

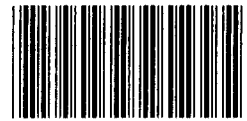
GAO

Report to the President and Chief
Executive Officer, Resolution Trust
Corporation

October 1992

RESOLUTION TRUST
CORPORATION

Subcontractor Cash
Management Practices
Violate Policy and
Reduce Income



147748





General Government Division

B-250476

October 20, 1992

The Honorable Albert V. Casey
President and Chief Executive Officer
Resolution Trust Corporation

Dear Mr. Casey:

On several occasions we have raised concerns about the Resolution Trust Corporation's (RTC) monitoring of contractor performance. As of June 1992, RTC had awarded over 85,000 contracts but had completed only 44 contract audits. More than 250 audits of contractors now are under way, but because these efforts were slow in starting, we initiated a review of the oversight of Standard Asset Management and Disposition Agreement (SAMDA) subcontractors. Although our audit work continues, we have identified practices that we believe warrant your immediate attention. This report discusses weaknesses with the cash management practices of several SAMDA subcontractors and addresses RTC's policy on using interest-bearing bank accounts.

We identified weaknesses in cash management practices of property management subcontractors that could make RTC's funds vulnerable to loss from unauthorized use. We also identified a policy that, if changed, could result in RTC receiving hundreds of thousands of dollars annually in interest income.

Results in Brief

A majority of the SAMDA subcontractors we surveyed did not follow RTC's policy governing the use and control of cash from RTC properties. Instead of establishing separate accounts for deposits and disbursements, almost all of the subcontractors we reviewed used one account for both. For example, some subcontractors were using cash generated from RTC properties to pay expenses, which in some cases included their own management fees, instead of submitting funding requests as required by RTC. This practice makes it difficult for RTC to monitor the cash received and the expenses paid by the SAMDA contractors and their property management subcontractors. Further, some of the subcontractors who were managing the properties before they were placed under a SAMDA contractor had not closed out the old accounts as required by RTC procedures. Instead, they continued to operate with their original bank accounts without providing the SAMDA contractor a full accounting of previous transaction related to the assets.

Neither RTC's field offices nor the SAMDA contractors adequately monitored these subcontractors to ensure compliance with RTC's policies and to ensure that funds were not vulnerable to loss from unauthorized use. Several subcontractors told us that they had not been visited nor had their operating procedures been reviewed by the SAMDA contractor or RTC.

In addition, although RTC requires SAMDA contractors to open interest-bearing operating accounts to pay asset management expenses, there is no such requirement for subcontractors. Our analysis of the bank accounts managed by 14 subcontractors showed that only one had opened an interest-bearing account. If the other 13 had opened interest-bearing accounts, RTC would have earned approximately \$111,000 in interest. If the more than 1,600 property management subcontractors have not established interest-bearing accounts, the amount of additional interest income forgone by RTC could be significant.

Background

RTC contracts extensively with the private sector to manage and dispose of its billions of dollars in assets from failed thrifts. SAMDA is one of RTC's principal types of contract. As of May 1992, RTC had awarded 184 SAMDA contracts with \$34.8 billion in real estate and nonperforming loan assets.¹

To help manage and dispose of the assets, RTC requires the SAMDA contractors to hire subcontractors for 12 types of services. (Appendix II provides a list of these services.) Many subcontracts have been awarded to property management companies (PMC), which manage and operate revenue-producing properties such as hotels, apartments, commercial office buildings, and shopping centers.

According to RTC's Contract Activity Reporting System, as of June 1992, more than 1,600 property management subcontracts had been awarded, with estimated total management fees of \$24 million. In addition to these fees, RTC reimburses the subcontractors for operating expenses such as those for maintenance, repairs, and utilities. Such operating expenses are passed through to RTC by the SAMDA contractors. Although RTC does not collect information on the amount of pass-through costs, one RTC official estimated that these costs could be several times more than the management fees paid to SAMDA contractors.

Under the terms of SAMDA, RTC has delegated to the contractor responsibility for ensuring that its subcontractors follow RTC's cash

¹All assets are presented at book value.

management policy and have adequate internal controls over cash collections and expenditures. RTC's field offices are, however, responsible for ensuring that the SAMDA contractors comply with RTC's cash management policy and procedures.

Objectives, Scope, and Methodology

Our objectives for this job were to (1) assess RTC's policy regarding controls over cash management and (2) determine whether SAMDA subcontractors were complying with this policy. To do this, we first reviewed the applicable policy and interviewed responsible RTC headquarters and field office officials as well as officials of three SAMDA contractors. We then judgmentally selected a sample of 3 SAMDA contracts and 22 PMCs to assess compliance with the policy. We selected the SAMDA contracts on the basis of the percentage of real estate assets in their portfolios and the number of PMC subcontracts awarded. We selected the PMCs on the basis of the types of commercial properties being managed and the estimated fees. We also visited 9 PMCs and 12 properties managed by them to independently verify selected cash transactions.

Also, we requested bank statements from 20 PMCs related to 1 of the SAMDA contracts we reviewed. Fourteen of the PMCs responded and provided bank statements that covered the period January 1, 1991, to February 29, 1992. From these bank statements we determined the average account balances and then calculated the interest income forgone since these were noninterest-bearing accounts. The objectives, scope, and methodology are more fully discussed in appendix I.

RTC Needs to Ensure That Contractors Follow Its Cash Management Policy

RTC, as receiver, has the fiduciary responsibility to account for all funds received for and expended on the assets of each receivership. To help meet this responsibility, RTC issued a policy in November 1991 that established its cash management procedures. This policy requires that SAMDA contractors and subcontractors deposit all funds received from asset management-related activities into a receipt account and make all asset-related expenditures from a disbursement account. The policy also states that cash received from asset-related activities may not be used for any asset expenditures, and all record keeping and reporting must reflect total receipts and total disbursements.

We reviewed the cash management practices of 22 PMCs and found that 18, or 82 percent of them, had not followed RTC's procedures. Further, the cash management practices made it extremely difficult, if not impossible,

for RTC and the SAMDA contractors to receive a full accounting of the cash activities of the subcontractors.

Of the 22 PMCs we reviewed, 18 had not established dual operating accounts. These 18 PMCs were managing cash from a single account with all receipts deposited into and all disbursements made from this account. Additionally, of the nine PMCs we visited, seven were using funds generated by the RTC properties to pay operating expenses. In fact, five of the PMCs used these funds to pay their own property management fees.

An RTC official acknowledged that there are differences between RTC's policy and private sector practices regarding dual accounting and expressed concern that if RTC were to insist on adherence to its policy, subcontractors would incur additional costs that might be passed on to RTC. Furthermore, this official expressed the opinion that having one account is not a problem as long as record keeping and internal control mechanisms were adequate.

However, we identified weaknesses with the PMCs' record keeping and internal controls over cash. All of the SAMDA contractors we reviewed were using some PMCs that were engaged to manage the properties before the SAMDA contracts were awarded. These PMCs were not, however, required to provide a full accounting of the financial activities that occurred before SAMDAs were awarded. RTC's procedures require that an incumbent PMC should close out its books, provide a full accounting to the SAMDA contractor, and establish a new operating account. We found that of the 22 PMCs we reviewed, 19 were managing the properties before the SAMDA contractors took control, but most had not complied with RTC's procedure. Eighteen of the 19 incumbent PMCs were using the same bank accounts they used before the SAMDA contractors assumed responsibility for the RTC properties.

This practice makes it difficult for RTC to fully account for and verify the PMCs' asset-related receipts and disbursements and adequately protect the assets from loss due to waste, fraud, and abuse. For example, we could not independently trace and verify selected cash transactions or obtain a full accounting of the receipts and disbursements at five RTC properties we visited. In fact, for one property we could not find any financial records at all. Other problems that we encountered included the following:

- Several PMCs for properties such as hotels, condominiums, and an office building commingled operating funds or revenues with funds from other RTC and non-RTC assets they were managing.
- One PMC paid more than \$16,000 in asset-related operating expenses from its corporate account and was reimbursed from the RTC property's operating account. However, we could not determine the accuracy or validity of these purchases because we could not match purchase orders to invoices and trace the expenditures to related checks.
- At an RTC-owned building, the PMC received payment for janitorial services totaling \$15,452. However, the PMC could not locate invoices to support all of these charges. Also, our review of the available invoices showed that the PMC was overcharged more than \$3,900 for janitorial services. These charges were passed on to the SAMDA contractor who, in turn, passed them on to RTC.
- The property manager for a mobile home park made several purchases totaling over \$10,500 for items such as a commercial lawn mower, personal computer system, and backhoe without obtaining approval from the SAMDA contractor or RTC. Furthermore, according to the property manager, neither RTC nor the SAMDA contractors had been informed of these purchases at the time of our visit.

RTC's field offices were not ensuring that the SAMDA contractors we reviewed were complying with its policy governing the use and control of cash generated from RTC properties. Neither the SAMDA contractors nor the RTC field offices took adequate steps to oversee the subcontractors' cash management practices. According to officials at seven of the nine PMCs we visited, neither RTC nor SAMDA contractor officials visited the subcontractors or the related assets. Further, two of the property managers told us that they did not submit financial reports to either RTC or the SAMDA contractor because they did not know who to send the reports to.

These cash management practices at the PMCs clearly demonstrate the need for better oversight by the SAMDA contractors and the RTC field offices. Without adequate oversight, cash receipts and expenditures for RTC assets are vulnerable to loss from unauthorized use.

PMC Bank Accounts Should Be Interest Bearing

RTC requires that each SAMDA contractor establish an interest-bearing account to pay asset management expenses. RTC is to accrue the interest income from these accounts. While there is no specific requirement that subcontractors establish interest-bearing accounts, RTC has the authority

to require SAMDA contractors to instruct their subcontractors to establish such accounts. Under the terms of SAMDA, the contractor is to act as a fiduciary with respect to the assets and the proceeds thereof and at all times act in good faith and in the best interests of RTC.

The vast majority of subcontractor bank accounts for RTC properties that we reviewed were not interest bearing. We reviewed the bank accounts for 87 properties managed by 14 PMCs engaged by 1 SAMDA contractor in RTC's San Antonio field office. Only one of the PMCs had an interest-bearing account for the asset it was managing. This property manager told us that it was the company's policy to have interest-bearing accounts whenever possible. Officials at the other PMCs said that they did not have interest-bearing accounts because the SAMDA contractor did not require such accounts.

We also reviewed 19 bank accounts for 11 properties managed by 8 PMCs engaged by 2 SAMDA contractors in RTC's Atlanta field office. Five of these 19 accounts, or 26 percent, were interest bearing. According to the three property managers responsible for these five accounts, it was their companies' policy to use interest-bearing operating accounts whenever possible.

If RTC required SAMDA subcontractors to use interest-bearing accounts, its earnings each year could increase substantially. For example, using the average account balances for the period January 1991 through February 1992 and the 91-day treasury bill interest rates for each month for the noninterest-bearing accounts established by 13 PMCs, we estimated that RTC would have accrued more than \$111,000 in interest income. Table 1 shows the interest income forgone by the 13 PMCs.

Table 1: Interest Income Forgone by 13 PMCs

PMC	Number of assets	Total average monthly bank balances ^a	Total interest forgone
A	35	\$1,611,073	\$60,786
B	10	396,814	14,565
C	8	332,068	11,077
D	4	166,189	8,214
E	1	69,455	3,148
F	4	48,595	2,819
G	1	43,585	2,625
H	1	57,383	2,621
I	5	116,080	1,834
J	13	103,421	1,717
K	2	21,356	1,036
L	1	46,519	393
M	1	4,909	256
Total	86	\$3,017,447	\$111,091

^aThese balances have not been adjusted for uncollected items, activity fees, and service charges.

Because RTC has engaged more than 1,600 PMCs throughout the country, it could be losing hundreds of thousands of dollars in interest income each year if property managers have not established interest-bearing operating accounts. These additional revenues could be used to offset RTC's asset management and disposition expenses and ultimately decrease the cost of the government's bail-out efforts.

Conclusions

RTC field office staff need to better ensure that SAMDA contractors comply with RTC's policy governing the use and control of cash generated from RTC properties. Neither the RTC field offices nor the SAMDA contractors we reviewed were adequately monitoring the cash management and related reporting practices of the property management subcontractors. As a result, RTC cannot fully account for cash received and the expenses paid by the SAMDA contractors and their subcontractors. The failure of subcontractors to comply with RTC policy has already led to the commingling and loss of control over some funds as well as the possible misuse of RTC funds.

In addition, unless RTC imposes the same cash management requirements on subcontractors that it requires of its SAMDA contractors, it may forgo significant amounts of interest income that could be used to offset the cost of managing and disposing of its assets.

Recommendations

We recommend that you improve oversight of SAMDA contractors and their property management subcontractors to better ensure that they comply with RTC's policy governing the use and control of cash. This should include requiring that SAMDA contractors report to the RTC oversight managers on whether their property management subcontractors (1) have established separate cash receipt and disbursement accounts, (2) are properly using cash received from asset management and disposition activities, and (3) have adequate accounting for total receipts and disbursements.

We also recommend that you revise the RTC policy and SAMDA contracts to require that property management subcontractors establish interest-bearing operating accounts for RTC assets with the interest accruing to RTC.

Agency Comments

RTC officials orally commented on a draft of this report. Generally, the RTC officials agreed with the accuracy of our information and said that they were aware of the findings cited in the report. With regard to our recommendation that RTC improve its oversight to better ensure compliance with its cash management policy and procedures, RTC officials said that audits planned by the Office of Contractor Oversight and Surveillance will facilitate assessment and oversight of contractor/subcontractor activities and provide a vehicle to evaluate the need for revisions to operating policies and procedures. RTC's comments are responsive to the thrust of our recommendation, assuming that any revisions would enhance internal controls over receipts and disbursements.

In response to our recommendation that RTC require its subcontractors to establish interest-bearing operating accounts, RTC officials stated that they will conduct further research to determine its relative merit. We incorporated other comments where appropriate.

We will send copies of this report to interested congressional committees and other interested parties. Copies will be made available to others upon request.

The major contributors to this report are listed in appendix III. Please contact me on (202) 736-0479 if you have any questions concerning this report.

Sincerely yours,

A handwritten signature in cursive script that reads "Gaston L. Gianni".

Gaston L. Gianni, Jr.
Associate Director,
Federal Management Issues

Objectives, Scope, and Methodology

Our objectives were to (1) determine the adequacy of RTC's policy regarding its controls over cash received and spent by SAMDA property management subcontractors and (2) assess compliance with this policy. To accomplish the first objective, we reviewed the requirements and procedures in RTC's policy and the SAMDA contract related to the use and control of funds by SAMDA contractors and subcontractors. We discussed the policy with officials at RTC headquarters, three field offices, and three SAMDA contractors.

To assess compliance with RTC's policy, we reviewed the operating accounts for 22 PMCs. We also visited 9 of the 22 PMCs and attempted to review cash transactions for 12 properties being managed by these subcontractors. However, for one property there were no financial records available for review. We judgmentally selected the three SAMDA contracts to review according to the following criteria: (1) at least 40 percent of the assets included in the SAMDA portfolio were real estate assets and (2) either 10 or more property management subcontracts had been awarded or none had been awarded.

Our methodology for selecting PMCs was to include as many types of commercial properties as possible. Therefore, we selected PMCs that were managing properties such as apartments, condominiums, hotels, retail shopping centers, mobile home parks, and office buildings. When information was readily available on the subcontractors' estimated fees, we selected PMCs that were expected to receive at least \$50,000 in management fees. The PMCs and related properties that we visited were located predominantly in Texas and several southeastern states.

In addition to visiting PMCs, we planned to contact and request bank statements from all 27 PMCs identified by the SAMDA contractor as being responsible for managing the 108 properties included in a SAMDA contract we reviewed. Because of time constraints and difficulties in locating some PMCs, we requested bank statements from 20 of the PMCs responsible for managing 100 RTC properties. Fourteen PMCs responded with bank account information for 87 properties covering the period January 1, 1991, through February 29, 1992. We selected this period because the SAMDA contract that included the subcontracts we reviewed was awarded in December 1990, and the subcontractors' most recent bank accounts were for the month of February 1992.

We used information in the bank statements to determine the amount of interest income forgone as a result of the PMCs using noninterest-bearing

bank accounts. We calculated the amount of forgone income using the average balance in each PMC's bank account and the monthly average interest rate paid by 91-day treasury bills for the appropriate months. We used the 91-day treasury bill because it was the basis for the earnings credit rate used by a large commercial bank where many of the PMCs had their asset-related bank accounts.

The findings from this review cannot be generalized to other PMCs and SAMDA contracts and apply only to those PMCs and SAMDA contracts included in our review. We conducted our review from April 1992 through July 1992 in accordance with generally accepted government auditing standards.

Mandatory Subcontracting Services Required by SAMDA Contractors

1. Property management, maintenance, and leasing
2. General construction and construction subcontracting services
3. Architectural/engineering consulting services
4. Construction consulting services
5. Environmental consulting services
6. Property tax consulting services
7. Title work
8. Financial investigation services
9. Appraisal services
10. Commission brokerage services for sales and rentals
11. Marketing signage and printing services
12. Surveying services

Source: RTC's SAMDA contract.

Major Contributors to This Report

General Government
Division, Washington,
D.C.

Carolyn Taylor, Assistant Director, Federal Management Issues
Leon H. Green, Advisor

Dallas Regional Office

James Cooksey, Evaluator-in-Charge
Norman Poage, Evaluator

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