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Audit Report Number	2011-FW-0002
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TO: Roger E. Miller  
Deputy Assistant Secretary, Office of Healthcare Programs, HI

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FROM: Gerald R. Kirkland  
Regional Inspector General for Audit, Fort Worth Region, 6AGA

SUBJECT: The Office of Healthcare Programs Could Increase Its Controls To More Effectively Monitor the Section 232 Program

## **HIGHLIGHTS**

### **What We Audited and Why**

We audited the U. S. Department of Housing and Urban Development's (HUD) Section 232 program as part of the Office of Inspector General's (OIG) goal of contributing to the improvement of HUD's execution and accountability of fiscal responsibilities. Our objective was to determine whether HUD had implemented adequate controls to properly monitor Section 232-insured mortgages.<sup>1</sup>

### **What We Found**

HUD's Office of Healthcare Programs had taken steps to strengthen the Section 232 program by implementing new monitoring controls. However, additional steps can be taken to strengthen the controls which were sometimes inconsistent or vague, and ensure punch lists are followed. Further, the Office of Healthcare Programs could place a higher priority on enforcing regulatory issues. By

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<sup>1</sup> We reviewed the controls that the Office of Healthcare Programs implemented over active mortgages. We did not review any controls that it implemented over the underwriting process for new mortgages.

increasing these controls, it will more effectively monitor the program and be aware of ongoing regulatory violations, which increase the likelihood of undetected program fraud, waste, and abuse at its at-risk properties.<sup>2</sup>

### **What We Recommend**

We recommend that the Deputy Assistant Secretary, Office of Healthcare Programs, develop and implement additional policies and procedures to strengthen controls and detect, correct, and prevent regulatory violations.

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 a draft report to HUD on March 14, 2011, with a request for written comments by March 28, 2011. We held an exit conference with the Office of Healthcare Programs on March 22, 2011. It requested an extension to provide comments and we agreed to extend the date to March 31, 2011. The Office of Healthcare Programs provided its written comments on March 31, 2011, which generally agreed with our recommendations.

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

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<sup>2</sup> HUD's portfolio of Section 232 properties on December 31, 2010, included 658 properties that it classified as potentially troubled, with mortgage balances totaling more than \$4 billion, and 153 properties that it classified as troubled, with mortgage balances totaling more than \$900 million.

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## BACKGROUND AND OBJECTIVE

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In 1959, pursuant to Section 232 of the National Housing Act, Congress established the U. S. Department of Housing and Urban Development's (HUD's) Section 232 program. The Section 232 program provides Federal Housing Administration (FHA)-insured mortgage loans to facilitate the construction and substantial rehabilitation of nursing homes, intermediate care facilities, board and care homes, and assisted living facilities.

There are several regulating methods for these healthcare facilities. For example, the Department of Health and Human Services and the Centers for Medicare and Medicaid regulate skilled nursing facilities and intermediate care facilities, while individual States regulate assisted living facilities and board and care facilities with licensing requirements and other laws. HUD regulates Section 232-insured properties with a regulatory agreement.

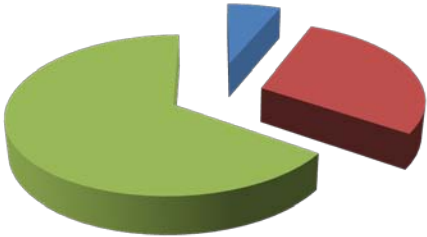
On July 31, 2002, Office of Inspector General (OIG) report 2002-KC-0002 reported that HUD did not have adequate controls in place to identify all nursing home regulatory agreement violations. In response to the audit report, HUD created the Office of Healthcare Programs in 2008 to administer the Section 232 program and the Section 242 program (mortgage insurance for hospitals). The Office of Healthcare Programs assumed responsibility for implementing the recommendations set forth in the audit report. The Office of Healthcare Programs submitted a management decision to OIG and reported several newly implemented controls including (1) standard operating procedures and checklists for all major asset management activities for use by lenders, owners, and HUD personnel; (2) riders<sup>3</sup> to the regulatory agreement used on all closings after December 2008; (3) analysis of lessee annual cost reports submitted to Medicare/Medicaid; (4) a new regulatory agreement, which was in the development phase; (5) enhanced monitoring efforts; and (6) stronger underwriting policies. OIG concurred with the management decision.

In December 2010, HUD's Section 232 portfolio included 2,390 mortgages valued at more than \$16 billion with unpaid principal balances totaling more than \$15 billion. This portfolio included 811 properties that HUD classified as troubled or potentially troubled, with mortgage balances totaling more than \$5 billion.

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<sup>3</sup> A rider is an amendment to the standard regulatory agreement language.

# Troubled status by loan balance on December 31, 2010



- Troubled: 153 loans, \$938 million
- Potentially troubled: 658 loans, \$4.28 billion
- Not troubled: 1,579 loans, \$9.83 billion.

Our objective was to determine whether HUD had implemented adequate controls to properly monitor Section 232-insured mortgages.

## RESULTS OF AUDIT

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### Finding: The Office of Healthcare Programs Could Increase Its Controls To More Effectively Monitor the Section 232 Program

After its establishment in 2008, HUD's Office of Healthcare Programs took steps to strengthen the Section 232 program by implementing new monitoring controls. However, opportunities exist to increase controls where they were inconsistent, vague, and weak, and where some of them were not followed. If the Office of Healthcare Programs strengthens its controls, it will be able to more effectively monitor the program. Further, the Office of Healthcare Programs could place a higher priority on enforcing regulatory issues to increase the likelihood of detecting program fraud, waste, and abuse at its at-risk properties.<sup>4</sup>

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#### The Office of Healthcare Programs Implemented New Controls

The Office of Healthcare Programs took steps to strengthen controls over Section 232-insured properties. For example, it

- Developed and implemented a rider to the regulatory agreements, which had been used on all newly FHA-insured loans since December 2008, and was developing new regulatory agreements that incorporated the rider provisions for future loans;
- Hired employees that had experience working in the health care industry;
- Developed and implemented internal "punch lists"<sup>5</sup> for staff to use when reviewing the performance of Section 232 properties; and
- Developed a comprehensive macro-analysis to help it assess the properties' financial risk.

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<sup>4</sup> We reviewed the financial records for two properties classified as troubled and identified \$756,833 in transactions that appear to violate the regulatory agreement.

<sup>5</sup> The punch lists provide directive guidance to staff for properties that do not submit audited financial statements, properties that fail a Real Estate Assessment Center inspection, troubled properties, etc.

## The Punch Lists Could be Strengthened

The Office of Healthcare Programs implemented its new controls largely through the use of punch lists. However, the punch lists could be improved by eliminating conflicting instructions to staff, by strengthening known weaknesses, and by adding steps to detect potential regulatory agreement violations and correct identified violations.<sup>6</sup>

Opportunities exist to make the punch lists more consistent. For example, when a property owner/operator requested to withdraw funds from the project's reserve for replacement account to make the mortgage payment, the "potentially troubled" punch list directed staff to consult with the Turnaround Team<sup>7</sup> and consider designating the project as troubled. The "not troubled" punch list instructed staff to designate the project as troubled immediately upon the event of such request without consultation or consideration. Treating a not troubled project more aggressively than a potentially troubled project does not allow the program staff to effectively address serious issues in the potentially troubled portfolio. Bringing the punch lists into agreement will allow the Office of Healthcare Programs to more effectively monitor its entire portfolio.

The punch lists can be more specific. The punch list for "not troubled" properties required staff to periodically (1) contact the property operator to determine the current census<sup>8</sup> and (2) review State surveys, Star ratings,<sup>9</sup> media sources, and HUD system flags. However, the punch list did not specify how often staff was to perform these activities. Further, the punch list stated that properties with serious mortgage delinquencies should be moved to troubled status, while a "not serious" delinquency should only be considered to be moved to potentially troubled. These punch lists could be strengthened by providing specific criteria to differentiate a serious delinquency from a not serious delinquency. The Office of Healthcare Programs could ensure more consistent monitoring by adding more specificity in its punch lists.

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<sup>6</sup> Regulations at 24 CFR (Code of Federal Regulations) 232.1 states, "The requirements set forth in 24 CFR part 200, subpart A, apply to multifamily project mortgages insured under section 232 of the National Housing Act (12 U.S.C. [United States Code] 1715w) as amended." Section 200.105(a) states, "As long as the Commissioner is the insurer of the mortgage, the Commissioner shall regulate the mortgagor by means of a regulatory agreement providing terms, conditions and standards established by the Commissioner."

<sup>7</sup> The Turnaround Team is comprised of one-third of the asset management staff at the Office of Healthcare Programs and was established to work out problems with the troubled properties.

<sup>8</sup> Census means occupancy, and a low census is an early indicator of cash flow problems. A low census was one of the key reasons for the cash flow problems at four of the five properties reviewed.

<sup>9</sup> Star ratings represent the 5-Star Quality Rating System on the Centers for Medicare and Medicaid Services "Nursing Home Compare" Internet site. The system was created to help consumers, their families, and caregivers compare nursing homes. Ratings are taken from health inspections, staffing, and quality measures. Forty-four percent of the Section 232 portfolio was rated below average by the rating system.

We also identified areas where the punch lists could be strengthened by including steps for detecting potential regulatory violations or correcting known violations. The following areas are currently not addressed by punch lists and present additional opportunity for an increase in the ability for the Office of Healthcare Programs to effectively monitor its properties.

- Punch lists could include specific steps that advise staff to review the audited financial statement notes for potential regulatory violations. The Real Estate Assessment Center reviewed compliance deficiencies that were identified by HUD's automated analysis of the audited financial statements. The deficiencies were then referred to HUD's Departmental Enforcement Center or the Office of Healthcare Programs. Without specific steps to follow, the referrals to the Office of Healthcare Programs will not be treated consistently by staff.
- Punch lists did not provide guidance for correcting violations. This could allow for violations to not be addressed consistently or at all by staff.
- New riders to the regulatory agreement required lessees of Section 232 properties to submit financial statements to HUD. Lessees submitted them directly to Office of Healthcare Program staff. According to staff members, a punch list is currently being developed.
- The punch list for "troubled" properties identified specific steps for staff to follow when evaluating defaults. However, there were no directives to staff regarding steps to take if they identified a regulatory violation (i.e., no mention of referrals to OIG or the Departmental Enforcement Center). By adding specific directives, staff would consistently comply with HUD's requirements and would be required to address all regulatory violations.
- Troubled project files should show a complete list of actions taken by staff to address the project's troubled status. The "troubled" punch list did not require staff to document the steps that they followed. Without documentation, the Office of Healthcare Programs management cannot review their staff's actions or evaluate the effectiveness of its policies.
- Staff monitored reviews and inspections from other regulatory agencies for skilled nursing home facilities and intermediate care facilities. Controls can be strengthened over assisted living facilities and board and care facilities if the Office of Healthcare Programs also required the same for these project types.

Further, the punch lists could include instructions or other guidance for referring indications of fraud, waste, or abuse to OIG.



### **Improved Processes Were Not Always implemented**

The Office of Healthcare Programs developed a comprehensive macro-analysis to help it assess properties' financial risk. According to the "not troubled" punch list, the Office of Healthcare Programs performed the macro-analysis quarterly. However, according to both staff and documentation, it did not perform the analysis quarterly. Staff members stated that they performed the macro-analysis semiannually rather than quarterly. Further, in July 2010, the Office of Healthcare Programs provided us its most current macro-analysis report, which was dated September 2009, nearly a year earlier. Failure to utilize this tool limited the Office of Healthcare Programs' ability to detect in a timely manner projects that may have recently become a financial risk and needed additional monitoring.

Also, the punch list for troubled properties identified specific steps for staff to follow in evaluating defaulted loans.<sup>10</sup> The steps included contacting the lender, owner, and operator to determine the cause of the default, possible remedies, and whether the default was due to operator mismanagement. Next, Office of Healthcare Programs staff and the lender were to consider engaging consultants, implementing a management improvement and operating plan, operator replacement, or sale of the property. For four of the five properties reviewed, Office of Healthcare Program staff did not follow the punch list steps and only contacted the lender and/or owner. By not taking the additional steps, staff may not be taking the necessary steps to bring these properties out of troubled status.

### **Enforcement of Regulatory Agreement Terms Should Be a Higher Priority**

Placing regulatory enforcement as a higher priority is not only required under Federal regulations, but will also contribute to a lower risk of defaults.

The Office of Healthcare Programs adopted a "no claims" goal, with an emphasis on claims reduction and customer service rather than on what it considered minor enforcement issues,<sup>11</sup> reasoning that the key to minimizing loss was to keep properties operating. The staff stated that HUD's previous losses in the Section 232 program were the result of weak operators. Staff further stated that owners would continue to pay the mortgage as long as they met the applicable State

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<sup>10</sup> HUD defines a default as the inability to make timely monthly mortgage payments or otherwise comply with mortgage terms. A loan is considered in default when no payment has been made 30 days after the due date. Once in default, the lender can exercise legal rights defined in the contract to begin foreclosure proceedings.

<sup>11</sup> According to the Director of Asset Management and Lender Relations, minor enforcement issues are small dollar regulatory violations such as early surplus cash distributions, excessive fees to contractors, etc.

regulatory requirements because owners were primarily focused on those State requirements.

The Office of Healthcare Programs could better comply with Federal requirements by consistently enforcing the terms, conditions, and standards in regulatory agreements. The Code of Federal Regulations requires HUD to regulate its Section 232 program with a regulatory agreement (see footnote 6). Further, Office of Management and Budget (OMB) Circular A-123 identifies management control standards applicable to anyone responsible for managing Federal programs or Federal funds.<sup>12</sup> The management control standards include (1) compliance with law (i.e., all program operations, obligations, and costs must comply with applicable law and regulations) and (2) reasonable assurance and safeguards (i.e., management controls must provide reasonable assurance that assets are safeguarded against waste, loss, unauthorized use, and misappropriation). Therefore, the Office of Healthcare Programs could place regulatory enforcement at a higher priority in order to better comply with the Code of Federal Regulations and OMB Circular A-123.

### **The Office of Healthcare Programs Was Unaware of Regulatory Violations**

Because the Office of Healthcare Programs placed regulatory enforcement at a low priority, it was unaware of important ongoing regulatory violations in its at-risk portfolio. Examples included a defunct property in Illinois and significant unsupported expenditures totaling \$756,833 at properties in Texas and Florida.

The Office of Healthcare Programs was unaware of ongoing regulatory violations at one Illinois property<sup>13</sup> until the State of Illinois revoked the property's operating license. The property was current on its mortgage, so the Office of Healthcare Programs was not aware of regulatory violations and did not know that a recent Real Estate Assessment Center physical inspection revealed exigent health and safety issues<sup>14</sup> or that the Centers for Medicare and Medicaid had rated the property "very below average" at its last inspection. In an effort to be proactive, the Office of Healthcare Programs responded by adding steps to its punch list to monitor State inspections and Centers for Medicare and Medicaid ratings. Had staff been aware of the issues identified by CMS, they may have been able to address the issues prior to the property's failure.

A financial record review of one property in Texas<sup>15</sup> for the period between October 2008 and September 2010 revealed potential ineligible transfers of

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<sup>12</sup> Chapter II, "Standards"

<sup>13</sup> FHA loan number 07122046.

<sup>14</sup> The regulatory agreement requires the owner to maintain the property in good repair and condition.

<sup>15</sup> FHA loan number 11322036, designated troubled in January 2010.

\$139,750, unapproved owner salaries of \$100,391, unsupported payments of \$85,706 to a contracted accountant, and unsupported payments of \$44,424 to a management agent.<sup>1617</sup> Office of Healthcare Programs staff had been in contact with the operator regarding the property’s troubled status and concluded that project management officials “...knew what they were doing.” However, the Office of Healthcare Programs was not aware of the regulatory violations at the property. Further, the owner’s audited financial statements submitted to the Real Estate Assessment Center did not disclose any of these issues. Therefore, the issues were not detected by the Real Estate Assessment Center. The Office of Healthcare Programs could improve its controls by requiring monthly cost reports for troubled properties and reviewing those cost reports to determine if regulatory violations contributed to the properties’ financial conditions. The following table summarizes the ineligible and unsupported costs in the Texas property’s financial records.

<b>FHA loan number 11322036 questioned costs</b>	
	<b>Unsupported costs</b>
Transfers to affiliates	\$139,750
Unapproved salary payments to president of the owner entity	100,391
Contract accounting fees	85,706
Management agent reimbursements	44,424
<b>Total</b>	<b>\$370,271</b>

A financial review of a Florida<sup>18</sup> property for January 2009 through September 2010 revealed potential ineligible transfers of \$183,454, unauthorized owner distributions of \$101,451, ineligible owner health insurance payments of \$65,886, and unsupported payments of \$8,477 and \$27,294 for or on behalf of the owner and other entities that may have been affiliated with the owner, respectively (see footnotes 16 and 17)<sup>19</sup> Office of Healthcare Programs staff members initially stated that they reviewed the financial statements, and while the project experienced expense control issues, there were no indications of unauthorized distributions. When we identified the questioned expenses, staff members contradicted their earlier statement when they informed us that they did not rely on the financial statements because they were not in the HUD format. Based on this contradiction, we concluded that staff members either did not review the financial statements sufficiently to identify the regulatory violations, or did not have the training to identify them. The Office of Healthcare Programs should

<sup>16</sup> We did not review the supporting documentation for any of these transactions. Therefore, they are classified as unsupported in this report.

<sup>17</sup> The regulatory agreement requires that the project’s funds be used only for the purposes of the project and expenditures are reasonable and necessary for the operation of the project. Further, the agreement prohibits payments to the mortgagor, its officers, directors, or stockholders without written approval from HUD.

<sup>18</sup> FHA loan number 06622026, designated troubled in December 2009.

<sup>19</sup> The regulatory agreement requires that funds be withdrawn only for expenses of the project and for surplus cash distributions.

implement steps in its punch lists to detect and correct regulatory violations, and provide training to staff to read cost reports and detect regulatory violations. The following table summarizes unsupported costs in the Florida property's financial records.

<b>FHA loan number 06622026 questioned costs</b>	
	<b>Unsupported costs</b>
Transfers to another property <sup>20</sup>	\$183,454
Unauthorized owner distributions	101,451
Payments for the owner's health insurance	65,886
Payments for and on behalf of the owner	8,477
Payments to possible affiliates	27,294
<b>Total</b>	<b>\$386,562</b>

## Conclusion

HUD's Office of Healthcare Programs took significant steps to strengthen the Section 232 program by implementing new monitoring controls. However, further opportunities exist to increase monitoring efforts, ensure consistency and ensure regulatory violations are identified and addressed.

## Recommendations

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

- 1A. Correct the inconsistencies in the punch lists, and clarify the vague language to ensure consistent reviews by staff.
- 1B. Develop controls and oversight procedures to ensure the macro-analysis is performed quarterly and punch lists are followed and implemented consistently by staff.
- 1C. Implement policies and procedures to detect, correct, and prevent regulatory violations, including establishing thresholds for making referrals to DEC and OIG when violations are suspected or identified, and requiring and reviewing monthly cost reports from troubled properties.
- 1D. Provide training to staff for reviewing monthly cost reports and detecting regulatory violations.
- 1E. Review the \$756,833 in unsupported costs at the two properties identified in this report, determine their validity, and take appropriate action.

<sup>20</sup> This property has the same owner, is located in Illinois, and is not insured by FHA.

## SCOPE AND METHODOLOGY

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To accomplish our objective, we

- Reviewed background information for the Office of Healthcare Programs including portfolio data;
- Reviewed HUD regulations, OMB circulars, regulatory agreements, and riders to the regulatory agreements;
- Interviewed Office of Healthcare Programs staff, FHA risk management staff, and Real Estate Assessment Center staff;
- Obtained an understanding of applicable internal controls;
- Reviewed procedures taken by the Office of Healthcare Programs for five properties with relatively large unpaid mortgage balances representing significant risk to the insurance fund;
- Reviewed financial records and interviewed owners of two of the five properties that presented significant indications of potential regulatory violations; and
- Toured one property.

We conducted the audit between July 2010 and February 2011 at the HUD San Antonio office and HUD headquarters in Washington, D.C. We also toured one property in Fort Worth, TX. At the beginning of our review, the Office of Healthcare Programs had 2,404 insured mortgages with 290,099 units totaling more than \$16.5 billion. The unpaid principal balance of those mortgages totaled more than \$15.3 billion. Within the portfolio, the Office of Healthcare Programs classified 636 mortgages as potentially troubled, with mortgage balances totaling more than \$4 billion, and 179 mortgages as troubled, with mortgage balances totaling more than \$1 billion. We did not test the portfolio data because we used the data only for informational and background purposes. We compared actions taken by the Office of Healthcare Programs for five troubled properties with relatively large unpaid mortgage balances, representing significant risk to the insurance fund, to the procedures described in the troubled punch list. Two of the five properties reviewed presented significant indications of regulatory violations. We performed a limited review of the general ledgers and cash disbursements for the two properties and conducted an onsite visit to one of the properties. We did not assess the reliability of the financial records for the two properties reviewed because they were not the subject of the audit. We only reviewed the financial records to identify specific instances of regulatory violations. Therefore, we do not assert that the financial records reviewed were accurate. Further, we did not review the supporting documentation for the questioned costs in this report. As a result, we classified them as unsupported. The Office of Healthcare Programs should verify the questioned costs, and take appropriate action.

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 objective.

# INTERNAL CONTROLS

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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.

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## Relevant Internal Controls

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

- Controls over the effectiveness and efficiency of operations.
- Controls over compliance with applicable laws and regulations.

We assessed the relevant controls identified above.

A deficiency in internal controls 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:

- Controls over applicable laws and regulations should be increased to more effectively monitor the Section 232 program (finding 1).

## FOLLOW-UP ON PRIOR AUDITS

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### **Nationwide Survey of HUD's Office of Housing Section 232 Nursing Home Program, 2002-KC-0002**

In HUD OIG report number 2002-KC-0002, "Nationwide Survey of HUD's Office of Housing Section 232 Nursing Home Program," dated July 31, 2002, HUD OIG determined that HUD did not have adequate controls in place to ensure that all nursing home regulatory agreement violations were identified. Significant control weaknesses occurred because past management did not properly assess and identify risks or design and implement proper controls to protect HUD's interests in its nursing home portfolio. While HUD's internal program data contained evidence of regulatory agreement violations; HUD did not have adequate controls in place to ensure that all violations were identified. In addition, the nursing home annual audited financial statements submitted to the Real Estate Assessment Center contained many examples of regulatory agreement violations; however, the system did not include audited financial statements for leased nursing homes.

During the survey, the Office of Housing initiated actions to identify and correct program control weaknesses. However, it did not create a timetable for implementing the proposed corrective actions. OIG commended the Office of Housing for its efforts and recommended that specific timeframes be established for implementing corrective actions.

HUD created the Office of Healthcare Programs on July 1, 2008, when it gave the Office of Healthcare Programs the responsibility for managing Section 232 properties. As a result, the Office of Healthcare Programs assumed responsibility for implementing the recommendations set forth in the audit report. The Office of Healthcare Programs submitted a management decision to OIG and reported several newly implemented controls including (1) standard operating procedures and checklists for all major asset management activities for use by lenders, owners, and HUD personnel; (2) riders to the regulatory agreement used on all closings after December 2008; (3) analysis of lessee annual cost reports submitted to Medicare/Medicaid; (4) a new regulatory agreement, which was in the development phase; (5) enhanced monitoring efforts; and (6) stronger underwriting policies.

The Office of Healthcare Programs also agreed to codify its new policies and procedures into corresponding handbooks and initiate rulemaking procedures to clarify the use of operator accounts. The Office of Healthcare Programs anticipated fully completing all OIG recommendations by August 2011. OIG concurred with the management decision.

## APPENDIXES

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### Appendix A

#### SCHEDULE OF QUESTIONED COSTS

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Recommendation number	Unsupported <u>1/</u>
1E	<u>\$756,833</u>

- 1/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.



## Appendix B

### AUDITEE COMMENTS AND OIG'S EVALUATION

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#### Ref to OIG Evaluation

#### Auditee Comments

#### Comment 1

Response to Finding that the Office of Healthcare Programs Could Increase Its Controls to More Effectively Monitor the Section 232 Program

#### INTRODUCTION

The Office of Healthcare Programs (OHP) appreciates the observations and recommendations of the Inspector General (IG) and OHP recognizes the many months of diligent effort invested in creating the audit document (Draft Report). Consistent with its Lean Processing approach, OHP seeks continuous improvement of its processes. Toward that end, OHP holds periodic Lean Processing Kaizen meetings (process improvement exercises) and also has the recent benefit of input from a consulting firm. OHP sees the IG Report as another opportunity to make further improvements and, toward that end, intends to work closely with the IG to address the issues raised and thus to further enhance operational effectiveness and risk management in the FHA Section 232 Program.

OHP does, in fact, concur with the IG's finding as worded, namely, that "OHP could increase its controls to more effectively monitor the Section 232 program". OHP looks forward to doing so. OHP does not, however, agree with the concluding language in the 'Internal Controls' addendum stating that controls "were weak (finding 1)". OHP considers that language to be more consonant with an *initial* IG draft report (since revised), and OHP requests that the IG conclude that this particular characterization is inaccurate in light of the policies and practices set forth in this response.

The Office of Multifamily Housing (MF) was responsible for monitoring the Section 232 Program from its inception up until December 2008. When the Assistant Secretary for Housing transferred responsibility for the Section 232 Program from MF to OHP (then known as the Office of Insured Health Care Facilities), he recognized that MF, on a national basis, simply did not have the concentration of focus and expertise essential to underwrite effectively and then service healthcare facilities.

Previous to OHP's involvement, HUD lacked a reliable means of tracking a Section 232 property's performance until the property was actually in financial distress and specific guidance in dealing with troubled healthcare projects was often lacking. Monitoring and risk mitigation has improved substantially since OHP has put in place, and continues to use successfully, protocols and systems to discern risks to the insurance fund and to respond proactively and aggressively to minimize claims. Those protocols reflect the fact that the operation of a residential care facility has a level of complexity wholly unlike that of an apartment complex.

Certainly, the risks that OHP's processes detect can include violations of HUD regulatory agreements. Further, while some violations have a minimal impact on risk, other regulatory

violations can involve draining a project of resources needed for fiscal and physical viability. Given its limited staff size and growing portfolio size, OHP uses its staff and other limited resources strategically so as to best protect the FHA Mortgage Insurance Fund. OHP's performance in this respect is strengthened by having a staff that is much more familiar with residential care facilities. OHP's performance is also strengthened by having a staff dedicated exclusively to the Section 232 Program, though that staff size is much smaller than envisioned at the time OHP assumed responsibility for the program, and the staff size is certainly less than optimal.

As part of its commitment to continuous improvement, OHP held an Asset Management Kaizen in January 2011, in which OHP management and senior staff met with senior Departmental Enforcement Center (DEC) officials and leading lenders. The subject of this Kaizen directly related to the implementation of recommendations from a professional consulting firm that reviewed OHP's operations. As a result of the Kaizen, OHP is pursuing improved/updated action plans covering various key elements of its operations, including:

- Protocols for future servicing requirements, including monitoring and pre-delinquency intervention, the prioritization/escalation of servicing properties where appropriate, and the consideration of workout options.
- Improved methods of financial analysis
- Enhanced interface with the Centers for Medicare and Medicaid Services (CMS)
- Formalized evaluation procedures using the recently contracted TSI Dashboard, which provides OHP, the DEC and mortgage servicers with up to date information on the results of state health inspections of Residential Care Facilities.
- A formalized Memorandum of Agreement increasing DEC/OHP collaboration in addressing problem properties.

#### THE OFFICE OF HEALTHCARE PROGRAMS IMPLEMENTED NEW CONTROLS

OHP appreciates that this section acknowledges improvements. Several of these improvements are of enormous magnitude. The macro-analysis evaluation process OHP implemented utilizes data that has never before been incorporated into a portfolio-wide risk analysis, including, for example:

- "Star ratings" from CMS related to actual resident care and operations
- Risk ratings obtained through the TSI dashboard providing a sophisticated analysis of CMS inspection and cost data
- Operator financial data itself—data that was not utilized by HUD previously.

The macro-analysis is now coupled with the TSI dashboard report mentioned above, and not only provides a better risk analysis for the SNF portion of the portfolio but also provides OHP with the tools with which to delve into the performance level and trends of a specific property when the circumstances warrant doing so. The macro-analysis also incorporates data from existing Financial Accounting System audited financial statements, and analyzes the data using a more meaningful, comparative method.

The IG also acknowledges that OHP hired employees with experience working in the healthcare industry. This step has had an enormous positive impact on the Department's overall effectiveness in managing risk. There have been many occasions on which the technical assistance of a former (and currently licensed) nursing home administrator, or former nursing home CFO—or both in tandem—has literally brought a project back from the brink of default or even from *beyond* default and avoided a claim, saving the Mortgage Insurance Fund tens of millions of dollars. Moreover, closely related to the use of “in-house” expertise is OHP's effective use of external consultants in several instances. OHP has utilized subject matter experts/consultants, where appropriate and feasible. Examples include one of the projects cited in the Draft Report (Lighthouse Inn) and also a project for which a partial payment of claim was being pursued.

With very limited resources and in a very limited time span, OHP has made significant improvements in Section 232 servicing. Those many improvements can be distilled into two key points, namely:

- OHP has brought on board key staff with the experience, knowledge, and analytical ability to effectively service a portfolio of properties involved in a business that is inherently very complex; and
- OHP has provided that staff with the *tools necessary to work effectively*.

Those *tools necessary* are many--and of many types--and include without limitation:

- The sharing of internal expertise. This is accomplished through recurring meetings, trainings and conferences. Training has covered a wide array of relevant topics including, for example, financial statement analysis, accounts receivable financing, master leases, and CMS Special Focus Facility status. The internal sharing of experience and the close collaboration among staff in problem resolution has resulted in many successes, including the ongoing removal of projects from the Priority Watch List.
- Ongoing and structured input from industry. The concentrated focus of OHP has made OHP accessible to industry input and positioned OHP to garner insight to enhance effectiveness. This is accomplished through industry participation in Kaizens and from much lender-specific communication, facilitated by OHP's staff assignment by lender.
- Written guidance/direction for HUD staff and for use by other parties. This most recently has included a Mortgagee Letter for Section 232 Partial Payment of Claims, posted in March 2011. It also includes the development of many punch lists covering a broad range of topics with a high degree of specificity—punch lists which OHP has utilized to continuously improve its processes
- Frequently provided data. In addition to existing HUD data, such as that contained in the Real Estate Management System (iREMS), OHP also equips its staff with data in a variety of other readily accessible forms. For example, OHP utilizes Multifamily Delinquency and Default Reporting System (MDDR) reports monthly (organized both

by AE and lender), Special Focus Facility Lists (showing changes in performance trends and list composition), and physical inspection data summaries.

#### THE PUNCH LISTS COULD BE STRENGTHENED

### Comment 2

Since assuming responsibility for the Section 232 portfolio in December 2008, OHP has created punch lists covering a wide array of procedures, and is continuously improving the punch lists. Numerous punch lists have gone through multiple iterations during the past two years as the punch lists have been tested in actual servicing. The overall Lean Processing approach involves the continuous strengthening of processes, and thus OHP does agree that the punch lists could and will continue to be strengthened.

The IG cites an inconsistency between two particular punch lists. OHP appreciates this and is addressing this issue, dealing with the impact of a property's use of reserve for replacement funds on its overall risk rating. OHP has amended its Not Troubled Punch List, and the referenced inconsistency has been removed. The amended Not Troubled Punch List is attached hereto as Exhibit A. More broadly, OHP intends to continuously improve its punch lists and, in doing so, assure the effectiveness of each punch list as well as the consistency among them.

The IG also indicates that the punch lists could be more specific. OHP is willing to add more specificity to any punch list where, upon OHP's further review, OHP determines that such additional specificity would aid monitoring. Regarding the one example that the report mentions (distinguishing a serious delinquency from a not serious delinquency), OHP will illustrate that difference in writing. Account Executives (AEs) in OHP are trained and generally expected to be able to discern and distinguish an isolated brief delinquency from one related to problematic financial performance.

The IG also sets forth areas in which it believes the punch lists could be strengthened by including steps for detecting potential regulatory violations or correcting violations.

- Specific Steps Advising Staff to Review Notes to Financial Statements. Review of the Notes to Financial Statements can be helpful in some circumstances, and OHP does review them when appropriate, but OHP does not believe review of the Notes to Financial Statements for each property in the portfolio is practical. OHP has now incorporated within its FAST Team (Financial Assessment Services Team) punch list specific circumstances in which it will review the Notes when resolving a compliance finding. When addressing Audited Financial Statements (AFS) review in its other punch lists, OHP will also enumerate the AFS Notes as appropriate for review.
- Punch List Guidance for Correcting Violations. The correction of regulatory violations is most often pursued by the FAST Team, and its latest punch list does address this issue.

### Comment 3



**Comment 4**

- Lessee-Submitted Financial Statements. Review of operator financial statements is addressed in the potentially troubled punch list. Not all of these will be reviewed; reviews will occur where indicators suggest the property is at substantial financial risk.

**Comment 5**

- Referrals of Troubled Projects to OIG or DEC. The FAST Team may make referrals to the DEC or OIG pursuant to its punch list. OHP has formalized a detailed punch list in this regard, which is being attached hereto as Exhibit B. Additionally, the Turnaround Team has worked with the DEC in developing a referral punch list that covers troubled properties. In OHP's effort to get the property performing financially, it is incorporating the DEC, and the DEC's pursuit of regulatory compliance enforcement, as a means of ensuring that the parties make operational and financial improvements.
- Recordation of Actions to Address Troubled Status. AEs use the Problem Statement screen to show actions taken, and on Priority Watch List properties, AEs also use the Project History Screen. OHP can certainly add punch list language reflecting that established practice as appropriate.
- OHP Monitoring of State Inspections of Assisted Living Facilities (ALF) and Board and Care Facilities. While OHP is open to this, there is not presently a means to obtain these reports consistently. OHP is working on regulatory agreement language that would require the operator to submit these inspection reports to HUD when certain threshold tests are met, and pursuing other sources for access to reports from those States which have a more robust inspection regime.

#### CONSISTENT IMPLEMENTATION OF THE IMPROVED PROCESSES

The processes referenced in this section all relate solely to the macro-analysis, a tool and process that has continually developed over an extended period. It is true that OHP considered doing the analysis quarterly, but experience suggested (given, for example, the timing of the release of data used in generating the macro-analysis) that doing the analysis more often than annually is not productive. (OHP does, however, provide AEs with more frequent updates of key elements that change more frequently, such as Special Focus Facility status.) OHP will amend its punch lists to indicate the currently intended frequency. OHP has had considerable database challenges in generating the macro-analysis, but has successfully produced an updated analysis as of February 4, 2011, working with the Office of Risk Management's Office of Evaluation to automate the process. OHP presently intends to construct the full macro analysis annually based on yearly filed financial information from HUD and CMS, and to update the analysis, as necessary, with quarterly revisions incorporating more frequently filed data.

**Comment 6**

With regard to the AE review of defaulted loans, OHP did provide written guidance in the Troubled Properties Punch List, as the IG notes. However, an advisory statement to consider engaging consultants, etc., does not mean that most, or even many, properties would warrant such consideration. The IG does note that the AEs routinely engaged the lenders on these matters. OHP will amend the Troubled Properties Punch List to explicitly state that the avenues to be considered (engaging consultants, etc.) are referenced in iREMS even if they may not be deemed appropriate for further pursuit in a particular instance.

**Comment 7**

ENFORCEMENT OF REGULATORY AGREEMENT TERMS

OHP respectfully submits that characterizing OHP’s overall prioritization of regulatory enforcement as low, and then concluding, from that characterization, that agency regulatory noncompliance exists, is not well founded. OHP requests that the draft report be re-written in this respect. OHP has expended substantial time and resources successfully resolving hundreds of potential regulatory violations, including the referral of many properties to the DEC (see the chart below). In addition to the DEC referrals that OHP has made on troubled properties—where the performance matters were intertwined with compliance issues—OHP has made many referrals across the whole range of its portfolio, which addressed regulatory violations. This is part of an aggressive effort to address regulatory violations that put mortgages at financial risk. OHP and the DEC have had a number of recent successes in this regard, most recently a \$3.3 million dollar recovery of distributions of project funds from an owner in Illinois.

For these reasons, OHP does comply with OMB Circular A-123 (as revised), which by its terms provides “guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting and reporting on internal control.”

**FAST TEAM STATISTICS**

<b>Description</b>	<b>#</b>	<b>Comment</b>
Compliance Project Actions Closed by OHP from 1.1.2006 through 12.31.2008.	936	Inherited by OHP from MF
Compliance Actions from 1.1.2006 through 12.31.2008 which remain open.	11	These are being actively worked. Inherited by OHP from MF
Compliance Project Actions Closed by OHP from 1.1.2009 through 12.31.2010.	532	
New Compliance Project Actions currently open for FYE 2009 and FYE 2010 filings between 1.1.2009 through 12.31.2010	410	Includes project fiscal years ending 3.31, 6.30 and 9.30 in 2010 and all of 2009
OHP Referrals to DEC 2009	34	All of 2009
DEC Monetary Agreement Referrals 2009	\$612,450	All of 2009
OHP Referral to DEC 2010 ( first six months of 2010)	20	All of 2010
DEC Monetary Agreement Referrals 2010 ( first six months of 2010)	\$286,614	All of 2010

As the chart shows, OHP is taking seriously its responsibilities regarding enforcement of regulatory agreements, and has strengthened those activities due to its enhanced relationship

**Comment 8**

with the DEC, use of trained personnel and consistent protocols, and concentration of resources. More importantly, OHP is emphasizing an aspect of risk monitoring and regulatory enforcement never previously undertaken by HUD, namely the use of state inspection reports to ascertain the project's compliance with care requirements. The three examples cited in the report, discussed below, document the importance of focused emphasis on important regulatory aspects, rather than a single concentration on minor technical financial calculations.

THE OFFICE OF HEALTHCARE PROGRAMS' AWARENESS OF VIOLATIONS

The IG Report references three specific properties in asserting a lack of awareness on OHP's part: Somerset, Westchester, and Lighthouse Inn. OHP addresses each of these properties below. As the discussion below illustrates, OHP is extremely proactive, both with respect to technical assistance and with respect to (often concurrent) effective enforcement action.

Somerset (071-22046)

The IG's observations with respect to Somerset are incorrect in some key respects. The Environmental, Health and Safety (EH&S) matter was closed out within 48 hours of it being reported, and the property's only CMS Star Rating to date had been a 2, not a level in and of itself, that would have raised significant concern. The property was fully performing financially. OHP acted *immediately and aggressively* upon learning of state regulatory compliance issues, including meeting with the owner-operator in Chicago, state regulators, and CMS officials. OHP also engaged the DEC to pursue enforcement action. Ultimately, the owner signed a consent document to close the facility, and its license was not revoked. The owner's problems with the State and CMS stemmed from the State and CMS' concern about the level of care provided, not from financial violations. The closure of the facility took place prior to OHP's acquisition of the TSI Dashboard, which may have more timely indicated the risk to the facility. This is an example of the importance of OHP's new emphasis on this type of violation.

The closure of this facility also illustrates the significance of OHP's current efforts to forge a strong partnership with CMS to gain early knowledge of impending risks related to adverse CMS, state regulatory, or third-party funding actions. While this effort is still in its early stages, OHP is well positioned to pursue it, given that OHP's recently appointed Associate Deputy Assistant Secretary is a former CMS official with a breadth and depth of CMS knowledge and relationships.

Westchester (113-22036)

The IG asserts that a financial record review revealed potential ineligible transfers, unapproved owner salaries, unsupported payments to a contracted accountant and unsupported payments to a management agent. OHP will examine these expenditures and take appropriate action if any appear to be in violation of Regulatory Agreements.

**Comment 9**

Lighthouse Inn (066-22026)

In reaching conclusions about this property, the IG has been at the same disadvantage as OHP—namely, not having the benefit of seeing the property’s audited financial statements.

With respect to the OIG contention that OHP was unaware of regulatory violations involving Lighthouse Inn North & South (FHA no. 066-22026), OHP has previously indicated that it was well aware of the important regulatory violation of failing to file audited financial statements as required. While the owner has supplied certain financial information, it has been determined that the information submitted to date is unreliable. This determination has been reached over months of interactions with the owner.

OHP is certainly aware of *potential* financial violations. However, determination (for enforcement purposes) of regulatory violations beyond the obvious non-filing violation requires audited financial statements. OHP has reserved its judgments about the violations and the suitability of this owner, pending the submission of independent audited financial reports. Toward that goal, OHP has done everything possible to arrange a proper audit, obtain a true picture of the financial condition of the project, and determine the past and current violations of the regulatory agreement. An auditor has now been engaged and is proceeding with collecting the information necessary for the audit. Since late November 2010, shortly after the owner finally was registered as a business partner in the Financial Accounting Sub-System (FASS), numerous conference call audit meetings have been hosted by OHP with the owner, the company accountant, the independent accountant, the HUD supported consultant, the previous administrator and the independent CPA firm partner to keep the audit process on track. It is expected that the 2008 audit will be completed within the next few weeks.

Concurrent with providing the technical assistance efforts referenced above with the owner and its accountants, OHP has also pursued enforcement action. In particular, OHP has followed up with the DEC analyst on numerous occasions to urge the DEC to send a warning letter to the owner regarding the regulatory violations, using the threat to the owner of civil money penalties. OHP has additionally conferred with senior DEC officials regarding the Lighthouse property and developed a joint OHP-DEC enforcement strategy. That strategy hinges on receiving and reviewing independent financial audits. Once the audit for 2008 is processed, any specific regulatory violations that are uncovered will be remedied in accordance with HUD policy. Relative to the unsupported costs referenced by the IG, the figures mentioned may or may not be verified by audit and will likewise be remedied appropriately.

It is important to view these concerns in the larger context. This is a very troubled project (originated prior to OHP’s assumption of responsibility for the Section 232 Program) with an inexperienced and undercapitalized owner, a difficult market, and both income and expense challenges. Through extensive interaction with the owner, the lender and the DEC, OHP has been successful so far in keeping the project operating and preventing a claim on the FHA insurance fund. While the regulatory violations remain an important concern, OHP’s paramount concern is to enable the project to achieve a sound financial footing and prevent such a claim.



RESPONSE TO IG RECOMMENDATIONS

OHP does not agree with the concluding language in the ‘Internal Controls’ addendum stating that controls “were weak (finding 1)”. OHP requests that the IG conclude that this particular characterization is inaccurate in light of the policies and practices set forth in this response, and its responses to the specific recommendations:

1A. Correct the inconsistencies and clarify vague language.

Response: OHP agrees with the recommendation.

With regard to the inconsistency that the IG Report identifies, OHP has amended the Not Troubled Punch List to be consistent with the Potentially Troubled Punch List, and so that a use of reserve funds for operating expenses or mortgage payment would not necessarily and in every instance result in a risk designation of “troubled.”

With regard to language the IG report finds vague, also in the Not Troubled Punch List, OHP has amended the language to specify that the AE would make the inquires the IG references (census, state survey results, Star rating, media sources and system flags) in conjunction with his/her review of the macro-analysis, and with the next macro-analysis guidance OHP will specify this requirement as well.

OHP is also creating an annual collaborative review, by the workload managers of all OHP servicing protocols, to identify aspects that an ever-increasing experience base may suggest could be improved, and also to assure consistency among the punch lists.

Deliverables for 1A	Timeline
• Amended Not Troubled Punch List	Attached as Exhibit A
• Annual WLM Review of Punch Lists	First review completed by June 30, 2011

1B. Develop controls and oversight procedures to ensure the macro-analysis is performed quarterly and punch lists are followed consistently.

Response: OHP agrees with the recommendation.

As discussed above, OHP’s experience since the IG Report was drafted has led OHP to conclude that quarterly macro-analyses are not appropriate, particularly given the time intervals at which some key information is available. In particular, the FASS data and the CMS cost report data, which are used in formulaic calculations of the macro-analysis, are only available annually. However, OHP will provide AEs with updates on specific elements, such as Special Focus Facility status, more frequently. Further, OHP will amend its punch list for troubled properties, which identifies various avenues to consider, so that AEs are directed to clearly affirm in the iREMS Problem Statement or Property History screen the alternatives (e.g., engaging

consultants, pursuing a transfer, etc.) that have been considered and rejected or pursued. (Additionally, the Troubled Properties Punch List is subject to more substantial amendment as a result of the January 2011 Asset Management Kaizen.)

1B Deliverables:	Timeline
• Special Focus Facility Update	May 31, 2011
• Star Rating Update	June 30, 2011
• Revised Overall Approach Punch List—Troubled Properties	June 30, 2011

1C: Implement policies and procedures to detect, correct, and prevent regulatory violations, including establishing thresholds for making referrals to DEC and OIG when violations are suspected or identified, and requiring reviewing monthly cost reports from troubled properties.

Response: OHP agrees with the recommendation.

The recently revised FAST protocol for REAC compliance findings does speak to this. That protocol is attached as Exhibit A, and clearly speaks to preventing and addressing regulatory violations. Additionally, a new protocol is being developed for referring troubled properties to the DEC, as a means of using enforcement action or the threat thereof to effect owner/operator *compliance and performance*. With respect to “requiring monthly cost reports from troubled properties,” OHP does typically obtain monthly operating reports for troubled properties, depending upon the cause of the troubled rating and the known information about the property. These reports do cover costs but other operational aspects as well. Additionally, monthly financial reports are required for new construction projects, starting with initial occupancy and continuing until twelve months after final endorsement. Further, interim financial statements are required for at least six months for loans on previously uninsured properties.

1C Deliverables	Timeline
• Provide Newly Revised FAST Team Protocol	Attached as Exhibit B
• Provide Final Draft of Revised OHP/DEC Protocol	June 30, 2011
• Revised Overall Approach Punch List—Troubled Properties	June 30, 2011

ID: Provide training to staff for reviewing monthly cost reports and detecting regulatory violations.

Response: OHP agrees with the recommendation.

Many OHP staffs have had the benefit of extensive training on reviewing CMS cost reports from an outside provider. OHP has also provided financial training to staff for reviewing operator financial reports. While this training did not focus specifically on regulatory violations, OHP is willing to provide training that does, and OHP is presently planning such training in connection with the DEC. The macro-analysis is a powerful tool in this respect, in that it is a means of analyzing the financial statements of the entire portfolio, thus positioning the AEs to review financial statements of properties for which financial performance indicators raised a concern. OHP could better assure that, when doing so, AEs be alerted for compliance issues that would adversely and substantially affect the property’s financial performance.

1D Deliverables

- Training in Coordination with DEC on Financial Analysis

Timeline

June 30, 2011

IE. Review the \$756,833 in unsupported costs at the two properties identified in this report, determine their validity, and take appropriate action.

Response: OHP agrees with the recommendation.

With respect to Lighthouse Inn, OHP will proceed as explained in this report, obtaining audited financial statements and then reviewing cost data and other aspects. With respect to Westchester, OHP appreciates the IG's concerns and will review the further information that the IG has for its conclusions that certain items are unsupported.

1E Deliverables

- Lighthouse Inn—Obtain, review and make appropriate DEC referrals related to AFS within 30 Days after Receipt
- Westchester—Review IG-provided data, seek further clarification from owner, and take appropriate action by April 30, 2011

## EXHIBIT A

**Process Name: Routine Monitoring Procedures for Section 232 Facilities – Not Troubled Status  
For: Account Executive Processing**

Step	Action	Activity	Key Point	Source Documents	Status/Next Step
1.	Medicare Low Star Rating Spreadsheet.	Low Medicare Star Rating.	Automatically identified as Potentially Troubled from Medicare Star Rating if: Overall Star=1 and/or Survey =1 per Macroanalysis.	www.Medicare.gov /NHCompare  Medicare Low Star Rating Spreadsheet	Change to potentially troubled and refer to potentially troubled punchlist.  Move on.
2.	Team TSI Dashboard Current Risk Rating	Current Risk Rating = "High."	Automatically identified as potentially troubled per Macroanalysis or ongoing servicing.	Team TSI Dashboard- SNF's only.	Change to potentially troubled and refer to potentially troubled punchlist.  Move on.
3.	Macro Report Generated and Ongoing per iREMS notifications	REAC Physical Score < 60	Automatically identified as potentially troubled in Macro Report if REAC Physical Score < 60 and cash forecast * is less than two-months worth of mortgage principal/ interest/ real estate tax payments. Consider for potentially troubled designation if iREMS notified of <60 REAC Physical Score.	Macroanalysis Risk Determination Spreadsheet, iREMS or Owner/ Operator financial statements.	Coordinate resolution of unacceptable REAC Score with Owner/Operator, and, if necessary, OIHCF REAC Physical Inspection Liaison.  Refer to < 60 Punchlist for additional information.  Move on.

4.	Macro Report Generated and ongoing per iREMS notifications	Active DEC Referral Status	Automatically identified as potentially troubled in Macro Report if active DEC Referral Status and cash forecast * is less than two-months worth of mortgage principal/ interest/ real estate tax payments. Consider for potentially troubled designation if iREMS notified of DEC Referral Status.	Macroanalysis Risk Determination Spreadsheet, iREMS or Owner/ Operator financial statements	Inquire into nature of DEC Referral with FAST Team.  If preliminary review indicates referral has substantial financial impact then change to potentially troubled and refer to potentially troubled punchlist.  If preliminary review indicates no substantial financial impact, then keep at "not troubled" status.  Move On.
5.	Macro Report Generated and ongoing through regular servicing of assigned portfolio.	Operator Net Income < \$0:  For SNF's, CMS Operator Net Income per Macroanalysis Ongoing, for SNF's, ALF's and B&C's, Net Income as requested	Automatically identified as potentially troubled in Macro Report if CMS Net Income <0. Consider for potentially troubled for SNF's/ALF's/ B&C's based upon net income presented in requested financial statements.	Macroanalysis Risk Determination Spreadsheet, Medicare Cost Report, Owner/ Operator financial statements.	Change to potentially troubled unless contravening, more current, financial information warrants keeping as not troubled. If changing to potentially troubled then refer to potentially troubled punchlist for ongoing review/intervention. If keeping at not troubled, move on.

		from Owner/ Lender/ Operator.			
6.	Macro Report Generated and ongoing through regular servicing of assigned portfolio	Days in Accounts Receivable > 100:  For SNF's, CMS Operator Days in Accounts Receivable per Macroanalysis. Ongoing, for SNF's, ALF's and B&C's, Days in Accounts Receivable as requested from Owner/ Lender/ Operator.	Automatically identified as potentially troubled in Macro Report if Days in Accounts Receivable >100. Consider for potentially troubled for SNF's/ALF's/ B&C's based upon Days in Accounts Receivable derived from requested financial statements.	Macroanalysis Risk Determination Spreadsheet, Medicare Cost Report, Owner/ Operator financial statements.	Change to potentially troubled unless contravening, more current, financial information warrants keeping as not troubled. If changing to potentially troubled then refer to potentially troubled punchlist for ongoing review/intervention. If keeping at not troubled, move on.
7.	Macro	Occupancy	Automatically	Macroanalysis Risk	Change to potentially troubled unless contravening, more current,
	Report Generated and ongoing through regular servicing of assigned portfolio	Level < 70%:  For SNF's, CMS Operator Occupancy Level per Macroanalysis. Ongoing, for SNF's, ALF's and B&C's, Occupancy Level as requested from Owner/ Lender/ Operator.	identified as potentially troubled in Macro Report if occupancy levels < 70%. Consider for potentially troubled for SNF's/ALF's/ B&C's based upon Occupancy Levels requested from Owner/ Lender/ Operator.	Determination Spreadsheet, Medicare Cost Report, Owner/ Operator financial reports.	occupancy information warrants keeping as not troubled. If changing to potentially troubled then refer to potentially troubled punchlist for ongoing review/intervention. If keeping at not troubled, move on.
8.	Macro Report Generated and ongoing through regular servicing of assigned portfolio	Accounts Payable Payment Days > 90:  For SNF's, CMS Operator Accounts Payable	Automatically identified as potentially troubled in Macro Report if A/P Payment Days >90. Consider for potentially troubled for SNF's/ALF's/ B&C's based upon Accounts Payable Payment Days derived	Macroanalysis Risk Determination Spreadsheet, Medicare Cost Report, Owner/ Operator financial statements.	Change to potentially troubled unless contravening, more current, financial information warrants keeping as not troubled. If changing to potentially troubled then refer to potentially troubled punchlist for ongoing review/intervention. If keeping at not troubled, move on.

		Payment Days per Macroanalysis. Ongoing for SNF's, ALF's and B&C's, Accounts Payable Payment Days as requested from Owner/Lender/Operator.	from requested financial statements.		
9.	Macro Report Generated and ongoing per e-mail notifications.	Special Focus Facility (SFF) Designation:  For SNF's, CMS Special Focus Facility designation. N/A for ALF's/ B&C's.	Automatically identified as potentially troubled in Macro Report if SFF is "shown improvement" or "recently graduated." Note: Other SFF statuses of "newly added" and "not improved" garner a project a "troubled" status. Consider for potentially troubled or troubled if notified of	Macroanalysis Risk Determination Spreadsheet, periodic e-mail updates.	Change to potentially troubled and refer to potentially troubled punchlist for ongoing review/intervention  Move on.
			deterioration in SFF status per e-mail notification.		
10.	Macro Report Generated and ongoing per e-mail notifications and/or iREMS notifications.	Mortgage Delinquency and/or Default Status	If mortgage delinquency or default, contact loan servicer and Owner/ Operator/ Lessee and attempt resolution. Involve Turnaround Team Member if necessary.	Macroanalysis Risk Determination Spreadsheet, MDDR Report-distributed via e-mail, iREMS Project Actions.	Change to potentially troubled and refer to potentially troubled punchlist for ongoing review/intervention  Move on.
11.	Ongoing through regular servicing of assigned portfolio.	Request to withdraw from R4R, suspend monthly R4R deposit, or reduce monthly R4R deposit in order to make mortgage payment or to cover operating expenses.	Monitor repayment terms/compliance closely to determine if further review is necessary using steps 1 – 11 of this punchlist.	Servicer/ Mortgagor/ Operator/ Management Agent/ Mortgagee notification.	Mark as potentially troubled and refer to potentially troubled punchlist and R4R punchlist.  Move on.
12.	Ongoing through regular servicing of assigned portfolio, and during macro-analysis review.	Outside sources such as media coverage, 2530 issues on other properties owned/operated by same entities, resident complaints		Newspaper, radio, internet information, APPS flags, State surveys, etc.	If any adverse information found, review Project using the other steps of this punchlist and move from not troubled as warranted.  End of Punchlist.

**\* Cash forecast as determined using "Operator Cash Analysis" template.**

## EXHIBIT B

### FAST Team Review procedures for REAC Compliance Findings

**NOTE:** These findings are generated by REAC from a review of the owner entity's financial filings in FASS. As such; any communication needs to be only with the owning entity and their auditor.

Step		Activity	Source Document		Next Steps
A1	Receive	Receipt of owner response to finding(s) (sent from REAC or AE)	Owner response		
A2	Review	REAC findings letter And Comments	REAC letter in iREMS	*If amount of any finding less than or equal to \$20,000 *If amount of any finding greater than \$20,000 but less than or equal to \$50,000 If amount of any finding greater than \$50,000	Move to B1  Move to C1  Move to D1
B1	Review	Response to findings	Owner response	If Satisfactory response and not a violation of the Regulatory Agreement close Project Action with comments.  If additional information is needed or potential violation of the Regulatory Agreement	Move to E1
C1	Analyze	1)Owner response  2) CPA Notes in FASS from fiscal year compliance finding(s) identified  3) Previous Project Actions and Problems Statement in IREMS to determine if any findings are repeats from previous years	Owner response  AFS Notes  IREMS: Project Actions and Problem Statement	If Satisfactory response and not a violation of the Regulatory Agreement Close Project Action with comments.  If additional information is needed or potential violation of the Regulatory Agreement contact owner with email template.  If prior year had an unauthorized distribution then it is a repeat and needs to be referred to DEC.  If review of Notes identifies potential regulatory violation FAST Team will notify AE of event and make a note to Project Actions	Move to E1  Move to F1
D1	Analyze	1)Owner response	Owner response	If Satisfactory response not a potential violation of the	



		<p>2) CPA Notes in FASS from fiscal year compliance finding(s) identified</p> <p>3) Previous Project Actions and Problems Statement in IREMS to determine if any findings are repeats from previous years</p> <p>4) Surplus Cash Calculations submissions</p> <p>5) Profit &amp; Loss in FASS for FY reported</p>	<p>AFS Notes</p> <p>iREMS: Project Actions and Problem Statement Surplus Cash submission</p> <p>Profit &amp; Loss –FASS</p>	<p>Regulatory Agreement, Close Project Action with comments. If additional information is needed or potential violation of the Regulatory Agreement contact owner.</p> <p>If prior year had an unauthorized distribution then it is a repeat and needs to be referred to DEC.</p> <p>If review of Notes identifies potential regulatory violation FAST Team will notify AE of event and make a note to Project Actions</p>	<p>Move to E1</p> <p>Move to F1</p>
E1	Contact	Owner regarding need for additional information or possible regulatory violation	Email with template to Owner, copy to the AE.		
E2	Review	Response from Owner	Email or letter	<p>If Satisfactory response and not a violation of the regulatory agreement close Project Action with comments.</p> <p>If a regulatory agreement violation, either issue written warning, with copy to AE or contact AE to resolve violation. Close Project Action with comments. If further information is needed, repeat until closed.</p> <p>If determined it is referred to DEC for unsolved findings and outstanding regulatory violations</p> <p>1) Obtain AE concurrence and refer to DEC. 2) FAST Team to recommend to AE if Risk Indicator should be changed</p>	<p>Move to E1</p> <p>Move to F1</p>
F1	Referral	Refer to DEC		<p>1) Discuss event and background details with DEC 2) Enter Referral into iREMS</p>	Stop

**NOTE: If review of Notes identified noteworthy event, FAST Team will notify AE of event**



## OIG Evaluation of Auditee Comments

**Comment 1** The Office of Healthcare Programs concurred with the finding but requested that we reword the Internal Controls section of the report to be more consistent with the language in the finding. We agreed and revised the the Internal Controls section as appropriate.

**Comment 2** The Office of Healthcare Programs agreed that its punch lists could be strengthened and committed to strengthening them by ensuring it continuously improves them to be more consistent and specific. We agreed and did not make changes to the report regarding recommendation 1A.

**Comment 3** The Office of Healthcare Programs stated that the correction of regulatory violations are most often pursued by the Financial Assessment Specialist Team and that its latest punch list addresses detecting potential regulatory violations and correcting them. The OIG has not reviewed the latest punch list and does not express an opinion on it. However, the OIG also notes that staff other than the Financial Assessment Specialist Team review troubled properties when evaluating defaults and determining the cause of the troubled status. Therefore, the other punch lists should include guidance for correcting regulatory violations.

**Comment 4** The Office of Healthcare Programs stated that its potentially troubled punch list will only require staff to review operator financial statements when indicators suggest the property is at substantial financial risk. OIG disagreed because operator financial statements could sometimes be a sole source of indicators that a property is at substantial financial risk. Lessees submit these financial statements directly to the Office of Healthcare Programs. Therefore, if the Office of Healthcare Program's staff do not conduct at least a cursory review of each financial statement, the indicators may be missed. We did not revise the report based on the comments.

**Comment 5** The Office of Healthcare Programs stated that its Financial Assessment Specialist Team may make referrals to the Departmental Enforcement Center or OIG under its punch list at Exhibit B, and its Turnaround Team has worked with the Departmental Enforcement Center to develop a referral punch list that covers troubled properties. OIG does not disagree but notes that while Exhibit B directs referrals to the Departmental Enforcement Center, it does not mention referrals to OIG. We did not revise the report based on the comments.

**Comment 6** The Office of Healthcare Programs stated that it intends to conduct a full macro-analysis annually based on yearly filed financial information from HUD and the Centers for Medicare and Medicaid instead of quarterly. OIG does not believe that an annual macro-analysis will provide timely information in all cases. Different properties will have different fiscal years causing an annual macro-analysis to provide up-to-date information for some properties and old information for other properties. For example, if the Office of Healthcare Programs conducts a full macro-analysis each year in September, it would include up-to-date information for properties with fiscal years ending in September of that year, but would not include up-to-date information for properties with fiscal years ending in December of the prior year. The Office of Healthcare Programs could consider separating the macro-analysis

into four quarterly segments with each segment focusing only on the projects whose fiscal years end during that segment. We did not make changes to the report regarding recommendation 1B.

**Comment 7** The Office of Healthcare Programs disagreed with the OIG's conclusion that its regulatory enforcement was low, and therefore, not in compliance with Federal regulations. The Office of Healthcare Programs provided statistics showing that it had made 54 referrals to the Departmental Enforcement Center from January 2009 through June 2010. We did not test the statistics and do not have an opinion on their accuracy. However, we made appropriate changes to the report to indicate that the OHP could better enforce the regulatory agreements to better comply with Federal regulations.

**Comment 8** The Office of Healthcare Programs stated that it acted immediately and aggressively when it learned of the State regulatory compliance issues. Further, the Office of Healthcare Programs has acquired a new system called TSI Dashboard which may more timely indicate risk to facilities. Finally, the Office of Healthcare Programs stated that acquiring TSI Dashboard is an example of its new emphasis on this type of violation. We have not evaluated TSI Dashboard and do not have an opinion on whether it will help the Office of Healthcare Programs to recognize State regulatory compliance issues in the future.

**Comment 9** The Office of Healthcare Programs stated that it was aware of potential financial violations of the regulatory agreement, but cannot take enforcement action until it receives the 2008 audited financial statements. The OIG respectfully disagrees. Even though the financial statements were not audited, they clearly identified regulatory violations. The Office of Healthcare Programs should utilize all sources of information for indicators of problems at its troubled properties, and research the indicators when appropriate to determine their validity. The OIG contacted the owner, who admitted that the more egregious regulatory violations identified in the report were occurring. In addition, the 2008 audited financial statements did not cover the review period (January 2009 through September 2010); therefore, will not address recommendation 1E.