

GAO

Report to the Chairman, Committee on
Government Reform, House of
Representatives

March 2004

HUD SINGLE-FAMILY AND MULTIFAMILY PROPERTY PROGRAMS

Inadequate Controls Resulted in Questionable Payments and Potential Fraud



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Highlights

Highlights of [GAO-04-390](#), a report to the Honorable Tom Davis, Chairman, Committee on Government Reform, House of Representatives

Why GAO Did This Study

In our 2003 performance and accountability report on the Department of Housing and Urban Development (HUD), we continued to identify HUD's single-family (SF) mortgage insurance program as high-risk—an area we have found to be at high risk for fraud, waste, abuse, and mismanagement. Also, for years, GAO and HUD's Office of Inspector General (OIG) have reported weaknesses in HUD's contract administration and monitoring for both SF and multifamily (MF) programs. Given these known risks and the millions of dollars in disbursements made by the agency each year, GAO was asked to review payments related to the single-family property program and determine whether (1) internal controls provide reasonable assurance that improper payments will not be made or will be detected in the normal course of business and (2) payments are properly supported as a valid use of government funds. You also asked us to assess HUD's monitoring of a major multifamily project with a state housing agency.

What GAO Recommends

GAO is making 24 recommendations to strengthen HUD's internal controls over SF and MF property programs, decrease questionable payments and improve contractor oversight. In responding to a draft of our report, HUD agreed with some of GAO's findings and disagreed with others. In particular, HUD disagreed with GAO classifying certain payments as questionable. GAO reaffirms its position on its findings and all recommendations.

www.gao.gov/cgi-bin/getrpt?GAO-04-390.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Linda Calbom at (202) 512-9508 or calboml@gao.gov.

HUD SINGLE-FAMILY AND MULTIFAMILY PROPERTY PROGRAMS

Inadequate Controls Resulted in Questionable Payments and Potential Fraud

What GAO Found

Significant internal control weaknesses in the process used to pay for SF property expenses made HUD vulnerable to and in some cases resulted in questionable payments and potential fraud. These weaknesses included (1) delegation of oversight functions in a manner that weakened the control environment, (2) lack of key control activities, including proper documentation and approvals and (3) limited monitoring of contractor performance. These weaknesses likely contributed to the \$16.5 million in questionable and potentially fraudulent payments that we identified using data mining, document analysis and other forensic auditing techniques.

GAO classified \$16.3 million of payments as questionable because they were not supported by sufficient documentation to determine their validity. GAO also classified \$181,450 of payments as potentially fraudulent after visiting single-family properties being managed by a certain contractor. At all the properties visited, GAO noted discrepancies between what was represented on paid invoices and what was actually received. The photographs below were taken at one of the occupied properties after HUD paid \$2,060 for bathroom repairs. These potentially fraudulent payments for single-family properties were made to the same contractor that was engaging in potentially fraudulent billing practices related to our earlier work on the HUD MF property program. HUD paid this contractor \$2 million in fiscal year 2002 and \$2.5 million in fiscal year 2003 for SF property expenses.



Source: GAO.

GAO also identified insufficient HUD monitoring of a major MF program with a state housing agency. While HUD provided all the funding for the program, it provided little oversight and instead relied on the state housing agency to perform oversight functions. Ten years into the program, actual cost totaled over \$500 million dollars, almost triple the original development budget.

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Abbreviations

AC	Allocated cost
FHA	Federal Housing Administration
GTM	Government Technical Monitor
GTR	Government Technical Representative
HUD	U.S. Department of Housing and Urban Development
MF	multifamily
SAMS	Single-Family Acquired Asset Management System
SF	single-family

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United States General Accounting Office
Washington, D.C. 20548

March 3, 2004

The Honorable Tom Davis
Chairman
Committee on Government Reform
House of Representatives

Dear Mr. Chairman,

A strong system of internal controls provides checks and balances against waste, fraud, abuse, and mismanagement and is an important component of an organization's ability to operate efficiently and effectively. This is particularly important to the Department of Housing and Urban Development (HUD), which depends heavily on contractors to accomplish its mission. These contractors deliver program services and perform many functions that used to be done by HUD's staff, including those in its mortgage insurance program area. HUD mortgage insurance programs are dependent on the actions of many third parties, including the contractors who market and manage the HUD single-family (SF) properties that HUD acquires when borrowers default on their mortgages.¹

In our 2003 performance and accountability report on HUD, we continued to identify HUD's single-family mortgage insurance program as high risk—an area we have found to be at high risk for fraud, waste, abuse, and mismanagement.² Also, for years, we and HUD's Office of Inspector General (OIG) have reported weaknesses in HUD's contract administration and monitoring for both SF and multifamily (MF) programs. These weaknesses, together with significant growth in HUD's contracting activity, increased the department's vulnerability to and in some cases resulted in fraud, waste, and abuse. Furthermore, HUD expects contracting to increase even more.

In light of these concerns, you requested that we review internal controls over fiscal year 2002 payments to contractors and other vendors related to SF properties. During fiscal year 2002, HUD reported that it paid more than \$310 million for various goods and services, including management fees

¹HUD single-family properties consist of one to four units or apartments.

²U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of Housing and Urban Development*, GAO-03-103 (Washington, D.C.: Jan. 2003).

and property repairs for its SF property portfolio. For these payments, our objectives were to determine whether (1) internal controls provided reasonable assurance that improper payments would not be made or would be detected in the normal course of business and (2) payments were properly supported as a valid use of government funds. In addition, you requested that we continue our review of HUD's multifamily program. Therefore, we assessed HUD's monitoring of a major MF program being carried out with a state housing agency that has payments of over a half billion dollars from its inception in 1994 through September 30, 2003.

To identify and assess internal controls, we obtained an understanding of HUD disbursement processes; conducted interviews with HUD headquarters, four homeownership centers, and three contractor offices, and performed walk-throughs of transactions. We also reviewed HUD policies and procedures; property management and marketing contracts and amendments, and reviewed our own reports, those by HUD's OIG, and others. In addition, we tested a statistical sample of transactions to evaluate key internal control activities. To test for validity of payments, we selected transactions using forensic auditing techniques, including data mining and document analysis. We then physically inspected selected properties to determine if the services or goods HUD paid for had been fully performed and the tangible goods received.

In June 2003, based on the results of the above described work, we communicated to HUD and members of your office that we had identified certain potentially fraudulent payments. At your request, we expanded our work to (1) determine whether HUD had made changes to its internal controls to address the causes of the potentially fraudulent payments that we had identified in June 2003 and (2) test for additional potentially fraudulent payments. To accomplish this additional work, we interviewed HUD officials and used forensic auditing techniques to test for additional potentially fraudulent payments made in fiscal years 2002 and 2003.

To assess HUD's monitoring of the MF program with a state housing agency, we reviewed HUD's MF policies and procedures, the state agency's policies and procedures, and HUD's interagency agreement with the state housing agency. We also conducted walk-throughs of transactions and interviewed officials at HUD headquarters, one field office, and the state housing agency. In addition, we analytically reviewed payment activity since inception of the project in 1994 through September 30, 2002.

While we identified some potentially fraudulent and questionable payments, our work was not designed to identify all fraudulent or questionable payments. Appendix I provides a more detailed discussion of our scope and methodology. We conducted our work from December 2002 through January 2004, in accordance with generally accepted government auditing standards as well as with the investigative standards established by the President's Council on Integrity and Efficiency. We requested comments on a draft of this report from the Secretary of HUD or his designee. HUD's written comments are reprinted in appendix II.

Results in Brief

Significant internal control weaknesses in the HUD SF property payment process made the agency vulnerable to and in some cases resulted in questionable and potentially fraudulent payments. These weaknesses included (1) the delegation of oversight functions in a manner that weakened the control environment, (2) a lack of key control activities, such as proper approvals and clear documentation to support all payment transactions, and (3) limited monitoring of contractor performance.

On the basis of a statistical sample, we estimated that about 42 percent³ of the total population of SF property payments for fiscal year 2002 were not adequately supported and 58 percent⁴ were not properly approved. Further, HUD's monitoring of contracted activities did not include the detailed analytical review of the contractors' performance or any augmentation of control activities in response to previously identified risks. The aggregate effect of these internal control weaknesses was that HUD did not and still does not have reasonable assurance that improper payments would be prevented or detected in the normal course of business.

These weaknesses contributed to the \$16.5 million in questionable and potentially fraudulent payments made during fiscal years 2002 and 2003 to contractors and others that we identified using data mining, document analysis, and other forensic auditing techniques, including physical inspection of properties to test for whether the goods and services billed and paid for had actually been delivered or satisfactorily performed. These

³We are 95 percent confident that the actual proportion of payments lacking key supporting documentation is between 35 and 49 percent.

⁴We are 95 percent confident that the actual proportion of payments not properly approved is between 51 and 65 percent.

improper payments occurred and were not detected in the normal course of business even though HUD paid contractors \$11 million during fiscal year 2002 for assistance in reviewing and processing payments and performing quality control oversight of management contractor performance.

The questionable payments included \$15.2 million to contractors for contract change orders that lacked adequate supporting documentation to substantiate the validity of the payments. Payments were made without basic support, such as standard contract modification agreements signed by the contractors and HUD officials or identification of the specific HUD properties covered by the payments.

We also questioned eight payments totaling \$268,800 for partial reimbursement of a contractor's claimed expenses for developing a lead-based paint abatement program. The support for these payments did not include a signed contract modification or other agreement for the contractor to develop such a program, an indication of the total amount to be paid by HUD to satisfy the claim, or the basis for reimbursing the contractor for these types of costs that, according to HUD's management agreement with the contractor, were not allowable unless approved by HUD in advance. We questioned an additional 65 payments totaling \$844,466 for such things as utility services, "For Sale" signs, and chain-link fences when the support for the payments was not adequate to enable us to determine if the payment was a valid use of government funds.

Deficient HUD monitoring resulted in potentially fraudulent single-family program payments to a property management contractor for work that was substandard or not performed at all. For example, in performing an inspection of an occupied apartment where a bathroom renovation had been billed and paid for by HUD, we found a rusted out, broken sink on the floor and an inoperable toilet. We visited 18 properties for which HUD had disbursed \$181,450 for renovations that we determined by physical inspection that a substantial portion of the work was either overcharged or not performed. This work was billed by and paid to the same contractor we identified previously in our multifamily work as having engaged in potentially fraudulent billing practices.⁵ Through data mining, we identified

⁵U.S. General Accounting Office, *Financial Management: Strategies to Address Improper Payments at HUD, Education, and Other Federal Agencies*, [GAO-03-167T](#) (Washington, D.C.: Oct. 3, 2002).

\$476,104 of fiscal year 2002 payments to the same contractor for construction renovations that had the same characteristics of the fraudulent billing scheme in the multifamily program on which we testified during October 2002. HUD held several meetings with this contractor over several years to discuss performance concerns and ultimately "heldback" payment for certain billed work. However, we did not find evidence of additional controls over the millions of dollars in payments made to this contractor subsequent to the time that questionable billing practices were identified. After months of discussion, HUD and the contractor agreed to end the contract as of October 31, 2003.

In addition, we identified a lack of monitoring by HUD of a MF pilot program with a state housing agency. While providing all funding for the program, HUD delegated almost all of its oversight functions, despite the fact that the program costs continued to escalate significantly higher than the original development budget approved by HUD. Ten years into the program, actual costs totaled over a half a billion dollars, almost triple the original development budget. Additional oversight by HUD may have helped to prevent at least some of this cost escalation.

Without significant improvements in its internal controls, HUD's ability to detect and prevent improper payments will continue to be severely limited. We make 24 recommendations in this report to address the internal control and improper payment issues we identified.

In written comments on a draft of this report from HUD's Assistant Secretary for Housing–Federal Housing Commissioner, HUD agreed with some of our findings and recommendations and disagreed with others. In particular, HUD disagreed with our classification of certain payments, including \$15.2 million of inadequately supported payments for contract change orders, as questionable payments. However, because HUD did not provide documentation needed to support the validity of the payments, they remain questionable.

Regarding our recommendations related to the MF pilot program, HUD agreed to examine opportunities to enhance its oversight over the remaining life of this particular program, but it did not agree to ask the HUD IG to review the propriety of the use of the funds at this time, but said it may elect to refer specific issues to the IG for review. HUD did not specifically comment on the other 22 recommendations related to its SF program. We continue to believe that our report is accurate and that all of the recommendations should be implemented. Our response to HUD's

comments is provided in the Agency Comments section of the report and in appendix II.

Background

HUD, through its Federal Housing Administration (FHA), helps finance home purchases by insuring private lenders against losses on mortgages for single-family and multifamily homes. If a borrower defaults on a loan and the loan is subsequently foreclosed, the lender may file a claim for most of its losses with HUD. After an insurance claim is paid from one of HUD's various mortgage insurance funds, HUD assumes title to the property and the property becomes part of the HUD property inventory. HUD's mortgage insurance funds support a wide variety of MF and SF insured loan activities, including management of HUD properties until they are sold. HUD's mortgage insurance funds are financed by annual appropriations from the Congress, upfront and periodic mortgage insurance premiums from transactions with the public, or interest revenue.

In 1994, we first designated HUD's programs as high risk due to serious, long-standing, departmentwide management problems. In January 2001, we reduced the number of programs deemed to be high risk from all HUD programs to two of its major program areas. One of the two programs was SF mortgage insurance, which includes the management of property inventory. In fiscal year 2003, we designated HUD's acquisitions management, to include contractor monitoring, as a new major management challenge because of extensive and growing reliance on contractors.

Our initial evaluation of payments related to HUD properties was first discussed in our October 2002 testimony on our review of, among other things, fiscal year 2001 payments to a contractor responsible for managing HUD multifamily properties. We reported that this contractor engaged in questionable billing practices that resulted in potentially fraudulent payments. The contractor split construction renovation charges into multiple projects to stay below the \$50,000 threshold of HUD-required approval. We identified about \$10 million of this contractor's invoices that individually were less than \$50,000. We also found cases for which HUD paid this contractor for goods or services that were not received.

Single-Family Program

In its SF property program, HUD contracts with six property management firms who are responsible for all activities associated with managing and

marketing properties. Each of the contracts includes (1) having the properties appraised; (2) securing the properties to prevent unauthorized entry; (3) inspecting the properties to ensure that they are clean and in presentable condition; (4) performing routine maintenance, as well as repairs and renovations necessary to preserve and protect the property; (5) listing the properties for sale, and (6) selling them. Each contract covers a different geographic area that is under the jurisdiction of what are referred to as HUD's homeownership centers. Contractors may have agreements in more than one geographical area. HUD also contracts with a support services contractor to facilitate payment to these management firms and other vendors.

The homeownership centers are located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California. Figure 1 shows the geographical jurisdiction of each of the four centers. The centers report directly to HUD's Deputy Assistant Secretary for Single-Family Housing who, in turn, reports to the Assistant Secretary for Housing—Federal Housing Commissioner.

Figure 1: Geographical Jurisdictions of HUD's Four Homeownership Centers



Source: GAO's analysis of data from HUD's Office of Housing.

The Director of the Real Estate Owned Division in each of the four centers is responsible for monitoring contractors' performance in the respective center's jurisdiction. Homeownership center staff manage and conduct the monitoring and prepare monthly assessments on contractors' performance. The homeownership centers have a number of resources upon which they can draw to aid them in making these assessments. For instance, to assist in HUD's oversight, third-party contractors are to inspect 10 percent of the properties handled by each management and marketing contractor. Also for oversight purposes, another national contractor is to follow a HUD checklist of procedures to be performed for the review of 10 percent of the management and marketing contractors' property case files each month. In fiscal year 2002, HUD paid contractors \$11 million for assistance in reviewing and processing payments and performing quality control oversight of management contractor performance.

In addition, the center's program support staff are to conduct follow-up property inspections and file reviews, as well as a monthly on-site review at the contractors' offices. As part of the analysis, the HUD staff assign a risk

rating of low, medium, or high to the contractor's performance on each of 11 performance dimensions such as claims review, property maintenance, and sales procedures. According to agency data, payments for SF property expenses totaled more than \$310 million in fiscal year 2002. The SF Acquired Asset Management System (SAMS) payment process reimburses management contractors for costs incurred in managing and marketing HUD properties, and makes direct payments to certain other vendors, such as oversight contractors, and pays management fees to the management contractors. The HUD payment process, as designed, includes four key steps: (1) the preparation of the payment request by the property management contractor or other vendor seeking funds, (2) initial review of the payment request by a support services contractor, (3) HUD approval, to include a technical review by a person appointed as the government technical monitor (GTM),⁶ and final authorization by a government technical representative (GTR),⁷ and (4) payment either by electronic transfer or paper check.

Multifamily Project

In its MF program, HUD contracts for property management services, such as on-site management, rent collection, and maintenance for the multifamily properties it acquires through the foreclosure process. In 1994, due to a substantial increase in HUD's inventory of MF properties, HUD entered into an agreement with a state housing agency for the renovation, disposition, and interim management of certain MF properties located in one geographical region.

HUD officials told us this program was intended to be a demonstration or pilot program, to determine if this type of agreement is feasible as a common practice within HUD. Under this pilot, HUD is responsible for providing all the money needed to fund the program, and the state agency is responsible for developing and monitoring the project.

⁶The GTM serves as a technical adviser to the GTR.

⁷*HUD - Government Technical Representative Handbook* states that the GTR is responsible for being the principal judge of a contractor.

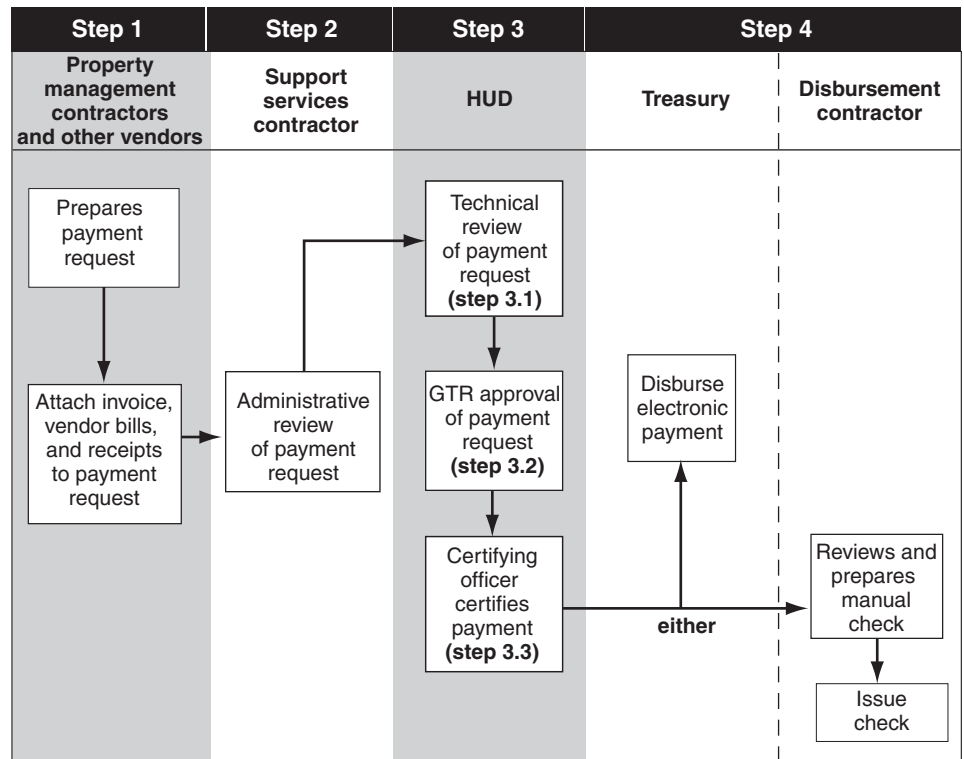
Internal Controls Over SF Property Payments Were Inadequate

HUD's internal controls did not provide reasonable assurance that improper payments would not occur or would be detected in the normal course of business. We identified fundamental weaknesses in the four-step process used to pay for SF property expenses. Our *Standards for Internal Control in The Federal Government* include (1) establishing a positive control environment throughout the organization, (2) performing of control activities, which are an integral part of an entity's accountability for stewardship of government resources, and (3) monitoring to assess the quality of performance over time. However, we found HUD did not delegate functions in a way that supported a positive control environment; specifically, the agency routinely relied on a support services contractor to prepare management contractors' and other vendors' payment requests and perform technical reviews of payment requests. HUD also routinely failed to require or ensure that all transactions were clearly documented, which is a control activity that helps ensure accountability for resources. HUD monitoring of contractors' performance, particularly the review of the nature and amount of expenses incurred, was also inadequate. In addition, HUD did not respond appropriately to identified vulnerabilities that increased the risk of unsatisfactory performance. These internal control weaknesses made the HUD SF property program highly susceptible to fraud, waste, and abuse.

Process for Payment of SF Property Expenses Relied Extensively on Contractor

HUD delegated oversight functions in a manner that weakened its control environment and resulted in established controls not being followed. We found that HUD routinely relied on a support services contractor to perform key elements of the first three steps in the four-step payment process (fig. 2) for SF property expenses. These delegated oversight functions included preparing payment requests (step 1), performing the administrative review (step 2) and performing a technical review (step 3.1) of payment requests.

Figure 2: Four-Step SF Property Payment Process



Sources: GAO and HUD's *Controls for M&M Contractors Disbursements*.

HUD relied on the support services contractor to perform the functions in both step 1 and step 2 of the payment process when HUD staff or the support service contractor determined that the original request needed to be modified. When payment requests received by HUD from the property management firms or other vendors needed modification to either the amount requested or property to be charged with the expense or other information, the support service contractor would make the change and prepare a revised payment request. This function is analogous to voiding and then replacing a check in a manual payment system. HUD's written policies require that the management contractor create its own payment requests and those needing modification be returned to the requesting

“The control environment is affected by the manner in which the agency delegates responsibilities.”^a

contractor for any changes.⁸ That is, the contractor requesting the payment was responsible for resubmitting the payment request after addressing the issues that caused the need for modification.

However, HUD regional officials advised us and were aware that this control was not followed primarily to avoid delays in processing payments. In these cases, the support service contractor, using the same transmittal number that was used for the original request, created the revised payment requests.

HUD also relied on the support service contractor to prepare payment requests (step 1) and perform the administrative review (step 2) of payment requests when the vendors requesting payment did not have access to the electronic payment system—HUD SAMS. While the property management contractors have access to SAMS, other vendors who routinely request payment from HUD, for example closing agents, do not. In some of the cases, the vendors without access to SAMS were submitting requests for payments directly to the support services contractor, rather than to the property manager of the underlying property or a HUD official who would be in a better position to monitor the completion and quality of work.

In addition, HUD requires that vendors provide a signed request form, as assurance that the information submitted on payment requests is true and accurate. We found numerous requests created by the support services contractor that did not have this signature. Instead, the support services contractor signed the request form.

The third step of the HUD payment process, as designed, is HUD approval that includes a technical review by a HUD-appointed employee. However, on the basis of the results of our statistical sample of payment transactions, we estimate that about 58 percent⁹ of the total population of single-family payment transactions to contractors and other vendors at the four

⁸Housing and Urban Development, *Controls for Management & Marketing (M&M) Contractors Disbursements* (Washington, D.C.).

⁹We are 95 percent confident that the actual proportion of HUD payments not properly approved is between 51 and 65 percent.

^aThis text box as well as those following in this section of the report are quotes from the U.S. General Accounting Office, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.31.1. (Washington, D.C.: Nov. 1999).

“Transactions and other significant events should be executed by persons acting within the scope of their authority.”

homeownership centers were not properly approved due to a lack of technical review. Specifically, we found that the support services contractor was routinely performing the technical review (step 3.1) reserved for the HUD-appointed GTM at two of the four HUD homeownership centers.¹⁰ In these situations, HUD permitted the support services contractor to act outside the contractor’s scope of authority granted through the HUD control structure by conducting the review, which requires a HUD-appointed individual with specific technical expertise. That is, the request for payment should not have been approved due to the absence of the GTM technical review.

HUD’s delegation of the oversight functions for three of the four steps of the SF property payment process significantly weakened the control environment. The overreliance on the support service contractor resulted in a control environment where the controls over rejected payment requests and the approval of requests were not followed. When oversight functions are delegated in a manner that does not support a positive control environment, the control process may not be effective in detecting and preventing improper payments.

HUD Payments Lacked Adequate Support

On the basis of our statistical sample, we estimated that about 42 percent¹¹ of the total number of SF property payments at the four homeownership centers were not adequately supported. That is, the minimum support necessary for a third party to determine the validity of the payment was not included in the documentation provided with the payment. Control activities, such as clearly documenting all transactions, are an integral part of an entity’s accountability for stewardship of government resources.

HUD did not enforce consistent program wide documentation requirements, but rather allowed each HUD approving official to determine the adequacy of supporting documentation. As a result, the nature and extent of acceptable supporting documentation was inconsistent from region to region. For example, two of the four HUD homeownership

¹⁰Housing and Urban Development: *Government Technical Representative Handbook 2210.3 Chapters 11 & 12* (Washington, D.C.: 2003) states, in order to act as the GTM for a contract and perform the duties of one, an individual must be formally appointed by HUD, have basic knowledge of the contracting process, and complete certain minimum training.

¹¹We are 95 percent confident that the actual proportion of payments lacking key supporting documentation is between 35 and 49 percent.

“All transactions need to be clearly documented.”

centers accepted “manual” payment requests that were created outside of the HUD automated system. This deviation from the written internal control policy created inconsistencies in the payment request process among the contractors for that region as well as across the four homeownership centers. These “manual” payment requests did not have all the supporting data elements (e.g., payee Social Security number or tax identification number, address, remittance address) that the system-generated payment request included. Therefore, edit checks in the automated system, such as limitations on who was authorized to change the payment remittance address, were lost when manual payment requests were created.

We found payments that also lacked adequate support, such as evidence that goods or services had been received, and that competitive bids had been obtained prior to the work being performed. Some supporting documentation lacked evidence of any validation of the charges. For example, payments to the contractor responsible for spot inspections of properties typically would be based on an invoice that reflected a fixed rate per property inspected and a list of the properties inspected. However, the support for these payments was devoid of any indication that the reviewer had verified the rate used, HUD’s ownership of the properties inspected, or otherwise determined the validity of the amount and relevant terms of the payment request. We also found that invoices and other supporting documentation were not effectively canceled to prevent unauthorized or inadvertent reuse as support for subsequent billings, and that other than original documents were used to support payments without any indication as to why other than an original invoice was accepted.

We advised HUD officials when adequate supporting documentation was missing and we could not determine the validity of a payment selected for review. HUD management advised us that the support for certain amounts paid was not included with the payment documentation; however, the reviewing, approving and certifying officials were to simply review the contract file to verify the accuracy of the charges. We did not see evidence of this contract review. For example, as discussed later, through data mining we identified \$15.2 million in payments for contract modifications with insufficient supporting documentation. The support for these payments was typically limited to copies of e-mails to the homeownership center from headquarters directing that payment be made, incomplete standard contract modification forms, and spreadsheets detailing by property only an insignificant portion of the total amount paid. We also identified cases where the HUD approving official at one of the

homeownership centers was not requiring a contractor to provide specific support for payments to subcontractors, even though certain minimum support was required by the terms of the management contract, such as evidence that the contractor had paid the subcontractor before requesting reimbursement from the government. Adequate support for these amounts is critical because the payment is a reimbursement for the amount paid by the contractor to the subcontractor. Later in this report, these and other examples of payments without adequate support that were identified through data mining will be discussed in more detail.

HUD Failed to Monitor Contractors Adequately

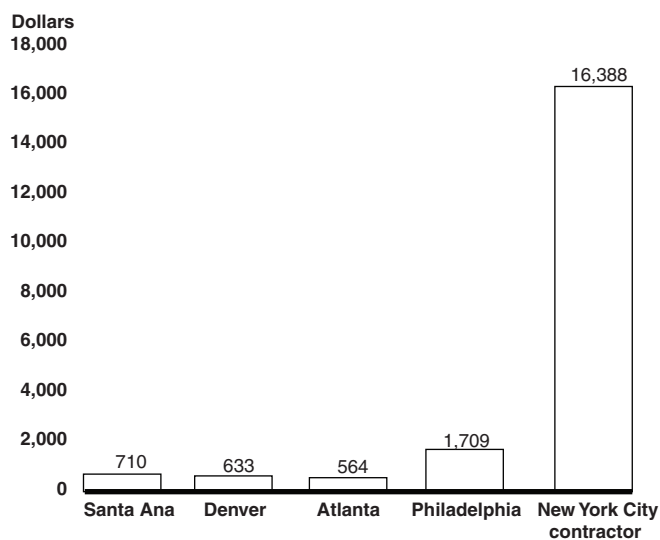
Neither HUD headquarters personnel, nor the regional staffs, systematically performed detailed analytical reviews of the millions of dollars in expenses generated by payments to contractors and other vendors. Monitoring the quality of performance over time is a critical control activity. Detailed analytical review of expenses focusing on key data elements is a way for management to assess performance and identify areas of risk. Although monitoring was deficient, HUD did perform some program wide analysis of certain financial performance indicators and limited analysis was done on a region-by-region basis. For example, the average holding costs per property¹² and average time held in inventory were calculated. HUD headquarters officials stated that when a region had a “spike” in one of its performance indicators, a conversation to identify potential causes will take place. However, without specific analytical review of expenses, the real causes of the “spikes” may not be identified.

Analytical reviews include focusing on key data elements, such as property number, vendor name, and expense classification, to identify patterns or anomalies that may require further inquiry or analysis. The results of detailed reviews can lead to cost-saving opportunities, the identification of usual patterns, and ultimately the discovery of instances of fraud, waste, and abuse. The automated SF payment system captures expenses by (1) case number and (2) expense category. These system features have the potential to assist HUD in strengthening its oversight of contractors. For example, totaling expenses by property provides HUD with the ability to compare and analyze property expenses over time from acquisition through sale of the property in a variety of ways, including by geographical region and contractor. Further, analyzing expenses by category, such as

¹²Holding costs represent total costs incurred from the date of acquisition through sale of the property.

board-up, general repair, and clean-up expenses, would provide HUD with meaningful oversight information. Also, HUD management may find focused expense analysis work, similar to that which we performed for this review, to be an effective and efficient method for assisting in preventing and detecting improper payments. Our detailed analytical reviews of HUD payment data identified patterns that led us to specific improper payments. For example, figure 3 illustrates one of the basic types of analyses we performed to determine areas of high risk that allowed us to focus on the areas we viewed as most vulnerable to improper payments.

Figure 3: Single-Family Properties Average per Property Expenses-Fiscal Year 2002



Source: GAO analysis.

Our analysis, as depicted at figure 3, focused our attention on determining the reason for the relatively high expense per property in the Philadelphia homeownership center, and then on one particular contractor within that center, when compared to other regions. We ultimately identified significant potentially fraudulent payments made at the New York City properties that are discussed later in the report. Our *Executive Guide: Strategies to Manage Improper Payments*¹³ explains how data mining and

¹³U.S. General Accounting Office, *Strategies to Manage Improper Payments: Learning from Public and Private Sector Organizations*, GAO-02-69G (Washington, D.C.: Oct. 2001).

other forensic auditing techniques analyze data for relationships that have not previously been discovered. The guide also provides examples of various federal and state agencies that had performed such analysis. HUD officials indicated that lack of resources was the primary reason that they did not perform detailed expense analysis.

We found that one potential roadblock to a meaningful detailed analytical review was HUD's lack of control over expenses that it classified as allocated costs (AC). This expense category was intended to be used to accumulate expenses that could not be directly charged to a property and then allocate those expenses over all properties or those that received some benefit from the expense. For instance, the expense incurred for bonding coverage and file reviews for the entire program would be properly chargeable to AC and then allocated to all properties. However, HUD routinely used AC for expenses that should have been charged to specific properties. For example, we identified renovation charges for a specific property being classified as allocated costs. The accountability for HUD resources and ultimately the monitoring of the contractors' performance were negatively affected when expenses were not consistently and accurately classified.

HUD's internal control monitoring of its contractors did not ensure timely and effective action in response to identified risks. For example, we found there was not an effective property inspection program that linked physical inspections to work billed. We also found that HUD made payments in its single-family program to a contractor for 1 year after we testified that the same contractor was engaging in abusive billing practices in HUD's multifamily program. Although HUD held numerous meetings with the contractor over several years since shortly after the inception of the contract in June 2001, HUD did not promptly or effectively address the identified risk by implementing compensating controls over this contractor's activities. We will discuss these issues in greater detail later in this report.

Lack of Controls Contributed To Questionable and Potentially Fraudulent Payments

The lack of fundamental internal controls over the process used to pay SF property expenses likely contributed to \$16.3 million of questionable and \$181,450 of potentially fraudulent payments that we identified through the use of forensic auditing techniques, including data mining and document analysis. We found questionable payments for invoices that had not been appropriately reviewed and authorized, that lacked adequate support and documentation, and where one person falsified a key support document. In

addition, HUD did not monitor contractor performance and take prompt action to correct known deficiencies. As a result, we found a number of instances where HUD paid for contractor services that were substandard or not performed at all. These potentially fraudulent billings were all made by a contractor we identified in our previous work on certain fiscal year 2001 MF property payments as carrying out highly questionable billing practices. HUD recently took action to end its use of this contractor. The \$16.5 million of questionable and potentially fraudulent payments made to contractors and other vendors during fiscal years 2002 and 2003 demonstrates the unacceptably high vulnerability of the program to questionable and potentially fraudulent payments.

Questionable Payments

We classified payments as questionable if they were not supported by sufficient documentation to enable an objective third party to determine if each payment was a valid use of government funds. For the \$16.3 million in payments we classified as questionable, we could not determine, as applicable, one or more of the following: (1) the nature of the goods or services HUD was paying for, (2) if the quantity and cost for the goods or services was correct for each item purchased, (3) if the government received the goods or services, (4) if a valid contract or other agreement existed to support the payment, (5) if the payment was for a valid obligation of the program, (6) if competitive bids had been obtained for the work, and (7) if there was a legitimate government need for the goods or services. Table 1 summarizes these questionable payments.

Table 1: Type, Number, and Amount of Questionable Payments

	Types of payment	Number of payments	Amount
1	<i>Contract change orders</i> Inadequate support	23	\$ 15,180,098
2	<i>Water and sewer services</i> HUD did not own the properties at the time of service	1	206,597
3	<i>Lead-based paint abatement program</i> Inadequate support	8	268,800
4	<i>Signs and airfreight delivery</i> Competitive bids not obtained	10	58,343
5	<i>Chain-link fences</i> Competitive bids not obtained	5	30,366
6	<i>Records management services</i> No evidence of an agreement for the services	3	296,087
7	<i>Relocation fee</i> No justification or verification	1	1,300
8	<i>Lawn service and repairs</i> Falsified work orders	23	23,000
9	<i>Other</i> Inadequate support	22	228,773
	Total questionable payments	96	\$ 16,293,364

Source: GAO analysis of payments for fiscal year 2002.

For illustrative purposes, we provide specific examples of actual support¹⁴ for eight payments. The documents that are reproduced in the examples were provided to us by HUD as support for these payments and are the same support that HUD officials relied on to review and approve the payments.

Example 1—Contract Change Orders

We identified \$15.2 million of questionable payments to contractors for contract change orders with inadequate support for the payments. For example, five property management contractors received \$10.6 million in payments for change orders when either no standard contract modification agreement supported the payments or the modification agreement was not

¹⁴We have redacted identifying information by “blacking-out” such information in the following figures.

signed by one or both parties. In addition, details of the amount charged for each property were not provided for most of the amounts included in each payment. Frequently, the payments were for services performed over long periods of time prior to the date of payment and the supporting documentation did not address why. For example, a change order issued March 2001 led to payments over a year later of fixed amounts totaling in the millions without an adequate explanation for the delay in payment included in the supporting documentation.

In January 2004, HUD headquarters officials advised us that fully executed contract modification agreements existed at the time each of the payments was made. While HUD officials acknowledged that the agreements and underlying detail support by property were not in the payment files, they stated that the reviewer, approver, and certifying official reviewed all documentation in order to verify the accuracy of the charges. We found no evidence that the reviewers, approvers, or certifying officials had located these documents to validate payments.

Figure 4 shows that the only support for a single payment of \$1,318,692 in June 2002 was an invoice that included two lines of explanation for \$452,000 and \$862,661 with the description: "Lump sum Payment for Change Order." No other support was provided for these two line items, such as a copy of a contract modification agreement signed by both parties, a list of the property numbers for the properties that received the goods or services, the time period covered by the payments, or an explanation as to what the government was paying for. Allocated costs, a pooled expense category, was charged with \$1,314,661 of the total payment. The balance of \$4,031 was charged to specific properties. HUD internal control policies require that specific properties be charged for all identifiable expenses. Further, there was no indication that the approver sought to determine the time period of the charges and relate that period to the dates HUD owned the properties for which the payments were made.

Figure 4: Invoice for Contract Change Orders

Equity Adjustment - MOD# 0033										
Case No	Street No	Address	City	Sta	Zip	New Date	Recon Date	Amount		
Transmittal#	00693									
Item 1:	131-ALLOCA	Lump sum Payment for Change Order							\$ 452,000.00	
Item 2:										
1	131-229696	7001	Chicago	IL	60621	Oct/03/01	Apr 08 2002	\$ 80.62		
2	131-270509	15213	Harvey	IL	60426	Sep/27/99	Apr 30 2002	\$ 80.62		
3	131-287723	15025	Harvey	IL	60426	May/05/00	Mar 07 2002	\$ 80.62		
4	131-303371	14929	Harvey	IL	60426	Jul/23/01	Mar 21 2002	\$ 80.62		
5	131-305048	8346	Chicago	IL	60617	Apr/24/01	Apr 12 2002	\$ 80.62		
6	131-335832	2810	Hazel Crest	IL	60429	Aug/14/01	Mar 26 2002	\$ 80.62		
7	131-349351	5943	Chicago	IL	60636	Nov/28/01	Mar 19 2002	\$ 80.62		
8	131-358752	7731	Chicago	IL	60620	Nov/23/01	Mar 13 2002	\$ 80.62		
9	131-376987	1217	Rock Island	IL	61201	Jan/18/00	Mar 13 2002	\$ 80.62		
10	131-381298	24	Round Lake Beach	IL	60073	Jul/26/01	Mar 26 2002	\$ 80.62		
11	131-383066	7001	Chicago	IL	60636	Dec/17/99	Mar 13 2002	\$ 80.62		
12	131-384938	7043	Chicago	IL	60636	Sep/27/99	Apr 05 2002	\$ 80.62		
13	131-390738	4338	Chicago	IL	60651	Sep/27/99	Apr 26 2002	\$ 80.62		
14	131-399918	13756	Riverdale	IL	60827	Oct/11/01	Mar 21 2002	\$ 80.62		
15	131-409181	5116	Cicero	IL	60804	Dec/27/01	Apr 29 2002	\$ 80.62		
16	131-417770	3536	Markham	IL	60426	Oct/04/00	Apr 12 2002	\$ 80.62		
17	131-447656	104	Calumet City	IL	60409	Jul/24/00	Mar 05 2002	\$ 80.62		
18	131-470936	6848-50	Chicago	IL	60636	Dec/21/01	Apr 15 2002	\$ 80.62		
19	131-475886	12414	Chicago	IL	60628	Jan/11/00	Mar 14 2002	\$ 80.62		
20	131-502344	140	Chicago	IL	60644	Mar/15/01	Mar 29 2002	\$ 80.62		
21	131-545224	11360	Chicago	IL	60643	Sep/07/01	Apr 12 2002	\$ 80.62		
22	131-550344	6341	Chicago	IL	60629	May/24/00	Mar 11 2002	\$ 80.62		
23	131-564937	1136	Chicago	IL	60651	Aug/18/00	Apr 26 2002	\$ 80.62		
24	131-571003	858	Chicago	IL	60651	May/22/01	Apr 26 2002	\$ 80.62		
25	131-580626	1318	Chicago	IL	60651	Sep/27/99	Apr 26 2002	\$ 80.62		
26	131-583695	5301	Chicago	IL	60609	Nov/09/01	Apr 23 2002	\$ 80.62		
27	131-584810	330	Park Forest	IL	60468	Aug/01/01	Apr 03 2002	\$ 80.62		
28	131-596163	511	Romeoville	IL	60446	Sep/27/99	Apr 17 2002	\$ 80.62		
29	131-602996	105	Chicago	IL	60644	Apr/21/00	Mar 20 2002	\$ 80.62		
30	131-607796	940	Chicago	IL	60651	Sep/05/00	Apr 26 2002	\$ 80.62		
31	131-608299	2812	Hazel Crest	IL	60429	Aug/18/00	Apr 01 2002	\$ 80.62		
32	131-614730	15722	Dolton	IL	60419	Sep/05/01	Mar 26 2002	\$ 80.62		
33	131-615348	348	Chicago	IL	60628	Sep/27/99	Mar 15 2002	\$ 80.62		
34	131-619770	15647	South Holland	IL	60473	Sep/20/01	Apr 17 2002	\$ 80.62		
35	131-626358	7828	Chicago	IL	60619	Jul/27/00	Mar 14 2002	\$ 80.62		
36	131-635642	15330	Harvey	IL	60426	Nov/26/01	Apr 09 2002	\$ 80.62		
37	131-642396	14317	Riverdale	IL	60827	Jun/22/01	Mar 18 2002	\$ 80.62		
38	131-645252	629	Bellwood	IL	60104	Oct/19/01	Mar 12 2002	\$ 80.62		
39	131-646259	230	Calumet City	IL	60409	Sep/27/99	Apr 12 2002	\$ 80.62		
40	131-647939	10133	Chicago	IL	60655	Oct/31/01	Mar 20 2002	\$ 80.62		
41	131-648069	6707	Chicago	IL	60649	Sep/24/01	Mar 29 2002	\$ 80.62		
42	131-661839	13941	Riverdale	IL	60827	Jun/07/00	Mar 27 2002	\$ 80.62		
43	131-670640	212	Joliet	IL	60433	Jan/07/02	Mar 21 2002	\$ 80.62		
44	131-673891	317	Peotone	IL	60468	Jul/20/01	Mar 04 2002	\$ 80.62		
45	131-674712	12241	Chicago	IL	60643	Jan/17/01	Apr 09 2002	\$ 80.62		
46	131-675360	2035	Carpentersville	IL	60110	Nov/23/01	Mar 13 2002	\$ 80.62		
47	131-683531	312	Round Lake Beach	IL	60073	Dec/11/01	Mar 15 2002	\$ 80.62		
48	131-687893	1009	Belvidere	IL	61008	Feb/09/01	Mar 22 2002	\$ 80.62		
49	131-688538	617	Chicago	IL	60619	Nov/07/01	Mar 07 2002	\$ 80.62		
50	131-692199	407	Vernon Hills	IL	60061	Dec/22/00	Mar 07 2002	\$ 80.62		
Total Item 2:								\$ 4,031.00		
Item 3:	131-ALLOCA	Lump sum Payment for Change Order							\$ 862,661.00	
Transmittal Total:								\$ 1,318,692.00		

For \$452,000 no support was included with the payment documentation

For \$4,031 there was no sign of verification of HUD ownership

For \$862,661 no support was included with the payment documentation

Source: HUD.

Example 2–Water and Sewer Services

We identified a \$206,597 payment to one contractor for water and sewer charges related to 31 HUD properties for an average of \$6,664 per property. HUD acquired the majority of the properties in 2001 or 2002. Substantially all the \$206,597 paid was for services provided prior to HUD's ownership. We considered this payment as questionable because the support was inadequate.

HUD regional officials informed us that payments were made to protect the properties from liens by the water authority. We found no indication in the payment support as to why HUD was paying for services provided even before the period of ownership covered by the most recent HUD-insured mortgage. While recognizing HUD's concern to protect the property from liens, we found no indication that HUD pursued why these charges had not been identified at the time of settlement and acquisition of the properties, or that the contractor or HUD had pursued negotiating a settlement with the water authority. Further, our review of the charges indicated numerous large amounts given the nature of the property and the time period involved. For example, one invoice dated July 2002 was for \$35,756 for water and sewer services from May 1995 through June 2002 for a property HUD acquired in June 2001. Our research identified three prior owners of this property during the period covered by the bill paid by HUD. Another invoice was for \$18,530 for services from January 1999 through May 2002 on a property HUD acquired in May 2002. Furthermore, at least two of the prior owners received FHA loans to purchase this property, even though at the time of purchase there were outstanding water and sewer bills related to the property. Yet, HUD's payment files contain no indication that HUD officials reviewed the charges for accuracy, despite the unusually large amounts.

Example 3–Lead-Based Paint Abatement Program

Our review found eight payments totaling \$268,800 that HUD headquarters directed its regional offices to make to a contractor for partial reimbursement of claimed expenses of \$529,682 to develop a lead-based paint abatement program. The contractor claimed that the lead-based paint abatement program was developed in response to a HUD request. Support for these payments did not include a signed contract modification form or other agreement for the contractor to develop such a program, or any indication of the amount or basis for settlement against the claimed expense of \$529,682. The support provided to us for two payments totaling

\$99,000 had no signatures by HUD officials indicating the requests had been reviewed, approved or certified for payment.

Further, the entire amount of the payments was charged to allocated costs, a pooled expense category, and not to specific properties as required by HUD policy.

Although we started asking for support for these payments in August 2003 and received some information from HUD over time, it was not until January 2004, HUD headquarters provided us with documentation that included emails from a HUD contracting official to the contractor that indicate that the contractor agreed to accept \$240,000 as the remaining payment on the lead-based paint services, that invoices for this amount will be handled as pass-through expenses similar to what was done for the initial payment of \$300,000 and that “we won’t need to issue contract modifications this way.”

No explanation was provided as to how the \$540,000 settlement was reached or why such amount exceeded the total amount claimed by the contractor. Further, the management contract provides that all costs of performance are at the expense of the contractor unless otherwise specifically identified as pass-through cost in the contract. HUD must approve any additional pass-through expenses prior to the expense being incurred. We found no evidence that development of a lead based paint abatement program was specifically identified as a pass-through cost or that HUD granted approval prior to the contractor incurring the expense.

Example 4-Signs and Airfreight Delivery

We identified 10 payments totaling \$58,343 for the purchase and shipping of over 14,950 “for sale” signs for use by contractors on HUD properties. The airfreight fee to ship the signs from Texas, the contractor's home office, to field offices in various states including California, Tennessee, and Illinois, totaled \$6,805. The contractor did not obtain the required competitive bids.¹⁵ Further, we found no evidence that (1) local supply sources had been considered, (2) the quantity of signs paid for was reviewed for reasonableness, or (3) the large air freight charges had been questioned. Also, we could not reconcile some amounts paid to the invoices used to support the payments. In January 2004, HUD headquarters officials advised

¹⁵HUD requires written bids for property expenses anticipated to exceed \$2,000.

us that they agreed to be responsible for all costs incurred by the contractor for developing the signs and for the accelerated delivery and that a contract modification agreement was executed. However, they did not provide an explanation as to why local supply sources had not been considered, nor did they address the other issues described above.

Example 5–Chain-Link Fences

We identified five payments totaling \$30,366, to reimburse a management contractor for fencing installed at multiple locations by a single vendor. Figure 5 shows one such fence. There was no evidence that the contractor obtained the required written competitive bids. The representatives of the contractor that we interviewed in August 2003 told us that a city ordinance requires this particular fencing vendor be used. In January 2004, HUD headquarters officials advised us that the vendor was awarded the work after a competitive bidding process. However, HUD could not locate the supporting documentation as the bidding process had occurred some years earlier.

Figure 5: Chain-Link Fence



Source: GAO.

Example 6–Records Management Services

We identified one payment of \$98,695 and two subsequent payments of \$98,696 each for a total of \$296,087 to a contractor for “Records Management.” The support for the first payment (fig. 6) was the billing from the contractor and an annotation from a HUD employee indicating that it was “OK to pay.” There was no contract included with the support for any of the payments. There also was no indication that the amount of the payments had been compared to a contract. HUD regional staff advised us that the “OK to pay” notation on one of the invoices by the division director was sufficient to process the payment. In January 2004, HUD headquarters officials advised us that a valid agreement for the services was in place at the time of payment, but neither the contract for the services, nor the modification to the agreement with the contractor, is required to be attached to the payment. However, we found no evidence that these documents were reviewed or considered prior to payment of the invoices.

Figure 6: Records Management Invoice

f #2 02 00069
Due to age of invoice, please pay as Non-Prompt.
 Invoice for October 10, 2001 Invoice # 1101
 (Contractor's Name) (Contract Number)
 Billing Address: [Redacted]
 NAID Number: [Redacted]
 Federal Tax ID Number: [Redacted]
 Bill To: U. S. Department of HUD
 Attention: [Redacted]
 40 Marietta Street
 Atlanta, GA 30303
Please process ASAP

SERVICES	COST
Records Management	\$ 98,695.00
TOTAL	\$ 98,695.00

 (Contractor's Signature) 10/10/2001 (Date)
OK to pay
Dir, All Chg Ops
10/3/01
Place under "allocate"
rec'd 10/18

Source: HUD.

Example 7–Relocation Fee

We identified a payment of \$1,300 to reimburse a contractor for a fee paid to an individual to vacate a property not in the HUD inventory. The support for the payment was an internal e-mail questioning if the property was in HUD’s inventory, a generic invoice that was unsigned and did not include the FHA property number—a HUD requirement for all payments (fig. 7), an unsigned “Agreement to Vacate” (fig. 8), and a final approval e-mail (fig. 9) without explanation. HUD regional staff subsequently told us that a signed “Agreement to Vacate” existed; however, we found no evidence of the signed agreement with the support for the payment. HUD charged the payment to Allocated Costs, a category for pooled expenses. The property located at the address on the form did not have a FHA property number, which is required to submit expenses for a HUD property. In January 2004, HUD regional officials confirmed that at the time of payment the property was not in the HUD automated payment system.

Figure 7: Relocation Invoice

INVOICE 50379 06/18/2002

PAYEE: [REDACTED]

CASE#	DESCRIPTION	PC	AMOUNT
	4 CONVENT ST	AC	\$1,300.00

INVOICE TOTAL \$1,300.00

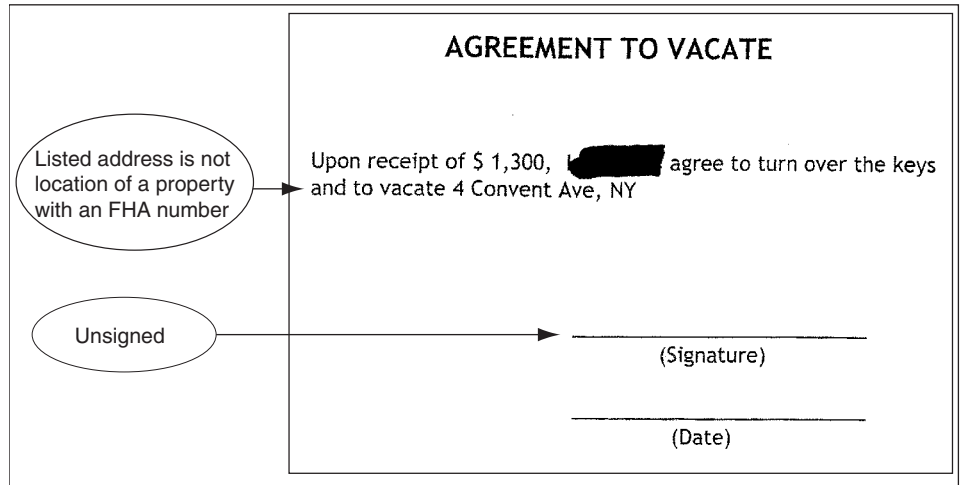
US Department of HUD
100 Penn Square East
Philadelphia, PA 19107-3380

USE AS ORIGINAL

No HUD property identifier (case number) →

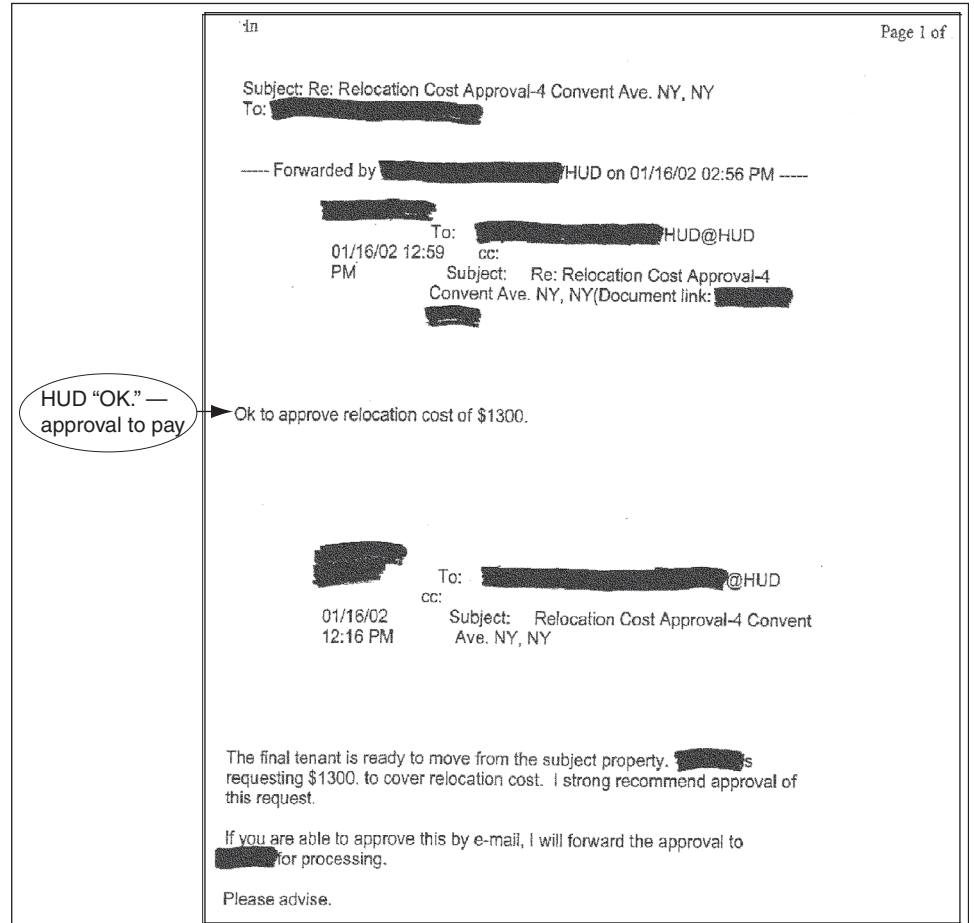
Source: HUD.

Figure 8: Agreement to Vacate



Source: HUD.

Figure 9: E-mail Approving Payment



Source: HUD.

Example 8—Lawn Service and Repairs

During our document analysis work we identified suspicious documents supporting a number of payments. Specifically, we found numerous work orders, one of which is illustrated by figure 10, that were initialed three times by the same person certifying (1) receipt of competitive bids, (2) completion of the work by the subcontractor, and (3) inspection of the work performed. During our site visit to Santa Ana, California, we interviewed representatives of the contractor and asked for an explanation for the initials on these work orders. We were told that they had not noticed the

similarity in the initials and did not know the identity of “S. C”, the person whose initials were on the work orders. Later the same day, the contractor advised HUD by phone that the work orders had been falsified to support disbursement requests.

Figure 10: Falsified Work Order

C102 00805

WORK ORDER

Work Order No: [REDACTED]
 Work Order Date: [REDACTED]
 2. REAM Area: VN
 REAM Telephone: [REDACTED]
 3. EONA: [REDACTED]
 4. FID/SSN: [REDACTED] (7)
 6. Case No: [REDACTED]
 MAPSCO: [REDACTED]
 Inspector: 7

1. Contractor: [REDACTED]
 Address: [REDACTED]
 Telephone: [REDACTED]
 5. Property: [REDACTED]
 City: Los Angeles, CA 90038

7. Description of Services	8. Quantity	9. Unit Price	10. Amount
AS PER YOUR BID AMOUNT FOR \$280.00, YOU HAVE AGREED TO REMOVE 20 WALLS OF GRAFFITI, 14 INTERIOR WALLS, 6 EXTERIOR WALLS, PAINT MATCH REQUIRED, BEFORE AND AFTER PICTURES REQUIRED, PER GF SPECS, RONALD /01			\$ 280.00
11. Total:			\$ 280.00

I certify the amount above is fair and reasonable based upon receipt of adequate competitive quotes. For "Emergency" work, if competitive quotes were not obtained the fairness and reasonableness of the quote was based upon quotes received over several years and periodically compared against current quotes and published national figures.

12. Certification: [Signature] Signature of REAM Name & Title Date

13. Work to begin by: Oct/17/01 Work to be completed by: Oct/21/01

14. Contractor's Certification of Completion:
 By signing this work order and submitting an invoice, I certify that all services stipulated in the "Description of Services" have been completed and/or supplies delivered, as of my signature date below, in accordance with the specifications, and that all claims of laborers or others performing services or furnishing materials in the performance of the services have been or will be paid. In addition, furnished herewith are all required permits and/or manufacturer warranties with respect to material, equipment or completion of services hereunder.

Contractor's Signature: [Signature] Signature Printed Name and Title Date

15. Inspection Statement:
 I certify that I (or my representative) personally inspected this property on the dates shown and to the best of my knowledge and belief, found that all specifications had been met and all items completed as stated in the "Description of Services. This also is to certify that, to the best of my knowledge, payment has not heretofore been made, and that the SAMS 1106 invoice Transmittal request, which is attached is relevant to this work order/purchase order and invoice.

e Invoiced Rec'd: [Signature] Date of Inspection: _____ Date of Acceptance: _____

Invoice Number Signature Printed Name of Inspector Date

14/02

Receipt of competitive bids should be signed by the contractor →

Completion of the work should be signed by the sub-contractor who performed the work →

Inspection of the work performed should be signed by the contractor →

Source: HUD.

We suggested to HUD that it perform an extensive review of payments meeting certain criteria to identify any additional potentially improper payments. HUD advised us in August 2003 that it was seeking reimbursement of approximately \$23,000 in payments that had been made based on similar falsified work orders. However, approximately 2 months later, HUD reversed its position and decided not to seek reimbursement for these payments because the contractor assured them the work had been performed. In January 2004, HUD headquarters officials advised us that they supported the decision to not seek reimbursement from the contractor because the work was “verified for completion.” However, the verification of performance of the work was provided—months after the date of payment—by the contractor that had falsified the documentation; HUD has not independently verified that the work was performed.

In addition to the previous eight examples, we identified 22 other questionable payments totaling \$228,773. These included payments for steel roll-up doors, appraisal services, newspaper advertising, and utilities. The common issue with these payments, like others classified as questionable, was the lack of adequate supporting documentation included with the payment. Without this support, we could not determine whether these payments were a valid use of government funds.

Because we tested only a small portion of the transactions that appeared to be high risk and HUD internal controls did not provide reasonable assurance that improper payments would not occur or would be detected in the normal course of business, there are likely other questionable payments that we have not identified.

Potentially Fraudulent Payments

HUD’s failure to monitor contractor performance and institute additional control activities in response to known risks resulted in at least \$181,450 of potentially fraudulent payments. We identified \$163,965 of potentially fraudulent payments made in fiscal year 2002 and \$17,485 made in fiscal year 2003. We classified payments as potentially fraudulent when the scope or quality of the work appeared to be misrepresented by the contractor or the work appeared not to have been done at all.

Through data mining, we initially identified 287 invoices, totaling \$476,104, for single-family construction renovations that were submitted to HUD by the contractor that our prior work identified as using highly questionable billing practices, including (1) alleging that construction renovations were emergencies, thus not requiring HUD preapproval, and (2) splitting

renovations into multiple projects to stay below the dollar threshold requiring HUD approval. Each of the 287 invoices supported fiscal year 2002 payments and was for an amount less than the \$2,500 threshold¹⁶ requiring HUD approval. We selected properties to test the validity, by physical inspection, of some of these \$476,104 in payments, focusing on those that appeared to be for tangible goods that we could readily identify. In total, we tested the validity of payments totaling \$136,264.

In June 2003, we visited nine HUD-owned single-family properties in New York City being managed by the contractor referred to above. HUD staff responsible for oversight of this contractor accompanied us to the properties. At each of the nine properties we visited, we noted discrepancies between what was represented on select invoices¹⁷ and what was actually received, and determined that all of the \$136,264 payments tested were potentially fraudulent payments. We took photographs to support our observations, when possible.

All of the invoices that we tested indicated that the work performed was purported to have been for emergency repairs, meaning that no HUD preapproval was required, nor was the property manager required to obtain competitive bids for the work. Many of the work projects for the same addresses were split among multiple invoices, most likely to stay below the dollar threshold requiring HUD approval—as in the case we reported last year about the multifamily construction renovation work performed by this contractor. The labor charge was always \$91 an hour—whether for clean up and debris removal or a project typically requiring a mastered skill, such as masonry.

We noted serious discrepancies between what was represented on invoices and what was actually received at each of the nine properties we visited. For illustrative purposes, we are providing specific examples of some of the discrepancies noted at five of the nine properties.

¹⁶Under the terms of the contract, the contractor was required to obtain HUD approval for all repairs anticipated to exceed \$2,500.

¹⁷It was not practical for us to test whether all of the other goods or services paid for were actually received due to the nature of the goods or services.

Property 1

On the basis of physical inspection, we determined that HUD paid at least \$30,701 in fiscal year 2002 for goods or services related to this property that were incomplete or do not appear to have been provided at all by the contractor. For example, HUD paid (1) over \$4,000 for replacement of the entire apartment floor, including the bathroom, (2) \$2,320 for a new ceiling and bathroom door, (3) \$2,170 to have four workers repair and install new Sheetrock®, and (4) \$1,590 for a small kitchen cabinet. The photographs (figs. 11 through 14) show little or no evidence that this work was performed.

Figure 11: Property 1—“New” Ceiling



Source: GAO.

Figure 12: Property 1–“New” Bathroom Floor



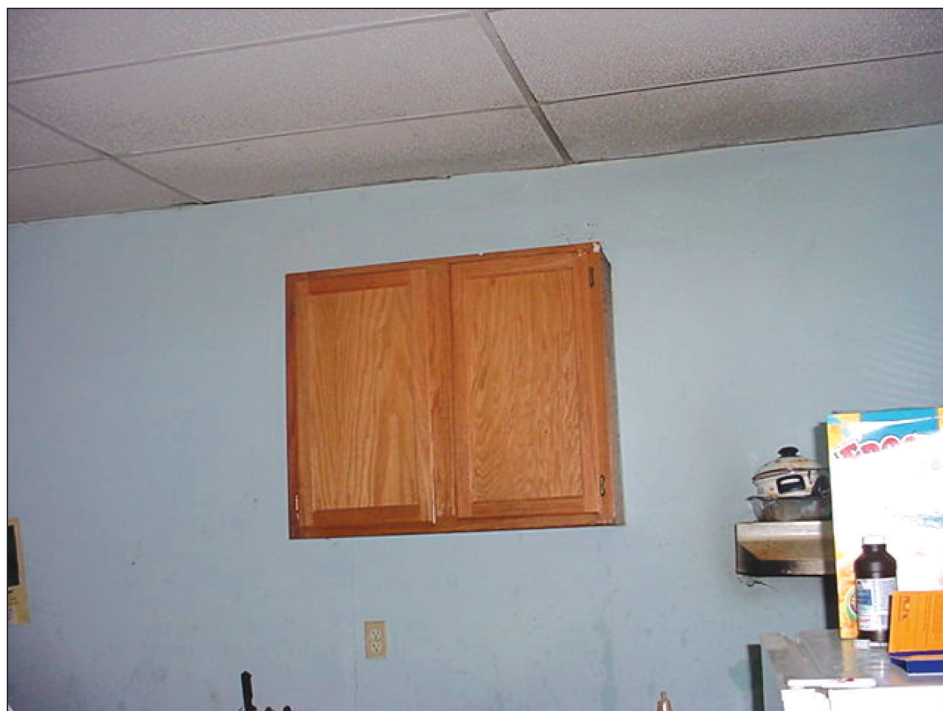
Source: GAO.

Figure 13: Property 1–“New” Sheetrock® Walls



Source: GAO.

Figure 14: Property 1—“\$1,590 Kitchen Cabinet”



Source: GAO.

As illustrated in figures 11 through 14, we saw no evidence of new flooring in the apartment, and in fact, most of the floors were missing tiles or otherwise very worn. The “new” ceiling was severely damaged and caved in, and there was no new bathroom door. We found no new Sheetrock®, but about two square feet of wall had been roughly patched. While there was a new cabinet, we found a cabinet similar to the one pictured at a large retailer for a price of less than \$50.

Property 2

On the basis of our physical inspection, we determined that HUD paid at least \$11,176, in fiscal year 2002, for goods or services related to this occupied property that were incomplete or do not appear to have been provided at all by the contractor. For example, HUD paid \$2,060 for “emergency repairs” to a bathroom and \$1,082 for repairs to a stairway. The photographs (figs. 15 through 17) show the condition of the “repaired”

bathroom and minimal work performed in the stairway at the time of our physical inspection.

Figure 15: Property 2–Bathroom “Repairs”



Source: GAO.

Figure 16: Property 2—More Bathroom “Repairs”



Source: GAO.

Figure 17: Property 2—“\$1,082 Wooden Dowels”



Source: GAO.

As illustrated in figure 17, the bathroom was in total disrepair. The repairs to the stairway were merely two wooden dowels that replaced missing balusters.

Property 3

On the basis of physical inspection, we determined that HUD paid at least \$9,538 for goods or services related to this property that were incomplete or do not appear to have been provided at all by the contractor. Specifically, HUD paid (1) \$2,265 for new ceilings, (2) \$3,560 for repairing and painting walls and ceilings, (3) \$3,162 for floor repairs and replacement, and (4) \$551 for a new refrigerator. The photographs (figs. 18 through 20) show the general condition of the ceilings, walls, and floors throughout this property after the repairs.

Figure 18: Property 3--“New” Kitchen Ceiling



Source: GAO.

Figure 19: Property 3—"New" Dining Room Ceiling on Floor



Source: GAO.

Figure 20: Property 3—"New" Living Room Floor



Source: GAO.

As shown in the preceding pictures, it appeared that new Sheetrock[®] was installed on the kitchen ceiling, however the job was not completed—the ceiling had not been sanded or painted. The dining room ceiling was caved in and the floors were old and in poor condition. In addition, the new refrigerator was missing.

Property 4

On the basis of a physical inspection, we determined that HUD paid at least \$32,677 for goods or services related to this property that were incomplete or do not appear to have been provided at all by the contractor. For example, HUD paid \$2,292 for four new metal doors and installation. We only found one metal door in the basement, shown in figure 21, which does not appear to be new.

Figure 21: Property 4—\$2,292 “New” Metal Door



Source: GAO.

In addition, HUD reimbursed the contractor for five invoices, totaling \$8,407, for additional work performed in the basement, including clean up

and debris removal and replacement of a wooden floor. The occupant we spoke with said the only work he was aware of being done to the basement was the installation of the one old metal door. HUD also paid \$3,978 for repairs to the front entrance stoop (fig. 22).

Figure 22: Property 4—\$3,978 in Stoop “Repairs”



Source: GAO.

Although we did observe patches of relatively new concrete, it appears that HUD was overcharged for this work. In addition, HUD paid \$3,200 for cleaning and removing debris from the backyard. The occupant said no one

had cleaned the backyard and we noted that the backyard was currently covered with debris, including old broken bicycles and large broken slabs of concrete.

Property 5

On the basis of physical inspection, we determined that HUD paid at least \$5,021 for goods or services related to this property that were incomplete or never received. The contractor was reimbursed \$1,048 for “emergency” repair and painting of the public hall. The photograph (fig. 23) is of the public hall.

Figure 23: Property 5—“Repaired and Painted” Public Hall



Source: GAO.

As shown in figure 23, only portions of the walls were roughly painted. In addition, HUD paid \$2,167 for repairs, including plastering and painting the walls and ceiling in the living room and dining room of one of the apartments on this property. The photograph (fig. 24) shows the condition of the ceiling and part of the wall in one of the rooms where this work was

said to have been performed. Similar conditions were observed in the other rooms purported to have been repaired.

Figure 24: Property 5—"Plastered and Painted" Ceiling



Source: GAO.

We noted similar discrepancies, totaling \$47,151, at the other four properties we visited. In total, based on our June 2003 physical inspection, our work indicated that 82 invoices, totaling \$136,264, were most likely fraudulent.

In June 2003, we met with HUD officials in headquarters to discuss the results of our June visit. The HUD Philadelphia office officials that accompanied us on our physical inspection were teleconferenced in on the meeting. We used the photographs included in this report to help communicate the severity of the deficiencies we noted.

We also discussed the results of our June visit with Committee staff, which resulted in an expansion of our work (1) to determine whether HUD had made changes to its internal controls to address the causes of the potentially fraudulent payments that we had identified in June 2003 and

(2) to test for additional potentially fraudulent payments. Our work included additional tests for receipt of goods and services for payments made in fiscal year 2002, as well as certain payments made in fiscal year 2003. As a result, we found another \$45,186 in potentially fraudulent payments, consisting of \$25,657 of fiscal year 2002 payments and \$19,529 of fiscal year 2003 payments.

We determined that HUD had not implemented new controls or modified existing controls to address weaknesses previously identified. For example, HUD did not institute monitoring policies that would increase the frequency or scope of the inspection to verify that goods or services paid for had, in fact, been received. Furthermore, HUD officials told us that the contractor had not been directed to perform the services for which HUD had paid \$136,264 and received little in return.

In November 2003, we attempted to physically inspect the same apartments in each of the nine previously visited properties. However, we only had access to the apartments within each property where the occupants allowed us to enter. In total, we gained access to seven of the nine properties that we visited in June. At these seven properties, we saw no evidence that any attempt was made to correct the work that HUD paid \$39,686 for and we previously identified as having been incomplete or not performed at all. The additional \$45,186 in potentially fraudulent payments that we found included \$13,138 for repairs and renovations to the properties we visited in June. The remaining \$32,048 of additional potentially fraudulent payments was related to nine additional properties that we visited. The same contractor managed these properties.

During this second visit, we again noted numerous discrepancies between what was represented on invoices and what was actually received. For illustrative purposes, we are providing specific examples of a few of the discrepancies noted.

At one of the properties that we revisited, HUD paid a total of \$2,759 for “emergency” repairs to a bathroom wall and floor tiles (\$1,756) and bathtub repairs (\$1,003). As evidenced by the photograph (fig. 25), the only indication that the bathroom wall or floor tiles had been repaired was that a few tiles on the wall by the toilet had been replaced.

Figure 25: “Repaired” Bathroom



Source: GAO.

As shown in the photograph (fig. 26), the “repaired” bathtub was old and rusted and did not appear to have received \$1,003 in repairs.

Figure 26: “Repaired” Bathtub



Source: GAO.

At yet another revisited property, we found an additional \$2,977 that HUD paid the contractor for repairs to the entrance lobby and public hallway. As discussed previously in this section, the entrance lobby had not been repaired and only portions of the public hall had been roughly painted. It was not evident that any further work had been done.

The remaining \$32,048 of additional potentially fraudulent payments was related to the nine new properties that we visited. We determined that HUD paid at least \$19,763 for goods and services related to one of these properties that did not appear to have been delivered. For example, HUD paid \$1,813 for installing new tiles to the stairs pictured (fig. 27).

Figure 27: “Newly Tiled” Stairway



Source: GAO.

As evidenced by the photograph above, the stairway was not retiled. At this same property, HUD paid the contractor \$2,008 to install a new ceramic tile bathroom floor, a shower rod, and a medicine cabinet. The floor we saw (fig. 28) appeared to be several years old. Furthermore, the occupant stated that he purchased and installed the medicine cabinet.

Figure 28: “New” Ceramic Bathroom Floor



Source: GAO.

At another property, we determined that HUD paid at least \$7,420 in potentially fraudulent payments, including \$1,847 for installing a new bathroom floor. As indicated in the photograph (fig. 29), portions of the bathroom floor were missing, and clearly had not been recently replaced.

Figure 29: “New” Bathroom Floor



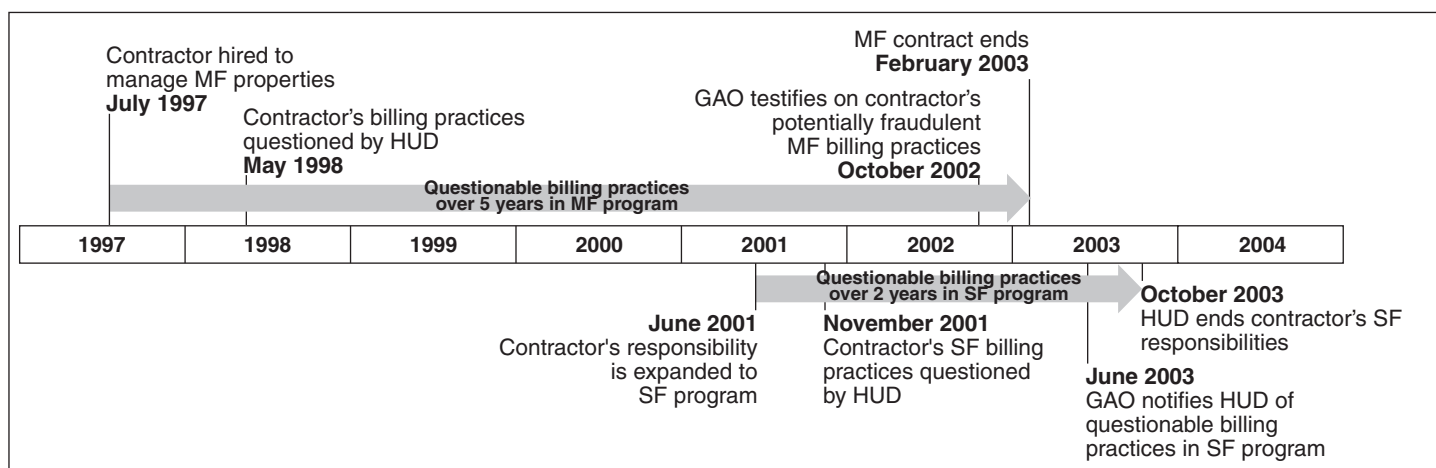
Source: GAO.

Our analysis of supporting documentation indicated that the contractor might have used the same scheme in the SF payment process that it had used to circumvent controls in the MF payment process, which we reported in October 2002. The scheme involved (1) alleging that construction renovations were emergencies, thus not requiring multiple bids or HUD preapproval, and (2) splitting renovations into multiple projects to stay below the dollar threshold of HUD-required approval. We referred the improprieties that we previously identified to the HUD OIG. A HUD OIG investigator told us that these improprieties have been referred to the U.S. Attorney’s Office.

As illustrated in figure 30, HUD hired the contractor in July 1997 to manage a portfolio of MF properties. During the first year of the contract, HUD became concerned about the contractor’s billing practices. HUD questioned the contractor about the rotation of vendors, determination of fair pricing, and reasonableness of work orders issued. HUD documented its many concerns, including that “it is evident that a great amount of money is being spent with little control in place.” In June 2001, despite serious performance deficiencies, including questionable procurement

practices, HUD increased the contractor's responsibilities by modifying the contract to include certain SF properties in New York City. In November 2001, HUD began to question the contractor about its billing practices related to the SF properties. In October 2002, we testified about the potentially fraudulent fiscal year 2001 billing practices of this contractor. According to HUD officials, the MF contract expired in February 2003.

Figure 30: Timeline of HUD's Relationship with Contractor



Source: GAO analysis.

According to HUD officials, the agency aggressively monitored the contractor's performance; identified performance deficiencies from the onset of the task order; and identified deficiencies in services, products, and billings to the contractor management. A HUD memorandum summarizing its efforts to improve the contractor's performance indicated that in November 2001, it began meeting with the contractor to review issues of concern about the SF properties. HUD noted that one of the obstacles to the contractor's successful performance was that the contract did not clearly define the details of work to be performed. In addition, the statement of work for the contract did not take into account the special nature of the 203(k) property challenges, such as sites dispersed throughout New York City and extensive legal and municipal involvement. The memorandum also stated that HUD considered terminating the contract. However, since the agency (1) had not issued any formal notices of concern to the contractor and (2) difficulty existed in quickly finding a qualified replacement contractor, HUD agreed to one final effort to

improve the contractor's performance. HUD and the contractor agreed to revise the statement of work to reflect a clearer and mutually agreed upon basis by which to measure the contractor's performance. The new statement of work was issued in June 2003. Within 60 days of the issuance of the new statement of work, HUD noted serious findings, including unacceptable work, unreasonable prices, and some work that appeared not to have been done at all. Throughout all of this period, HUD continued to pay bills from this contractor.

On October 23, 2003, HUD issued an amendment to the contractor's task order to end the contractor's management responsibilities on October 31, 2003. A new contract was put in place on October 17, 2003, which requires the new contractor to absorb the cost of all routine maintenance and repairs. HUD officials stated that the agency held back the payment of recently submitted billings from the prior contractor that HUD deemed questionable. However, HUD officials also told us that the agency was not seeking reimbursement for any previously paid billings, including those identified by our audit for which HUD received little in return. HUD paid this contractor \$2 million in fiscal year 2002 and over \$2.5 million in fiscal year 2003 for SF property expenses.

Insufficient Monitoring of a Major Multifamily Program

We found HUD's monitoring of a major multifamily pilot program with a state housing agency to be insufficient. HUD entered into an agreement that made it responsible for providing all the money needed to complete the program, while the state agency was responsible for developing and monitoring the program. HUD viewed the program as a way for the state agency to employ innovative management and disposition methods and entered into a sole source agreement with an initial development budget in the amount of \$187.5 million.¹⁸ However, HUD did not fully assess the program's inherent risks under the terms of the agreement and design compensating internal controls to address these risks. In addition, HUD did not implement internal controls appropriate for monitoring the escalating risks, while the cost of the program, borne by one of HUD's mortgage insurance funds, climbed to over \$537 million from inception in 1994 through September 30, 2003. Additional oversight by HUD may have helped prevent at least some of the more than half a billion dollars in program

¹⁸The development budget is based on rehabilitation costs of \$100,000 per apartment units.

costs—\$286,400 expended per apartment unit—for the renovation, interim management, and ultimate disposition of 1,875 apartment units.

The National Housing Act authorizes the Secretary of HUD to delegate to state agencies the performance of management and disposition-related functions.¹⁹ HUD determined that it was in the public interest for it to enter into a sole source agreement with a state housing agency for interim property management, to include renovation and ultimate disposition of 18 HUD-owned multifamily properties within the agency’s home state. HUD is providing all the money for the program and the state agency is responsible for all spending, including amounts for construction, renovation, and day-to-day operations of the properties. Although the program agreement did not list an expected completion date, HUD officials told us that the program was intended to take approximately 3 years. It is currently in its 10th.

Our publication, *Standards for Internal Control in The Federal Government*, states that (1) management needs to comprehensively identify risks and should consider all significant interactions between the entity and other parties, (2) internal control monitoring be performed to assess the quality of performance over time, and (3) appropriate internal controls should be implemented to improve accountability. However, we found that HUD’s monitoring was limited to the approval of property budgets. Internal controls should be designed to ensure that ongoing monitoring occurs in the course of normal operations. When, as here, the terms of the agreement charge one party with authority over virtually all spending decisions, including to whom, in what amount, and under what terms large construction contracts will be let, and the other party is responsible for paying all the bills, strong monitoring controls are necessary to control spending and encourage financial accountability.

In spite of the inherent risks that stemmed from the terms of the underlying agreement with the state housing agency, HUD did not analyze these risks and design controls to address them either initially or in reaction to escalating costs over a 9-year period. HUD did not incorporate adequate spending controls that may have served to limit its financial exposure before entering into the program agreement with the state agency. Spending controls that may have been appropriate considering the terms of the agreement with the state agency include: specifying performance

¹⁹12 U.S.C. § 1702.

penalties for missed completion dates, requiring that feasibility studies be conducted prior to undertaking major contractual commitments, providing a cost-sharing formula that would assign some economic risk to the program developer, and limiting the amount that HUD would pay for specific line items by project, such as a ceiling on the amount that would be reimbursed for tenant upgrades by property. Furthermore, despite significant spending in excess of the original budget, HUD's oversight of the program never evolved beyond approval of the properties' initial development budgets. HUD also did not establish processes to routinely estimate and compare projected development costs to total estimated costs per the program agreement or to consider the impact of unanticipated occurrences, such as expenses to mitigate environmental hazards.

The largest categories of expenditures were for general construction and other contractor charges. The state agency was responsible for all aspects of the contracting process including the competition plan, which typically is a key function in ensuring that the government receives the best combination of price and quality. These general construction payments totaled approximately \$178 million of the total incurred cost of \$481 million through September 30, 2002. The state agency awarded 23 separate construction contracts to rehabilitate the 16 properties in the program that ranged in amount from \$49,600 to over \$45 million. The construction contractors received periodic payments based on the percentage of work completed, which was reflected in monthly requisitions. The state agency was solely responsible for reviewing and approving the monthly requisitions and construction contractors' periodic payment requests. HUD paid all of these expenses, while providing no oversight of the construction contractor's monthly payments beyond the approval of initial development budgets.

HUD paid significant amounts for expenses in excess of amounts in the original contract award due to unforeseen natural conditions, tenant requests, and other contract amendments for changes in the architectural scope of work. For example, HUD paid an additional \$8.9 million in contract amendments at one property, which had an initial construction contract of over \$45 million. Contract amendments were granted when the architectural specifications included in the original construction contract did not include certain work being performed by the construction contractor. These payments were for unforeseen conditions, such as the need to address environmental hazards and requests from tenants for tenant upgrades. Tenant upgrades at one 236-unit property included the following: installation of molding on stairs, \$101,779 (\$431 per unit); labor

and materials for two coats of varnish on stair molding, \$115,000 (\$487 per unit); upgrades to ceiling light fixtures, \$114,648 (\$189 per bedroom); ceramic tile back splashes, \$71,775 (\$304 per unit); soap dispensers at sinks for \$19,430 (\$82 per unit); and upgrades of door hardware from satin chrome to satin brass for \$18,650 (\$79 per unit). HUD was not in a position, due to its limited monitoring of the program, to challenge or otherwise determine the validity of these payments.

HUD also granted the state agency the flexibility to make payments “off-budget.” The expenses designated as off-budget included such costs as environmental hazards, consulting and monitoring, and tenant relocation expenses. The state agency’s annually adjusted asset management fee was also considered off budget. In addition, for one property we found that HUD directed the classification of charges associated with extraordinary site development and building demolition as environmental hazard expenses. This classification allowed the costs to be considered as off budget. Since inception of the program, payments made by HUD that were classified as off-budget totaled over \$241 million (see table 2), including environmental hazard expenses of approximately \$58 million, and expenses related to tenant relocation of \$46 million. When HUD granted the state agency the ability to charge off-budget items and then did not define or limit this type of spending, it substantially weakened the effectiveness of the limited control stemming from its approval of the original development budget for each property.

Improper payments result in hidden expenses that must be paid for by either decreases in program spending or increases in appropriations or mortgage insurance premiums paid by the public.

Table 2: HUD Spending Related to Multifamily Program

Dollars in millions		
Program spending through fiscal year 2002		Amounts
Budget costs		
Original budget	\$187.5	
Amendments	<u>52.0</u>	
		\$239.5
Off-Budget costs		
Environmental hazard abatement	57.6	
Tenant relocation expenses	45.5	
State agency management fee	15.1	
Operating cost (security, payroll, etc.)	<u>123.3</u>	
		241.5
Total		\$481

Source: GAO analysis.

As of the close of fiscal year 2002, the program has cost HUD in excess of \$481 million, almost \$300 million more than the original development budget, and remains a work in progress. In addition, HUD reported that an additional \$56 million was expended for this program in fiscal year 2003. HUD officials have advised us that they do not plan on entering into any future agreements with similar terms. Internal controls tailored to address the inherent risk, including additional oversight by HUD, may have prevented some of the cost escalation and would have provided management with a reasonable basis for ensuring that the more than half a billion dollars in program payments were properly supported as a valid use of government funds.

Conclusions

The problems we identified with internal controls and risk management over HUD single-family and multifamily property programs leave the agency vulnerable to wasteful, fraudulent, or otherwise improper payments. This vulnerability was capitalized upon by at least one contractor and potentially others during the period of our review as evidenced by the potentially fraudulent and questionable payments we identified in the SF program. Even after HUD officials became fully aware of this improper activity, they did not take timely action to stop the flow of money being paid to this contractor for substandard or nonexistent services. Further, HUD also failed to establish any kind of control over money it provided for the major multifamily program, even though costs escalated to triple the original development budget.

Improper payments increase the expense of program delivery and may reduce the quality of program services. This additional expense must be funded by either a decrease in spending in the affected program area or in other FHA programs or by an increase in revenue from congressional appropriations or mortgage insurance premiums paid by those buying homes through the FHA SF program. Because of the long-term nature of funding decisions for the HUD mortgage insurance funds, including the rates charged for mortgage insurance, the impact of improper payments might not be visible to policymakers and managers. Such hidden expenses are nevertheless real and cumulative in effect. HUD must take steps to identify and manage its improper payments in order to minimize costs to FHA mortgage holders and taxpayers and maximize funds available to carry out its programs.

Recommendations for Executive Action

Single-Family Property Program

To improve internal controls over HUD's single-family property program, we recommend that the Secretary for Housing and Urban Development direct the Assistant Secretary for Housing-Federal Housing Commissioner to take the following 22 actions to address the weaknesses within the single-family program discussed in this report.

- Establish policies and procedures that create a positive control environment for all key steps in the single-family payment process. These polices and procedures should
 - require management contractors to prepare all payment requests for which they are the payee, including any revised payment requests that may be required;
 - provide adequate controls over preparation, review, and approval of payment requests for vendors that do not have access to the automated HUD Single-Family Acquired Asset Management System;
 - specify that the technical review of payment requests be performed solely by HUD-appointed individuals with the requisite training and experience; and
 - require HUD monitoring at prescribed time intervals to ensure that these control features are being consistently implemented at all payment review locations.
- Establish policies and procedures over single-family payments to contractors and other vendors that ensure all such payments are clearly documented and the documentation is readily available for appropriate officials to consider at the time they review and approve payment requests. Depending on the type of payment, these policies and procedures should
 - necessitate evidence of the nature of the goods or services the payment is for;

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- call for documenting that the quantity and cost for the goods or services is correct, was received and has been reviewed for each item purchased;
 - require annotated verification that the amount and timing of the payment is supported by a valid contract or other agreement signed by both parties;
 - require documentation that the payment is for a valid obligation of the program;
 - stipulate that competitive bids be obtained and evaluated before the work is performed;
 - require confirmation that the goods or services are for a legitimate government need;
 - require that all invoices and other supporting documentation be effectively canceled to prevent reuse; and
 - require that only original documents be used to support payments, or that there be evidence of compliance with policies concerning the use of reproduced documents.
- Establish policies and procedures over single-family payments to contractors and other vendors that will improve the effectiveness of HUD's oversight of contractor performance. These policies and procedures should
 - establish standard business metrics for comparing contractor performance, to include expense data by contractor, total expenses per property, and per expense classification;
 - ensure the preparation and review of these metrics regularly to identify cost saving opportunities, unusual patterns that require attention, and potential instances of fraud, waste, and mismanagement; and
 - establish specific guidelines for when single-family payments to contractors and other vendors may be classified as allocated costs.

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- Establish consistent practices for single-family payment processes, to include the preparation of payment requests, review and approval of payment requests, and minimum supporting documentation standards for all payments, that will clarify what policies and procedures must be adhered to by headquarters and all homeownership centers.
 - Follow up on each of the payments we identified as questionable or potentially fraudulent to
 - determine if the payments are a valid use of government funds;
 - identify the causes for these payments to occur and not be detected in the ordinary course of business; and
 - pursue recovery of amounts paid, as appropriate.
 - Perform a risk assessment of single-family payments to contractors and other vendors to determine the nature and extent of HUD's exposure to improper payments. The risk assessment should
 - include a comprehensive review and analysis of operations to determine where risks exist and what those risks are, including assessing the need for linking property inspections with billed amounts for goods and services provided;
 - measure the potential or actual impact of identified risks on program operations; and
 - establish compensating internal controls to address areas of vulnerability identified through the risk assessment process.

Multifamily Program with a State Housing Agency

- To address the significant internal control weaknesses that we identified related to monitoring the multifamily program with a state housing agency under a sole source agreement, we recommend that the Secretary of Housing and Urban Development direct the Assistant Secretary for Housing-Federal Housing Commissioner take the following two actions.
 - Implement risk-based oversight and monitoring policies and procedures to reduce HUD's vulnerability to fraud, waste, abuse, and

mismanagement in the multifamily program with the state housing agency.

- Consider requesting the HUD Office of Inspector General to review the propriety of the use of funds under the program with the state housing agency.

Agency Comments and Our Evaluation

In written comments on a draft of this report, from HUD's Assistant Secretary for Housing–Federal Housing Commissioner which are reprinted in appendix II, HUD agreed with some of our findings and recommendations and disagreed with others. In particular HUD (1) disagreed with our classification of certain payments, including \$15.2 million of inadequately supported payments for contract change orders, as questionable payments; (2) agreed that the contractor for the New York properties failed to provide certain services or provided unacceptable services, but stated it had held back certain payments to the contractor that included amounts we reported as potentially fraudulent; and (3) regarding our recommendations related to the MF pilot program, acknowledged that its agreement with the state agency did not contain the necessary controls and oversight protocols to preclude the types of problems we identified and agreed to examine opportunities to enhance its oversight over the remaining life of this particular program; however, it did not agree to enlist the HUD IG's support to review the propriety of the use of the funds at this time. HUD did not specifically comment on the other 22 recommendations related to its SF program.

With regard to contract change orders, HUD stated that it is inappropriate for us to consider these 23 payments totaling \$15.2 million as questionable. HUD stated that for each of these payments (1) it had provided us signed copies of the contract modifications, (2) the payments are clearly supported by contract modifications issued by approved HUD contracting specialists, (3) agency staff adhered to appropriate procedures in the review and payment for the services identified in the modifications, and (4) notations on the respective invoices by the HUD reviewing official that he or she had looked at the contract modification to confirm its *existence prior to payment* [emphasis added] is certainly not a prescribed procedure and should not cause these payments to be classified as questionable.

We disagree. We classified payments as questionable if they were not supported by sufficient documentation to enable an objective third party to determine if the payment was a valid use of government funds. We found

each of these 23 payments totaling \$15.2 million to be inadequately supported at the time the payment was made. As stated in the report, these payments were made without basic support such as standard contract modification or other agreements signed by the contractors and HUD, indication of the timing, quantity, and nature of the goods and services provided, and identification of the specific properties covered by the payments.

In January 2004, several months after our initial request for supporting documentation for these payments and after our fieldwork was completed, HUD headquarters officials advised us that fully executed contract modification agreements existed at the time each of these payments was made. These officials acknowledged that the agreements and underlying detail support by property were not in the payment files but that the reviewing, approving, and certifying officials reviewed all documents in order to verify the accuracy of the charges. However, we found no evidence of this during our site visits. In fact not one HUD reviewing, approving, or certifying official indicated to us that they went beyond the documentation contained with the payment request to ascertain the propriety of the payments we reviewed.

Also, in January 2004, HUD headquarters officials forwarded us signed copies of some, but not all of the contract modifications. That fact that the signed contract modifications may have existed at the time payments were made is peripheral to one of our core points that—HUD reviewing, approving, and certifying officials have available and consider at the time they review and approve the payment sufficient supporting documentation to determine that a payment is a valid use of government funds. It is clear from our review that this did not occur in the case of these \$15.2 million payments for contract change orders. In addition, the existence of the contract modifications does not negate our other core point. Without specific documentation, which HUD did not provide, indicating such things as (1) the properties the charges relate to, (2) the time period the charges were incurred, (3) an explanation of what goods or services were provided, and (4) that HUD owned the properties at the time the goods or services were provided, we could not determine the validity of these payments. Therefore, they remain questionable.

HUD raised similar issues with regard to each of the other 8 categories of payments totaling \$1,113,266 that we classified as questionable. We address these other issues in our more detailed comments in appendix II, where we reaffirm our position that all of these payments are questionable.

Regarding the potentially fraudulent payments, HUD stated, and we agree, that the department is obligated by government contracting procedures to work with a sub-performing contractor to improve performance, rather than move to immediate termination. However, it is not clear to us why knowing of these serious performance deficiencies, including questionable procurement practices that became apparent within the first year of the contract, HUD continued for over 6 years to pay this contractor over \$425 million for charges related to SF and MF properties without instituting additional controls to determine whether the goods and services billed for had actually been provided at the properties.

In addition, we disagree with HUD's statement that its "hold back" included disbursements reported as potentially fraudulent payments in this report. First, we assume that HUD means that it is recouping some of these payments by holding back payment on newly received invoices from this contractor. However, HUD staff responsible for oversight of the contractor informed us that the held back payments relate to a barrage of old invoices, some going back 2 or 3 years, that the contractor submitted during the contract termination process. Many of these invoices had previously been rejected by HUD, and the contractor merely resubmitted them. Therefore, holding back payment on these invoices, while helping HUD avoid making additional potentially fraudulent payments, does not result in the recoupment of previously made payments for invalid charges.

In regards to our MF program recommendation to consider requesting the HUD IG to review the propriety of the use of funds under the program, HUD stated it has already initiated enforcement actions and claims against certain architects and contractors for failing to perform satisfactorily and plans to vigorously pursue all necessary enforcement actions that arise related to this program. However, HUD said it would not consider requesting the IG to review the propriety of the use of the funds for this program at this time, as we recommended, but may elect to refer unsatisfactory performance issues to the IG for further review. HUD also said that it intends to complete a full evaluation of the program goals and implementation at the end of the program and that the current HUD administration would not recommend that the program be repeated. We share HUD's concern regarding this type of program and continue to believe that given the hundreds of millions of dollars in budget overruns, and the minimal oversight by HUD, that an independent review by the IG office should be considered a part of HUD's fiduciary responsibilities over the funds.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its date. At that time, we will send copies to the Ranking Minority Member of the House Committee on Government Reform; the Secretary of Housing and Urban Development; and other interested parties. We will make copies available to others upon request. In addition, this report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

Should you or your staff have questions on matters discussed in this report, please contact me at (202) 512-9508 or calboml@gao.gov or Robert Owens, Assistant Director, at (202) 512-8579 or owensr@gao.gov. Major contributors to this report are acknowledged in appendix III.

Sincerely yours,



Linda M. Calbom
Director, Financial Management
and Assurance

Scope and Methodology

Single-Family Property Program

To assess internal controls over HUD SF property payment transactions and determine whether they provide reasonable assurance that improper payments will not be made or will be detected in the normal course of business, we

- reviewed HUD SF policies and procedures, property management and marketing contracts and amendments, our previous reports, and reports issued by HUD's IG, a financial management consultant, and an independent contractor.
- conducted walk-throughs of transactions and interviewed officials at HUD headquarters, each of the four homeownership centers, and three contractor offices.
- tested internal controls using a statistically selected sample of transactions. Specifically, we selected a stratified random probability sample of 145 single-family disbursement transactions from a population of 238,411 fiscal year 2002 transactions. We stratified the population into HUD's four regions—Atlanta, California, Denver, and Philadelphia—on the basis of SF disbursement transactions made during fiscal year 2002. The sampling unit was one disbursement transaction occurring between the October 1, 2001, and September 30, 2002 posting dates. Our estimates were calculated using a 95 percent confidence level. In other words, we are 95 percent confident that each of the confidence intervals in the report includes the true values in the population. We tested the following attributes: (1) proper approval and (2) validity of payment. We provided HUD with the transactions selected and obtained and reviewed related supporting documentation.

To determine whether payments are properly supported as a valid use of government funds, we

- performed data mining¹ on the database of HUD's fiscal year 2002 disbursements for HUD SF properties to identify potentially improper and questionable payments. We discussed the results of our analysis with HUD regional and headquarters managers and requested that they provide specific written responses to the payments that we identified as

¹Data mining applies a search process to a data set, analyzing for trends, relationships, and interesting associations. For instance, it can be used to efficiently query transaction data for characteristics that may indicate potentially improper activity.

potentially improper and questionable. We considered the responses we received to assess whether in fact the payments were improper—that is, questionable or potentially fraudulent and

- nonstatistically selected certain payments described in the payment records as incurred for tangible goods and services and physically inspected the properties to test if the work described in the books and records was fully performed and the tangible goods received.

In June 2003, on the basis of the results of the above-described work, we communicated to HUD and representatives of your Committee on Government Reform, that we had identified certain potentially fraudulent payments. In November 2003, at the request of the Committee, we expanded our work to (1) determine whether HUD had made changes to its internal controls to address the causes of the potentially fraudulent payments that we had identified in June 2003 and (2) test for additional potentially fraudulent payments. We performed this work by interviews with officials at HUD headquarters and one homeownership center, data mining and physical inspection of properties. Our data mining and physical inspection work included additional tests for receipt of goods and services for payments made in fiscal year 2002 as well as certain payments made in fiscal year 2003.

To assess internal controls over HUD SF properties and to identify generally accepted principles and practices for a sound internal control environment, we used our *Standards for Internal Control in the Federal Government*, *Internal Control Management and Evaluation Tool*, *Guide for Evaluating and Testing Controls Over Sensitive Payments*, and *Strategies to Manage Improper Payments*.

While we identified some improper payments—questionable and potentially fraudulent—our work was not designed to identify all improper payments made in the HUD SF property program.

Multifamily Program with a State Housing Agency

To assess HUD's monitoring of the multifamily program with a state housing agency, we

- reviewed HUD's MF policies and procedures, the state housing agency's policies and procedures, contracts and agreements including HUD's contract with the state housing agency, our previous reports, as well as reports issued by HUD's IG and

-
- conducted walk-throughs of transactions and interviewed officials at HUD headquarters, a field office, and the state housing agency and its contractor offices to identify what controls had been established to manage the inherent risk of the program as well as monitor payments over time.

We also performed analytical reviews of the payment activity since inception in 1994 through September 30, 2002. Specifically, we developed a template of program expenses for each property by expense line items, such as general construction expense, environmental abatement expenses, and expense per housing unit. We compared total costs per property to amounts per the initial contract with the general contractor as well as subsequent amendments. We discussed the results of our analysis with HUD regional and headquarters managers and requested that they provide specific written responses to issues and questions identified by our analysis. We considered the responses we received – in writing and orally – in assessing HUD’s performance in monitoring the program.

We conducted our review, in accordance with generally accepted government auditing standards as well as with the investigative standards established by the President’s Council on Integrity and Efficiency, from December 2002 through January 2004 at HUD headquarters, a field office, and homeownership centers in Atlanta, Ga.; Philadelphia, Pa.; and Santa Ana, Calif. We also visited contractor offices in Atlanta, Ga.; Philadelphia, Pa.; Santa Ana, Ca.; and Falls Church, Va.

We requested written comments on this report from the Acting Secretary of HUD or his designee. Written comments were received from Assistant Secretary for Housing–Federal Housing Commissioner and are reprinted in appendix II.

Comments from the Department of Housing and Urban Development

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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

February 19, 2004

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

Ms. Linda M. Calbom
Director, Financial Management and Assurance
United States General Accounting Office
Washington, DC 20548

Dear Ms. Calbom:

Thank you for the opportunity to comment on the draft report, "HUD Single-Family and Multifamily Property Programs – Inadequate Controls Resulted in Questionable and Fraudulent Payments." (GAO-04-390). This report resulted from a review by your office lasting a period of approximately 18 months. The draft report notes that the General Accounting Office (GAO) and HUD's Office of Inspector General (OIG) have previously reported weaknesses in HUD's monitoring of both Single Family and Multifamily programs. In fact, significant improvements have been implemented in both programs over this 18-month period, and this year HUD's OIG removed a "reportable condition" noted in earlier years concerning HUD's oversight of its Single Family Management and Marketing (M&M) contractors.

The report raises four issues: (1) questionable payments to Management and Marketing contractors; (2) improper payments to a single contractor and subcontractor for a group of properties in New York City, apart from the Management and Marketing contractors; (3) failure to follow appropriate review procedures for Management and Marketing contract payments; and (4) failure to establish adequate controls for a single multifamily demonstration project in Boston. I will address each of these issues in turn.

Questionable Payments to Management and Marketing Contractors

A series of ostensibly questionable payments are listed on a chart on page 28 of the report. Related to Category 1 on the chart, the report states that GAO classifies \$16.3 million of payments on single family properties as questionable because they were not supported by sufficient documentation to determine their validity. Of this amount, \$15.2 million involves a single category of payments to single family M&M contractors (Category 1 on the chart, subsequently detailed in Example 1). These payments are appropriate and are clearly supported by contract modifications issued by approved HUD contracting specialists. Copies of the contract modifications, signed by representatives from both HUD and the contractors, have been forwarded to your staff. Copies of the initial unilateral work orders that directed that contractors complete specified tasks, again signed by appropriate HUD contracting specialists, have also been provided. In all payments related to these modifications, HUD staff adhered to appropriate procedures in the review and payment for the services identified in the modifications.

www.hud.gov espanol.hud.gov

See comment 1.

See comment 2.

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Comments from the Department of Housing
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Further information concerning these payments may be useful. During March 2001, each M&M contract was modified pursuant to the Changes Clause (FAR 52.243-1) to revise specific terms of the contract scope of work. As provided by FAR 43.103(b)(2) and 43.201, these "change orders" (a type of contract modification) were issued unilaterally by the contracting officer. The change orders required each M&M contractor to alter its performance accordingly, and extended to each contractor an opportunity to submit a proposal and negotiate an equitable adjustment to the contract price and terms. These negotiations lasted about a year, because there was a significant difference between the prices that each M&M contractor sought and the charges that HUD believed to be reasonable.

As a result of the negotiations, each M&M contract was modified (in most cases more than once) by a supplemental agreement (a modification signed by both parties- FAR 43.103(a)(1)). *While these negotiations were protracted, HUD negotiated a cumulative reduction of over \$88 million from the amount proposed by the M&M contractors.*

Within this category, the specific instance cited by GAO on pages 29 - 31 of the draft report concerns contract C-OPC-21519 with Golden Feather (GF) covering "Atlanta Area 1" (Illinois). GAO Figure 4, page 31, is an invoice from GF. Items 1 and 3 on the invoice track directly to the lump sum settlement outlined in modification 33 (bi-lateral supplemental agreement - signed by both parties) to the GF A1 contract. The top of the invoice (GAO Figure 4) has the header "Equity (sic) Adjustment - MOD#0033." Modification 33 to the GF contract was provided to GAO and it established as item 1 that GF was entitled to a "Lump sum payment of \$452,000 for Atlanta Area 1...for costs resulting from the Change Order (excluding windows, roofs, and incentive/disincentives)." Item 3 of the same modification established a "Lump sum payment of \$862,661 for Atlanta Area 1...for costs resulting from the Change Order covering windows, roofs, and incentive/disincentives." The audit trail is very clear.

It is inappropriate to label these payments as questionable. Your staff has expressed a concern that the invoices submitted by the contractors and the contract modifications and change orders were maintained in separate files within each Single Family Homeownership Center, raising a concern that the HUD reviewing official failed to confirm proper support for the payment. In fact, the example of an invoice provided in your draft report included the correctly referenced contract modification. Further notation on the invoice by the HUD reviewing official that he or she had looked at the contract modification to confirm its existence prior to payment (as recommended by your staff) is certainly not a prescribed procedure, and should not cause these payments to be classified as "questionable."

Category 2 on the chart concerns \$206,597 for water payments for properties owned by HUD, where the obligations were incurred prior to HUD's acquisition of the property. Failure to satisfy such obligations as water bills may result in liens being placed on the property. Even if the Department were successful in challenging these liens, delays in property sales due to the liens would increase property expenses and would certainly have a detrimental impact on the communities in which these houses are located. Further, under their contract of insurance, lenders

See comment 3.

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who own properties after foreclosure and prior to conveyance to HUD can be reimbursed by HUD for expenses such as water bills, and former occupants who have lost their homes to foreclosure are unlikely to pay restitution to HUD on this matter. When properties are conveyed by lenders with such obligations still outstanding, payment by M&M contractors (with reimbursement by HUD to the M&M contractor rather than to the lender) to utility companies to satisfy these obligations are a practical and appropriate action. With the exception of two properties where part of the obligation was incurred prior to FHA loan insurance, these payments are justified.

See comment 4.

Category 3 on the chart concerns \$169,800 for partial reimbursements of a contractor's claimed expenses for a lead based paint abatement program, which lacked a signed contract modification. This category of payments is also discussed on page 6 and page 33 of the draft report. As part of your request for relevant documentation, the Department provided your staff with an e-mail issued by the HUD Contracting Officer in the HUD Denver Office just prior to disbursements, verifying for Office of Housing staff that no contract modification was necessary as these payments were reimbursable expenses. On February 2, 2004, your staff requested two transmittals related to these reimbursements. HUD staff noted, in response to this request, that copies of the transmittals had been previously provided to GAO. We have again obtained copies of the two transmittals requested and three others that support payments made for these services, and these transmittals have been forwarded to your staff.

See comment 5.

Category 4 on the chart concerns payments for Management and Marketing contractors to produce revised "For Sale" signs. This example is also discussed on page 7 of the draft report. Revisions to HUD For Sale signs were directed by the prior FHA Commissioner, based on his determination that communities were being adversely effected by ineffective signs failing to clearly designate where referrals could be made regarding poor property conditions. Using his management prerogative, the former Commissioner directed that the signs be produced on an emergency basis. Contract modifications supporting these expenditures were put in place and have been provided to your staff.

See comment 6.

Category 5 on the chart concerns special expenses related to chain link fence installations in the Los Angeles area. This example is discussed on page 35 of the draft report. Your staff was provided with a copy of the local ordinance requiring special fencing. HUD officials were unable to locate copies of competitive bids from fence installers and provide these to your staff, although such bids had been obtained by HUD staff at an earlier date. Recently the HUD office acquired updated bids to support payments related to this required activity.

See comment 7.

Category 6 refers to a payment made to Best Assets/Citiwest. This is also a proper payment supported by a signed, appropriately executed contract modification previously provided to GAO staff. Similar to other contract modifications which were the result of negotiations by HUD contracting officers, the contract modification represents the appropriate supporting documentation for this disbursement.

See comment 8.

Category 7 refers to one payment listed on the chart of \$1,300 for relocation expenses. HUD agrees that this payment, made to pay for relocation expenses of a tenant living in a property securing a HUD insured loan, should not have been treated as a pass through expense, but rather should have been made directly to the servicing lender on the HUD-insured property.

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See comment 9.

Category 8 refers to an invoice improperly prepared and attested to by a management and marketing subcontractor for \$23,000. HUD agrees that the actions taken by the subcontractor in submission of this invoice were inappropriate.

See comment 4.

The remaining items are combined into a single category. Page 42 of the report provides only slight reference to these items, but does mention two disbursements totaling \$99,000 which were approved in Headquarters. These two disbursements refer to reimbursement for the lead based paint issue identified above (Category 3). They are redundant and also do not represent questionable payments.

See comment 2.

To more properly illustrate findings, I recommend that GAO correct the chart on page 28 to eliminate those payments clearly supported by contract modifications, and to redefine the remaining items as those involving "questionable payment procedures", rather than questionable payments. By correcting the report to eliminate payments where HUD has provided appropriate supporting documentation, the amount of payments in this category will represent less than 1 percent of the payments made to single family M&M contractors during the period covered by the GAO review.

Improper Payments to a Single Contractor and Subcontractor for a Group of Properties in New York City

See comment 2.

Beginning on page 43, the report refers to possible fraudulent payments to a contractor providing property management services to occupied properties in New York City. The Department agrees that this firm failed to provide services or provided unacceptable services for extensive periods in FY 2002. In fact, this contract was terminated in 2003, and HUD held back \$892,199 in payments to the contractor. The holdback amount included amounts for disbursements reported by GAO in the draft audit. In addition, the contractor was referred to HUD's OIG for further investigation.

These properties came into HUD's inventory as a result of a scam that occurred during 1998-2000. Both HUD and GAO testified about this scam at a Congressional hearing in Harlem on September 10, 2001. To repair these properties HUD staff had previously issued a task order to this contractor in June 2001. Initial work performance was not satisfactory, and specific concerns were addressed in a series of formal meetings held between November 2001 and February 2002. The Department is obligated by Government contracting procedures to work with a sub-performing contractor to improve performance, rather than move to immediate termination, and these efforts seemed to bear fruit, as work performance improved in early 2002. However, by May 2002 HUD again found it necessary to conduct a series of meetings with the contractor to identify serious performance issues. These concerns were documented in "Letters of Concern" sent to the contractor in June and again in November of 2002. In FY 2003 the contractor and HUD modified the task order through a series of negotiations to clarify contract responsibilities, while contract performance deficiencies were identified. The task order was formally modified in June 2003. By July the contractor's failure to perform even under the modified contract was apparent, and HUD

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issued a "cure letter," advising the contractor of the Government's intent to terminate the task order if dramatic improvement and corrective actions were not taken. The Department undertook an intensive effort to acquire replacement contract services, and the task order was terminated in October 2003.

In addition to the steps noted above, the Department directed the replacement contractor to take emergency steps to address the most chronic problems associated with these properties. As evidence of the implementation of tighter contract controls and effective property management, the Department has offered to provide GAO with five volumes of pictures and data on work already performed by the replacement contractor on the 150 occupied properties in New York City.

Failure to Follow Appropriate Review Procedures for Management and Marketing Contract Payments

See comment 10.

The report states that 58 percent of single family property payments were not properly approved (page 5). HUD agrees that in two of the four Single Family Homeownership Centers, payment review procedures were not strictly followed. The procedures require an initial review of payment requests by an outside contractor, and subsequent reviews by a HUD Government Technical Monitor and HUD Government Technical Representative. In the sample of payments referenced by the report, in two of the Homeownership Centers only the outside contractor and the Government Technical Monitor completed the review. However, it is important to note that in these two Centers, two of the three internal control reviews did occur.

See comment 11.

HUD disputes the statement that detailed analytic review of vouchers did not take place. HUD staff provided data from the SAMs system indicating that during FY 2002 1,190 vouchers were returned to the M&M contractors because errors were detected in voucher preparation, based on careful HUD reviews. These returned vouchers represented effective financial controls in all four Homeownership Centers.

Failure to Establish Adequate Controls for a Single Multifamily Demonstration Project in Boston

See comment 2.

With regard to the Multifamily Demonstration Disposition Program in Boston, it is first important to note that this program was a demonstration, beginning in 1994. It is not reflective of any of the program requirements, policies, procedures and monitoring that the Department has implemented for its regular Multifamily Property Disposition Program. The major goal of the Demonstration Program was to provide to the fullest extent possible the opportunity for the residents (over 1,800 families) in these projects to purchase the projects and become homeowners. This is not an objective of the Department's regular property disposition program.

Based on this ambitious goal and the physical condition of the housing inventory in this Demonstration, the Department would agree with GAO that the Agreement between the state agency and the Department executed in 1994 did not contain the necessary controls and

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oversight protocols to address the inherent risks in the Demonstration. For example, the extensive resident involvement including homeownership training and property management training should have been taken into account in both the timing and the funding of the Demonstration. In addition, there were no requirements in the Agreement (with respect to either costs or time) for the unforeseen issues such as environmental concerns and extensive rehabilitation needs. The Department was forced in some projects to proceed with new construction or gut rehabilitation, neither of which was anticipated in the original agreement.

However, despite the absence of those controls in the Agreement, the Department has implemented a number of specific protocols and actions regarding oversight and monitoring of the program over the last three years. These protocols and actions include: monthly reporting; rescinding the state housing agency's authorities where necessary (change orders in excess of \$50,000 are required to have HUD approval); implementing sanctions against architects and contractors (including claims, suspensions, and debarments); and requiring additional HUD approvals for certain budget items (environmental and resident relocation). These steps were taken to attempt to minimize the cost overruns of the Demonstration Disposition Program.

In order for the Department to provide the opportunity for the residents to purchase their projects, the residents were required to be involved in all phases of the development process, including relocation, rehabilitation and/or new construction, security, and the eventual ownership entity. Resident involvement has unfortunately resulted in extensive delays. Cost overruns have also resulted in the areas of environmentally hazardous materials remediation, security and resident relocation in a tight Boston rental market.

This Administration reviewed the Demonstration Disposition Program and determined that, after six years of effort, it was in the best interest of the residents and the Department not to terminate the existing Agreement with the state housing agency, despite the cost overruns. Rather, the Department preferred to aggressively continue to monitor the program and work to complete the redevelopment. The Department has sold four projects to the residents and is on schedule to sell all of the projects by the end of this calendar year. The Department has also initiated enforcement actions and claims against the architects and contractors that have failed to perform satisfactorily (involving poor installation of aluminum siding, faulty masonry work, lack of proper testing and removal of asbestos).

During this Administration, per year costs have been approximately \$20 million less than in previous years.

GAO has recommended that the Department implement additional risk based oversight and monitoring for this Program. The Department will agree to review what additional oversight and monitoring protocols may be put in place at this juncture; but the Department will also aggressively pursue completing the construction and rehabilitation of these buildings, and selling the projects to the residents by the end of this year.

With regard to the second recommendation, HUD will not consider requesting the Inspector General to review the propriety of the use of funds under this Demonstration at this time. As stated earlier, the Department is vigorously pursuing all necessary enforcement actions

See comment 12.

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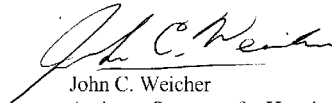
7

against entities that have not performed satisfactorily. In pursuing those actions, the Department may elect to make referrals to the Inspector General for further review.

At the end of the Demonstration Disposition Program, the Department intends to complete a full evaluation of the Demonstration goals and implementation. Based on the costs and length of time to complete this demonstration, this Administration would not recommend that the demonstration be repeated or be made a permanent program.

Again, thank you for this opportunity to comment on the draft report. If you have any questions regarding these comments, please contact Joseph McCloskey at 202-708-1672.

Sincerely,



John C. Weicher
Assistant Secretary for Housing-
Federal Housing Commissioner

The following are GAO's comments on the Department of Housing and Urban Development's letter dated February 19, 2004.

GAO Comments

1. During the course of our work, we considered whether changes had been made to HUD's processes and procedures. For example, we identified HUD's over reliance on a support services contractor in the payment process for fiscal year 2002 payments and determined that this practice continued through the conclusion of our work. In addition, in November 2003, we updated our work to determine whether HUD had made changes to its internal controls to address the cause of the potentially fraudulent payments that we had identified in June 2003. Again, no changes had been made.
2. See "Agency Comments and Our Evaluation" section.
3. We understand that it may be necessary to pay for services provided before HUD owned the properties in order to avoid liens. However, given the unusually large amounts involved and the nature of the properties and time period covered by the bill, we continue to believe that HUD officials should have questioned these charges before payment. As stated in our report, we found no indication that HUD attempted to find out why these charges were so large, or why they had not been identified at the time of settlement and acquisition of the properties. We also found no indication that the contractor or HUD had pursued negotiating a settlement with the water authority or recovery from other parties who may have been responsible for the charges.
4. The draft of this report sent for agency comment included 6 payments totaling \$169,800 that were paid to a contractor for developing a lead based paint abatement program that we classified as questionable because they were not adequately supported at the time the payments were made. Based on recently provided HUD documents, we shifted \$99,000 previously included in the "other" questionable payments category to this category (lead based paint abatement program). We had originally classified it as "other" because we had received no support for the payments and thus had no basis for knowing that the \$99,000 related to the paint abatement program. We initially requested support for 2 payments totaling \$99,000 in October 2003. On February 17, 2004—for the first time—HUD provided some documentation for these two payments which indicated that these were made to the same contractor for developing the lead based paint

abatement program. On this basis, we changed our report to clarify that 8 payments totaling \$268,800 is the amount of questionable payments to a single contractor for developing a lead based paint abatement program.

None of the \$268,800 in payments were adequately supported because, among other things, there was no evidence of a contract modification or other agreement for the contractor to develop such a program. In addition, there was no indication of the total amount to be paid by HUD to satisfy the amount claimed by the contractor, or the basis for reimbursing the contractor for these types of costs that, according to written provisions in HUD's management agreement with the contractor, were not allowable unless approved by HUD in advance.

5. Our review found no indication of the emergency nature of the charges in HUD's supporting documentation for any of these payments. The payments we identified took place over an extended period of time in fiscal year 2002 and were not limited to a narrow "emergency" period. Our stated concerns about duplicate invoices used to support payments and invoices not matching amounts paid also are unresolved. Further, we continue to question why local supply sources were not considered, which would have avoided the incurrence of significant airfreight charges.
6. Each of the five payments we tested were made not only without documentation of the competitive bids, but also without any indication by the reviewing, approving or certifying official that they were even aware of the possible existence of competitive bids, or whether the billing contractor had in fact been the successful bidder. Therefore we continue to view these payments as questionable.
7. HUD provided us with a copy of the signed modification on January 26, 2004, more than 3 months after our initial request for documentation to support the payments totaling \$296,087 that HUD paid for records management services. As stated in the report, there was no contract (or modification) included with the support for these payments or any indication that the payment had been compared to a contract (or modification) prior to payment to confirm that HUD had authorized these services at the amount charged. Rather, HUD regional staff advised us that the "OK to pay" notation on one of the invoices by the division director was sufficient to process the payment. Such action

represents circumvention of HUD's payment process controls and therefore these payments continue to be questionable.

8. HUD's response does not address the points raised in our report regarding the lack of proper documentation to support the validity of the payment including whether HUD owned the property or a related FHA loan existed at the time of payment.
9. As described in the report it is the actions of the management contractor that are at issue, not the actions of a subcontractor.
10. Regarding HUD's statement that "it is important to note that in these two Centers, two of the three internal controls reviews did occur", our view is that internal controls over payments are not one event, but rather a sequential process with each action being dependent on the preceding steps having been satisfactorily performed. The flaw we identified in these cases relates to a fundamental control for authorizing payments whether in the public or private sector. Without confidence that payment requests are justified based on contracts or other agreements for those specific services at the prices billed and that the work has been satisfactorily completed, there is no basis for payment.
11. It is unclear what HUD means by "detailed analytical reviews of vouchers." Our point is that detailed analytical reviews of expenses did not take place. As stated in our report, such reviews would be an efficient and effective way of analyzing expenses to identify anomalies and cost saving opportunities. It was just such review that alerted us to potential improprieties in payments related to the New York City properties.
12. Neither our report nor our recommendations address the timing for completion of construction and rehabilitation of the MF program. However, given that the program has now extended over 10 years and the costs are in excess of \$500 million dollars through fiscal year 2003, we agree with HUD's stated goal to complete the program by the end of this year.

GAO Contacts and Staff Acknowledgments

GAO Contacts

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Acknowledgments

Staff members who made key contributions to this report include Sharon Byrd, Stephanie Chen, Lisa Crye, Bonnie Derby, Carmen Harris, Kelly Lehr, Sharon Loftin, Julia Matta, Irvin McMasters, Andrew O'Connell, Lien To, Estelle Tsay, and Brooke Whittaker.

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