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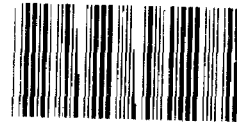
**Report To The Honorable William Proxmire
United States Senate**

**Improving Controls Over Rent And
Management Fees At Multifamily
Housing Projects**

The Department of Housing and Urban Development (HUD) is responsible for reviewing and approving rent and management fees at about 16,000 multifamily housing projects. GAO reviewed the criteria and procedures for approving rent increases and management fees at three field offices and found that inadequate controls have resulted in excessive rents, higher management fees, and possible overpayment of HUD subsidies at some projects.

HUD is in the process of developing procedures to strengthen its rent and management fee control processes. GAO recommends that these procedures include

- further guidance on the analysis and documentation required before processing rent increase requests,
- a uniform method for approving management fees, and
- guidelines setting forth supervisory responsibilities



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GAO/RCED-84-118
APRIL 11, 1984

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RESOURCES, COMMUNITY,
AND ECONOMIC DEVELOPMENT
DIVISION

B-214786


The Honorable William Proxmire
United States Senate

Dear Senator Proxmire:

As requested in your April 26, 1983, letter, this report discusses our evaluation of the Department of Housing and Urban Development's procedures for controlling rents and management fees at multifamily projects. While we observed a need for improvements, the Department is in the process of making procedural revisions which, if implemented with our recommendations, should strengthen controls.

As agreed with your office, copies of this report are also being sent to the appropriate House and Senate committees; the Secretary of Housing and Urban Development; the Director, Office of Management and Budget; and other interested parties.

Sincerely yours,


J. Dexter Peach
Director

D I G E S T

The Department of Housing and Urban Development (HUD) has oversight responsibility for approximately 16,000 multifamily projects consisting of 1.8 million housing units constructed through a variety of housing programs. These programs support housing projects through rent subsidies, interest subsidies, and mortgage insurance commitments. The programs and projects are administered and monitored by 10 regional offices and other field offices. As part of its oversight role, HUD reviews and approves rent and management fee increases. (Management fees are the compensation owners pay to agents for overseeing and supervising projects.) In approving rents, HUD assesses each project's expenses to determine whether a proposed increase is reasonable and to assure that federal rent subsidies are minimized. Since management fees are a direct expense of a project and affect tenant rents and HUD subsidies, they are also subject to HUD's review and approval.

At the request of Senator William Proxmire, GAO reviewed HUD's processes for approving rents and management fees at HUD multifamily housing projects. GAO visited three HUD field offices which had responsibility for 2,200 projects and found that inadequate controls are resulting in excessive rents, higher management fees, and possible overpayment of HUD subsidies at some projects. HUD recognizes many of the control problems and is in the process of developing procedures to address them.

STRENGTHENING RENT
REVIEW AND APPROVAL

The primary method for controlling rents is through field offices' analyses of data submitted by owners to justify the need for rent increases. GAO found that the three HUD field offices processed and/or approved rent increases without receiving full supporting

documentation. While the absence of adequate supporting documentation does not mean that rents were excessive, it raises questions about how well HUD is carrying out its oversight responsibilities for ensuring that rents and associated government subsidies are maintained at reasonable levels. GAO reviewed 46 of 838 rent increase proposals at three field offices and found that 36 had incomplete information. In 24 of these cases, the documentation and/or analysis was insufficient to support approximately \$761,000 of the \$1,149,129 in projected increases in operating expenses. (See p. 8.)

Additionally, GAO found that approved rents were overstated by about \$510,000 at 17 of the 46 projects. As a result, HUD may pay about \$149,000 in excessive rent subsidies at seven of these projects in the year immediately following the rent increase.

Included in the \$510,000 is \$256,000 in capital improvements, \$31,000 in commercial income, \$17,000 in expenses associated with providing rent-free apartments to on-site management personnel, and \$206,000 in calculation errors. Capital improvements and commercial income were overstated because HUD field staff did not follow existing procedures. Current HUD instructions, however, are not clear concerning how the value of rent-free units are to be handled. Consequently, GAO relied on interpretations of HUD headquarters and field office officials in computing this portion of excessive rents. Finally, the calculation errors were generally attributable to mathematical mistakes. (See p. 10.)

GAO also found no evidence in 29 cases that supervisors reviewed the work of loan servicers who processed rent increases. The Federal Manager's Financial Integrity Act of 1982 requires renewed focus on the need to strengthen internal controls. Supervision is an important internal control and, with regard to the rent review process, helps to assure that loan servicers are following procedures and are not allowing excessive rents. (See p. 12.)

As of January 1984, HUD was in the process of developing new procedures for reviewing and approving rent requests. These procedures are a positive step and, if implemented, should

resolve the problems GAO identified if they (1) include additional guidance on the documentation needed to process rent increase requests and a requirement that field offices obtain this documentation, (2) describe how rent-free units are to be considered in calculating rents, and (3) include procedures setting forth supervisory responsibilities for assuring that rents are reasonable. (See p. 17.)

STRENGTHENING CONTROLS
OVER MANAGEMENT FEES

HUD field offices review and approve management fees paid to agents at properties receiving HUD assistance. At each of the three field offices GAO visited, management fees were being approved using different criteria and the rationale for arriving at specific fees was not always documented or explained in project files. Because HUD does not have specific criteria or guidelines for establishing the level of management fees, GAO cannot say whether the established fees were reasonable. (See p. 13.)

GAO also found that the three field offices were not adequately comparing the payment of management fees with those approved. In 28 of 60 projects reviewed, GAO noted that management fees exceeded the amounts approved by approximately \$220,000. Since management fees directly affect rents and subsidies, it is important to assure that the fees paid correspond to the rates approved. Strengthening supervisory oversight will increase HUD's system of internal control, thereby minimizing errors in approval and payment of management fees. (See p. 15.)

As of January 1984, HUD was in the process of developing new procedures aimed at providing a uniform and documented approach for establishing management fees. HUD plans to include in the new procedures a requirement that field office supervisors review a sample of management fee approvals to ensure compliance with the proposed instructions and to ensure that the fees paid correspond to the rates approved. HUD also plans to clarify what sources of a project's income are allowed in calculating the basis for the payment of management fees. GAO believes that if HUD

implements these new procedures, the problems cited in this report should be resolved. (See p. 17.)

OTHER HUD ORGANIZATIONAL PROBLEMS
MAY AFFECT FIELD OFFICES

Historically, HUD has experienced broad organizational and operational problems that have adversely affected field offices' abilities to administer oversight responsibilities. A number of studies performed by GAO and internal HUD groups have indicated that HUD has had to deal with staffing and workload imbalances, skill shortages, and training inadequacies. At each of the three field offices, HUD officials cited one or more of these problems as obstacles in their operations. GAO recognizes that it may not be possible to demonstrate a direct correlation between the findings of these prior studies and the comments of HUD officials and the effectiveness of HUD controls over rents and management fees. Such comments, however, reenforce observations documented in prior reports and should not be overlooked when considering the long-term success of loan management activities, including the review and approval of rents and management fees. (See p. 18.)

RECOMMENDATIONS TO THE
SECRETARY OF HUD

GAO recognizes that the success of loan management activities is influenced by many factors, including broad organizational and operational problems as well as specific procedural problems. In this report GAO is recommending that the Secretary of HUD finalize and implement new procedures for improving controls over rents and management fees. These procedures should include

- developing more specific guidelines on the documentation required and the analysis needed for field offices to review and approve rent increases,
- clarifying guidelines pertaining to the treatment of rent-free units in evaluating rent increase requests,
- establishing a uniform method for approving management fees,

--clarifying what types of project income are permitted in calculating the basis for the payment of management fees, and

--developing guidelines for supervisory controls over the rent and management fee processes.

AGENCY COMMENTS AND
GAO'S EVALUATION

HUD agreed with all but one of GAO's recommendations and is in the process of implementing them. HUD did not agree with a proposal GAO made in its draft to establish a systematic method for monitoring the payment of management fees to better assure that fees do not exceed approved levels. HUD attributed the overpayment of management fees primarily to the lack of supervision, staff shortages, and unclear guidance on what income items should be included when computing the basis for payment of the management fee rather than to the absence of a systematic method for monitoring. After further analysis of this issue, GAO agrees with HUD's comments. Accordingly, GAO now recommends that in addition to improved supervision over the payment of fees, HUD clarify what types of project income are permitted when calculating the basis for payment of management fees. (See p. 20.)

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<u>ABBREVIATIONS</u>	
GAO	General Accounting Office
HUD	Department of Housing and Urban Development

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CHAPTER 1

INTRODUCTION

On April 26, 1983, Senator William Proxmire requested that we review the Department of Housing and Urban Development's (HUD's) procedures and criteria for approving rent and management agent fee increases at HUD multifamily housing projects. The request was prompted by a 1982 review by the HUD Inspector General indicating that the San Francisco field office was not following procedures and, as a result, was approving excessive rents and management fees.

HUD's ROLE IN APPROVING RENTS AND MANAGEMENT FEES

One of HUD's missions is to provide safe, decent, and sanitary housing for low- and moderate-income families. The Department has oversight responsibility for approximately 16,000 multifamily projects consisting of about 1.8 million housing units constructed through an assortment of programs. These programs support housing projects through rent subsidies, interest subsidies, and mortgage insurance commitments. The programs and projects are administered and monitored by the Office of Multifamily Housing Management, 10 regional offices, and other field offices located throughout the country.

HUD's oversight of multifamily projects consists of a wide range of activities, including evaluating project management, monitoring the financial and physical condition of each project, advising property owners on program matters, and ensuring that programs are operated in accordance with HUD regulations. As part of its oversight role, HUD reviews and approves rent and management agent fee increases with the objective of keeping these costs at reasonable levels, thereby assuring that federal subsidies are minimized. During fiscal year 1983, federal subsidies for rents exceeded \$5 billion.

Field offices have a cadre of staff within the Loan Management Branch, including supervisors, technical support specialists, and loan servicers. Loan servicers and their immediate supervisors are the front line individuals who carry out specific oversight functions, including reviewing rent increase requests and management fee proposals for an assigned caseload of housing projects.

How HUD controls rents

Property owners are responsible for initiating rent increase proposals when they believe increases in operating costs justify doing so. HUD has two primary methods for reviewing and approving these proposals--the project-by-project method and the automatic adjustment factor method. The project method entails a detailed

HUD assessment of each project's expenditures and the documentation and rationale submitted by property owners to support the proposed rent increase. After receiving a rent proposal, loan servicers have 30 days to decide whether to approve the requested rent increase or to modify or deny the request.

For the automatic adjustment factor method, loan servicers apply an inflation factor to the prior year's rent level. These inflation factors are directly connected to increases in the costs of rental housing in 34 standard metropolitan statistical areas. The method is used at projects receiving direct rental assistance under Section 8 of the Housing and Community Development Act of 1974 (Public Law 93-383). The major difference in this method and the project-by-project method is that loan servicers do not perform a detailed analysis of the operating costs at each project.

How HUD controls management fees

A management fee is the amount of compensation paid to a management agent or company to directly oversee and supervise the project. This compensation is usually based on a fixed percentage of the gross income realized at the project. The percentage is negotiated between the owner and agent. Management fees are an expense that directly affects tenant rents; therefore, they are subject to HUD's review and approval. The owner selects the agent, but HUD, in its oversight role, has developed standards and expectations for hiring quality management. The agent is accountable for assuring that the project (1) has qualified on-site staff, (2) has a system of fiscal controls, (3) has proper procedures for determining tenant eligibility, and (4) is operated in conformance with program regulations.

The fee paid varies between HUD projects and usually depends on the amount and type of work required of the agent and on local market conditions and rates. HUD projects with physical problems, rent subsidy programs, and large numbers of units usually justify a higher fee because of added administrative requirements. Loan servicers review the reasonableness of fee structures and monitor each agent's performance through on-site project inspections. Since management fees directly affect rents and subsidies, monitoring is important to assure that fees paid correspond to the rates approved.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our review objectives were to

- determine if HUD is following its criteria and procedures for regulating rent and management fee increases at multi-family properties,

- assess the status of recent HUD actions to change and improve rent and management fee control procedures, and
- identify organizational issues and problems that are affecting HUD's ability to effect control over rent and management fees.

We conducted our work at HUD headquarters and field offices in Dallas, Texas; Chicago, Illinois; and San Francisco, California. The Dallas and Chicago field offices were selected because of the large number of multifamily housing projects in their regions. Senator Proxmire specifically asked that we review activities in the San Francisco field office. Collectively, these field offices administer approximately 2,200 multifamily projects with approximately 292,000 rental units.

We selected 46 of 838 rent increase requests processed at the three field offices between July 1, 1982, and June 30, 1983, to evaluate whether HUD is following its criteria and procedures for regulating rents. Our selections for reviewing these rent increases were done both randomly and judgmentally. We paralleled the work of the HUD Inspector General by concentrating our review on those requests processed under the project-by-project method of rent control. Our findings cannot be projected nationwide or at the three field offices. We used Department procedures and guidelines to review the adequacy of documentation in support of each request. These documents included each project's financial statements, basis for projected cost increases, and field office analyses of the requests. We also discussed the basis and rationale for decisions on rent increase requests with loan servicers and their supervisors.

We followed a similar approach in assessing the adequacy of the Department's control over management fees. We judgmentally selected 35 recent cases where field offices approved increases in management fees and reviewed the adequacy of the documentation used in support of fee increases. We also discussed the reasonableness of management fees with Department field office officials responsible for evaluating and approving management fee requests. We supplemented the above 35 cases with 25 additional projects to evaluate HUD's method of monitoring management fees once approved. At each project, we compared fees actually paid with those approved by HUD to determine whether they were consistent.

We reviewed proposed changes to Department regulations governing controls over rent and management fees. We reviewed these changes to assess their likely impact on problems that we observed with the Department's control over rent and management fees. We discussed our observations and the proposed changes with officials at the three field offices and at HUD headquarters, including the Director, Office of Multifamily Housing Management.

We reviewed a number of past GAO and HUD studies concerning HUD's organization and operation. These studies were reviewed to determine whether problems associated with the control of rent and management fees were extensions of broader organizational issues and concerns.

We made our review in accordance with generally accepted government auditing standards. Our field work was conducted between July and September 1983.

CHAPTER 2

STRENGTHENING CONTROLS OVER

RENTS AND MANAGEMENT FEES

HUD field offices have processed requests for rent increases without obtaining required information from project owners and without adequately analyzing the expense projections used to support these increases. Also, field offices have approved excessive rents at a number of projects on the basis of incorrect treatment of expense items and calculation errors. This may result in HUD's rental subsidies going up at some projects during the year following the rent increases.

HUD also needs to clarify its procedures used in evaluating and approving management fees. Vague procedures have led to inconsistencies in field office approval of management fees; also, the rationale for fee increases is often not documented. Further, because field offices have not adequately monitored the payment of fees, management agents have received fees that were higher than HUD originally approved.

As of January 1984, HUD was in the process of revising its procedures to improve controls over rent and management fees. These changes could offer HUD an opportunity to more effectively monitor and control rent and management fees if they include

- further guidance on the documentation required and the type of analysis loan servicers should perform in evaluating rent increase requests,
- guidelines describing how rent-free units provided to resident managers are to be treated in calculating allowable rents,
- a uniform method for approving management fees,
- clarification of what types of project income are permitted in calculating the basis for the payment of management fees, and
- procedures setting forth supervisory responsibilities for assuring that rents and management fees are reasonable.

IMPROVING THE RENT CONTROL PROCESS

The primary means of controlling rents at properties receiving HUD assistance is through field office analysis of data submitted by owners or their representatives to justify the need for rent increases. However, our review of 46 projects at three field offices showed that:

- Thirty-six project owners did not submit the required information when applying for rent increases.
- Field offices approved rent increases at 24 projects without adequately documenting about \$761,000 in expenses used to support these increases.
- Field offices approved approximately \$510,000 in excessive rents at 17 projects because of incorrect treatment of expense items and calculation errors. Since HUD provides rental assistance at seven of these projects, these overstated rents may result in increased HUD subsidies of about \$149,000 during the year following the rent increases.
- Supervisors did not provide adequate oversight in 29 rent increase decisions.

Owners are not submitting required information

Project owners are not submitting required and current documentation in support of requests for rent increases. Of the 46 rent requests processed at the three field offices we visited, 36 had incomplete documentation contained in project files. Of these 36 rent requests, the field offices subsequently approved 33.

HUD's guidance to field offices states that rent increases should be allowed where increases in operating expenses can be readily foreseen and determined with reasonable accuracy. This guidance is contained in HUD handbook 4350.1, Insured Project Servicing Handbook, which explains that requests for rent increases must be supported by a complete submission by the owner and will be subject to careful examination. Such submissions are to include

- a current financial statement covering a period of at least 1 year and
- a formal written statement describing (1) the basis for the request and justification for any unusual items of expense and (2) the general condition of the property, including existing and proposed gross rental income.

HUD headquarters, to ensure that the most current information is available, has advised its field offices to obtain interim financial statements for each property if the time between the last annual financial statement and date of the rent increase request exceeds 4 months.

We found that loan servicers often did not obtain the above information when processing rent requests.

Number of Rent Applications Which
Did Not Contain
Information Required by HUD

<u>Information</u>	<u>Rent applications</u>	<u>Applications not containing required information</u>	
		<u>Number</u>	<u>Percent</u>
Current financial statements	46	20	43
Basis for rent increase/ description of property's condition	46	36	78

Current financial statements are important tools in updating the overall status of a project because a project's financial condition can change even over short periods of time. Accordingly, HUD believes that loan servicers should have the most current information available to analyze trends in operating costs and make judgments regarding the reasonableness of any projected increases. We found that in 20 of the 46 requests, loan servicers did not obtain current financial information. In 6 of 11 cases reviewed at the San Francisco field office, loan servicers relied primarily on cost projections submitted by property owners rather than on updated financial statements. At the Dallas field office, servicers did not obtain updated statements in 5 of 20 cases reviewed, and in the Chicago field office, updates were absent in 9 of the 15 cases. The age of the data in the 20 cases where servicers did not receive current financial statements ranged from 5 to 19 months.

Owners also frequently requested rent increases without describing the overall basis for their proposals or including a statement about the current condition of the property. As shown above, this condition occurred in 36 of the 46 rent requests we reviewed. The purpose of this information is to provide the loan servicer with additional insight for evaluating the reasonableness of a proposed rent increase. The owners are asked to explain any unusual increases in expenses and bring to HUD's attention any changes in the physical condition of the property since the last rent increase was approved. We found that owners have requested and received rent increases without explaining the basis for their requests. For example, in two cases, San Francisco and Dallas, owners asked for and received HUD's approval to raise rents by 43 and 14 percent, respectively, but did not justify the increase or describe the property's condition.

HUD loan management supervisory officials at the three field offices said that each loan servicer should determine whether the information submitted by property owners is adequate. These officials added that loan servicers are generally familiar with their project caseloads and, therefore, documentation is not always

needed. In addition, these officials also pointed out that since rent increases are an integral factor in maintaining a project's financial stability, field offices often give rent increase requests quick approval even if full documentation is not provided.

Documented evidence contributes to a system of internal control and facilitates continuity in the field office's knowledge about each project. For example, in San Francisco loan servicers have up to 50 to 60 projects in their caseloads and are rotated between these caseloads every 12 months. In this regard, transition is enhanced when new loan servicers have complete documentation of past rent increase decisions. Such documentation provides a historical basis for evaluating the reasonableness of subsequent rent increase requests.

Loan servicers are not documenting the basis used to approve or disapprove rent increases

Loan servicers in 24 of the 46 projects selected did not document their rationale for approving or disapproving rent increases. HUD field office instructions state that rent increases should be granted to compensate for "demonstrated increases in operating expenses and taxes." This has generally been interpreted by headquarters and field offices to mean that unless costs can be readily predicted and documented, rents should not be increased. At the 24 projects in question, approximately \$761,000 of \$1,149,129 in projected increases in expenses was inadequately supported. In all 24 cases, rent increases were eventually approved by the field offices. Examples of the types of expenditures that were not adequately documented include property taxes, maintenance expenditures, utility charges, service contract costs, miscellaneous expenses, and administrative expenditures (equipment, office supplies, etc.). The table below shows some of the more significant undocumented increases in operating costs for 7 of the 24 projects.

Significant Increases in Expenditures
Not Documented at Selected Projects

<u>Project</u>	<u>Expense category</u>	<u>Increase approved over prior years</u>	
		<u>Amount</u>	<u>Percent</u>
A	Utilities	\$28,004	30
	Maintenance	10,477	29
B	Utilities	19,697	102
	Maintenance	19,490	241
C	Utilities	48,950	33
	Service contract	9,029	96
	Miscellaneous	20,421	193
D	Property taxes	28,838	34
	Maintenance	12,179	465
	Utilities	15,651	15
E	Utilities	17,786	60
	Administrative	5,581	104
F	Administrative	20,378	440
	Maintenance	5,865	275
G	Administrative	3,912	58
	Maintenance	63,376	66
	Utilities	50,733	27

At project A, utility costs were projected to increase by about \$28,000 (30 percent above prior rent increase figures). The analysis to support this increase was not shown in the file but, according to the loan servicer, was based on personal knowledge of utility costs in the community where the project is located.

Project C is an example of a case in which the loan servicer did not follow handbook instructions that require that miscellaneous expenses be excluded from rent calculations unless these expenses are explained in full. In this instance, \$20,421 in miscellaneous expenses were included in the rent increase without the loan servicer's documenting the validity of these expenditures.

Loan servicers and their supervisors told us that documentation was not always obtained because they were familiar with a project's operations and were able to make assessments of expenses based on this familiarity. While the absence of adequate supporting documentation does not mean that rents were excessive, it does raise questions about how well HUD is carrying out its oversight responsibilities for ensuring that rents and associated government

subsidies are maintained at reasonable levels. This is particularly true in light of the examples of undocumented expenditures reflected in the table on page 9. Conversely, understating expenses used to support rent levels also can affect the financial viability of a project because rents and federal subsidies would be too low.

Overstatement of rents due to incorrect treatment of expenses and calculation errors

In 17 of the 46 rent requests we reviewed, loan servicers did not follow procedures for treating certain expenses and/or made calculation errors when computing rents. All 17 requests were eventually approved and resulted in overstated rents of about \$510,000. The following table summarizes the cases in which expense items were incorrectly treated and/or calculation errors were made.

<u>Problem</u>	<u>Number of cases^a</u>	<u>Overstatement of rents</u>
Incorrect treatment of expense items:		
Capital improvements	5	\$255,710
Commercial income	6	31,168
Rent-free units	2	17,123
Calculation errors	12	<u>206,390</u>
Total		<u>\$510,391</u>

^aEight of the rent increases had more than one problem.

Since HUD subsidizes rents at 7 of the 17 projects in which rents were overstated, subsidy costs to the government may increase by about \$149,000 in the year immediately following the rent increases. These increased subsidies could range from about \$2,800 at one project to as much as \$66,000 at another.

Incorrect treatment of expenses

For these 17 projects, loan servicers did not follow the procedures pertaining to capital improvements. These improvements can include such items as repairs to roofs, improvements in foundations, replacement of appliances, and resurfacing of parking lots. HUD's insured project servicing handbook states that:

"No portion of a capital improvement should be recognized as an operating expense. Care should be taken not to include extraordinary or non-recurring items unless scaled to permit recoupment in a three or five-year period."

The costs of a project's capital improvements are normally expensed over time to recover invested capital at a rate that is consistent with the rate at which the assets are consumed. This concept of matching expenses with the period for which they result in revenues is a main principle of accounting theory. Recovering all costs of capital improvements in the year incurred will overstate expenses and rent requirements in the same year. Capital improvements for properties receiving HUD assistance are normally funded through a special reserve account, which the owner is required to pay into monthly. Under unique circumstances, such as when the reserve is depleted, exceptions can be made to this funding practice. In these situations, the handbook permits an item to be financed through a rent increase provided the costs are prorated over the 3- or 5-year period specified in the handbook.

We noted that capital improvements of \$255,710 were included in the rent structures at 5 of the 17 projects without being prorated over the required time frame. For example, rents increased over 23 percent at one project in order to fund \$111,000 in repairs, decorating, and other nonrecurring expenses over a 2-year period, even though officials agreed that they met the handbook criteria for capital improvements. Rents at another project were increased by 14 percent and included a \$20,000 expense for capital improvements while, at the same time, the reserve for replacement account had a balance of \$75,329. When asked why the improvements were included as a line item expense and funded through the rent structure rather than the reserve for replacement account, the loan servicer had no explanation.

HUD's handbook also specifies that expenses and revenues associated with income-producing commercial entities, such as laundry facilities and vending operations, should be excluded in determining rents. These activities are generally viewed as self-supporting, and therefore, any income received or expenses incurred are not considered in determining rents. We found that loan servicers did not exclude \$31,168 in commercial expenses when computing rents at 6 of the 17 projects. These overstatements ranged from \$600 in one case to \$11,512 at another project.

While the HUD handbook is specific regarding the treatment of capital improvements and income-producing entities, it does not clearly explain how the value of apartment units provided rent free to on-site management personnel should be handled. However, HUD officials at two field offices and at HUD headquarters stated that costs associated with nonrevenue-producing units should be

deducted when considering the overall project expense projections. Based on these officials' interpretation of the handbook, rents were overstated at 2 of the 17 projects by \$17,123 because adjustments for nonrevenue-producing units were not made.

Calculation errors

In 12 of the 46 cases in our review, calculation errors resulted in rents overstated by \$206,390. These errors included mathematical mistakes, incorrect loan amortization rates, and incorrect management fees. For example, the servicer for a project overstated rents by \$76,920 by making mathematical errors and including janitor supply expenses twice in maintenance costs. Since this project has direct rent subsidies, HUD could pay more than \$15,000 in excess rental assistance.

We brought these errors to the attention of loan management branch officials. These officials agreed that the errors had been made and said that they would make the appropriate adjustment in forthcoming rent increase requests at these projects.

Need for better supervision over rent review process

Field office loan management branch supervisors were not exercising sufficient internal control over the loan servicers' decisions pertaining to the reviews of rent increase requests. Supervisory reviews are needed to assure that loan servicers are following procedures, making consistent and good judgments, and not allowing excessive rents. The Federal Manager's Financial Integrity Act of 1982 requires renewed focus on the need to strengthen internal controls. The act requires that agency internal control systems be periodically evaluated and that the heads of executive agencies report annually on their systems' status. Pursuant to the act, GAO has developed and published in 1983 Standards for Internal Controls in the Federal Government. Regarding supervision, the standards require that supervisors ". . . continuously review and approve the assigned work of their staffs."

In 29 of 46 requests for rent increases that we analyzed, there was no evidence that supervisory officials had reviewed the work of loan servicers. We believe that if supervisors had been more thorough in performing quality control checks, such problems as the lack of documentation and calculation errors could have been avoided or minimized.

HUD's handbook pertaining to approval of rents does not specify what supervisory controls field offices should institute to assure that rents are processed according to departmental policies and guidelines. Without this guidance, supervisors in the

three offices we visited relied almost exclusively on the decisions of each loan servicer. Supervisors explained that primarily due to other work demands, including oversight of project case-loads specifically assigned to them, they were not able to perform more thorough supervisory reviews. Supervisors stated that, given their overall workloads, their reviews of loan servicers' decisions relating to rents are usually cursory in nature unless unusual circumstances dictate more intensive involvement. Such circumstances could occur, for instance, when a loan servicer is experiencing difficulties in reaching rental agreements with an owner or when rents approved by a loan servicer appear out of line with those at similar projects.

Problems associated with heavy workloads and staffing imbalances are not new to HUD, and we recognize that competing demands on supervisory staff time may make it impractical to perform in-depth reviews of each decision reached by a loan servicer. We believe, however, that the benefits of periodic assessments of loan servicers' decisions need to be considered in light of our findings. HUD has initiated steps to do this by including in recently proposed revisions to rent procedures suggested approaches for supervisors to follow in reviewing the work of servicers. If implemented and followed, these recommended approaches can strengthen the rent approval process.

STRENGTHENING CONTROLS OVER MANAGEMENT FEES

HUD field offices are responsible for reviewing and approving management fees paid to agents at HUD properties. However, we found that, because of inadequate guidance, (1) methods being used to determine reasonableness of fees vary and (2) the rationale for arriving at specific fees was not well documented or explained in project files. Additionally, HUD is not aggressively monitoring the payment of management fees once they are approved as evidenced by the \$220,379 in overpayments we identified at 28 of 60 projects.

Lack of specific guidance for determining reasonableness of fees

HUD procedures for reviewing and approving management fees are contained in Handbook 4381.5, Compensation for Management Services in Multifamily Housing Projects with Insured or HUD-Held Mortgages. This handbook specifies that fees are to cover the costs incurred by a management agent to oversee the project, including assuring that tenants are properly selected, rents are properly computed and collected, and a sound system of fiscal controls is implemented. The handbook goes on to provide the following guidance to field offices for computing fees.

"The maximum approvable management fees for various types of projects shall be established by each HUD Area/Insuring Office, based upon the cost of good quality professional management services. Local HUD offices should make sure that the management fees established are sufficient to encourage capable management entities to provide high quality professional management services to HUD-insured and HUD-held projects. Both the program under which the project is insured and the size of the project are important factors in establishing the amount of the approvable fee."

HUD studies in 1978 and 1982 in the San Francisco region have criticized the above guidance for not being specific enough to ensure reasonable uniformity in the methods used by field offices in computing fees. Our review at the three field offices revealed that specific guidance is still lacking, and as a result, each office is using its own method to evaluate fees. For example, in the Chicago field office, loan servicers judgmentally assess the reasonableness of fees based on their knowledge of the physical and financial condition of a project. Information used to make such judgments is generally obtained through review of annual financial statements, annual physical inspections, and periodic management reviews at the property. Criteria issued by the field office state that fees will be approved as long as they are reasonable; however, reasonableness is not defined. According to the branch chief, a reasonable fee is one that is commensurate with the management requirements of the property that must be judgmentally determined by the loan servicers.

The Dallas field office is similar to Chicago in that loan servicers develop their own standards of reasonableness based on their knowledge of the project's location, physical condition, and fees paid on similar HUD projects. A few loan servicers compare fees with other HUD and private sector projects by contacting local apartment associations to obtain the level of fees paid on similar types of properties. Most, however, limited their comparisons to projects within their individual caseloads.

The San Francisco field office, on the other hand, established standard procedures and guidelines for use by all loan servicers in computing fees. Procedures consisted of a formula that takes into account the number of units in the property, size of units, the property's location, and rent subsidies involved. The formula also allows for any other variables that might stem from unique problems. Loan servicers are required to utilize this approach on each proposed increase in fees and to document the analysis on a standard form.

In addition to the lack of guidance for evaluating management fees, current procedures also do not require that the basis for

approving fee levels be documented unless an approved fee exceeds those generally accepted by the field office. We reviewed 35 fee proposals and found in 20 cases a lack of support for the basis and assumptions used to determine reasonableness. Some of the approvals resulted in fee increases of as much as 71 percent, which we believe is significant enough to be explained and documented.

Specific guidance and documentation are needed to ensure consistency among field offices in establishing management fees. In the absence of such procedures, field offices may approve fees that are excessive and/or inconsistent with what is justified for similar HUD projects. Field office and headquarters officials generally agreed that guidance for determining fees should be more specific and that the basis for determining fees should be documented.

HUD is not adequately comparing the payment of management fees with what has been approved

Each loan servicer is responsible for reviewing the disbursement of management fees to ensure that the fees being paid to the management agent during the operating year do not exceed the level originally approved. In 28 of 60 projects analyzed, we found agents were overpaid by approximately \$220,000 because field office personnel did not properly review each property. HUD was paying rental subsidies in 15 of these projects; however, because these excessive fees were paid over a number of years, we could not accurately determine the extent to which HUD subsidies resulted in excessive costs to the government in any one year. Examples of instances where management fees exceeded the amounts established in agreements between HUD and management agents are described below.

- At a Chicago project the management agent was paid fees ranging from 4.8 percent to 7.6 percent over 7 years while the management agreement stipulated a 4-percent fee. This resulted in an overpayment of about \$40,000 during that period. Field office officials were unaware of these overpayments until we brought them to their attention.
- At a Dallas project excessive fees of \$36,247 were paid over a period of 6 years because the original agreement stipulated 8 percent, but up to 11 percent was paid to the agent. The loan servicer was unaware of the overpayment until we brought it to his attention.
- In San Francisco a project received a management fee that was above that authorized by HUD. According to the field office formula for calculating maximum allowable fees, a

management fee of 8 percent was authorized in 1982. However, the agent received a fee of 8.8 percent, or \$8,437 more than authorized. In addition, the agent received a 9.2-percent fee in 1981, or \$11,061 more than authorized.

In addition, some of the difficulties field offices are experiencing in reviewing fees can be attributed to HUD's vague definition of what income categories are permitted in calculating a basis for the management fee. The HUD handbook states that fees are based on gross income of the property and can include rental income; rent subsidy payments; and income from other sources, such as coin-operated laundry equipment. The handbook does not define what items of income should be excluded when calculating management fees. However, HUD officials at the field offices visited indicated that revenues generated by such items as interest on invested funds, security deposits, late charges, apartment key deposits, pet deposits, and maintenance fee charges are not allowed when calculating management fees. We found, however, that one field office had permitted income derived from several of these sources. For example, one management fee included \$9,900 in income derived from pet deposits and late charges.

Headquarters officials within the Office of Multifamily Housing Management said that additional clarification is needed concerning what income is allowed in determining the basis for payment of management fees. They indicated that revised instructions were being developed at the time of our review and would address this issue. They were uncertain, however, when the revisions would be implemented.

Need for better supervisory oversight

HUD guidelines for controlling management fees do not provide for periodic reviews of loan servicers' decisions regarding the processing of proposed fee increases and the disbursement of fees once they are approved. One of three area offices visited did not have a system whereby supervisors were systematically checking loan servicers' evaluations of proposed fees. Additionally, none of the offices had policies for periodic assessments of how well loan servicers were reviewing financial activities of projects in their caseloads to determine whether fees are being paid in accordance with levels approved by HUD.

As discussed earlier, our standards for internal controls specify that supervisors should review and approve the work of their staffs on an ongoing basis. We were told at one office that supervisory officials relied primarily on the decisions of each loan servicer when reviewing management fees unless there was a need to become more intensely involved, such as when fees appear out of line with the supervisor's assessment or opinion of what a reasonable level is. Loan management branch officials told us

that because of their workloads and other priorities, they have not been able to provide as much in-depth supervision as they would like. We believe that if supervision had been more thorough, the problems we have noted with the overpayment of management fees could have been reduced.

CHANGES UNDER DEVELOPMENT TO
IMPROVE THE RENT AND MANAGEMENT
FEE CONTROL PROCESSES

At the time we completed our review, HUD was in the process of developing new procedures for determining the reasonableness of rent and management fees. These procedures, if implemented as planned in early 1984, should improve rent and management fee controls by providing more specific guidance for analyzing rent increases, providing a uniform approach to approving management fees, and requiring supervisory reviews of rent and fee decisions.

In the new procedures for rent increases, HUD is emphasizing the use of budget projections to complement past financial statements in developing expense estimates. As support for their projections, project owners will be required to provide greater detail in explaining why operating expenses are expected to increase. For instance, each expense category (e.g., utilities, administration, maintenance, etc.) in a project's budget must be analyzed by the owner, and if an increase is anticipated, the reasons are to be stated. The new procedures would also provide additional guidance for loan servicers to use when examining and documenting the propriety of rent increase requests. For example, key questions and specific approaches are being described for use in each of the various expense categories reviewed in a project's budget. Additionally, HUD is proposing that supervisors review a sample of rent increase requests processed by loan servicers to ensure that procedures are being followed and that rents are not too high or too low.

To improve the process for evaluating management fees, HUD is designing procedures to provide a uniform approach to establishing fees. Under this uniform approach, field offices will set forth acceptable base fees for various-sized HUD projects and apply these fees when reviewing requests for increases at each project. Field offices will also develop a set of "add-on" fees that compensate agents for conditions that add to the difficulty of managing a project. These add-on fees will be included with the base fee when appropriate. The new procedures also will require that the basis for the new fee be documented by the loan servicer. To assist in this, HUD is preparing a standard form for loan servicers to use when analyzing each management fee increase being proposed. Additionally, the new procedures will contain further clarification on what types of project income are permitted in calculating the basis for paying the approved fee. Also, supervisors will be required to review a sample of management fee approvals to assure compliance with proposed procedures.

These proposed procedures are positive steps for improving the rent and management fee control processes. They offer the opportunity, if implemented, for processes to be uniform, objective, and documented.

OTHER IMPACTS ON LOAN MANAGEMENT ACTIVITIES

Over the past several years, GAO, HUD's Inspector General, congressional committees, and HUD internal studies have reported management problems that have had a negative impact on the effectiveness of field office loan management activities. These problems have included staffing and workload imbalances, skill shortages, and training inadequacies.¹

During our field work, we received a number of comments relating to the above problems and their effect on operations. Loan management branch officials said that workloads, staffing imbalances, training inadequacies, and employee turnover have made it difficult for them to perform oversight functions. At one office the loan management branch chief said that for a number of years HUD field offices have been adversely affected by overall budget cutbacks and reductions in staff throughout the organization. In this regard he noted that for the last several years a hiring freeze has prevented field offices from filling positions in their loan management branches. This has increased the case-loads of each loan servicer by as much as 50 percent.

At another office, loan servicers were responsible for as many as 60 projects. HUD officials, including one loan management branch chief and an official of the Office of Multifamily Housing Management at headquarters, said that under these conditions it is difficult to properly carry out their oversight responsibilities at each project. One branch chief said that the acute shortage of clerical staff has necessitated that loan servicers perform routine functions that they normally would not be required to do, such as typing, filing, and other administrative duties. We were told that if the branch had several technicians to process the required documents for a rent increase request, loan servicers would have more time to concentrate on the analytical aspect of determining whether the request was justified.

¹The breadth of these problems and related recommendations are covered in a Jan. 10, 1984, GAO report entitled Increasing the Department of Housing and Urban Development's Effectiveness Through Improved Management (GAO/RCED-84-9).

We recognize that it may not be possible to demonstrate a direct correlation between the perceptions noted above and the effectiveness of the rent and management fee processes. However, such comments reinforce observations documented in other reports and should not be overlooked when considering the long-term success of loan management activities.

CONCLUSIONS

Our review of three HUD field offices disclosed that inadequate controls over rent and management fees have resulted in excessive rents, higher management fees, and possible subsidy overpayments at multifamily housing projects. Field offices frequently have processed rent increase requests without requiring project owners to submit required information supporting these requests. Also, loan servicers have approved rent increases without documenting the basis for their decisions, included improper expenses in approved rent levels, and have made analytical and computation errors in calculating rents. Finally, field offices have not provided adequate supervisory controls over the rent approval process to assure better compliance with HUD policies and procedures. Documentation and supervision are two integral components of a system of internal controls.

HUD did not have specific guidance for documenting and evaluating the reasonableness of management fees. This led to inconsistencies among field offices in approving fees. Further, HUD's review to assure that management fees paid to management agents do not exceed the levels approved has not been adequate. As a result, agents have been overpaid and HUD subsidy payments have increased. Some of the difficulties field offices are experiencing in monitoring fees can be attributed to HUD's vague definition of what income categories are permitted in calculating a basis for the management fee. Similar to the rent approval process, supervisory controls over management fees have not been adequate.

HUD is developing new procedures to improve both the rent and management fee control processes. These procedures, if implemented, should address the problems we documented provided they (1) include guidance on the documentation and analysis necessary before rent increases are approved, (2) describe how rent-free units are to be considered in calculating rents, (3) establish a uniform method for approving management fees, (4) clarify what portion of a project's income is allowed in computing the basis for the payment of management fees, and (5) include procedures for supervisory controls over the rent and management fee processes.

Over the past several years, HUD has experienced other organizational problems, such as staffing and workload imbalances, skill shortages, and training inadequacies, which have had a negative impact on the effectiveness of field offices. Although it may not be possible to establish a direct correlation between

these problems and the weaknesses we observed, we believe that they should not be overlooked when considering HUD's success in carrying out responsibilities for rent and management fee controls.

RECOMMENDATIONS

We recognize that the success of loan management activities is influenced by many factors, including broad organizational and operational problems as well as specific procedural problems. In this report, we recommend that the Secretary of HUD finalize and implement new procedures for improving controls over rents and management fees. These procedures should include

- developing more specific guidelines on the documentation required and the analysis needed for field offices to process and approve rent increases,
- clarifying guidelines pertaining to the treatment of rent-free units in evaluating rent increase requests,
- establishing a uniform method for approving management fees,
- clarifying what sources of project income are permitted in calculating the basis for the payment of management fees, and
- developing guidelines for supervisory controls over the rent and management fee processes.

AGENCY COMMENTS AND OUR EVALUATION

HUD agreed with all but one of our recommendations and is in the process of implementing them. HUD, however, did not agree with a proposal made in our draft report to establish a systematic method for monitoring the payment of management fees to better assure that fees do not exceed approved levels. HUD attributed the overpayment of management fees primarily to the lack of supervision, staff shortages, and unclear guidance on what income items should be included when computing the basis for payment of the management fee rather than the absence of a systematic method for monitoring.

We modified our earlier proposal after consideration of HUD's comments. We now recommend that in addition to improving supervision over the payment of fees, HUD clarify what types of project income are permitted when calculating the basis for payment of management fees.

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United States Senate

COMMITTEE ON BANKING, HOUSING, AND
 URBAN AFFAIRS

WASHINGTON, D.C. 20510

April 26, 1983

Mr. Charles Bowsher
 Comptroller General
 General Accounting Office
 441 G Street, N.W.
 Washington, D.C. 20548

Dear Mr. Bowsher:

I have recently been supplied information which makes me question whether the Department of Housing and Urban Development (HUD) is properly administering its rental assistance programs. The Department is evidently approving unjustified rent increases and excessive management fees, at least at the San Francisco area office.

I request that the General Accounting Office (GAO) examine a sample of the Department's field offices to determine how rent increases are approved. It should also determine whether these offices follow departmental criteria when setting management fees.

The law now gives HUD a significant amount of administrative discretion in approving these payments. Yet large amounts of money are at stake. In light of the survey of how well field offices are managing these programs, the GAO should recommend whether legislative changes are needed to reduce this discretion.

Thank you for your assistance. Any questions about this request should be directed to Bob Mauney at 224-5653.

Warm regards.

Sincerely,


 William Proxmire, U.S.S.

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