

**REPORT ON AUDIT
OF
FINANCIAL AND OPERATIONS ANALYSIS SECTION
MULTIFAMILY HOUSING DIVISION
FEDERAL HOUSING ADMINISTRATION
HOUSING AND HOME FINANCE AGENCY
JANUARY 1956**

UNITED STATES GENERAL ACCOUNTING OFFICE

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WASHINGTON 25, D. C.

Civil Accounting and
Auditing Division

JAN 2 - 1957

B-118731

Mr. Norman P. Mason, Commissioner
Federal Housing Administration

Dear Mr. Mason:

Herewith is the report on our audit of the Financial and Operations Analysis Section, Multifamily Housing Division, Federal Housing Administration. This Section reviews the financial operations of multifamily housing projects on which mortgages are insured by the Federal Housing Administration. Our examination was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Our audit was made in the Federal Housing Administration's Washington, D.C., central office and was completed in January 1956. We made a general survey of the Financial and Operations Analysis Section and reviewed procedures and practices including a review of reports prepared by this Section and by the Federal Housing Administration Audit Division.

Our review indicates that the functions now performed by the Financial and Operations Analysis Section either can be eliminated or decentralized to the FHA field offices. Our findings were reviewed with the Director or other employees of the Multifamily Housing Division during the course of the audit. On October 25, 1956, a draft of our proposed report was submitted to you and to the Housing and Home Finance Administrator, Mr. Albert M. Cole, for review and comments. Your reply of November 19, 1956, states:

"Your recommendation as summarized on the first page of your report is fully in accord with our plans and your support in this regard should be of material aid in implementing the changes at an early date. General instructions to insuring offices, together with detailed procedural instructions are being prepared ***."

B-118731

We wish to acknowledge the cooperation given our representatives during our audit and would appreciate being advised of any further action taken regarding our recommendations.

Sincerely yours,

A. T. Samuelson
A. T. Samuelson
Director, Civil Accounting
and Auditing Division

Enclosure

C o n t e n t s

	<u>Page</u>
SUMMARY OF PRINCIPAL RECOMMENDATIONS	1
REVIEW AND ANALYSIS OF FINANCIAL STATEMENTS AND AUDIT OF MORTGAGOR CORPORATIONS	1
Types of findings reported	2
Lack of administrative control over reports	3
Lack of administrative action on findings	3
Current deficiencies in operations of the Financial and Operations Analysis Section	4
Decentralization of functions recommended	5
Technical supervision of field accountants	10
SUBMISSION AND CONTENT OF FINANCIAL STATEMENTS	12
Uniform presentation	12
Need for additional data on initial statement	12
Extension of time for submission	13
PREPARATION OF UNNECESSARY ANNUAL STATISTICAL REPORT	14

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SUMMARY OF PRINCIPAL RECOMMENDATIONS

We recommend (1) decentralization of the review and analysis of mortgagors' financial statements and of the audits of mortgagor corporations, and (2) discontinuance of the accumulation of statistical operating data on multifamily projects and of the preparation of an annual statistical report on project operations.

In brief, implementation of these recommendations would decentralize or eliminate each of the functions now performed in Washington by the Financial and Operations Analysis Section.

Our findings and the above recommendations as well as other related recommendations are discussed in greater detail in subsequent pages of this report.

REVIEW AND ANALYSIS OF FINANCIAL STATEMENTS
AND AUDIT OF MORTGAGOR CORPORATIONS

Annual financial statements of mortgagor corporations on which mortgages are insured by the Federal Housing Administration are reviewed and analyzed in the Washington office of FHA by the Financial and Operations Analysis Section, Multifamily Housing

Division. Before the financial statements are sent to Washington, a preliminary review of such statements is made in the FHA field insuring office having jurisdiction over the project.

Audits of mortgagor corporations are performed on a selective basis at the site by FHA auditors from Washington.

There is no coordination of financial statement analysis and audit. The two functions are performed independently by separate divisions of FHA. (1)

Findings concerning mortgagor corporations are reported by the Financial and Operations Analysis Section and the Audit Division to the Project Servicing Section, Multifamily Housing Division. Administrative action on the findings reported is the responsibility of the Project Servicing Section.

Our review and comparison of a number of reports prepared by the Financial and Operations Analysis Section and the Audit Division showed a similarity of findings, primarily violations of corporate charter provisions. In a number of cases we found that no administrative action had been taken.

TYPES OF FINDINGS REPORTED

Findings reported by the Financial and Operations Analysis Section or the Audit Division concerning the operations of mortgagor corporations included:

1. Failure to maintain accounting records in accordance with the FHA prescribed uniform system of accounts.
2. Failure to submit annual financial statements.
3. False certification or declaration by sponsors at the date of final endorsement of the mortgage for insurance as to the existence of liabilities.

4. Loans to corporate officers, stockholders, and affiliates in violation of corporate charter.
5. Stockholders' personal expenses charged to the corporation.
6. Rents charged in excess of those approved by FHA.

LACK OF ADMINISTRATIVE CONTROL OVER REPORTS (2)

Our review included an evaluation of the administrative control by the Project Servicing Section over the reports of the Financial and Operations Analysis Section and the Audit Division. We found this administrative control to be inadequate. There is no assurance that action on findings is taken when required.

We recommend that the Project Servicing Section record each report, showing date of report, nature of each finding, action taken and date thereof, or reason for no action, and final disposition of each finding.

LACK OF ADMINISTRATIVE ACTION ON FINDINGS (2)

We found many instances where the Project Servicing Section, after having the financial analysis and audit reports for several months, either had failed to take any action or did not forcefully press mortgagors for compliance. Pending litigation was not a major factor causing inaction on the findings. Of the cases reviewed by us, actions resulting in corrective measures by mortgagors had been completed in only 43 percent of the cases involving violations reported by the Financial and Operations Analysis Section and in only 35 percent of the cases involving violations reported by the Audit Division.

We believe that faster and more forceful action to obtain corrections of deficiencies would be taken by the field office

director in whose area a delinquent project is located. We recommend, therefore, that the authority and responsibility for obtaining remedial action by mortgagors be delegated to FHA field office directors.

CURRENT DEFICIENCIES IN OPERATIONS OF THE
FINANCIAL AND OPERATIONS ANALYSIS SECTION

③
④ Transfer to field
Discontinue Statistical

1. Backlog

Approximately 5,450 multifamily projects are required to submit annual financial statements to FHA. From the date the Financial and Operations Analysis Section actively began operations in May 1955 to completion of our review in January 1956, this section analyzed only 315 of these statements. We were unable to determine how much analytical work still had to be done on the remaining 5,135 financial statements. However, the chief of the section indicated that some additional work (although possibly not detailed analyses) would be necessary on all of the remaining 5,135 financial statements.

2. Lack of written instructions

No written instructions for the review and analysis of mortgagor corporations' financial statements have been issued. We recommend the preparation of written instructions and/or a manual for (1) the guidance of accountants in their analysis of financial statements and to eliminate the present need for individual personal instructions to the analysts and (2) uniformity in the analysis work.

We selected at random and reviewed the financial statements of 25 projects which had been analyzed by the Financial and

Operations Analysis Section. In 6 of the 25 cases we found that one or more items which were omitted, not explained, improperly recorded, or erroneously valued in mortgagors' financial statements were not reported or were reported incorrectly to the Project Servicing Section.

3. Inadequacy of preliminary review of financial statements

The preliminary review of mortgagor corporations' financial statements by the Financial and Operations Analysis Section consists of a cursory examination to determine that the statements comply with FHA requirements. In addition, mortgagor corporations operating at a deficit or reporting changes in fixed assets and/or capital structures are considered for further analysis.

To strengthen the preliminary review, we recommend further analysis of statements which indicate poor occupancy or a deficiency of cash or working capital. Further, we recommend that the preliminary review include a mathematical determination of the propriety of dividends declared. This would be merely a computation of earnings available for distribution in accordance with FHA's formula.

DECENTRALIZATION OF FUNCTIONS RECOMMENDED

We believe that (1) the reviews and analyses of financial statements and the audits of mortgagor corporations could be made on a more timely basis and more satisfactorily in the field by professionally qualified accountants working out of the principal FHA insuring offices and (2) the authority and responsibility for initiating remedial action on findings reported by accountants should

be delegated to the field office director having jurisdiction over the particular project being reviewed.

If professionally qualified accountants were assigned to the principal field offices, administratively they would be under the supervision of the field office director; however, they would receive technical supervision from the Director, Examination and Audit.

Decentralization of the review and analysis of financial statements and the audits of mortgagor corporations would have the following advantages:

1. The two functions would be coordinated in each office. The analysis of financial statements would provide a basis for selecting mortgagor corporations for audit. Identical findings and the administrative review of duplicate reports would be eliminated.
2. Dealing with a limited number of mortgagors in a smaller area compared with the present method of dealing with all mortgagors throughout the country should give the accountant a more intimate knowledge of the individual operations and problems of each mortgagor.
3. Few financial statements submitted by mortgagors are required to be certified by independent public accountants. Noncertified statements usually cannot be relied on to the same extent as certified statements. Firsthand information regarding the mortgagors' operations and problems obtained at the field office level should place the accountant in a better position to evaluate the reliability of the noncertified statements submitted.

4. The accountant's firsthand knowledge of projects operating at a loss, requiring modification agreements, requiring rental increases, dissipating income, etc., should aid the field office director in the administration of his office.

5. Placing authority and responsibility on the field office director for obtaining remedial action by mortgagors on findings reported by the accountant should reduce backlogs.

6. Traveling expenses would be decreased.

7. One preliminary review of financial statements would be eliminated. Statements now receive a preliminary review in the field office and in the Financial and Operations Analysis Section in Washington.

Although recognizing that coordination of the two functions in Washington also could result in certain of the above advantages, we believe that professionally qualified accountants working out of the larger FHA field offices can perform more effectively the audits of mortgagor corporations and analysis of financial statements because they will have a more intimate working knowledge of the operations of a limited number of mortgagors and because they can be more readily assigned to assist with day-to-day problems as they arise.

In addition to the foregoing work, a professionally qualified accountant assigned to a field office could perform the following services:

1. Analyze monthly accountings

Monthly accountings submitted by mortgagor corporations operating under a modification agreement should be reviewed by FHA to determine whether improper disbursements have been included. Such disbursements reduce or eliminate income which should be paid to the mortgagee on the mortgage indebtedness.

Monthly accountings now receive only a cursory review in Washington. No formal instructions to the field regarding procedures to be followed in obtaining and processing mortgagors' accountings have been issued by Washington.

Except in those instances where the reported net income for the entire modification period has been certified by an independent public accountant, FHA should determine, by an on-site audit, that the monthly accountings and the reported income are accurate and that the mortgagor has paid any excess income to the mortgagee.

2. Assist Mortgage Credit Section

The accountant could assist the Mortgage Credit Section in analyzing complex financial statements of operator-builders (small homes) and sponsors and mortgagors of multifamily projects who apply for mortgage insurance.

Our audits of FHA field offices show that, in many cases, mortgage credit employees do not properly analyze complex financial statements. This has resulted in approval for mortgage insurance of the applications of some individuals and corporations whose financial ability to complete construction was questionable.

3. Review requests for rental increases

Requests by mortgagor corporations for rental increases should be reviewed and analyzed by a field accountant with a first-hand knowledge of the mortgagor's situation so that more informed determinations can be made of the accuracy and reasonableness of the income and expenses reported by the mortgagor. This function is performed in the field offices and reviewed in Washington by the Operations Analysis Unit, Financial and Operations Analysis Section. The accountant's review and analysis in the field should provide the director with more reliable information on which to base his decisions.

4. Review scope of independent public accountants' audit of construction cost certifications

Construction cost certifications are prescribed by section 227 of the National Housing Act, as amended. If audits of the cost certifications are performed by independent public accountants, in lieu of FHA auditors, the scope of such audits should be reviewed on a selective basis by FHA accountants to determine compliance with principles and procedures established by FHA.

5. Audit rental brokers who operate properties under contract with FHA

Periodically the field accountant should audit the accounts and records of rental brokers who operate properties under contract with FHA to see whether project income could be increased or project expenses could be reduced.

Both the FHA Audit Division and the FHA Comptroller's Division audited some rental brokers in calendar year 1955. In two instances duplicate audits were made. We understand that the

Comptroller's Division recently discontinued the audits of rental brokers. We believe that (1) the limited personnel of the Audit Division should continue to work out of the central office in Washington and should be concentrated on internal audits of FHA operations and that (2) external audits such as audits of rental brokers should be performed by qualified auditors under the technical supervision of the Director, Examination and Audit, but should be the responsibility of the operating divisions.

6. Assist mortgagors and rental brokers
in establishing books and records

An FHA accountant should assist mortgagors and rental brokers in establishing basic fiscal records and in maintaining the accounts in accordance with the uniform system and other requirements prescribed by FHA.

This function is performed by the Financial and Operations Analysis Section for mortgagors and by the Project Control Section, Comptroller's Division, for rental brokers.

We believe this work can be performed better by an accountant assigned to the FHA field office. In addition, traveling expenses would be decreased.

TECHNICAL SUPERVISION OF FIELD ACCOUNTANTS

Accountants assigned to field offices should receive technical supervision from the Director, Examination and Audit, even though they would be administratively responsible to the respective field office directors. The Director, Examination and Audit, should (1) establish written procedures, audit programs, and reporting standards to guide the accountants in analysis and audit

work; (2) recruit accountants and determine qualifications for the position; (3) advise and instruct the accountants on complex accounting and auditing problems; and (4) review and evaluate the accountants' work to determine whether sound auditing and analysis concepts have been used and whether the form of reporting is in accordance with prescribed standards.

This arrangement would be similar to the delegation of authority over field office underwriting employees who, although administratively responsible to the field office director, perform their technical duties in accordance with standards established by the Assistant Commissioner for Technical Standards.

SUBMISSION AND CONTENT OF
FINANCIAL STATEMENTS

UNIFORM PRESENTATION

Although mortgagors are instructed by FHA to follow the Uniform System of Accounts, many annual financial statements lack some of the prescribed information. Consequently FHA must carry on extensive correspondence with mortgagors to obtain the desired information or explanations.

We recommend that standard forms be developed for balance sheets, profit and loss statements, surplus statements, and statements of earnings available for distribution in accordance with FHA's formula. The mortgagors could complete the forms by filling in blanks. We also recommend that a questionnaire be developed on which mortgagors would be required to furnish full details concerning officers' salaries; receivables from and payables to affiliated companies or individuals; and management fees or other payments to affiliated companies or individuals.

NEED FOR ADDITIONAL DATA ON INITIAL STATEMENT

The provisions of corporate charters require mortgagor corporations to submit annual financial statements to FHA. Some mortgagors have shown an opening surplus or deficit on their initial financial statements without appropriate explanations. A surplus arising from appreciation of fixed assets would not be disclosed except by an explanation from the mortgagor or by an audit. Unless the source of an opening surplus or deficit is known, FHA cannot intelligently analyze the statements. We recommend prompt

action requiring new mortgagors to fully explain any opening surplus or deficit.

EXTENSION OF TIME FOR SUBMISSION

The provisions of corporate charters require mortgagors to submit annual financial statements prepared from the corporate books and records within 60 days after the end of the fiscal year. However, corporations have approximately 75 days in which to file Federal tax returns, and several states allow approximately 105 days in which to file state tax returns.

Extending the time in which to submit financial statements to 120 days need cause no reduction in effectiveness and should reduce considerably the need for correspondence with delinquent mortgagors.

PREPARATION OF UNNECESSARY
ANNUAL STATISTICAL REPORT

The Operations Analysis Unit, Financial and Operations Analysis Section, compiles statistical data from profit and loss statements submitted by mortgagor corporations. An annual report is prepared from this data showing detailed expenses on a per room basis for about 1,000 projects. Presumably such report is for the use and guidance of underwriting employees in FHA field offices in their appraisal of proposed rental housing projects.

The last report was released in December 1955 and contained combined data on projects whose fiscal years ended in calendar years 1953 and 1954. The long delay in releasing this data would appear to make it of doubtful value. We were informed by several general underwriting supervisors in Washington that such data was not used by underwriting employees in the field offices and that no underwriting instructions refer to such data. In fact, field office underwriting employees are required to compile, maintain, and use their own similar data on FHA Form No. 2558, Income and Operating Expense Analysis.

We recommend that the accumulation of statistical data and the preparation of the annual statistical report by the Operations Analysis Unit be discontinued. We also recommend that the preparation of any required statistical reports currently prepared by the Operations Analysis Unit be delegated to the FHA field offices and/or the Research and Statistics Division in Washington.