invoices for cleaning and painting apartments and hallways. During our visits at the apartment complex, we observed that the hallways were dirty and had not appeared to have been painted in a long period of time. However, the identity-of-interest companies charged more than \$19,000 to the two complexes for these services. Based on interviews with tenants, and our observations (see Finding 2), we doubt that this much work was actually completed at the complexes. For instance, tenants told us that a woman not associated with the management company cleaned the hallways and common areas of the complexes. We interviewed this individual and she informed us that the management company paid her [] to clean the hallways and common areas at the apartment complex. She also stated that she was paid [] to clean vacated apartments. These amounts were significantly less than the actual charges made by the identity-of-interest companies, which were typically \$100 or more for similar tasks. The inflation of actual costs through the use of identity-of-interest companies is a common scheme identified during past audits of the RRH Program.¹³

The accounting records also indicated that work was routinely done during the period of our audit to clean the outside areas and to maintain the landscaping of the properties. However, we observed garbage scattered around the property and poor upkeep of the landscaping during our site visits. Even though our visits occurred outside the audit period, there was no reason to believe that the management company would discontinue charging such costs after doing so for the three prior years. Our conclusion was reinforced when several tenants stated that they had never seen any individuals performing landscaping services around the apartment complexes. The management company's failure to disclose the identity-of-interest companies hindered agency officials from properly monitoring the services provided to the complexes and ensuring that they were made in the best interest of the program and the tenants.

Unsupported Charges

The management company did not provide evidence to support \$31,568 in expenses charged to the complexes. (See exhibit B.) We considered the charges to be unallowable because there were no documents, such as invoices and receipts, that described the work performed and by what company. We were also unable to determine if the company had an identity-of-interest relationship with the management company.

The only documents supporting the charges were the cancelled checks. For instance, the management company wrote two \$1,300 checks to “[]” on March 7, 2005 (one check from the bank account of each apartment complex). There was no description for the charge in the accounting system and no supporting documents to justify the expense. The check itself did not identify the payee as it was endorsed as “for deposit only.” During our audit, we found that the owner of the management company owned another apartment complex in Indiana named []. However, management officials did not respond to our inquiries on whether “[]” on the checks stood for [].

Other examples included a \$340 charge for “Quality Reglazing,” a \$1,450 charge for a “Maintenance Contractor,” and a \$550 charge for “Services.” There was no contact information for the companies on the cancelled check or the general ledger. We attempted to track these

¹³ OIG Audit Report 04600-47-CH, September 1994, and OIG Evaluation Report 04801-6-CH, March 1999.

items down through internet sources and the phone book, but we were unable to contact anyone to verify the propriety of the charges. The management official who signed the checks could not remember the companies or provide contact information.

The agency's primary internal control to detect unallowable charges is an independent audit and an engagement based on agreed-upon procedures.¹⁴ The owners and management agents of apartment complexes participating in the RRH Program are responsible for obtaining these engagements. An independent practitioner performed the required year-end engagements for the years ended 2006 and 2007, for the two [] apartment complexes. However, no exceptions or deviations were reported with any of the transactions reviewed by the independent practitioner. In addition, the practitioner's reports state that no undisclosed identity-of-interest companies were uncovered during the course of their work. Based on the extent of the problems we found, we can conclude that the internal control was not an effective mechanism to identify, or alert the agency to the program abuse occurring at these apartment complexes.

Agency officials stated that they did not seek action to remove the management company from the program because the owner did not support it. To remove the owner and management company required the use of non-monetary default procedures¹⁵ to foreclose on the properties. The officials stated that this process would have temporarily removed the property from the program and disqualified rental subsidies, which would have increased rent payments for low-income and elderly tenants.

We met with agency officials in November 2009 to discuss the results of our audit. We discussed our conclusion that the management company had made unallowable charges to the operating accounts of the apartment complexes. We also discussed our plan to recommend the removal of the management company from managing properties in the RRH Program. The agency officials agreed with our findings and assessment of the management company's actions. Those actions, in our view, contributed to the physical deterioration we observed at the apartment complexes. (See Finding 2.) The management company's actions also depleted the operating funds available to meet reserve account requirements, which may not be sufficient to meet the future capital needs of the apartment complexes. (See Finding 3.) On December 14, 2009, agency officials notified us that they had required the ownership of the apartment complexes to terminate the management company, which was done on January 7, 2010. According to agency officials, on February 16, 2010, a new management company assumed responsibility for the apartment complexes.

Recommendation 1

Require the owner to reimburse the \$152,970 in unallowable expenses charged to the operating accounts of the apartment complexes during calendar years 2005 through 2007.

¹⁴ 7 CFR 3560.308 Annual Reports, dated January 1, 2005, and Rural Development Multi-Family Housing Asset Management Handbook; HB-2-3560; Chapter 1: Attachment 4-B, Annual Agreed-Upon Procedures Engagements, dated February 24, 2005, and October 5, 2007.

¹⁵ 7 CFR 3560.452 (c) Nonmonetary Defaults, dated January 1, 2005, and January 1, 2010. Rural Development Multi-Family Project Servicing Handbook; HB-3-3560; Chapter 10: Compliance Violations, Defaults, and Work-Out Agreements, Part 5, dated February 24, 2005.

Agency Response

Rural Development officials agreed with this recommendation and will pursue recovery of the \$152,970. However, the agency plans to try and recover the funds from [], and not the owner as we recommended. The agency stated that it was the management company that performed the infractions resulting in fraud due to nondisclosure of identity-of-interest companies and failure to properly maintain financial records. The agency will issue a demand letter to [] for \$152,970.

OIG Position

We accept management decision for this recommendation. However, in the event Rural Development is unsuccessful at collecting \$152,970 from the management company, we recommend that the owner be billed for the misappropriated funds.

Recommendation 2

Require the owner to obtain new management for Apartment Complexes A and B.

Agency Response

Rural Development officials agreed with this recommendation and submitted information illustrating that new management was obtained for the properties on February 16, 2010.

OIG Position

We accept management decision for this recommendation.

Recommendation 3

Refer the principals of the management company and the management company to the agency Suspension and Debarment Official for consideration of suspension and debarment action.

Agency Response

Rural Development officials agreed with this recommendation. After receipt of the final report, the agency will submit the principals of the management company, and the management company as a separate entity, to the RHS Administrator for a decision on suspension and debarment action.

OIG Position

We accept management decision for this recommendation.

Finding 2: Complexes had Physical Deterioration and Safety Hazards

The management company had neglected the physical condition of both apartment complexes. Federal regulations require owners and management agents to maintain RRH apartment complexes in a manner that provides decent, safe, and sanitary housing for tenants, and protects the Government's security value.¹⁶ Management company officials stated that they did not have sufficient funds to adequately maintain the physical condition of the properties. However, the management company charged almost \$153,000 in unallowable costs to the properties (see Finding 1.) Those funds would have been sufficient to repair damage and properly maintain the properties. The physical deterioration we observed threatens the safety of tenants and the Government's security interests in the apartment complexes.

We visited both apartment complexes and observed conditions at each that warranted immediate attention to prevent further deterioration or where there was a threat to the safety of tenants. A pervasive problem for both apartment complexes was the exterior wood trim and siding, which badly needed paint or stain. In some areas, the wood siding had become severely worn and rotted. (See exhibit C, photograph numbers 1 through 6.) We noted other exterior problems as well. For example, there were severe undulations and cracks in the concrete walkways, and large potholes in the parking lot. In our view, the undulating cracks in the walkways posed a serious safety concern for the elderly tenants residing in the complexes, especially those with disabilities.

The interior of the buildings was generally dirty and had not been properly maintained by the management company. The entrance to one building had a large stain on the carpeting and holes in the wall. (See exhibit C, photograph number 7.) This type of condition was prevalent throughout the apartment complex. One tenant we interviewed informed us that in the 12 years she has resided in the complex, her unit had never been painted and her carpeting had never been cleaned or replaced. The management company provided us with an unoccupied apartment unit to use as work space during our audit. That unit was similar to the unit occupied by the tenant we interviewed. The carpet was dirty and extremely worn. The walls were dirty and needed to be painted. Further, there was an unpleasant smell throughout the apartment and a broken window.

Another tenant informed us that she had personally installed a deadbolt lock on her door because the standard lock on the door could easily be opened with a credit card. She added that without the deadbolt lock, she felt vulnerable because intruders had already broken into her apartment. She stated that management company officials were unresponsive to her numerous requests to install a deadbolt lock on the door even though she provided them with a police report on the break-in. When we returned to the apartment provided as work space, we were able to unlock the door by sliding a credit card over the lock between the door frame and the door, just as the tenant had explained to us. We considered this to be a serious safety risk.

Rural Development field officials had inspected the apartment complexes each year from 2005 through 2009. We examined their inspection reports and determined that they had identified much of the physical deterioration and conditions that we observed during our visits.

¹⁶ 7 CFR 3560.103 (a)(i)(ii) Maintaining Housing Projects, dated January 1, 2005, and September 21, 2009.

For instance, we noted that agency officials had identified the worn exterior siding during their 2005 inspection. Their report, dated September 16, 2005, stated that “Wood siding on all buildings is deteriorating and needs to be replaced.” The report added that all deficiencies needed to be corrected by October 16, 2005. We examined the agency’s annual inspection reports for 2006 through 2009 and they all cited the deteriorated siding as an issue.

Federal regulations and agency guidance¹⁷ state that failure to adequately maintain the exterior physical condition of complexes in accordance with agency standards is considered a compliance violation. The regulations add that the agency must notify the owner and management agent that timely action is to be taken to correct violations. If corrective action is not taken by the owner or management agent, the agency will pursue further servicing actions up to requiring new management or foreclosure on the property. While agency officials did notify the management company of the physical deterioration, they did not enforce the rule and ensure compliance with Federal regulations. Agency officials stated that they did not enforce the requirement because formal action against the owner and management company would have resulted in the loss of rental assistance for the tenants. At the conclusion of our site visits to the apartment complexes, we met with agency officials to discuss our concerns and review photographs of the premises. The officials acknowledged the problems and agreed that corrective action, such as a workout agreement or new management of the property, was necessary.

Recommendation 4

Require the owner to submit a work-out agreement to correct the physical deficiencies present at the apartment complexes. The owner’s work-out agreement should include a plan to correct the deficiencies within an acceptable period of time. Agency officials should inspect the two properties at the end of the acceptable period of time and take foreclosure action and transfer ownership of the property if the conditions continue to exist.

Agency Response

Rural Development officials agreed with this recommendation. The agency will require the owner and its new management company to submit a work-out agreement to correct the physical deficiencies present at the properties within a 2-year period. The agency will closely monitor and inspect the properties during this timeframe. If at the end of the 2-year period the agency determines that sufficient progress has not been made, foreclosure actions will be considered.

OIG Position

We accept management decision for this recommendation.

¹⁷ 7 CFR 3560.452 (c)(2), dated January 1, 2005, and May 7, 2010, and Rural Development Multi-Family Housing Project Servicing Handbook; HB-3-3560; Chapter 10: Compliance Violations, Defaults, and Work-out Agreements, Parts 8, 10, and 15, dated February 24, 2005.

Finding 3: Reserve Accounts Were Underfunded and Not Properly Protected From Abuse

According to the agency's Multi-Family Housing Information System (MFIS), the reserve accounts for Apartment Complexes A and B were underfunded by at least \$18,700, as of October 2009. Also, the reserve funds had not been placed into bank accounts that required the signature of an agency official before funds could be released from them. Management company officials stated that there were insufficient funds in the operating accounts of the properties to fully fund the reserve accounts. However, the management company charged almost \$153,000 in unallowable costs to the properties (see Finding 1), which would have been a sufficient financial resource to fully fund the reserve accounts. Consequently, the reserve account funding level is likely inadequate to meet current and future capital expenditure needs, such as replacing external siding on the apartment complexes.

The loan agreement for Apartment Complex A stated that \$4,120 was to be deposited into a reserve account each year until the balance reached a sum of \$41,200. We reviewed the September 2007 bank statement for the reserve account, which showed the balance at \$11,331. Since that amount was below the required \$41,200, the management company should have deposited \$12,360 (\$4,120 times 3 years) to the reserve account for this property during the period of our audit. However, our examination of bank statements from 2005 through 2007 disclosed that the management company had deposited only \$800 into the reserve account, which was significantly less than the \$12,360 that should have been placed into the account. We also examined the agency's MFIS records as of October 2, 2009, to determine the reserve account balance for Apartment Complex A. The agency's records in MFIS indicated that the required balance should have been \$24,297, but the actual balance was only \$12,580. The underfunded difference was \$11,717. Our analysis of both the bank and agency records determined that the management company should have deposited more funds into the reserve account of the apartment complex.

For Apartment Complex B, the loan agreement stated that \$5,892 was to be deposited into a reserve account each year until the balance reached a sum of \$58,920. As with the Apartment Complex A, we found that the balance was below the required level at the time of our audit. Thus, the management company should have been depositing funds annually to the account. Our review of bank statements for the audit period disclosed that the management company had not deposited the required amount each year into the reserve account. We also examined the agency's MFIS records as of October 2, 2009, to determine the reserve account balance for the apartment complex. The agency's records in MFIS indicated that the required balance should have been \$58,903, but the actual balance was only \$51,907. The underfunded difference was \$6,996. Again, our analysis determined that the management company should have deposited more funds into the reserve account of the apartment complex.

Federal regulations¹⁸ require owners and management agents to establish and maintain a reserve account to meet the future capital expenditure needs of properties participating in the RRH Program. When the agency questioned management company officials about their lack of

¹⁸ 7 CFR 3560.306 (a) (c) Reserve Account, dated January 1, 2005, February 10, 2009, and 7 CFR 3560.65, dated May 4, 2010.

compliance with this provision, they stated that there were insufficient funds in the operating accounts of the properties to fully fund the reserve accounts. However, we dispute this claim after examining the accounting records for the operating accounts. As discussed in Finding 1, the management company charged almost \$153,000 in unallowable costs to the properties. The funds spent for unallowable costs, in our view, should have been deposited into the reserve accounts to be used for current and future capital expenditures of the apartment complexes.

Agency officials informed us they were aware that the reserve accounts were underfunded and that they had contacted the management company to discuss the issue. In a letter dated October 26, 2007, agency officials notified the management company that the reserve accounts for the apartment complexes were underfunded by more than \$14,300. The management company responded to the letter on December 3, 2007, but they did not properly fund the reserve accounts of the complexes as stated. Despite this fact, agency officials did not take action as directed by Federal regulation and agency guidance¹⁹ to enforce the reserve account requirement. Agency officials told us that they had not removed the management company from its responsibilities primarily because the action would have involved foreclosure action and termination of rental assistance to the complexes, which would have increased rent payments for the tenants.

We also found that since the management company became involved in the property in 2004, it had not placed reserve funds into a dual signature bank account. Federal regulations²⁰ state that accounts holding reserve funds are to be established with an agency countersignature requirement on all withdrawals. Agency officials implemented this procedure as an internal control to prevent owners and management agents from making unauthorized withdrawals from reserve accounts. Our examination of available bank statements during the audit found no evidence that unauthorized withdrawals had been made from the accounts. However, agency officials agreed that this was a serious issue. They had also identified the problem and required the management company in a letter dated October 26, 2007, to comply with this agency requirement. In July 2009, agency officials successfully obtained countersignature authority for two of four bank accounts that held reserve funds for the two complexes. In March 2010, subsequent to the removal of the management company, the agency was able to account for all reserve funds. As a result, we are not recommending a corrective action to resolve this issue.

Recommendation 5

Require the owner to fund the reserve accounts to the required balance. If the accounts are not funded to the required balance, take foreclosure action and transfer ownership of the property.

¹⁹ 7 CFR 3560.461, dated January 1, 2005, and May 7, 2010, and Rural Development Multi-Family Housing Project Servicing Handbook; HB-3-3560; Chapter 10: Compliance Violations, Defaults, and Work-out Agreements, Parts 8, 10, and 15, dated February 24, 2005.

²⁰ 7 CFR 3560.306 (e) (2) Reserve Account, dated January 1, 2005, and February 10, 2009.

Agency Response

Rural Development officials agreed with this recommendation. The agency will require the owner and its new management company to submit, as a part of their work-out agreement, plans to bring the reserve accounts current within a 2-year period. The agency will closely monitor the reserve accounts during this timeframe. If at the end of the 2-year period the agency determines that the reserve accounts are still delinquent, the area office will request a change in ownership or take foreclosure actions to liquidate the account.

OIG Position

We accept management decision for this recommendation.

Scope and Methodology

We audited the operating and reserve accounts, as well as the management operations, of Apartment Complexes A and B located in [], Indiana. The apartment complexes were participating in Rural Development's Rural Rental Housing (RRH) Program, and were managed by []. Apartment Complexes A and B consisted of 24 and 22 units, respectively, and were occupied by elderly and family tenants.

Our audit included the period of calendar years 2005 through 2007. However, in determining the actual financial conditions of the complexes, we examined records and other documentary evidence through the date of our fieldwork, October 2009, for the operating and reserve accounts. We performed fieldwork at the Rural Development area office located in Muncie, Indiana, and at the management company's office located in [], Indiana. We judgmentally selected the management company for audit based on its location, small size, and concerns brought to our attention by agency officials.

To accomplish our objectives, we assessed the RRH Program's policies and procedures, and discussed them with agency officials. We reviewed supporting documentation for charges made to the operating accounts of the apartment complexes and reported to Rural Development on Forms 3560-7, Multiple Family Housing Project Budget. That documentation included general ledgers, bank statements, and other financial documentation. The information reported on Forms 3560-7 and for reserve accounts is maintained in the agency's Multi-Family Housing Information System. We did not verify the accuracy of information contained in that system and make no representation of the adequacy of the system or the information generated from it. While on-site, we interviewed management company officials and tenants, and observed the physical condition of the apartment complexes.

We performed our audit fieldwork from February through October 2009. This audit had to be postponed after October 2009 in order to perform higher priority audits related to the American Recovery and Reinvestment Act. 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 objectives.

Abbreviations

CFR	Code of Federal Regulation
MFIS	Multi-Family Housing Information System
OIG	Office of Inspector General
RRH	Rural Rental Housing

Exhibit A - Summary of Monetary Results

Finding Number	Description	Amount	Category
1	Unallowable Operating and Maintenance Costs	\$152,970	Questioned Costs Recovery Recommended
TOTAL		\$152,970	

The table above summarizes monetary results by finding, and includes a description, dollar amount, and the category of questioned costs. The table illustrates Finding 1 has \$152,970 in monetary results for unallowable operating and maintenance costs which are categorized as questioned costs with recovery recommended.

Exhibit B - Unallowable Expenses Charged to Apartment Complexes

Charges Made by Undisclosed Identity of Interest Companies that could not be Substantiated

Year	Apartment Complex A	Apartment Complex B	Total
2005	\$31,738	\$32,329	\$64,067
2006	\$13,735	\$12,600	\$26,335
2007	\$13,400	\$17,600	\$31,000
Total	\$58,873	\$62,529	\$121,402

The table above presents total charges made by undisclosed identity-of-interest companies to Apartment Complexes A and B for calendar years 2005, 2006, and 2007. The total amount of undisclosed identity-of-interest charges to Apartment Complex A is \$58,873. The total amount of undisclosed identity-of-interest charges to Apartment Complex B is \$62,529. The overall total of charges made by undisclosed identity-of-interest companies to Apartment Complexes A and B for calendar years 2005, 2006, and 2007, is \$121,402.

Charges Made by Unknown/Unaffiliated Companies that could not be Substantiated

Year	Apartment Complex A	Apartment Complex B	Total
2005	\$1,605	\$2,911	\$4,516
2006	\$7,029	\$15,438	\$22,467
2007	\$1,988	\$2,597	\$4,585
Total	\$10,622	\$20,946	\$31,568

The table above presents total charges made by unknown or unaffiliated companies to Apartment Complexes A and B for calendar years 2005, 2006, and 2007 that could not be substantiated. The total amount of unsubstantiated charges to Apartment Complex A is \$10,622. The total amount of unsubstantiated charges to Apartment Complex B is \$20,946. The overall total of unsubstantiated charges made by unknown or unaffiliated companies to Apartment Complexes A and B for calendar years 2005, 2006, and 2007, is \$31,568.

Exhibit C - Photographs of Physical Deterioration

Photograph numbers 1 and 2



Photographs 1 and 2 above show deterioration of exterior wood siding, with holes and moisture issues.

Photograph numbers 3 and 4



Photographs 3 and 4 above show holes, cracks, and rotted areas of exterior siding.

Exhibit C – Photographs of Physical Deterioration

Photograph numbers 5 and 6



Photographs 5 and 6 above show rotted siding and peeling paint.

Photograph number 7



Photograph 7 above show stained carpet in hallways.

USDA'S

RURAL HOUSING SERVICE

RESPONSE TO AUDIT REPORT



**United States Department of Agriculture
Rural Development**

April 22, 2011

SUBJECT: Rural Rental Housing Program – []
(Audit No. 04601-020-CH)

TO: Gil Harden
Assistant Inspector general
for Audit

Attached for your review is the Rural Housing Service's response dated April 21, 2011, to the official draft for the subject audit.

This response is being submitted for inclusion in the final report and your consideration to reach management decision on the recommendations.

If you have any questions, please contact Arlene Pitter Bell of my staff on (202)-692-0083.

/S/ John M. Purcell

JOHN M. PURCELL
Director
Financial Management Division

Attachment

1400 Independence Ave, SW • Washington, DC 20250-0700
Web: <http://www.rurdev.usda.gov>

Committed to the future of rural communities.

"USDA is an equal opportunity provider, employer and lender."
To file a complaint of discrimination write USDA, Director, Office of Civil Rights, 1400 Independence Avenue, S.W.,
Washington, DC 20250-9410 or call (800) 795-3272 (voice) or (202) 720-6382 (TDD).



**United States Department of Agriculture
Rural Development**

April 22, 2011

TO: John Purcell
Director
Financial Management Division

FROM: Bryan Hooper /S/ Bryan Hooper
Deputy Administrator
Multi-Family Housing Programs

SUBJECT: Rural Rental Housing Program –
[]
(Audit No. 04601-0020-Ch)

This memorandum is in response to the above-referenced official draft report.

Recommendation No. 1

Require the owner to reimburse the \$152,970.00 in unallowable expenses charges to the operating accounts of the apartment complexes during calendar years 2005 through 2007.

Agency Response

While it is the owner's responsibility to provide acceptable management for Rural Rental Housing properties and the owner is the one ultimately responsible to the Agency, the owner did not benefit from management's actions. It is clear that management took advantage of the owner's age and ill health. We recommend that the management company and its principals repay the \$152,970.00. It was management that performed the infractions resulting in fraud due to nondisclosure of identity of interest companies and failure to properly maintain financial records.

The Agency will submit a demand letter to the management company for repayment of the amount.

Timeframe: Estimated completion: September 30, 2011.

Recommendation No. 2

Require the owner to obtain new management for Apartment Complexes A and B.

Agency Response

New Management was obtained February 16, 2010, and we have enclosed screen shots from the Multifamily Information Systems (MFIS) database, which indicates the two properties in question are now managed by [].

Recommendation No. 3

Refer the principals of the management company and the management company to the Agency Suspension and Debarment Official for consideration of suspension and debarment action.

Agency Response

We concur with Recommendation 3. This action will take place after receipt of the final report.

The Agency will submit the principals of the management company, and the management company as a separate entity, to the RHS Administrator for a decision on suspension and debarment action.

Timeframe: Estimated date: September 30, 2011.

Recommendation No. 4

Require the owner to submit a work-out agreement to correct the physical deficiencies present at the apartment complexes. The owner's work-out agreement should include a plan to correct the deficiencies within acceptable period of time. Agency officials should inspect the two properties at the end of the acceptable period of time and take foreclosure action and transfer ownership of the property if the conditions continue to exist.

Agency Response

We agree that a work-out agreement should be submitted by the owner and its new management to correct the physical deficiencies present at the apartment complexes within an acceptable period of time. We suggest a reasonable and acceptable period of time to be within two (2) years, with Agency inspections of the property each year monitoring progress. At the end of the 2-year period, the Agency will evaluate the condition of the property and determine if foreclosure is warranted based on the progress made during the time period.

The Agency will submit an acceptable work-out plan submitted by the owner and agreed to by the Agency.

Timeframe: Estimated completion: December 31, 2011.

Recommendation No. 5

Require the owner to fund the reserve accounts to the required balance. If the accounts are not funded to the required balance, take foreclosure action and transfer ownership of the property.

Agency Response

We agree that the Reserve Accounts should be brought current and that it is the responsibility of the owner(s) to do so. As with Recommendation 4, the Agency suggests that the delinquent Reserve Accounts be included in the recommended "work-out agreement" and given the same time frame (2 years) to bring the accounts current. If the Reserve Accounts are still delinquent after this 2 year period, the Area Office will request ownership change of the properties and/or take foreclosure action to liquidate the accounts.

The Agency will provide a copy of the accepted work-out plan submitted by the owner and agreed to by the Agency.

Timeframe: Estimated completion: December 31, 2011.

If you have any questions regarding this, please contact Stephanie White at (202) 720-1615 or Janet Stouder at (202) 720-9728.

attachments