



Issue Date	September 25, 2009
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Audit Report Number	2009-KC-0002
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TO: Carol J. Galante, Deputy Assistant Secretary, Multifamily Housing Programs, HT

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

SUBJECT: HUD's Office of Multifamily Housing Needs a Uniform Process to Ensure That Commercial Rent Rates Are Comparable to Market Rate Rents

HIGHLIGHTS

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) process for reviewing and approving commercial rents for multifamily properties. We performed this audit to follow up on a previous audit, report # 93-SE-11-0001, which disclosed that the regional HUD office did not ensure that properties received commercial rents that were comparable to market rate rents. Our objective was to determine whether HUD's review and approval process for commercial rents ensured that multifamily properties received commercial rents that were comparable to market rate rents.

What We Found

HUD's Office of Multifamily Housing did not have a uniform process to ensure that commercial rent rates were comparable to market rate rents. HUD's Office of Multifamily Housing, Asset Management Division, allowed each regional office to establish its own procedures for determining the adequacy of commercial rents. As a result, multifamily properties may not have received an appropriate level of rents for all commercial space.

What We Recommend

We recommend that the Deputy Assistant Secretary of Multifamily Housing Programs, develop and implement a uniform, written process to ensure that regional and field office staff fully understand and uniformly comply with requirements to ensure that owners set commercial rents at appropriate levels.

For each recommendation in the body of the report without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the discussion draft of the audit report to HUD on August 31, 2009, and requested its comments by September 15, 2009. HUD provided its written response on September 18, 2009, and generally agreed with the finding and recommendation.

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

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BACKGROUND AND OBJECTIVE

The U.S. Department of Housing and Urban Development's (HUD) Office of Asset Management is responsible for oversight of multifamily properties after development. The office develops policy for and oversees field office asset management operations. It is also responsible for oversight of regulated property ownership and management, routine mortgage servicing, default servicing, acquisition and disposition of loans (mortgage notes) and properties, and management of properties for which HUD is the owner or lender in possession.

Our audit related specifically to the HUD multifamily properties with commercial space(s) that were rented to commercial tenants. Property owners and management agents are required to lease the commercial space at comparable market rates, at least covering debt service and related operating costs. Commercial space is to be self-sustaining and operate in a financially sound manner. HUD multifamily asset managers are responsible for reviewing and approving the commercial rents.

Our objective was to determine whether HUD's review and approval process for commercial rents ensured that multifamily properties received commercial rents that were comparable to market rate rents.

RESULTS OF AUDIT

Finding: HUD's Office of Multifamily Housing Did Not Have a Uniform Process to Ensure That Commercial Rent Rates Were Comparable to Market Rate Rents

HUD's Office of Multifamily Housing did not have a standardized process for determining whether commercial rent rates were comparable to market rate rents. HUD's Asset Management Division within the Office of Multifamily Housing, allowed each regional office to establish its own procedures for determining the adequacy of commercial rents. As a result, multifamily properties may not have received an appropriate level of rents for all commercial space.

HUD Did Not Have a Uniform Process to Ensure That Commercial Rent Requirements Were Met

HUD did not have a uniform process for reviewing and approving commercial rent rate amounts to ensure that they were adequate. HUD requires owners to set commercial rents at market rate levels or, at least, at levels that will cover the commercial space's share of project debt service and operating expenses. HUD multifamily asset managers are responsible for reviewing and approving the commercial rents.

Although responsible for reviewing and approving commercial rents, none of the HUD asset managers interviewed, for the four properties in our sample, knew the market rent rates for his or her respective properties. Additionally, none of the other HUD field office personnel interviewed knew of or performed rental studies to determine the fair market value of multifamily property commercial space. Further, HUD personnel did not have the information necessary to determine whether the commercial rents were sufficient to cover the cost of operating the commercial space.

In general, when a commercial rent increase request came to an asset manager, the asset manager approved it. If something suspicious or abnormal was readily apparent or if HUD's Real Estate Assessments Center's review of the property's audited financial statements identified anything unusual, the asset manager may have reviewed the rent increase request(s) with more scrutiny. Otherwise, asset managers did not normally apply extra scrutiny before approving requested rents for commercial space.

The New York City hub was the only field office reviewed that had a written procedure for the review and approval of commercial rents. This hub required property owners to provide market rent data that they had developed when submitting requests to HUD to approve commercial space leases. This procedure provided the New York hub with data to consider when reviewing the request to approve commercial rent rates. Neither of the other two field offices reviewed had these or other written review procedures.

Multifamily Properties May Not Have Received Appropriate Levels of Rent

Multifamily properties may not have received the fair market value for commercial space or, at least, rent sufficient to cover the cost of operating the space. HUD did not know the market value rents or the costs to operate the commercial spaces, and, therefore, it could not determine whether the rent requirements were met before approving the commercial rent requests submitted. Because the market value was unknown for the four properties reviewed, we could not determine whether the commercial space rates charged were at appropriate levels.

Recommendation

We recommend that the Deputy Assistant Secretary of Multifamily Housing Programs

- 1A. Develop and implement a uniform, written process to ensure that regional and field office staff fully understands and uniformly complies with requirements to ensure that owners set commercial rents at appropriate levels.

SCOPE AND METHODOLOGY

Our audit covered the period January 1, 2007, through December 31, 2008. We performed our on-site audit at the Denver, St. Louis, and New York multifamily hubs from March 10 through April 1, 2009.

To accomplish our objectives, the Office of Multifamily Housing, Asset Management Division, in headquarters provided to us a list of all properties with commercial space between January 1, 2007, and December 31, 2008. The list included information such as the corresponding property name, property identification number, Federal Housing Administration number, property address, responsible hub jurisdiction, property owner and/or management agent name, property owner and/or management agent address, and amount of monthly rent charged for the commercial space according to its audited financial statements.

We selected our sample from a nationwide universe of 974 properties with more than \$52 million in commercial rents reported during 2007 and 2008. To help us gather information more efficiently, we chose properties with subsidized units in three large metropolitan areas that also had an OIG office: Denver, Colorado; Brooklyn, New York; and St. Louis, Missouri. We reviewed the properties that had the highest amount of commercial rents in each of those cities as reported during 2007. We added a fourth property in Denver, Colorado because its proximity to our office. We interviewed multifamily hub staff and officials in Denver, St. Louis, and New York. We reviewed the four related asset management files, rent schedules, and annual financial statements. We also visited the commercial space and spoke with the property owner or management agent.

We used the computer-generated data list provided by headquarters to obtain background information and as a basis to select multifamily properties with commercial rent space to audit. We did not use computer-generated data as evidence to support our audit conclusions.

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

INTERNAL CONTROLS

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

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Control

We determined that the following internal control was relevant to our audit objective:

- HUD policies and procedures for ensuring that multifamily commercial property rents are accurate and compliant.

We assessed the relevant control identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

Based on our audit, we did not identify any significant weaknesses.

Appendix A

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

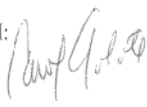


U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

OFFICE OF HOUSING

SEP 17 2009

MEMORANDUM FOR: Ron Hosking, Regional Inspector General for Audit, 7AGA

FROM:  Carol J. Galante, Deputy Assistant Secretary for Multifamily Housing Programs, HT

SUBJECT: Discussion: Draft Audit Report entitled *HUD's Office of Multifamily Housing Needs a Uniform Process to Ensure Commercial Rent Rates are Comparable to Market Rate Rents*

Thank you for the opportunity to respond to the draft audit report. While we are in general agreement with the intent of the report and the recommendation, we are recommending a few suggested edits which will enhance the clarity of the report.

Comment 1

During the Exit Conference you mentioned that this current review was a follow up to a previous audit, #93-SE-11-0001. While you refer to this older audit in this current effort, you do so generally, but at the Exit Conference your staff stated that the older audit dealt with an Identity of Interest problem where commercial rents were not charged. To distinguish the current effort from this prior effort, we suggest that you indicate that the focus of the prior audit was the Identity of Interest problem.

Comment 2

Regarding this current audit report, the wording on page two in the first section states the conclusion, "As a result, multifamily properties may not have received an appropriate level of rents for all commercial space." An analysis by staff from the Office of Asset Management, of the 974 projects recording commercial rents notes that rents vary greatly and that a relatively few projects account for a significant % of the total commercial rent potential. Furthermore, many of these properties are also concentrated in a few Hubs, notably the New York Hub. We also know that projects may have nominal rents by design. Rents from commercial activity in our projects support our mission goals by providing funds and augmenting services to the residents and the community. Also, during the development phase, local jurisdictions may provide funds to allow the project to include commercial space. Therefore, while our response will address your recommendation, we would like you to revise the conclusion you reached to add the phrase, "where that is the goal." The revised sentence would read, "As a result, multifamily properties may not have received an appropriate level of rents for all commercial space, where that is the goal."

Comment 3

As we discussed at the Exit Conference, our response will be to agree with the recommendation within the context of our comments above. Our plan will be to produce guidance through the Housing Notice process. We will start with the New York Hub process you reference in your report, which we will augment with input from our other Hubs. We anticipate a process that will address the issue of appropriate levels of commercial rents as your recommendation states, applicable to the goals for each project as discussed above.

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OIG Evaluation of Auditee Comments

- Comment 1** The "Identity of Interest" problem discovered during the prior audit was mentioned during the exit conference to disclose details behind what occurred, but does not have any bearing on our current audit effort, and in our opinion, would not enhance the clarity of the final audit report.
- Comment 2** HUD Handbook 4350.1, Chapter 7, Section 8, Charges For Commercial-Facilities, 7-41. Determining Charges, provides HUD's guidance relating to properties with commercial rents. The guidance specifically states that, "Generally, Field Offices should require owners to set commercial rents at least at levels that will cover the commercial space's share of project debt service and operating expenses." We left the wording in the report as it was to be consistent with the wording in the handbook.
- Comment 3** We agree that HUD's intended action(s) should adequately address our audit recommendation.