



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



AUDIT PROGRAM	Rural Development Rural Housing Service Multi-Family Housing Division Rural Rental Housing Program

This audit program provides instruction and guidance for independent public accountants in conducting agreed-upon procedures engagements of recipients of Rural Development loans, except for those audits required to be performed in accordance with Office of Management and Budget Circular A-133. The audit program is effective for the period ending December 31, 2005, and thereafter.

This audit program may not be changed, altered, revised, or modified without the concurrence of the Office of Inspector General.

APPROVED BY: _____
/s/
ROBERT W. YOUNG
Assistant Inspector General
for Audit

9/29/04
Date

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I. **GENERAL**

A. **PURPOSE**

This guide is designed to assist independent public accountants (“practitioners”) in conducting agreed-upon procedures engagements of Rural Rental Housing (RRH) properties financed by Rural Development. The RRH Program has a history of abuse involving the construction and ongoing operation of properties. This guide includes procedures to assist the practitioner in determining borrower and management company compliance with certain statutory, regulatory, and contractual requirements of the RRH Program. Thus, practitioners need to be familiar with laws, regulations, and procedures related to the RRH Program.

B. **BACKGROUND**

Rural Development uses cost certifications to verify that borrowers spent loan funds for eligible and actual costs when constructing apartment complexes as part of the RRH Program. Rural Development requires borrowers to annually report the financial operations of RRH properties on Form RD 3560-7, “Multiple-Family Housing Project Budget”.

RRH borrowers typically use identity-of-interest companies in both the construction of apartment complexes and in managing the day-to-day operations of RRH properties. RRH borrowers that have an identity-of-interest with the borrower (general contractor) are required by Rural Development to report the actual costs of construction on Form RD 1924-13, “Estimate and Certificate of Actual Cost.” In addition, Form RD 1924-13 must be submitted whenever there is an identity-of-interest relationship between a borrower and a subcontractor, material supplier, or equipment lessor.

The USDA Office of Inspector General has performed audits and investigations that identified significant fraud and abuse in the RRH Program. Some of the fraud and abuse related to construction includes: Ineligible, unsupported, and duplicate costs; misrepresentation by borrowers of their roles as general contractors; shifting costs (e.g., overhead expenses) that exceeded budgeted amounts to different cost categories on Form RD 1924-13; and using identity-of-interest companies which are merely “shell” companies to either inflate legitimate charges or bill properties for costs that were never incurred.

Similar abuse using identity-of-interest companies has been identified in the ongoing management of RRH properties. Borrowers and management companies also charge ineligible, unsupported, and duplicate expenses (generally for management related costs) to properties. Also, management companies frequently do not maintain suitable records when using employees to perform maintenance of properties, and overcharge for these services. Rural Development

regulations refer to any scheme that improperly withdraws funds from RRH project accounts as “equity skimming”.

USDA Office of Inspector General audits have also identified instances of conflicts of interest and a lack of independence on the part of certified and licensed public accountants when performing audits of RRH properties. Thus, practitioners should strictly adhere to the standards and principles of the American Institute of Certified Public Accountants’ Code of Conduct and Bylaws and applicable State Boards of Accountancy.

C. PERTINENT REGULATIONS AND INSTRUCTIONS

Construction Cost:

The instructions for Form RD 1924-13 provide guidance on eligible construction costs, as well as the required format for the presentation of costs. Rural Development has also established regulations that restrict the amount of builder’s profit for each project, the use of identity-of-interest companies, and the business relationships of practitioners performing engagements of RRH construction costs. The following regulations and Rural Development instructions should be used as guidance:

- Rural Development Instruction 1924-A, and
- Rural Development Instruction 1944-E.

Management of Ongoing Operations:

Rural Development regulation RD 3560 provides details on allowable and unallowable operating costs, and places restrictions on the use of identity-of-interest companies and other activities related to managing RRH properties. The instructions for Form RD 3560-7 also provides direction on eligible costs.

D. STANDARDS FOR CONDUCTING THE AGREED-UPON PROCEDURES ENGAGEMENTS

Practitioners are to perform attestation engagements using agreed-upon procedures of construction costs and ongoing operations in accordance with attestation standards established by the American Institute of Certified Public Accountant’s (AICPA) and the standards applicable to attestation engagements contained in Government Auditing Standards issued by the Comptroller General of the United States.” The practitioner’s report on agreed-upon procedures should be in the form of procedures and findings. (See exhibit A for an illustrative example.)

If practitioners become suspicious of fraud or illegal acts during the course of performing the agreed-upon procedures engagement, they are to promptly report these matters (regardless of materiality) to:

U.S. Department of Agriculture
Rural Development
Rural Housing Service
Director, Multi-Family Housing Processing Division
14th and Independence Avenue SW
Washington, D.C. 20250
(202) 720-3773

The report and workpapers prepared in the course of these engagements are subject to a quality control review by the USDA Office of Inspector General.

E. OBJECTIVES

The objective of the construction cost engagement is to verify the propriety of costs reported on Form RD 1924-13. The practitioner should be alert for kickbacks on the purchase of services and materials, billings in excess of agreed-upon prices, billings for nonexistent materials or services, “sweetheart contracts,” and the diversion of materials to other construction sites.

The objective of the ongoing operations engagement is to verify the propriety of operating and maintenance expenses reported to Rural Development on Form RD 3560-7, Part II, and reserve account activity reported on Form RD 3560-7, Part III. The practitioner should be especially alert for equity skimming schemes involving maintenance costs, and unauthorized withdrawals from reserve and tenant security deposit accounts.

Of primary concern is compliance with general contractor and management company requirements and the role of identity-of-interest companies in the construction and management of RRH properties.

II. CONSTRUCTION COST ENGAGEMENTS

A. AGREED-UPON PROCEDURES FOR THE CONSTRUCTION COST ATTESTATION ENGAGEMENT

The procedures in this section are designed to identify ineligible expenses and fictitious charges to Forms RD 1924-13. RD Regulations 1924-A and the instructions for preparing Form RD 1924-13 provide guidance on eligible construction costs.

Borrowers and contractors involved in the construction of Rural Development financed RRH properties are required to maintain recordkeeping systems which establish accounts that categorize costs in conformity with sections 1924.13 (e) (1) (v) (A) and 1924.13 (e) (2) (i) (H) of Rural Development Instruction 1924-A. Form RD 1924-13 includes a certification that the cost of labor, materials, and other necessary services incurred during construction are accurate and fairly presented.

Borrowers are required to comply with laws, regulations, and Rural Development procedures related to the construction of RRH properties. USDA Office of Inspector General audits have identified borrowers that received builder's profit for being the general contractor when, in fact, general contractor responsibilities were being performed by other contractors. The audits also disclosed that some identity-of-interest companies were merely "shell" companies with no employees, inventory, or other business activities. Other identity-of-interest companies have charged rental fees for equipment use for the entire construction period when the equipment was actually used for short or intermittent periods during construction.

These actions have resulted in significant amounts of overcharges to RRH properties. Sections 1924.13 (e) (1) (v) (H) and 1924.13 (e) (2) (viii) of Rural Development Instruction 1924-A prohibit borrowers from receiving builder's profit for acting as the general contractor if more than 50 percent of the property is subcontracted to one subcontractor or 75 percent to three or fewer subcontractors. Sections 1924.13 (e) (1) (I) and 1924.13 (2) (viii) of Rural Development Instruction 1924-A require that before a borrower can claim expenses paid to an identity-of-interest company, it must also provide services and/or materials to the general public and not just to RRH properties.

Agreed-Upon Procedures

1. Compare the total amount paid through the construction checking account (by adding the total amount from monthly statements) to the total amount of costs reported on Form RD 1924-13. Report any differences.
2. Examine selected checks, invoices, job cost ledgers, receiving documentation, etc., that support costs presented on form RD 1924-13 to

ensure they were actually incurred to construct the project. (Note: Verify that checks have been cancelled and ensure that indirect costs are not included with the cost of labor and materials on Form RD 1924-13.)

3. Inspect selected checks held as retainage from subcontractors for evidence that they were actually paid by the bank. Confirmation with subcontractors may be necessary if cancelled checks are not available or not cancelled by the bank. (Note: Office of Inspector General audits have disclosed instances where checks were made to subcontractors, but never cashed.)
4. Compare the address on selected delivery documents and invoices (using the sample from audit step II.A.2.) to the project's address to ascertain whether materials and services were provided to the project under review. (Note: Office of Inspector General audits have disclosed instances where delivery was not made to the RRH project site.)
5. Examine selected cancelled checks related to accounts included in the "to be paid" column of Form RD 1924-13 to determine the propriety of the costs reported. (Note: Office of Inspector General audits have disclosed instances where these costs were invoiced by identity-of-interest companies, but were never actually paid by the borrower.)
6. Confirm payments with selected subcontractors and material suppliers and investigate any discrepancies. (Note: Be alert for any discounts, rebates, or refunds that were provided to the contractor but not included on Form RD 1924-13.)
7. Inspect selected bid documentation to verify that the lowest bid submitted was accepted. If the lowest bid was not accepted, evaluate the justification for the higher bid. If documentation does not exist, report this and the reason why as a finding. (Note: Be alert for "sweetheart contracts" and contracts to disclosed or undisclosed identity-of-interest companies.)
8. Compare selected subcontractor billings (invoices) to contract amounts. If billings were in excess of contractual terms, ascertain the reason for the higher expense.
9. Obtain the number of subcontractors used during construction and calculate the percentages of subcontractors to ensure compliance with Rural Development requirements.¹
10. Examine selected accounting records for undisclosed identity-of-interest companies. The practitioner should focus on transactions involving the use of one or two contractors/subcontractors, or if one

¹ Sections 1924.13 (e) (1) (v) (h) and 1924.13 (2) (2) (viii).

contractor/subcontractor provided a significant percentage of materials or services.

11. Determine if identity-of-interest companies meet Rural Development requirements² of providing services to the general public.
 - a. Question the general contractor/borrower about the business activities of any identity-of-interest company used and request evidence that the company provides services or materials to the general public.
 - b. Review identity-of-interest records (e.g., sales records, invoices, receiving documents, etc.).
 - c. Confirm by independent verification that identity-of-interest companies exist and provide services to the general public. (Note: This evidence could include listings in a telephone directory, advertisement to the public, etc. Also, be alert for “shell” companies that exist solely for processing invoices and adding markups to the original supplier’s invoices. Markups made by identity-of-interest companies that do not provide services/supplies to entities other than the RRH property are not allowable.)
12. Compare equipment rental and supervision charges by identity-of-interest companies to independent rental companies to determine reasonableness³ of charges. Report any significant variances.
 - a. Question the borrower about the use of equipment during construction and how rental rates were established and time of use determined.
 - b. Contact an independent rental company to determine commercial rental rates and compare them to the identity-of-interest charges.
 - c. Examine borrower documentation (e.g., commercial rate lists, time sheets, construction schedules, etc.) to support the rates that were used and time that was charged for equipment rental fees. (Note: Office of Inspector General audits have disclosed that borrowers are charging rental fees when equipment is not in use.)
 - d. Question the borrower about supervision charges.
 - e. Verify that the borrower has documentation (e.g., timesheets or timecards, travel reports, payroll records, etc.) to support supervision charges.

² Sections 1924.13 (e) (1) (I) and 1924.13 (2) (viii).

³ A charge would be considered reasonable if it is approximately the same amount of cost that a non identity-of-interest company would charge.

III. ANNUAL AGREED-UPON PROCEDURES ENGAGEMENTS

A. AGREED-UPON PROCEDURES FOR THE ANNUAL ATTESTATION ENGAGEMENT

The Office of Inspector General has identified significant fraud and abuse of operating and maintenance expenses in the RRH Program. The procedures in this section are designed to assist practitioners in identifying ineligible charges and misused funds reported on Form RD 3560-7, Part II, Operating and Maintenance Expense Schedule and Part III Account Budgeting/Status. RD Regulation 3560 provides requirements for owners and management companies participating in the RRH Program, particularly those involving identity-of-interest companies. The procedures in this section are designed to identify noncompliance with these requirements.

The most common occurrence involves identity-of-interest companies that are merely “shell” companies with no employees, inventory, or other business activities. In these instances, owners and management companies use identity-of-interest companies to inflate costs from legitimate vendors or bill the properties directly for work that was never performed. While Rural Development requires the disclosure of identity-of-interest companies, many owners and management companies fail to comply with this requirement.

Agreed-Upon Procedures

1. Compare the total amount paid from the operating and maintenance bank account (by adding the total amount from monthly statements) to the total amount of costs reported on the general ledger and Form RD 3560-7, Part II.
2. Examine selected receipts, invoices, cancelled checks, etc., that support operating and maintenance expenses presented on Form RD 3560-7, Part II, to ensure they were actually incurred during the ongoing operations of the project. The practitioner should focus on line items 1-10, and 19-32. (Note: Do not accept photocopies of receipts or invoices and be alert for invoices that appear to be altered, have duplicate invoice numbers, or that are not pre-printed.)
3. Compare selected operating and maintenance records pertaining to expenses on Form RD 3560-7, Part II, to RD regulations for eligibility and reasonableness. Practitioners should use professional judgment in determining the reasonableness of charges.
4. Confirm payments with selected vendors for maintenance and operating expense items (or any questionable charges) from Form RD 3560-7, Part II. (Note: Discounts, rebates, or refunds should be credited to the property’s account.)

5. Confirm with the financial institution year-end reserve account balances on Form RD 3560-7, Part III, and that there are no encumbrances of reserve account funds.
6. Calculate the number of reserve account withdrawals from bank statements. This number is to be included in the engagement report. (Note: Original bank statements should be used for this analysis and be alert for transfers and automatic withdrawals from the reserve account.)
7. Examine the caretaker agreement for compliance with Rural Development requirements⁴. (Note: Office of Inspector General audits have disclosed instances where caretaker duties included services paid for in the management fee.)
8. Examine documents to confirm that owners/management companies solicited bids from independent companies for services/materials that were provided by identity-of-interest companies.
9. Determine who owns selected contractor companies from the applicable State agency (for example Secretary of State records) and compare to RRH project owner and management company ownership names to uncover undisclosed identity-of-interest companies.
10. Compare the address on selected work orders, delivery documents, invoices, remittance notices, etc., to the RRH project address to ensure that services/supplies were provided to the appropriate property.
11. Confirm by independent verification that identity-of-interest companies exist and provide services to the general public. (Note: The evidence could include listing in a telephone directory, advertisement to the public, etc. Also, be alert for “shell” companies that exist solely for processing invoices and adding markups to the original supplier’s invoices. Markups made by identity-of-interest companies that do not provide services/supplies to entities other than RRH property are not allowable.)

⁴ RD Regulation 3560.102(b)(1)(ii)

Illustrative Auditor’s Agreed-Upon Procedures Report
(Form RD 1924-13 or Form RD 3560-7)

To the Owners and Management Company of *(name of RRH project, city and State)* and the project’s financial accounts:

We have performed the procedures enumerated below, which were agreed to by Rural Development and the owner of *(name of RRH project, city and State)* and the project’s financial accounts, solely to assist those parties in evaluating the accompanying (Form RD 1930-7, “Multiple Family Housing Project Budget” or Form RD 1924.13, “Estimate and Certificate of Actual Cost”) prepared in accordance with the criteria specified in Rural Development Regulations 1924 and 3560 for the year ended December 31, *(applicable year)*. The owner is responsible for *(name of the RRH project)* financial accounts. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and the standards applicable to attestation engagements contained in Government Auditing Standards issued by the Comptroller General of the United States. The sufficiency of these procedures is solely the responsibility of Rural Development. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The agreed-upon procedures performed during this engagement were included in the audit program designed for the Rural Rental Housing Program dated September 29, 2004. The findings for each of the agreed-upon procedures are as follows.

<i>(Agreed –Upon Procedure No.)</i>	<i>(Finding)</i>
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<i>(Agreed –Upon Procedure No.)</i>	<i>(Finding)</i>
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(etc)

We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on the financial statements of *(name of RRH project, city and State)*. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the owner and management company of *(name of RRH project, city and State)*, and Rural Development, and is not intended to be and should not be used by anyone other than these specified parties.

(Signature)

(Date)