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TO: Roger E. Miller, Deputy Assistant Secretary, Office of Healthcare Programs, HI

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

SUBJECT: HUD Generally Established Controls Over the Section 242 Program but Used an Outdated Handbook, and Its Guidance Had Not Been Cleared Through HUD's Directives System

HIGHLIGHTS

What We Audited and Why

We reviewed the U.S. Department of Housing and Urban Development's (HUD) Section 242 Mortgage Insurance for Hospitals program. We initiated the review as part of our national annual audit plan. Our objectives were to determine whether HUD established controls to approve and administer projects under the Section 242 program and whether HUD used an updated handbook to administer its Section 242 program and used and provided to program participants written guidance that had been approved through HUD's Directives System.

What We Found

HUD generally established controls to approve and administer projects under the Section 242 program. However, the Office of Healthcare Programs used an outdated handbook to administer its Section 242 program, and the written guidance it used and provided to participants had not been cleared through HUD's Directives System. As a result, HUD provided conflicting guidance.

What We Recommend

We recommend that the Deputy Assistant Secretary, Office of Healthcare Programs, (1) continue to place a priority on developing an updated handbook and ensure that it is implemented in a timely manner and (2) submit its written guidance for approval through HUD's Directives System.

For each recommendation 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 draft report to the Office of Healthcare Programs on March 27, 2012, with a request for written comments by April 25, 2012. The Office of Healthcare Programs generally agreed with our finding and recommendations. It did not provide written comments.

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BACKGROUND AND OBJECTIVES

The Housing and Urban Development Act of 1968 added a new Section 242 to Title II of the National Housing Act, which authorized the U.S. Department of Housing and Urban Development (HUD) to provide Federal Housing Administration-insured mortgage loans to facilitate the construction and substantial rehabilitation of hospital facilities. As of the end of fiscal year 2011, there were 101 active loans totaling more than \$9 billion in original loan amounts. The purpose of the Section 242 program is to encourage the provision of comprehensive health care, including outpatient and preventive care as well as hospitalization, to all residents of a community regardless of their ability to pay.

The Office of Healthcare Programs, located within the Office of Housing, is responsible for the overall management, oversight, and policy development of the Section 242 program. Under the Office of Healthcare Programs, the Office of Hospital Facilities administers and monitors the program, and the Office of Architecture and Engineering provides technical support. The Office of Healthcare Programs' primary offices are located in Washington, DC, and New York City, with out-stationed staff in St. Louis, MO, Ft. Worth, TX, and Jacksonville, FL.

HUD requires hospitals to take certain steps, both before they apply for mortgage insurance and as part of the application process. Hospitals must compare their organizational structure, services provided, nature of the project, and financial status with the program's minimum requirements. If they meet these requirements, HUD requests additional information regarding their market need, project description, business plan, and historical financial results. HUD then determines whether to invite the hospital to attend a preapplication meeting. The preapplication meeting is an opportunity for the potential borrower to summarize the proposed project and for HUD to summarize the application process. Following the meeting, HUD may invite the hospital to submit an application for mortgage insurance if HUD sees no issues that could affect the eligibility or underwriting of the project.

The application generally takes up to 5 months to prepare, and HUD has an additional 4 months to review it. Among other items, hospitals must submit a financial feasibility study containing historic and forecasted financial statements and ratios, a financing plan, and information about market demand. In reviewing each application, HUD hires consultants to evaluate the feasibility of each proposed project and makes site visits as additional, independent checks on the viability of the project.

HUD uses a regulatory agreement to monitor the insured hospitals. According to the agreement, hospitals are required to submit financial, operational, and construction progress reports to HUD. Certain reports are prepared by external auditors and include an assessment of compliance with Federal program requirements. HUD uses these submissions to assess and rank hospitals according to risk of claim. Riskier hospitals are more closely monitored by senior program staff.

On February 28, 2006, the Government Accountability Office reported that the Section 242 program and risk management could be enhanced. Specifically, the Government Accountability Office recommended that HUD update the Section 242 program handbook to make publicly

available current eligibility requirements, policies, and procedures. HUD provided comments stating that the program area planned to complete the full handbook and enter it into clearance no later than November 2009. This recommendation was still open when we started our review and was included as part of our objectives.

Our objectives were to determine whether HUD established controls to approve and administer projects under the Section 242 program and whether HUD used an updated handbook to administer its Section 242 program and used and provided to program participants written guidance that had been cleared through HUD's Directives System.

RESULTS OF AUDIT

Finding 1: HUD Used an Outdated Handbook, and Its Guidance Had Not Been Cleared Through HUD's Directives System

The Office of Healthcare Programs used an outdated handbook to administer its Section 242 program, and the written guidance it used and provided to participants had not been cleared through HUD's Directives System. This condition occurred because management did not make following the HUD Directives System a priority. As a result, HUD provided conflicting guidance.

HUD Used an Outdated Handbook and Guidance That Had Not Been Cleared Through Its Directives System

HUD's Office of Healthcare Programs used Handbook 4615.1, Mortgage Insurance for Hospitals, last updated in May 1984, which included requirements that are no longer relevant to the Section 242 program. For example, the handbook instructed the hospitals and lenders to direct their correspondence and submissions to program offices that no longer exist. In addition, the handbook provided information that does not apply to current construction documents and procedures.

To provide current and relevant instructions, the Office of Healthcare Programs developed guidebooks and various training materials, which it provided to the Section 242 program participants via its Web site. However, this guidance had not been cleared through HUD's Directives System. HUD's Directives System provides HUD program managers with the means to effectively convey instructions to users and document policies and procedures within the framework of established laws and regulations. In part, the Directives System is designed to ensure that the guidance is kept up to date, includes all current information essential to program delivery, is canceled when no longer useful, and does not contradict itself or serve cross-purposes.

Management Did Not Make Following the Directives System a Priority

The condition described above occurred because management did not make following the HUD Directives System a priority. When the Office of Healthcare Programs was given the sole responsibility for approving and administering the

Section 242 program, management focused on merging the various divisions and expanding the Office of Healthcare Programs. Additionally, management waited for impending changes in the program requirements before submitting the guidance for approval through the system.

HUD Provided Conflicting Guidance

As a result of not following its established process, HUD provided conflicting guidance. Some of the guidance provided on HUD's Web site conflicted with statutory requirements. Regulations at 24 CFR (Code of Federal Regulations) 16(a)(1) and (3) require that independent studies of market need and financial feasibility be submitted with the application to participate in the Section 242 program. However, the preapplication and application guidebooks, which had not been cleared through HUD's Directives System, contained provisions that contradicted the regulations and allowed hospitals that met certain requirements to not submit the studies. One of the four hospitals reviewed did not submit these two required independent studies. In addition, information provided on HUD's Web site sometimes conflicted with other information on the site. For example, the historical operating margin, an important underwriting indicator, was calculated differently according to the preapplication guide, the applicants' guide, and the presentations provided on HUD's Web site.

As the result of the outdated and conflicting guidance, representatives from the four hospitals reviewed indicated that they relied heavily on verbal communications with HUD staff.

Conclusion

To ensure that it provides current, consistent, and relevant instructions, HUD needs to update the handbook in a timely manner and submit its written guidance for approval through HUD's Directives System before providing the guidance to program participants. According to Office of Healthcare Programs officials, management was updating the handbook and would soon submit it for clearance.

Recommendations

We recommend that the Deputy Assistant Secretary, Office of Healthcare Programs,

- 1A. Continue to place a priority on developing an updated handbook and ensure that it is implemented in a timely manner.

- 1B. Submit its written program guidance for approval through HUD's Directives System and require future written guidance to be cleared through the Directives System before providing the guidance to program participants.

SCOPE AND METHODOLOGY

We conducted the audit fieldwork at HUD headquarters in Washington, DC, between October 2011 and February 2012. Our audit period was October 1, 2009, through September 30, 2011.

To accomplish our objectives, we

- Reviewed background information for the Office of Healthcare Programs.
- Reviewed HUD regulations, Office of Management and Budget Circular A-123, regulatory agreements and riders, program handbooks, and written policies and procedures provided by the Office of Healthcare Programs and located on the program Web site.
- Reviewed the Office of Healthcare Programs' procedures for approving, processing, and monitoring the hospitals from the application phase through initial endorsement, construction, final endorsement, and the repayment period. We reviewed the preapplication package, the application package, financial statements, the draw requests, and the final endorsement package submitted by the hospitals to HUD.
- Reviewed internally generated reports used by the Office of Healthcare Programs to evaluate the applicant hospitals.
- Interviewed Office of Healthcare Programs staff.
- Interviewed the chief executive officers and chief financial officers from the four hospitals in our sample.
- Interviewed representatives from the lenders for the four hospitals in our sample.

As of the end of fiscal year 2011, there were 101 active loans totaling more than \$8 billion in unpaid principal balances. We selected four hospitals, with original mortgage amounts totaling more than \$163 million, to review. We selected the one hospital that HUD approved using a streamlined application process that did not comply with the regulations. For the remaining three hospitals, we determined the six hospitals with final endorsement dates during our audit period and then selected the three hospitals with the lowest ratings on the Office of Healthcare Programs' Early Warning Report, dated March 2011. A lower rating indicated a higher risk.

We used the hospital financial and mortgage data maintained by HUD in the Multifamily Data Mart, the Integrated Real Estate Management System, and the Hospital Mortgage Insurance Management Information System for background information and in selecting our sample of loans. We did not rely on the data to base our conclusions. Therefore, we did not assess the reliability of the data.

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

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls 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 Controls

We determined that the following internal controls were relevant to our audit objectives:

- Controls to ensure that the participants are approved and the Section 242 program is administered in accordance with HUD requirements.
- Controls to ensure that HUD's handbooks and guidance provided to participants were up to date and had been cleared through the HUD Directives System.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- HUD lacked controls to ensure that its program handbook was current and that all of its guidance provided to participants had been cleared through the HUD Directives System.

**Separate Communication of
Minor Deficiencies**

Minor internal control and compliance issues were reported to the auditee in a separate memorandum dated April 10, 2012.

FOLLOW-UP ON PRIOR AUDITS

Hospital Mortgage Insurance Program – Program and Risk Management Could Be Enhanced, GAO-06-316

In the Government Accountability Office report number GAO-06-216, “Hospital Mortgage Insurance Program – Program and Risk Management Could Be Enhanced,” dated February 28, 2006, the Government Accountability Office recommended that HUD update the program handbook to make publicly available current eligibility requirements, policies, and procedures. HUD’s corrective action plan for this recommendation was to have a complete handbook entered into clearance no later than November 2009. The completion date was revised to December 2011. This recommendation is still open.